COMMENTS ON THE CURRENT AND NEAR-TERM WORLD OIL SITUATION

July 16, 1979
The oil shortage which has plagued the U.S. and threatened other major importing countries for the past six months is by no means over. But it is now possible to foresee the restoration of a global supply-and-demand balance which will at least end the trauma of physical constraints on consumption at prevailing prices. The new balance would be very precarious, depending on visibly unstable political forces in the Middle East on the supply side and unpredictable consumer reaction to the end of the physical shortage on the demand side. But barring unforeseen negative developments, the current global movement towards restoration of a new supply/demand equilibrium, including the rebuilding of stocks to desirable working levels, will continue.

The principal contributors to this balancing act are the U.S. on the demand side and Saudi Arabia on the supply side. The U.S. has been the only major consuming country registering an actual decrease in consumption from last year—nearly 2% in the first 6 months of 1979. The decrease occurred in every month except January but accelerated significantly in May when it reached 5.6%. Preliminary data for June indicate a similar reduction. Since under the unconstrained demand conditions and relatively modest price increases projected for 1979 prior to the Iranian crisis, U.S. oil demand was expected to rise by at least 2% this year, the full swing in the demand reduction in May and June may have amounted to nearly 1.5 million b/d—equal to 3% of total free world oil demand.
Given the world supply conditions since the Iranian revolution, the reduction in demand in the first half of 1979 has certainly been desirable but it could turn out to be quite ephemeral. Its principal cause was of course the physical constraint on gasoline availability--rationing by inconvenience--which has sharply reduced actual consumption of this product from year-ago levels (nearly 10% in May and June). If and when this constraint disappears, consumption must be expected to move closer to last year's level, despite the 34-40% retail gasoline price increase since then. However, gasoline consumption is unlikely to come up to last year in the second half of 1979, both because of the impact of past and prospective price increases and because of the lingering after-effects of the supply constraint trauma on consumers.

Demand for other oil products is also likely to be reduced in the second half for a variety of reasons. Among these are the highly probable general economic recession which will primarily affect residual fuel and diesel oil demand, the 50% price increase in home heating oil prices since last winter which will encourage further conservation measures as well as accelerate the utility-promoted switch to natural gas, and the increased current availability of gas as a substitute for oil in the industrial and electric power markets.

Thus, altogether U.S. oil demand in 1979 should be nearly 2% below last year, with some decline registered in both six-month periods.

Most other industrial countries are unlikely to register a similar downward trend. In the first four months of the year the
major European countries and Japan registered a significant increase in demand, about 3% collectively. To a large extent the increase was due to exceptionally cold weather in Europe in the first quarter. However, Europe and Japan experienced almost none of the physical supply constraints which reduced U.S. consumption, nor has there been any slowdown in the overall economic growth rates in these countries. Thus, in contrast to the U.S., first half 1979 consumption in the rest of the industrial world will be several percent up from last year.

In the second half of the year the impact of the price increases on consumption will begin to register both directly through reduced consumer oil purchases and indirectly through a reduction in the overall economic growth rate. The latter will result largely from the additional transfer of money from the oil importing to the oil exporting countries, due to the higher prices, with a concomitant drop in the oil importers' domestic purchasing power. For 1979 the Current Account surplus in OPEC's collective Balance of Payments is likely to amount to at least $50 billion. This is 5 to 6 times the surplus generated in 1978 and equals nearly 1% of the OECD's composite GNP. In Europe and Japan the resulting deceleration in economic growth is likely to keep oil consumption levels in the second half of 1979 about in line with a year ago.

To round out world oil demand we have to consider consumption in OPEC and other developing countries. Among these, the oil exporters are likely to show a sustained high growth rate while the oil importers will of course be negatively affected by the rise in
prices. Altogether, this group, which accounts for less than one-fifth of free world demand, may register an increase in demand of about 4% this year.

Putting all these figures together gives the following rough estimate for oil demand in the non-communist world in 1979 (in million barrels daily):

<table>
<thead>
<tr>
<th></th>
<th>1st half</th>
<th>2nd half</th>
<th>Year</th>
<th>Change From Corresponding Period Of Previous Year (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>18.7</td>
<td>18.3</td>
<td>18.5</td>
<td>-1.9</td>
</tr>
<tr>
<td>All Other</td>
<td>33.5</td>
<td>32.9</td>
<td>33.2</td>
<td>+2.8</td>
</tr>
<tr>
<td>Countries</td>
<td>52.2</td>
<td>51.2</td>
<td>51.7</td>
<td>+1.1</td>
</tr>
<tr>
<td>Total World</td>
<td>52.2</td>
<td>51.2</td>
<td>51.7</td>
<td>+1.1</td>
</tr>
</tbody>
</table>

Even if the increase outside the U.S. in the second half should be somewhat higher than our projection, the global increase in demand for all 1979 would probably still be well under 1%. This contrasts sharply with the nearly 3% average annual increase of the last two years and an increase of the same magnitude generally forecast for the current year, prior to the Iranian oil interruption.

