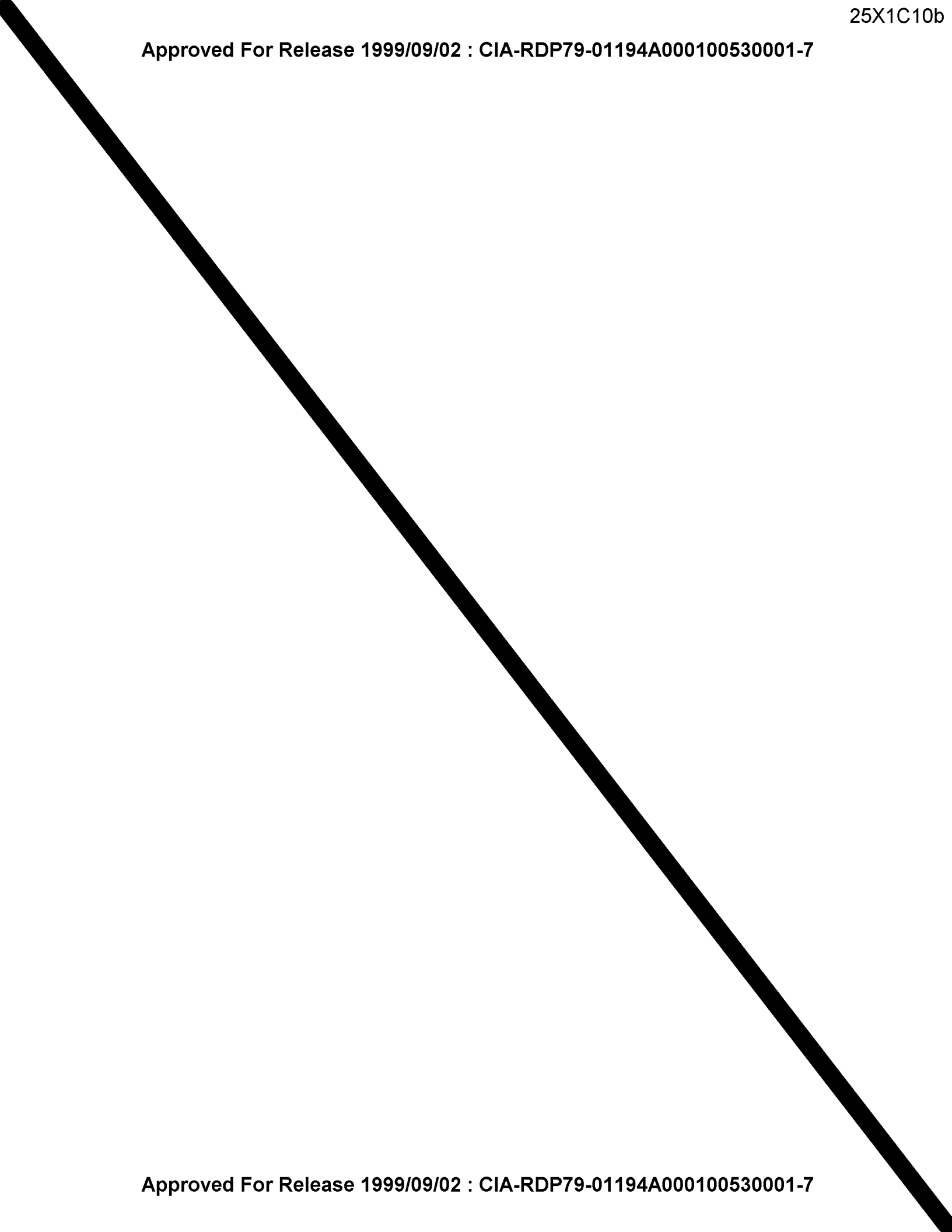

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A BAD YEAR FOR THE RICH COUNTRIES

by Lawrence A. Mayer

In terms of real economic growth, 1973 was one of the best years on record for the industrialized nations of the world. Their economies grew by more than 6 percent overall, because production hit high levels in a good many of these nations at the same time. The year's remarkable economic growth was accompanied, however, by accelerating inflation, fast-climbing interest rates, and international monetary strains. And, of course, toward the end of the year came the damaging effects of oppressive increases in the price of crude oil.

As a result, 1974 is proving to be an exceptionally unpleasant year for the richer nations of the world. We have the problems of 1973, and others besides, without the consolations of vigorous growth. It now appears that the overall growth rate for the developed world will not even reach 2 percent this year, the lowest in sixteen years. And 1975 may not be much better.

