Klaus Matthies*

Steadying of Oil Prices

Oil prices have fallen below the 30 dollar mark sooner than expected. In March they were in the lower half of OPEC's target price band. Will OPEC manage to maintain high prices and revenues by restricting production?

World market commodity prices have fallen considerably since late last autumn and in February they had returned to the previous year's level. This was primarily due to the development of crude oil prices. There was little change in the prices of other commodities during the same period; in February, measured using the HWWA index, they were just under 5% cheaper than a year previously (see HWWA Index of World Market Prices of Raw Materials, p. 112). Prices for industrial raw materials remained suppressed on the whole; the slight recovery which seemed to be materialising late last summer could not last long in view of the world economic slowdown. In February, quotes for industrial raw materials were all in all 3% lower than the previous year's level.

Oil Price Stabilisation

Oil prices fell substantially in the last weeks of the year 2000, with Brent crude dropping by 10 dollars from the end of November to finish the year at 23 dollars a barrel. Although prices increased again temporarily in the new year, Brent crude had again fallen to 25 dollars in late March. The average price for the OPEC basket of seven types of oil – which is always lower than the price of Brent crude – was in the lower half of the target band set by OPEC of 22 to 28 dollars. In real terms[1], too, there was a strong increase in the price of oil during the course of last year; however, it is still well below the record level of the early 1980s, when it stood at more than 40 dollars a barrel (see Figure 1).

At the start of this year, the OPEC countries announced further cuts in their production quotas of 5.6% or 1.5 million barrels a day as of February in anticipation of seasonally lower demand for oil in the second quarter of the year. This step clearly demonstrates that the organisation is now serious in its efforts to move swiftly to thwart a stronger drop in the price of oil. The resolution to cut production levels had been generally expected and so failed to lead to any notable rise in oil prices. The tendency towards higher prices in February was the result of temporary oil market insecurity regarding future oil supplies in view of the fact that Iraq, contrary to expectations, continued to throttle its oil deliveries. At the same time, moreover, demands were being voiced from within OPEC for further production cuts to take effect from April. Even before the March summit, additional supply restrictions were thus announced should there be any further decline in the price of oil. On 17th March the OPEC ministers announced a further production cut of 1.0 million barrels a day (see Table 1).

Iraq's decision, with effect from December 2000, to deliver oil only to customers who, in contravention of the terms of the UN sanctions, pay part of their bills[2] directly to Iraq, led to a considerable reduction of Iraqi oil exports, since only some of its customers accepted the new delivery terms. As a consequence, the country's oil exports have not yet risen to the old level; in February, Iraq's production stood at just 2 million barrels a day, around 70% of the volume previously attained. But exports are rising; in mid-March the figure reported by the UN was 2.6 million barrels a day, the highest level since late October.[3] Current production is well below Iraq's target of 3.4 million barrels a day; this level has not been reached since before the Gulf War. In view of the ongoing negotiations with the UN, it is unclear when Iraq will again be able to supply oil to the full extent of its capacities. However, other OPEC countries have pledged to make up for any shortfall in Iraqi deliveries.

Considerable Revenue Improvement

The strong increase in oil prices in the past two years has provided the oil-producing countries with substantial income growth which OPEC does not wish to see jeopardised by abundant oil supplies. However,

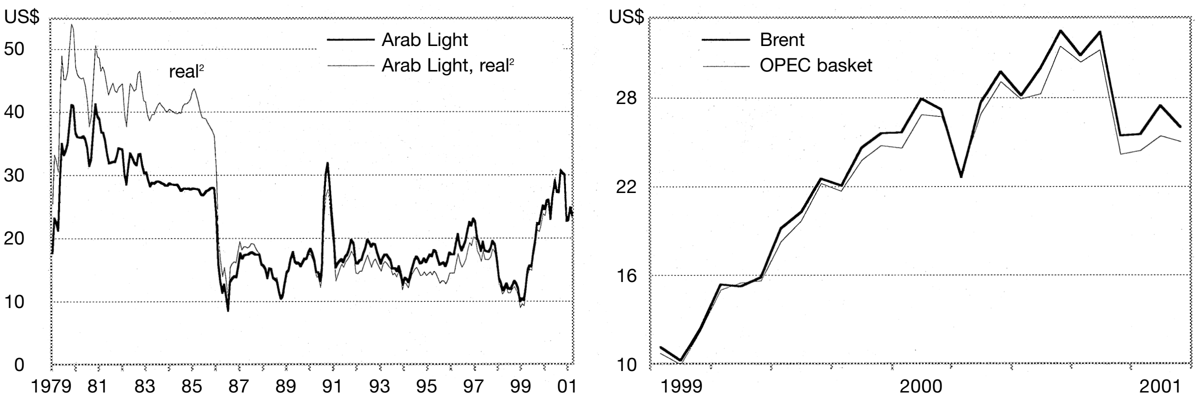
* Senior Economist, Hamburg Institute of International Economics (HWWA), Germany.

