

OIL, PETRODOLLARS AND RELATED PROBLEMS

by

JOHN MARETT KNOWLES

Thesis submitted to the
School of Graduate Studies
in partial fulfillment of
the requirements for the
degree of Master of Arts
in Economics

University of Ottawa
Ottawa, Canada, 1976



© J.M. Knowles, Ottawa, Canada, 1976

UMI Number: EC56207

INFORMATION TO USERS

The quality of this reproduction is dependent upon the quality of the copy submitted. Broken or indistinct print, colored or poor quality illustrations and photographs, print bleed-through, substandard margins, and improper alignment can adversely affect reproduction.

In the unlikely event that the author did not send a complete manuscript and there are missing pages, these will be noted. Also, if unauthorized copyright material had to be removed, a note will indicate the deletion.

UMI[®]

UMI Microform EC56207
Copyright 2011 by ProQuest LLC
All rights reserved. This microform edition is protected against
unauthorized copying under Title 17, United States Code.

ProQuest LLC
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106-1346

PREFACE

The energy crisis and the recycling of petrodollars are problems of such recent origin that conducting the detailed research for this thesis has been a jigsaw puzzle task of assembling and analysing material and information from hundreds of sources, including books, newspapers, trade journals and other periodicals, U.S. Congressional hearings and legislation, studies made by international agencies, etc. Most of the work on this subject prior to 1970, or even as late as 1973, is already outdated. Much of the recent, and accordingly most pertinent, material has been found in such publications as The Economist, Middle East Economic Digest, and Petroleum Economist, upon which the author has perforce had to rely extensively. The Bibliography is "Selected", since to quote all of the pertinent references in any one of these three publications would take up several pages, and it was accordingly not considered practical to include them all individually. The material has been photocopied, however, and is available for inspection if desired. Little that is useful or relevant to current conditions, with few exceptions, has yet appeared in book form, although undoubtedly many volumes are now in preparation, and will be flooding the market in the course of the next year or two.

In economics, as in engineering, it is always needful at some point to "freeze the design" before going into production; a stage which would never be reached in a rapidly changing world if one forever were to keep on trying to incorporate the latest improvements in the "state of the art". Accordingly, the data on which this thesis is based, with one or two exceptions, refer to events prior to October 1, 1975.

This date is particularly appropriate for a number of reasons. It is almost exactly two years, hence two albeit mild northern heating seasons, and two automobile-driving summers, from the outbreak of the October 1973 War, and the subsequent unsheathing of the "Arab Oil Weapon". It is a period long enough to have allowed the world to make substantial and measurable progress toward a new equilibrium based upon the profoundly altered economic relationships among nations. It is also, coincidentally, the date with effect from which OPEC oil prices have formally been raised once more to a level where they are supposedly to remain frozen for nine months. And it is a time which immediately follows the conclusion of the Seventh Special Session of the United Nations, which just conceivably may have laid the groundwork for a new set of relationships between the underdeveloped and the developed nations of the world, the poorest countries of which have been so deeply affected by the energy crisis.

Moreover, at this time there appear to be increasingly firm indications of a decline in the rate of growth of an unprecedented, worldwide inflation, at least in the stronger national economies such as that of the bellwether United States.

It is, all in all, a highly suitable moment at which to pause for reflection, to take stock of the current situation, and to attempt to plan for the future.

TABLE OF CONTENTS

I.	THE OIL CRISIS	2
II.	THE INTERNATIONAL OIL COMPANY CARTEL	14
III.	THE OPEC CARTEL	30
IV.	THE DOMESTIC DEVELOPMENT POLICIES OF OPEC COUNTRIES	40
V.	OPEC FOREIGN INVESTMENT	50
VI.	OPEC OIL REVENUES	67
VII.	WHAT PRICE CRUDE?	81
VIII.	THE EROSION OF OIL INCOME AND THE "INDEXATION OF OIL PRICES"	104
IX.	THE RECYCLING PROBLEM	113
X.	THE "MILITARY SOLUTION" TO THE OIL PROBLEM	137
XI.	SUMMARY AND CONCLUSIONS	155
XII.	SELECTED BIBLIOGRAPHY	164

APPENDICES

A.	"A Plan to Resolve the Balance of Payments Problem" - March 16, 1973	174
B.	U.S. Foreign Investment Study Act of 1974 (Text)	182
C.	Summary of U.S. Federal Laws Bearing on Foreign Investment in the United States	188
D.	The International Energy Agency	208
E.	Glossary of Terms used in the Oil Trade	220
F.	Conversion Factors used in the Oil Trade	224

LIST OF TABLES

Table	Page
1. Ownership links among the major international companies and the major crude oil producing companies in the Middle East, by percentages of ownership	17
2. OPEC Countries: Populations, 1973 Oil Production, Reserves	36
3. Comparison of estimated development expenditures of Middle East OPEC countries with their estimated oil revenues 1975-1977	48
4. Estimated Oil Earnings 1973-1983 (Al-Bazzaz)	70
5. Estimated Foreign Exchange Surpluses 1973-1983 (Al-Bazzaz)	71
6. Projections of OPEC Revenues and Capacity (Chenery)	73

LIST OF ILLUSTRATIONS

Figure	Page
1. Diagram of the ownership links among the major international oil companies and the major crude oil producing companies in the Middle East.....	16
2. Map of The Middle East, Fields and Main Pipelines.....	226
3. Maps of Arabian (Persian) Gulf-Southern Shore, and Southern Arabian Peninsula.....	227

I. THE OIL CRISIS

I. THE OIL CRISIS

Much has been written in the past two years on the economic problems raised, and the earlier problems compounded, by the successful actions of the members of the Organisation of Petroleum Exporting Countries (OPEC) to raise the price of crude oil to consuming nations, to make these price rises stick, and to furnish an example to other countries of the underdeveloped world which would hope to achieve comparable monopolistic advantages as purveyors to the wealthy OECD countries of other strategic raw materials. Many international conferences have been held on the subject culminating in the United Nations Special Session of September 1975. So much has, in fact, been said on the subject of recycling of so-called petro-dollars (an entire vocabulary has come into existence to describe these phenomena) that it is now difficult to realize that prior to the outbreak of the October 1973 War between certain Arab countries and Israel, the possibility of an oil crisis was not taken very seriously.

In March 1973, some seven months prior to the energy crisis precipitated by the October War in the Middle East (known to partisans as the "Ramadan" or the "Yom Kippur" War, depending upon which side they are on) the present author wrote a paper entitled "A Plan to Resolve the Balance of Payments Problem", which, inter alia, made a modest

prediction with respect to what was deemed to be the inevitable balance of payments difficulties to be anticipated in the 1980's, due to the ever growing flow of petro-dollars in favour of the OPEC countries, particularly the Arab countries and Iran.¹ The facts upon which this conclusion was based were already well known, and had been for a number of years. The western industrialised countries had become increasingly dependent upon the availability of cheap fuel in virtually limitless amounts. Rather more than one-half of all international trade was in crude oil. The United States alone, with six per cent of the world's population, was consuming some 35 per cent of the world's energy. Conventional fuel sources in the United States were becoming increasingly scarcer and more expensive to develop. The development of other energy sources either entailed very large capital outlays and long time delays (conventional nuclear power, conversion to coal, etc.) or were not yet technically (nuclear fusion) or economically (solar power, oil sands, oil shale, offshore oil wells) available, at least in the near term. The greater part of the world's readily-accessible crude oil reserves were located in a handful of sparsely-populated, under-developed Middle Eastern countries. In brief, the industrialised world was highly vulnerable to OPEC action. Despite this, the abrupt

¹Appendix A.

quintupling of oil prices by the OPEC countries was almost totally unanticipated. The vast ramifications of this action were, generally, entirely unforeseen.

It must be stated at the outset, that the problems caused or intensified by OPEC's actions are as much political as economic. As Mr. Henry Kissinger, speaking of the oil crisis in January 1975, is reported to have said:

"It became clear that every economic policy had profound foreign policy implications, and really required political inspiration and leadership to make it effective. You could never implement the energy policy as a purely economic matter. It has been a foreign policy matter from the beginning."²

Accordingly, this work will also attempt to treat of the political aspects of the energy crisis, including military matters where appropriate, an understanding of which is necessary as a background to the economic analysis.

Historically, the major international oil companies, beginning in the early years of this century, established an extremely successful oil producers' cartel. This monopolistic grouping of transnational companies, as will be seen, profited greatly from its total control over production, transportation, refining, and distribution of this vital commodity. Having now been replaced at the producing end by the OPEC cartel, it still controls all other "downstream" activity in oil processing and marketing. A third grouping, the International Energy Agency of the OECD, has been established indirectly

²Business Week, January 2, 1975

by the governments of the industrialised consumer countries to represent the interests of those countries. All three of these groupings will be examined herein, the first two in the main body of this thesis, and the International Energy Agency in an appendix.³

When reviewing the recent course of events, it should be noted that the sharp rises in the prices of oil since October 1973 were not the sole, or even the principal, cause of recent world economic problems. Prior to the 1973 oil crisis, economic conditions in the industrialised countries were deteriorating rapidly, with accelerating domestic inflation resulting, very largely, from excessive domestic demand and from the commodity price boom which, to an important extent, owed its origins to what was occurring in the industrialised countries themselves. Nevertheless, while the oil price rises were not the sole cause of the inflationary pressures, by their size and timing they seriously exacerbated those pressures. In consequence, both oil importers and oil exporters have a responsibility for restoring non-inflationary growth in the industrialised world, and for coming to the rescue of the most seriously affected countries (M.S.A.'s) of what is coming to be called the "Fourth World".

The high rate of accumulation of financial assets by the OPEC countries is slowing down. Largely due to cyclical

³Appendix D.

developments in the OECD countries, the OPEC countries' current account surplus is expected to decline, from \$66 billion in 1974 to \$40-45 billion (annual rate) in 1975 and the first half of 1976.⁴ It may be tentatively estimated that their cumulative stock of financial assets, or "petrodollar surpluses", may level off at somewhere around \$200-250 billion (in 1974 dollars) by about 1980. Such estimates are however based upon necessarily debatable assumptions as to OPEC absorptive capacity, future oil price trends, the allocation of oil production volumes among OPEC members, the effectiveness of energy conservation measures, and the rate of development of alternative energy sources in the consuming countries.

Some of the possible financial repercussions of the oil producers' surpluses, such as the scope for switching funds among different financial assets, the competition for OPEC funds, and the direct investment of such funds, do not, so far, appear to have caused widespread strains in the international monetary system, and seem unlikely to do so, at least in the immediate future.

Nevertheless, there is reason for some concern about the possibility of strains on the international financial markets, and the scope for volatile, and hence destabilising, movements of funds inherent in the existence of very large stocks of more or less liquid financial assets.

⁴OECD, Paris. Unpublished Document CPE/TWP(75)10 (1st Rev.). 4th December 1975

One potential problem has to do with the fact that the greater part of higher oil payments to OPEC by the industrialised countries does not find its way back again to the latter countries through symmetrical or fully synchronised increases in OPEC imports or investment of oil funds in real estate and securities. The bulk of it is currently being held in the form of relatively liquid claims on relatively few commercial banks or in the government securities of a few of the most "safe" countries. The growth of such liabilities of banks, and the potential for shifting among different kinds of financial assets may complicate the task of domestic monetary management for a number of countries. The volatility of the stock of accumulated assets has not, at least so far, been a serious problem, the OPEC countries having conducted their investment policies in a responsible way. Moreover, the scope for really large movements should tend to be moderated by the dampening effect of the system of floating exchange rates and the limited range of alternative assets which could absorb very large amounts.⁵

One specific banking problem has to do with mismatched maturities. Concentration of OPEC deposits on a relatively small group of large banks has led to a rather unbalanced distribution of their short-term investment among financial institutions. These investments initially put heavy strains on the maturity transformation rôle of the commercial banking

⁵Ibid.

system, since the demands coming from oil-consuming countries have been very largely for longer-term funds. However, although a number of OPEC countries continue to display a high liquidity preference, the low absorbers among the OPEC countries, such as Saudi Arabia and Kuwait, appear to be investing an increasingly large percentage of their surpluses in longer term assets. Nevertheless, the problem of mismatched maturities may eventually be one with which the international banking system may have to deal in some cohesive, joint manner. Individual banks are reported to have already refused some OPEC deposits, and individual members of the banking system, acting in concert and in self-defence, may have to oblige OPEC investors to place their funds in longer term assets.

The overwhelming portion of longer-term OPEC investments has been in government-to-government credits, government securities or bonds, or loans to government agencies or nationalised industries. Long-term investments in private enterprise seem to have favoured industrial "blue-chip" stocks and commercial property development. Direct investment has been relatively insignificant, although a few cases have drawn an unusual degree of public attention. While host governments certainly have the means to safeguard what they may consider to be their interests with respect to foreign ownership in key branches of industry, this is a problem which is, rightly or wrongly, very sensitive to public opinion, and is accordingly one of which more is likely to be heard in the future.

The events of the past two years have had extremely diverse effects on the two billion people of the so-called Third World. Although the commodity boom of 1972-74 improved the terms of trade of most primary exporters, this trend has now been largely reversed, with the notable exception of petroleum and a few minerals and food items. The impact of oil and food prices on non-OPEC members of the Third World has been more than to double or even to treble their balance of payments deficits - from \$10 billion in 1973 to about \$25 billion in 1974 and possibly \$35 billion in 1975 - more than offsetting the effects of the flows of concessionary loans and grants from the developed countries.

These events have divided the Third World itself into three sub-groups: Group I, comprising those countries, containing some 400 million inhabitants, which export oil and other minerals, and whose development prospects have greatly improved; Group II comprises a number of countries in the upper income tier of the developing countries, e.g., Brazil, Turkey, Korea, Thailand, etc., with a total of about 600 million inhabitants, many of which have suffered losses through the impact of higher petroleum prices, but which have sufficiently diversified economies to adjust to the need for increased exports and changed internal allocation of resources.

Group III comprises the lower tier of less developed countries, embracing some billion people. For these countries, mainly in Asia and Africa, and already desperately poor,

export prices have lagged behind the general inflation while import costs have risen sharply. The very steep rise in petroleum prices came as a complete and unexpected disaster. For many of them, notably India and Bangladesh where some two-thirds of these billion people live, development prospects have been set back 10 years and more. It is in this "Fourth World" that the oil and food crises come together with devastating effect.

Robert McNamara, addressing the Board of Governors of the World Bank Group in September, 1974 declared that growth in the worst-hit of these countries can only be sustained, even at reduced levels, by an increase in concessional lending of three to four billion dollars annually (in constant prices) over the next few years. Clearly, given the balance-of-payments deficits mentioned above, this is not enough. However, it is equally clear that any further increase in crude oil prices can only make matters worse.

From the balance-of-payments point of view, even the most developed of the industrialised countries face a difficult real adjustment in the longer run. The largest share of the financial burden caused by the rise in the price of oil imports, however, has fallen on non-oil-producing developing countries.

Accordingly, it is recommended that every opportunity be taken by the industrialised countries to open a dialogue with the OPEC countries, with a view both to establishing cooperative arrangements with them for the investing of their

surpluses, and to emphasize to them the joint responsibility of the OPEC countries and the industrial countries for the functioning of the international economic system. Consequently, the industrial countries should be prepared to discuss with the OPEC countries any questions relating to their investments which are of concern to them and on which action could be taken which would contribute to the continuation of responsible OPEC investment policies. The possibility of special forms of cooperative action to help the non-oil developing countries in the financial field could be an important feature of this dialogue; for example, triangular arrangements could be entered into, whereby the industrialised countries would provide technical and management expertise in respect of long-term investments by OPEC countries in the non-oil developing countries.

From the OPEC standpoint, aside from the alternative of leaving their oil resources in the ground, there are only three choices open to them as to how to dispose of their current account surpluses:

- (a) domestic development;
- (b) foreign aid to the non-oil developing countries; and
- (c) foreign investment

All three of these possibilities are examined in this thesis, and the conclusion is reached that the OPEC countries are doing all that they can to develop viable, industrial economies before their oil resources run out; more than they

were generally expected to do in the foreign aid field; and have generally acted responsibly with respect to foreign investment. It is concluded that, emotional issues aside, it would be wise and prudent for OPEC countries to place their investible surpluses essentially in long-term direct and portfolio investment in the industrialised countries, thereby ensuring both the generation of sufficient rentier income to sustain them when their oil resources are eventually exhausted, and the continuation of a firm and stable international monetary and banking system. By continuing to act in so responsible a manner, they will thereby both cultivate the good will of the industrialised countries, with whose best interests their own will be increasingly identified, and render the possibility of any form of military intervention ever more remote.

II. THE INTERNATIONAL OIL COMPANY CARTEL

II. THE INTERNATIONAL OIL COMPANY CARTEL

The OPEC countries have been roundly condemned for having forced a highly traumatic quintupling of oil prices upon the rest of the world, thus drawing to themselves huge foreign exchange surpluses, and causing great distress to the poorer countries of the Fourth World. Yet, as will be explained more fully in the subsequent chapter, it is perhaps not sufficiently appreciated that the OPEC cartel was originally created in 1960 as a defence mechanism to combat the long-established international oil companies' cartel at the producing end; and that the latter continues to operate in other producing areas and, through market-sharing arrangements, throughout the downstream transportation, refining and distribution systems on a worldwide basis.

The oil companies, pre-eminently the so-called "Seven Sisters",¹ have jointly established producing companies in the production areas. No one of them owns any producing company by itself. Aramco in Saudi Arabia, for example, is jointly owned by Texaco (30%), Exxon (30%), SoCal (30%) and Mobil (10%). A detailed map of the ownership links among the "Seven Sisters" (plus CFP, Compagnie Française des Pétroles)

¹Exxon, Texaco, SoCal, Mobil and Gulf comprise the American "Big Five". British Petroleum and Royal Dutch Shell make up the balance of the "Seven Sisters".

is drawn up on the accompanying diagram (figure 1) and table (table 1).²

The companies have reaped great profits over the years. For the entire 35 years from 1913 to 1947, aggregate financial data for Middle East oil operations show that their total receipts came to more than \$3.7 billion, of which just over \$1 billion met the cost of fixed assets and ongoing operations, while a mere \$510 million was distributed in payments to local governments, mainly as rents, royalties, and bonuses.³ This left the oil companies with a net income of \$2.2 billion. Only \$425 million of this was reinvested in the area, while \$1.7 billion was transferred abroad as profit. On the average, this worked out to something under \$50 million annually for the period covered.

For the ensuing 13 years, formerly known as the "Bonanza" years, 1948 to 1960, these profits were multiplied by 20. Of \$28.4 billion in total receipts, operating costs accounted for \$4.8 billion, net investment in fixed assets for \$1.3 billion, payments to local governments for \$9.4 billion, and profits transferred abroad rose to \$12.8 billion, or approximately \$1 billion a year on the average.

So far, owing to lack of data from the oil companies, it has been impossible to calculate company profits from

²Joe Stork, Middle East Oil and the Energy Crisis, Monthly Review Press, New York and London, 1975, p. 73.

³Ibid., p. 56.

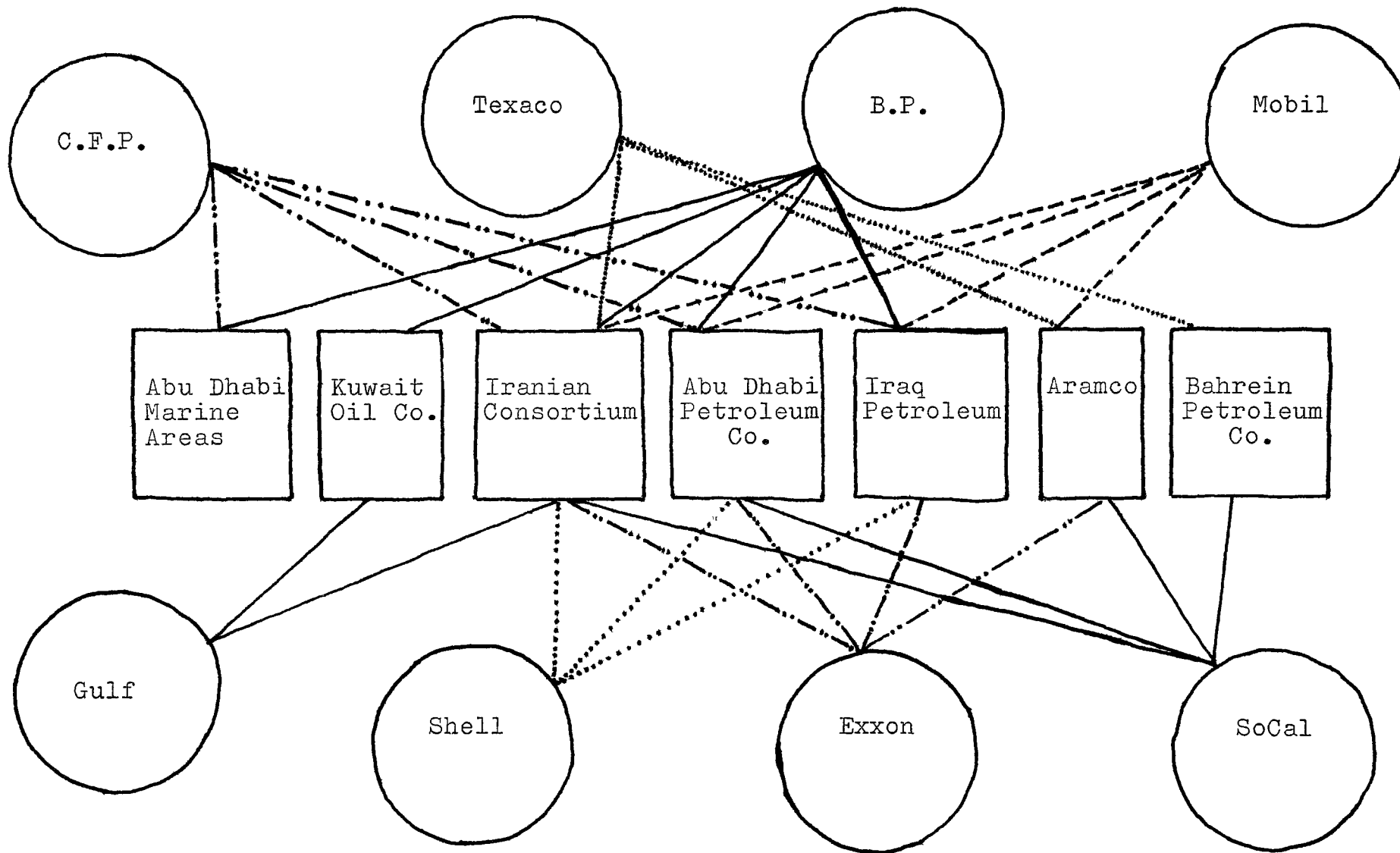


Figure 1.--Ownership Links Between the Major International Oil Companies
 (Including Compagnie Française des Pétroles)
 and the Major Crude Oil Producing Companies in the Middle East

	Texaco	B.P.	Mobil	C.F.P.	Gulf	Shell	Exxon	SoCal
Abu Dhabi Marine Areas	-	66,2/3%	-	33,1/3%	-	-	-	-
Kuwait Oil Company	-	50%	-	-	50%	-	-	-
Iranian Consortium	7%	40%	7%	6%	7%	14%	7%	7%
Abu Dhabi Petroleum Company	-	23.75%	11.875%	23.75%	-	23.75%	11.875%	-
Iraq Petroleum	-	23.75%	11.875%	23.75%	-	23.75%	11.875%	-
Aramco	30%	-	10%	-	-	-	30%	30%
Bahrein Petroleum Company	50%	-	-	-	-	-	-	50%

Table 1.-Ownership Links Between the Major International Oil Companies
(Including Compagnie Française des Pétroles)
and the Major Crude Oil Producing Companies in the Middle East

Middle Eastern production operations through the 1960's with any precision, but there are indications that profits rose by another 50 to 60 per cent over those of the "Bonanza" years. One writer⁴ has "conservatively" estimated repatriated profits as approximately \$1.61 billion for 1963, and \$1.4 billion for 1969. Such figures are probably fairly representative for the decade.

These highly prosperous years were but a prelude for what was to come. For analysis of the subsequent period, it should be realized that, in a time of increasingly strong market growth characterised by an ever greater dependence by the industrialised West upon Middle Eastern oil, from a market low of perhaps \$1.25 per barrel in 1969, of which about 95 cents was local government revenue and 20 cents was company profit - by the middle of 1973 the market price had risen to about \$2.50 per barrel, with \$1.50 for the government and 80 cents for the companies. Hence, while the governments' "take" had risen by about three-fifths, that of the companies had quadrupled. This was prior to the outbreak of the October War later that year, and the further quintupling of oil prices in its aftermath.

Following the October War and the unsheathing of the "Arab Oil Weapon", OPEC unilaterally imposed price increases in two stages, to a level five times higher than they were before the War. The original OPEC target in its new pricing

⁴Ibid., pp. 119-120

scheme worked out to an 84:16 split of profits with the oil companies. This raised the profit per barrel to the companies to about \$1.20, some 50 per cent higher than the 80 cents they were receiving earlier in 1973. Moreover the OPEC 84:16 split was based on setting posted prices at 40 per cent above what it considered to be market prices.

But since most crude oil is sold through integrated company channels, it is highly unlikely that the international oil companies were selling crude at OPEC's estimated \$8.00 per barrel, when crude oil was actually being sold to panicky buyers at auctions for \$15-20 per barrel. In reality, the companies were able to use their control of market prices to increase their crude oil profits far above the target limit envisioned by OPEC.⁵

Even this is only part of the picture. The rise in oil prices imposed by OPEC has resulted in correspondingly higher "world market" prices. This has obviously correspondingly increased the value, and profitability to the companies, of energy sources elsewhere. The "Big Five" in the United States had already been making a good return on their domestic crude oil when it was selling at \$3.00 per barrel. Yet they complained bitterly when they were legally restricted to \$5.25 per barrel for "old" oil being produced from existing wells - a mark-up which would still allow them

⁵Michael Tanzer, The Energy Crisis, Monthly Review Press, New York and London, 1974, pp. 126-127

a huge rise in profits. "New" oil, being produced at presumably higher costs, was allowed initially to rise to \$13.00 a barrel, but on September 23, 1975 the U.S. Congress cut this back to \$7.50 per barrel, which still will leave them a more than adequate return on their new investment.⁶

In the course of all this, in the single year 1973, Exxon's profits were up 59 per cent, and those of the "Big Five" American companies by over 50 per cent, to a total of \$6.2 billion. In 1974, profits shot even higher, rising to \$7.8 billion.⁷

Oil companies' earnings for the first half of 1975 were down sharply from the enormously swollen earnings of 1974, described by the U.S. Senator Henry Jackson as "obscene". Nevertheless, they can hardly be alluded to as "losses". The oil companies are now being described by their apologists as "reeling" from cutbacks in their profits to a mere \$2.6 billion in the first half of 1975 alone.⁸

Accordingly, our sympathies are now being earnestly solicited over the "losses" which are driving earnings down to a level 100 times higher than that of the 1913-1947 period; ten times higher than that prevailing throughout the "Bonanza" years 1948-1960; and all the way down to just below the fantastically profitable year of 1973.

⁶Toronto Globe and Mail, September 24, 1975.

⁷Petroleum Economist, London, March 1975, pp. 91-92, "Profits Past Their Zenith".

⁸Business Week, August 11, 1975, p. 18, "Oil companies count their profit losses". - a fascinating caption in itself!

For once unimpressed, the U.S. Congress has been subjecting the international companies (as well as the domestic independents, who have also been doing extremely well) to tighter control on three major issues: taxing excess or "windfall" profits due to revaluation of inventories; eliminating or reducing the percentage depletion tax allowance which permitted oil producers to deduct 22 per cent of their gross income from their taxable income up to a limit of half their net taxable income, allegedly in order to provide exploration risk capital funds; and eliminating or changing the foreign tax credit, whereby the international oil companies subtract directly from their U.S. tax payable the taxes they pay to foreign governments, in order to "avoid double taxation".⁹

This last arrangement deserves rather extended treatment. Not only does it go some way toward explaining some part of the profits made by the industry (it was the key to the "Bonanza" years) but also, and perhaps more significantly, it illustrates the special relationship which has always heretofore characterised the U.S. Government's dealings with the petroleum industry. To help Saudi Arabia while avoiding hurting the oil companies which were being pressured to pay higher royalties to the Saudi Government, an extraordinary arrangement was worked out between the U.S. Treasury Department and Saudi officials, which took effect in 1951.

⁹Ruth Sheldon Knowles, America's Oil Famine, Coward, McCann and Geoghegan Inc., New York, 1975, pp. 152-153.

With the acquiescence of the U.S. Government, a Washington, D.C. lawyer drafted an Income Tax Law for the Kingdom of Saudi Arabia, which, in effect, transformed the previously paid "royalties" into "income taxes". If the Saudi Government had simply increased the amount of royalties payable by the company (in this case Aramco) per barrel of oil, that action would have had a direct and damaging effect on the profits of the company. Royalties as such are a business expense, and accordingly are deductible from taxable income in the hands of the companies. If, however, the Saudis were instead to levy an income tax, any such funds paid to them could, under U.S. law, be deducted from the company's tax payable in the United States, to "avoid double taxation".

Under the last year of the old system (1950) of payment by royalty only, Aramco paid \$56 million to the Saudi Government. In the first year of the new system of royalty, lease and income tax combined, all under the heading of "income tax", the government received \$110 million. This arrangement did not cost the company anything at all. The ensuing years were not known as the "Bonanza" years for nothing. Aside from higher production in a rising market, the difference lay in the advantage to the owning parent companies of being able to deduct their royalty and other such costs, not from their taxable income as part of the cost of doing business, but from their tax payable - an extremely

profitable situation for them. It is significant that, in testimony before the U.S. Senate Committee, Joint Hearings on the Emergency Oil Lift Program and Related Oil Problems, 85th Congress, 1957, a senior official of Aramco admitted that he "guessed" that his company had paid no taxes at all "for two or three years".¹⁰ It is probably safe to "guess" that the company had been paying no taxes at all for quite a few years before that - and since!

Be that as it may, governments all over the Middle East quickly adopted this method of payment, substituting "income taxes" for "royalties". This became famous as the "50-50" system. If, under it, both the producer country governments and the oil companies gained, there could be only one loser: the Government and, through it, the people of the United States, to the tune of hundreds of millions of dollars a year. A long time observer of the oil scene¹¹ has this to say in support of the oil companies:

"In public discussions, much of the controversy over the application of the foreign tax credit is due to a lack of understanding of how it works and its limitations. U.S. oil companies cannot offset increases in foreign tax liabilities by a corresponding lowering of tax payments to the U.S. Treasury through the foreign tax credit."¹²

¹⁰Leonard Mosley, Power Play - Oil in the Middle East, Random House, New York, 1973, p. 195.

¹¹Ruth Sheldon Knowles, op. cit., p. 163.

¹²This sentence is now literally true. They can, however, deduct all of it up to 100 per cent of the U.S. tax rate, which she does not make unequivocally clear in this passage.