Signs of financial distress, public as well as private, are already evident. The city of Rome has suspended interest payments on its massive debts, and the creditworthiness of the Italian national government has been questioned. With interest rates high and stock prices low throughout the world, a great many companies are finding it exceedingly expensive to raise capital—in some cases, prohibitively so.

A number of individual banks have run into trouble. They include Franklin National in the U.S. and Herstatt in Germany, as well as lesser institutions in Italy, Britain, and elsewhere. In an unusual move to maintain confidence in the international banking system, the central bankers of major countries have let word be spread that within their own countries they will assist banks threatened by the general liquidity squeeze.

Sign of a cloudy outlook

Not surprisingly, the piling up of so many economic troubles has brought more than the usual number of gloomy predictions about things to come. Various voices warn of catastrophic inflation or worldwide depression ahead—and sometimes both, the one followed by the other. Even some sober and hardheaded observers find the prospects deeply disturbing. It is a sign of a very cloudy economic outlook that so acute a financier as Britain's Jim Slater has been liquidating many of the assets of his company, Slater, Walker Securities, and putting the funds into short-term paper.

The cheerful view (comparatively cheerful, that is) foresees a marked reduction in the rate of inflation later this year—and an accompanying retreat in interest rates—without deep reductions in output and employment. On this view, the great surge in inflation starting last year resulted from an extraordinary concatenation of circumstances, including the run-up of food prices after poor harvests in 1972-73, the worldwide boom that pushed up the prices of raw materials, and the radically transformed situation in oil. This line of argument implies that the inflation will be largely self-correcting as more normal conditions begin to prevail.

If self-correction doesn't come about, however, a large dose of distasteful medicine may be needed to stop inflation. The old orthodoxy dictates deflation to slow the rise in prices and put credit on a firmer footing. But that course would bring on a lot of unemployment, and cause many companies to fail. In a time marked by widespread political and social instability, governments are even more reluctant than usual to impose such severe measures.

Besides intensifying inflation around the world, the quadrupling of oil prices has created grave problems in international trade and finance. Most advanced nations will be running deficits this year on their current accounts (mainly international trade in goods and services). Primarily because of the immense increase in payments for oil imports, the combined deficit of the advanced nations may run to $40 billion.

The beggar-my-neighbor peril

The immensity of that deficit reflects the fact that the oil-producing nations are not in a position to use their added oil revenues to buy an equivalent amount of goods and services from the developed countries. Most of the oil-exporting countries are too small or too underdeveloped to be customers on that kind of scale. Meanwhile, poorer countries that have no oil are having to cut back on less essential imports in order to afford fuel, food, and fertilizer.

These circumstances place severe constraints on the ability of the industrialized nations to deal with their current-account deficits. Efforts by one country to improve its individual position by pushing exports or restricting imports will serve to worsen the position of other countries. The name of this game is "beggar-my-neighbor." (That phrase, frequently used in discussions of international economic relations these days, is the name of an old card game in which you try to capture all the cards.) Playing it could lead to economic downturns that would spread from country to country.

The developed countries have agreed not to take measures that would damage their trading partners. But before that agreement was formally signed, Italy, Denmark, and France had already taken actions that their neighbors did not like. And Britain's Labor government has decided to strive for "export-led growth"—although it is not clear who will take those additional exports, especially since the volume of world trade is expected to increase only about 5 percent this year, compared to 13 percent last year.

When trade deficits are so nearly universal among advanced countries, borrowing to cover a shortfall does less damage to international commerce than do drives to expand exports. But heavy borrowing will bring its own problems. Most of the funds would have to come from the recycling of money paid to oil-exporting countries, and this process involves some special financial complications (see "Oil, Trade, and the Dollar,"

FORTUNE, June, 1974). Oil-rich countries have wanted to lend at very short term, while governments of oil-importing countries need to borrow at medium or long term. This disparity has caused some big international banks to turn down short-term deposits from oil-exporting countries, or to lower interest rates on them.

The oil countries are putting additional strain on the system by depositing most of their funds in the twenty or so largest banks around the world; understandably, they are seeking safety. At the same time, the loans requested by money-short countries tend to be enormous. Lenders, of course, like to diversify their risks, so they are forming consortia to get the money together. About 100 institutions participated in a $1.2-billion loan to Italy last spring (the loan brought the total borrowed abroad by Italy in the last two years to $10.5 billion). As Arab money gets concentrated in a few big banks, these banks will have fewer other lenders to call on for funds in their effort to spread the risks on very large loans.