[1] Measured in prices for industrial goods.

[2] A sum of 25-30 cents per barrel were quoted recently. Cf. Energy Information Administration (EIA): OPEC Fact Sheet, 6th March 2001.

[3] Cf. "Iraq Wk Oil Exports Up", Dow Jones Newswires, 20th March 2001.

Figure 1
World Market Prices for Oil[1]



[1] Spot prices fob per barrel (monthly figures).

[2] Deflated using export prices for manufactured goods from industrialised countries. Base year 2000.

Sources: IEA; OPEC; author's own calculations.

the level of inventories held by the importing countries is also of considerable significance for the price of oil, a factor which cannot easily be influenced by OPEC. OPEC representatives fear that if production cuts do not come into force promptly enough, a subsequent accumulation of inventories could take place which would make it more difficult to maintain the level of oil prices.[4] Given an average price of 25 dollars for Brent crude, export revenues would be around 8 % lower this year than in the year 2000 – assuming the same production levels. However, oil incomes would still be around 80% higher in real terms than the 1990s average (see Figure 2). The marked fluctuations in oil prices – and thus also in oil revenues – pose a particular problem for the OPEC countries, which are highly dependent on oil exports. To this extent, their desire for high and stable oil prices is understandable. However, OPEC's attempt to maintain the price of oil at its current level is something of a balancing act. For high oil prices raise the incentive in the oil-consuming countries to reduce oil bills by lowering consumption and using oil more effectively. At the same time, high oil prices encourage the development of new sources outside OPEC, sources which could hardly prove profitable in times of low prices. As a result, as the experience of the 1980s has shown, oil prices will again come under pressure in the longer term.

The increase in energy costs has already put the brake on world oil demand, which rose by less than 1% in the year 2000 – less than half the growth rate of a year previously. The main reason for this development was that consumption in the industrialised countries virtually stagnated in spite of strong economic expansion. In the developing countries, on the other hand, and not least in China, demand for oil continued its strong growth. In view of the greatly improved earnings prospects compared to the previous year, however, the oil supply expanded faster than before, with particularly strong export growth among the countries of the former Soviet Union.

Weakening Oil Demand

Although oil demand will this year be stimulated by lower oil prices, the marked slowdown in the US economy – which will affect other regions and lead to a slowdown in world economic expansion - will also dampen oil consumption. Nonetheless, according to International Energy Agency (IEA) estimates, oil consumption will this year grow at a somewhat stronger rate than in the year 2000, due above all to a more pronounced increase in the developing regions. In its most recent estimates, the IEA, which has repeatedly lowered its forecasts in the past few months, expected global demand to grow by 1.4 million barrels per day, following an increase of 0.6 million barrels per day last year.[5] The oil supply can also be expected to increase at a faster rate, however, due not least to greater production efforts outside OPEC. Pressure on oil prices could thus be expected to increase in the second quarter of this year. Accordingly, the OPEC member states will thus try to

[4] Cf. "Ignoring market pleas", in: Petroleum Economist, February 2001, p.19.

[5] Cf. IEA Oil Market Report, 14th March 2001.

Table 1
OPEC: Crude Oil Production and Actual Production
(in million barrels per day)

	Oil quotas from: October 1 2000	February 1 2001	April 1 2001	Total agreed cuts (%)	Actual production October 2000	January 2001	February 2001	Change since October (%)
Algeria	0.85	0.81	0.77	–9.4	0.84	0.85	0.81	–3.6
Indonesia	1.39	1.31	1.26	–9.4	1.25	1.26	1.25	0.0
Iran	3.92	3.70	3.55	–9.3	3.81	4.05	3.75	–1.6
Kuwait	2.14	2.02	1.94	–9.3	2.21	2.22	2.17	–1.8
Libya	1.43	1.35	1.30	–9.4	1.44	1.45	1.39	–3.5
Nigeria	2.20	2.08	1.99	–9.3	2.13	2.18	2.15	0.9
Qatar	0.69	0.65	0.63	–9.4	0.71	0.74	0.72	1.4
Saudi Arabia	8.67	8.19	7.87	–9.3	8.68	8.64	8.32	–4.1
UAE	2.33	2.20	2.11	–9.4	2.34	2.37	2.24	–4.3
Venezuela	3.08	2.90	2.79	–9.5	2.95	3.03	2.98	1.0
OPEC 10	26.70	25.20	24.20	–9.4	26.36	26.77	25.76	–2.3
Iraq[1]					3.00	1.73	2.05	–31.7
OPEC total					29.36	28.50	27.81	–5.3

[1] Iraq is not a party to the production agreements.

