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Oil and Stable Growth

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As I was preparing myself for this panel discussion on "Oil: From conflict to agreement for stable growth", I looked back to an article that appeared in the journal *Foreign Affairs* in January, 1975-- almost precisely one year after the first so-called oil shock. Written by five eminent scholar-statesmen from Europe, North America, the Middle East and Japan, it was entitled, "How Can the World Afford OPEC Oil?"[1] Reading this article almost twelve years after its publication, I found it strikingly prescient in foreseeing the kinds of long-term problems that would emerge in the tumultuous readjustment of the world economy after 1974. The article anticipated the debt crisis of the oil-importing developing countries, the instability of currencies caused by petro-dollar liquidity, the cumulative deflationary effect of each oil-importing country's efforts to reduce its current account deficits, the related protectionism and reduced volume of imports in some countries, and the institutional challenges of recycling the last decade's vast OPEC surpluses.

The article concluded with a well-argued plea for triangular cooperation between the oil-producing countries, the industrialized oil-importing countries and the developing oil-importers. The authors wrote, in 1975, when oil was still only $10 per barrel, "The astonishing fact, in the face of the largest single mutation in payments patterns that the modern world economy has ever experienced, short of war, is that so little dialogue about the problems ahead has yet occurred among the countries principally concerned, in the spirit of responsible nations consulting together over a staggering common problem."[2]

What is even more astonishing is that, twelve convulsive years later, this dialogue has still not occurred, although the problems foreseen at that time have materialized in even starker terms than envisaged, and a new round of wrenching adjustments of the world economy has been inaugurated by a collapse of oil prices nearly as dramatic as the previous rise. It has taken us more than a decade of pain, disruption and sacrifice to grasp the need for cooperation-- if we have grasped it yet. Perhaps now that *both* consumers and producers have known the pain of violent instability in oil markets, a new appreciation of the benefits of cooperation for stable growth can be kindled.

The basic sources of dislocation in the world economy must be addressed if stable growth is to be achieved. The greatest threat to stability is the continued exclusion of most of the Third World from the growth process. Any pattern of economic expansion that excludes the Third World is inherently unstable, for political and social as well as economic reasons. Among the fundamental dislocations that must be dealt with in order to bring the Third World as a whole back into the growth process are the debt crisis, the stagnation of the volume of world trade, the instability of foreign exchange markets, the drying up of new investment funds for the developing countries, and the instability of energy prices. I need hardly point out that the question of oil prices is intimately related to all of these, not just the last. It is only in this whole context that one can analyze the role of oil in a stable, growing world economy.

The debt crisis is in many ways a product of the oil shocks of 1974, 1979 and 1986. It is not simply that the oil-importing developing countries had to borrow to pay their oil bills, though of course many did have to do so, with ruinous effects. But the impetus for heavy borrowing went beyond that. In the absence of coordinated and coherent recycling mechanisms, too large a part of the task of on-lending surplus oil funds was left to the commercial banks, many of which marketed loans aggressively to the Third World. Often the money went into investments hardly worthy of the name, in that they did little to increase the long-term productive capacity of the borrowing countries or their ability to service and repay their debts.

The oil shock of 1986 is not expected to provide a simple mirror image of the events of the 1970s, though a massive redistribution of income is again taking place, this time from oil producers to oil consumers. This time, the beneficiaries are not likely to devote so large a proportion of their windfall gain to savings-- the consumers of oil as a group have much higher absorptive capacity for the funds than the producers did in the 1970s. The expenditures of the oil producers are therefore likely to fall much more rapidly than the spending of the consumers is likely to increase, because many of the consumers are already laboring under heavy budget and current account deficits. A few consumer countries-- most notably Japan and West Germany-- will increase their savings massively as a result of the lower price of oil. It is profoundly to be hoped that the mistakes of the 1970s will not be repeated, and that an orderly, productive way of recycling these new surpluses will be agreed upon.

One of the authors of the Foreign Affairs article that I referred to at the beginning of my remarks is Dr. Saburo Okita of Japan. In his capacity as the Chairman of the Board of the United Nations University's World Institute for Development Economics Research (WIDER), he has headed a study group of the institute that has recommended specific measures to recycle the Japanese surplus in such a way as to meet the investment needs of the developing countries. Among other proposals it suggests that Japan should initiate an international fund to insure against the risks of investing in the developing countries, guarantee reasonable rates of return on such investments[3], and perhaps subsidize interest rates on private lending to the Third World.

The private banking system, unaided, cannot be expected to meet the investment needs of the developing countries. Indeed, in the first quarter of this year, commercial bank lending to the developing countries actually declined, with outstanding loans falling by more than five billion dollars. The persistence of high real interest rates and the continuing shortage of capital inflows have made the debtor countries net exporters of capital: from Latin

America the outflow since the debt crisis began is reckoned at almost 100 billion dollars. The effect has been a drop in real per capita incomes in Latin America of 8 percent since 1980[4].

The collapse of oil prices has brought relief to some of the debtor countries and exacerbated the problems of others. Among the most obvious sufferers are the oil producing countries such as heavily-indebted Mexico, or financially vulnerable Indonesia, Nigeria and Venezuela. The general collapse of commodity prices in the mid-1980s has amplified the financial difficulties of many developing countries, reducing their earnings at the time when they most need foreign exchange either to service their debts or to make up for the shortfall in their oil income or both.