It is available only up to the point where foreign tax rates equal U.S. rates. Since the mid-1960's foreign tax rates have exceeded U.S. tax rates, by and large, and have had very little effect on tax payments to the Treasury¹³ since the companies have had nothing to write off against all the foreign tax increases. They have built up large amounts of unusable excess foreign tax credits."

This intended defence of the companies is, in fact, a damaging admission, and tantamount to a declaration that the companies pay no U.S. tax at all on their foreign income, although they are now paying some taxes on their U.S. revenues. This sort of thing has been sarcastically referred to as "creative accounting" by other writers on the subject.¹⁴

Oil industry propaganda, speaking generally, has never talked about the profitability of foreign, and particularly Middle East, operations. The companies prefer always to talk in terms of overall, fully integrated operations which, they say, bring only modest returns quite in line with the profit margins of manufacturing industries as a whole (10 to 20 per cent). To the extent that this is true, and not a product of the "creative accounting" that the oil industry has pioneered, it indicates how much this industry has been subsidised by cheap and easy access to the resources of the Third World. The truth remains, however, that no one outside the industry itself has yet managed fully to penetrate

¹³It is difficult to pay less than zero taxes.

¹⁴Joe Stork, op. cit., p. 71.

the darkness with which the oil companies cloak themselves and their operations, particularly their accounting methods.

We do know that "creative accounting" tax avoidance dodges are legion in this business, but details are hard to come by. Until very recently, most oil produced in the Middle East was utilised by refining affiliates of the producing companies, and simply had "transfer prices" for internal integrated accounting and tax purposes. The rest was mainly exchanged among the major international companies at negotiated prices, often on long-term contract. Very little was sold at arms' length bargaining to outsiders, so that there was no real "market price" for crude, established on the basis of competitive supply and demand. For integrated companies largely using their own oil, the profits calculated from transfer prices merely indicated the extent to which net integrated profits were assigned to the producing stage rather than to the later transportation, refining and marketing stages. In setting these transfer prices, various factors were taken into account, including market factors and, particularly, the tax laws of the home countries of the parent companies and of the countries where they operated.¹⁵ As Sheikh Abdullah Tariki said to the Arab Petroleum Congress, an audience which included representatives of the major oil companies:

¹⁵Sam H. Schuur, Paul T. Homan, et. al., Middle East Oil and the Western World, Prospects and Problems, American Elsevier Publishing Co., Inc., New York, 1971, pp. 121 et.seq.

"You say we are in it together? But when you make money, you make it alone. When you lose, you come out and cut the posted prices. Somebody here mentioned that we don't need a formula. We do; we need a formula to protect ourselves, because if we don't have one, you can easily sell our oil at fifty cents a barrel and make your profit through your tankers, refiners and marketers. You use the formula when you like it; you don't use it when we like it."¹⁶

This statement has never been successfully refuted. Moreover, from the consumers' standpoint, the oil industry, through its control of transport, refining and distribution systems, is still in overall control. It can still quite legally "pass through" all cost increases on foreign crude while maintaining its margins on new domestic crude.

One real danger to the international oil companies is local nationalisation, whereby the governments of the oil-producing countries would take complete command of crude oil supplies, and either use them internally, by building indigenous refineries, or market them directly to foreign buyers. This would mean that the oil-exporting countries could deal directly with foreign governments or refiners or marketers in consuming countries, thereby cutting off the oil companies' foreign crude oil profits and ultimately perhaps even their refining profits. As will be seen, however, this sort of activity contains its own risks for the OPEC countries. Suffice to say, at this time, if the oil companies were to become mere shoppers for the cheapest oil, they would represent an even greater danger to the OPEC cartel.

¹⁶Leonard Mosley, op. cit., p. 296.

The development or the perpetuation of a cartel is encouraged if at least four sets of circumstances are present:

1. There must be a steady demand in the market.
2. The product must be standardised and easily definable with respect to quality.
3. The industry most liable to foster formation of cartels is that with heavy fixed or overhead costs or large transportation costs, or one which cannot be rapidly adjusted to changing market conditions.
4. Members of the cartel must have a certain natural inclination for collective agreement and action.¹⁷

It could be added that, if there is fundamental tendency to overproduction in the industry, these factors are likely to become more active. A fifth requirement could be that the numbers of the producers of the commodity should not be too large and their economic structure not too different.

The petroleum industry is, almost uniquely, a "natural" cartel which fulfills all of these conditions. Two distinct phases seem to operate alternately in this situation: growth and stabilisation. Formerly, the international oil companies' objectives as a cartel were to stabilise conditions through efficient production, with a growing market stimulated by

¹⁷P.H. Frankel, Essentials of Petroleum - A Key to Oil Economics, Frank Cass Co., Ltd., London, 1946, p. 82.

low prices, for a good product which was universally in demand, cheap to produce, and available in virtually unlimited quantities, at least in the short to medium term.

The OPEC countries' cartel was, as will be seen, initially concerned only with stabilising already low price levels, and only later undertook to drive prices upwards in spectacular fashion. The groups of OPEC countries led respectively by Saudi Arabia and Iran, are now trying to work out an appropriate stabilisation at a new and higher price level. As will be elucidated in the ensuing chapters, the Saudis are for stopping now, while the Iranians are for pushing for all that the traffic will bear. The situation is rendered more complex by problems of inflation, and certain inconsistencies of policy as between one group and another, which, inter alia, seriously threaten destruction of the OPEC cartel.

III. THE OPEC CARTEL

III. THE OPEC CARTEL

The Organisation of Petroleum Exporting Countries was conceived as a counter to the oil company cartel, to secure the interests of the major crude oil exporting nations against what they regarded as the artificially and ruinously low revenues they received for such a vital commodity. It was founded in 1960 as the brain-child of Sheikh Abdullah Tariki, then Minister of Petroleum of Saudi Arabia, and Dr. Juan Pablo Pérez Alfonso, Minister of Petroleum of Venezuela.¹ The original members were the governments of the five countries that were supplying 80 per cent of all the oil moving in international trade: Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. The following additional countries have since become members: Algeria, Ecuador, Indonesia, Libya, Nigeria, Qatar, and the United Arab Emirates. Gabon is an associate member. OPEC should not be confused with the Organisation of Arab Petroleum Exporting Countries (OAPEC) which contains the Arab members of OPEC, plus Egypt and Bahrein.²

¹Ruth Sheldon Knowles, America's Oil Famine, Coward, McCann and Geoghegan Inc., New York, 1975, p. 63.

²In 1973, oil production by members of OAPEC was equal to 58 per cent of total OPEC production.

The deployment of the "Arab Oil Weapon" was the work of OAPEC, not OPEC,³ which is an economic, not a quasi-political organisation.

The objectives of OPEC were stated in its statute as follows:

"A. The principal aim of the Organisation shall be the coordination and unification of the petroleum policies of Member Countries and the determination of the best means for safeguarding their interests, individually and collectively.

B. The Organisation shall devise ways and means of ensuring the stabilization of prices in international crude-oil markets with a view to eliminating harmful and unnecessary fluctuations.

C. Due regard shall be given at all times to the interests of the producing nations and to the necessity of securing a steady income to the producing countries; an efficient, economic, and regular supply of petroleum to consuming nations; and a fair return on their capital to those investing in the petroleum industry."⁴

OPEC's first resolution is regarded as the Magna Carta of oil exporting countries. The governments agree:

"That members can no longer remain indifferent to the attitude heretofore adopted by the Oil Companies in effecting price modifications;

That members shall demand that Oil Companies maintain their prices steady and free from all unnecessary fluctuation;

³Iran supplied Israel with oil throughout the October 1973 War and has continued to do so without interruption since that time. Venezuela and other non-Arab OPEC members did not take part in the oil embargoes against the United States and the Netherlands.

⁴Organisation of the Petroleum Exporting Countries, The Statute, Chapter I, Article 2.

That members shall endeavour, by all means available to them, to restore present prices to the levels prevailing before the reductions; that they shall ensure that if any new circumstances arise which in the estimation of the Oil Companies necessitate price modifications, the said companies shall enter into consultation with the member or members affected in order fully to explain the circumstances;

That members shall study and formulate a system to ensure the stabilization of prices by, among other means, the regulation of production, with due regard to the interests of the producing and consuming nations, and to the necessity of securing a steady income to the producing countries, an efficient, economic and regular supply of this source of energy to consuming nations and a fair return on their capital to those investing in the Petroleum industry."⁵

This appears to be a very reasonable and moderate appeal for co-operation. It simply and quite sensibly argued for a stabilisation of the governments' oil revenues at a level which today would be regarded as extraordinarily low, i.e., a posted price in the order of \$1.25 - \$1.50 a barrel. Despite this, for some time after the creation of OPEC, the oil companies ignored its existence and treated its spokesmen, representatives of sovereign governments, with contempt. They consistently refused to enter into any meaningful dialogue, and simply went ahead with the unilateral setting of prices. The birth of OPEC was, in fact, the immediate outcome of a cut of 14 cents per barrel in the posted price of Middle East oil, without any warning or prior consultation with the affected countries, by Standard Oil of New Jersey (now Exxon); a cut which was almost immediately followed by the other major companies.

⁵Quotation by Ruth Sheldon Knowles, op. cit., p. 66

It should now perhaps be explained what the oil industry means when it talks about "posted prices". Except for the new independents, all the oil companies operating in the Arab countries and Iran, as previously explained, were, and still to a large degree are, joint subsidiaries of the Anglo-American majors. These subsidiaries are simply and solely producers of oil, and while they do a little refining of crude locally for domestic markets, they have no hand in transporting, processing or distributing it outside the producing countries. They sold (and still sell) their oil to their parent companies at what used to be low prices, and paid a royalty and/or a tax based on that deliberately low price to the governments of the countries in which they operated. Their parent companies would then process and/or re-sell this bargain-rate crude at the prevailing world prices, which were based on more expensively produced U.S. oil. The result was low revenues for the producing countries and high profits for the Anglo-American majors.

The U.S. price of domestically-produced oil had been consistently maintained at a high level by means of "pro-rating", or shared production restrictions.⁶ Under the "basing-point" system, the price of crude oil around the world, even in Tehran, Baghdad, or Ras Tanura, Saudi Arabia, was set as the Texas price plus the cost of transportation

⁶Leonard Mosley, Power Play - Oil in the Middle East, Random House, New York, 1973, p. 289.

from the Gulf of Mexico to the point of purchase.⁷ Texas Gulf port prices were, then, together with a phantom shipping charge, the historical origin of the "posted price".

Posted prices are now expressed in terms of a hypothetical Gulf crude oil used as a "marker", which is established as Arabian Light crude oil, 34° API specific gravity, on the basis of FOB Ras Tanura, Saudi Arabia.⁸

By 1973 the industrialised world had become so dependent upon internationally-traded crude oil that with the emergence of OPEC, it became a matter of a change of masters, a substitution of one cartel for another. While this shift of monopoly power was immediately and dramatically precipitated by the October War, OPEC had for several years succeeded in pushing prices significantly higher. Even without the influence of political events, it was only a matter of time before the OPEC countries would have realised the strength of their position and moved to assume control of the oil industry at the production end. What must be emphasised, however, is that these developments were inevitable. As has been seen, the international oil companies had profited hugely for many years, and today are doing better still - so well, in fact, that they would probably be the first to resist any return to the status quo ante.

⁷Joe Stork, Middle East Oil and the Energy Crisis, Monthly Review Press, New York and London, 1975, p.58.

⁸These and other terms are defined in Appendix E, "Glossary of Terms used in the Oil Trade".

The members of OPEC are all developing countries for which petroleum is not only the principal source of foreign exchange, but also the key to their further development. Far from being a homogeneous group, they differ enormously in their need for imports and in their volume of oil reserves, in relation both to present levels of production and to the needs of their varied populations, which are quite disparate. There are, in fact, basically three different groups of countries, the individual members of which have quite different, and perhaps, in the long run, mutually inconsistent structures of resources and population, as well as objectives.

These countries' structures are depicted in the accompanying Table 2. As will be seen later, these inconsistencies constitute a grave danger to the solidarity of the OPEC countries, and could very well lead to the breaking up of the cartel. These country groupings are:

A. Saudi Arabia, Kuwait, Qatar, Libya and the United Arab Emirates.

These countries contain 65 per cent of proven crude oil reserves, and about half of current output, but, taken together, a combined total of only about 10 million people, and accordingly a very limited ability to absorb large quantities of imports. These countries basically take a long-term view of petroleum policy, and would see it as in their interest to retain their oil reserves for as long as possible, on the theory that "oil in the ground is better than money in the bank."

Table 2.--OPEC Countries: Populations, 1973 Oil Production, Reserves*

Country	Population (millions)	Proven Reserves (billion tons)	Output (million barrels per day)	Reserves Years (at 1973 output rate)
<u>Group A</u>				
Saudi Arabia	5.3	19.3	7.5	51
Libya	2.6	3.4	2.1	32
Kuwait	.9	10.1	3.0	66
Qatar	.1	.9	.5	31
UAE (Abu Dhabi)	.3	2.9	1.2	45
Sub-total	9.4	36.4	14.3	50
Share of OPEC		65 %	48 %	
<u>Group B</u>				
Iran	34.5	8.2	5.9	28
Venezuela	11.3	2.0	3.5	11
Iraq	10.8	4.3	2.0	44
Algeria	16.0	1.0	1.0	20
Sub-total	72.6	15.5	12.4	25
Share of OPEC		28 %	41 %	
<u>Group C</u>				
Nigeria	73.4	2.7	2.0	27
Indonesia	125.0	1.4	1.3	22
Sub-total	198.4	4.2	3.3	25
Share of OPEC		7 %	11 %	
Total	278.2	56.1	30.2	

*Adapted from Hollis Chenery, "Restructuring the World Economy", Foreign Affairs, January 1975, derived ultimately from Oil and Gas Journal (reserves) and the World Bank. 1973 is sufficiently recent for the purpose, and the addition of Ecuador and Gabon to Group C would make little or no difference in the analysis. Population figures for Groups A and B are updated to 1975.

They neither need nor want excessive incomes at this time. Their reserves have a potential life of 50 years or more, and they have no other significant natural resources.

B. Algeria, Iran, Iraq and Venezuela

These countries have already achieved a significant level of economic development. Their combined populations number nearly 73 million. They already possess, to a substantial degree, the infrastructures necessary to make full and effective use of their oil reserves in the medium term. Their oil reserves will run out, at present depletion rates, in perhaps 25 years or less. They are running down their reserves at higher rates, and would find it to be advantageous to exact the highest possible revenues in the short run, to take full advantage of the many opportunities for productive investment in their domestic economies. These countries are "racing against time". They are trying to achieve viable, independent, long-term, modern, industrialised, diversified status before their oil runs out.

C. Ecuador, Gabon, Indonesia and Nigeria

These countries comprise a third group which has a limited share of the world's oil resources and no problem in absorbing all the oil revenues they can generate. All of them are very under-developed, and both Indonesia and Nigeria have very large populations. These countries have

the greatest and most urgent developmental requirements. They constitute another "weak point" in the OPEC front, and could be expected to "shade prices" to maximize their short-term revenues.⁹

All of the points made above will be developed further in this thesis. At this juncture, however, it will be more useful to examine the oil countries' own development plans, as well as they are known, prior to attempting to assess both the nature and the magnitude of the problem of recycling of so-called petrodollars. For reasons which will be clear, further analysis will be limited essentially to the countries of the Middle East. These constitute all of the Group A, and all but one of the Group B countries, the exception being Venezuela. These nations are where most of the problems lie.

⁹Following the September 27, 1975, OPEC price rise of 10 per cent, Indonesia significantly raised prices formally by only 4 per cent. It was subsequently reported that, to retain the Japanese market, it had actually raised prices by only 10 cents a barrel.

IV. THE DOMESTIC DEVELOPMENT POLICIES
OF OPEC COUNTRIES

IV. THE DOMESTIC DEVELOPMENT POLICIES OF OPEC COUNTRIES

As a result of their newly achieved wealth after the rise in oil prices in 1973-1974, OPEC countries have engaged in heavy spending in the fields of internal and external development and military armament, and have drafted ambitious plans for the future development of their economies. The implementation of these plans has generated enormous increases in imports from the industrialised countries. This has had a positive effect on the balance-of-payments between consuming and producing countries and forecasts of the accumulation of surplus oil revenues have had to be revised repeatedly. As indicated elsewhere in this thesis, there is still great uncertainty in this area. The rapidity of this development, however, and the fact that it coincided with the recent slump in OPEC oil exports, has reduced available funds to the point where indications of financial constraints can be noted in some countries.

For example, the Iranian Ministers for Foreign Affairs and for Planning recently announced on different occasions that aid and development programs would have to be curbed as a result of reduced oil revenues and in order to fight inflation, which exceeds 20 per cent. The Algerian and Iraqi governments have negotiated \$500 million loans to finance their development plans.

The Sultanate of Oman had to be, and still is, subsidised by Saudi Arabia after large expenditures, particularly on military goods.

In view of the future economic growth and the future expenditure of these countries as scheduled in their development plans, these extremely ambitious aims will represent a heavy financial burden for many of these countries and might well bring them to a deficit position within a short time, in particular if oil production does not correspond with the forecasts made so far. Such a development might have considerable influence on the producing countries' policies. To avert an otherwise necessary reduction of their aims and expenditures, producing countries would then have to try either to reach agreement with consuming countries on levels of production and corresponding price levels or to increase oil prices further in order to meet expenditure requirements.

It is, therefore, important to obtain as much information as possible on the development plans and expenditure policies of producing countries, as compared with their expected revenues for oil and other exports.

The development policies of the Middle Eastern OPEC countries differ according to their national characteristics. Qatar, Kuwait, the United Arab Emirates, Libya and Saudi Arabia have small populations and a very high per capita GNP. Their development potential is limited so that the huge

development plans being launched recently may be too ambitious to be fully implemented. Thus large surpluses may continue to accumulate.

Iran, Iraq and Algeria are countries with a medium per capita GNP and a medium-sized population. They are already relatively advanced in their economic and social development and consequently have a high absorptive capacity. Therefore large commitments in their development plans tend to result in big deficits if and when estimated oil revenues are not actually achieved.

So far as they are known from various published sources,¹ the present development policies² of each of the most important OPEC Members are furnished hereunder:

Algeria

The new four-year development plan (1974-1977) adopted in May 1974 schedules capital investment totaling about \$22 billion. The main items of the development plan are education, water, rural development and communications.

Iran

The Fifth Five Year Development Plan (1973-1978) originally aimed at 11.4 per cent annual GNP growth with total investment of \$32 billion. Major areas of investment are industry, oil, housing, communications, agriculture and education.

¹Primarily Middle East Economic Digest, London, (weekly): issues from November 1973 through September 1975.

²No attempt is made at evaluation of these policies, which is beyond the scope of this thesis.

A large scale revision, almost doubling the total investment up to \$69 billion, was made in August 1974. Now the plan aims at 26 per cent average annual growth of GNP and puts far more emphasis on electricity, communications, industry and government buildings, rather than education and rural development.

The plan was further revised in December 1974 adjusting to the fiscal 1975 budget of \$36.2 billion.

Slowdown of the plan through reassessment of the priorities was publicly announced in June 1975. A reduction in oil revenues, shortage in manpower and construction materials, bottlenecks in infrastructure and inflation were mentioned as the main reasons.

Iraq

Fourth 5-year plan (1975-1979) with total investment of \$16.9 billion at 1973 prices was made public in October 1974. The Plan aims at extensive industrialization and agricultural development. The investments are allocated among industry (\$4 billion), agriculture (\$4 billion), transport and communications (\$3.4 billion), buildings and social services (\$3.4 billion) and others. Major projects are petrochemical, refinery, steel, aluminum, cement, fertiliser, textiles, food, electricity and irrigation networks.

Budgets for 1975 and 1974 are respectively \$12.3 billion and \$9.92 billion, of which about 30 per cent is used for the development plan.

Kuwait

The new 10-year Plan for providing guidelines for annual budgets allocations was drafted in 1969 and will be effective until 1978.

Because of small domestic markets and the lack of skilled labour, the potential for industrial development is limited to oil-based industries or downstream activities and to some joint ventures with assured foreign markets.

The total budget for 1974-1975 is set at \$3.25 billion and expenditure for development projects at \$0.6 billion, while the total anticipated oil revenue is about \$10.14 billion.

Libya

The Revolutionary Council has a three-year (1973-1975) economic and social development budget totaling \$8.69 billion as the result of successive upward revisions.

The development budget for 1975 was set at \$3.75 billion in February 1975 in which high priority items are agriculture (21 per cent), industry and materials (17 per cent), housing (12 per cent), electricity (10 per cent) and education (10 per cent).

Qatar

No comprehensive development plan is known to exist, but varieties of development projects concerning housing, water and gas supply, transportation, communication, and social development, most of which are in the Doha area, have been noted.

Future industrial development is expected to include factories for aluminum, steel, glass refinery products, chemical-fertiliser, LPG and cement.

Saudi Arabia

The second five-year plan (1975-1980) with the required total investment of \$142 billion was approved in May 1975. The projected annual growth of GDP is 10.2 per cent combined with a structural shift away from oil's predominant position.

Principles of development strategy are diversification of economic base, rapid development of manpower and development of economic regions.

The projected growth of private non-oil production in five years is threefold and an annual growth rate of 15 per cent is expected equally for mining and quarrying, construction, utilities, transport and communications, trade and business services. Between 1975 and 1980 the share of construction in private non-oil production will rise to 33.3 per cent from 26.6 per cent while that of agriculture declines to 4.6 percent from 8.6 per cent.

Average annual growth rate of the private oil sector is estimated at 9.7 per cent.

Increases are expected in the labour force from 1.6 million to 2.3 million, of which 0.6 million will comprise non-Saudi foreigners.

The implementation of this second plan seems to be excessively ambitious when various constraints and large social impacts are taken into account.

United Arab Emirates (UAE)

The Federal Ministry of Planning located in Abu Dhabi is in its very early stage, and is currently collecting information and data about the member countries; projects are approved on an ad hoc basis with interstate trade-offs among the members of the group.

The priority in development is on transport and communications to unite the member countries.

The federal budget for 1975 was approved in April with the total expenditure of \$703 million of which \$245 million will be spent for developing projects. Abu Dhabi's contribution to the budget is set at \$506 million (i.e. 72 per cent of the total). Including this contribution, Abu Dhabi's own total expenditure for 1975 is estimated at \$3.26 billion, with \$886 million for development. No

details on actual plans are yet established.³

The accompanying Table 3 compares the estimated development expenditures of Middle Eastern OPEC countries for 1975-1977 with their estimated oil revenues for the same years.

The following points should be noted:

Development expenditures are estimates based on national development plans and development budgets. They are first order approximations because of the limited information and differences in development plans. Figures for Qatar were unobtainable; in their place values of imports are quoted as a preliminary estimate (underlined).

Development expenditure is evidently only a part of total expenditures which are also partly financed by non-oil revenues. Nevertheless, the share of development expenditure is relatively large and non-oil revenues are generally very small in most OPEC countries. The indicated "surpluses" will become even smaller or turn into deficits if other expenditures are taken into account and more conservative estimates for oil revenues are applied.

³ Known previously as the Trucial States, the seven Gulf emirates of Abu Dhabi, Dubai, Sharjah, Ajman, Umm Al-Qawain, Ras Al-Khaimah and Fujairah formed the United Arab Emirates in December, 1971. Abu Dhabi is the largest and wealthiest, with most of the oil revenues, followed by Dubai, the principal commercial and entrepôt centre. The others are all poor, but have now signed oil exploration agreements, and some oil has been discovered in Sharjah. Inter alia, the unification resulted in the formation of the UAE Currency Board and the issue of the UAE Dirham, currently worth about 25 cents.

	1975			1976			1977		
	Oil revenues	Dev. Exp.	Sur- [*] plus	Oil revenues	Dev. Exp.	Sur- [*] plus	Oil revenues	Dev. Exp.	Sur- [*] plus
Algeria	3.7	5.5	-1.8	4.4	5.5	-1.1	5.1	5.5	-0.4
Iran	20.5	13.8	6.7	22.4	13.8	8.6	23.4	13.8	9.6
Iraq	7.5	3.4	4.1	9.3	3.4	5.9	11.4	3.4	8.0
Kuwait	7.5	0.6	6.9	8.0	0.7	7.3	8.4	0.7	7.7
Libya	5.3	3.8	1.5	6.8	4.2	2.6	8.4	4.6	3.8
Qatar	2.0	<u>0.4</u>	1.6	2.2	<u>0.4</u>	1.8	2.3	<u>0.5</u>	1.8
Saudi Arabia	31.1	28.8	2.3	32.3	28.8	3.5	35.8	28.8	7.0
U.A.E.	5.6	1.1	4.5	6.4	1.2	5.2	7.7	1.3	6.4
Total	83.2	57.4	28.6	91.8	58.0	33.8	102.5	58.6	43.9

^{*} The word "surplus" here means only the difference between oil revenues and development expenditure and not the surplus of trade or balance-of-payments.

Table 3.--Comparison of estimated development expenditures of Middle East OPEC countries with their estimated oil revenues, 1975-1977

V. OPEC FOREIGN INVESTMENT

V. OPEC FOREIGN INVESTMENT

The importance of the issues raised by the possibility of heavy investment by the OPEC countries in the industrialised world, particularly in the equities of established companies, has caused this matter to be subjected to periodic examination by the Committee for Invisible Transactions (CIT) of the OECD. Other OECD bodies are also regularly concerned with examining other aspects of OPEC investments.¹ The CIT is primarily concerned with methods of controlling access of foreign investors to domestic markets.

At a meeting of the CIT in April 1975,² a decline in the overall level of direct investment was noted for 1974. Although there were exceptions, (e.g. Austria, United States), it was generally felt that the pace of direct investment had slackened, especially in real terms, owing to the deepening recession, continuing currency uncertainties, and lack of business confidence, linked to the high rate of inflation and the share price declines on most stock markets. Even over a longer period, there appeared to be deceleration in

¹The EPC ("OPEC Investments within the consumer-producer dialogue", and "Recycling of oil producer funds and balance of payments effects"; and the IME ("General policies towards OPEC direct investments").

²OECD/Committee for Invisible Transactions, DAF/INV/75.26, Paris, June 3, 1975.

the rate of growth of direct investment in the industrialised countries.

A number of developed countries have expressed an active concern with problems presented by direct investment, and some, notably Canada and Australia, have adopted legislation in order the better to control it. France and Japan, on the other hand, have simplified their procedures.

It is interesting to note that the CIT feels that the publicity given to the phenomenon of OPEC investment has been out of all proportion to the reality. While reliable investment figures have been difficult to obtain, the actual volume of OPEC direct investment was quite small in 1974, relative both to the total funds that they deploy and to the volume of total direct investment into the OECD countries. It is estimated at roughly one billion dollars invested, principally in France, Germany, Britain, and the United States, and to a lesser degree in Australia, the Netherlands and Japan, the amounts being negligible elsewhere.³

³It should be borne in mind, however, given the lead time involved in many direct investment projects, that it is possible that surplus funds have been only temporarily channeled into short-term money markets, while waiting for good investment opportunities to materialise. If this should be the case, we may be witnessing the very early days of OPEC direct investments. Even though the forecasts of surplus funds available have been revised downwards, there are indications that a larger proportion will be invested long-term in real estate, securities, and direct investment. It is still too early to ascertain the sectors or activities which might attract OPEC investors.

So far as is known at the present time, there is no official discrimination applied between OPEC investments and comparable investments from other industrialised countries, although that possibility cannot be ruled out, particularly in the United States, where Congressional reaction to the prospect of massive OPEC investment has been rather hostile. While no specific measures have yet been enacted to curtail OPEC investments, as such, the possibility still exists of the introduction of emergency curbs in some conceived national interest.

So far, although highly visible transactions from OPEC sources have as yet occasioned no alarm, the possible use of nominees or intermediaries has been the subject of some concern. Only in the United States is there a stringent requirement that any party, domestic or foreign, acquiring more than ten per cent of the voting rights of a quoted company must report its beneficial ownership to the Securities & Exchange Commission (SEC).⁴

One of the major concerns of the industrialised countries is the possibility that OPEC countries would achieve not only a financial interest, or even operating control, but also have as an objective the employment of such control for political purposes. Hence, even though

⁴While purchases of shares through a "front" may provide little direct control to a buyer, it is possible to control and to direct the policies of a company through a number of such nominees, and to build up a takeover position.

boycotts and embargoes associated with foreign control are still a hypothetical issue, some governments are contemplating certain "sensitive" areas of their economies (infrastructure, defence, advanced technology) where foreign control, especially by OPEC interests, might be discouraged. The United States, of course, has already long since adopted a number of measures of control over foreign investment into certain "sensitive" sectors, supplemented over the past two years by a number of actions aimed in fact, if not formally, at countering the possibility of OPEC control.

The fear of political control may be misplaced. It is the OPEC countries who have more to worry about in that respect, and it may be, indeed, such fears which have inhibited their potentially massive investment in real estate and company shares up to the present time. Money so invested is essentially locked in. Having lost its liquidity, and incapable of being quickly transferred to a newer, safer haven, it becomes a hostage under the virtually complete control of the government of the recipient country. As the United States has had frequent occasion ruefully to note in the past, a foreign enterprise can be quickly and easily nationalised, practically overnight, with little or no compensation at all comparable to the real value of the assets lost.

From the international political standpoint, the United States has everything to gain, and nothing to lose by allowing in as much OPEC money as it can absorb while

still maintaining reasonable economic stability. It is difficult to believe that the U.S.A., despite its neo-mercantilist philosophy, can fail to see the long-term implications and benefits of such spreading of the ownership of U.S. industry.

Assuming that the OPEC countries control their very ambitious efforts to modernize their domestic societies, and assuming further that they will still continue to make a necessary contribution toward resolution of the problems of the Fourth World, their investible surpluses could very logically be invested in existing industry in the industrialised world, primarily, but by no means exclusively, in the United States. Such investment might be in the order of \$200-250 billion over the 20 year period to 1995.

The OPEC countries would thereby assure for themselves, for their people and for their descendants in perpetuity, a share in the productive wealth of the world, such as it may be in the far future, regardless of what happens to the currently vital, but in the future possibly relatively less vital, diminishing irreplaceable resource, which is all they have.

As a consequence, their economic objectives would become one with those of the industrialised countries. As the latter prosper and grow, so do they. Secondly, one could expect that their political interests would also merge and coalesce with those of the western countries in a natural

alliance wherein the safety and security of the West would be indistinguishable from their own.

The United States asserts the claim that U.S. policy in general has been to maintain an "open door" policy to foreign investment, with a few exceptions to assure national security and to protect vital national interests. Nevertheless, the Foreign Investment Study Act,⁵ signed by President Ford on October 26, 1974, mandates a comprehensive study of inward foreign investment as of the end of calendar year 1974. It directs the Secretary of the Treasury to conduct a survey of foreign portfolio investment in the United States, and the Secretary of Commerce⁶ to conduct a survey of foreign direct investment. The Treasury study is expected to be largely completed by late Fall 1975, and reports to the Congress from both the Treasury and Commerce Departments are to be submitted by Spring 1976. Moreover, Executive Order 11858, signed by President Ford on May 7, 1975,⁷ created the Committee on Foreign Investment, which is charged with assessing general trends and significant investments in the United States which, in its judgment, might have major implications for essential U.S. national interests. It is also responsible for considering proposals for such

⁵Text in Appendix B.