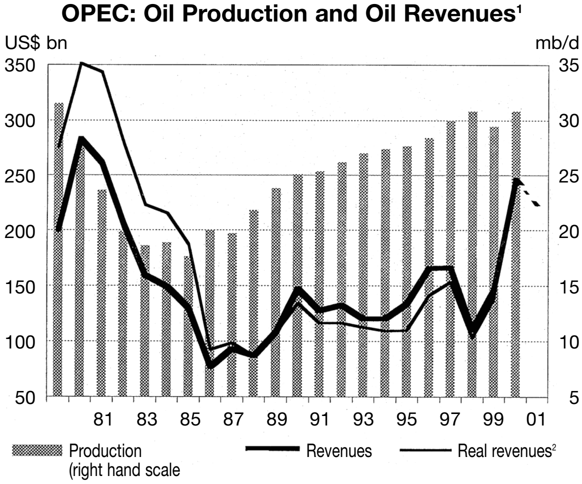
Sources: IEA; OPEC; author's own calculations.

ward off a further decline in prices by reducing production volumes. It is doubtful, however, whether the "automatic" adjustment mechanism[6] – which is supposed to prevent often protracted discussions among the OPEC members about the correct course of action to take – will come into effect. While all the OPEC members again confirmed their acceptance of the mechanism in January, this acceptance was augmented by a remark to the effect that production adjustments are also possible even if intervention is not necessary from the point of view of the adjustment criteria. Since its introduction last year, there has in any case been a tendency to decide on changes in production volumes irrespective of whether or not the conditions were fulfilled.

Production regulation – an instrument which, since the 1999 spring resolution to curb output, has once again been used to an increasing degree by OPEC as a means of stabilising oil prices at a high level – has had little effect on oil price fluctuations. This is due on the one hand to objective handling difficulties, which nourish fundamental doubts concerning the suitability of the instrument, but also, on the other hand, to the often protracted process of achieving agreement, which prevents swift reaction to changes in demand as they become apparent. A further factor are the – whether intentionally or unintentionally – sometimes contradictory announcements and denials, which, in turn, trigger off short-term price effects.

The unexpected unity shown by OPEC in output policy last year raised the level of oil prices well above the long-term average. The resulting increase in income will probably strengthen the willingness to maintain production limits for the foreseeable future. How united OPEC really is will be seen when further downward adjustments in production volumes become necessary. In the past, such cases led time and again to considerable disagreements regarding the allocation of output cuts among the members. Moreover, with increasingly large shares of the market being lost to independent producers, it could become more difficult for OPEC to prevent oil prices from falling. It is assumed here that by means of conjoint

Figure 2
OPEC: Oil Production and Oil Revenues[1]



[1] 2001 revenues: cf. text.

[2] Deflated using manufactured goods exports price. Base year 2000.

Sources: IEA; OPEC; author's own calculations.

[6] Cf. Klaus Matthies: Tight Supply Keeps Oil Prices Soaring, in: INTERECONOMICS, Vol. 35, No. 5, 2000, p. 256.

output adjustments OPEC will this year succeed in keeping the price of oil within its target area. Nevertheless, short-term price swings – determined by intervention and relatively low inventory levels – will probably remain strong. However, a pre-requisite for an oil price development of this sort is that the problems in the crisis regions of the Middle East do not lead to an escalation of violence and to confrontations. With the fronts hardening in the wake of Israel's spring election these risks have, if anything, actually increased recently.