A road to depression

To help Italy and other national governments increase their borrowing capacity, the Group of Ten (the major financial powers) has agreed to let nations increase the value of their gold holdings, when used as collateral for loans. The official gold price remains at $42.22 an ounce, but gold can now be offered as collateral at a "market related"—i.e., negotiated—price, perhaps $100 to $125 an ounce. Even with the higher valuation, however, few nations have enough gold to cover their oil deficits for more than a year or two.

Some economists are concerned about the cumulative effects of heavy national borrowing over a span of years. William A. P. Manser, economic adviser to a London investment bank, has reached some dramatic conclusions about the possible consequences of piling up debt to buy oil. Assuming that oil-consuming nations get the loans they need, then at the end of five years they will have borrowed something like $250 billion. Manser calculates that it would take $25 billion a year just to service these debts.

As governments become conscious of the growing burden, Manser predicts, they will curb imports, push exports, and start down the every-nation-for-itself road that can lead to a world depression. Like the American oil consultant Walter J. Levy, Manser believes the oil-consuming nations must somehow convince the oil producers that the only way to avert worldwide economic distress is to reduce the price of crude.

The industrialized world, then, must engage in a perilous balancing act. It must try to bring down the rate of inflation, and still hold down unemployment. It must pay its oil bills, and still prevent an international trade war. How these conflicting aims can be reconciled is not at all clear—nor is it clear that the governments involved, oil rich or oil poor, fully perceive the gravity of the dangers they all face.

The diffusion of power

The cartel set up by the Organization of Petroleum Exporting Countries has generated a massive shift in economic power. And the sudden improvement in the fortunes of O.P.E.C.'s members has certainly had more traumatic effects on other countries than did, for example, the gradual postwar emergence of Japan as an industrial power, or the economic growth in such "third world" nations as Brazil, Iran, Taiwan, and South Korea.

Producers of other raw materials, moreover, have noted the success of O.P.E.C.'s tactics. Jamaica has lifted export taxes on bauxite enough to yield it about $200 million this year, instead of $25 million. Among exporters of phosphate for fertilizers, Morocco, the largest, has already raised the price from $14 to $63 per ton.

In addition, producers of raw materials are having to seek price increases to counter the higher cost of the oil they use. This is one reason Chile and Peru are looking for a way to lift world copper prices. Malaysia has persuaded the International Tin Council, which represents both producing and consuming nations, to raise the guaranteed floor and ceiling prices of tin. As a result of all this, the world is witnessing a remarkable diffusion of economic power.

The various attempts by producers to get more control over pricing will contribute to world inflation while they last—but some of the attempts may not succeed for long. Among other things, artificially puffed-up prices discourage demand and encourage the use of substitute materials.

Prices of some commodities have already fallen quite a bit from recent lofty heights. From the end of 1971 to the peak reached early last May, total commodity prices tripled, as measured by the *Economist*'s index. But by mid-July they had dropped 12 percent. It seems very likely that some buyers who committed themselves for commodities in excess of real needs are now trying to unload. Such a development, coupled with improved food harvests this year, would mean that the broad-based commodity boom is over—for a while, at least. And that, of course, would be a big help in the fight against inflation.

Traveling downward

Virtually every line of business has been affected by this year's combination of slowdown and inflation. This looks like a lean year even for international tourism, which for a long time seemed to be perpetually expanding. And the $28 billion or so that tourism now generates around the world is vital to the economies of a great many countries. The number of U.S. visitors to Europe this summer is down by at least 15 percent. The countries being hit the worst are among Europe's poorest—Portugal, Spain, Greece, and Italy.

For automobile manufacturers, general inflation and high gasoline prices are making 1974 a year of recession. Sales and production are down substantially for every major carmaker in the world. Both home-market and export sales are declining from the extremely high levels of 1973. Volkswagen, expecting its first loss since World War II, is furloughing some workers, while paying others a substantial bonus to quit for good. Even the Japanese auto industry, which more than doubled its output from 1968 to 1973 to become the second-largest producer in the world, is selling fewer cars than last year both at home and abroad.

Despite the downturn in autos, the steel industry has been doing surprisingly well. Total world production may [illegible] record of 696 million

metric tons. Some of the steel not being used by automakers has been picked up by appliance manufacturers, who are using it to replace plastics in their products. (There is a general shortage of plastics, and prices of those made from petroleum are up sharply.)

Energy producers will be supplying a strong base for the steel business for some time to come. Steel is going into coal mines, pipelines, supertankers, and nuclear power plants. In particular, immense quantities will be required for the oil and gas pipelines that are being built in the North Sea.