⁶U.S. Commerce Department Regulations of February 3, 1975.

⁷U.S. Presidential Executive Order 11858 of May 7, 1975.

new legislative or administrative actions as could affect foreign investment.

A compendium of U.S. laws which currently bear on foreign investment into the United States is in Appendix C. This summary details specific provisions of U.S. federal law which restrict participation by foreign individuals, corporations, governments, and foreign-controlled enterprises in U.S. economic activity. These restrictions are up-to-date, but are naturally subject to change as a result of the findings of the Committee on Foreign Investment.

It is, however, only fair to say that up to the present time, most governments dealing with sizeable inflows (France, Germany, Britain, and the United States) have reported⁸ that OPEC investors have been co-operative and have kept the authorities fully informed, even where there is no requirement to do so. In general, it has been observed that OPEC investors are interested in sound and orderly market conditions, and quite apparently desire to maintain cordial relations with host governments.

It may be that the industrialised countries should be actually encouraging OPEC investment, particularly in their stock markets. Much-needed capital would be provided, and a general upward stimulus imparted to the stock markets themselves and, through them, to the economy in general.

⁸OECD/CIT DAF/INV/75.26, Paris, June 3, 1975.

It seems to be clear that the OPEC countries, of which the Saudi case can be considered rather typical, themselves suffer from a certain "money illusion". Aside from the much-publicised Krupp and Daimler-Benz acquisitions, and a few dealings in British and U.S. real estate and U.S. banks, they have shown little imagination in obtaining real resources in exchange for their own, instead of the favoured dollar and other paper holdings. Of \$11 billion placed in the U.S.A. by OPEC countries in 1974, \$6 billion went into government securities and \$4 billion into bank deposits, leaving a mere \$1 billion for all other, presumably more productive, investments.

These countries are still very dependent on western private bankers and financiers. Because of their huge surpluses, the two major foreign investors are Kuwait and Saudi Arabia. Despite their country's reputation for financial expertise, few Kuwaitis have had experience in investment banking. Although official instructions to the investment department of the finance ministry are (a) to give priority to the purchase of real assets; (b) to look for these first in the Arab world; and (c) to involve Kuwaitis in their management, in practice, probably no more than ten per cent of Kuwait's foreign holdings are in equities or direct investments.⁹

⁹The Economist, June 7, 1975, p. 46, "Investment from the Gulf".

The main trends of Saudi Arabian investment are:

- Increasing purchases of the long-term marketable debt of the governments of big countries, e.g., the British gilt-edged, and special loans. Loans of ten years' maturity, for example, have been made to Canadian provincial governments and to France.
- A move into corporate bonds, of companies with the very highest credit ratings.

Bankers regard SAMA (the Saudi Arabian Monetary Agency) which is both the central bank and the state investment institution as "an ultra-conservative pension fund". The Saudi Government appears to be quite content to place its surplus funds with western institutions at minimum inconvenience to itself.¹⁰

Since these countries' holdings are primarily in various forms of money or near-money, denominated in dollars, it is understandable that they should be constantly concerned with fluctuations in the value of the dollar in international exchange markets, and that they should intermittently give serious consideration to tying their own currencies to a "basket" of strong currencies, and to quoting oil prices in SDR's. The same problem is at the root of the intermittent pressures within OPEC to raise the price of oil, or to establish some form of indexing, to mitigate the effect on OPEC countries of the inflationary increases in the prices

¹⁰Ibid.

of the goods and services they themselves must import from the industrialised world.

It has been proposed¹¹ that it might be possible to establish an "OPEC Mutual Investment Trust", or family of trusts, to purchase equities in the form of either new or already existing securities. The originators of this suggestion have proposed the creation of an elaborate system of equity-holding in the trust form, so as to "provide a buffer against the direct holding of voting stock by OPEC governments", which would, in turn, "have the satisfaction of acquiring investments purely on their merit as sound earning assets, removing any possible implication of political motives or a desire to control the industry of another country".¹²

This approach would seem to be a rather emotional reaction to the question of foreign ownership. If it is perfectly acceptable, even highly desirable, for United States interests to own over \$300 billion (book value) worth of overseas investments, including myriad major manufacturing concerns with, in many cases, complete domination of the entire industrial plant of some countries, there would seem to be no reason why foreigners should not

¹¹Farmanfarmaian, K, Gutowski, A, Okita, S., Roosa, R.V., and Wilson, CL., "How can the World Afford OPEC OIL?", Foreign Affairs, January 1975

¹²Ibid., p. 221

be allowed to purchase control of some part of U.S. business. There is no need for such a prospect to generate alarm and despondency.

Farmanfamaian, Gutowski, et al go on to say (and it is worth quoting in full):

"In the interests of oil-consuming countries:

1. No trust should hold shares in any company which would bring the known total holding of such shares by OPEC governments or their agencies above, say, ten per cent of the total outstanding, unless specific approval is obtained both from the management of the company and the government in which (sic)¹³ its head office is located.
2. The trusts would undertake to buy or sell shares (or debentures) in amounts above, say one million dollars (or the equivalent in other currencies) only with the knowledge of the company. In this way, the company may have first refusal of an opportunity to offer stock (or debentures) directly at the going market price or, if it wishes, to buy back such instruments at the going market price. This would help protect the trusts against creating an undue movement of the market price against their interests, and would assist the company in maintaining an orderly market for its obligations.
3. The trusts should undertake to give prior notice to the affected central banks whenever they contemplate transfers into or out of a particular currency in amounts of, say, five million dollars or more (or whatever benchmark each central bank wishes to set). In this way, undue disturbances to exchange rates could be avoided, as desired by the affected central banks, to the advantage of everyone, including the OPEC investors.
4. The directors should agree that voting shares in companies will be exercised by the management with a view solely to protecting the value of the investment, in a manner comparable to the normal exercise

¹³This just may be an interesting example of a Freudian slip! All of the authors are influential officials and former officials of, or economic advisers to, the U.S., British, West German, or Japanese Governments.

of such rights by leading trust companies in behalf of their clients, and not for any other purpose".

The article goes on to say that:

"The OPEC countries, whose principal product has been for so long underpriced and overused, must be able to convert their exhaustible oil into permanent capital and perpetual earnings, at home and abroad. They need, and undoubtedly want capital markets of their own, and ready access to flourishing capital markets in other countries, to provide an assured base for the economic growth they rightly expect for their descendants".

While this is probably quite correct, it is at least questionable if there is any justification for establishing discriminatory restrictions against OPEC investment. It is suggested that OPEC investors, suitably advised, will themselves perceive the wisdom of diversifying their holdings as to real and intangible property; by country; by objectives (that is, capital appreciation vs. current dividends); by currency area; by degree of liquidity desired, and so on, as would any other major investor, albeit on a smaller scale, such as a pension fund or an insurance company.

Notwithstanding recent experience in the stock markets of the world, equities in sound companies, together with real estate, still offer the best hedge against inflation in the long term, although profit-making opportunities are available in the commodities markets in the shorter term. At current depressed levels of equity prices, there is an extremely good opportunity for capital appreciation as an offset to erosion through inflation. Opportunities of this kind were even greater at the still lower share

prices which prevailed throughout 1973-74. Diversification among firms, industries, countries, etc., should provide the greatest practicable assurance to OPEC investors that their principal values can be maintained in real terms, and their earnings assured in perpetuity. They should certainly, by now, have learned a sharp lesson with respect to the magnitude of possible losses to be incurred, in real terms, by holding mere money.

Moreover, the movement of large amounts of U.S. dollars into western economies would give a much-needed stimulus to business and industrial activity generally. The push given to stock prices in the exchanges by such large investment would give rise to a virtually self-fulfilling prophecy.

In summary, it is recommended that OPEC investment companies be created and structured in such a way as to invest primarily in North America and Western Europe, and, with due regard to diversification to spread their risks, primarily in existing stocks of strong companies and in real estate, to the extent permitted by the law in each recipient country. Respecting legal restrictions, if reporting to affected central banks of major transfers into or out of a particular currency, and limiting the holding of stock by a single investor to ten or any other percentage, are good ideas, they should be established as rules of general application, on an entirely non-discriminatory basis. There is no more, or less, justification for U.S. business

interests to own 100 per cent of a Canadian company than for Iranian business interests to own 100 per cent of a U.S. company, with all that such ownership normally implies in terms of corporate policy and control.

The oil-producing countries should become large equity holders in the financial institutions and industrial companies of the United States, Western Europe, and Japan. This would seem to be the only viable solution which is consistent with their legitimate economic and political aspirations, and it is inherently just. The U.S.A., in one way or another, has achieved a position whereby six per cent of the world's population controls a very large proportion of its prime resources and manufacturing industry. It is no more than fair to allow other countries to share in the prosperity to which they have been such major and in fact indispensable contributors. Moreover, such investment would, by to an important degree removing the threat presented by U.S. economic imperialism and creating direct financial interest on the part of other countries in U.S. industrial progress, contribute to world peace. If the Arab countries, for example, were to hold a major stake in U.S. industry, they would be far less likely to play the East against the West, holding out their resources as a prize. This situation should be acceptable to the U.S.A. as a major contribution to U.S. security inasmuch as it would render the interests of such countries more or less identical to its own.

One might emphasise the obvious element of relative stability which would be imparted to the international exchange markets of the world if these surplus funds were to be placed in stable, long-term investments rather than in financial instruments. This is particularly important in this era of more or less freely floating exchange rates, when the sudden movement of large sums of money can have enormously destabilizing and harmful effects. For example, it was recently reported,¹⁴ no doubt because of an increasing lack of confidence in sterling vis-à-vis the U.S. dollar, that oil-producing countries have begun to transfer large amounts, of money out of Britain in favour of investments in the United States and continental Europe. They reduced their investments in pounds sterling by the equivalent of \$300 million in the second quarter of 1975. This movement against sterling can only help to bring about the crisis, the fear of which caused the outflow in the first place. Had these funds been invested in real estate or in private British firms, they would have been far less liquid, hence less capable of doing harm.

Finally, the OPEC countries would be wise to invest in the West. It would contribute to foreign exchange, and general economic stability worldwide, if they would invest in equities and in real estate, and in the most productive

¹⁴Ottawa Journal, 20 September 1975, "Oil Producers Pulling Money out of Britain".

areas possible so as to generate sufficient rentier income against the day, which will inevitably come, when either the cartel breaks of its own internal inconsistencies, or cheaper energy becomes generally available from other sources. As will be discussed later, it may well be that the cartel will break first. But if it does not, the OPEC countries must still look forward to the arrival of the day when inexhaustible, virtually cost-free energy will become universally available. Once the technological breakthroughs come, their oil, if indeed any oil is left, will be worth little more than its marginal cost of production, and will be in demand chiefly for the manufacture of lubricants and petro-chemicals. As a fuel, it will be passé. They must take full advantage of their opportunity while they have it. They will not have a second chance.

VI. OPEC OIL REVENUES

VI. OPEC OIL REVENUES

To obtain some insight into the nature and magnitude of the recycling problem, it is first necessary to achieve an understanding of the magnitude of OPEC oil revenues. In other words, just how much money is flowing to the OPEC countries?

Before considering this question, one thing must be made quite clear. The "era of cheap energy" is not over. It is only temporarily in suspense. The technology of the industrialised countries will, inevitably, overcome the scientific and engineering problems which stand in the way of the production of virtually marginal-cost-free energy in a world of inexhaustible energy supplies - a world in which petroleum will have relatively limited uses outside of lubrication and feedstocks for petrochemical industries.

Without international conflict, and in the normal course of events, this goal would probably have been achieved toward the middle of the twenty-first century. Under the spur of unnecessarily high crude oil prices, it is likely to be achieved in the late 1990's.

Before that, however, from now until 1985, large-scale efforts are being devoted to bringing new energy sources on stream. The days of the OPEC price dictatorship are numbered. Accordingly, the OPEC countries will have to

look forward to a period 5 to 10 years from today, when their huge oil payments will be a thing of the past, and they will be far more heavily dependent upon their revenues from other sources, such as proceeds from their exports of products from their newly established industries, and/or rentier income from overseas investments.

Hence, OPEC oil wealth is, in itself, a short-lived phenomenon, and of long-term value only to the extent that full advantage is taken by the OPEC countries of this unique concatenation of historical and geological circumstances to establish modern, industrial economies which will be economically viable in the long term.

Essentially, therefore, what are to be ascertained are the nature and magnitude of OPEC revenues from, say, 1973, to the early-to mid-1980's.

Surprisingly, however, and notwithstanding the passage of more than two years since the inception of the problem, it is still extremely difficult to determine with any confidence the magnitude of OPEC net oil revenues, and hence of the recycling problem. The greater the number of "experts" consulted, the more confusing and conflicting the evidence.

In a celebrated and much-quoted article,¹ The Economist estimated the oil producers' surplus (not to be

¹The Economist, London, December 7, 1974.
"The Défi OPEC", p. 85.

confused with revenues) at about "60 billion a year, or \$7 million an hour, or \$115 thousand a second". The article went on to estimate that in 15.6 years these funds could buy all companies on all the world's major stock markets; in 9.2 years, all stocks on the New York Stock Exchange; in 6 years, all of Britain's industrial assets; in 3.2 years, all central banks' gold at \$170 an ounce; in 1.8 years, all of the United States' direct investment abroad; in 0.9 years, all French and German quoted companies; IBM in 143 days, and Exxon in 79 days,

Quite aside from the fact that this simplistic type of analysis ignores the effect on the prices of all these things of the pressure of such huge quantities of funds on them, even assuming completely free and accessible markets, these figures are as much as double those calculated by others. An Iraqi economist, who at one time taught at Simon Fraser University, one Mahdi al-Bazzaz, has estimated total oil earnings (not surpluses) over 10 years at about \$600 billion, as in the accompanying table:²

Al-Bazzaz went on to calculate that foreign exchange reserves would accumulate in accord with the figures in Table 5:³

²Middle East Economic Digest, London, March 15, 1974, p. 304.

³Ibid.

Table 4.-- Estimated Oil Earnings
 1973 - 1983 (Al-Bazzaz)
 (in millions of dollars)

	<u>1973</u>	<u>1974</u>	<u>1973-1983</u>
Saudi Arabia	4,915	17,269	177,605
Iran	3,889	13,758	175,872
Kuwait	2,001	7,004	72,041
Libya	2,210	6,701	69,220
Iraq	1,317	4,610	47,417
Algeria	1,117	3,289	34,007
Abu Dhabi (UAE)	1,035	3,172	32,755
Qatar	397	1,391	14,307
Dubai (UAE)	165	576	5,925
Oman	106	524	5,346
Total	17,148	58,294	634,495
Arab Total	13,263	44,436	458,623
% of Total	(77.3)	(76.4)	(72.3)

Table 5.--Estimated Foreign Exchange
 Surpluses, 1973 - 1983
 (in millions of dollars)
 (Al-Bazzaz)

	<u>Lower Limit</u>	<u>Upper Limit</u>
Abu Dhabi	13,102	19,653
% of total	(7.05)	(6.55)
Algeria	nil	3,400
% of total		(1.13)
Dubai	2,370	3,555
% of total	(1.27)	(1.18)
Iran	nil	35,174
% of total		(11.72)
Iraq	16,596	23,709
% of total	(8.93)	(7.9)
Kuwait	28,816	43,225
% of total	(15.51)	(14.4)
Libya	27,688	34,610
% of total	(14.9)	(11.53)
Oman	2,673	3,742
% of total	(1.43)	(1.24)
Qatar	5,723	8,584
% of total	(3.08)	(2.86)
Saudi Arabia	88,803	124,324
% of total	(47.8)	(41.44)
 Total 10 States	 185,771	 299,976
 Arab Surplus	 185,771	 264,802
% of Total	(100.0)	(88.28)

These figures broadly bear out the A, B and C groupings of the Arab countries and Iran, with the notable exception of Iraq. The methodology employed is questionable, however; they were calculated on the basis of estimates of historical (1963-1972) import coefficients (the ratio of total imports to total oil earnings, e.g., a coefficient of 0.9 means that of every dollar of oil revenue, 90 cents is spent on imports). In fact, historical ratios are no longer valid in current circumstances, in which our Group A countries have incomparably more vast revenues to dispose of than they had in the control period. Experience based upon a period of limited financial resources simply cannot be meaningfully extrapolated on a straight line secular trend basis in this way.

Even more fundamentally, it ignores entirely the substitution effect, as other countries marshal other energy resources in sheer self-defence. British North Sea oil, for example, is already beginning to trickle in, and during the next year or two other major energy sources will be coming on stream - sources previously uneconomical to exploit during the era of cheap and plentiful oil.

That this is a most important factor in trying to estimate OPEC oil funds accumulation is borne out by a most interesting article by Hollis B. Chenery, Chief Economist of the IBRD,⁴ wherein the author predicts that OPEC oil

⁴Foreign Affairs, January 1975, "Restructuring the World Economy", pp. 242 et. seq.

revenues would be significantly greater after 1985 at a price of \$7 a barrel rather than at the then prevailing price of about \$10. He argues convincingly that total energy demand in OECD countries would grow at 3.8 per cent per annum in Case I, as opposed to 4.3 per cent in Case II. The lower price would lessen the inducement to OECD countries to practise extremes of conservation to reduce imports, and to engage in large-scale, crash development of alternative sources of energy. His table of projections of OPEC revenues, and production capacity, are reproduced in the accompanying table, as modified to fit our OPEC country group classification:

Table 6.--Projections of OPEC Revenues and Capacity*
(in billions of 1974 dollars and millions
of barrels per day)

	Group A	Group B	Group C	Total Revenues	Production
Case I					
Price remains at 9.60					
1980	49	47	13	109	33
1985	51	54	16	121	36
1990				88	26
Case II					
Price decline to \$7.00 by 1980					
1980	52	41	11	103	42
1985	58	52	12	122	49
1990				135	55
Planned Productive Capacity					
1980	27.8	16.3	4.5		49

*Based on estimates of OECD and IBRD.

Even at present prices, however, reports throughout 1975 have consistently indicated that earlier estimates of the size of OPEC reserves will have to be revised downwards.

On January 24, 1975, Kuwait's Finance and Oil Minister, Abdel Rahman al-Atiqi, stated that the \$60 billion figure often cited as the OPEC surplus was far too high, ignoring the increases in the price of goods which the OPEC nations import. Four days later, a U.S. Treasury official estimated accumulated OPEC reserves of \$200-250 billion, in constant dollar terms, by 1980. This may be contrasted with an earlier World Bank estimate of \$650 billion. Morgan Guaranty Trust Company of New York, in its January 1975 survey of financial markets, estimated that the current account surpluses of the OPEC states would peak in 1976 and will then decline, perhaps going into a deficit before the end of the decade.⁵

Morgan Guaranty's scenario suggests that OPEC's peak accumulations of financial assets would occur in 1978-79 and would total no more than \$248 billion.⁶ Further, OPEC as a

⁵Middle East Economic Digest, London, January 31, 1975, p. 5, "Estimates of OPEC Funds Revised".

⁶World Financial Markets. In its May issue, Morgan Guaranty estimated that the OPEC current account surplus for 1975 would be even lower than previously implied, and concluded that "the scaling down of the projected OPEC surpluses by many observers, especially the international organizations, has not gone far enough".

whole would be running a current-account deficit beginning in 1979, amounting to some \$56 billion in 1980, by which time OPEC accumulation would have been drawn down to under \$180 billion.

Another interesting attempt at analysis has been made by the First National City Bank of New York,⁷ which predicts that the "once-terrifying OPEC surplus will be replaced by an OPEC deficit" and, moreover, declares unequivocally that "...what began in 1973-74 as a ferocious tiger was first declawed and is now becoming a Cheshire cat."!

It is very difficult to evaluate any of these scenarios. They are all based on varying assumptions as to: world energy and oil consumption in the light of new discoveries, technological development, and conservation measures; the contribution of alternative fuels and of non-OPEC oil; the price of oil which, in turn, depends on the ability of the OPEC cartel to remain united and strong. Many of these assumptions rest, in turn, upon other explicit or implicit assumptions with respect to such imponderables as the relative warmth of winters, economic recession, depression, or recovery, the foreign aid policies of individual OPEC countries, the rate of military procurement of these countries within their general

⁷Monthly Economic Letter, June 1975, "OPEC Rocket Loses its Thrust".

readiness and ability to absorb imports, the rate of inflation in the prices of their imports, and so on almost ad infinitum.

What we do know from the Citibank analysis is that in 1974, the total value of OPEC exports was \$135 billion, of which oil accounted for \$126 billion. Of that \$126 billion, some \$16 billion accrued to foreign-owned, private oil companies. When imports and transfers are deducted from total exports, there is a \$66 billion surplus on current account.

But because of lags, both in receipts and in payments, the \$66 billion figure overstates what OPEC could lend or invest abroad in 1974. Since \$19 billion due to OPEC governments were not paid before 1975, actual government oil revenues were \$91 billion. Partially offsetting this is the delay in paying for OPEC's huge increase in imports. As much as \$7 billion of the \$35 billion in OPEC's imports of goods in 1974 were not paid until sometime in 1975. Hence, OPEC's actual "investible" surplus was about \$54 billion in 1974 - that is, $66 - 19 + 7 = 54$.

However, such a large discrepancy - \$12 billion - between OPEC's current account and investible surpluses should not recur. Therefore, notwithstanding the unique situation in 1974 caused by the sudden surges in both imports and exports in that year, the current account is the most reliable reference for analysis of the future of OPEC surpluses.

This trend seems to have continued into 1975. Total estimated oil revenues of OPEC countries in the first half of 1975, as published by the Bank of England's latest Quarterly Bulletin,⁸ reached \$50.9 billion, compared with \$36.1 billion during the first half of 1974. However, the rise in OPEC country imports has substantially reduced the surpluses available to \$17 billion, as compared with \$34 billion in the second half of 1974.

Even with the recent nominal 10 per cent price rise, surplus OPEC revenues seem to be established in the range of \$30-45 billion per annum. But it must be emphasised again and yet again that because of the vast number of possible permutations and combinations of essentially unpredictable variables in any model devised for the purpose, the best that one can hope to achieve is an educated guess.

One prominent and highly-respected petroleum consulting economist, Walter Levy, has, in fact, recently challenged the relatively complacent views recently expressed to the effect that the oil-induced problem of financial imbalance will be temporary and of manageable proportions.⁹

⁸Reported in Middle East Economic Digest, London, September 19, 1975, "OPEC's Half-Year Income Well Down", p. 7.

⁹Walter J. Levy, Future OPEC Accumulation of Oil Money: A New Look at a Critical Problem, W.J. Levy Consultants Corp., 30 Rockefeller Plaza, New York, 10020, N.Y.

Levy does not dispute that OPEC balances are running at a substantially lower level now than seemed likely a year ago, the main reasons being that OPEC oil exports, and therefore revenues, have been adversely affected by the business recession, mild weather and consumer resistance to the excessive price; that the OPEC governments have been showing an unexpected ability to spend money on imports of goods and services; and that they have been extending loans and making grants to governments of the developing countries. In his own interpretation of these developments, Levy thinks that too much is being read into this improvement. He suggests, in contrast to the views held by others such as Morgan Guaranty Trust and the First National City Bank, that OPEC countries as a whole will still be running a substantial surplus on current account at the end of this decade. His figuring, which is in some ways analagous to the latest estimates by the World Bank, point to a cumulative OPEC surplus in 1980 of \$449 billion, as contrasted with Morgan's \$179 billion and Citibank's \$189 billion.

All that can be said after studying these analyses, well-argued as they all are, is that economic forces are playing their accustomed rôle in gradually bringing about a new equilibrium. How soon the desired balance will be attained, and at what level, will depend in the main on three factors. The first is the level of oil prices during the next few years. The second is the degree of success

that attends the efforts of the oil importing countries to reduce their dependence on imported liquid fuels. The third is the growth of exports (in volume and value) from the oil exporting countries.

As already stated, a high degree of uncertainty surrounds each of these main variables, and the many unspoken assumptions behind them - most of all in regard to the likely course of oil prices. And since the size of the cumulative OPEC balances, their investible surplus, is the residual item in the equation, there is room for wide differences of opinion about the year in which that surplus is likely to disappear, if at all in the foreseeable future. The basic difference between Levy's analysis and others has to do with the price of oil. He assumes \$14.65 per barrel in 1980. Morgan assumes \$13.25 and Citibank \$9.10.

The present author, for reasons which will become clear in the course of this thesis, anticipates a drop to a floor of \$7.00 in that year, more probably earlier, say 1977-78. On this basis, and making certain other assumptions as to the escalating costs of the major infrastructure programs which the OPEC governments are increasingly locked into,¹⁰ the cumulative OPEC surplus would peak at about \$200 billion in 1977 and disappear in 1980.

¹⁰The extent to which the OPEC countries have become captives of their own development programs is not generally appreciated. Once fully embarked upon, major infrastructure projects cannot be discontinued without incurring enormous cancellation charges. For this reason, it is often more economical to accept large cost over-runs rather than to cancel major projects.

VII. WHAT PRICE CRUDE?

VII. WHAT PRICE CRUDE?

As the most important element in determining the size of OPEC oil revenues, it is now timely to discuss the price of crude oil, and what is likely to happen to it, that is, the major assumption upon which all the analyses herein must be based. Before doing so, however, it is useful to devote a moment or two to defining certain other terms employed in this industry.

Prices for OPEC oil are quoted per U.S. barrel of 42 U.S. gallons, or about 35 Imperial gallons (34.9726, to be precise), in terms of the "posted price" of so-called "marker" crude, i.e., Arabian Light, 34° A.P.I.,¹ on the basis of F.O.B. Ras Tanura, Saudi Arabia. Because of differences in comparative freight rates from other points to principal markets, compensatory premiums can be charged, or discounts extended, by OPEC producers other than Saudi Arabia. For example, the shipment of Libyan crude to Europe costs less than that of Gulf crude, hence Libya can charge more for oil of equivalent quality, and be expected to hold the market, as long as the premium charged does not exceed the freight difference. If tanker rates then drop, Libya has to discount its premium to the extent necessary

¹American Petroleum Institute grading scale for specific gravity.

to remain competitive with Saudi Arabia or other less-advantageously-located producers. There is nothing to prevent Libya from discounting even more than necessary, so as to maximize oil revenues at the expense of Saudi Arabia's or some other producing country's market share.

Other premiums are charged for higher quality crudes, of lower sulphur content, which are cheaper for customers to process, as well as being more desirable to meet pollution control standards in various user countries, and for differences in specific gravity. Another way of adjusting prices downward is by the extension of credit terms of varying periods to buyers. The extension of low-interest or interest-free credit is obviously a concealed price reduction.

OPEC countries are continually under-cutting each other by shading prices in these ways. Extension of credit to buyers normally relates, of course, to sales made directly to customers by state-owned companies, rather than to the "equity" and "buy-back" crudes lifted by the major concessionaires (i.e., the "Seven Sisters, CFP, etc.).²

"Equity" oil is oil "owned" by the foreign concessionaires, on which they pay royalties and taxes to the producer countries' governments, based on the "posted

²The Petroleum Economist, March 1975, p. 94, "OPEC-Exports Continue to Decline".

price". "Buy-back" or "participation" oil is crude owned outright by the producing countries' governments, who, through "participation agreements", may require that a certain percentage of all oil lifted and marketed by a concessionaire be government-owned oil. Outside such participation arrangements, government-owned oil is marketed directly, frequently by auction, to arms-length buyers.³

It is worth pointing out here that, quite aside from the traditional secrecy and "creative accounting" of the oil companies, the complexity of these arrangements has contributed a great deal to a general lack of public comprehension of the subject of oil prices. This difficulty has been vastly compounded by a new structural problem which relates to the current operations of all the OPEC countries; the difficulty of arriving at reasonably accurate estimates, not only of prices, and hence of revenues, but also of oil production and exports.

In the past, when operations in the exporting countries were almost entirely in the hands of a few major international companies, although those companies concealed their internal transfer pricing methods, it was at least possible to obtain precise production and export figures. Now that the exporting countries have taken over most of the responsibility for their own operations, this is no

³See Appendix E - "Glossary of Terms used in the Oil Trade", for precise definition of these and other terms.

longer the case. Gross and net government revenues are also not available. It appears that even the permanent Secretariat of OPEC itself does not have access to accurate and up-to-date figures on a regular basis. The problem is further compounded by the fact that exports are lifted not only by the majors but also by state-owned and independent companies, as a result of direct sales by national companies in the exporting countries, and by smaller concerns who have been allocated concessions under a variety of agreements which include joint ventures, production sharing, and service contracts.

These problems explain some, if not most of the discrepancies which occur in statistics estimated and published in various journals, and also by such organizations as the World Bank, the IMF, and the OECD.⁴ Hence, it is enormously difficult to determine with any confidence the magnitude of the recycling problem, for example, in circumstances such as these. Analysis based on such questionable statistics is, therefore, potentially that much more prone to error. With the passage of time, statistics will no doubt improve, and the situation will gradually be corrected. In the meantime, one must make do as best one can with what is available.

With effect from October 1, 1975, the OPEC countries, not without predictably severe internal dissension, raised

⁴The Petroleum Economist, March 1975, p. 84, "Footnote".

the posted price of OPEC "marker" crude by a nominal 10 per cent, to a level at which it is supposedly to be maintained until July 1, 1976. Prior to this action, prices had been frozen since November 1974. Prices will not, in actual fact, go up by 10 per cent. Indonesia almost immediately announced that its effective price increases would be only 3-4 per cent.⁵ Early in October, Algeria raised its prices by \$1.00 from \$11.75 to \$12.75 per barrel, an increase of only 8.45 per cent.⁶

These are only the latest events in the steadily accumulating body of evidence that OPEC price rises are often more apparent than real. Because of cutbacks in consumption due to both a succession of mild winters and a worldwide economic recession, coupled with the high production associated with the growing need of certain OPEC countries for greater revenues to achieve their development and defence objectives, an oil glut has been created. OPEC Secretary-General Chief M. O. Feijide, of Nigeria, stated as far back as February 11, 1975, that OPEC statistics showed that the present over-supply of crude had reached 2-2.5 million barrels a day. Production in Abu Dhabi, Libya, Algeria and Kuwait had to be cut to maintain prices, and Venezuela announced a reduction of 200 thousand barrels a day on February 6. Saudi Arabia cut off the flow of crude

⁵The Economist, October 4, 1975, p. 69, "Bother OPEC".

⁶Canadian Press, October 10, 1975.

through the Trans-Arabia Pipeline (TAPLINE) across Syria and Jordan to the Lebanese terminal at Sidon, in April. This flow has only recently been resumed at a modest level. Iran's oil exports fell by 10 per cent in January 1975, and have fallen farther sharply throughout the year. Total OPEC production has also fallen throughout 1975.

