

THE OIL EXPORTERS AND WORLD FINANCIAL MARKETS

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This note considers the prospects for investment in overseas financial markets by the oil-exporting countries.* It examines the implications of a declining oil price both for the total amount of new investment, and its composition.

Total Investment

The flow of investment funds from the oil-exporting economies into world financial markets depends primarily on the size of the oil exporters' current account surplus. This is shown in Table 1.

Table 1: Oil Exporters' Current Surplus and Overseas Investment, \$ billion

	1978	1979	1980	1981	1982
Overseas investment:	19	63	113	65	18
Of which:					
current surplus:	-1	60	106	59	4

Source: Bank of England Quarterly Bulletin, June 1983.

The sharp reduction in overseas investment between 1980 and 1982 reflected the deterioration in the oil exporters' combined current account surplus. The main factor behind this was a decline in oil consumption and stockbuilding in the OECD area, resulting in a cut of about 30 per cent in OPEC production (to around $18\frac{1}{2}$ million barrels per day in 1982). At the beginning of 1983 OPEC reached agreement on a ceiling of $17\frac{1}{2}$ mb/d but by July it was apparent that actual production was running at 18.4 mb/d.

The current prospect is for continued weakness in the world oil market. Against the background of a modest $2\frac{1}{2}$ per cent growth in real OECD GNP this year, oil consumption is likely to decline further. There may well be stockbuilding

*The oil-exporting countries referred to in this paper are: Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates and Venezuela. Bahrain, Brunei, Oman and Trinidad and Tobago are not members of OPEC. Ed.

in the last quarter of this year but, given the relative firmness of the OPEC agreement, this is unlikely to produce an actual increase in output. The most likely outcome for 1983 overall is an OPEC production of perhaps 17½-18 mb/d (year average). This could increase to 18-20 mb/d in 1984.

The main difficulty in gauging the implications for the oil exporters' current account lies in assessing the prospect for oil prices. The combination of a disintegrating cartel, a large margin of surplus capacity, and a low short-run price elasticity of demand implied at the beginning of 1983 that there was a real possibility of a major crack in oil prices. It is difficult to estimate where the price might have come to rest under such circumstances, but a \$15-20 range was then widely discussed. The relatively successful implementation of the March 1983 agreement has kept the Saudi marker price stabilised at \$29 per barrel and maintenance of price at this level seems the most likely prospect in the near future.

Nevertheless, the table below considers two alternatives: a \$28 price, and a \$20 price. Under either of these price assumptions, it is virtually certain that the OPEC countries as a group will record a substantial current account deficit in both 1983 and 1984. Compared to 1982 a cut in the oil price to \$28 would result in oil revenues in 1983 being about \$40-45 billion lower; a cut to \$20 would generate a further \$50 billion reduction. Some of this reduction would be offset by a squeeze on imports, particularly those from the OECD area. However, there would still be a marked further deterioration in the overall current account position. The likely outcome is shown in Table 2.

Table 2: Forecast of Oil Exporters' Current Account Surplus, \$ billion

	Oil at \$28 p.b.	Oil at \$20 p.b.
<u>Actual</u>		
1981		59
1982		4
<u>Forecast</u>		
1983	-25 - -35	-55 - -65
1984	-10 - -20	-25 - -35

Source: Morgan Grenfell & Co Ltd estimates.

Under these circumstances, it is likely that most members of OPEC will be in current account deficit for 1983 even if the oil price falls no further than the present account

marker price of \$29. The only oil exporters likely to remain in surplus this year are Kuwait, Qatar and the UAE. The UAE is likely to record a relatively modest surplus, which would probably be removed by a fall in the official marker price to around \$26 - 28. Kuwait has not only a trade surplus, but also a surplus on invisibles trade, and a fall in the oil price to as low as maybe \$4 - 6 would be required to eliminate the Kuwaiti surplus. Qatar, like the UAE, uses a substantial portion of its trade surplus to fund a deficit on trade in invisibles, and it is estimated that a fall in the official oil price to \$24 - 25 would reduce the Qatari current account to a position of balance. Estimates of the current account positions of OPEC countries relevant to this analysis are shown for each year in the period 1981-1983 in Table 3. Details are given for those countries whose current accounts are believed to have been in substantial surplus in 1981, before the downward pressure on oil prices evident in 1982.

Table 3: Current Account Balances of some selected Oil-Exporting Countries, 1981-83, \$ billion

	<u>1981</u>	<u>1982 (est)</u>	<u>1983 (forecast)</u>
Saudi Arabia	+45.1	+3	-10 - -14
Kuwait	+13.7	+6	+ 3 - + 6
UAE	+ 3.5	0 - -1	- 1 - - 3
Venezuela	+ 4.0	+1 - +2	+ 1 - + 2

Source: IMF statistics and Morgan Grenfell & Co Ltd estimates.