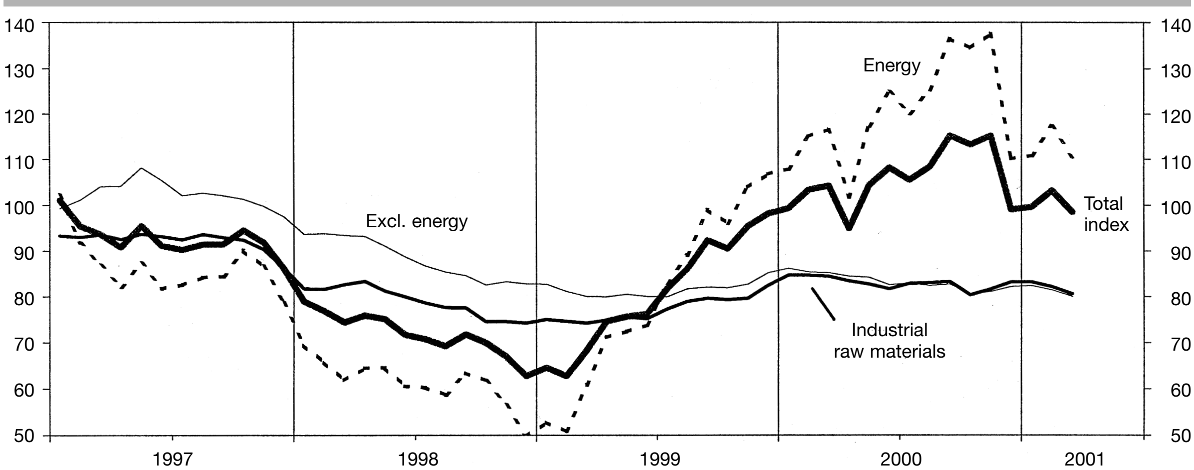
As a result of production agreements within the OPEC cartel, and in contrast to the prices for most other commodities, world market prices for crude oil have for the past thirty years been maintained at a level far in excess of the production costs in many of the oil-producing countries. In many of the oil-producing regions, production costs for a barrel of oil are less than 10 dollars, in the Middle East they are just two dollars.[7] This is all the more remarkable given that in the case of oil products, and of fuels in particular, considerable levies are added to the import price of crude oil in the form of petroleum taxes. This is particularly true of the EU, where, according to OPEC calculations, the average tax burden on oil products amounted to between 50 and 100 dollars a barrel in 1999. Taxes and duties accounted for around two thirds of the consumer price in these countries.[8] As a result, oil price fluctuations tend to have relatively little effect on consumer prices in Europe. In the USA, on the other hand, where the tax burden is just 14 dollars a barrel, the direct effect is much greater, albeit on the basis of far lower prices.

[7] Cf. on the various costs of production Jonathan Pershing: Fossil fuel implications of climate change mitigation responses, IEA, Paris, October 1999, Table 5.

[8] Cf. OPEC: Who gets what from imported oil?, http://www.opec.org

HWWA Index of World Market Prices of Raw Materials[1]

(1990 = 100)



Raw Materials and Groups of Materials	2000	Sep. 00	Oct. 00	Nov. 00	Dec. 00	Jan. 01	Feb. 01	Mar. 01[2]
Total Index	105.9 (31.5)	115.2 (24.8)	113.2 (25.1)	115.2 (20.7)	99.1 (0.9)	99.6 (0.3)	103.1 (–0.2)	98.5 (–5.4)
Total, excl. energy	83.3 (2.3)	82.7 (0.8)	80.6 (–1.7)	81.0 (–2.0)	82.1 (–3.6)	82.4 (–4.4)	81.4 (–4.6)	80.0 (–6.1)
Food, tropical beverages	84.3 (–10.5)	81.2 (–9.1)	81.3 (–9.3)	79.4 (–13.5)	79.2 (–15.1)	80.2 (–11.4)	79.5 (–9.2)	78.4 (–10.5)
Industrial raw materials	83.0 (7.5)	83.2 (4.6)	80.3 (1.2)	81.6 (2.5)	83.1 (0.8)	83.1 (–1.8)	82.1 (–3.0)	80.6 (–4.6)
Agricultural raw materials	81.9 (4.2)	80.6 (1.8)	78.4 (–0.8)	81.9 (3.8)	83.0 (1.2)	82.8 (–0.7)	81.8 (–1.4)	80.7 (–3.3)
Non-ferrous metals	83.0 (15.5)	86.8 (9.5)	81.3 (3.6)	79.0 (–0.6)	82.1 (–0.5)	82.1 (–5.5)	81.0 (–6.8)	78.2 (–7.5)
Energy	120.6 (50.9)	136.4 (37.8)	134.5 (40.0)	137.5 (32.4)	110.1 (3.2)	110.8 (2.8)	117.3 (2.0)	110.6 (–5.1)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 23rd March.