"I'd rather look back"

If governments could moderate inflation without putting economic activity into a sharp downturn, a great new boom in capital investment might ensue—the result chiefly of the demand for energy and raw materials. But that prospect lies beyond the perplexities of 1974, a year that a lot of people would like to be done with. As one prominent European economist recently observed: "I would rather not look ahead at how 1974 will turn out—I'd rather look back on it."

If 1974 is a rather grim year for the developed world in general, things are a lot worse in some countries than in others. Here is how the situation looks in leading countries outside the U.S.:

▪ ITALY's economy is fragile. During most of the 1960's its growth rate was enviably robust, but beginning with a wave of strikes in late 1969, Italy frittered away a chance to become a first-rank economy. Over the years, weak and unstable governments became a drag on economic progress. They created a class of "golden bureaucrats"—civil servants with high pensions—and allowed an enormous number of other people to feed at the public trough.

The country was especially hard hit by the higher costs of oil and other commodities, since to a large extent its economy is based on the transformation of imported raw materials into manufactured goods for export. By last spring Italy was in such a state that Guido Carli, the forceful governor of its central bank, issued a stern warning: "Today's problem is not that of the quality of life in the factory, but that of the continuing life of the factory."

In May, the country moved to curb imports of consumer goods, including the expensive beef that Italians—to the horror of some economists—had grown very fond of. Stringent limits were also put on bank credit, and the country borrowed heavily abroad to help meet its external deficit. But all of this added up to just a stopgap program. And it didn't stop the gap very effectively—for example, the French were able to keep their beef flowing into Italy by supplying credit to Italian importers.

Last month, after much internal dissension, the political parties, trade unions, and big corporations got together, more or less, on an ambitious program to put Italy on the path to solvency. Tariffs were raised sharply. Taxes were increased on luxury goods, and efforts to tighten up the inefficient tax-collection process were promised. These and other measures should serve to reduce the budget deficit and cut excess imports. Capital stashed abroad is already on its way home—a cheering bit of news. There has been some relaxation of limits on bank credit for small enterprises, both to help them survive and to maintain employment.

Bruno Brovedani, chief economist of the Banca Nazionale del Lavoro, thinks that Italy's G.N.P. will increase about 4.5 percent in real terms for the year as a whole. But he expects the new program to cool off the economy toward the end of this year and into 1975.

The labor unions are already sponsoring sporadic strikes to protest some of the tough new policies, but those policies please Italian businessmen, by and large. Says Umberto Agnelli, the managing director of Fiat: "For the short term I'm pessimistic, for the medium and long term, I'm optimistic." In spite of Italy's problems, he believes that his country has "a very great strength."

▪ BRITAIN began the year with a coal strike, which made it necessary to put industry on a three-day week. The new Labor government, believing that inventories were severely drawn down during the strike, expected a mini-boom while restocking took place. The budget presented in March, therefore, was designed to be nearly neutral in economic effect, and the money supply was kept under tight rein. It turned out, however, that output during the strike had exceeded expectations, and so did the amounts of inventory left in the economy when the miners went back to work. Accordingly, the automatic recovery in production has been considerably weaker than was forecast. Now economic stimulation, rather than budget neutrality, seems to be required. And in fact, last month, Chancellor of the Exchequer Denis Healey proposed a number of mildly reflationary measures, including reductions in some taxes and an increase in the rate at which companies can raise their dividends.

Output held up surprisingly well during the three-day-week episode, in large part because of an unusual degree of cooperation between labor and management. Both sides made sacrifices to keep factories in operation. The whole episode suggests that the British economy has hidden reserves of productivity that are not normally brought into play.

Wage controls have just been lifted, but price restrictions remain in effect. In place of wage controls, the Labor government is trying to promote something it calls a "social contract," which it hopes will lead unions to ask for wage increases only as large as those justified by inflation. For its part, the government has already made considerable effort to win union cooperation—it has increased old-age pensions, imposed stiffer taxes on unearned income, provided subsidies on essential foods, and canceled a rise in rents.

Business confidence has been low for some time, and isn't being helped by a Labor suggestion that trade unions be given a share in the management of companies. In 1973 there was hope of breaking out of the long years of semistagnation, and indeed, the G.N.P. grew by 5.8 percent. But 1974 threatens to be a year of skimpy—perhaps negative—growth. The longer-term outlook is clouded, in part by fears among businessmen of what the Labor party may be cooking up.

