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OIL PRICES AND WORLD MONETARY SCENE

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Towards the close of the year, 1973, the Organization of Petroleum Exporting Countries, OPEC for short, decided to quadruple the international price of oil. The price rise thus decided upon become effective from the beginning of 1974. As can be seen from Table 1, over the next five years, 1974-78, both years included, the price received by OPEC for its oil registered an improvement of only 35%. In mid-1979, however, the price was raised by 60%, to be followed by a further rise of 60% effective from the beginning of 1980. The result of the two successive hikes decided upon within a short span of six, seven months, i.e. between June and December 1979, has been that the price of oil has more than doubled. This naturally will lead to an increase in the OPEC oil revenues from $ 125 billion in 1978 to $ 277 billion in 1980, assuming no increase in the offtake of oil from PEC which was estimated at 10.14 billion barrles in 1978.

That the increase in oil revenues accruing to OPEC in 1980 is quite substantial, at least in absolute monetary terms, can easily be seen, when one compares it with the increase accruing to them in 1974, after the oil price was quadrupled. Then the OPEC oil revenues had gone up from $ 23 billion to $ 92 billion i.e. by $ 69 billion. But there can be little argument that the additional dollar on oil revenues in 1980 does not mean the same in real terms as it did in 1974 since, among other things, the prices of goods and services that OPEC imports have gone up considerably in the meanwhile. In fact that is the principal justification OPEC have adduced in defence of the price rises decided upon in 1979. Still, the storm signals have gone up practically all round to warn that a very serious, almost cataclysmic economic situation has arisen for the oil importing world, facing as it would be a very much larger strain on its balance of payments. In fact, voices have now been raised foreboding that the new crisis posed by the oil exporting world will be far more serious than the one in 1973. In particular, the fear has been expressed that the global monetary and financial system "that is perhaps terminably sick and certainly much weaker than it ever was back in 1974-75" might collapse under the weight of the new crisis.[1/]

Not that there is anything particularly to sacrosanct about the present global monetary and financial system. But it certainly has served the developed industrial countries, as a group, very well. So it is quite understandable that people there who see this system collapsing feel alarmed. On the other hand, for the vast non-developed, non-industrialised world which gets a raw deal under the dispensation of the present financial and monetary system its collapse could possibly hold a prospect of something better emerging. In any case, people in the deprived two-thirds of the world need not shed any tears should this system collapse.

But are we so sure that the present monetary and financial system is really in danger of imminent collapse and that too under the weight of the price pressures from the oil exporting countries? It is to this question that this paper addresses itself first and foremost, drawing on the experience gained since the price of oil was raised towards the end of 1973.

The First Round

Let us start with a quick over-view of the world monetary scene that obtained at the time of the increase in the price of oil in October 1973. The old regime of fixed exchange rates, often referred to as the Bretton Words System, was already in shambles and for no fault of the oil exporters. Flexible exchange rates were very much the order of the day at least among the principal trading nations of the world. Though the principal reserve currency, the U.S. dollar, was no longer convertible into gold, it continued to be the major source of monetary reserves even after the shift from fixed to flexible exchange rates. Thus the centre-piece of the World monetary system, namely the dependence on a few national currencies, one or two, for the settlement of accounts between different countries and for monetary reserves remained very much intact. There was no shift from this, not even from the old reserve currency, the dollar.

When the oil price was quadrupled in 1973, it did immediately create apprehensions about the ability of the monetary system to cope with the payments inbalances that would ensue as a result between the oil exporters and the oil importing countries. These inbalances were expected to be both large and persistent. Actually, however, while they did turn out to be large to start with, they started declining quite fast so that by 1978, they had altogether been absorbed. As can be seen from Table 2, the balance of payments surplus on current account of the major oil exporting countries had declined from \$ 68 billion in 1974 to \$ 6 billions in 1978, to the same level as obtained in 1973. This came about principally because of considerably increased imports by oil exporters at significantly enhanced prices.[2] Unfortunately, however, the benefits of this increased OPEC demand for goods and services accrued almost entirely to the industrialised countries, accounting as they did for almost 85% of the additional imports by the oil exporters.[3] The result has been that while the industrialised countries, as a group, were able to regain the position of a commanding surplus by 1978, the non-oil developing countries were as badly off in 1978 as in 1974. In 1978 they paid higher prices for not only their oil imports but also their imports from the developed world. In the end, therefore, it is this latter group of countries that has come out rather badly after the adjustments to the oil price rise of 1973 have worked themselves out. The other group of countries to suffer has been that of the more developed primary producing countries. The overall result naturally has been that in 1978 though the oil exporting countries had a surplus in balance of payments no larger than in 1973, the gross global inter-group gross imbalance in payments on current account was still more than four times as high as in 1973.

