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OIL IN THE EIGHTIES

by

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Thank you very much for inviting me to participate in your International Symposium on the World Economy. Since my field of specialization is the economics of petroleum I presume you have invited me because of the pivotal role of oil in the world economy. Historically, oil has of course played such a role. In the 1950's and 1960's the ready availability of ever growing quantities of oil at declining real prices was a major factor in the world's unprecedented economic growth, although this was not generally recognized at the time. From 1973 to mid-1981 oil had just the opposite effect on the world economy and since the reversal was spectacular it was immediately recognized. The explosive price increases during that period contributed substantially to the postwar era's two major world-wide recessions and ushered in a period of much slower economic growth which is now entering its tenth year.

To some degree this economic slow-down had to come, regardless of whether the OPEC cartel or the free market had set the price of oil, since no system based on finite resources and other physical limitations can grow indefinitely at an unchanging exponential rate. Thus, the world's 5.5% average annual economic growth rate from 1960 to 1973 could not have been sustained much longer under any realistic assumption. Yet, history will always associate the end of the great postwar economic boom with the emergence of OPEC as a price setter for the world's oil.

Can OPEC survive in the new economic climate which it has helped to bring about? The question has been debated as hotly since the fall of 1981 as the question of how high OPEC prices would go had been in the previous eight years. For oil importing countries the new debate is obviously preferable to the earlier one. Instead of worrying about renewed oil shortages by the mid-1980's and the possibility of an oil price of \$100/Bbl in real dollars before the end of the decade, both of which were widely predicted until 15-16 months ago, we are now speculating about whether OPEC can survive as a functioning cartel if the demand for its commodity should remain several million B/D below its economically desirable production level and still further below its technically sustainable level. We can be fairly sure that the real dollar price of oil will fall again this year, as it did last year. The only current uncertainty is whether the nominal price will also fall (it did slightly in 1982) and, if so, will OPEC be able to control the fall or will the market determine the price in which case the fall would be quite steep.

To measure the extent of the changes in the world oil market since the beginning of the second OPEC price shock let us look briefly at the oil import ceilings for 1985 adopted at the historic Summit Meeting of the leaders of the western world's seven principal industrial nations here in Tokyo in late June 1979 and where we are today relative to these targets, keeping in mind that they were considered difficult to achieve when they were adopted. The

following table shows both the 1985 targets and estimated actual imports in 1982.

NET PETROLEUM IMPORTS

(Million B/D)

	<u>1978</u>	<u>1981</u>	<u>1982 First Half</u>	<u>1985 Goal Tokyo Summit</u>
EEC	9.5	7.1	6.8	9.5
US	8.2	5.6	4.2	8.5
Canada*	0.7	0.6	0.4	0.6
Japan	5.1	4.5	4.3	6.3-6.9

\*Gross imports

Source: OECD, "Quarterly Oil Statistics".

In each case the actual level of imports in the first half of 1982 was substantially below the target set for 1985. Imports into these countries are likely to be somewhat higher this year because the exceptional inventory reduction of 1982 can not be expected to be repeated in 1983. But it is safe to predict that in 1985 all major oil consuming countries will still import considerably less oil than they did in 1978. At the Tokyo Summit Meeting this was considered quite unlikely. But neither was it considered likely that the average OPEC oil price which was around \$20/Bbl at the time of the meeting would rise to nearly \$35 by January 1981 or that the industrial world, partly because of this increase in the price of oil, would face the economic stagnation which has been going on for three years and has not yet ended. Thus the price for this remarkable reduction in world oil consumption and, even more so, in dependence on OPEC oil has

been quite high and we are still paying it.

It must of course be recognized that the price of oil has been declining from its January/February 1981 peak--about 5% in nominal dollars and at least 20% in real (inflation-adjusted) dollars by now. But for Japan, most European countries and most developing countries, the decline has been largely, in some cases fully, offset by the rise in the dollar exchange rate during this period. Thus in many oil markets the impact of the 1979/80 price increase has been fully maintained. This is one reason for the continued decline in world oil demand.

Recently, the dollar has started to fall relative to a number of foreign currencies. If this movement continues, OPEC's nominal oil price drop will be transmitted to non-dollar oil markets this year and next. Of course, the same development would also reduce the oil exporters' foreign purchasing power per barrel of oil.

Some OPEC ministers have suggested that the current nominal dollar export price of oil remain unchanged (except for technical adjustments) through 1985. If this were done the real OPEC price (expressed in 1979 dollars) in 1985 may be only modestly above the \$20 level of mid-1979, based on projected OECD inflation rates. This would be a quite tolerable price path for most oil importing countries. I am not predicting that this is the way prices will actually move over the next few years. But, in my view, a price freeze in nominal dollars is more likely than

the real OPEC price increases so widely predicted for the first half of the 1980's until 15-16 months ago.

It is therefore time to revise the view, still widely held, that the present situation is but a brief hiatus in the trend of rapidly rising real oil prices which began in 1973. The 1980's are likely to be quite different from the 1970's. The structural changes in oil demand brought about by the two OPEC price shocks, as well as the ongoing shift in the mix of industrial production towards higher technology and lower energy intensity, are such that, in our view, the demand for OPEC oil in none of the remaining years of the current decade will come close to the organization's readily available and technically sustainable productive capacity. This despite an expected slight increase in world oil demand and in the requirements for OPEC oil between now and 1990. Hence, there should not be any upward pressure from underlying market forces on real oil prices during this period. And without support from the market OPEC will no longer have the strength to raise the real price of oil significantly in the 1985-1990 period.