Britain's exports are doing relatively well now but not nearly well enough to offset the increased costs of oil. Conse-

quently the country is again in difficulty on its trade balance. One promising note for the balance of payments is that a good deal of oil money has been flowing into London—partly because Britain has traditionally been a banker to Middle Eastern countries.

■ FRANCE is making a fresh attack on some long-standing problems under the leadership of its new President, Valery Giscard d'Estaing. An economic expert, Giscard aims to give French workers a better deal; up to now, they have benefited less from national economic growth than workers in most of the other West European countries. Giscard has raised pensions, minimum wages, and family allowances. He is seeking guarantees of a year's pay for workers who lose jobs because of economic conditions.

The government plans to raise income taxes, principally of corporations and high-income individuals. Taxes on fuels also are going up. Consumer spending is being discouraged by tighter credit, and interest rates on savings accounts have been raised. Controls will be imposed on the use of heating oil.

All of these measures are intended to keep the budget in trim, while cutting France's bill for imported oil and freeing more goods for export. Meanwhile, an existing ceiling on increases in total bank credit is being more strictly enforced, and the central bank's discount rate has been pushed to 13 percent, the highest in the industrialized world. Giscard is trying to get the French inflation rate—now about 13 percent—down to 7 percent in 1975.

Another of Giscard's important moves involves a big deal with Iran. In the next decade, France is to help that country with a lot of advanced-technology projects, including nuclear power plants and a subway system for Teheran. This deal, valued at $4 billion, will partially offset France's oil bill. But the transaction blocks other countries from the possibility of meeting *their* oil deficits by selling to Iran. And in going to grand-scale barter, France is turning the economic clock back. Says one French economist: "For three centuries the path of progress has been to get away from barter to the use of money as an intermediary. Bartering is characteristic of the propensity of states to interfere in trade."

■ WEST GERMANY remains the strongest economy in Europe. With the Continent's stiffest monetary and fiscal policies, it has held the inflation rate to about 7 percent—even though wage increases have been running to 12 and even 14 percent. As a consequence, profit margins have been squeezed.

Restrictive governmental policies slowed the growth rate in the first half of the year, and growth for the year as a whole may be no more than 2.5 percent. Unemployment is rising, largely because industries such as autos, construction, and textiles are having a poor year, and the government—astonishingly for inflation-shy Germany—is contemplating a tax cut for 1975 as a tonic for the economy.

The big export industries—steel and machinery especially—continue to do amazingly well despite the revaluations of the mark. The conventional explanation for this sturdy performance cites the quality, reliability, and quick delivery of German goods. But Britain's three-day workweek earlier this year helped by bringing a switch of orders to West German manufacturers.

West Germany exports so much of its production that a good deal of the benefits from its gains in G.N.P. go abroad. Otto von Fieandt of the Paris-based firm of economic consultants, Eurofinance, calculates that the increase in the standard of living of West Germans last year lagged about 2 percentage points behind the increase in total G.N.P.

West Germany holds two important cards in the world oil game. First, its total exports exceed imports by a large margin, even counting in oil. This makes Germany a large potential lender to oil-deficit countries. The other card is an abundance of coal. Until recently a good many mines were uneconomic, but the new high price of oil has improved the arithmetic of coal.

Getting coal production to much higher levels will require large investments, however, and so will the development of coal-gasification technology. Germany produced gasoline out of coal in World War II, but the process is relatively expensive [illegible] than gasoline from crude oil, even today. Exactly how West Germany exploits its coal reserves will depend to a considerable degree on what energy-sharing policies emerge in the European Community—and what happens to oil prices.

■ CANADA "is incredibly lucky," says Fred H. McNeil, president of the Bank of Montreal. "We are almost alone in the Western world in having no balance-of-payments problems due to oil. We have the things the world wants, and prices favor us—wood products, minerals, agricultural products. We have a virtually complete base in energy resources and materials for significant advance in manufacture . . . This is our time." A great many Canadians speak of their country's prospects in such expansive terms these days.

Last year Canada's real growth came to 7.1 percent, the best in seventeen years. The growth was spurred by an increased inclination of businessmen to export, as well as by some special tax concessions. Economic policies were less restrictive than in most other nations, because unemployment was relatively high, and the government was convinced that inflation in Canada is largely international in origin and therefore cannot be effectively dealt with by domestic restraints.

This year Canada will wind up with real growth of about 5 percent—one of the few major countries with a strong advance. Capital investment is again playing a big role, with increases of 13 percent in real spending on equipment and nearly 10 percent in nonresidential construction. Consumer durables and housing, which powered the Canadian economy for some years, are providing somewhat less impetus.