Another group of developing countries likely to suffer from the collapse of oil prices is made up of those that have become dependent on the oil-producing countries as aid donors, as export markets, and as labor markets. Pakistan provides an extreme example: it sends about one-third of its exports to oil-producing countries, mainly in the Middle East, as well as substantial numbers of workers who remit income back to Pakistan. The earnings it derives from these sources far outweight the savings it can expect from low oil prices. It also receives significant aid from the Middle East, which may be jeopardized by the donor's new economic austerity[5].

There are various winners and losers among countries in each swing of the oil market. But the system as a whole suffers from the waves of instability that ripple out from each oil shock, whether it brings a rise or a plunge in prices. High prices and unpredictable market conditions have brought about large investments in developing new oil reserves, alternative energy sources and energy-conserving technologies which are uneconomical under current conditions. Yet the products of most of these investments will continue to be employed, since the capital costs are already sunk, and this will limit the demand response to lower oil prices.

Over the medium term, however, a different danger could arise: the poor record of previous energy investments coupled with the persistence of low oil prices for a few more years could inhibit investment in energy alternatives and leave many countries unprepared for a return to higher prices, thus setting off a new cycle of instability. This is a particular concern to the nations of the Western Pacific region, which is and is likely to remain an area of chronic energy-deficit. The Pacific Rim as a whole has more than half of the world's population, but only about a fifth of its proven oil reserves. The emphasis in the region over the next few years is likely to be on the diversification of energy sources, even if this means paying higher prices for the sake of energy security.

In the current disarray of the world oil market, there is a tendency to regard oil as just another commodity, the price level of which is best left to market forces to determine. This is a view both short-sighted and, in my opinion, dangerous, for it ignores the multiple ramifications of oil prices on industrial planning, capital markets, investment patterns and financial stability. The price of oil has always been politically inflected, going back to the days of the Texas Railway Commission. Certainly OPEC is at least as much a political as an economic association. In the era of the "Seven Sister" oil companies, the price of oil was perhaps less overtly politicized than subsequently, but the companies also operated in a politically-charged context of U.S. dominance of the world economy.

The situation today is radically changed, with both political and economic power in the energy marketplace widely diffused. The high oil prices of the 1970s pulled many more suppliers into the oil market, so that OPEC's market share declined, while also boosting the development of alternatives to oil and encouraging the application of energy-conserving technologies. The diversification of supply is a stabilizing factor in the energy market and the world economy in general. A prolonged period of very low prices could threaten the consolidation of this stabilizing trend, even as it threatens the economic viability of the oil-producing states.

I have spoken earlier of the need to look at the question of oil prices in the overall context of the broader search for solutions to:

- the Third World debit crisis
- the stagnation in the volume of world trade
- the instability of foreign exchange markets
- the drying up of new investment funds for the LDCs
- the instability of energy prices
- and here, if I may say so, the notions of linking oil prices to the average cost of nuclear energy seems to me too narrow (and simplistic) a concept that does not do justice to the inherent complexity of the problem.

Within this broader context then, the political question for the mid-1980s is how to constrain the price of oil within a band that is high enough to encourage the development of further oil reserves and alternative energy sources, and not cripple the growth of supplier countries; but low enough to be manageable through existing or foreseeable financial arrangements, and not cripple the growth of the consumer countries. The traumas of the past twelve years are surely enough to convince both suppliers and consumers that more orderly changes are to everyone's advantage.

What kind of mechanisms could be devised that would restrain the violent fluctuations of oil prices but still allow the market to do its work of efficient allocation of supplies? The problem is a difficult one because of the diversity of actors in the energy market today. There are public and private bodies, technologically sophisticated and technologically dependent developers, large and small producers, industrialized and developing states, to say nothing of the divergent political orientations of the actors. There have been a number of proposals for regulation of the market by the cooperative effort of producing and consuming countries. It requires an arduous process of negotiation with all parties taking a long-term view of their own interests.

With the best will and the firmest determination, the prospect of moving from conflict to agreement for stable growth is a distant one. We must face the fact that stability is not determined only, or even primarily, by economic factors. The United Nations University for several years has had a group of Arab scholars researching and reflecting upon the impact of the sudden flood of oil wealth into the region - the dramatic changes in social and political relationships, the erosion of traditional values, the reaction to overly-rapid change.

If the past decade has taught us anything, it is that humankind is involved in a series of major and complex interlinked social changes, at an accelerated pace, and that unanticipated factors may completely overwhelm the best laid plans for stable and orderly development. Energy prices and markets have in the past proven to be exceptionally vulnerable to unpredictable events. Our priorities for the next decades should include the development of resilience - the capacity to anticipate, imagine and respond with flexibility to whatever surprises may be waiting around the next corner.

Note

1. Khodadad Farmanfarmajan, Armin Gutowski, Saburo Okita, Robert V. Roosa and Carroll L. Wilson, "How Can the World Afford OPEC Oil", in Foreign Affairs, Volume 53, Number 2 (January, 1975).

2. Ibid.

3. Saburo Okita, Lal Jayawardena and Arjun K. Sengupta, The Potential of the Japanese Surplus for World Economic Development, Study group series, Number 1, World Institute of Development Economics Research, United Nations University, Helsinki, 1986.

4. Peter Montagnon, "Creditors Under Pressure", in The Financial Times (London), 30 September, 1986.

5. Fereidun Fesharaki and David T. Isaak, "Declining Oil Prices: Impact on Debt and Foreign Exchange Balances in Asia and Latin America", a paper presented to the Asia-Pacific Banker's Club annual general meeting, Singapore, 27-28 February, 1986.