# Oil, the Crisis Evolves



## Oil producing countries dream of a slow but steady rise in prices, but realize that it will take years to recover from this year's shock

*In our previous issue, VOICES OF MEXICO presented a government specialist's analysis of the events that led to this year's oil crisis. This article presents a slightly different analysis: the same crisis and its effects on Mexico's economy today, as seen by a private specialist. Irving Roffe is a leading expert on Middle East affairs and a member of ANAFACTA, a privately-owned think-tank. Mr. Roffe's views:*

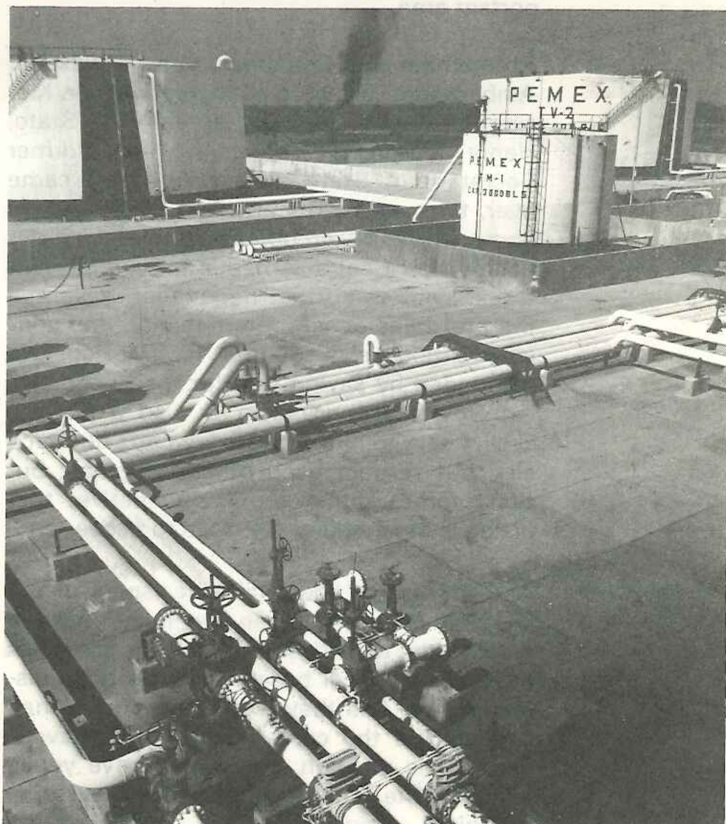
Like all really important news, it came across the wires in just a few words. The Oil Minister of the United Arab Emirates, Mana Said El-Oteiba, declared last November that "from this moment on, each member of OPEC is free to produce the amount of oil that they so desire...There will be no more sacrifices."

The announcement came as no real suprise to anyone directly involved in the process. But it did confirme peoples 'worst fears; what had been mere pessimistic speculation, became a reality to be confronted. If not, national economies might plummet, the international banking system might be endangered and quite unpredictable political consequences might result. Thus, those simple words set off what is now being called, the "third oil shock." Some of the implications have yet to be played out completely, and the problem is far from resolved.

### SIMPLE WORDS AND MAJOR EVENTS

Mana Said El-Oteiba's statements did not, in and of themselves, unleash the third oil shock. Rather they simply described an already existing situation whose development had begun some five years ago. New oil producers such as Mexico, Great Britain and Norway had entered the market, cutting into those that had previously been dominated by OPEC. For example, in 1979, the oil cartel controlled more than sixty percent of the world oil export market; by 1985, the figure had dropped to thirty percent. This reduction had profound effects on the cartel because it implied that the member countries would have to limit their production. If not, they would run the risk of having prices plummet.