IMF's Abdication

From the point of view of the world monetary and financial system, however, it is the gross imbalance in payments between countries that is significant because it indicates the extent of financial intermediation that is called for the settlement of international payments. Thus, for instance, since the inter-group gross imbalance in 1974 was more than four times as high as in 1973, the extent of financial intermediation required between the group can be said to be correspondingly higher.

In order to meet this demand for financial intermediation on the new scale a number of proposals were mooted for a substantial recycling of funds from the countries with payments surpluses to the countries with payments deficits under multi-lateral auspices. However, all that could be organised for the purpose was the Oil Facility in the International Monetary Fund. Compared to the gross inter-group imbalance of $ 101 billion in 1974 and 1975, this special IMF facilities could come forth with something like $ 7.9 (SDR 6.5) billion. Other drawings from the Fund, in the course of the same two years, amounted to $ 6.3 (SRD 5.2) billion.[4] Thus the Fund's response to the member countries to meet probably the most extra-ordinary situation faced by them since its establishments turned out to be pitifully inadequate. In the circumstances, the main task of settling the large balance of payments depicts had to be undertaken under some other suspices. These auspices were provided by the international capital market.

Euro-currency Expansion

Cross border borrowings on the international capital market had been rising rapidly during much of the period from the mid-1960's through the early 1970's, the period spanning the dying phase of the Bretton Woods per value system. Since these lendings, though organised in European countries, were denominated in dollar, they were generally referred to as Euro-dollar operations. However, the real upsurge in these operations came about after 1973.

As can be seen from Table 3, net external lending by bank (excluding bond financing by the market) was almost twice as large during the quinquennium ending with 1978 as the amount of net bank claims outstanding at the end of 1973. A substantial, though not all, of this bank lending went to help countries settle their large balance of payments deficits on current account.

What exactly spurred the Euro-dollar market to take on this major role of financing balance of payments deficits is a matter one can speculate about. But the situation was basically like this. On the one hand, were these oil exporting countries with a large accretion of funds which they could not immediately absorb and which they were willing to place, in large proportion, in this market. On the other hand, there were several countries faced with an enormous upsurge in their balance of payments deficits to finance which they had nowhere else to turn to. So the private banks and other institutions already specialising in international lending even though it was meant largely for project financing stepped in to the breach.

A reference back to Table 2 will show that more than ~~two-thirds~~ of the inter-group gross imbalance (i.e. the aggregate of inter-group deficits ignoring the surpluses) during 1974 and 1975 were accounted for by the non-oil developing countries. In the following three years, 1976 to 1978 though the gross imbalance was somewhat lower, with the non-oil developing countries still accounting for two-thirds thereof, the expansion in Euro-dollar lending was very much larger than in the two years immediately preceding, 1974 and 1975, relative to the gross imbalance. As against the gross payments imbalance of $ 111 billion, Euro-dollar lending expanded by $ 100 billion during 1974 and 1975, whereas during 1976 to 1978 Euro-dollar lending expanded by $ 255 billion as against the gross payments imbalance of $110 billion.

It is also worthwhile noting in our context that during this latter part of the quinquennium, 1974 to 1978, the surplus in balance of payments of the oil exporting countries declined drastically from $ 40 billion in 1976 to $ 6 billion in 1978 while the surplus of t industrial countries recovered significantly from $ 7 billion to $ 33 billion.

Two points can be made straightaway. Firstly, whatever push the initial placement of the OPEC surplus funds in the Euro-dollar market may have provided for the market to expand its lending, the subsequent expansion of the market lending can be ascribed only partly to that source of supply of funds. Secondly, increasingly the expansion of Euro-dollar market lending seems to have taken place out of proportion to, and quite independently of, the deficits in the balance of payments on current account.