Libya cut its prices several times in the course of the spring and summer of 1975, so that just before the latest OPEC-wide nominal price increase, that country was obtaining the equivalent of about \$8.50 per barrel net for "marker" crude. Actual Libyan contract prices dropped steadily from \$16.00 on January 1, 1974, in a long series of intermittent price cuts, to \$11.10 on June 1, 1975, the latest month for which statistics are available.⁷

Libyan willingness to cut oil prices has brought sharp criticism from neighbouring Algeria, which complained that, as a result of "unjustified" cuts, Iraqi, Nigerian and Libyan crudes were underpriced in relation to Algerian oil, which was allegedly priced exactly in line with Gulf crudes. Algeria is extremely anxious to avoid a price-cutting war with fellow producers because, with production already well down on the previous year, it is only by maintaining prices that the government can hope to generate

⁷The Petroleum Economist, August 1975, p. 290, "Libya Trims Prices".

sufficient revenues and credits for its ambitious economic development program.

The Libya-Algeria dispute is only a minor altercation, however, as compared with that between Iran and Saudi Arabia.

The latter country has always been an advocate of moderation in the pricing of crude. The sensible and conciliatory approach of Saudi Arabia's oil minister, Sheikh Ahmed Zaki Yamani, stands in sharp contrast with the attitudes taken by the Shah of Iran and other advocates of the "all the traffic will bear" school. The clash between the two reached a crisis point at the end of September 1975, at OPEC's 45th meeting.

The most fundamental fact of the OPEC cartel is that it can hold together only through the acquiescence of Saudi Arabia, the leader of the Group "A" nations, and the country with the largest productive capacity (12 million barrels a day, nearly one-third of OPEC's entire potential output) and the largest financial surplus. When world demand slumps, as it did earlier this year to 25 million barrels per day, it is the Saudis who bear the largest cutbacks in production to support the price. If, for any reason, they were to choose not to curb production, the consequent excess of supply over demand in world markets would quickly force prices down. Saudi Arabia can, in fact, such is its discretionary power over the marginal supply of oil, set the

price (within certain undetermined, but wide limits, say, from \$2.50 to \$25.00 a barrel) more or less anywhere it wishes, and maintain the new price by adjusting supply to meet demand at the desired level.

At the 45th OPEC Conference, Saudi Arabia at first asked for an indefinite continuation of the price freeze which had been in effect since November, 1974. In the face of violent objections from other members, notably the Iranians, the Saudis moderated their proposal to one of a two-phase increase, in steps of 5 per cent each. Having originally demanded as much as from 35-40 to 75-80 per cent more, to compensate for alleged losses due to inflation in the prices of the goods imported by OPEC, the Iranians countered with a demand for a straight increase of 15 per cent. Saudi Arabia, originally backed only by Abu Dhabi, opposed this.

Sheikh Yamani flew to London to consult his government, and to obtain permission to warn the other OPEC members that, if they went ahead with their plan, Saudi oil would be sold at \$10.46 per barrel, or \$1.55 less than the level set by the other states, with no restrictions on production. In the face of this threat to the cartel, all members except Iran yielded, the latter finally doing so only after the President of Venezuela personally intervened with the Shah.⁸ The final agreement was for a nominal

⁸The Economist, op. cit.

10 per cent, which is more than unlikely actually to be implemented. One reason for this has to do with the "differentials", already explained, the manipulation of which has much to do with determining the pattern of production within OPEC.

As has already been pointed out, this year Libya (as well as Iraq and Nigeria) has been shading prices by cutting the premiums charged for specific gravity, low sulphur content, and freight, while also selling its crude on extended credit. The subsequent boosts in production to meet the demand switched away from other OPEC countries (Libya's output in June was 60 per cent higher than in March) were achieved largely at the expense of Saudi Arabia. The OPEC Conference failed to reach agreement on a new range of differentials, which has left each member state free to set its own. A special conference convened in early November 1975 also failed to resolve the problem.

It is reported that the Saudis have themselves decided to cut prices.⁹ Obviously, the indicator to watch will be any increases in Saudi production in coming months. Three and one-half million barrels a day is the minimum needed to meet the kingdom's financial requirements. Recent production has been in the order of 6.5-7 million barrels per day. Increases to the 7.5-8 million barrels per day range

⁹The Economist, Ibid.

or higher would be very significant.¹⁰

While the consumers would apparently stand to gain from oil prices marginally lower even than those which obtained prior to the 45th OPEC Conference, it is unlikely that they would actually do so. The reason for this is not far to seek. Oil prices charged by the international companies have already risen to reflect the full nominal 10 per cent increase in OPEC crude, in anticipation of which the companies, in the spring and summer of 1975, bought up huge stocks at the old price, looking for windfall gains. As explained herein, posted prices, differentials, and all the other complex pricing paraphernalia of the oil trade are pretty esoteric stuff for the man in the street and even for consuming governments. Oil costs to the international companies will not only not go up more than marginally; indeed they may actually fall rather lower than they have been all year. Characteristically, the oil companies can be expected to "pass through" the full nominal increase, and skim off the cream, not only on their OPEC crude, but in the form of any additional margin they can squeeze from their domestic and other non-OPEC oil as well. Look for sharply higher oil company earnings in the last half of 1975, particularly in the final quarter,

¹⁰According to Middle East Economic Digest, London, September 19, 1975, p. 26, Aramco output in Saudi Arabia rose almost to 8 million barrels per day in August 1975.

coupled with highly publicised unfavourable comparisons with the outlandishly high returns for the same period in earlier years, and a heart-rending appeal for public understanding in the face of the allegedly enormous anticipated demand for capital for future investment; capital which can only come out of profits. The only way in which the consumer is likely to benefit would be by a spectacularly sharp drop in prices, of a kind such as would be associated with a de facto break-up of the OPEC cartel.

In present circumstances, this just could happen, and with a dramatic suddenness equal to that of the quintupling of crude prices two years ago. While maintaining or even increasing current price levels might seem to be in the best interests of the OPEC countries in Groups B and C, this price is well above the long-term costs of major alternative energy sources. Such a policy could be expected to induce, and to a degree has already induced, a more or less strong effort by the OECD countries to cut back on consumption and to develop alternative sources, e.g., North Sea, Alaskan, and Canadian Arctic oil, coal, oil shale, tar sands, conventional nuclear fission, nuclear fusion, solar energy, etc. Accordingly, it is in the interests of Saudi Arabia, and other Group A countries, to oppose any price rise that might drive the industrialised countries even faster toward alternative fuels.

It is, in fact, in Saudi Arabia's interest to lower the price of crude to the point just below that at which the next cheapest alternative fuel can be made available in quantity.

For the purpose of analysis, the alternative fuel is realistically enough, considered herein as being represented by British North Sea oil. Development by Britain of this resource involved very large investment, in the order of \$15 billion, before any oil was produced. When in full production, North Sea oil is expected to cost at least \$5-6 a barrel, which is far above the production cost of Middle East oil. Accordingly, Britain has a strong vested interest, in view of the major costs already undertaken, to keep OPEC oil prices high - certainly higher than the projected \$5-6 a barrel for North Sea oil, which from the British point of view, is an absolute floor below which the world market price for crude must not be permitted to fall.¹¹

The price-cutting which is already underway is quite logical when viewed in the light of recent developments. Banking sources in London, according to a Reuters despatch

¹¹On December 27, 1975, The Economist reported (p.42) that the IEA had adopted a \$7 per barrel Minimum Safeguard Price for oil, which is intended to protect the development of new sources of existing types of energy, such as North Sea oil. Should oil drop below \$7 a barrel, member countries would tax it at least up to the MSP in their home markets.

quoted in a local newspaper,¹² first reported last spring that a number of OPEC countries were even running short of cash, the problem having been caused by a fall in the demand for oil and the need to extend credit to customers to avoid further production cuts. Iran, and even Kuwait and Abu Dhabi, the latter two from Group A, were listed as countries which had sought bridging loans on the international capital market to pay for their development programs, and were cashing part of the short-term certificates of deposit into which they had originally channeled large sums of the surplus oil revenues received after the five-fold increase of prices. Since then, Algeria has completed arrangements for a \$500 million Eurodollar loan. There is, accordingly, great and growing evidence that many of the oil-exporting states are in a technically overspent position, that is, their funds are tied up in investments which cannot be liquidated quickly enough to meet their demands for funds.

United States demand for oil products fell during 1974 for the first time in 32 years. At an average of 16.8 million barrels a day, demand was down 3.9 per cent below 1973. Oil imports averaged 6,097,00 barrels per day, compared with 6,202,00 barrels per day the previous year. Stocks of crude oil rose 9.9 per cent, to 266 million barrels, as compared with the end of 1973. During the first

¹²Toronto Star, March 26, 1975.

10 months of 1975, oil consumption by the U.S.A. dropped even lower, by 1.7 per cent over 1974, with a 1.3 per cent decline in imports in the same period.¹³

Empty tankers throughout 1975 were backed up in the Gulf.¹⁴ They had instructions to travel, when full, as slowly as possible, so as to act as "floating storage tanks".¹⁵ Throughout the year to date, in addition to slow steaming, lay-ups, and early scrapping of older ships, the slump in tanker freight rates is causing a dearth of new orders and widespread cancellations of new tanker ship-building contracts.¹⁶

While the Arab Maritime Petroleum Transport Company (AMPTC), which was founded in 1972 under the joint ownership of 8 Arab oil-producing states (Abu Dhabi, Algeria, Bahrain, Kuwait, Libya, Qatar, Iraq and Saudi Arabia)¹⁷ has bought its first tankers, the bottom is out of the tanker market. AMPTC recently purchased a Norwegian tanker, which was completed earlier in 1975 at a cost of \$21.5

¹³Ottawa Journal, November 10, 1975, p. 11, "U.S. Burning Less Oil, Gas," quoting American Petroleum Institute figures.

¹⁴Middle East Economic Digest, London, February 28, 1975.

¹⁵The Economist, March 8, 1975, p. 16.

¹⁶The Petroleum Economist, March 1975, pp. 89- 0, "Tanker Market Blues".

¹⁷The Petroleum Economist, August 1974, p. 305, and September 1974, p. 337.

million, for only \$15.2 million.¹⁸ Tanker freight rates are at or close to record lows. In sum, all of the indications point to the existence of a vast oil glut overhanging the market.

Prices are almost bound to fall, certainly in real terms, as they already have owing to inflation, but possibly also in current dollar terms. Given the political factors in the equation, the wide divergencies of economic interest between the Group A countries typified by Saudi Arabia on the one hand, and the Groups B and C nations typified by Iran on the other, it is becoming increasingly possible that the cartel will actually break.

This would mean a sharp and dramatic drop in the price of oil, which could conceivably fall all the way back to its pre-October 1973 level, or at least to that level in real terms, after a moderate adjustment for inflation. But while a fall may be anticipated, anything quite so drastic is rather unlikely for at least 4 over-riding reasons:

1. Even the Saudis could find it hard to live with \$2.50 oil, in view of their new, major, long-term commitments to development.
2. The market demand is still there. The world, at present, still needs Middle East oil enough to pay more than \$2.50 for it, and will be in that position for many years to come.

¹⁸The Petroleum Economist, August 1975, p. 311.

3. The governments of consuming countries which are also actual and potential producers of alternative fuels, have invested too much in high-cost fuel development to abandon it now.
4. The major oil companies have a strong interest in keeping Middle East crude oil prices high, because they have profited enormously from price increases on both imported crudes and, even more, domestic crudes.¹⁹

A fifth reason has to do with elementary justice. A higher price for oil is fully supportable on the basis of the "user cost" to the producing countries, i.e., the sacrifice involved in disposing of a diminishing stock of an irreplaceable natural resource. The arguments frequently advanced by the OPEC countries to justify their exaction from consuming nations of a substantial element of economic rent do not normally take the aspect of user cost sufficiently into account. Every barrel of oil extracted and exported for consumption today will no longer be available for the use of the original resource

¹⁹The years from 1973 on are now being labelled the "Golden" years.

owner in the future. The OPEC countries are, therefore, justified in charging far more than the marginal cost of production for their product. On this basis, countries such as Saudi Arabia and Kuwait might well find it advantageous ultimately to cut back on production and to stretch out their oil resources as far as possible into the future.

Be that as it may, at the old price of oil, determined essentially by the interplay of market supply and demand (i.e., about \$2.50 per barrel), and without regard to user cost, supply, which was under the control of the oil companies, was for all practical purposes infinitely elastic.

Following the imposition of multiple price increases by the OPEC countries, the supply of oil was adjusted to the point where it maintained its relatively infinite elasticity at the new price, about \$12.00 a barrel, for the quantity demanded, which did not appear to be subject to significant reduction in the short to medium term.

However, if demand should drop, it may be assumed that, at some point, in order to maintain the new, high

revenues upon which they have become increasingly dependent, some supplying countries will drop their prices. Accordingly, because of a shrinkage in demand for whatever reason, coupled with an over-supply of a commodity produced at negligible marginal cost (10-25 cents a barrel),²⁰ the price of oil could drop very sharply, and in an accelerating fashion, until it reaches a new equilibrium point at which supply will again be equal to demand. This point, for several reasons, having mainly to do with the cost of production of alternative energy supplies, is assumed to be at the price level of about \$6.50 - \$7.00 per barrel, but the actual price would depend upon the degree to which the various groups of OPEC countries, primarily the two factions led respectively by Iran and Saudi Arabia, would be able to reconcile their competing objectives and to harmonise their pricing activities once again.

²⁰That is, negligible marginal production cost, without any allowance being made for user cost, in terms of the sacrifice of future possible returns involved in using up a non-renewable resource today.

The likelihood or otherwise of this happening will have a major bearing on the problems under consideration. Just what is the magnitude of present and proposed oil revenues, what is their effect on the non-OPEC countries, particularly developing countries already below the poverty line, which do not even now have the resources required to lift themselves up, and whose already perilous position has been undermined by the price-fixing activities of the OPEC countries, upon which they depend for vital energy supplies?

The OPEC cartel has maintained a united front in the past, and it may be considered that its success to date has strengthened it. Actually, OPEC's militancy, in destroying the old oil company producers' cartel, has increasingly replaced the Seven Sisters (the big companies which once controlled nearly all production and distribution) with a dozen inexperienced, nationalised companies trying to sell their oil into a market of surging surplus and now confronted by the old oil companies' cartel, which still controls distribution, and whose major incentive in the OPEC area will be to shop for the best purchases it can obtain. In these circumstances, the OPEC cartel can endure only if the western oil companies have a strong reason to keep oil prices up.

As indicated previously, there is evidence that they indeed have such a reason, and that it is not only in the

oil companies' interest, but also in the interest of a number of OECD countries, that the price of oil should be maintained at a relatively high level. The oil companies, despite their public posturings, have never prospered so much. The governments of countries like Britain, Norway, and even the United States, now have a vital vested interest in ensuring that prices do not fall back below the cost of producing oil from the North Sea and other areas. A world of new inter-relationships has come into existence, precipitated by the employment by OPEC of the "oil weapon", and short of military intervention, it is irreversible.

Oil prices should fall, the effective floor being the cost of the alternative supplies from non-OPEC sources which will be coming "on stream" over the next 3-5 years. This is the real rationale of the establishment of a floor price of \$7 per barrel. Quite fortuitously, it is also the price which would actually maximize revenues to the OPEC countries as a group, and particularly to the Group "A" countries. It would not do this for the Groups "B" and "C" countries, however, hence, led by Iran, their strong resistance to this eventuality.

The wisest pricing policy for the OPEC countries as a whole to follow at the present time would be:

- (a) to maintain their solidarity vis-à-vis the outside world;
- (b) to maintain current prices until these are essentially overtaken, in real terms, by the cost of the least expensive of alternative forms of energy; and only then,
- (c) to increase crude oil prices gradually, maintaining them at a point at or just below the price of the next most expensive energy source, with due allowance for premiums and/or discounts related to proximity to major markets, quality, and other factors discussed herein.

If the OPEC countries were to follow this pricing policy, they would delay, in some cases indefinitely, the development and production of alternative energy sources, thus extending the period of their control over the market. This would, as previously stated, work in favour of the countries with the largest reserves and against those with the smallest, while maximizing OPEC revenues as a whole. By stretching out the time and reducing the peak total of cumulative surpluses, probably at about \$200-\$225 billion, this would ease the impact of OPEC surpluses on the international banking system and on the rest of the world, while the lower price would be immediately and directly beneficial to the countries of the Fourth World.

The achievement of these generally desirable objectives will depend upon the degree to which the OPEC countries can maintain their internal harmony. The crack in the OPEC façade which was displayed to the world in the course of the 45th meeting of that Organisation in September 1975 is clear evidence that the dispute between Iran and Saudi Arabia is a truly major and essentially irreconcilable problem. The damage has been done, and it may well be that OPEC will never again be so strong and unified as it was before that historic meeting.

VIII. THE EROSION OF OIL INCOME AND
THE "INDEXATION OF OIL PRICES"

VIII. THE EROSION OF OIL INCOME AND THE INDEXATION OF OIL PRICES

OPEC estimates that inflation has eroded its members' buying power by about 30 per cent, but while authorities vary, the huge increase in crude prices is itself thought to be responsible for about one-third of the increase in the prices of goods imported by the OPEC countries.

There is no question that the erosion of their oil revenues by inflation poses a real problem for producing countries. They will, of course, be aware that their opportunity for accelerated development is limited in time and extent. From their standpoint, they must try to achieve viable, self-sustaining, industrialised economies which, supplemented by rentier income from foreign investment, will assure for their citizens and their descendants an equitable share of the world's goods and services in perpetuity. Nevertheless, the OPEC countries should, in fairness, concede that their own actions have contributed to the inflation in the prices of the goods and services which they must import, and approach this particular problem in a responsible way.

The oil exporting countries are now considering various "indexation" proposals aimed at maintaining the real value of their exports. Recently they have added the

suggestion that the price of oil be denominated in the SDR unit of account rather than in the U.S. dollar in order to protect the real value of OPEC oil receipts from a decline in the value of the dollar in foreign exchange markets.¹

"Indexation" can be defined as a device whereby the price of oil is periodically adjusted to observed past variations in the price of a particular "basket" of goods and services according to an established formula.

It is recognised that as long as the existing market conditions in crude oil prevail, and in the absence of all-out conservation measures by the industrialised countries, the members of OPEC probably have the power to impose oil price indexation unilaterally, within certain as yet undefined limits, including extremes that could bring about a "military solution".

Notwithstanding the validity of the OPEC countries' arguments for an adjustment mechanism, there is a strong case, on both theoretical and practical grounds, to be made against any scheme for indexing.² The indexation of oil prices, which in effect freezes the price of oil relative to the price of a chosen basket of other commodities, would tend to distort resource allocation,

¹It is noted, however, that had this linkage been generally adopted when proposed, the OPEC countries would have been the losers, as the dollar has significantly strengthened in recent months in terms of SDR's.

²The arguments adduced herein apply with equal force against any attempt to administer prices, not only indexation schemes.

investment patterns and trading patterns. It may well be questioned whether it makes economic sense to tie the price of oil to some general price index, any more than it would to tie the price of any other commodity to such an index. Price changes for each particular product should ideally serve the essential economic function of stimulating or reducing its own demand and supply in line with changing market conditions. An effort to set prices on the basis of arbitrary "purchasing power parity" ratios tends to distort the market's role in the allocation of resources, and leads to artificial shortages or surpluses. Hence, it would inhibit world economic growth and progress. Similar arguments could, of course, be raised about arbitrary, non-market-related determination of oil prices by the cartel.

Politically, any form of indexation agreed to by the consuming countries would likely be interpreted as legitimising OPEC's ability to set the price of oil and would tend to preclude criticism by the industrialised countries on the costs and damages future oil price changes might impose on the world economy. It would further reduce the role of market forces in determining the production and distribution of oil.

Oil price indexation which resulted in oil price changes that do not reflect changing market conditions would require structural adjustments in the economies of the oil importing countries which would be unrelated to

the true costs of productive factors, and thus would delay the hoped-for recovery in the world economy. Since many factors of production are highly specialised over the short-run and yield low productivity in other uses, structural unemployment of labour and under-utilisation of capital - hence decreased real output - would result. The linkage of oil prices to the prices of other commodities would also be destabilising to world trade.

Indexation of oil prices would tend to intensify world inflationary spirals. The 1973-74 oil price increases are estimated to have contributed about one-third of the increase in the general level of prices in the oil importing countries in 1974. As these price increases add to wage pressures, they will have secondary inflationary effects for some time. Further oil price increases based upon inflationary trends, which were themselves intensified by earlier oil price increases, could permanently raise inflationary expectations and would serve only to perpetuate the inflationary spiral.

Oil price indexation would establish an unfortunate precedent. Other primary product producers could well feel discriminated against and seek the same treatment. During the Producer/Consumer Preparatory Conference in April 1975 several of the developing countries took a strong pro-indexation stance regarding commodities of interest to them (Brazil on coffee, India on iron ore, and Zaire on copper).

Once applied to oil, the concept of indexation is likely to spread to other commodities. There are probably only very few other commodities for which market conditions are such as to permit an indexation agreement to hold, but the attempt by producers to achieve such agreements would be politically costly. For those commodities for which indexation might be feasible, at least over the short-term, it would, as in the case of oil, send the wrong signals to producers and excess supplies or supply shortages are likely to develop. Indexation of commodity prices would lead to inevitable conflicts of interest among producers of different commodities, each of which would like to maximise its own export revenues.

Indexation would result in a further redistribution of world income if it increases over time the real resource transfer to the oil-exporting countries from the oil-consuming countries - which, it should be stressed, include less developed countries as well as developed countries. The pattern of this form of resource transfer would be likely to yield serious anomalies such as transfers from the former to the latter or from the poorer "Fourth World" to not-so-poor developing countries. It would be a highly inefficient and undesirable method of redistribution.

A practical problem concerning indexation is the selection of an appropriate index which would measure the price changes of OPEC countries' imports. There is no index

regularly available on a current basis which directly measures their import prices. The OPEC Economic Commission Board is currently conducting a study of the feasibility of constructing such an index.

As the OPEC countries do not yet have statistical systems adequate to allow them to construct useful import price indices, they will probably have to rely for the present on export price indices for the countries from which they import. These price indices, or an index which might be calculated on the basis of regularly published data, give widely differing results depending upon which index is used and which base period is selected. The selected series are apt to be subject to erratic variations, and there is no assurance that they will reflect the variations in the price level of the goods and services that individual OPEC countries actually import. Also, available price indices for manufactured goods do not adequately reflect changes in the quality of these goods. These indices therefore, are likely to overstate actual price increases for goods imported by OPEC countries.

Moreover, there is the problem of the incomparability of negotiated contracts for major infrastructure installations, a large element of current OPEC procurement. Price escalation as part of the process of project definition is quite common in "normal" times, and an installation of a particular type of plant in one OPEC country cannot

be directly compared with an installation of a similar plant in another country, where different conditions prevail. Such price differentials as arise may not be at all "inflationary".

In summary, the economic arguments against indexation of oil prices are:

- (a) the freezing of oil prices relative to other commodities would distort resource allocation, leading to excess supplies or shortages. In particular, if indexation were to maintain, or to result in, oil prices higher than the level that would be warranted by market factors (which seems most likely), unless they form successful producers' cartels willing and able to restrict production, the producers will price themselves out of the market to the long-run detriment of their own economies;
- (b) it would seriously intensify inflationary spirals, exacerbate recession, decrease the real volume of world trade, and most importantly, reduce rates of economic growth throughout the world;
- (c) it would establish a precedent which, if applied to other commodities, would seriously further exacerbate inflation and deter world economic growth and progress;

(d) it is inefficient and inequitable as a means of transferring resources to the developing countries.

Other measures are more suitable for that purpose.

Accordingly, although a case may be made on grounds of delayed justice for such price rises as have already been imposed by the OPEC countries, and although a comparable case may be made for periodic price adjustments to maintain oil producers' revenues in real terms, it is considered that indexation schemes, as such, are both impractical and unfair. Future adjustments, if deemed to be necessary, should be made through the mechanism of price changes, rather than by such questionable and inherently inaccurate and erratic measures as any form of indexation. The same arguments apply equally, mutatis mutandis, to possible future producer-consumer agreements relating to other primary commodities. Nevertheless, in the oil producers' case, price rises will certainly hasten the day when the OPEC cartel will be broken, and may, if inordinate, bring about military intervention. The OPEC countries are treading an exceedingly narrow and increasingly dangerous path. This matter will be more fully discussed later.

IX. THE RECYCLING PROBLEM

IX. THE RECYCLING PROBLEM

"In a purely book-keeping sense, the world balance of payments is always stable, the deficits in certain countries being offset by surpluses in others - provided, of course, that the products being traded are not destroyed in transit and that world reserves remain constant (should the reserves increase, total surpluses might exceed the amount of the deficits). This poses no great problem as long as the countries with surpluses agree to play the part of creditors and those with deficits succeed in financing their shortfalls, and as long as both groups follow economic policies in keeping with their respective roles as responsible creditors and debtors."¹

This is quite true. The recycling problem arises, however, because the OPEC countries have succeeded in very suddenly imposing enormous oil prices increases on consuming countries, hitting the very poor nations just as hard absolutely and even much harder relatively, than the more affluent states of the industrialised world. Hence, foreign exchange has flowed in favour of the OPEC nouveaux riches,

¹Jacques Henry, "Global oil crisis: the benefits of the confrontation process", International Perspectives, the journal of the Department of External Affairs, Ottawa, September/October 1974, p. 50.

to the particular detriment of the M.S.A.'s (Most Seriously Affected) countries of the Fourth World.

Traditionally, the problems of the Fourth World are the problems logically to be associated with the pressure of too many people upon too few resources, unalleviated by the availability of sufficient capital investment to overcome these natural disadvantages which in themselves render the needed investment so unattractive. With the help of the industrialised nations, supported by an apparently inexhaustible supply of relatively cheap energy in the form of crude oil, in the course of the past quarter of a century the poorest countries had, by and large, entered upon the long, hard climb toward self-sustaining growth, however distant that goal may have appeared to be.

The seizure by the OPEC countries of direct control of their oil resources and of their economic destiny, expressed in a quintupling of the price of crude oil entering international trade, came as a devastating blow to the 40 or so poorest countries of the world. The industrialised countries, indeed, have recycling problems of their own, but are sufficiently developed, and accordingly resilient enough, eventually to make the necessary adjustments and to establish a new equilibrium among themselves as well as with the OPEC countries. The question is, how is the vast majority of the people of the very poorest

countries, already struggling at or below a bare subsistence level, to continue to survive in the face of this setback? One way, perhaps, would be for the OPEC countries to sell oil, to the M.S.A.'s alone, at a very low price, say at the pre-October 1973 level. For many reasons, this would very probably not work, and they have wisely refrained from doing so. As has been seen, the international oil company cartel exercises worldwide control over the transportation, processing, and distribution of crude oil and its manifold products. It is difficult to envisage how arrangements could be made in any practical way, for the M.S.A.'s to benefit fully from a discriminatory low price in these circumstances. The same industry group which so effectively frustrated the Arab oil embargo of 1973-74 could be expected to be equal to the challenge. While the OPEC countries have been subject to much criticism, not least and most recently from the Fourth World itself, over its failure to lower prices for the M.S.A.s' benefit, they can achieve much the same objective, more economically, and with far greater assurance that the M.S.A.'s will derive the maximum advantage, by extending direct aid themselves, on a bilateral basis. There is strong evidence that they have actually done this, and on a very large scale.

The data available so far are by no means definitive, and also present major problems of interpretation.

Statistics on official aid have always posed problems of concept, definition, and reporting. Since major aid flows may now be expected, at least in part, to move through untraditional channels, these problems acquire a new dimension.

By way of illustration, it is pointed out that the countries requested to report on aid may be either the donors or the recipients (in some cases both). Reports are usually easier to collect from the donors' side because they are fewer in number and their record-keeping is more advanced. In the past, however, the oil producing countries were for the most part neither major donors nor recipients, and thus tended to be outside the established reporting networks altogether. Moreover, as indicated elsewhere in this thesis, many of these countries have not been accustomed to releasing statistics of any kind on a regular basis.

Furthermore, statistics on aid flows mostly become available only after a substantial time lag and at infrequent intervals. Many of the series' available stress commitments rather than disbursements, since the former are much easier to ascertain. When the underlying aid programs are continuing without major change from one period to another, the distinction may not be too significant. In present circumstances, when new programs are being introduced, figures on commitments cannot be

accepted as a reasonable proxy for actual flows. The length of time that it will take for commitments to be translated into actual disbursements is not predictable and may be rather long, especially since in many instances new agencies are being organised to carry out the programs. In addition, the form that aid takes (cash, goods, rebates, etc.) and the terms and conditions on which it is to be provided are not clear in many instances.

These things being said, however, there can be no question that the OPEC countries have responded very generously to the needs of the M.S.A.'s. By the end of 1974, the I.M.F. estimated total aid of the order of SDR 26 billion, a total that included SDR 2.8 billion for the I.M.F. oil facility and SDR 943 million for loans to the I.B.R.D.²

Commitments through international, multilateral and national institutions amounted to some SDR 12 billion of which SDR 7.9 billion represented financing to be provided through channels other than the IMF facility and loans and contributions to the I.B.R.D. and the U.N. Emergency Fund. A major part of these other commitments (SDR 5 billion) pertains to the statutory capital of newly-created national development agencies (in Saudi Arabia and Iraq) as well as an increase in the capital

²International Monetary Fund, Washington, D.C., "Adequacy of Present Financing Arrangements for the Recycling of Oil Surplus Funds". Unpublished Document SM/74/250, November 1974, p. 4.

of already existing ones (the Kuwait and Abu Dhabi Funds) to enable them to expand their lending operations to non-Arab developing countries. Venezuela has made commitments to channel funds to various regional organisations in the Western Hemisphere.

Bilateral commitments reported in 1974 added up to about SDR 13.9 billion. The bulk of this (SDR 10.5 billion) represents the aid provided and pledged by the Arab oil exporting countries to Egypt and the Syrian Arab Republic; it also includes a sum of SDR 872 million committed by Iran to Egypt. Other large commitments were those by Iran to India and Pakistan (SDR 986 million) and to Afghanistan (SDR 829 million). The bulk of the multilateral commitments by OPEC countries is directed to the assistance of the developing countries. Emphasis is placed in a number of these programs on assistance to nations on the United Nations list of most seriously affected countries, to African countries south of the Sahara, and to Arab states. According to the OECD,³ by far the most important donor of assistance to M.S.A. countries among the oil exporting states in 1974, was Iran, followed by Kuwait, the United Arab Emirates (for which read "Abu Dhabi"), and Saudi Arabia. The largest amounts of aid were directed

³OECD, Paris, Development Assistance Directorate, "Official Economic Assistance by Oil-Exporting Countries to the Most Seriously Affected Countries", unpublished document DD-406, November 21, 1974.

to India, Pakistan, Sri Lanka, Bangladesh, and Arab and other Moslem countries in Africa. In the case of Pakistan, estimated total aid disbursements by OPEC countries alone exceeded the emergency needs as assessed by the United Nations, and all but met the emergency requirements of Somalia and Sudan.

This aid effort has not been of the one-shot variety. Abdelatif Al-Hamad, Director General of the Kuwait Fund visited Ottawa during the week of April 29, 1975. He was reported⁴ to have said that one-third of Kuwait's vast revenues goes for internal development, one-third for investment in developed countries, and one-third for assistance to developing countries, and that the OPEC countries generally, after a slow start, are helping the developing countries on a wide scale. Quoting I.B.R.D. figures covering the whole of 1974, he said that the OPEC countries had provided \$17.4 billion in aid as compared with \$11 billion from OECD countries.