It was in this context in 1981 that OPEC established a system of production quotas for member nations. But from the very beginning, the quotas were systematically broken by all of the members, with the exception of Saudi Arabia. In fact, the Saudis voluntarily assumed the role of limited, stable production, exporting between 2.5 and 9 million barrels of oil per day. But the decision brought them more headaches than advantages, and they were constantly faced with the dilemma of having to produce more or




PEMEX facilities

Photo by Rogelio Cuellar.

suffer noticeable restrictions in their economy. By mid-1985, after an uninterrupted, ten-year boom period, the Saudis had a $30 billion deficit in their current accounts.

Given the situation, it was totally predictable that OPEC would try to do something to break out of their trap. That "something" was guided by two basic objectives: first, to force their competitors to reduce production, thus opening the way for OPEC to win back some of its lost markets; and second, to force cartel members to abide by the rules of internal discipline as a measure to prevent à potential definitive split in OPEC.

According to an OPEC study published in the cartels' magazine, *OPEC Review* (Spring 1986), their only option for confronting their competition was to cut prices. If they had raised prices, as they did during the "oil shocks" in 1973 and 1980, they would only have made the situation worse for themselves, allowing their competitors to gain even greater advantages on the world market. Thus, OPEC took into consideration the fact that their production costs are the lowest in the entire world; for example, fifty cents a barrel for Saudi Arabia and $1.20 a barrel for Kuwait. If OPEC (or at least the Persian Gulf members) were to increase production, and thus lower world market prices, they could cut out some of their major competitors. This is particularly true in relation to North Sea producers, where production costs vary from $5 to $10 per barrel, and to Alaska, where production costs are possibly the highest in the world, $25 per barrel.

By the end of 1985 and beginning of 1986, there were occasional reports of increased Saudi production, which Riyad systematically denies. Nonetheless, prices began to plummet at a dizzying pace. From an average price of $25 per barrel in mid-1985, prices dropped to $9.90 by mid-February 1986.

## A VERY SPECIAL CASE

OPEC's major competitors entered the world oil market beginning with the second "oil shock" in 1980. Prices had soared to such an extent (almost $40 per barrel on the spot market) by then, that consuming countries and multinational companies began to seek alternative supply sources. The high prices meant that certain regions, like the North Sea and Alaska, where production costs had made operations there economically unfeasible in 1973, could now be opened for profitable production.

But that was not the case with regards to Mexico, even though the country had also entered the market in 1980 and seen its share grow, at least until the beginning of this year. Before 1980, Mexico had confronted the problem of how to self-finance an adequate oil platform. But the problem was finally resolved with relative ease. As Alan Riding tells it in his book, *Distant Neighbors*, major banking trusts literally fought among themselves to loan money to Mexico. The country had all the characteristics of a secure and profitable investment.

Nonetheless, while Mexico was in fact an OPEC competitor, it had opted for a rather prudent, non-confrontational policy. Unlike Great Britain, and until recently, Norway, who refused to limit production to sustain prices, Mexico not only participated as an observer in major cartel meetings, but also maintained close communication with OPEC in designing its own market strategy.

Photo by uno más uno

Alfredo del Mazo, Secretary of Energy, Oil and Nationalized Industry with Mario R. Beteta, Director of Pemex.

## THE DAMAGE IS ALREADY DONE

The third "oil shock," however, has already set off a process that will profoundly change the market. For now, it means that most countries view the question of pricing from a different optic. At first, importing countries saw the plummetting prices as a blessing. A U.S. government official even declared that "the price of oil is a tax that countries have to pay to make their economies function." Cheap oil would mean less inflation, a real drop in prices to the consumer and the posibilitiy that consumers, and not producers, would now determine prices and contractual conditions.

But these advantages appear only when the situation is analyzed from a purely economic point of view. In political terms, cheap oil presents a rather more somber picture. Contrary to what happened with the second "oil shock," now some oil producing regions have become unprofitable. To this, must be added the fact that banks had invested huge sums in oil development ventures, many of which had yet to report a profit. The end result is

that importers are once again increasingly dependent on the Middle East for oil.

