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MEMORANDUM ON OIL PRICES

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Oil Prices

Thanks for your telex about oil prices. The Energy Group last year produced a series of memoranda which suggested that supply and demand were basically in balance so that the price of oil should remain indefinitely at a nominal price around $34 per barrel. In other words, they predicted a slow decline in real terms but no decline in nominal terms. In January 1983, they predicted that no price break to below $30 would occur. Their position now is a more flexible argument for $29 per barrel.

Energy Group officially speaks for the Bank. We respect their opinions, and we respect their position as the Bank's full-time energy economists. At the same time, for strictly confidential, internal purposes, the Economics Department doesn't think their $29 scenario the most likely. Brainard held a meeting about a month ago of all members of the Economics Department who deal with this subject, and reached a consensus of the economists that the most likely Saudi marker price toward the end of this year is in the $25 range, with a lot of oil traded at $22-$23, and a possible overshooting to $20-$21. He has distributed a memo to that effect. They also reached a consensus that, if OPEC tried to defend a $25-$26 per barrel price, it would have some chance of doing so because such a price would be reasonably close to the market, defined as a reestablishment of a long-term relationship between oil prices and certain other commodity prices. On the other hand, everyone agreed OPEC efforts to defend a price in the $28-$30 range would guarantee a further major break in the oil price in the relatively near future.

My own controversial opinion argues that the Economics Department consensus may apply only to the next year and may be subsequently followed by a further decline. For two years I have been publishing in Global Political Assessment warnings that oil prices would fall drastically and that this would affect Mexico, Venezuela, Nigeria and Indonesia in drastic fashion. I made such remarks more than once at ID Group Heads meetings. I encouraged David Beers to include a $15 oil price scenario in his recent review of Indonesia. Herb Krupp and Bill Pelley in the Energy Group have exchanged views with me on this, quietly and professionally, but we have respectfully disagreed. I endorse the Economics Department argument that the next phase of oil prices will be a fall to the mid or low $20's. I do not, however, believe that it will stop there. My best guess is that, 18-24 months hence, oil prices will fall to average production costs in key areas, namely around $15.00.

A real extremist on this subject would argue that the price could well fall to the marginal price of the marginal barrel of oil in key areas. Such an opinion is not ridiculous.

A lot of my perspective on this subject comes from four sources. One is a feeling that many of the major oil producing countries, including Saudi Arabia and Kuwait, are far more desperate for money than is largely realized, and therefore the pressures on decision makers to increase their production and sales by infringement of the OPEC guidelines is larger than believed. Second, the intensity of the political antagonism among Nigeria, Saudi Arabia and Iran seems to me not to have been adequately taken into account by some of the higher predictions for oil prices. Third, I do not share the widespread belief that a gradual recovery in the Western economies means tremendous pressure on demand. In the last couple of years OECD growth has been positive but oil demand growth has been strikingly negative. Growth led by automobiles and housing, as is currently happening in the U.S., will lead to a gradual substitution of relatively energy-efficient automobiles and housing for older energy-inefficient autombiles and housing, and I suspect that much of the same is true in industry. (The average American automobile is a 1976 automobile with virtually no energy-saving features. Even if there is a gradual move back toward larger automobiles, they will be energy-efficient ones). Finally, and perhaps most important, many of the arguments for oil prices staying high strike me as mirror images of the arguments I heard in 1972 and 1973 for oil prices remaining low. In that earlier period, Hudson Institute published a study indicating that oil prices were likely to go through the roof by the mid-1970s, for supply and demand reasons; the study was almost universally ridiculed. Prices subsequently went far higher than Hudson's ridiculously high projections. Now there is symmetrical ridiculing of arguments that oil prices could fall sharply. There is an implicit theory around that oil prices are somehow not subject to the same kinds of pressures that, for instance, sugar prices are, but I have always had a problem with that theory.

Thus, there is a wide array of "best guesses". In the face of this, what is the policymaker to do? One possibility is to base policy on the assumption that one or the other of the analysts is smarter or has better arguments, and to base the policy on the assumption that, for instance, oil will almost certainly remain at $22 per barrel. While I have my own best guess on the subject, I simply don't believe that God has spoken with sufficient clarity to any of us on this subject to justify such a narrow bet. Instead, I would base policy on the argument that oil prices are very volatile, that no best guess has enough weight behind it to be completely decisive, and that therefore we should be prepared for a fairly broad range of outcomes.

My own recommendation would be to lend only after doing scenarios for alternative oil prices in the $15 to $29 range and the likely policy responses of the countries in each of those scenarios. Then decide what you're comfortable with.

Such a range does not cover all the possibilities, even though it is fairly wide. As indicated above, $5 per barrel oil is not silly. Moreover, very low oil prices could cause severe strains within Saudi Arabia and trigger a revolution there; a revolution could virtually shut down production for a year or more, and, if the markets panicked or OECD governments made missteps, oil prices could go to $70 per barrel. Over five years the probability of such extremes is high enough that we probably would not offer a mortgage to a homebuyer who faced equivalent risks. However, compared to recent international standards, a policy of lending to any country which can survive between $15 and 29 per barrel would be conservative.

If you buy this line of argument, we shouldn't lend any unsecured money to Indonesia unless we are confident that Indonesia will somehow manage to service its debt at $15-$25 per barrel. The only such argument I can see is an argument that Indonesia has such strategic importance to Japan and the United States that they would bail Indonesia out. If Indonesia were one of only a small number of countries in trouble, that argument would be totally convincing and decisive. Indonesia's strategic importance is indeed very great. Under any circumstances, there will certainly be some bailout of Indonesia. But the risks of the banks' being forced to swallow a significant part of whatever losses are involved seems to me to be high in the current Washington and Tokyo environment. I would add that a large drop in oil prices might well lead initially to counterproductive reactions in Jakarta, and that a financial crisis could well bring to a head the political and social problems detailed in my 1981 review of Indonesia.

I do think that the declining oil prices are great news for Korea, Taiwan, Singapore, Hong Kong, the Philippines, Thailand, Sri Lanka, India, Bangladesh and Pakistan. Malaysia probably has the capacity to adjust, albeit with considerable anguish, even to very low oil prices, because its other markets will recover roughly the proportion to the oil price decline. Brunei may or may not have sufficient flexibility. Thailand's interminable negotiations with Union Oil, Gulf, Exxon, Texas and others will be set back once again.

cc: L. Brainard
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