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Oil Prices: Greater Challenges Ahead

The 1979/80 wave of oil price increases has so far resulted in raising the average price of the liquid gold by \$ 18, viz. from roughly \$ 14 a barrel in early 1979 to \$ 32 now. Whereas in relative terms this increase is much lower than that of the first round in 1973/74 – the price has now "only" about doubled compared to a quintupling then –, the present augmentation is obviously higher in absolute dollar terms. What gives rise to more concern: there are indications that the oil producing countries may this time be slower in adjusting their imports to their greatly expanded export proceeds. And: it becomes more and more clear that this price round is by far not the last one. On the contrary the oil producers, divided as they may be, are unanimous in their intention to further raise the prices of their precious asset not only in nominal but also in real terms in the months and years to come, and they have a good chance of succeeding. Even without any politically motivated disruption of supply the world is therefore facing an even greater challenge than in the midseventies – at least seen from our present viewpoint.

The response to this challenge is to come from adjustment and financing alike. In the short term, the greater part of the burden is to be borne by financing. The task is twofold: to provide the oil producers – and in particular the oil-rich "low absorbers" – with safe and profitable investment opportunities and to recycle the funds to deficit countries in need and channel them into productive uses. As to the first objective there is a growing realisation, particularly among Arabian oil producers, that the rate of return on their financial assets has kept up neither with the price increases of their imports nor with those of their own export product, petroleum. If this trend were to continue the authorities there might well come to the conclusion that the long-term economic interests of their countries would be served better if oil production were curtailed and more oil than hitherto kept in the ground. This judgment would be reinforced if financial investments in national and international financial markets became subject to greater political risk; indeed there is such concern following the freezing of Iranian assets held with US financial institutions. Whereas it is true that production cutbacks will be inevitable in the medium term, given the – by nature – limited oil deposits, it is desirable that such cutbacks take place gradually and that they be linked in some way to the progress made in the development of alternative sources of energy and of energy saving techniques.

It appears, therefore, that the oil consuming countries, and in particular the industrialized economies, will have to consider offering more attractive investment opportunities to OPEC countries as a quid pro quo for an orderly oil supply in the years to come. To some degree, such opportunities do exist already in the long-term end of the market spectrum, and it was largely due to the oil countries' own high liquidity preference that they have not been able to make full use of them. The recent sales of German and Japanese government securities to Arabian countries and Kuwait's acquisition of a participation in *Metallgesellschaft* are topical examples of transactions which are likely to yield an acceptable real rate of return also in a longer-term perspective. In addition to such more "traditional" types of investment new instruments need to be explored. One may think especially of floating-rate paper carrying an agreed real – rather than nominal – rate of interest and issued by some international body like the International Monetary Fund.

The IMF may also have a greater role to play in facilitating a smooth recycling of funds to deficit countries. To bring the IMF more into the picture may not only be necessary in view of the limitations which banks are seemingly facing with regard to a further increase in their lending to LDCs. It would also be appropriate under the aspect of inducing deficit

countries to apply adjustment measures more timely than in the seventies. This position is obviously at odds with the current strand of political thinking, mainly in LDCs, that the IMF should increase its lending largely on an unconditional basis, a view that is gaining ground also in industrialized countries. Indeed, given the external cause of the oil consuming countries' current account deficits, sole reliance on the traditional type of demand-oriented adjustment policies will be only of limited usefulness. Yet, to infer from this reasoning that no adjustment is required at all, would certainly be misleading.

What all countries – industrialized as well as developing economies – will have to apply is a deliberate policy of energy saving in general and oil saving in particular. The best overall setting in which this objective can be pursued is one of a low rate of inflation where the increases of oil prices relative to those of other goods and production factors can make themselves felt without giving rise to general wage and price increases. (Besides, price stability is also a precondition for a moderation in the OPEC countries' price demands.) Given that consumers will indeed be fully exposed to the high and rising oil prices they will react by economising in the use of petroleum and petroleum-based products (mainly chemicals) and/or by substituting other goods for them. At the same time, producers will be induced to apply less energy-intensive production methods and to substitute the relatively cheaper production factor "human labour" for the increasingly expensive factor "energy". Energy productivity will be raised. Agriculture, in developed economies a highly oil and energy intensive industry, should also be fully exposed to the changes in relative factor prices rather than compensated for the increase in the oil bill. Indeed, to make the program fully effective no sector of the economy must be shielded from the impact of rising oil prices.

Adjustment policy under present conditions would thus have to be largely supply-oriented and consist of a number of elements: the securing of a low rate of general price increases; the removal of domestic barriers to an effective working of the price mechanism with respect to oil; deliberate measures to increase the mobility of production factors and to encourage the introduction of new production techniques with a view of increasing energy productivity; and the application, where appropriate, of specific incentives (e. g. higher energy taxes; more stringent energy saving standards) to speed up the process away from oil.

Incentives to oil saving and substitution are only one side of the coin, however. The other is the quick adjustment of the national economies to the changing pattern of international demand. As far as the demand from non-oil economies is concerned one may expect some reduction in the demand for consumer goods and an increase in investment demand, whereas for OPEC countries no major change in the demand structure is likely to occur. These changes should be allowed to work themselves through in a competitive framework. Again, any attempt to shield national economies from the impact of change are likely to multiply the future adjustment burden. Therefore, resistance to growing protectionist demands is now more topical than ever. It is along the lines indicated that the IMF will have to work in its periodic consultations with member countries and its negotiations with potential borrowers.

Even with well designed adjustment strategies on the part of oil consuming countries their aggregate current account deficit is there to stay for some time to come. The clue to this is in the hand of the oil sheiks. Whereas one may well doubt whether the generally pessimistic forecast of the OPEC countries' future rate of increase of absorptive capacity or their willingness to absorb will in the end materialise, a major part of their growth of import expenditure may be compensated for by further growing export-proceeds.

Yet, whereas the financial aspects of the oil price problem have received widespread international attention they are also most amenable to solution. Readjustment of production, consumption, and savings patterns presents the greater challenge. With regard to this, no easy solution lends itself. By stretching the adjustment period through recourse to external financing the burden may be eased. But in the end it has to be borne.

Hans-Eckart Scharrer