The Second Round

Given the increases in oil price already decided upon in 1979 and with the prospect now of further increases to follow, how will the world monetary system in general and the Euro-dollar market in particular cope up with the consequential imbalance in the balance of payments of the countries. There is absolutely no indication that the International Monetary Fund either is prepared or is preparing to meet the possible new demands for financial intermediation. True, that (a) Fund quotas will soon be revised from SDR 39 billion to SDR 59 billion and (b) a supplementary financing facility has been set up with funds amounting to SDR 7.75 billion to assist members with balance of payments problem that are larger relative to their quotas.5/ But these steps have to be seen in the context of a likely OPEC surplus of over $ 80 billion in 1980 and a much larger gross imbalance for the oil importing countries. At the same time it cannot be overlooked that even a $ 100 billion deficit of the oil importing world, in 1980 as against $ 53 billion estimated for 1979, will be less than the net increase in Euro-dollar lending of $ 110 billion in 1978.

Of course, the more the world comes to depend on the Euro-dollar market for financing its balance of payments the greater will become its hold on the world monetary scene but this is not something that those in control of the private banks will not really welcome. Though the International Monetary Fund is a multi-lateral institution in conception, in effect it is very much in the control of the same group of countries that controls the Euro-dollar market. It should be quite understandable if inspite of the fact that the Fund has been reduced to the role of a bystander it has hardly raised any protest. Nor will it protest in the future.6/

The likelihood seems to be that the world will be stuck with the system of liquidity generation that has evolved over the past five years, however much one does not approve of it. And, the developing countries, especially the non-oil developing countries, have every reason to worry on this score because (a) they are the ones likely to be worst hit over the coming years as this vicious process of oil price rise leading to the rise of industrial imports which causes a further upsurge in oil prices continues unabated and (b) this system of generating liquidity is as, grossly unjust as, possibly more than, that under the old system.7/ The major difference it has made now is that the banks, largely U.S. owned, instead of the U.S. government, generates the necessary finance.

Gold price.

One should take note, however, of the major assumption underlying the question posed in the preceding section. The assumption is that the oil exporting countries will continue to place their surplus funds in the Euro-dollar market in the same proportion at least as before. How far will this assumption hold good in the future?

The current phenomenal spurt in the international market price of gold from less the $ 300 to over $ 850 an ounce within a short span of 6 to 7 months (See Table 4) is being widely attributed to the attempt on the part of the oil exporting countries to move into gold. It is quite understandable that these countries should want to move out of currencies, especially dollar, holding which has provided them with little hedge against continuing world wide inflation, whatever may be the role of the concerned countries themselves in keeping the fire aflame. At the same time, the manner and pace at which the price of gold has rocketed should leave none in doubt about the prospects of success the oil exporting countries will have in making any marked shift into gold.

The likelihood, on the other hand, seems to be that the more this realisation sinks in in the oil exporting countries, particularly those of them with sizeable surplus funds, the more they may at long last get round to the view, a la Ayatollah Khomeini, that surpluses had best be left stored underground until such time as they actually need them either for their domestic use or to exchange them for imports of goods and services. But this will meet strong resistance from the oil importing world, particularly the segment that gobbles up three-fourths of the quantity exported. It may not be prepared to reduce its demand for oil below the level already reached because it see in oil a base for its current life style. In the circumstances, for the oil exporting countries to significantly reduce the volume of their oil exports might bring them face to face with military threats. If those threats materialise, it will certainly not leave the world monetary scene unaffected but the end result can then be anybody's guess.

Concluding Observations

However distasteful the developments in the world monetary field in recent years, especially the evolution of the system of recycling and generating finance through the Euro-dollar market, it is highly unlikely that the new surpluses generated by the increase in oil prices just decided upon (and even the increases that might well follow) will throw this system out of gear. The danger possibly lurks in another corner, a corner to which the recent upsurge in the price of gold is a pointer though a rather indirect one. To the extent that this upsurge in the price of gold reflects (a) the decision on the part of the oil exporters to hold their surpluses hereafter in gold and not in Euro-dollar d[illegible]s or national currencies of other countries and (b) the extreme unwillingness on the part of the holders of existing gold and traditional buyers of newly mined gold to make way in favour of the oil exporting countries.

it may well lead to developments which endanger world peace and through that the whole institutional order including the world monetary order. But the present world monetary order is the one about whose demise at least we in the developing world should least be grieved.

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Notes and References

1/ See The Petro-Crash of the '80s, Business Week, November 19, 1979. Though written in advance of the OPEC meeting in December 1979, the article evidently had strong premonition of the order of price rise round the corner. Its main conclusion seems to be that the OPEC by using its control over the supply and price of oil in this manner is so rushing the West towards the edge of economic survival that "the option of a military response becomes more and more reasonable."