Kuwait, with a population of about one million, is providing aid of \$1.5-2 billion annually, not including subsidies to Arab "confrontation" countries. Arab countries were stated to be providing from 10 to 49 per cent of their GNP's for assistance, as compared with the OECD average of under 0.50 per cent.

⁴Ottawa Citizen, May 6, 1975, p. 7, "Kuwait seeking ties with Canada in trade, aid".

As recently as September 1, 1975, Mr. Robert McNamara, President of the World Bank told the annual meeting of Bank and International Monetary Fund Governors in Washington that the nations of the OECD, the industrialised western countries - are at present contributing only about 0.33 per cent of Gross National Product in official development assistance, and added that this would continue to fall, perhaps to 0.28 per cent, although the target set by the United Nations is 0.7 per cent. He added: "Many of these nations, under present policies, are failing to increase their concessionary aid commitments by amounts sufficient to offset inflation and reflect their rising incomes". He went on to declare that OPEC members had provided about one-sixth of all concessional assistance in 1974, but that they could not be expected, as developing countries themselves, to maintain this level throughout the current decade. He concluded that the major contribution to any growth in the flow of aid to the poorer countries would have to come from the industrialised states, not the oil exporters.⁵

There are indications that the OPEC countries are not receiving the recognition they deserve for their efforts to help the underdeveloped world. While they are in part responsible, it has been all too easy to

⁵Middle East Economic Digest, London, September 5, 1975, p. 38, "OECD, Not OPEC, must Step Up Aid".

blame them for the worsened plight of the Fourth World nations, and the Arab nations, at least, have suffered from a poor press in the West. It has been reported⁶ that in September 1975 the Executive Directors of the IBRD, led by the U.S. and Japanese representatives, actually refused to endorse a report submitted by Hollis B. Chenery, Vice President and Chief Economist of the Bank, on economic prospects for the poorer countries, with which McNamara had been in agreement, because of its supposedly pro-OPEC stance. The "pro-OPEC" evidence seems to be related to the information contained in the Bank's Annual Report for the fiscal year 1974/75, to the effect that at the same time as Bank borrowings reached a record level of \$3.51 billion (\$1.657 billion or 89 per cent above 1973/74), borrowings of \$1.984 billion from the oil exporting countries (including non-OPEC members Oman and Trinidad and Tobago) were up \$1.419 billion over the previous year. OPEC thus accounted for about 57 per cent of the total, compared with 31 per cent and 13 per cent respectively in the previous two fiscal years. The Middle East total of placements with central banks and governments was 40.3 per cent, compared with 31.3 per cent in 1973/74. Co-financing by the Bank and the oil

⁶Middle East Economic Digest, London, October 10, 1975, p. 4, "World Bank borrows more from oil-exporting states".

exporting countries also increased during fiscal year 1974/75.⁷

In a recent interview in London with the Deputy Editor of Middle East Economic Digest, Dr. Ali Ahmad Attiga, Secretary General of OAPEC pointed out that the oil producing countries' generosity towards poorer undeveloped countries had enabled a large proportion of oil revenues to be recycled into the industrialised world. Because the oil exporters had given a much higher proportion of their income as aid, and because they had disbursed much of it in the form of direct grants or loans on very easy terms, the poorer states had ready cash to buy much more from the industrialised world.⁸

This comment expresses a most important truth. Aside from subsidies and credits relating to the provision of crude oil itself, the OPEC countries can do little more in the way of aid than indirectly to finance the export of goods and services from the developed to the developing world. This is by a "secondary recycling" process of two kinds: credits to M.S.A.'s for spending in the developed world; and their own purchases in the developed world, which should then themselves extend credits to the M.S.A.'s.

⁷World Bank, Annual Report, 1975, "Borrowing and Finance", pp. 75-82 incl.

⁸Middle East Economic Digest, London, 25 July 1975, p. 6.

In summary, for reasons which have already been explained, it is difficult for structural reasons to ascertain the quantity and the quality of OPEC foreign aid with any degree of precision. There is, nevertheless, definite evidence that the OPEC nations are entirely aware of the magnitude of the responsibilities which inescapably go with their newly-found financial power, and are doing a very great deal to discharge them.

Since 1973, the world has plunged into slump and inflation. Both were intensified by the oil price rises. The hardest hit victims were the non-oil-producing countries of the poor two-thirds of the world.

OPEC quintupled oil prices just as much of the developing world was on the crest of a boom. Earnings among non-oil less-developed countries (LDC's) had never been higher. But the raw materials boom broke shortly before the oil crisis began. The trade of the non-oil LDC's went deeper into the red, and their deficits on current account rose from \$9 billion in 1973, to about \$28 billion in 1974, and as much as an anticipated \$35 billion in 1975.

The poorer countries of the Fourth World will not be able to finance a deficit of this magnitude. Except to the extent that they receive help from other countries, they will have to cut their imports, which will, in turn, harm directly the recovery prospects of the industrialised countries, and indirectly the interests of the OPEC

countries themselves, the sustaining of whose revenues depends upon continuing and even growing western consumption of their crude.

Many proposals have been put forward to assist the M.S.A.'s to "finance" their new, enlarged current accounts deficits. Some of the world's most intelligent men have put forward some of the world's most ingenious ideas on the subject. Some types of international schemes which have been discussed, and in the first case actually implemented, include:

1. Mr. Johannes Witteveen, managing-director of the IMF, introduced an IMF "oil facility" of \$3.5 billion in 1974, funded by the oil producing countries. This money was available for onward lending to the LDC's to cover their oil-related deficits. The industrialised countries, with the exception of Italy, did not draw upon it.

For 1975, the IMF is raising a second "oil facility" from the same creditors and for the same purpose, in the amount of SDR 5 billion. Access to the facility for any country is under strict conditions relating to putting forward acceptable proposals to solve its medium term balance of payments problems. Moreover, each drawing member would have to describe the measures it has taken to conserve

oil or to develop alternative energy sources. Each Drawing member must also first have exhausted its gold tranche, and interest is payable at rates of 7¼ per cent and up.⁹

2. Mr. Denis Healey (British Chancellor of the Exchequer) has proposed a plan for the IMF to raise funds from the OPEC countries at commercial rates. He envisages raising as much as \$30 billion a year in this way for onward lending to the M.S.A.'s.¹⁰
3. Mr. Henry Kissinger and Mr. William Simon of the United States have proposed a \$25 billion supplementary loan facility to be established by the industrialised countries associated with the OECD, as an insurance policy. It would recycle money among the rich countries themselves, leaving to the IMF the responsibility of lending to the LDC's at discretionary rates under a special trust fund. The facility might obtain its funds directly from individual governments or from the capital markets. Decisions on lending would be made by a weighted vote of participants, taking into

⁹IMF, Washington, D.C., "The Oil Facility for 1975 - Conditionality and Assessment of Need and Decision", April 10, 1975, unpublished document SM/75/72, Revision 2, p. 1; also Appendix 1.

¹⁰The Economist, London, December 14, 1974, "World Finance" Survey, p. 15, "Stalemate on Recycling".

account the general economic position of any would-be borrower and not merely the size of its oil import bill. What this scheme amounts to, and the rationale behind it, is that if the OPEC countries prefer to place their surplus funds in private financial markets rather than international institutions, then the wealthier countries (perhaps just the Group of Ten) could provide swap lines to the new facility, much as they do under the New York Federal Reserve swap network, but on longer terms.

4. A new international governmental agency in which the oil countries and the major industrialised countries would share the risks and the responsibilities. There are several variants of this idea. The one supported by the German authorities envisages the creation of a specialised investment institution, operated jointly by oil-producing and oil-consuming nations. The version favoured by the international oil consultant, Mr. Walter Levy, would envisage a new international financial organisation, with agreed-upon criteria both for the share of each group of donor countries and for the selection of countries which qualify for financial aid - but drawings would be allowed only for the purpose of covering the additional burden of oil import costs caused by the OPEC cartel price.

Alternatively, or as a supplement, he suggests that a needy importing country could pay for its oil imports partly in its own currency, with restrictions as to its convertibility.¹¹

Mr. Robert McNamara, President of the I.B.R.D., in the speech to the annual meeting of I.M.F. and I.B.R.D. Governors on September 1, already alluded to, emphasised concessional financing as a solution to the Fourth World's balance of payments problems.

Rightly pointing out that the major contribution to any growth in the flow of aid to the poorer countries would have to come from the industrialised nations, rather than from the oil exporters, and also quite correctly highlighting the severity of the foreign exchange crisis facing developing countries, he then proposed that the I.B.R.D. should lend \$7 billion to them in the current fiscal year, and about \$40 billion over the next five years. He added that, although this would be the biggest program of financial and technical assistance to the poorer states ever undertaken by a single agency, it would still fall short of meeting the full capital needs of the developing world. He also announced that the intermediate lending facility - the so-called "Third Window" - planned as an interim measure to assist lower-income countries, would be established within a few weeks. At least \$500 million, and

¹¹Ibid.

possibly \$1 billion, would be lent. The facility would be financed by an "interest subsidy fund", which 12 OECD and OPEC countries had already agreed to support.

It would appear that schemes such as these all suffer from one fatal flaw, which the sheer magnitude of the recycling problem should by now have rendered quite obvious. Monetary phenomena are only a superficial reflection of what is happening in the real world. It is self-evident that all international obligations must ultimately, sooner or later, be settled in goods and/or services, directly or indirectly, by the debtor country. It is difficult to see how the poorest countries are to be helped if they are simply to be lent more "money" where-with to "finance foreign exchange deficits". Such devices can work only when they iron out more or less temporary, relatively minor fluctuations in the terms of trade. They do not, and cannot, resolve deep-seated, basic disequilibria of the nature and magnitude considered here.

Peering through this particular "money illusion", it can be seen that the West would be simply extending further credit for the goods and services the M.S.A.'s need to acquire today, but which credit will, at least in the formal sense, have to be repaid eventually in the form of goods and services from their own future, and very probably non-existent, surpluses. The only possible grounds for this are if the "money" buys investment in

future production, and not in current consumption beyond that required for actual physical survival; and, moreover, that another, more Keynesian "money illusion" continues to operate: that created by inflation,

In the latter context, there is some justification for so-called "optical", or "cosmetic" reasons, for loans which are so concessionary as to terms (nominal rates of interest, long grace periods, repayment extended up to 30-35 years), particularly in inflationary times like the present and the foreseeable future, that such loans would contain an actual grant element, in real terms, in the order of 90 to 95 per cent. That is to say, the value of goods or services furnished today in today's dollars, vis-à-vis what their depreciated equivalent repaid, on the average, 15 to 25 years from today, would purchase at that time.

Not the least of the advantages of the concessionary-to-the-point-of-all-but-a-grant loan over an outright grant are:

- (a) the real terms are scarcely more onerous;
- (b) the recipients of such loans will be able to maintain a greater measure of national self-esteem, or "face", with respect both to other countries and to their own domestic populations; and
- (c) the donor governments presumably will be able to command greater public support for what appear

to be loans, rather than outright gifts labelled as such.

The point to be made here is that no amount of monetary tinkering with loans, swap arrangements, or any other of the exotic solutions proposed can possibly solve the "recycling of petrodollars" problem as far as the poorest countries are concerned. Recycling of their surpluses from the newly-rich oil producers to the industrialised western countries is natural and inevitable. From the OPEC countries' point of view, they have only three investment options for their surpluses: domestic development, including defence; foreign aid; and foreign investment. They are doing all they physically can on the first; more than had been expected and possibly a good deal more than their share on the second; and apparently will still have large sums available for the third option. The only question remaining to be answered is with respect to the form in which their investments in the industrialised world should be held.

As has already been suggested the OPEC countries ought to concentrate on equity investment into the most productive sectors of the industry of the industrialised countries, and in real estate. This would provide both the greatest ultimate return to OPEC and a needed stability to the international banking and foreign exchange systems.

Finally, we must address the question of the mechanics of recycling; the effectiveness, to date, of the

recycling mechanism provided by the private international banking system.

As discussed in the introductory chapter, the fears which were widespread over the past two years that the OPEC countries' vast new revenues would literally swamp the international banking system, which would therefore be physically incapable of handling the recycling task, have at least so far proven to be, in the event, largely without foundation. International banking has been subject to severe stress, but its problems have been due more to the need to readjust to a world of floating exchange rates and foreign exchange speculation, coupled with real estate and other forms of inflation, rather than to the impact of petrodollars as such. The Herstatt Bank failure, which briefly rocked the international banking community recently, was simply caused by poor foreign exchange management.

That is not to say that there are no petrodollar problems from the banking standpoint. Many bankers have their doubts as to the ability of the system they administer to continue efficiently to handle the vast sums of oil money involved. It is quite possible, nevertheless, that their fears may be unjustified.

From the bankers' point of view, there are two aspects to the recycling problem: the financing or funding of the purchase of oil; and the servicing of the enormous

and growing debt that is being thereby created.

The first aspect, that of the supply of funds, is not really a major problem. OPEC revenues are an embarrassingly large source of funds, and that aspect of the problem really comes down to one of mismatched maturities. The banking system, within certain limits, cannot forever borrow short-term money and lend long. If the OPEC countries were always unwisely to insist on liquidity, rather than investing longer term, as advised herein, the banks would eventually have no option but to refuse to accept their funds. Acting in concert, they certainly have the power to do so. With the limited avenues open to them for investment, the OPEC nations would soon have to accept the realities of the marketplace for that particular kind of transaction.

It is really the second aspect, that of servicing the huge debt being created by deficit financing of the M.S.A.'s, which causes most of the trouble, and which leads many bankers to conclude that the banking system is not up to the job.

Bankers are debt managers. They can readily perceive that, even with the softest terms from lenders in the OPEC group and in the industrialised world, the restructuring, refinancing, or "rolling over" of debt can go only so far before actual default becomes inevitable.

A bad credit risk is a bad credit risk, and no self-respecting private international banker could possibly lend money in current conditions, without 100 per cent recourse to a credit-worthy guarantor, to any of the M.S.A.'s. The private banking system could simply not bear the consequent losses. Hence, and quite correctly within his own reference framework, the banker considers the problem as insoluble.

Regarded in that way, it must be frankly admitted that it is insoluble. Which brings this analysis full circle to the only possible, already stated conclusion: debt financing is not the answer to the balance of payments problems of the M.S.A.'s, already great, and now greatly enhanced by the rise in oil prices. What is called for is not another new financing gimmick, but a basic change in philosophy. If the industrialised countries are to assume this responsibility at all, they may have to be prepared to transfer or, put more bluntly, to give, not merely to lend, in the same way as they already do almost universally within their own countries for the benefit of their less fortunate individual citizens. Few nowadays would be prepared to withdraw all help from the countries of the Fourth World. On the contrary, it can be argued that every human being has a right to a share of the Gross World Product sufficient at least for bare survival.

An analogy may make this point clearer. During the Great Depression in the 1930's tens of millions of people in western societies were "on the dole"; capable and potentially valuable contributors to society who, through no fault of their own, were a vast and wasted economic resource. Welfare was at the subsistence level, and was generally considered to be shameful. Unemployment insurance did not exist, and family allowances, and all the other transfer payments which are commonplaces in today's society, as well as universal health insurance plans, were unheard of. Today, with progressive income taxation systems, and various other redistributive mechanisms with which developed countries are long familiar, all of these things are regarded as rights with which any democratically-elected national government would interfere at its peril. It may be that the time has arrived to begin to extend the same concepts to the international arena. On the one hand, it may be considered that by doing so all would become poorer. On the other hand, it is also possible to view the vast numbers of the world's poverty-stricken masses more positively: as unemployed and under-employed resources, to be mobilised for the greater good of humanity as a whole. If the world's poor can become producers of goods and services, Gross World Product would increase, international specialisation and trade would grow, and all would benefit, the richer and the poorer.

The very magnitude of the recycling problem has virtually forced this choice upon us. It is now possible to see clearly what was formerly perceived only dimly. Perhaps the only viable, long-term solution is a transfer of resources, including technology and capable management, to the Fourth World, without expectation of recompense. For the reasons already stated, it may be practically useful or necessary to represent such gifts as loans, but these loans should be made in the full, if hidden, anticipation of default. To the rationalisations for such deception may be added yet another. The discipline inherent in loans would discourage borrower countries from excessive resort to aid. For this reason alone, it may be necessary to practise this pretence, otherwise the developed countries' capacity to give would be overwhelmed by the demands on it. Let the industrialised countries deceive them then, in their own interest; but at least let the developed world not fool itself that, ultimately, there is any other viable solution to the recycling problem, or to the overall problems, of the very poorest countries. There isn't.

X. THE "MILITARY SOLUTION" TO THE OIL PROBLEM

X. THE "MILITARY SOLUTION" TO THE OIL PROBLEM

Oil holds an unique place in the security of the modern industrial state. It is in a special category. In the modern world, it is an increasingly indispensable means of enjoying other goods. It is also indispensable as a fuel for today's largely mechanised armed forces. Accordingly, it occupies a key position in the political sphere. As long ago as World War I, Clemenceau declared oil to be "as necessary as blood". U.S. President Coolidge, writing in 1924, said:

"It is even probable that the supremacy of nations may be determined by the possession of available petroleum and its products".

Also about a half-century ago, Briand asserted that "international politics today are oil politics". At the end of 1943, the editor of Oil and Gas Journal reported that:

"It is an open secret that the conferences at Moscow, Cairo, and Teheran concerned with the plans for the post-war world, discussions centred in the future development and distribution of petroleum. Essential in war, the statesmen of the United Nations are more and more impressed with the fact that petroleum is the world product on which a just and lasting peace must be founded".¹

¹Clemenceau, Coolidge, Briand, and Oil and Gas Journal quotations from P. H. Frankel, op. cit., p. 3.

If oil was seen to be so important in the relatively unsophisticated era of one or two generations ago, it is scarcely surprising that today the control of a secure oil supply could be considered as a sine qua non of any major, sovereign, industrial nation.

To the vital importance of oil as the sinews of peace and war must now be added the problems of the Fourth World, already extremely difficult, and rendered even more so by every rise in the price of internationally-traded oil. These problems have caused great concern in the industrialised western world, traditionally the bearer of its burdens and still the primary long-term source of aid, notwithstanding the greater financial contributions to the poorest nations which have recently been made by the OPEC countries.

Also to be considered is the unpredictable effect of national pride. Sovereign world powers, accustomed to controlling their destiny, greatly resent finding themselves at the mercy of countries which, in their view, have done little or nothing to earn their new power, which is due entirely to an accident of geography.

There are signs that the United States is becoming impatient. Ample warning of possible military action, generally considered to be almost unthinkable a few years ago, has already been given to the OPEC countries. Throughout 1974 and 1975, a mixture of interviews, leaks, and denials has emanated from the U.S. Administration.

In January 1974, the then U.S. Secretary of Defense, James Schlesinger, warned Arab oil producers that they would risk military reprisals if they were to cripple the industrialised world. He said that he did not expect that these circumstances would arise, but if they did, the Arabs must expect force to be used against them. The statement was met by strong protests from the Arabs, and there were reports that Saudi Arabia, Kuwait and Iraq subsequently prepared their oil fields for demolition.

In his first interview on the subject,² President Ford significantly declined to condemn military action as such. Another news analysis³ stated that a comprehensive study of "military options" for dealing with the oil crisis had been initiated, and that "top-level Administration policy makers, in casual conversations", had been "candidly discussing the possibility of armed action by the U.S.A. if the oil crisis should become unmanageable".

On September 23, 1974 and again on January 2, 1975, U.S. Secretary of State Henry Kissinger resorted to veiled threats of military intervention to dissuade the Arabs from imposing an embargo in the event of a new Middle East war. In the latter episode, in an interview with Business Week, the following exchange took place:

²U.S. News and World Report, November 25, 1974.

³U.S. News and World Report, December 2, 1974, "If Pushed Too Far - Will U.S. Seize Mideast Oil?".

"Q. Have you considered military action on oil? Dr. Kissinger: A very dangerous course ... I am not saying that there's no circumstance where we would not use force - but it's one thing to use it in the case of a dispute over price, it's another where there is some actual strangulation of the industrialized world".

Some days later, President Ford told Time magazine that he stood by the view that Dr. Kissinger had expressed, and added: "Now the word 'strangulation' is the key word". A few days later, on January 15, 1975, James Schlesinger was asked whether, from a purely military point of view, military intervention in the Middle East was practical. He replied that, in his opinion, "in the Persian Gulf area" it was feasible, though he emphasized that such action would be considered "only in the gravest emergency".

More recently, on June 25, 1975, President Ford told a press conference that possible price rises such as OPEC had been discussing - up to \$4 a barrel - would be "unacceptable" to the United States.⁴ "Any increase in foreign oil (prices) would be, in my judgement, very disruptive and totally unacceptable", he is quoted as having said. Asked what he meant by "unacceptable" he replied, "It means that it is unacceptable in the sense that we as a nation individually, and we as a nation in conjunction with our allies, are going to find some answers other than OPEC oil". It should be noted that, in diplomatic parlance, the term "unacceptable" is extremely strong.

⁴Toronto Globe and Mail, June 26, 1975, p. 1.

It amounts to a virtual ultimatum. Moreover, the reference to "allies" is a clear hint that concerted western military action is contemplated, notwithstanding the evasive wording of the rest of the President's sentence, quite possibly caused by his departure from a prepared text.

While it must be a matter of judgement whether the United States actually is seriously contemplating an undertaking of this kind, it would appear that the U.S.A. may to date have held its hand for at least five reasons:

1. The U.S.A. is still essentially self-sufficient in energy, If a full-scale effort were to be mounted to develop all possible sources, regardless of financial and environmental costs, and this were to be coupled with a really serious conservation program, the country could survive practically any emergency. Imported energy, or at least that from OPEC sources, is still relatively marginal.
2. In a real national emergency, the U.S.A. has the political influence and the military capability either to persuade adjacent source areas voluntarily to co-operate if possible, or to invade and to occupy them if necessary. Such countries include Canada, Mexico, Venezuela, and Ecuador. Other easily-conquerable oil countries, which are adjacent to the U.S.A., in the air-naval strategic

sense are Libya and Gabon. Nigeria is equally accessible, but could be a rather tougher nut to crack.

3. Fear of precipitation of World War III, a fairly remote contingency if operations were to be mounted against any or all of the countries listed in (2) above, but one which would be rather more likely if countries more or less adjacent to the Soviet Union, such as Iran, Saudi Arabia, Kuwait, Iraq, the United Arab Emirates, etc., were to be subjected to attack.
4. The absence of an "occasion"; for example, a new outbreak of hostilities between Israel and her immediate Arab opponents might furnish the excuse for a U.S. "police" action to "restore order" in an area "vital to western interests".
5. The crude oil price increases since their quintupling in the aftermath of the October 1973 War have been relatively moderate.

The U.S.A. and the rest of the industrialised world seem to have swallowed the nominal 10 per cent price increase which took effect on October 1, 1975, and which has worked out in practice to a good deal less than that. But the situation is still delicate. Had the Shah of Iran succeeded

in forcing upon OPEC his recent demands for a price rise from 35-40 to 70-80 per cent, it could have been a very different story. The OPEC countries should realise that further inordinate price increases or severe production cutbacks, and most certainly a politically-motivated embargo, would invite, and probably precipitate, military intervention.

Presumably there are already in existence U.S. plans for all possible scenarios, including invasion and occupation of the Arab countries. If such an action should be undertaken, the gravest consequences could ensue. The Soviet Union might, in turn, find an invasion of, say, Saudi Arabia, "unacceptable". Most U.S. strategic and foreign policy analysts apparently discount the risk of Soviet intervention. U.S. News and World Report quotes an unnamed "high-level U.S. policy maker"⁶ as follows:

"The Soviets would recognize that American military intervention in Arab oil states involved vital U.S. interests and only marginal Russian interests. They would stand aside - just as we did in Czechoslovakia where we recognized that Soviet national interests were at stake".

The validity of this belief is at least questionable. Certain British analysts, with a rather better intelligence track record, have reported an intensification of the Soviet effort, in their usual trouble-making style, to bring about an all-out confrontation between the Arab

⁶U.S. News and World Report, December 2, 1974, "If Pushed Too Far - Will U.S. Seize Mideast Oil?"

oil producers and the West, with open talk of "capitalist" preparations for the military seizure of oil resources, and the U.S.S.R.'s readiness to come to the aid of the Arabs. Citing presumably the same sources in Washington, the Russians maintain that the primary target will be the oil-producing countries in the Gulf. The Soviet message, originating with a Kremlin spokesman, one Yevgenyi Rusakov, goes on to say:

"The attempts by the Western Imperialist circles to solve the oil problem from a position of strength stand little chance of success. The balance of power in the world has changed, but not in their interests. In the struggle against imperialism the oil producing countries can increasingly rely on the support of the countries of the Socialist community ... the consolidation of the alliance with the Socialist countries is a decisive factor in the battle against imperialism, which is trying to impose its domination in the Middle East."⁷

The Russians may, of course, be bluffing. But can the Gulf countries afford to take the risk? That the Americans just may not be bluffing is indicated by U.S. Government moves to proceed with the Diego Garcia base build-up in the Indian Ocean. In commenting on this proposed naval augmentation program, Senator John Stennis, Chairman of the U.S. Senate Armed Services Committee, recently declared:

⁷Intelligence Digest, Intelligence International Ltd., Cheltenham, Gloucestershire, England, January 1975. "The Oil War".

"I feel like (sic) it is clear that we ought to be somewhere around in that part of the world in order not to have an empty gasoline tank."⁸

Moreover, and most significantly in the context of the Diego Garcia expansion, the U.S.A. is reported to be negotiating, with the acquiescence of the Sultan of Oman, either to share or to take over the Royal Air Force base on the island of Masirah, off the coast of Oman, in the Arabian Sea. Masirah is stated to be quite capable of supporting major operations, and all that is required to make it fully operational is the siting of air-transportable ground support equipment to service tactical aircraft. Accordingly, all of the arguments once advanced against the probability of success of such an operation have been rendered nugatory.

These arguments may be summarized by pointing out that, to prevent the destruction by local authorities of oil facilities, a surprise attack would be extremely difficult to mount; an airborne operation would be necessary, and to achieve success it would require up to 60,000 men, delivered aboard strategic aircraft which would need to "stage" in friendly airfields. The most important requirement would be a mounting base where assault troops could be transferred to aircraft and where logistic support could be coordinated. There was previously no obvious mounting area

⁸Quoted in Interavia Air Letter, No. 8305, Geneva, Switzerland, July 29, 1975, p. 7.

within the reach of the Gulf which did not entail over-flying potentially hostile territory.⁹

These arguments are correct if one thinks only in Atlantic Ocean and Mediterranean terms. Through U.S. expansion of Diego Garcia and access to Masirah, however, the Gulf countries will have been outflanked.

In a word, the U.S.A. is not only talking, but also acting to acquire the strategically located installations needed for a quick invasion of the Gulf States, not through the Atlantic and the Mediterranean, where military movements would be highly visible and subject to both harassment by possible enemies and non-cooperation by erstwhile allies, but quietly and almost clandestinely through the vast and virtually unpatrolled Indian Ocean.

The logical target is the 400 mile long western coastline from Kuwait to Qatar. It comprises a 40 mile wide strip which contains some 1,778 oil wells grouped in 31 fields and served by 9 refineries and 10 ports.¹⁰ A sudden, massive assault from Diego Garcia, staged through Masirah, would secure this area in a matter of hours, if not minutes.

While the temptation could be very great for the United States thus to act unilaterally to "solve" the

⁹Strategic Survey - 1974, The International Institute for Strategic Studies, London, 1975, "Military Intervention to Secure Oil Supplies?", pp. 30-33.

¹⁰Robert Tucker in Commentary, January 1975, pp. 21-31.

industrialised and the Fourth Worlds' energy problems with one bold stroke, that is not the only quarter wherefrom danger to the Arab oil producers is likely to appear. If the U.S.A. were to occupy "adjacent" countries as defined above, including Libya, and yet to fail to move against the Gulf States, the Soviet Union, which is much better placed both politically and geographically to mount a clandestine build-up and to launch an assault directly from home territory, could reasonably be expected to occupy the Gulf countries to "protect" them.

A direct confrontation between the U.S.A., and the U.S.S.R. in the Gulf would be essentially a re-enactment of the October Missile Crisis of 13 years ago, in reverse, with the Arabian Peninsula in the rôle of Cuba. The critical years from 1975 through 1980 are not, however, 1962. The military balance of power has shifted in favour of the Soviet Union, which has been rearming at an ever greater rate; to such an extent, in fact, as to lead many observers to the conclusion that it really views all efforts at détente as a mere tactic whereby to strengthen its own position vis-à-vis the West. In any event, in present circumstances, given their short supply lines as against the enormously long logistic support channels to the Gulf for the U.S.A., the Soviets are quite unlikely to back down.

There is yet a third possibility, and one which

may not have been given sufficient emphasis in the literature. On the assumption that both the United States, with or without the co-operation of its allies, and the U.S.S.R. will refrain from such action, the Gulf States would do well to keep an eye on happenings in fellow OPEC-member Iran.

As discussed elsewhere herein, the main differences on pricing policy within OPEC have been between the groups of countries led, respectively, by Saudi Arabia and Iran. The OPEC cartel has, in fact, been in some danger of breaking up, and could well eventually collapse anyway, because of Saudi insistence on relatively low prices, while the spokesmen for the Shah have been pushing for the highest possible returns. The reasons for this are obvious. Saudi Arabia, with a little over five million people and truly huge oil reserves, takes the long view, and regards its oil in the ground as better than money in the bank. It simply does not need or really want all that income in the short term; hence its ability and readiness to increase or to decrease oil production is the key to OPEC power.

Iran, on the contrary, with nearly 35 million people, enormous and immediate development needs, and much less oil, has been spending all of its revenues on development and on national defence. It has, indeed, overspent, and has been borrowing funds on world money

markets against future income, to finance current expenditures. It seeks urgently to maximize its revenues now, and in the immediate future, so as to become established as a viable, self-sustaining, modern, industrial nation before its oil reserves run out. If, as seems to be possible, Iranian achievements prove not to be commensurate with Iranian ambitions, the Iranians, who are arming at a very accelerated rate, who outnumber all the adjacent Arabs combined, and who are neither racially nor linguistically akin to them, would almost certainly be willing, and able, to exercise their newly-acquired power by occupying the Arab Gulf countries in what they would, quite logically, consider to be their own vital interests. It is particularly noteworthy that Iranian air and naval bases are all in the south of the country, "aimed" at possible operations in the Gulf, and noticeably absent from the northern areas bordering upon the Soviet Union. Briefly, then, there are four possible future political scenarios for the OPEC countries of the Arabian Peninsula. These are:

1. Continuation of their present status as sovereign nations, with or without structural changes within these countries, either individually or as a group.
2. Incorporation into the United States Empire, ultimately either as one or more of its constituent

states or, more probably and certainly initially, with some sort of territorial possession or Commonwealth status.

