Klaus Matthies*

Production Cuts to Support Oil Prices

Most commodity quotations have continued to fall in recent months as a result of the weaker global economy. Crude oil prices, on the other hand, had been maintained at the high level targeted by OPEC since the start of the year, but lately they, too, have started to fall. Is the success of the oil exporters' change in production policy built to last?

World commodity prices have continued to fall in recent months. In August, calculated using the HWWA index on a US dollar basis, they were 11 % lower than a year previously (see HWWA Index of World Market Prices of Raw Materials, p. 276). In the case of industrial commodities, the price slide that began in very moderate terms at the beginning of last year accelerated this year in the wake of the global economic slowdown. These goods have become 13 % cheaper since the start of the year. In contrast, the decline in prices for food and tropical beverages, which has been going on for several years now, has finally come to a standstill. Energy commodity prices, which are largely determined by oil price developments, have fallen below the level they had at the start of the year. While the terrorist attacks in the USA initially sent quotations for Brent crude shooting up to more than 30 dollars a barrel, they fell markedly in late September as recession concerns grew.

Spot market quotations for crude oil were again subject to considerable volatility this year, although the rises in the price of Brent crude (which reached a peak of 31 dollars) were relatively small compared to those of last year (when the peak was 37 dollars). The average price for the OPEC basket of seven kinds of oil, which is slightly lower than that of Brent crude, fell below OPEC's target price band of 22 to 28 dollars only in late September.[1] In real terms, i.e. measured in terms of export prices for industrial goods, the present level of oil prices is much higher than during the second half of the 1980s and the 1990s, but lower than during the period of high prices from 1979 to 1985 (see Figure 1).

Higher Oil Prices Dampen Demand

As a consequence of the substantial rise in oil prices during the past two years, demand for oil has increased at a markedly slower rate, growing at 0.9 % last year compared to 2.2 % in 1999. In the first half of 2001, global oil consumption was 1 % higher than a year previously.[2] In the first half of the year, world oil supply initially increased at a stronger rate than demand following last year's strong output expansion that was spawned by improved revenue prospects. However, output growth in the non-OPEC countries did not keep up with market expectations. In most of these countries, oil production has stagnated in recent months as readily available output capacity has now been largely exhausted. Oil companies' capital expenditure is only gradually creeping back up to a level comparable with the period prior to the oil price slump of 1998, and in some cases the delay between investment and output expansion can amount to several years. Only in Russia did the expansion of domestic oil production lead to a marked increase in oil exports. The coming year will again bring strong growth in production, which in the past two and a half years has expanded by around 15 %.

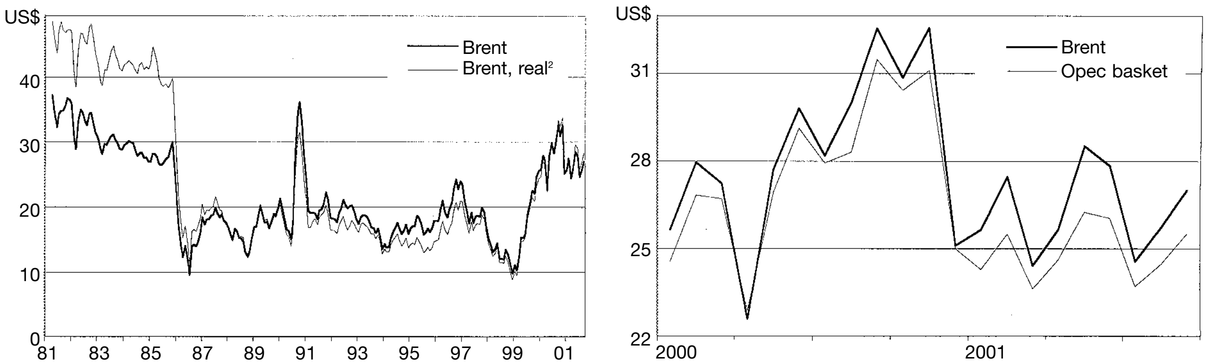
Given the current weakness of global economic growth, any increase in demand for oil can be

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

[1] The last time it had been outside the target price band was in December 2000.

[2] Cf. IEA Oil Market Report, September 2001.