2/ See Rehman Sobhan, Financial Flows between Developing Countries: Prospects for Economic Cooperation between OPEC and the Third World, Centre for Research on New International Economic Order, 1979 (mimeo). According to Rehman Sobhan's calculation, out of $ 451 billion received by OPEC by way of additional revenue in 1974-78 in consequence of the hike in the price of oil, as much as $ 274 billions or 61% was absorbed by inflation in the prices of goods and services that OPEC imported during the same period. This assessment differs totally from the assessment of the IMF, which ascribes the decline in the OPEC current account surplus between 1974 and 1977 to the substantial expansion in the volume of OPEC imports, although at a decelerating pace and that in 1978 almost entirely the fall in the volume of oil exports. See IMF, Annual Report, 1979.

3/ See Rehman Sobhan, op.cit.

4/ See International Monetary Fund, Annual Report 1978, Chapter 3, Activities of the Fund.

5/ See International Monetary Fund, Annual Report 1979, Chapter 2, Developments in the International Monetary System.

6/ The latest Annual Report (ibid) of the Fund observer as follows on the reported growth in the provision of credit by the international capital market during the decade of the 1970's:

> "It is widely recognised that private banking institutions contributed greatly to the smooth functioning of the world trade and payments system in the years 1974-76 by recycling the funds deposited by oil exporting countries and they can be expected to continue to play a major role in international financial intermediation in the future."

7/ See I.S.Gulati, International Monetary Development and the Third World: A proposal to reduces the imbalance, R.C.Dutt Memorial Lecture, February 1979.

Table 1

Average Net Price* per Barrel of Crude Received by OPEC during 1973-1980

Year		1973	1974	1975	1976	1977	1978	1979	1980
Weighted average price per barrel U.S. $		2.09	9.09	10.29	11.14	12.23	12.29	16.17	27.30
Index	1)	100	435	492	533	585	588	774	1306
	2)	–	100	113	123	135	135	173	300
	3)	–	–	–	–	–	100	132	222

* Prices for 1978 and 1980 have been worked out by the author. Though the price rise decided upon in June 1979 was of the order of 60%, only half of it is reflected in the index since the price rise became effective in July 1979. The estimate for 1980 is based on the assumption that the price decided upon in December 1979 will hold good throughout the year.

Source: Chase Manhattan, Current Accounts of OPEC Countries, 1975-79, November 1978.

Table 2

Balance of Payments on Current Account, 1/ 1973-79

US $ billion

Group	1973	1974	1975	1976	1977	1978	1979 2/
Industrial countries	19	-4	25	7	4	33	10
More developed primary producing countries	1	-14	-15	-14	-13	-6	-10
Major oil exporting countries	6	68	35	40	32	66	43
Non Oil developing countries	-11	-30	-38	-26	-21	-31	-43
Net position 3/	15	20	7	8	2	2	-
(Gross imbalance 4/	(11)	(48)	(53)	(40)	(33)	(37)	(53)

Notes: 1/ On goods, services and private transfers

2/ As projected by IMF staff on the basis of the price rise of oil decided upon in June 1979. It is estimated that the surplus of oil exporting countries will be as high as $ 80 billion in 1980 taking into account the further rise in the price of oil decided upon in December 1979.

3/ Reflects errors, omissions and asymmetries.

4/ These are yearly totals of group deficits on current account only. The imbalance these figures reflect from year to year is probably very much understated because the figures for each group is still that of deficit net of surplus, if any, enjoyed by a country within the group.

Source: International Monetary Fund, Annual Report 1979.

Table 3

Growth of Euro-dollar Lending or External Bank Claims, 1970-1979

U.S. $ billion

	end 1970	end 73	end 74	end 75	end 76	end 77	end 78	June 1979
Gross claims	180.0	290.0	394.0	475.0	580.6	689.7	903.0	946.5
Net claims after adjustment for double counting due to redepositing among reporting banks	95.0	185.0	245.0	285.0	355.0	430.0	540.0	585.0
Net new lending			+60.0	+40.0	+70.0	+75.0	+110.0	

Source: IMF Survey, September 3, 1979

Table 4

Gold Price* in the London Market 1972-1980

	1972	1973	1974	1975	1976	1977	1978	1979 end-June	1980 Jan., 22.
U.S.dollars per ounce	64.90	112.25	186.50	140.25	136.75	164.95	226.50	277.50	850.00
Rate of change %		+72.96	+66.15	-24.80	-3.25	+20.62	+37.31	+22.52	

* These prices are for the end of the year except for 1979 and 1980.

Source: International Monetary Fund, Annual Report 1979.