3. Incorporation into the Russian Empire as, perhaps, the Arabian Soviet Socialist Republic (A.S.S.R.).
4. Incorporation into the emerging Achaemenian Empire of Greater Iran.

During the last quarter of the present century, no country or group of countries other than the listed three is likely to emerge which would or could take over control of these areas, either directly by military action or indirectly by subversion, in the face of the vital interests of the three named powers.

It is assumed that the objective of the Arab OPEC countries of the Gulf will be to perpetuate scenario number one, i.e, the political status quo. As they are undoubtedly aware, to succeed in this they will have to choose their path with considerable care and circumspection. Their crude oil pricing policies must steer the narrow course between the Scylla of United States and the Charybdis of Iranian interests, with the enigma of the Soviet Union looming as a vast storm cloud overhead, capable at any time either of a pre-emptive move to counter an anticipated U.S. or Iranian occupation or of a counter-attack to repel an actual invasion from either of these.

This chapter is not, however, really intended to be a treatise on the military aspects of the current situation. These aspects are, nevertheless, sufficiently important to warrant the attention devoted to them. The considerations raised herein have a definite bearing on Saudi Arabian pricing decisions, and there is no question but that, with its small population and needs, coupled with its vast oil reserves and productive capacity, Saudi Arabia is the key, as the one country in a position to dictate the price of OPEC oil. Iranian-led opposition has kept the price of oil up, and forced the recent increase, against Saudi resistance. The Saudis eventually agreed to a modest increase, less than one-third of that which Iran had been demanding, but they did not have to do so. At any time, they can unilaterally set a lower price at which they are prepared to sell Saudi oil in virtually unlimited quantities, and that would be the price to which all other OPEC members would be forced to adhere. To date, however, the actual and potential military threat from Iran has clearly exerted a strong effect on Saudi pricing policy and an upward push to OPEC prices.

The Arab OPEC countries will by now have realised that they have entered a period of great and growing insecurity and trouble. They are undoubtedly shrewd enough to perceive that their weakness is an invitation to major foreign powers to move in to fill the power

vacuum created by the final withdrawal, several years ago, of the British presence from the Gulf - hence their current efforts to establish strong defence forces. Their survival as independent nations, however, would logically seem to depend upon their readiness to co-operate with the West. Such co-operation will almost have to be expressed in restraint on the questions of oil prices and availability. This may mean, as has already occurred, freezing nominal prices for an extended period, deliberately allowing inflation to erode the purchasing power of their revenues. Such action would assist the industrialised countries themselves to bring inflation more easily under control and would ease the problems of the most seriously affected Fourth World countries.

While pursuit of such a policy will hasten the day of confrontation with Iran, the dangers from that quarter would be obviated if a special relationship were to be established with the industrialised countries of the West, primarily the United States, as a guarantor of their freedom against threats from whatever source.

As Brian Beedham, the foreign editor of The Economist, wrote, following a visit to the Gulf early in 1975:

"... the Gulf world and the Atlantic world, the main starting and ending points of the oil nexus, are not natural adversaries of each other, and are indeed to a considerable degree natural partners ... the partnership is a closer one now they can afford our technology and we need their capital, and both of us are starting to want more of each other's exports ... these two non-adversaries have at least a potential

adversary in common. They both have greater cause for concern about the policies and intentions of the Soviet Union ... than they do about each other. They are both trying to work out a new relationship with Russia, but they are not at all confident that this new relationship will prove to be strong enough to bridge the chasm of ideology and power-interest; and on the present evidence from Russia they are entitled to be sceptical about that. For all the undeniable differences between the Gulf and the Atlantic, they have more in common with each other than either has with Mr. Brezhnev's world ... They both have a powerful reason to settle their private disagreement over oil in a way that leaves them free to deal with other and bigger problems ... The reason for the Gulf and the Atlantic to compose their oil disagreement is not that they do not have other things beyond oil to argue about, but that their reasons for pulling together are more compelling than any of their differences, including the oil one."¹²

One can only hope that the wisdom of this approach commends itself to the Arab Gulf countries. Led by Saudi Arabia, they have already given evidence of an intention to rely upon and to work closely with the West. It is the best insurance they could possibly have for survival.

¹²The Economist, Survey "Out of the Fire - Oil, the Gulf and the West", May 1975, p. 8.

XI. SUMMARY AND CONCLUSIONS

XI. SUMMARY AND CONCLUSIONS

The oil industry is unique, and has always been characterised by cartel arrangements in one form or another. From the mid-1950's on, the ever-growing need of the industrialised and the developing worlds for cheap power led imperceptibly to a change in the terms of trade, favouring the OPEC countries, primarily those of the Middle East. More than ever before, oil has become the essential lifeblood of nations, in both peace and war. As a consequence, the problems thrust upon the world by the unilateral quintupling of oil prices by OPEC in the wake of the October 1973 War are as much political as economic.

Put into its simplest terms, the petrodollar recycling problem is the result of the OPEC countries having taken advantage of their new, albeit temporary, position of control over a relatively moderate but vital percentage of world energy resources to impose huge oil price increases on the consuming countries, without discrimination as to their ability to pay. This has caused foreign exchange "flows"¹ of unprecedented magnitude in favour of

¹The banking face of a country does not necessarily change when a payment is made by, say, Exxon, to Saudi Arabia. All that may happen is that the ownership of deposits in the U.S. banking system changes hands. The vision of large funds sloshing around, flowing in and out, is mostly imagery, or a manner of speaking.

the OPEC nations, to the particular detriment of the Most Seriously Affected countries (M.S.A.'s) of the Fourth World.

The size of the recycling problem is commensurate with the magnitude of the unspent surpluses of the OPEC countries, the level of which will be primarily determined by the price they can obtain per barrel of oil, and secondarily by the rate at which they can spend their revenues for their own development and in foreign investment, and the rate at which prices of the goods and services which they import go up.

The price obtainable per barrel, and the time period during which it will endure will depend, economically, upon the amount of oil produced and the rapidity with which other countries can develop alternative energy sources, and the cost of these, and politically, upon the readiness or otherwise of certain countries to intervene militarily.

From the standpoint of the non-oil developing countries, the crux of the recycling problem is that the very poorest countries still have to pay the same price for oil as any other. It therefore becomes needful, if the M.S.A.'s are not to lose the little development they have already so laboriously achieved, for some part of the large OPEC surpluses of petrodollars to be placed at their disposal. Such recycling can be either primarily and directly by OPEC countries in the form of grants and soft

loans, or indirectly through OPEC purchases and investments in wealthier consumer countries, from which some part of these surpluses can be secondarily recycled to the M.S.A.'s.

We now come to the question of the mechanics of such transfers. The fears almost universally expressed over the past two years that the OPEC countries would be unable to utilise their new wealth, and that the international banking structure would be inadequate to the recycling task have, at least so far, proven groundless. International banking has been severely tried, but its problems have been due more to a readjustment to a world of floating exchange rates and foreign exchange speculation, coupled with real estate and other forms of inflation, rather than to the impact of the petrodollar surpluses as such.

From the bankers' point of view, there are two aspects to the problem of recycling: the financing or funding of the purchase of oil; and the servicing of the enormous and growing debt that is being thereby created. It is the second aspect which leads bankers to believe that the banking system is not up to the job. As debt managers, they readily perceive that, even with the softest terms from OPEC and industrialised world lenders, the restructuring or refinancing of debt can proceed only so far before actual default. The consequent losses obviously cannot be borne by the private banking system. Accordingly, the banker views the problem as insoluble,

and quite correctly, within his own particular, if narrow, frame of reference.

What is needed here is a change not in the mechanism, but in the basic philosophy of recycling. It involves a readiness unilaterally to transfer real resources to the M.S.A.'s. These real resources, primarily in the form of capital goods and improved technology, with few exceptions can come only from the developed world, although they can be, and are being, financed monetarily by the OPEC countries as well. It is necessary for national governments and international agencies to function in this area, so as to make recycling possible.

This means that aid should be in the form of grants, not loans, however generous be their terms, for loans only add to the burden of the recipient, and must eventually be repaid, not really in "money", but ultimately in the form of goods and services which those countries will in all probability need to retain for themselves.

The OPEC oil price should soon fall to the equivalent of \$7 a barrel in 1975 dollars; indeed it is in the interests of OPEC countries themselves, as a whole, that it should do so. The OPEC cumulative surplus would then peak in about 1978 at a little over \$200 billion, and it should disappear entirely in 1980. Nevertheless, it is impossible at this time to develop a model which will predict these outcomes with precision. There are too many

highly uncertain variables, such as:

- (i) the price of oil;
- (ii) the consequent growth of OPEC revenues;
- (iii) the rate at which the OPEC countries will be able or willing to give away, to lend, and to invest their surpluses domestically and abroad;
- (iv) the form(s) in which their surpluses will be held;
- (v) the ability and the willingness of consuming countries to restrict or to re-order energy consumption;
- (vi) the speed with which alternative energy sources will be developed and brought on stream, and in what quantities and at what cost;
- (vii) the cohesiveness of OPEC in the face of internal inconsistencies among members of the organisation with respect to their varying and contrasting economic and political objectives;
- (viii) the likelihood or otherwise of one or more of the major powers resorting to the "military solution"; and even
- (ix) the poverty of statistical data.

These are some of the issues which have been considered in greater or lesser detail in this work. It

really is impossible to do more than to make a more or less intelligent guess as to what may happen, and all that has been or can be accomplished herein is to establish some sort of analytical framework: to identify and to define the problems; to make certain reasonable assumptions; and to draw some tentative conclusions.

Philosophically, it may be said that the OPEC countries and the OECD nations are natural allies, not opponents. What is perhaps not adequately appreciated in the West is the extent to which the OPEC countries have themselves become the captives of their ambitious development programs, from which they cannot now withdraw without ruinous losses. Moreover, neither the western governments nor the international oil companies really want a return to cheap oil. The time is, accordingly, appropriate for both sides, OPEC and OECD, to confer in a spirit of conciliation and cooperation, to work out a pricing system which will protect the interests of both, while perhaps giving consideration to joining together to introduce into the international community redistributive mechanisms analogous to the income tax, public ownership, welfare schemes, and social insurance which the OECD countries have already accommodated so successfully within their own societies over the past century.

There are many things for which the industrialised world may be grateful. It has been forced to call a halt

to its carefree and wanton waste of precious, irreplaceable resources. The search for limitless, virtually cost-free energy has been accelerated. Belated justice has been done to at least a moderate number of primary commodity producing countries, in a way which can serve as a model for western dealings with producers of primary commodities other than oil.

So far, at least, the world has been spared the "military solution", which would only sow the seeds of a far greater and utterly ruinous international conflict.

As for the investment strategy recommended for the OPEC countries, the industrialised world has to learn to accept the truth that foreign ownership in itself is, or can easily be made to be, politically neutral. It is certainly not intrinsically evil. The OPEC countries, in turn, must learn to trust the western world not to seize their assets, for indeed they have no other choice. This implies a tacit or open agreement that the Arab Oil Weapon will henceforth remain in its sheath. It also implies negotiation in good faith, in the true spirit of co-operation which characterised the early pronouncements of OPEC, as is quite clear from the evidence which has been adduced.

It is in the West's own vital interest to guarantee the freedom and independence of the OPEC countries; to help them to solve their domestic development problems;

to assist them to invest their financial surpluses wisely and in such a way as to guarantee to them and their descendants a commensurate share of the world's wealth in perpetuity; and to encourage them to continue to assume a fair portion of the burden of the world's truly poor - a challenge to which they have already so generously responded.

XII. SELECTED BIBLIOGRAPHY

XII. SELECTED BIBLIOGRAPHY

- Abushadi, M. M. "Will New York Attract Arab Capital?"
Text of an address, Financial Times Conference
on "New York as a World Financial Centre".
June 11, 1974.
- Aerospace International. "The Middle East and the
Mediterranean". November/December 1974
- Alamuddin, Shaikh Najib. "Co-operation will lead to
a reformed world economic order." Middle East
Economic Digest. London. 20 December 1974
- Al-Bazzaz, Mahdi. "Middle East Oil Revenues; An
Assessment of their Size and Uses". Middle
East Economic Digest. London. 15 March 1974.
- Al-Hamad, Abdlatif Y. "Arab capital and international
finance". The Banker. January 1974
- Balbach, Anatol. "Foreign Investment in the United
States - A Danger to our Welfare and Sovereignty?"
Federal Reserve Bank of St. Louis. October 1973.
- Bank of Montreal. Business Review. January 1975;
March 1975. "International Financial Markets;
Recycling of Petrodollars.
- Bureau of National Affairs. Daily Report for Executives.
Washington, D.C. Many issues 1973-1975.
- Business Week. Many issues 1974-1975
- Chase Manhattan Bank. Chase Economic Report "To Supply
the World with enough Oil by 1985, the Petroleum
Industry Needs to Spend over \$220,000,000 a Day".
June 1975.
- Chenery, Hollis B. "Restructuring the World Economy".
Foreign Affairs. January 1975
- Cleveland, Harold van B., and Brittain, W. H. Bruce.
"A World Depression?" Foreign Affairs.
January 1975.

- Crockett, Andrew D., and Ripley, Duncan. "Sharing the Oil Deficit". Unpublished Staff Study. IMF Document DM/75/3. January 13, 1975.
- Demaree, Allan T. "Arab Wealth as seen through Arab Eyes". Fortune. April 1974.
- Engler, Robert. The Politics of Oil. New York, Macmillan. 1961.
- Farmanfarmaian, K., Gutowski, A., Okita, S., Roosa, R. V., and Wilson, C. L. "How Can the World Afford OPEC Oil?" Foreign Affairs. January 1975.
- Financial Post. Toronto. Many issues 1973-1975.
- First National City Bank of New York. Monthly Economic Letter. "Why OPEC's Rocket will lose its thrust". June 1975.
- Fleming, J. Marcus. Reflections on the International Monetary Reform. Unpublished Document DM/74/63. I.M.F. June 27, 1974.
- Fleming, J. Marcus. International Monetary Reform and the Stabilisation Problem. Staff Study. Unpublished Document DM/74/71. I.M.F. July 16, 1974.
- Foreign Report. The Economist Newspaper Ltd. London. Various reaues 1974-1975.
- Frankel, P. H. Essentials of Petroleum. London. Frank Cass & Co. Ltd. 1969.
- Hay, K. A. J. "Afloat in Oil Money". Canadian Banker & ICB Review. No. 3/1974.
- Henry, Jacques. "Global oil crisis: the benefits of the confrontation process". International Perspectives. Journal of the Department of External Affairs, Ottawa. September/October 1974.
- Hudson Institute. Report of Corporate Environment Program Meeting on Middle East Issues. No. HI-2242-P. March 12, 1975.
- Interavia Air Letter. (daily). Geneva. Many issues 1973-1975.

International Bank for Reconstruction and Development (IBRD). Prospects for the Developing Countries. Report No. 477. July 8, 1974.

International Business. Many issues 1973-1975.

International Defence Business. Many issues 1973-1975

International Monetary Fund (IMF). Adequacy of Present Financing Arrangements for the Recycling of Oil Surplus Funds. Unpublished Document SM/74/250. November 13, 1974.

_____. A Facility to Assist Members in Meeting the Initial Impact of the Increase in Oil Import Costs. Staff Study. Unpublished Document SM/74/41. February 19, 1974.

_____. Annual Reports 1974 and 1975.

_____. Currency Arrangements and Banking Legislation in the Arabian Peninsula. Staff Study. Unpublished Document No. DM/74/86. August 30, 1974.

_____. Euro-Currency Markets. Staff Study. Unpublished Document No. SM/74/225. September 24, 1974.

_____. Excerpts from Governors' Speeches at the 1974 Annual Meetings. Unpublished Document. No number. October 17, 1974.

_____. Executive Board Decision. Facility to Assist Members in Payments Difficulties Resulting from Initial Impact of Increased Costs of Imports of Petroleum and Petroleum Products. No number. June 13, 1975.

_____. Immediate Issues in the Euro-Currency Market. Staff Study. Unpublished Document No. SM/74/232. September 26, 1974.

_____. International Banking - Recent Developments and Current Outlook. Staff Study. No number. April 10, 1975.

_____. Possibilities of Establishing a Special Trust Fund. Unpublished Documents Nos. SM/75/54. March 15, 1975; April 7, 1975.

- _____. Review of Oil Facility Decision. Staff Study. Unpublished Document No. SM/74/220. September 11, 1974.
- _____. Statistics in Euro-Currency Banking. Staff Study. Unpublished Document No. SM/74/224. September 23, 1974.
- _____. The Need for, and Possible Features of, a 1975 Oil Facility in the Fund. Staff Study. Unpublished Document No. SM/74/249. November 11, 1974.
- _____. The Oil Facility for 1975 - Conditionality and Assessment of Need and Decision. Unpublished Document No. SM/75/72. April 10, 1975.
- Intelligence Digest, London. "The Oil War". January 1975.
- Iskandar, Marivan. The Arab Oil Question. 2nd ed. N.p. Library of Congress Card No. 74-75322. January 1974.
- Kenward, Michael. "Punch Drunk in Paris". New Scientist. 13 June 1974.
- Kissinger, Henry A. "Energy Crisis: Strategy for Co-operative Action". Text of an address delivered in Chicago, Ill., November 14, 1974.
- Klebanoff, Shoshana. Middle East Oil and U.S. Foreign Policy. New York. Praeger. 1974.
- Knowles, Ruth Sheldon. America's Oil Famine. New York. Coward, McCann and Geoghegan Inc. 1975.
- Langer, Frederick, Iran: Oil Money and the Ambitions of a Nation. Hudson Institute. European Division Special Report. Paris, 1975.
- _____. The Oil Producers - What Lies in their Future. Research Memorandum. Hudson Institute. June 1975.
- Levy, Walter J. Future OPEC Accumulation of Oil Money: A New Look at a Critical Problem. New York. Walter J. Levy Consultants Corp. June 1975.
- Lomax, David. "Oil and international debt". The Banker. April 1974.
- Longrigg, Stephen Hemsley. Oil in the Middle East. London, New York and Toronto. Oxford University Press. 1968.

Longworth, Richard C. "The Ecopolitics of Oil". Saturday Review of the World. January 26, 1974.

Los Angeles Times. Editorial. "Oil Prices and the Arms Race". September 23, 1974.

Mabro, Robert. "Dialogue may be frustrated by failures of understanding". Middle East Economic Digest. 20 December 1974.

McLean, John G. "The United States Energy Outlook and its Implications for National Policy". Text of an address to World Affairs Council. September 21, 1975.

Middle East Economic Digest (weekly). London. Many issues 1973-1975.

Montreal Gazette. Many issues 1973-1975

Montreal Star. Many issues 1973-1975

Morgan Guaranty Trust Company of New York. World Financial Markets. "Oil: looking back and looking ahead". January 21, 1975. "Reduced OPEC Surplus". May 20, 1975.

Mosley, Leonard. Power Play - Oil in the Middle East. New York. Random House. 1973.

Organisation for Economic Co-operation and Development (OECD). International Energy Agency (IEA). Standing Group on Long Term Co-operation. Sub-Group on Energy Conservation. Evaluation of Member Country Conservation Programmes as of 30th June 1975. Unpublished Document No. IEA/SLT(75)68. 5 September 1975.

_____. Oil Section. Report on Conventional Crude Oil Reserve Position and Potential for an Increase in Oil Production in OECD Member Countries by 1980 and 1985. Unpublished Document No. DIE/E/PE/74.78. 18 April 1974.

_____. International Energy Agency. Ad Hoc Group on Financial and Investments Issues. Absorptive Capacity of the OPEC Countries. Unpublished Document No. IEA/GB/FIN.(75)4. 30 September 1975.

_____. International Energy Agency. Ad Hoc Group on Financial and Investment Issues. Indexation of Oil Prices. Unpublished Document No. IEA/GB(75)56. 15 September 1975.

- _____. Committee for Invisible Transactions. Follow-Up Report. International Direct Investment. Unpublished Document No. DAF/INV/75.26. 3 June 1975.
- _____. International Energy Agency. Standing Group on Long-Term Co-operation. IEA Conservation Goals. Unpublished Document No. IEA/SLT(75)82. 10 September 1975.
- _____. Total Liabilities of Developing Countries. 1974
- _____. Long-Term Energy Assessment. Unpublished Document No. ELT/CU/0300. 11 September 1974.
- _____. International Energy Agency - Secretariat. Producing Country Positions. Unpublished Document No. IEA/GB(75)45. 27 June 1975.
- _____. IEA. Record of the Meeting of the Governing Board at Ministerial Level - 27 May 1975. Unpublished Document No. IEA/GB(75)37. 11 July 1975.
- _____. IEA. Standing Group on Emergency Questions. Report of Oil Industry Working Party on Allocation Principles. Unpublished Document No. IEA/SEQ(75)1. 21 January 1975.
- _____. IEA. Review of IEA Member Country Conservation Programmes. Unpublished Document No. IEA/SLT(75)68. 10 September 1975.
- _____. IEA. Standing Group on the Oil Market. The International Oil Price Situation Following the OPEC Meeting of 12th-13th December 1974 - An Interim Report. Unpublished Document No. IEA/SOM(75)4. 4 February 1975.
- _____. IEA. Ad Hoc Group on Financial and Investment Issues. The Erosion of Oil Revenues. Unpublished Document No. IEA/GB/FIN(75)5. 22 September 1975.
- _____. IEA. Ad Hoc Group on Financial and Investment Issues. Trends in U.S. Export Prices to OPEC Countries. Unpublished Document No. IEA/GB/FIN(75)6. 29 September 1975.
- Ottawa Citizen. Many issues 1973-1975
- Ottawa Journal. Many issues 1973-1975
- New York Journal of Commerce. July 7, 1975.

Penrose, Edith. "Consequences of the oil squeeze for the less-developed nations". International Perspectives. Journal of the Department of External Affairs, Ottawa. September/October 1974.

Petroleum Economist (formerly Petroleum Press Service) (monthly). London. Many issues 1974-1975.

Petroleum Press Service. London. October-December 1973

Reuber, Grant L. "Coping with the larger issues involved in monetary reform". International Perspectives. Journal of the Department of External Affairs, Ottawa. September/October 1974.

Ridler, Duncan and Tarapore, S. S. Imports of Fertilizers by Developing Countries. Staff Study. Unpublished Document No. DM/74/376 IMF. April 1, 1974.

St. Pierre, Claude J. "Iran Doubles Development Plan". Foreign Commerce. Department of Industry, Trade and Commerce, Ottawa.

Schuur, Sam H. and Homan, Paul T. et al. Middle Eastern Oil and the Western World - Prospects and Problems. New York. Elsevier Publishing Co. 1971.

Stocking, George W. Middle East Oil. Kingsport, Tenn. Vanderbilt University Press. 1970.

Stork, Joe. Middle East Oil and the Energy Crisis. New York and London. Monthly Review Press. 1975.

Strategic Survey. "The Western Crisis"; "The Energy Crisis: One Year On"; "Military Intervention to Secure Oil Supplies" International Institute for Strategic Studies. London. 1974.

Tanzer, Michael. The Energy Crisis: World Struggle for Power and Wealth. New York and London. Monthly Review Press. 1974.

The Arabs. A handbook on the politics and economics of the contemporary Arab World. London. BBC Publications. 1971.

The Banker. "Oil and Money". A Survey. March 1974.

The Economist. London. Many issues 1973-1975

The Economist Intelligence Unit. QER Special No. 15.
Oil and Economic Growth. 1974

Time. Many issues 1973-1975.

Toronto Globe and Mail. Many issues 1973-1975.

Toronto Star. Many issues 1973-1975

Tugendhat, Christopher. "Financing the Future of Oil".
The Banker. April 1972.

_____. "Oil - Avoiding a Catastrophe?" The Banker.
February 1974.

U.S. Congress. Public Law 93-479.(S. 2840). "Foreign
Investment Study Act of 1974". 93rd Congress.
October 26, 1974.

U.S. Department of Defense. Commander's Digest. "DOD
Security Relationships with Persian Gulf States".
September 12, 1974.

U.S. Department of State. Memorandum. "Raw Materials
Other than Oil as Economic Weapons against the
United States and Other Major Consumers".
January 22, 1975.

U.S. News and World Report. Many issues 1973-1975.

Vicker, Ray. The Kingdom of Oil. New York.
Charles Scribners Sons. 1974.

Zombanakis, Minos. "Arab Funds and the Markets".
The Banker. July 1974.

A P P E N D I C E S

A.

" A P L A N T O R E S O L V E T H E
B A L A N C E O F P A Y M E N T S P R O B L E M "

-

M A R C H 1 6, 1 9 7 3

A.

A PLAN TO RESOLVE THE BALANCE OF PAYMENTS PROBLEM

The objective of this thesis is, first, to examine the U.S. balance of payments so-called problem, focussing particularly on the magnitude of U.S. foreign investment, and the methods used by U.S. statisticians in calculating B.O.P. statistics. As a result of this examination, a judgment will be made as to exactly what extent the U.S. B.O.P. deficit is real, and to what extent it is illusory. For example, reinvestment abroad of profits earned in other countries by U.S.-based companies is considered as, to that extent, adding to the U.S. deficit, although it is difficult to see any justification for this.

In any event, real or unreal, there is no question that the \$80 billion or so of U.S. funds held by foreigners represents only the beginning of a U.S. deficit which will reach a magnitude many times that figure within the next 10 years. The major reason for this is the enormous and growing requirement for energy which the U.S.A. will be unable to satisfy in the short and medium term without recourse to massive imports, primarily from Iran and the Arab oil countries in the Persian Gulf area, where by far the greater part of the world's oil resources lie. Before new sources of power such as a technologically feasible nuclear fusion process can be developed, probably about 1985, the U.S.A. will rely heavily upon such imports.

Even on the unlikely assumption of current prices remaining stable, the U.S.A. will almost certainly incur a deficit of about \$300 billion over the next 10 years to pay for the increase in oil imports alone.

There are five ways and only five ways, used alone or in combination, whereby the U.S.A. can deal with this problem:

- (a) attempted conquest of a major oil-producing country;
- (b) cut its imports of manufactured goods virtually to zero;
- (c) cut down or eliminate U.S. foreign investment;
- (d) vastly increase its exports of manufactured goods;
- (e) vastly increase its imports of foreign capital.

Course (a) is not practical because it would ignite World War III, which the U.S.A. would not necessarily win. To pursue course (b) would largely destroy existing world trade patterns, and would require the development, at a very high and uneconomic premium, of manufacturing facilities in the U.S.A., to replace imports. Alternatively, U.S. consumers would simply have to do without, which would significantly lower the quality of life in the United States. If U.S. manufacturing is to grow to replace imports, there will still be a major call on imported raw materials, and further significant demand for additional energy.

The third course, that of cutting down or eliminating U.S. foreign investment, is a very logical one, but seems to be contrary to U.S. economic philosophy. Practically unrestrained U.S. foreign investment has been one of the principal contributors to the present U.S. B.O.P. problem if it is not its primary cause. It is also the greatest source of U.S. long term economic strength. U.S. exports of private capital abroad have generally taken the form of equity investment. United States industry is literally "buying up the world" primarily for its own benefit, but in a way which also works secondarily to the benefit of the United States as a country. The strongest criticism of the U.S. Government is that it could have dealt with its B.O.P. problem, without recourse to punitive trade measures, by taking vigorous action to bring foreign investment under control. On the contrary, it has just been announced that the one existing minor restraint on foreign investment, the Interest Equalization Tax, is to be eliminated by the end of December, 1974. The U.S. Government has elected to attempt to force other countries to redress the balance by allowing in more U.S. imports.

In stark terms, the U.S. Government's policy is actually to force other countries themselves to finance, by increased imports, the takeover of their own economies by private U.S. interests, which are themselves under the ultimate control of the U.S. Government.

It is, however, inherently unlikely that the trading partners of the United States will, in the long run, be content to absorb unlimited U.S. manufactured goods, reverse the tide of industrial development, and sink into a position of permanent poverty and subservience to the United States.

In the face of existing U.S. policy, there is only one way left with which to deal with the problem. Countries with large reserves of U.S. dollars should establish the necessary mechanism to reverse the flow of capital investment by themselves

pouring available U.S. funds into investment in U.S. industry in the United States. By 1985, the oil-producing countries of Africa and the Middle East could be collecting oil revenues at an annual rate of almost \$50 billion. Most of these countries are not able to absorb greatly increased imports from the U.S.A. and other oil-importing countries. They do not have the populations, markets, and economic infrastructures to accept a large volume of imports. A large portion of such revenues could, as they have in the past, move into the short- and long-term money markets of the world in ways which are difficult to predict but which are normally destabilizing in their effects. An obviously better way is that these countries should become large equity holders in the financial institutions and industrial companies of the United States, Western Europe, and Japan.

In the more immediate context of current Canada-U.S.A. relations, it is recommended that the Canadian Government establish an agency (or an office within an existing agency, such as the Bank of Canada) to invest a proportion of official foreign exchange reserves (other than that necessary to conduct day-to-day buying and selling operations in support of a floating exchange rate) in private U.S. industry. The same thing could be accomplished indirectly by selling foreign exchange for Canadian currency to a consortium of Canadian chartered banks, which could set up an agency to invest in U.S. private industry. In this event, profits eventually realized would accrue to the banks' shareholders, but there would be an addition to Canadian Government revenues of the amount of Canadian funds realized directly from such sales. There is actually some precedent for this. In the period 1910-1913, large holdings of pounds sterling were sold to the banks for Canadian dollars, which were then added to government revenues, with the foreign exchange then being invested abroad by its new owners.

Another possibility, based on the experience gained with our Telesat Corporation structure, would be to establish an agency owned in part by the Canadian Government in part by the chartered banks (representing "industry"), and in part by private Canadian individual investors.

The U.S. dollar funds could be transferred to a special account in the United States, say \$1 billion or so for a start, and used to buy U.S. stocks, i.e., for equity investment in private industry. Such investments would have the immediate effect of reducing the U.S. balance of payments deficit by like amounts. Profits eventually realized from capital appreciation and from

dividends could be re-invested, or remitted to Canada in whole or in part, as required to pay dividends to corporate or individual stockholders and/or to support normal international monetary operations.

The system would be extraordinarily flexible. By buying or selling stocks in U.S. corporations, Canada's foreign exchange holdings could, within limits, be anything we want it to be at any time.

A particular advantage of this system, however, would be the opportunity to advance Canadian economic and commercial policy by achieving control of particular U.S. corporations.

Only a very small percentage of equity is necessary to achieve control of a widely-held corporation such as General Motors, IBM, or Standard Oil of New Jersey. With the enormous power of the several billions of dollars available, it would be practical for Canada to pursue a policy of acquiring substantial holdings in or even control of the parents of corporations which have extensive Canadian operations, and of subsequently influencing, from behind the scenes as it were, those anonymous foreign board-room decisions against which we have frequently complained as being contrary to Canadian interests. It is not at all impossible to envisage our quietly and judiciously gaining control of even such giant multi-national corporations as major oil companies and automobile and aerospace manufacturers.