Figure 1
World Market Prices for Oil[1]

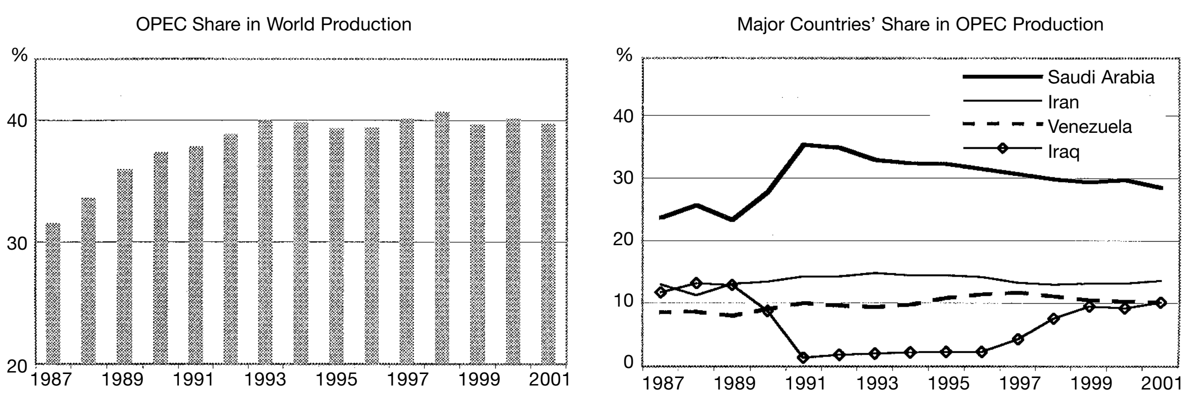


[1] Spot prices fob per barrel (monthly figures; September 2001: until 21st).

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

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

Figure 2
OPEC Countries' Oil Production Shares 1987-2001
Annual figures[1]



[1] 2001: August.

Source: IEA; author's calculation.

expected to be relatively slow at first, despite lower oil prices. Following several downward corrections to its forecasts, the International Energy Agency (IEA) now expects demand to increase at only 0.7 % this year, which is even less than last year. The increase is hardly likely to be much higher next year either, as energy consumption among Asia's emerging economies – which were a major source of additional demand in the past – is being increasingly subdued.

The oil supply from non-OPEC countries will also continue to increase, especially as a result of enhanced Russian exports. The inclusion of further countries in OPEC production agreements has been of very limited success so far, and can probably be expected to founder on disparate national interests in the future too. As a consequence, the OPEC countries will probably have little scope for increasing production in the foreseeable future should they wish to prevent a decline in oil prices.

In view of the subdued demand for oil, the OPEC countries this year felt repeatedly obliged to counteract declining prices by reducing output volumes. So far, three resolutions to cut production – which together amounted to 13 % of the output volumes of the ten countries involved (see Table 1) or just under 5 % of global output – ensured that the price of oil remained within the target price band until recently. The latest OPEC agreement, which took effect in September, was signed at the end of July under the impact of further falling prices, although shortly beforehand there had been talk of a possible expansion of production.

Output Quotas Exceeded

Against this background, it was questionable whether the OPEC countries would be particularly rigorous in the implementation of their latest resolution. While OPEC representatives made an assurance as recently as at the start of September that cuts in oil output would be implemented in line with the official resolution, oil production in August was 0.7 million barrels greater than agreed. In view of the poorer global economic outlook, the pressure being brought to bear on OPEC by the oil-consuming nations to lift production limits intensified after the events of September 11. OPEC's secretary-general promised that the organisation would implement any necessary measures to prevent an explosion of crude oil prices.[3] The recent drop in crude prices due to a weakened oil demand changed the situation. After the decision by OPEC ministers at their September meeting to leave the production quotas unchanged the member countries will probably reduce their output to the agreed levels in order to stabilise crude prices. There will be a time lag of several weeks before any throttling of OPEC production is felt on the product markets in the oil-consuming countries.

The increase in spot market price quotations following the terrorist attacks in New York and Washington was of a temporary nature only, but a renewed rise is to be expected if the actions and counter actions in response to the attacks lead to an intensification of the conflicts in the Near East and to oil supply restrictions. In that case there would almost certainly be a sharp and rapid increase in oil prices.

Changes in OPEC production policy during the past two years, expressed in terms of a stricter adherence to agreed output limits, has raised the level of oil prices well above the long-term average. Given the success felt by the oil producers in terms of greater revenues from oil exports,[4] it can be assumed that

[3] Cf. Alexei Barrionuevo: Crude-oil prices soar amid fear supplies could be disrupted, in: Wall Street Journal, 12.9.2001.