Prime Minister Pierre Elliott Trudeau's electoral victory gives him an opportunity to develop new policies toward the perennially sensitive subject of foreign capital. Nationalism is on the rise, but Canada plans to undertake extensive energy projects—and capital to help carry them out will certainly have to come from abroad. The major ventures are natural-gas pipelines, a huge hydroelectric project at James Bay, and development of Arctic gas fields. It will [illegible] capital to exploit the Athabascan tar sands, which are esti-

mated to contain 300 billion to 400 billion barrels of recoverable oil—nearly equivalent to the present petroleum reserves of all O.P.E.C. members.

■ JAPAN will not soon again attain the 10 percent rate of economic growth that it averaged over the past twenty years. Of all the major nations, Japan is the most dependent on imported oil. Accordingly, it has felt the impact of fuel prices sharply. Higher prices of other raw materials have also hurt. For these and other reasons, Japan's planners have reduced their goal for long-term growth to 6 or 7 percent. The short-term prospects are for quite modest growth: 2.5 percent or less for all of 1974, even with the pickup that is expected in the latter part of the year.

Prices have been going up faster in Japan than in other advanced nations. Wholesale prices of manufactured goods are up about 33 percent over a year ago, and consumer prices about 25 percent. One reason for the present rapid pace of inflation is that many Japanese workers won a basic wage increase of 32 percent last spring. While worker productivity has been doing remarkably well, it is not nearly high enough to offset wage increases of that magnitude, especially with industry not running at top speed.

Several industries have been hit hard by shortages and high prices—autos, textiles, appliances, and construction. Steeply climbing interest rates aren't helping. The discount rate has reached 9 percent, the highest by far in the modern history of Japan. Despite financial aid from the government, small businesses have been failing this year at a rate of about 800 a month. The industries doing best are those in which supply is short all over the world—steel, shipbuilding, petrochemicals, machinery, and paper.

Japanese exports continue to rise, but imports have been rising more—partly because of the large oil bills and the appreciation of the yen against other currencies. As a result, Japan's balance of payments has gone into deficit. The country has been losing reserves, and in the last few months the exchange rate of the yen has been edging down.

Despite Japan's economic troubles, labor is still in short supply, so people who are laid off can easily find jobs. Workers seem to be saving more, rather than spending all of their increased income. In short, the Japanese economic performance may now seem less miraculous than it once did, but there is still a lot of life in it. END

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The Rising Cost of Crude

THE impression that oil prices have reached their peak and are now likely to decline seems to have been gaining ground in recent weeks. It stems from the knowledge that bids for crude oil supplies offered at state auctions have failed to meet the expectations of rapacious governments; that Mr Yamani of Saudi Arabia still appears to believe that posted prices are too high; and that, with storage tanks full, there is much talk of an oil surplus. Surely the forces of the market will now operate to bring cheaper oil to hard-pressed consumers? This is certainly what the consumer would like to believe. Unfortunately, a more realistic interpretation is that crude oil costs are still rising and that they are unlikely, without a change of policy by host governments, to decline in coming months.

But what exactly is meant by crude oil costs? A fruitful source of confusion in any current discussion of price trends is the fact that crude oil is changing hands at an extraordinarily wide range of prices. Cheapest of all is the equity crude or "cost-crude" to to which oil companies are still entitled under concession agreements: in the Persian Gulf, for instance, the tax-paid cost of these supplies is of the order of $7.10–7.90 a barrel. Then there are the buy-back prices paid by oil companies for supplies purchased from governments under "participation" arrangements: in the Persian Gulf these range up to $11 or more a barrel. Finally there are the so-called free-market prices charged by state entities or oil companies for crude oil sold to "consumer" governments or to other companies; these can fluctuate within wide limits in a short period of time.

Market Price

Free market prices have in some cases fallen a long way from the dizzy heights reached at the time of the Arab production cuts last winter. In those anxious days, panicky buyers paid up to $20 a barrel for much-sought-after non-embargoed oil. But, with production restrictions removed, and with consumption checked by steep increases in products prices, panic buyers are no longer in the market. As long ago as last March, the Kuwait government failed to line up purchasers for 462 000 b/d of royalty oil at its hoped-for prices. Offers ranged from $8.50 to $10 a barrel, and when the government insisted on the posted price ($11.545) as the minimum it sold only some 100 000 b/d. Similar failures have been reported from Iran, Abu Dhabi, Tunisia and elsewhere. Algeria recently lowered its asking price by $1 to $13 a barrel to retain its customers, and Tunisia followed suit.