It is anticipated that there will be many objections raised to this proposal. There will be an almost instinctive negative reaction based upon our highly conservative approach to foreign exchange management. Nevertheless, it is felt that no solution, however exotic it may appear to be at first glance, should be rejected in these perilous times without the most careful examination as to its actual feasibility. Moreover, upon the most mature reflection it will become increasingly obvious that it is the only viable solution to the U.S. B.O.P. deficit, now and in the future, which threatens to destroy the economies of the free world. To tinker with rates of exchange is to treat the symptoms, not the disease. Monetary phenomena are only a superficial reflection of what is happening in the real world. Unconstrained exports of U.S. capital have created a problem which can only be resolved by a reverse flow into the U.S.A. of this same U.S. money capital. The job simply cannot be done by raising U.S. exports of manufactured goods or by limiting imports into the U.S.A. to raw materials only.

With something in the order of \$4-4.5 billion to play with, Canada is now in a good position to take a bold, new initiative in defence of its future as an independent country, and in a way which will take advantage of certain aspects of the so-called "American way of life" to protect itself against a particularly vicious form of economic imperialism. It would also be the first of a long series of dollar-holding countries which will eventually and inevitably be doing the same thing, and would have both the initial advantage of picking off the choicest investments and the later advantage of greater capital appreciation in money terms caused by the flood of U.S. dollars seeking an investment home in the U.S.A. over the next ten to fifteen years.

In summary, the proposed plan:

- (a) would be an extraordinarily powerful, yet flexible and delicate instrument of monetary policy;
- (b) would be under direct or indirect central government control, depending upon how the agency is structured;
- (c) would not run counter to the interests of any Canadian province, as it would not introduce what to them would be unwelcome restraints on foreign investment. Foreign exchange realized from such investment would become available for reinvestment back into the United States, and to the extent that it is derived from investment in bonds rather than in equities, would be a positive advantage, as it would be exchanged for U.S. equities; thus helping to reverse the historic trend the other way;
- (d) would immediately eliminate our foreign exchange holdings to the extent that the government may wish at any time;
- (e) could not reasonably be objected to by the United States, as it would accord with that country's most cherished principles of private enterprise in free markets;
- (f) could be represented as a form of integration of the North American economy, which some Americans view as something to be desired;
- (g) could be manipulated in such a way as directly to serve Canadian economic and commercial interests, including opening up a really feasible way to "buy back" Canadian industry through achieving control of its U.S. parents;
- (h) would be highly profitable to Canada and Canadians, both directly and indirectly;

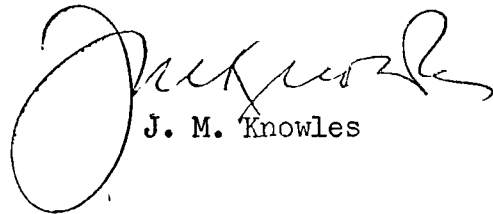
- (i) would remove any U.S. criticism of this country as a possible contributor to its balance of payments problems;
- (j) would free Canada to continue to go all out to reduce trade barriers and to enhance Canadian exports of manufactured goods to the U.S.A. and elsewhere; and, in the long run,
- (k) is the only viable solution, which is consistent with the legitimate economic and political aspirations of all countries;
- (l) is inherently just. The U.S.A., one way and another has achieved a position whereby 6 per cent of the world's population consumes 35 per cent of its energy output and controls a very large proportion of its prime resources and manufacturing industry. It is no more than fair to allow other countries to share in the prosperity to which they have been such major and in fact indispensable contributors; and finally
- (m) If generally adopted internationally, the implications for monetary stability would be immense:
 - (i) it would be immaterial whether exchange rates are floating or partially or wholly fixed in relation to each other. Speculative dollar holdings would all be back in the U.S.A., and major countries could defend their chosen rates of exchange against any likely assault, provided that these bear a reasonable relation to their relative internal purchasing powers;
 - (ii) if exchange rates could be permitted to float, changes in internal value could be reflected in gradual appreciation or depreciation over time, in the rate of exchange, without violent fluctuations and disruptions in trade;
 - (iii) problems of liquidity would be reduced to a minimum. There would no longer be any need to use the dollar, or any other currency, as a reserve. Gold and SDR's would be adequate to settle international accounts. Temporary palliatives such as currency swaps would no longer be necessary, and the International Monetary Fund might finally be able to function, as Keynes originally proposed at Bretton Woods, as a central bank for central banks;

- (iv) would, by to an important degree removing the threat presented by U.S. economic imperialism and creating direct financial interest on the part of other countries in U.S. industrial progress, contribute to world peace. If the Arab countries, for example, were to hold a major stake in U.S. industry, they would be far less likely politically to play the East against the West, holding out their resources as a prize;
- (v) should be acceptable to the U.S.A. as a major contribution to U.S. security by rendering the interests of such countries more or less identical to its own.

It is respectfully submitted that any plan which can achieve all this is not lightly to be dismissed.

I shall be concluding this study with an investigation into and an analysis of the U.S. legislation which governs foreign investment and control of U.S. industry, to ensure that this proposal is legally feasible.

March 16, 1973



J. M. Knowles

B.

U . S . F O R E I G N I N V E S T M E N T
S T U D Y A C T O F 1 9 7 4

(T E X T)



B.

Public Law 93-479
93rd Congress, S. 2840
October 26, 1974

An Act

88 STAT. 1450

To authorize the Secretary of Commerce and the Secretary of the Treasury to conduct a study of foreign direct and portfolio investment in the United States, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Foreign Investment Study Act of 1974".

SEC. 2. The Secretary of the Treasury and the Secretary of Commerce are hereby authorized and directed to conduct a comprehensive, overall study of foreign direct and portfolio investments in the United States.

SEC. 3. The Departments of Commerce and Treasury, in consultation with appropriate agencies, shall determine the definitions and limitations of direct and portfolio investments for the purposes of the study authorized in section 2 of this Act.

SEC. 4. In carrying out the study described in section 2 of this Act, the Secretary of Commerce and the Secretary of the Treasury shall, respectively and jointly as may be appropriate—

(1) identify and collect such information as may be required to carry out the study authorized in section 2 of this Act;

(2) consult with and secure information from (and where appropriate the views of) representatives of industry, the financial community, labor, agriculture, science and technology, academic institutions, public interest organizations, and such other groups as the Secretaries deem suitable; and

(3) consult and cooperate with other government agencies, Federal, State, and local, and, to the extent appropriate, with foreign governments and international organizations.

SEC. 5. The Secretary of Commerce shall carry out that part of the study authorized in section 2 of this Act relating to foreign direct investment, and shall, among other things, to the extent he determines feasible, specifically—

(1) investigate and review the nature, scope, magnitude, and rate of foreign direct investment activities in the United States;

(2) survey the reasons foreign firms are undertaking direct investment in the United States;

(3) identify the processes and mechanisms through which foreign direct investment flows into the United States, the financing methods used by foreign direct investors, and the effects of such financing on American financial markets;

(4) analyze the scope and significance of foreign direct investment in acquisitions and takeovers of existing American enterprises, the significance of such investments in the form of new facilities or joint ventures with American firms, and the effects thereof on domestic business competition;

(5) analyze the concentration and distribution of foreign direct investment in specific geographic areas and economic sectors;

(6) analyze the effects of foreign direct investment on United States national security, energy, natural resources, agriculture, environment, real property holdings, balance of payments, balance of trade, the United States international economic position, and various significant American product markets;

(7) analyze the effect of foreign direct investment in terms of employment opportunities and practices and the activities and influence of foreign and American management executives employed by foreign firms;

Foreign Invest-
ment Study Act
of 1974.

15 USC 78b

note.

Study.

15 USC 78b

note.

15 USC 78b

note.

15 USC 78b

note.

Foreign direct
investment,
study.

15 USC 78b

note.

(8) analyze the effect of Federal, regional, State, and local laws, rules, regulations, controls, and policies on foreign direct investment activities in the United States;

(9) compare the purpose and effect of United States, State, and local laws, rules, regulations, programs, and policies on foreign direct investment in the United States with laws, rules, regulations, programs, and policies of selected nations and areas where such comparison may be informative;

(10) compare and contrast the foreign direct investment activities in the United States with the investment activities of American investors abroad and appraise the impact of such American activities abroad on the investment activities and policies of foreign firms in the United States;

(11) study the adequacy of information, disclosure, and reporting requirements and procedures;

(12) determine the effects of variations between accounting, financial reporting, and other business practices of American and foreign investors on foreign investment activities in the United States; and

(13) study and recommend means whereby information and statistics on foreign direct investment activities can be kept current.

Foreign portfolio investment, study, 15 USC 78b note.

SEC. 6. The Secretary of the Treasury shall carry out that part of the study authorized in section 2 of this Act relating to foreign portfolio investment, and shall, to the extent he determines feasible, specifically—

(1) investigate and review the nature, scope, and magnitude of foreign portfolio investment activities in the United States;

(2) survey the reasons for foreign portfolio investment in the United States;

(3) identify the processes and mechanisms through which foreign portfolio investment is made in the United States, the financing methods used, and the effects of foreign portfolio investment on American financial markets;

(4) analyze the effects of foreign portfolio investment on the United States balance of payments and the United States international investment position;

(5) study and analyze the concentration and distribution of foreign portfolio investment in specific United States economic sectors;

(6) study the effect of Federal securities laws, rules, regulations, and policies on foreign portfolio investment activities in the United States;

(7) compare the purpose and effect of United States, State, and local laws, rules, regulations, programs, and policies on foreign portfolio investment in the United States with laws, rules, regulations, programs, and policies of selected nations and areas where such comparison may be informative;

(8) compare the foreign portfolio investment activities in the United States with information available on the portfolio investment activities of American investors abroad;

(9) study adequacy of information, disclosures, and reporting requirements and procedures; and

(10) study and recommend means whereby information and statistics on foreign portfolio investment activities can be kept current.

October 26, 1974

Pub. Law 93-479

88 STAT. 1452

POWERS

SEC. 7. (a) The Secretary of Commerce and the Secretary of the Treasury may each by regulation establish whatever rules each deems necessary to carry out each of his functions under this Act.

(b) Each such Secretary may require any person subject to the jurisdiction of the United States—

(1) to maintain a complete record of any information (including journals or other books of original entry, minute books, stock transfer records, lists of shareholders, or financial statements) which such Secretary determines is germane to his functions in the foreign direct investment and foreign portfolio investment studies to be conducted pursuant to this Act; and

(2) to furnish under oath any report containing whatever information such Secretary determines is necessary to carry out his functions in such studies. Whenever an order under clause (2) of this subsection requires a person to produce information which can be specifically identified as being part of the records of its customers, the Secretary shall, upon being provided the names and addresses of such customers, send a notice to such customers that information from their records will be disclosed pursuant to this Act; *Provided*, That this requirement shall not apply when such person is directly involved in the ownership or management of assets for the customer as nominee, agent, partner, fiduciary, trustee, or in a similar relationship.

The authority of each Secretary under this subsection shall expire on the date provided under section 10 of this Act for the Secretary of Commerce and the Secretary of the Treasury to submit a full and complete report to the Congress.

(c) In addition to the Secretary of Commerce and the Secretary of the Treasury, the only individuals who may have access to information furnished under subsection (b) (2) are those sworn employees, including consultants, of the Department of Commerce or Department of the Treasury designated by the Secretary of either such Department. Neither such Secretary nor any such employee may—

(1) use any information furnished under subsection (b) (2) except for analytical or statistical purposes within the United States Government; or

(2) publish, or make available to any other person in any manner, any such information in a manner that the information furnished under subsection (b) (2) by any person can be specifically identified, except for the purposes of a proceeding under section 8.

Such Secretaries may exchange any such information furnished under subsection (b) (2) in order to prevent any duplication or omission in the studies conducted by each such Secretary pursuant to this Act.

(d) Except for the requirement under subsection (b) (2), no agency of the United States or employee thereof may compel (1) the Secretary of Commerce or the Secretary of the Treasury, (2) any individual designated by either such Secretary under the first sentence of subsection (c), or (3) any person which maintained or furnished any report under subsection (b), to submit any such report or constituent part thereof to that agency or any other agency of the United States. Without the prior written consent of the person which maintained or furnished any report under subsection (b) and without the prior written consent of the customer, where the person maintained or furnished any such report which included information identifiable as being

Rules and regulations.
15 USC 78b
note.
Records, maintenance and availability.

Notice.

Expiration of authority.

Information, restrictions on accessibility.

Information exchange.

derived from the records of such customer, such report or any such constituent part may not be produced for any judicial or administrative proceeding, except for a proceeding under section 8(b) of this Act.

ENFORCEMENT

Failure to
furnish in-
formation.
15 USC 78b
note.
Civil penalty.

Procedure.

SEC. 8. (a) Whoever fails to furnish any information required pursuant to the authority of this Act, whether required to be furnished in the form of a report or otherwise, or to comply with any rule, regulation, order, or instruction promulgated pursuant to the authority of this Act may be assessed a civil penalty not exceeding \$10,000 in a proceeding brought under subsection (b) of this section.

(b) Whenever it appears to either the Secretary of the Treasury or the Secretary of Commerce that any person has failed to furnish any information required pursuant to the provisions of this Act, whether required to be furnished in the form of a report or otherwise, or has failed to comply with any rule, regulation, order, or instruction promulgated pursuant to the authority of this Act, such Secretary may in his discretion bring an action in the proper district court of the United States or the proper United States court of any territory or other place subject to the jurisdiction of the United States, seeking a mandatory injunction commanding such person to comply with such rule, regulation, order, or instruction, and upon a proper showing by such Secretary of the relevance to the purposes of the Act of such rule, regulation, order, or instruction, a permanent or temporary injunction or restraining order shall be granted without bond, and such person may also be subject to the civil penalty provided in subsection (a) of this section if the judge finds that such penalty is necessary to obtain compliance with such injunction or restraining order.

Failure to
submit in-
formation.

Penalty.

(c) Whoever willfully fails to submit any information required pursuant to this Act, whether required to be furnished in the form of a report or otherwise, or willfully violates any rule, regulation, order, or instruction promulgated pursuant to the authority of this Act shall, upon conviction, be fined not more than \$10,000 or, if a natural person, may be imprisoned for not more than one year or both; and any officer, director, or agent of any corporation who knowingly participates in such violation may be punished by a like fine, imprisonment, or both.

Experts and
consultants.
15 USC 78b
note.
Compensation.

SEC. 9. (a) The Secretary of Commerce and the Secretary of the Treasury may procure the temporary or intermittent services of experts and consultants in accordance with the provisions of section 3109 of title 5, United States Code. Persons so employed shall receive compensation at a rate to be fixed by the Secretaries concerned but not in excess of the maximum amount payable under such section. While away from his home or regular place of business and engaged in the performance of services for the Department of Commerce or the Department of the Treasury in conjunction with the provisions of this Act, any such person may be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5703(b) of title 5, United States Code, for persons in the Government service employed intermittently.

Federal gov-
ernment facil-
ities, use.

(b) The Secretary of Commerce and the Secretary of the Treasury are authorized, on a reimbursable basis when appropriate, to use the available services, equipment, personnel, and facilities of any agency or instrumentality of the Federal Government in conjunction with the study authorized in this Act.

Report to
Congress.
15 USC 78b
note.

SEC. 10. The Secretary of Commerce and the Secretary of the Treasury shall submit to the Congress an interim report twelve months after the date of enactment of this Act, and not later than one and one-

October 26, 1974

Pub. Law 93-479

88 STAT. 1454

half years after enactment of this Act, a full and complete report of the findings made under the study authorized by this Act, together with such recommendations as they consider appropriate.

Sec. 11. There is authorized to be appropriated a sum not to exceed \$3,000,000 to carry out the purposes of this Act. Any funds so appropriated shall remain available until expended.

Appropriation.
15 USC 78b
note.

Approved October 26, 1974.

LEGISLATIVE HISTORY:

HOUSE REPORT No. 93-1183 accompanying H.R. 15487 (Comm. on Foreign Affairs).

SENATE REPORT No. 93-910 (Comm. on Commerce).

CONGRESSIONAL RECORD, Vol. 120 (1974):

June 13, considered and passed Senate.

Aug. 21, considered and passed House, amended, in lieu of H.R. 15487.

Oct. 9, Senate concurred in House amendment with amendments.

Oct. 10, House concurred in Senate amendments.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 10, No. 44:

Oct. 28, Presidential statement.

C.

S U M M A R Y O F
U . S . F E D E R A L L A W S
B E A R I N G O N F O R E I G N I N V E S T M E N T
I N T H E U N I T E D S T A T E S

C.

SUMMARY OF FEDERAL LAWS BEARING
ON FOREIGN INVESTMENT
IN THE UNITED STATES

SPECIFIC FEDERAL RESTRICTIONS ON PARTICIPATION
OF FOREIGN-CONTROLLED ENTERPRISES OR FOREIGN NATIONALS
IN UNITED STATES ECONOMIC ACTIVITY

I. COMMUNICATIONS.

1. Radio and Television Licensing
2. Telegraph Operations
3. Radio and Television Operations
4. Communications Satellite Corporation
5. Foreign Investment in U.S. Newspapers and Magazines

II. ENERGY AND NATURAL RESOURCES.

1. Atomic Energy
2. Pipelines and Mineral Leasing on Federal Lands
3. Land
4. Fishing

III. TRANSPORTATION AND TRADE.

1. Aviation
2. Shipping
3. Customs House Brokers

IV. GOVERNMENT PROCUREMENT AND BENEFITS.

1. Procurement
2. Subsidies, Insurance, and Other Government Benefits

V. BANKING.

1. National Banks
2. Edge Act Corporations
3. Bank Holding Company Act
4. Federal Reserve Membership and FDIC Coverage

VI. DEFENCE.

1. Industrial Security Program
2. Priority Performance Statutes

FEDERAL RESTRICTIONS ON PARTICIPATION
OF FOREIGN-CONTROLLED ENTERPRISES OR FOREIGN NATIONALS
IN UNITED STATES ECONOMIC ACTIVITY

I

COMMUNICATIONS

1. Radio and Television Licensing. The Federal Communications Act prohibits aliens, representatives of aliens, foreign governments or their representatives, or foreign-registered, foreign-owned, or foreign-controlled corporations from receiving a licence from the FCC to operate an instrument for the transmission of communications. A corporation is considered foreign-owned if any director or officer is an alien, or if more than 20 per cent of its capital stock is owned by aliens, by a foreign government, or by a corporation organized under the laws of a foreign country. A corporation is considered foreign-controlled if any officer or more than one-fourth of the directors are aliens or if it is directly or indirectly controlled by a corporation, 25 per cent of the capital stock of which is owned by foreign interests. Certain exceptions can be made if the FCC determines that the grant of a licence would be in the public interest (e.g. broadcasting operations ancillary to another business of a foreign-controlled corporation). 47 U.S.C. / 310(a).

2. Telegraph Operations. The FCC is prohibited from approving a merger among telegraph carriers which would result in more than 20 per cent of the capital stock of the carrier being owned, controlled or voted by an alien, a foreign corporation, a foreign government entity or a corporation of which any officer or director is an alien or of which more than 20 per cent of the capital stock is owned or controlled. 47 U.S.C. / 222(d).

3. Radio and Television Operations. Foreign citizens may not be licensed by the FCC as operators in radio or television stations. Waiver of the citizenship requirement is permitted for certain licensed aircraft pilots. 47 U.S.C. / 303(1).

4. Communications Satellite Corporation. Not more than an aggregate of 20 per cent of the shares of stock of Comsat which are offered to the general public may be held by aliens, foreign governments, or foreign-owned, registered or controlled corporations. 47 U.S.C. / 734(d).

5. Foreign Investment in U.S. Magazines and Newspapers. There are currently no prohibitions against foreign investment in U.S. newspapers. However, the

Foreign Agents Registration Act (22 U.S.C. / 611) applies to any U.S. corporation (e.g. a newspaper or magazine) which is controlled or financed by a foreign entity if it carries on any activity in the United States intended to influence U.S. domestic or foreign policy, or to promote the interests of a foreign government. The scope of the law is broad and requires registration with the Attorney General and filing and disclosure with respect to a wide range of political propaganda disseminated in the United States on behalf of foreign interests. However, if the registration requirement is satisfied and the publication is properly labeled as propaganda, the Act does not permit the Government to control content. Exemptions are permitted for (1) diplomats, (2) nations deemed vital to national defence, and (3) various nonpolitical activities.

II

ENERGY AND NATURAL RESOURCES

1. Atomic Energy. The Atomic Energy Act prohibits the issuance of licences for the operation of atomic energy utilization of production facilities to aliens, foreign governments, foreign corporations, or corporations owned,

controlled, or dominated by such foreign interests. In defining foreign ownership or control, there is no threshold test of percentage ownership or other rule of thumb. Determinations are made on a case by case basis.

42 U.S.C. § 2133, 2134.

2. Pipelines and Mineral Leasing on Federal Lands.

Under the Mineral Leasing Act of 1920, aliens or foreign-controlled enterprises may not acquire rights of way for oil pipelines, or acquire any interest therein, or acquire leases or interests therein for mining coal, oil, or certain other minerals, on federal lands other than the outer continental shelf. However, a foreign-controlled corporation may hold such an interest if its home country grants reciprocal rights to United States corporations. 30 U.S.C. § 22, 24, 71, 181, 185, 352, 42 CFR § 3102.1-1; see generally 43 CFR Chapter II (Bureau of Land Management). However, a foreign-controlled corporation may hold and exploit a lease on the outer continental shelf under the Outer Continental Shelf Act and Department of Interior regulations (43 U.S.C. § 331-43; 43 CFR 3300.1). Foreign ownership up to 100 per cent is permitted.

Under the Geothermal Steam Act, (30 U.S.C. § 1001-1025), leases for the development of geothermal steam and associated resources may be issued only to United States

citizens and corporations organized under the laws of the United States or of any State. 30 U.S.C. § 1015.

However, a domestically incorporated enterprise may be foreign owned or controlled.

3. Land. Federally-owned land may be transferred or leased only to (i) U.S. citizens or persons having declared their intention to become U.S. citizens; (ii) partnerships or associations, each of the members of which is a U.S. citizen; and (iii) corporations organized within the United States and permitted to do business in the state in which the land is located, and States, municipalities or other political subdivisions. 43 U.S.C. § 682(c). There is no limit upon the percentage of foreign ownership that a domestically-incorporated firm may have, provided that the country whose citizens own shares of the U.S. firm grants reciprocal privileges to U.S. citizens. Where there is no such reciprocity, an American corporation purchasing public land must be majority owned by United States citizens. In addition, there are restrictions on alien land ownership in territories of the United States; however, these have little contemporary relevance to foreign investment in view of the small portion of United States land remaining in a territorial status. 48 U.S.C. § 1501-1508.

4. Fishing. Foreign vessels may not fish in the territorial waters or fishing zone of the United States or land fish caught on the high seas in the United States. 16 U.S.C. § 1081 et. seq., 1091 et. seq. The restrictions apply to foreign-controlled fishing companies unless certain management restrictions are met. (The president or chief executive officer of a domestic corporation must be a United States citizen; foreign citizens serving as directors cannot be more than a minority of the number necessary to constitute a quorum.)

III

TRANSPORTATION AND TRADE

1. Aviation. A foreign-controlled enterprise (e.g. a foreign air carrier) may not acquire control of a company engaged in any phase of aeronautics unless approval is granted by the Civil Aeronautics Board. Under the Federal Aviation Act, ownership of 10 per cent or more of the voting securities gives rise to presumption of control. In addition, aggregate foreign equity holdings are limited to 25 per cent. 49 U.S.C. § 1301(1) and (13); 1378 (f).

A foreign-controlled enterprise may not be issued a permit for intra-United States air commerce or navigation (cabotage) (49 U.S.C. § 1371, 1401(b), 1508. Domestic air

transit (with limited exceptions based on reciprocity by the carrier's home country) is limited to domestically registered aircraft. Eligibility to register aircraft in the United States is limited to:

1. individual United States citizens;
2. partnerships in which all partners are United States citizens;
3. corporations formed in the United States in which the president and at least two-thirds of the directors and other managing officers are United States citizens and at least 75 per cent of the voting stock is owned by United States citizens. 49 U.S.C. § 1371 and 1401.

2. Shipping.

a. Coastwise Shipping. Under the Jones Act of 1920 coastal and fresh water shipping, including towage, of freight or passengers between points in the United States or its territories must be done in vessels which were built and are registered in the United States and which are owned by United States citizens. As in the case of aviation, for a corporation to register a ship in the United States, the corporation's principal officer must be a United States citizen and 75 per cent of the stock must be owned by United States citizens. 46 U.S.C. § 802, 883, 888. Certain exceptions are permitted to this general rule, for example, shipping incidental to the

principal business of a foreign-controlled United States manufacturing or mining company. 46 U.S.C. § 883-1. There is also an exception for intercoastal transportation of empty items such as cargo vans, containers, tanks, etc., where the country of the vessel's registry grants reciprocal privileges to United States vessels. 46 U.S.C. § 883.

b. Transfer of Shipping Facilities during War or National Emergency. During the time of war or national emergency proclaimed by the President a foreign-controlled enterprise may not acquire or charter, without the approval of the Secretary of Commerce, United States flag vessels, vessels owned by a United States citizen, or shipyard facilities, or acquire a controlling interest in corporations owning such vessels or facilities. 46 U.S.C. § 835.

c. Salvage. To engage in dredging or salvage operations in United States waters, a foreign-controlled enterprise must satisfy certain management restrictions. To register a vessel to engage in these activities, the President or chief executive officer of a domestic corporation, and the chairman of its board, must be United States citizens, and foreign citizens serving as directors cannot be more than a minority of the number necessary to constitute a quorum. 46 U.S.C. § 316(d), 11.

d. Transportation of Government Financed Commodities. A foreign-controlled enterprise must meet certain management restrictions (see c. above) to transport certain commodities procured or financed for export by the United States Government or an instrumentality thereof. 15 U.S.C. § 616(a); 46 U.S.C. § 1241.

e. Officers of Vessels. Foreign citizens may not act as officers of or serve in certain other positions on certain vessels. 46 U.S.C. § 221.

3. Customs House Brokers. For a foreign-controlled firm to obtain a licence to operate as a customs house broker, at least two of the officers must be United States citizens. 19 U.S.C. § 1641.

IV

GOVERNMENT PROCUREMENT AND BENEFITS

1. Procurement. At least two federal statutes require that, with certain exemptions, government agencies purchase only items produced in the United States. However, neither statute restricts procurement from a foreign-controlled U.S. corporation which is producing domestically. The Buy American Act (41 U.S.C. § 10a.-d.) requires that government agencies acquire for public use

only materials produced or manufactured in the United States. These provisions do not apply where the agency head determines that they would be "inconsistent with the public interest", or that the cost of the domestic articles is unreasonable (generally 6-12 per cent above the foreign bid price, 41 CFR 1-6.104-4); nor do they apply to items purchased for use outside the United States, or to items not produced in the United States "in sufficient and reasonably available commercial quantities and of a satisfactory quality".

A second restriction on federal procurement is the "Barry Amendment" to the Defence Appropriations Act (Section 724) (86 Stat. 1200), which restricts the Department of Defense from procuring articles of food, clothing, cotton, silk, synthetic fabric or specialty metals which are not produced in the United States.

2. Subsidies, Insurance and Other Government Benefits. Foreign-controlled enterprises operating in the United States, whether in branch or subsidiary form, may not:

(a) obtain special government loans for the financing or refinancing of the cost of purchasing, construction or operating commercial fishing vessels or gear. 16 U.S.C. § 742(c)(7).

(b) sell obsolete vessels to the Secretary of Commerce in exchange for credit towards new vessels. 46 U.S.C. § 1160.

(c) receive a preferred ship mortgage. 46 U.S.C. § 922.

(d) obtain construction-differential or operating-differential subsidies for vessel construction or operation. 46 U.S.C. § 1151 et. seq., 1171 et seq., 802.

(e) purchase vessels converted by the government for commercial use or surplus war-built vessels at a special statutory sales price. 50 U.S.C. § 1737, 1745.

(f) obtain certain types of vessel insurance unless the management restrictions applicable to companies operating vessels in salvage are satisfied. 46 U.S.C. § 1281 et. seq.

(g) obtain war-risk insurance for aircraft. 49 U.S.C. § 1531, 1533.

(h) purchase Overseas Private Investment Corporation insurance or guarantees. However, foreign corporations, partnerships or other associations, wholly owned by one or more United States citizens, corporations, partnerships, or other associations are eligible. (Up to 5 per cent of the shares may be held by foreigners if required by law without affecting "wholly owned" status.) 22 U.S.C. § 2198(c).

(i) obtain special government emergency loans for agricultural purposes after a natural disaster (7 U.S.C. § 1961) or government loans to individual farmers or ranchers to purchase and operate family farms. 7 U.S.C. § 1922, 1941.

V

BANKING

1. National Banks. Under the National Bank Act, as amended, every director of a national bank must, during his whole term of service, be a citizen of the United States. 12 U.S.C. § 72. Although there are no restrictions on the degree of foreign ownership of national banks, such ownership is inhibited by the citizenship requirement for directors.

2. Edge Act Corporations. An Edge Act Corporation may be organized for the purpose of engaging in international or foreign banking or other international or foreign financial operations. A majority of the shares of the capital stock of an Edge Act Corporation must at all times be held and owned by citizens of the United States, by corporations the controlling interest in which is owned by citizens of the United States,

chartered under the laws of the United States or of a State of the United States, or by firms or companies the controlling interest in which is owned by citizens of the United States. 12 U.S.C. § 619. Moreover all of the directors must be United States citizens.

3. Bank Holding Company Act. At present, the Bank Holding Company Act contains no specific restrictions on foreign banks. However, under the general provisions of the Act, which apply equally to domestic banks, any foreign company establishing a United States banking subsidiary or acquiring control of an existing domestic bank must be approved by the Board of Governors of the Federal Reserve Board.

(Acquisition of a 25 per cent interest creates a conclusive presumption of control. In addition, lesser ownership amounts -- down to 5 per cent -- are likely to be found to constitute control.) There have been a number of recently established foreign subsidiaries approved by the Board under the Act (e.g., Sanwa Bank of California, Mitsubishi Bank of California, Banco di Roma of Chicago).

4. Federal Reserve Membership and FDIC Coverage.
A foreign banking operation in the United States may

take the form of a branch, agency, subsidiary, or representative office. Of these, only subsidiaries incorporated under State or Federal law may become members of the Federal Reserve System and/or the Federal Deposit Insurance Corporation 12 U.S.C. § 321, 1814-16. Thus, at present, neither branches nor agencies of foreign banks are members or subject to regulation by the Federal Reserve.

NOTE: Pending Foreign Bank Legislation (the "Foreign Bank Act of 1975"). S. 958, the "Foreign Bank Act of 1975" has been introduced in the 94th Congress at the request of the Federal Reserve Board. The Bill would place foreign bank operations in the United States under effective Federal control. It would bring United States branches and agencies of foreign banks within the purview of the Bank Holding Company Act. That Act's restrictions on multistate branching and nonbank activities would then apply to such foreign bank operations. All subsidiaries, branches, and agencies of foreign banks having worldwide assets of \$500 million or more would be required to become members of the Federal Reserve System. In addition, all foreign banks covered by the bill would be required to carry coverage of the Federal Deposit Insurance Corporation.