[4] Cf. Klaus Matthies: Steadying of Oil Prices, in: INTERECONOMICS, Vol. 35, No. 2, 2001, pp. 109-112.

Table1
OPEC: Crude Oil Production Quotas and Actual Production
(in million barrels per day)

	Oil quotas				Agreed	Production in		Change since
	October 1 2000	February 1 2001	April 1 2001	September 1 2001	2001 cuts (%)	January 2001	August 2001	January (%)
Algeria	0.85	0.81	0.77	0.74	-13.1	0.85	0.85	0.0
Indonesia	1.39	1.31	1.26	1.20	-13.1	1.26	1.21	-4.0
Iran	3.92	3.70	3.55	3.41	-13.0	4.05	3.75	-7.4
Kuwait	2.14	2.02	1.94	1.88	-13.1	2.22	2.03	-8.6
Libya	1.43	1.35	1.30	1.24	-13.2	1.45	1.39	-4.1
Nigeria	2.20	2.08	1.99	1.91	-13.1	2.18	2.07	-5.0
Qatar	0.69	0.65	0.63	0.60	-13.2	0.74	0.70	-5.4
Saudi Arabia	8.67	8.19	7.87	7.54	-13.1	8.64	7.89	-8.7
UAE	2.33	2.20	2.11	2.03	-13.2	2.45	2.10	-14.3
Venezuela	3.08	2.90	2.79	2.67	-13.2	3.03	2.81	-7.3
OPEC 10	26.70	25.20	24.20	23.20	-13.1	26.87	24.80	-7.7
Iraq[1]						1.73	2.79	61.3
OPEC total						28.59	27.59	-3.5

[1] Iraq is not a party to the production agreements.
Sources: IEA; OPEC; author's own calculations.

output discipline will remain resolute for the time being. Whether or not the fact that output limits have been exceeded in recent months[5] can already be interpreted as an indication of crumbling unity among OPEC members or whether this additional production was merely intended to compensate for lower exports from Iraq is currently unclear. Oil deliveries from Iraq take place under United Nations supervision within the framework of an export programme that is reviewed semi-annually; deliveries were discontinued in June as a result of disagreements between Iraq and the UN. The interruption was shorter than the previous occasion, however, and Iraqi exports quickly returned to more or less normal levels during the course of July. Purchase approval for spare parts and equipment within the framework of the oil export programme could even enable Iraq to increase its output capacity in the coming months.

Prices To Fall Next Year

The current level of oil prices is considered by OPEC representatives to be acceptable for the oil-consuming countries. In answer to the view that weaker demand for oil is the result of high crude oil prices, OPEC points to the fact that, in many industrialised countries in particular, the price of crude oil accounts for only a small proportion of the price finally paid for oil products, so that the resulting burden for the consumer is relatively small. The OPEC countries will continue their efforts to maintain the price of oil in the region of 25 dollars a barrel for the OPEC basket and will vary their output accordingly. As this will only be possible to a limited degree – if only because of insufficient knowledge about the current supply situation – we can expect spot market quotations to continue to be subject to considerable short-term volatility. Next year, oil prices should fall slightly as a result of weak oil demand on the one hand and supply growth from non-OPEC countries on the other. Assuming that the political and military response to the terrorist attacks in the USA does not jeopardise oil supplies, the HWWA expects an average price for Brent crude of 24 dollars a barrel in 2002, following 25 dollars this year.

The fact that the price of oil has been moving within the OPEC target corridor this year pays tribute to the organisation's modified production policy, which is characterised by a swifter response to approaching changes in the oil markets. In this context it would appear that the "automatic" output adjustment mechanism presented by OPEC in the spring of 2000 and officially accepted by the member countries at the start of this year has already become redundant.[6] Instead, the OPEC countries now implement adjustments in a different manner, by means of formal resolutions or, as in July, informal consultations.