In recent weeks various other reports have confirmed the disappearance of the fantastic prices that were quoted for marginal sales earlier this year. In this sense it is true that the free market has been showing a downward trend. It is relevant to point out, however, that the quantity of oil that changed hands at these exceptional prices was very small in relation to world demand – and that the effect of these dramatic falls on the average cost of crude is correspondingly limited. Far more important are the costs to international companies of the bulk supplies that pass through their integrated systems to emerge as finished products in consuming countries.

Equity Crude

These costs are, of course, related to posted prices. The raising of posted prices by some 70 per cent last October and by a further 130 per cent on 1st January, meant a fourfold increase (or more) in tax-paid costs of equity crude to something like $7.11 for Arabian light, $7.03 for Kuwait, $9.10 for Nigerian and $10.00 for Libyan. At its Vienna meeting last March and again at Quito in June, OPEC decided to leave posted prices unchanged, with Venezuela reserving the right to go its own way. At Quito, however, the majority of the governments – not Saudi Arabia or Venezuela – agreed to squeeze the buyer a little further by adding 2 percentage points to their royalty rates, raising these from 12½ to 14½ per cent of posted prices. Where applied, this decision raises the tax-paid cost of equity crude by just over 10 cents a barrel in the Persian Gulf and by 13 cents in Nigeria. This is the only direct increase in the cost of equity crude made in the Middle East and Africa this year, though there is, of course, no guarantee that further increases may not follow OPEC's conference in September.

Venezuela, which has a 16⅔ per cent royalty and a complicated tax-reference system including a basic price, a percentage surcharge, a variable freight element and sulphur premiums, did not follow the OPEC-recommended course. Effective 1st July, the government raised its tax-reference prices by an average of 35 cents to an average of some $14.43 a barrel; bigger increases were applied to the lighter than to the heavier crudes. The government is also threatening to increase the present tax rate (58 per cent for most companies, though nominally 60 per cent) by a considerable margin – which would of,

course, further increase the cost of these expensive crudes.

The cost of the cheapest supplies available to international companies has thus been creeping up in recent months, and there seems to be no immediate prospect of relief. It is true that Mr Yamani, Saudi Arabia's Oil Minister, has several times expressed the opinion that the current level of prices is too high; and it was thought that he might have justified this view by auctioning a large quantity of oil last month and allowing the price to find its own level. But his belief (if it really is his belief) is strongly opposed by his OPEC colleagues, notably by the Iranians, some of whom have threatened to cut back production if Saudi Arabia tries to engineer a price decline. In the light of this opposition, it is significant that the long-heralded August auction of Saudi Arabian oil did not take place.

While the cost of equity crude is rising, the quantity available to the companies is being sharply reduced. (See our March issue, p 84). Apart from the outright nationalizations that have taken place in Algeria, Libya, Iraq and Iran, governments have been forcing "participation" agreements on reluctant companies.

Effect of Participation

Under the 1973 participation agreements in Persian Gulf countries, governments took 25 per cent of the equity – in Nigeria 35 per cent – and granted relatively favourable buy-back prices, only 20 to 60 cents above tax-paid costs. The position is very different now. By an agreement finally ratified by the National Assembly on 14th May, the Kuwait government raised its stake in Kuwait Oil (Gulf and BP) from 25 to 60 per cent, effective 1st January. The Qatar government signed a similar agreement with the Qatar Petroleum Co. (IPC group) and Shell of Qatar in mid-April. As an interim measure, pending the finalising of longer-term arrangements, the Saudi government took a 60 per cent interest in Aramco, backdated to the beginning of the year, while desultory negotiations for a similar arrangement have been going on in Abu Dhabi.

The sting of these agreements is the high buy-back prices that have to be paid by the oil companies for the state-owned crude. Saudi Arabia set the pattern earlier this year by insisting on a price equivalent to 93 per cent of the posted price, which means approximately $10.80 for Arabian light against a cost of about $7.12 for equity crude – a gap of $3.68. The Qatar agreement gave the companies the right to purchase during the first half of this year at least 60 per cent of the state's share (i.e. 36 per cent of the total output) at a price – $11.546 for QPC and $11.172 for Shell – which also equated to 93 per cent of the posting. The terms were to be revised quarterly but have been left unchanged for the third quarter.

After prolonged discussions about buy-back prices in Kuwait, Gulf Oil agreed in July to pay $10.95 a barrel, equivalent to about 95 per cent of the posted price, for oil purchased from end-June to end-September; and BP followed suit. This price, which is subject to quarterly review, is almost $3.80 above the cost of equity crude, but the companies' buying commitment is restricted to a maximum of 350 000 b/d each.