There is another economic issue that has important political implications. International banks not only financed oil projects in their own countries, but also in other countries, whose major source of wealth in most cases were their petroleum deposits. Their economies soon became dependent on their capacity to export oil, in such a way that foreign exchange income hinged to a large extent on export levels. This is the case for Norway, where 40% of its foreign exchange comes from oil exports, for Venezuela (95% of its foreign exchange) and for Mexico (75% of its foreign exchange).



The drop in oil prices has cut foreign exchange income for these countries in half, thus greatly reducing their capacity to meet debt payments. In the majority of cases, they have been forced to implement severe austerity programs, which have been accompanied by growing public discontent. Many countries which had been considered politically stable, now potentially face the prospect of social unrest. And this posibility is not just restricted to developing countries; in industrialized Norway, for example, the oil question played an important role in bringing about the change from a Conservative government to one headed by Laborite Gro Harlem Brundtland.

The Mexican case has received special attention because of the eloquence of the figures. Its foreign debt is $95 billion, and it is likely that the country's income will fall by some $4.5 to $6 billion this year. In order to make payments on its debt, the country would have to make further cuts into its already greatly restricted budget. In 1983, Mexico was considered to be a model debtor by the international banking system, regularly fulfilling its obligations. Nonetheless, the current situation is influenced by factors beyond Mexico's control. In particular the drop in oil prices is due to a more generalized crisis, which in turn is determined by a diversity of factors. The fact that Mexico controls five percent of the world oil export market has meant that the country has been severely affected by the overall crisis.

From Mexico's point of view, then, it would be futile to implement unilateral measures in an attempt to correct the situation. In February, the ex-Minister of Energy, Mining and Para-State Industries, Francisco Labastida Ochoa, stated to the Mexican press, "If we were to unilaterally reduce our oil exports, as has been suggested, we would simply leave the market open to others, who would immediately move in on it." Recognizing the fact that a surplus of some two to three million barrels of oil are offered on the market daily, Labastida added, "Solidarity and coordination among exporting countries is more important today than ever before." His last statement may seem rather dramatic, but more and more countries are taking the idea seriously.

## WHAT DOES THE FUTURE HOLD?

The oil market has been quite erratic recently, experiencing significant fluctuations. In February, the barrel price had dropped to $9.90, the lowest level in 13 years. Two months later the price was back up to $17, only to drop once again, shortly thereafter. A number of different reason have been given to explain this phenomenon, although no single one provides a complete explanation. Perhaps the most plausible of explanations, however, lies in the fact that a strike in Norway paralyzed that country's production (almost one million barrels per day), while Britain closed down two of its platforms for maintenance, taking an additional 200,000 barrels off the market every day. These two situations brought about the increase in prices. But when the strike was settled and Englands' platforms went back into service, prices plunged again.

The temporary price increase injected new spirit into producing countries. OPECs' most recent campaign has been to make contact with independent producers, expecially Egypt, Malasia, Angola and Mexico. Their objective is to get these countries to agree to reduce production by some 100,000 barrels per day. The negotiations have already produced some results, among them, Mexico's stated willingness to reduce the rhythm of its exports. And Norway has also begun negotiations with Venezuela, accepting in principle the need to restrict its share of the market.

In general, it seems that major producers have drawn a series of conclusions from the third "oil shock." One of them is the need to optimize prices; the current low prices have caused serious economic problems for a number of countries. Yet, the soaring oil prices of the second "shock" were really counterproductive, especially for OPEC, in that they brought so many new competitors onto the scene and as a result, produced the present super-saturated market. A number of statements have been issued in recent weeks, both by producers and consumers, calling for a $20 per barrel price.

That is not an impossible goal, although it is still a distant prospect. In the meantime, debtor nations will have to try to repair the damage already caused by the third "oil shock." One thing they must confront is the need to modify debt payments in accord with the current situation. For Mexico, this has meant seeking new agreements with its creditors to retain a certain degree of flexibility in its efforts to promote economic growth. And even though predictions call for a gradual recovery in oil prices, nations with oil-dependent economies will have to work for years to reestablish their stability.★