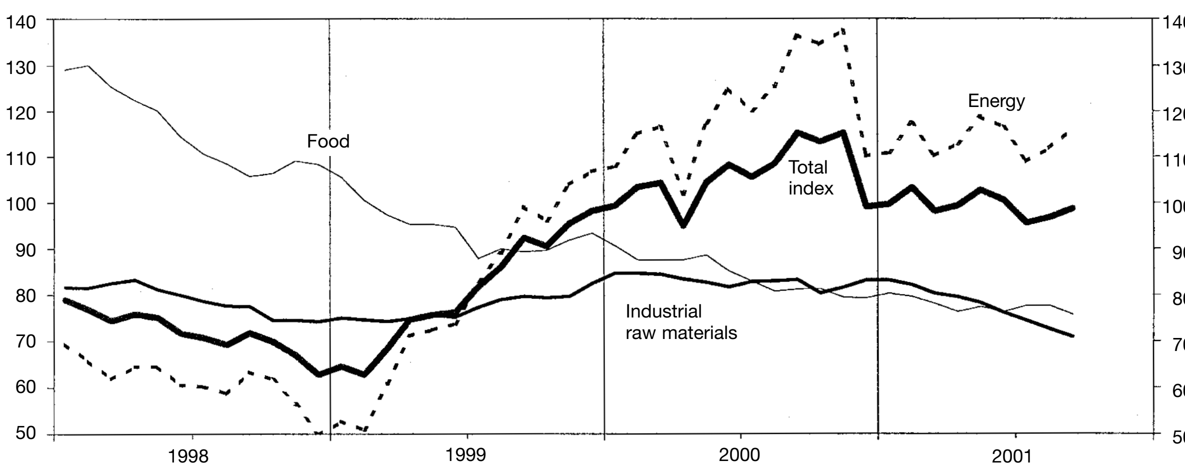
[5] Excluding Iraq, the ten OPEC countries produced 3 % more than agreed in August.

Whether or not this success can be maintained is uncertain. Three quarters of the world's entire oil reserves are accounted for by OPEC member countries, and in the long term this high concentration of reserves will place OPEC in an ever stronger position when it comes to influencing global oil supplies. In the next few years, however, the question of available reserves is unlikely to be of decisive significance. In the short to medium term, the relatively high level of oil prices improves the competitive position of OPEC's rivals – countries with substantially higher production costs than the OPEC countries. As a result of its output policy, OPEC's share of global production has already fallen to just under 40 % (see Figure 2). Moreover, greater incentives to use oil more efficiently and to develop energy alternatives are accelerating the "departure" from oil. As the pressure on prices increases, OPEC could soon feel obliged to reduce output further than planned. It is doubtful whether it will then be easy to maintain unity among the organisation's member countries. In particular, the question of a "correct" allocation of production quotas among the member countries remains unresolved. This is an issue which has repeatedly occupied OPEC summits in the past, and while it has been pushed to the sidelines for the time being by the sharp rise in export revenues enjoyed by all the oil producing countries, it could once again jeopardise OPEC unity should a more radical reduction in production quotas become necessary.

[6] According to this mechanism, the price of oil for the OPEC basket would have to be below the 22 dollar mark for ten consecutive days of trading before production could be throttled. At the top end of the scale, the price ceiling would have to be exceeded for 20 days.

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

(1990 = 100)



Raw Materials and Groups of Materials	2000	March 01	April 01	May 01	June 01	July 01	Aug. 01	Sep. 01[2]
Total Index	105.9 (31.5)	98.1 (–5.8)	99.3 (4.6)	102.6 (-1.6)	100.5 (-7.1)	95.5 (-9.4)	96.8 (-10.6)	98.7 (-14.3)
Total, excl. energy	83.3 (2.3)	79.7 (–6.5)	78.6 (-6.9)	78.0 (-7.3)	76.1 (-7.8)	75.2 (-9.3)	73.8 (-10.4)	72.1 (-12.8)
Food, tropical beverages	84.3 (–10.5)	78.1 (–10.8)	76.2 (-13.0)	77.4 (-12.6)	76.2 (-10.5)	77.6 (-6.5)	77.5 (-3.9)	75.7 (-6.7)
Industrial raw materials	83.0 (7.5)	80.2 (–5.0)	79.5 (-4.7)	78.2 (-5.4)	76.1 (-6.9)	74.3 (-10.3)	72.6 (-12.5)	70.9 (-14.8)
Agricultural raw materials	81.9 (4.2)	80.3 (–3.7)	79.1 (-5.6)	75.9 (-6.8)	74.0 (-7.9)	72.8 (-10.9)	71.1 (-13.6)	69.2 (-14.1)
Non-ferrous metals	83.0 (15.5)	77.6 (–8.3)	76.4 (-4.6)	78.3 (-4.9)	74.6 (-7.8)	71.1 (-14.1)	68.5 (-17.0)	66.7 (-23.1)
Energy	120.6 (50.9)	110.1 (–5.5)	112.7 (10.9)	118.7 (1.1)	116.4 (-6.7)	108.8 (-9.4)	111.8 (-10.7)	116.1 (-14.9)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 21st September.