In Nigeria, effective 1st April, the government took a 55 per cent participation. Here the companies have the right to buy back half the government's share at $13 a barrel (which is over 88 per cent of the posted price of $14.691) and half the remainder at $13.25 – prices which look increasingly unrealistic. For the time being, therefore, they have access to 86.25 per cent of total production; this percentage will, however, be reduced to a maximum of 69.75 per cent for 1975, after which they will have no further buy-back entitlement: they will have merely their 45 per cent share of the equity.

In Libya the position is that the government has expropriated a number of companies with a total 1973 production of the order of 500 000 b/d and has taken a 51 per cent share in the remainder. (See our April issue p 127 and May p 173.) This gives it (on the basis of 1973 production statistics) approximately two-thirds of the total output, which has lately been declining. Its buy-back prices range from $12.75 to $13.40 a barrel, according to grade, against a tax-paid cost for equity crude of around $10 a barrel.

This continued rise in the average cost of oil in the Middle East and Africa is reflected also in Indonesia. Here the state entity, Pertamina, fixes its own selling prices which also serve as tax reference prices for oil companies with production-sharing agreements. The price (now uniform for all grades) was raised from $10.80 to $11.70 a barrel on 1st April and again to $12.60 on 1st July. Buyers in Japan – the main market – may reflect ruefully that the highly prized sulphur-free Minas crude was selling last year for $2.96 a barrel.

Which Way Now?

Consumers looking hopefully for cheaper oil were disappointed at the stiff buy-back price agreed by Gulf and BP for Kuwait crude – as a percentage of posting, the highest so far accepted. The reason for the companies' acquiescence is clear enough: there is always the threat that if the government's share remains unsold total production will fall and the available supply of cost crude will shrink correspondingly. The companies in Nigeria were threatened last month with a production cutback, following Shell-BP's refusal to lift more than the minimum quantity of "participation" crude for the month of August.

As the average cost of crude oil rises and the [illegible] supply contracts, the

question arises how long it will be before the latter is swept away by the nationalizing zeal of host governments. If this were to happen – and it is not suggested that complete nationalization is imminent – the governments with all the oil under their own control would presumably at first be reluctant to reduce their selling prices. Thus the immediate consequence of the disappearance of "cost crude" would be a further jump in average crude oil costs, necessitating still higher prices for products, and imposing even more serious constrictions on demand.

Questions for OPEC

OPEC enthusiasts could argue that this powerful cartel would meet such a situation by imposing production cuts drastic enough to maintain prices at the higher level, though even the most optimistic would concede that such restrictions would introduce painful tensions into the organisation. But the situation could not last. To the impartial observer it is already clear that the present punitive level of oil prices cannot be sustained in the long run. The governments of oil exporting countries would be well advised to ponder the reasons why this is so.

On the demand side, the steeply rising cost of oil is having the natural consequence of restricting the quantity sold, since consumers simply cannot afford to pay for all the oil they would like to buy. In all consuming countries, householders and business firms are finding ways of economising fuel, and the process is cumulative. Hence the symptoms of oversupply mentioned earlier, including overflowing storage tanks and the slow-steaming of ocean-going tankers. Moreover, because of the frightening balance-of-payments problems that are building up in many importing countries, governments may soon be compelled to add mandatory restrictions on oil usage to those which consumers are already having to impose on themselves. Meanwhile, the national economies of all the main industrialized countries are running down, and the threat of massive unemployment looms.

On the supply side, the swingeing taxes imposed by the exporting countries are having the effect of strengthening the determination of individuals and governments to reduce their dependence on OPEC oil, by the more rapid exploitation of oil resources in other parts of the world and by the active development of all alternative forms of energy. The industrialized nations that are being forced into this expensive course have enormous resources of knowledge, skill and capital equipment at their disposal and the ultimate success of their substitute-fuels policies is not in doubt. Of course the "lead-times" are in some cases very considerable. But the effort that is being put into the search for alternatives will begin to bear fruit before many years have passed. World energy supplies will then greatly outrun demand and the need for Middle East oil will be drastically reduced.

Are the host governments capable of looking that far ahead? They have succeeded in forcing up the price of oil to an extent that is extremely damaging, not only to consumers – that is obvious enough – but to their own long-term interests as well. The path of wisdom for OPEC would be to recognise now that its monopolistic position must inevitably be short-lived and to decide forthwith to reduce the price of oil to something much nearer its long-term competitive level.