As the full effect of the 60%, or $7.50/bbl, weighted increase in the composite OPEC price over 1978 spreads through the world economy, it may well be that the next year (1980) will show no increase at all in world oil demand, or even a slight decline. In that case the annual increase in world oil demand from 1973 to 1980 will have averaged less than 1% (compared to 7.5% annually in the seven previous years) and the volume of OPEC exports will actually be somewhat less in 1980 than it was in 1973. Such a trend would seem
at variance with the frequently depicted image of the excessively rapid depletion of OPEC's resources by the oil addicts of the industrial world. However, one must recognize that it took the shock treatments of the OPEC price increases of 1973 and 1979 to "cold turkey" the industrial countries.

A potential problem arising from these price increases is that while they are clearly reducing oil demand, they may actually have the opposite effect on supplies from certain major OPEC countries. It appears that the higher the price of oil the less incentive these countries may have to increase their exports, since they have set monetary limits on their import requirements and economic development expenditures. The higher the price of oil the less they need to sell to reach these limits. Thus, a given import reduction by consuming nations could well be met by an equal or deeper export reduction by producing nations to maintain or raise the unit price. From the point of view of OPEC and other exporters' self-interest such a policy is entirely rational. However, from the point of view of the importing countries it may lead to a temporary no-win situation where every effort to reduce demand could be countered by a decreed reduction in supply. Until now, OPEC members have not actually adopted such a strategy but it is being openly discussed as a policy aim. Kuwait, for instance, has tentatively indicated its intention to lower its production ceiling next spring from the long held figure of 2 million b/d to 1.5 million b/d.

For the moment, however, OPEC's production is fortunately moving up, thanks to Saudi Arabia's decision to raise its output by 1 million
b/d to 9.5 million b/d. The increase will be maintained at least for the third quarter and quite possibly for the remainder of the year. If Iran produces at a rate of at least 3.5 million b/d (which is about half a million b/d below the officially reported production level for May and June) and if no other OPEC member reduces its output significantly from May-June levels, total available OPEC crude output for the third quarter should be around 31.5 million b/d. This would be 1.1 million b/d above the year-ago level. Meanwhile, non-OPEC production in the third quarter will have increased by about 1.3 million b/d from a year ago to just over 20 million b/d. Thus, total free world supplies during this period should be up by nearly 5% or about 2.4 million b/d. Since, as we have seen, world oil demand in the second half may not rise above last year's level, the present supply availability should be ample to restore stocks to desired levels by October. In fact, Western European stocks are not far from these levels now, except for distillate fuel oils.

The main problem with this reassuring scenario is that something may go wrong on the supply side. Realistically, this is not at all unlikely. The most threatened supply source is of course Iran where sabotage and guerilla warfare in the oil producing area of Khuzistan are a clear and present danger to the maintenance of production. If Iran should be shut down again for an extended period a shortage of crisis proportion could develop, probably requiring formal international allocation. Small reductions in output by other OPEC producers for various domestic reasons may
also occur in the third quarter. But these are not likely to have a significant impact while Saudi Arabia produces at its increased level.

Thus, in the absence of any new calamity in Iran or any other major new supply interruption, a degree of "normalcy" should soon be restored to the market. Official OPEC prices will not decline even under our most favorable supply assumptions. In fact, there is a distinct possibility that OPEC's stipulated $23.50 contract price ceiling may not hold for crudes of low-sulfur quality. (Ironically, the North Sea rather than OPEC may become the bellwether for such a move.)

But spot price premiums over contract prices will decline. In fact, they are already doing so. How big the drop will be depends not only on actual market conditions but also on buyer and seller perceptions of future market developments. In general, buyers, for good reasons, have not yet recovered their badly shaken confidence in the availability of supplies. Thus, they may well be willing to continue to pay some premiums for the time being to assure themselves of additional supplies, even in the absence of a visible shortage.

By the same token, OPEC exporters, having learned to utilize spot markets to their advantage, may be reluctant to give up this attractive outlet and, hence, may continue to channel some of their sales, directly or indirectly, through it. And, of course, the slightest indication of renewed supply problems can be expected to cause an instant upsurge in the spot market prices.
Thus, while the Saudi production increase can be expected to bring about a significant reduction in the spot-contract price differential, real and imaginary uncertainties may cause some spread between the two prices to be maintained for the rest of this year or perhaps even longer.