Most OPEC members will have to finance deficits, probably implying a rundown of existing assets. Those countries still in current surplus will on the other hand continue to invest. In either case an estimate of the effects on financial markets of the move by OPEC as a whole towards current deficit needs to take account of past OPEC portfolio preferences. Estimates of the likely use of their surpluses by those countries still in surplus can only be made on the basis of the past behaviour of OPEC as a whole, since data disaggregated by country is not available.

Asset Mix

Information on the existing assets of the oil producers is extremely sketchy. Bank of England estimates suggest that total assets may have been over \$400 billion by the end of 1982; however, this could be a substantial underestimate owing to the difficulty in identifying private

capital flows. Perhaps three-quarters of this total was accounted for by Saudi Arabia, Kuwait and UAE.

In terms of asset composition, the statistics on identified deployment suggest the following breakdown as at end-1982 (Table 4).

Table 4: Identified Deployment of Oil Exporters' Surpluses

	<u>Per cent, end-1982 (est)</u>
Bank deposits	35 - 40
Government securities*	10 - 15
IMF, IBRD and loans to LDCs	15 - 20
Other (including equities)	30 - 35

*NB Government securities percentage relates only to US and UK.

Source: Bank of England Quarterly Bulletin, June 1983.

Within the overall total, the proportion denominated in US dollars is thought to be around three-quarters.

In assessing the likely allocation of the prospective rundown in the total asset holdings of OPEC as a whole, the experience of 1978 is relevant, since that was also a year of combined current account deficit for the oil exporters. In that year, holdings of government securities were reduced, particularly in the US. All other major asset categories were increased, although the net increase in bank deposits was extremely modest compared to the previous year (\$4 billion compared to \$13 billion in 1977). Lending to LDCs, the IMF and IBRD held up well in total.

In 1983, it is likely that both bank deposits and holdings of government securities will be reduced. Indeed, the rundown in identified bank deposits has been under way since last year. However, unlike 1978, it also seems likely that new "aid" lending will be sharply reduced. Such a cutback was already apparent last year. Longer term investments in the industrialised economies were also sharply reduced in 1982, and a reduction in holdings is likely this year.

With respect to the three countries expected to achieve a current surplus in 1983 however, the question remains how they are likely to invest, rather than what assets will be realised. Because data on the past deployment of OPEC financial surpluses disaggregated by investing

country are not available, the assumption has to be made that the surpluses of the UAE, Kuwait and Qatar in 1983 will be invested broadly in line with the portfolio preferences demonstrated by OPEC as a whole in the past. On this basis bank deposits and "other" are likely to absorb the greater part of the expected surpluses.

In the four years to 1982, the surpluses of oil-exporting countries, totalling \$259 billion, were invested in the manner shown in Table 5.

Table 5: Investment of Oil-Exporting Countries
by Category of Investment, 1979-82

	<u>Per cent</u>
Bank Deposits	25.4
Government Securities	12.5
IMF, IBRD and LDCs	14.0
Other	48.1

Total	100

Source: Bank of England Quarterly Bulletin, September 81, March 82 and June 83.

In the same four years, the geographical distribution of investment was as shown in Table 6.

Table 6: Investment by Oil-Exporting Countries,
1979-82, Geographical Distribution

	<u>Per cent</u>
United Kingdom	17.5
United States	19.5
Other Industrial Countries	26.9
LDCs, IMF & IBRD	14.0
Residual	22.1

Source: Bank of England Quarterly Bulletin, September 81, March 82 and June 83.

Both the geographical and category distributions of the oil exporters' surpluses in these years display a shift of portfolio preferences compared to the period 1974-1979. Bank deposits have taken a lower proportion of the overall surplus in the later period, and "other" investments, including direct investment, have taken a larger share. At the same time, the oil exporters have effected considerable geographical diversification of their portfolio. The share of the surplus invested in the UK and the USA has declined

sharply between the earlier and later periods; at the same time, a greater proportion of available funds has been invested in other industrial countries.

The investments as a whole display a strong preference for liquidity. Over 60 per cent of funds invested by oil exporters in the UK in the four years to 1982 were placed in Eurocurrency deposits, while approximately 60 per cent of the funds invested in the US were invested in readily marketable US Treasury securities. Nearly half the funds placed in other industrial countries were deposited with banks.

Although these various portfolio preferences are likely to be evident in the investment by the UAE, Kuwait and Qatar in 1983 and 1984, it is well to remember that OPEC as a whole is expected to be in deficit, a user rather than a source of funds in the world financial markets. In 1984, the current account position of OPEC as a whole is likely to improve somewhat, but no single country is likely to show a substantial surplus which is not expected to do so in 1983. OPEC as a whole is expected to remain in deficit. Further reductions in asset holdings are therefore to be expected.

From the viewpoint of the world financial economy, one important aspect of this outlook is the prospect of additional pressure on the banking system. More fundamentally, a reduction in the assets of oil exporters reduces the flow of investment funds into world financial markets, and tends to increase upward pressure on real interest rates. Thus the downward pressure on nominal interest rates from the reduction in oil prices and inflation rates is partly offset by an upward twist to real interest rates.