Does that mean we can stop worrying about oil as a potentially destabilizing factor in the world economy, at least for the next 8-9 years? My answer is a qualified no because of two potential threats in opposite directions to the future price of oil. One

comes from the political and military instability at the Arabian Gulf which could bring about another physical interruption. The other threat is from OPEC's organizational and political instability which could cause it to lose control over the world oil price with a resulting sharp and fast price drop for a period of time. Let us briefly examine both these contingencies.

In 1982 the countries located in the Arabian Gulf region accounted for 30% of the non-Communist world crude oil production and had enough readily available spare capacity to supply nearly 50%. Since most of this oil is produced for export, the oil importing countries of the world are, and will remain, highly dependent on this region which is politically and strategically probably the most insecure in the world.

Given the present and expected world oil surplus, the cessation of oil exports from any Middle East oil producer other than Saudi Arabia could probably be offset through higher production in other OPEC countries. A total interruption in Saudi supplies, on the other hand, could not be offset. Since the possibility of such a temporary interruption is real, the oil importing countries must be prepared for it to avoid another oil price shock. In one way, most are better prepared today than they were in 1979. In the U.S. which had virtually no strategic petroleum reserves then, the current level is 300 million Bbls, equal to 60 days of total imports, and will be

close to 400 million Bbls by the end of this year. In Japan government stocks were 75 million Bbls in November 1982, compared to 33 million in November 1979. Several European countries also have government emergency stocks. In 1979 these were either non-existent or much smaller than today.

Company stocks are probably also adequate to deal with interruptions. But if the massive reduction of these stocks which has taken place in 1982 continues in 1983 because of the correct perception that oil prices are far more likely to stay flat or fall than to rise, compulsory industry stocks could at some time drop below the safety level required to deal with major interruptions. It is important that the governments of the importing countries do not allow this to occur.

At the other end of the scale of potentially ominous price developments is the possibility of a sudden sharp decline in the world price of oil. While I do not consider this very likely, in the present market situation it can by no means be excluded. There is no doubt that under free market conditions the current price of oil would be substantially lower than the actual cartel price. If OPEC should really lose control, this price would plunge to a very low level--perhaps less than \$20/Bbl, given the low production cost of most of the world's currently shut-in excess capacity. OPEC is still effective but its position has clearly been weakened both from the outside by market forces and from the inside by growing internal dissensions. At the moment,



the dissensions present the bigger threat to its survival.

It might be asked why a sudden sharp reduction in the price of oil would be bad for countries which import this commodity. It would certainly have its positive aspects for importers in the form of lower energy costs, lower foreign exchange expenditures, and the positive repercussions of these developments on general economic conditions.

On the other hand, a price break would greatly reduce existing incentives for further energy conservation as well as for the development of new energy sources and the switching from oil to other fuels. The dramatic reversal in the world oil demand trend from growth to decline since 1979 has in large part been the result of the rise in the price of oil, although the worldwide economic recession has of course also played a significant part in it.

If this ongoing move of declining oil requirements and increasing supplies is sharply reversed, as it surely would be by the price level which would prevail in a completely unfettered market, an oil supply tightness is quite likely in the not too distant future. If the price break were to occur now, the resulting changes in supply and demand would probably require real price increases starting within a few years. For oil is a naturally depleting resource which must either be continuously replaced through exploration and development or

continuously reduced in consumption to reflect its depleting resource character. If neither of these is done, a shortage is bound to ensue. The oil market was clearly moving in that direction in the pre-1974 period when oil was increasingly sold below its replacement value. A significant part of the price increases since then was therefore not due to OPEC's cartel power but to underlying supply and demand imbalances.

I would like to make clear that I am not suggesting that the present OPEC price is the right one. It is a cartel price, artificially maintained above the replacement cost for oil. This is neither tenable nor desirable. However, under current supply conditions the price of oil would probably drop temporarily below this level in a free fall, giving misleading signals to the market. Thus an OPEC survival strategy that might also be acceptable to its customers would consist of regular modest real price reductions over the next several years until the replacement cost level is reached.

Such a "soft path" price reduction should enable oil exporters with heavy foreign debt burden to continue to repay their loans. A fast and sharp price reduction, by contrast, would probably force such exporters as Mexico, Venezuela and Nigeria to default on some of their foreign debts, thereby reducing the ability of the international banking system to service other developing countries. In the present precarious international economic situation in which bank loans to these

countries are already being curtailed this could have serious repercussions.

I don't wish to imply that a price break and another upward leap in the price would have equally negative consequences for the world's oil importing countries. A price leap would be entirely negative while a price break would have both positive and negative aspects. I did want to call attention to the latter since they could be quite significant.

At the moment the possibility of a substantial increase in the price of oil seems as remote as the possibility of a substantial reduction was from 1973 through 1981. However, a price break now would greatly increase the possibility of a price jump in later years. This should be kept in mind as we watch the weakening of OPEC's price setting power.