The bill would require a foreign bank to obtain a Federal banking licence from the Comptroller of the Currency as a precondition of obtaining a state charter. Licences would be issued only with the approval of the Secretary of the Treasury after consultation with the Secretary of State and the Federal Reserve Board. The bill also would provide for chartering by the Comptroller of the Currency of a branch of a foreign bank as a "Federal branch" permitted to conduct a banking business on the same basis as a national bank in its state of operation.

The bill would make it possible for foreign banks to establish national banks and Edge Corporations. It would amend the National Bank Act to allow up to half of the directors of a national bank to be non-citizens. With respect to Edge Corporations, the bill would permit the Federal Reserve Board to waive the requirements of majority ownership by the United States citizens and the citizenship requirement applicable to directors.

The Administration has not taken a position on many of the specific provisions of the legislation. It is likely that in the course of the legislative process, substantive changes in the proposal will be introduced.

Neither the timing nor the substance of Congressional action can be predicted at this time.

VI

DEFENCE

1. Industrial Security Program. The Executive Orders and Department of Defense regulations which constitute the Industrial Security Program (Executive Orders 10450, 1086 , and 11652: DoD 5220.22-R, Section II, part 2) make it very difficult for foreign-controlled corporations, except possibly subsidiaries of Canadian or U.K. parents, to obtain the security clearances necessary to carry out a classified contract. Both a "facility" clearance and individual clearances for key management personnel and others who may have access to classified information are required.

 Generally, facilities which are "under foreign ownership, control or influence" are ineligible for facility clearances, and foreign nationals are ineligible for individual clearances. There are certain limited exceptions for facilities owned or controlled by foreigners, and a foreign-controlled U.S. subsidiary

might obtain clearances by forming a "voting trust", in which it gave up management rights but retained rights to profits.

2. Priority Performance Statutes. While not aimed specifically at foreign investors, the priority performance statutes bear on the operation of a United States business by foreign investors.

(a) Defence Production Act. Under Title I of the Defence Production Act of 1950, the President possesses the authority to require that performance under defence contracts take priority over other contracts. The Act also authorizes the President to require acceptance and performance of such contracts by any person he finds capable in preference to other orders or contracts and further authorizes him to allocate materials and facilities in such manner and under such conditions as he deems necessary to promote the national defence. 50 U.S.C. App. \neq 2071. Any willful failure to perform any act required by the Act is punishable by fine of \$10,000 or one year in prison. 50 U.S.C. \neq 2073.

(b) Selective Service Act. Under Section 18 of the Selective Service Act (50 U.S.C. App. \neq 468), the President, whenever he determines that it is in the interest of national security, may place an order for

articles or materials, the procurement of which has been authorized by Congress exclusively for the use of the armed forces of the United States, with any person capable of producing them. Under this authority, the President may assign such contracts as "rated orders" which take priority over any unrated order. Procurements for military assistance programs are included.

D.

THE
INTERNATIONAL
ENERGY AGENCY

D.

The International Energy Agency.

The IEA was established within the OECD framework, in November 1974. Its 18 members include the USA, Canada, Japan and all the main industrialised countries of Western Europe (except France) plus New Zealand. Its highest decision-making body is a Governing Board, composed of Ministers or their delegates. It is assisted by a Management Committee, headed by the Executive Director, and by four specialised Standing Groups.

The main tasks of the IEA are¹:

- (a) to provide for the equitable sharing of scarce supplies in the event of a future oil crisis;
- (b) to restrain the demand for energy, particularly oil;
- (c) to encourage the development of new energy sources;
and
- (d) to make further efforts towards a better understanding with the oil exporters and other interested parties.

A distinctive feature of the IEA is its statutory right to take majority decisions on certain important matters.

¹As reported in the Petroleum Economist, London, May 1975, p. 173-174.

which are then binding on all members.

As for its policies for crisis management, the Executive Director is to inform the member governments if oil supplies to any one country, or to the group as a whole, have been reduced by 7 per cent or more below a "base period" comprising the four most recent quarters with a delay of one further quarter necessary to collect information. In such an event, supplies to unaffected members will be automatically reduced so as to avoid gross inequalities, unless a large majority of the Governing Board decides otherwise. In co-operation with the oil industry, IEA has already done a great deal of technical preparation to facilitate crisis management.

A more general commitment to economize energy was reached in February 1975, with a decision that this year's crude oil imports into the IEA area (excluding Norway and New Zealand) should not exceed the 1973 level of almost 20 million barrels a day. In late 1975, it is hoped to establish suitable global figures for the area's main imports in 1976 and 1977, and also to agree on guidelines for oil imports in 1980 and 1985. It is recognized that the scope for energy conservation varies from country to country, and the intention is to supplement the global program by national programs in all member states. Studies are underway to determine ways of reducing energy consumption without causing severe reductions in either energy

output or the general standard of living.

The IEA's most controversial project is the proposal of the U.S.A. for a guaranteed floor price for oil which would protect the economic viability of the huge investments now being made or contemplated in alternative energy resources. The Governing Board of the IEA has accepted the proposal in principle, but has been unable to achieve agreement on the level of the floor price.

The floor price proposal was originally put forward by Henry Kissinger, but has been opposed by Japan, Italy, Sweden, Denmark, and several other nations which would benefit most by a sharp drop in prices. The IEA members have set themselves a deadline, 1 December 1975², for completing a whole package of measures including conservation, alternative energy sources, and research and development, as well as a floor price.

This notwithstanding, there are indications that the initial dynamism in dealing with the oil supply crisis has gone out of the IEA. The lack of solidarity at the Agency's meetings stands in marked contrast with the essentially common front put up by the OPEC countries, which are trying to consolidate their power over the international oil supply system by taking over from the oil companies the ownership of reserves and production, and by investing in downstream operations such as tanker transport, refineries, and distribution.

²As reported in the Petroleum Economist, London, August 1975, p. 285.

In the way of international agencies, the IEA has established a series of standing groups and sub-groups, of which the Sub-group on Energy Conservation has been doing some important work in detecting and analysing problems which have arisen in this area, and in proposing solutions to them.

In general, it may be said that the establishment of energy conservation programs, if assiduously pursued, will benefit the world in general by conserving resources, and the consuming countries in particular by cutting demand for imported oil, thus helping to reduce the likelihood of price increases, and moderating the effect of such price increases as do occur.

While the International Energy Agency may have been doing its best, recent studies³ indicate that there are considerable differences in the quality of the conservation programs now existent in consuming countries. Not all programs are of equal impact, and countries are not yet sharing the conservation responsibility equitably. All programs have room for improvement. Even the better programs have gaps or lack meaningful action in certain areas. Hence, the overall conservation effort falls significantly short of its potential.

³OECD, International Energy Agency, Paris, IEA/SLT(75)68, September 5, 1975.

There is a pressing need to intensify conservation programs immediately. The expected general economic upturn is certain to generate renewed growth in the demand for imported oil, which inevitably means at least a short-term increase in the industrialised countries' demand for oil. The foreign exchange implications are also significant, the more so if OPEC imposes yet another price increase, however modest.⁴

The most notable weakness of some of the programs is failure to allow energy prices to rise to competitive market levels, or to raise fuel taxes, in such a way as to curb consumption.

The IEA recommends that national energy conservation programs be based on general acceptance of the following principles (as edited by the writer):

- (1) All energy priced at competitive market levels.
- (2) Significantly increased taxes on certain fuels to reinforce the effects of market prices where these prices are judged to be inadequate economic signals.

⁴On September 27, 1975, OPEC announced a 10 per cent increase in the price of crude oil, to expire on July 1, 1976.

- (3) Lower speed limits on all highways (e.g., 55 m.p.h.).
- (4) A comprehensive public education program.
- (5) A permanent, full-time Government conservation staff.
- (6) Policies and programs to improve the efficiency of electrical generation, such as Peak Load Pricing.
- (7) Programs to increase use of waste heat from electrical operation and from industrial processing.
- (8) Programs to stimulate energy efficiency in industrial production (e.g., loans for energy improvements, tax credits, rapid depreciation allowance, etc.).
- (9) Raising thermal and lighting efficiency of new commercial, public, and residential buildings through changes in building codes and standards.
- (10) Incentives to increase retrofiting of existing buildings to improve thermal efficiency.
- (11) Energy efficiency labelling for all major consumer appliances.
- (12) Programs to increase automobile efficiency where average new car efficiency is low (i.e., by applying fuel economy standards, or weight, horsepower, or displacement taxes).

- (13) Reduction or elimination of government funding or subsidies for energy intensive products and practices (e.g., air travel, highway construction).
- (14) Reduction in all forms of government use of energy.
- (15) Programs to increase load factors on carpools, public transit, etc.
- (16) Programs to intensify energy conservation research and development.

Measured against the standard of these principles, it must be said at once that both Canada and the United States have failed to set a very good example for the other developed countries, which have at least given an indication that they take matters much more seriously.

The Canadian program has had to try to reverse the adverse trend of a very high and increasing level of per capita energy consumption. It is doubtful that the program so far adopted will be sufficient to do so. The program does include mandatory appliance labelling, new higher insulation standards for residential construction, an expanded public education program, a permanent energy conservation staff, a move toward less regressive electrical rates, and the removal of the

Federal Sales Tax from insulation and other thermal improving materials.

Unfortunately, it is hampered considerably by petroleum and natural gas prices being controlled below world market levels. Moreover, the program lacks any major incentive for industry to conserve, any automobile efficiency standards except as imported from other countries, any incentives to upgrade the efficiency of existing houses, or any program in waste management or strong measures to shift transportation from automobiles to more efficient modes. It must be admitted, however, that much of Canada's failure has been due to the divided responsibilities of the various levels of government within our federal system. A strong central authority seems to be needed to make these programs work, and it is noteworthy that the most successful countries have strong central governments, such as France and Britain.

If Canada is doing badly, the United States is doing worse. The U.S. program must, of course, overcome an extremely high per capita historical energy consumption pattern, hence, must be comprehensive and very strong to be effective. At the present time it is neither. The current program depends almost entirely on voluntary programs, research and development, and

public education. The Great American Consumer does not willingly brook any interference with his God-given right to burn up the resources of the planet as if there were no tomorrow.

The major recent improvement in the program includes the implementation of a \$2 per barrel tariff on imported oil, which has the effect of raising all petroleum prices by over 20 per cent.⁵ The program also includes a mandatory oil-to-coal conversion program, and a large permanent conservation staff. The President has proposed a fairly comprehensive conservation program but the Congress is, perhaps characteristically, not moving very rapidly to adopt it at the time of writing. The U.S.A. has its own problems of divided responsibility in the doctrine of separation of powers as between the Executive and the Legislature, which is happily absent from Canada.

A major deficiency of the current situation in the U.S.A. is that energy prices for oil and natural gas are controlled below world market levels. In addition, there is no incentive for improving the thermal efficiency of appliances; no incentives to improve energy efficiency in industry or programs to encourage waste management; almost no taxes on gasoline or other energy products to

⁵Rescinded in January 1976.

curb usage; and no incentives or standards to reduce automobile mileage travelled or to improve automobile efficiency. While there is a supposedly mandatory speed limit of 55 miles an hour, anyone who has driven in the U.S. recently will have readily observed how this injunction is honoured more in the breach than in the observance. Electrical rates are generally regressive in that rates are lower as consumption increases, and there is very little use of peak load pricing or other load management techniques common in some European countries.

Perhaps typically, Britain has one of the most comprehensive conservation programs extant. Energy fuel prices had been controlled at levels below world market prices. This policy has been reversed. Taxes have been introduced that add 25 per cent to the cost of gasoline. Electricity rates have been revised so as to bear more heavily on larger consumers than on smaller ones. The program also includes compulsory reduced heating levels for all non-residential buildings; loans to industry for energy-saving investments; new building standards for new homes that double insulation requirements; a change in insulation tax allowance for industry from 40 per cent to 100 per cent; restrictions

on the daytime use of electricity for external display and advertising; introduction of a major, two million pound publicity campaign; and creation of a new energy conservation unit within the government.

Recommendations for possible program improvements include establishing a public national savings target; developing programs to utilize waste heat from electrical power plants; considering pricing incentives/disincentives to discourage automobiles in urban areas; and adopting possible incentives for insulating existing houses.

E.

G L O S S A R Y O F T E R M S U S E D
I N T H E O I L T R A D E

E.

Glossary of Terms used in the Oil Trade

Buy-back Oil -

Crude oil owned outright by producing countries' governments, who may require that a certain percentage of all oil lifted and marketed by a producer company be government-owned oil. Also known as "Participation Oil" (q.v.) because bought back by producer companies in accord with the terms of "Participation Agreements". Known as "Free Oil" if sold to outside independent buyers through "Direct Sales".

Differentials -

Discounts which may be extended, or premiums charged to buyers, for oil which deviates from the "marker" crude by reason of transportation costs to various markets, sulphur content, and specific gravity.

Direct Sale Price -

The price of crude oil in "Direct Sales" by producer governments or their national oil companies to third parties, other than owners or former owners of concessions in that country. This oil is known as "Free Oil".

Equity Oil -

Oil "owned" by oil companies from their own concession areas in countries in which they have an equity investment for the extraction of oil, and on which the companies pay royalties and taxes, set by the governments, as percentages of the "Posted price".

Free Oil -

Government-owned oil sold directly by producer governments or their national oil companies through "Direct Sales" at arms length to independent buyers. The same oil sold to concessionaires through Participation Agreements would be called "Buy-back", or "Participation" Oil.

Government Take, Average -

The net revenue accruing to a producer government from the average barrel of oil, disposed of through an operating oil company, comprising royalties and taxes of all kinds levied on the production of "equity oil", and proceeds from sales of "Buy-back" or "Participation" oil.

Marker Crude -

A hypothetical Gulf crude oil used as a "marker" for the purpose of setting "posted prices", and imposing royalties and taxes and calculating "buy-back" prices. Established as Arabian Light crude oil, 34° A.P.I. specific gravity, on the basis of FOB Ras Tanura, Saudi Arabia.

Participation Oil -

"Buy-back" oil. Crude owned by producer governments and sold to producer companies under Participation Agreements. The same crude would be called "Free Oil" if sold to independent outside buyers through "Direct Sales".

Posted Price -

An artificial price quoted for "marker crude", on which royalties, taxes, and "buy-back" prices are based. May be adjusted by "differentials" to make crude of equivalent quality from all sources theoretically equal in price, or crude of all qualities theoretically equal in attractiveness, to all markets in different locations.

Proration -

Production restrictions shared on a pro rata basis.

Transfer Price -

The price actually paid for oil.

F.

C O N V E R S I O N F A C T O R S U S E D
I N T H E O I L T R A D E

F.

Conversion Factors Used in the Oil Trade¹

1 U.S. barrel	=	42. U.S. gallons
	=	34.9726 Imperial gallons
	=	158.99 litres
	=	0.15899 cubic metres
1 cubic metre	=	1,000. litres
	=	264.17 U.S. gallons
	=	219.97 Imperial gallons
	=	6.2898 U.S. barrels

SPECIFIC GRAVITY - volume per ton (60° F. average)

Degrees API	Specific Gravity	Barrels per metric ton	Barrels per long ton
25	0.904	6.98	7.09
26	0.898	7.02	7.13
27	0.893	7.06	7.18
28	0.887	7.10	7.22
29	0.882	7.15	7.27
30	0.876	7.19	7.31
31	0.871	7.24	7.36
32	0.865	7.28	7.40
33	0.860	7.33	7.45
34	0.855	7.37	7.49
35	0.850	7.42	7.54
36	0.845	7.46	7.58
37	0.840	7.51	7.63
38	0.835	7.55	7.67
39	0.830	7.60	7.72
40	0.825	7.64	7.76
41	0.820	7.69	7.81
42	0.816	7.73	7.85

¹Compiled by Petroleum Economist.

Specific Gravity Ranges

	Specific Gravity	Barrels per metric ton
Crude oils	0.80 - 0.97	8.0 - 6.6
Aviation gasolines	0.70 - 0.78	9.1 - 8.2
Motor gasolines	0.71 - 0.79	9.0 - 8.1
Kerosines	0.78 - 0.84	8.2 - 7.6
Gas oils	0.82 - 0.90	7.8 - 7.1
Diesel oils	0.82 - 0.92	7.8 - 6.9
Lubricating oils	0.85 - 0.95	7.5 - 6.7
Fuel oils	0.92 - 0.99	6.9 - 6.5
Asphaltic bitumens	1.00 - 1.10	6.4 - 5.8

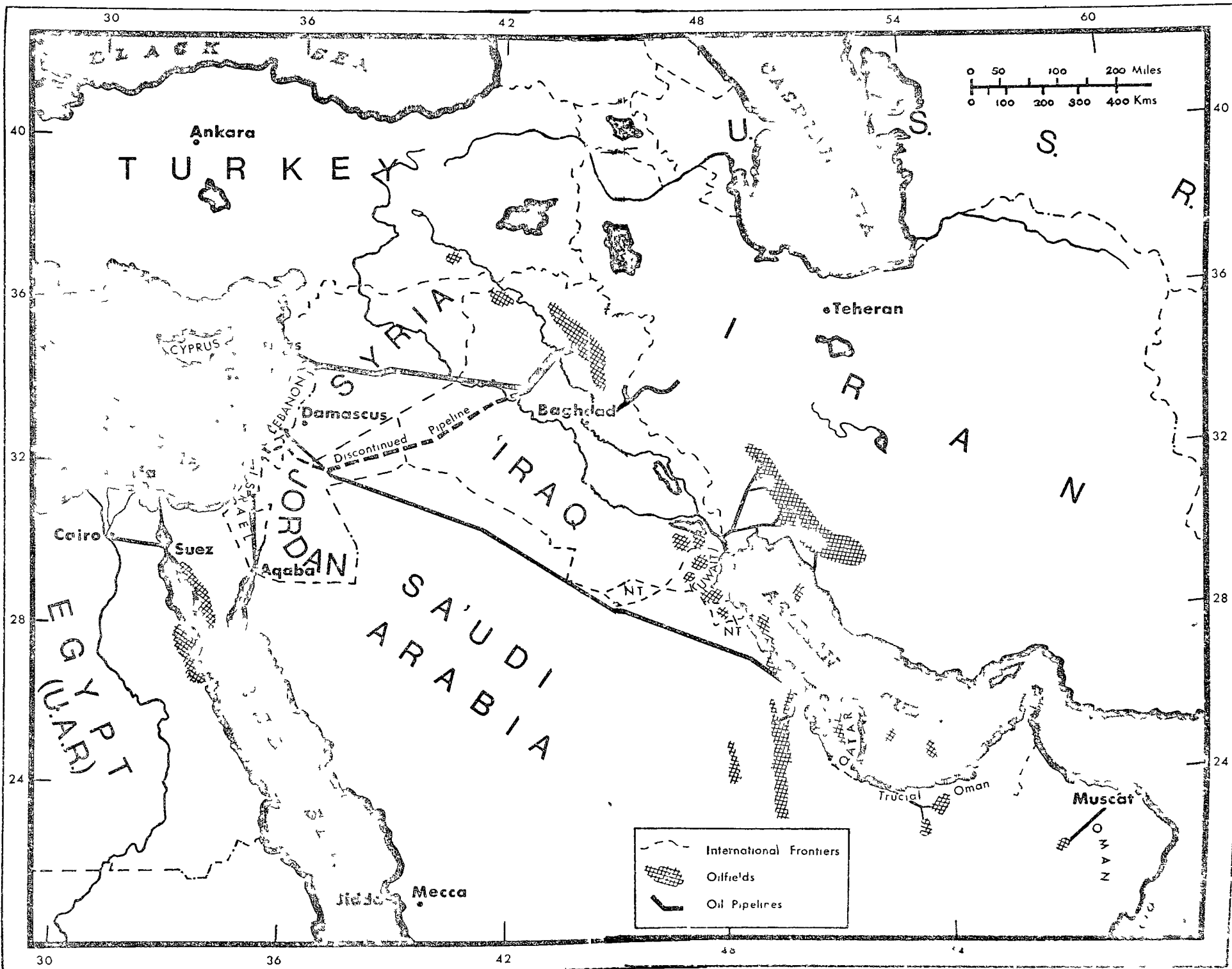


Figure 2. The Middle East, Fields and Main Pipelines.

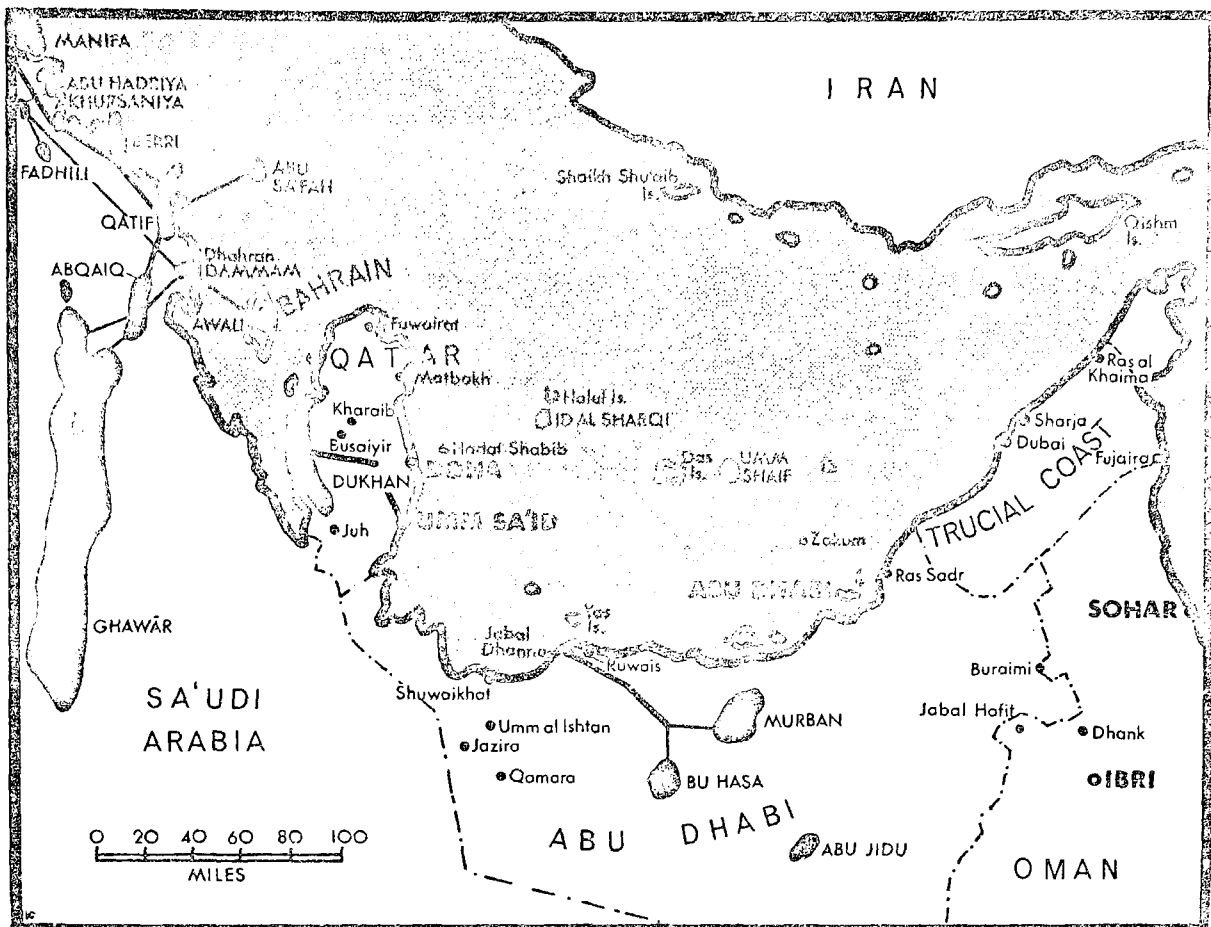
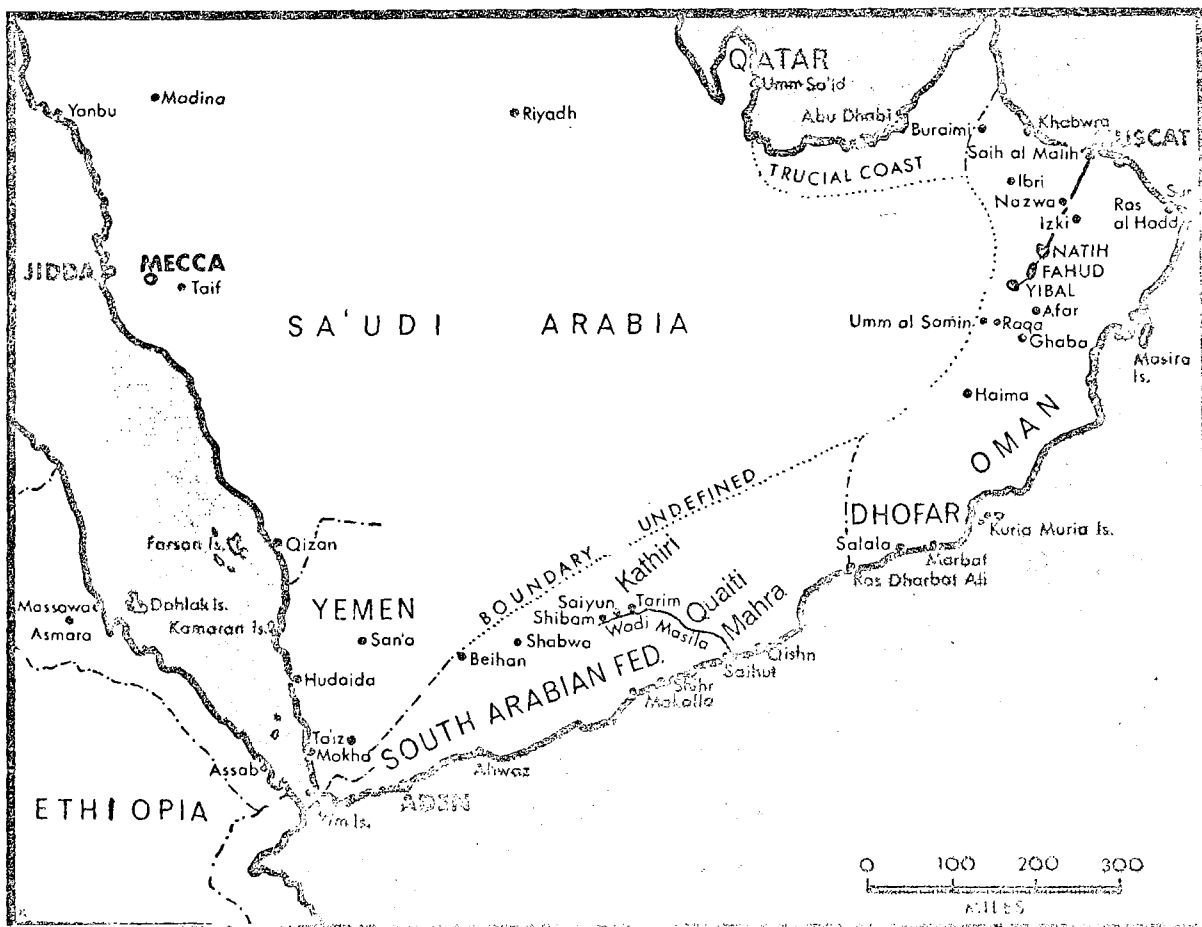


Figure 3. (upper) Arabian (Persian) Gulf, Southern Shore.
(lower) Southern Arabian Peninsula



ABSTRACT

OIL, PETRODOLLARS AND RELATED PROBLEMS

JOHN MARETT KNOWLES

1. Statement of the Problem

The petrodollar recycling problem is the result of the members of the Organisation of Petroleum Exporting Countries (OPEC) having succeeded in taking advantage of their new monopoly position to impose huge oil price increases on the consuming countries without discrimination as to their ability to pay, to the particular detriment of the Most Seriously Affected countries (M.S.A.'s) of the "Fourth World". The new politico-economic inter-relationships to which these events have given rise contain a number of other new problems, not only for the M.S.A.'s, but also for the industrialised world and for the OPEC countries themselves. The objective of this work is to describe fully the circumstances which caused these problems, to identify and to analyse them, and to make certain policy recommendations to the governments both of the industrialised countries and of the members of OPEC.

2. Main Topics

Following an examination of the nature and extent of the oil crisis precipitated by the October 1973 War, together with its international financial and monetary implications, and a brief analysis of the background and structure of the international oil company cartel, the OPEC cartel is studied, both structurally and in terms of the options open to the members of that Organisation, for the disposition of their current and foreseeable petrodollar surpluses; options which include domestic development, foreign aid, and foreign investment. An attempt is made to estimate the magnitude of OPEC revenues and surpluses, and future movements in the price of oil upon which such estimates must be based. Worldwide inflation has brought about an erosion of the real value of OPEC revenues, leading to the proposal that oil income be indexed in some fashion to compensate producer countries for the rises in price of their imports. This problem is also examined, as is that of the nature and magnitude of the recycling problem from the standpoint of the poorest countries. Finally, an analysis is made of the so-called "military solution" to the oil problem.

3. Conclusions

The OPEC countries have achieved a temporary advantage which will, sooner or later, be overcome by the advance of future technology. The price for oil which these countries can obtain, and the time period during which it will endure, will depend, economically, upon the amount of oil produced and the rapidity with which other countries can develop alternative energy sources, and politically, upon the readiness or otherwise of the United States, the Soviet Union, or Iran to intervene militarily.

To maximize their revenues and to ensure the security of their later generations, the OPEC governments should lower oil prices to the equivalent of \$7 per barrel in 1975 dollars, which would lead to a cumulative surplus of about \$200 million by 1978, a surplus which would disappear by the early 1980's. The problems of the M.S.A.'s can be mitigated by primary, direct recycling of petrodollars to them by the OPEC countries themselves, in the form of grants or concessionary loans, or indirectly through OPEC purchases and investments in wealthier consumer countries wherefrom some part of these surpluses can be secondarily recycled to the M.S.A.'s.

From the standpoint of the developed countries, from which all real development assistance must come, what is needed is a change not in the mechanism but in the basic philosophy of recycling. They must be ready unilaterally to transfer real resources to the M.S.A.'s, primarily in the form of capital goods and advanced technology. Aid should be in the form of grants, not loans, since loans only add to the burden of the recipient and must eventually be repaid, not in "money", but ultimately in the form of goods and services which those countries will almost certainly need to retain for themselves.

The OPEC countries and the OECD nations are natural allies, not opponents. The OPEC countries have become the captives of their ambitious development programs, from which they cannot now withdraw without huge losses. Neither the oil companies nor the western industrialised nations want a return to cheap oil. Accordingly, the time is appropriate for both OPEC and OECD countries to confer in a spirit of conciliation and cooperation, to work out a pricing system which will protect the interests of both, while joining together to introduce into the international community redistributive mechanisms analogous to the income tax, welfare

schemes and social insurance which the OECD countries have already created so successfully at the national level over the past century.

It is in the West's own vital interest to guarantee the freedom and independence of the OPEC countries; to help them to solve their domestic development problems; to assist them to invest their financial surpluses wisely and in such a way as to guarantee to them and their descendants a commensurate share of the world's wealth in perpetuity; and to encourage them to continue to assume a fair portion of the burden of the world's truly poor.