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**The Global Implications of a
Possible Oil Price Decline**

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An Intelligence Assessment

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*GI 82-10275
December 1982*

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The Global Implications of a Possible Oil Price Decline

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An Intelligence Assessment

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The Global Implications of a Possible Oil Price Decline [Redacted]

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Overview

Information available as of 10 December 1982 was used in this report.

The possibility of a sizable oil price decline is growing. If it occurs, decisions made during the first year will largely determine its eventual impact. If oil prices fall in early 1983, for example, the most critical period from a policy standpoint would extend into early-to-mid-1984. [Redacted]

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Policy decisions made immediately following a price decline will largely determine how the global economy is affected. There are substantial positive aspects that could occur, including:

- Lower inflation.
- Higher economic growth.
- Reduced interest rates.
- Reduced Soviet hard currency export potential. [Redacted]

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At the other extreme, lower oil prices could lead to intensified international financial stress, as well as increased Third World political instability—which would provide Moscow with opportunities to exploit. Unsettled conditions in key oil-exporting countries could eventually translate into a supply disruption of major proportions, threatening an oil price runup well before the positive impact of the initial price decline worked its way through the system. [Redacted]

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For Western governments there will be a number of policy choices to make:

- They must decide on whether to reinforce downward price pressures. This could be done by increasing purchases from oil-exporting countries that decide to reduce oil prices—either by arranging government-to-government purchases or by expanding purchases for official stockpiles.
- Once prices decline, they must decide whether to adjust macroeconomic policy:
 - Governments could take advantage of the oil-related reduction in inflation to further accelerate economic growth by adopting more stimulative policies.
 - Alternatively, they could decide to keep the deflation dividend and forgo some of the policy adjustments that might give added push to the economic recovery. [Redacted]

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If Western governments choose deflation, they risk sending the wrong signals to the banking community. Indeed, the most immediate concern brought on by a price decline would be the risk of damage to the international financial system unless some sort of help were provided to high-debt countries that are dependent on income from oil, especially Mexico. Nigeria, Venezuela, Indonesia, and Egypt would also be in trouble. Among nonoil less developed countries (LDCs), Pakistan could suffer considerable losses as Persian Gulf oil exporters cut back on aid and foreign purchases. In all cases the central question would be what kind of help to provide and under what conditions. 

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An oil price decline also has important implications for East-West issues. The Soviet Union stands to lose considerably on the financial front since more than one-third of Soviet hard currency earnings now come from oil exports. The Soviets will also earn less from the export of gas because the price formula is linked to oil. If the price of oil remained low, however, the financial viability of alternative gas supply projects, such as the Norwegian option, would suffer serious damage over the longer term. This could lead Western Europe to greater reliance on Soviet gas supplies than would otherwise be the case. The risk of Soviet meddling in politically fragile oil-rich countries might also rise. 

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This report will describe the pressures that are mounting on oil prices, explain how an oil price decline, if it occurs, might work its way through the global economic system in the short run, and highlight the factors that will influence the magnitude of the impact of a price decline. Because an oil price decline would have broad impacts that feed back on one another, this analysis primarily will draw attention to these connections and indicate what factors will determine how they operate. Because of the complexity of the issues, the analysis in places will be more impressionistic than precise. Moreover, inadequate data prevent us from addressing the micro-effects of an oil price decline. We have not, for example, discussed how the banking system would be affected by a possible loss of investments in the oil sector; nor have we assessed the impact on the oil industry itself, including the international oil companies. Moreover, we have not addressed how a major oil price decline would affect the medium and longer run nature of energy markets and the feedback effects that such changes would clearly have. 

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The Global Implications of a Possible Oil Price Decline

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Introduction

During the past year, oil-exporting countries have been trying to buy time on the expectation that Western economic recovery would begin by late 1982. This has not occurred, and consequently oil consumption by non-Communist countries has declined steadily. Unless a healthy industrial-country expansion begins soon, we believe there is no reason for the decline to stop. Barring an economic surge in the major developed countries, the financial and political pressures on individual oil exporters to do something will intensify. We believe the next six months will be a critical period because of the nature of the pressures on them and the direction the oil market seems to be moving. 


A large number of potential price paths could materialize if and when the market breaks. Each of these different paths would create unique opportunities and problems. From a strictly financial standpoint some countries will be winners, some will be losers. Which country falls into which group will depend not only on the price path itself but also on the reaction of non-OPEC governments and the international financial community. Perhaps the most important factor will be the policy response of major Western governments. In any event, we believe that the first year following an oil-price decline will be the highest risk period. If the downside risks can be avoided during this period, an oil price decline could have major positive effects on the global economy. 

Oil Market Pressures



Market pressures for an oil price adjustment have been building for some time. The key reasons are the structural adjustment of the world economy to higher oil prices and the failure of the long-awaited recovery to materialize in non-Communist-country demand for oil:

- In OECD (Organization for Economic Cooperation and Development) countries, the intensity of oil use per unit of GNP has fallen by 25 percent in the past decade. This process is continuing.

- When the OPEC production-sharing agreement was pieced together six months ago, it was based on oil industry projections that fourth-quarter 1982 demand for OPEC oil would reach 22-23 million barrels per day (b/d). As recently as three months ago these same analysts were projecting fourth-quarter demand at 21-22 million b/d.

Based on the most recent industry data available, however, we estimate that demand in October and November approximated only 20.5 million b/d—about 7 percent below the same 1981 period. 

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Despite a recent increase in OPEC oil production there is still no end in sight to the decline in consumption. OPEC oil production in November was almost 2 million b/d above levels in August. The increase, however, reflects no more than the normal seasonal increase in oil consumption and perhaps an end to the drawdown of excess commercial inventories. Normally, companies build inventories during the summer when consumption is low to meet seasonal increases during the winter.  the combination of high carrying costs, surplus productive capacity, and the increased flexibility of the refining system is causing oil companies to carry lower inventories and shift more of the seasonal pattern of oil consumption to producers. 

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Unless some dramatic changes occur we expect little or no growth in demand for OPEC oil during 1983. If OECD economic growth approximates 2 percent next year we would expect demand for OPEC oil to be about 20-21 million b/d. This is consistent with almost all oil industry assessments. Because of seasonal variations in demand over the course of a year, the pricing issue will be touch and go at least through next spring. Seasonal factors, for example, could raise demand for OPEC oil by about 1 million b/d during the next four months. During the second and third quarters of 1983, however, demand for OPEC oil could fall by up to 2 million b/d if oil companies are

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successful in shifting the burden of midyear seasonal adjustment to oil producers. In our view, the second quarter of 1983 will be the period when prices will be most vulnerable, even if internal discipline is maintained at the December meeting of OPEC. [redacted]

Producer-Country Pressures

With financial strains in most oil-exporting countries mounting there is already extensive pressure to maximize production without regard for the impact on the market. The OPEC production-sharing agreement reached last May was only delicately pieced together and is now all but dead. Iran, for example, is currently producing 1.7 million b/d more than the agreement called for, Libya is producing 1 million b/d above its allocation, and Venezuela is exceeding its quota by 700,000 b/d. To push their market share, Iran, Libya, and Nigeria have been shaving prices either directly or indirectly through such mechanisms as credit discounts and barter deals. Saudi Arabia has thus far absorbed most of the production-sharing agreement overages. As a result Saudi output now approximates 5.6 million b/d. [redacted]

We doubt that the Saudis will continue to allow their market share to erode much further. [redacted]

[redacted] internal

political conditions and a growing sense that industrial-country economic recovery will face additional delays is leading Yamani to conclude that a sizable price cut may be needed soon. [redacted]

[redacted] We

would not be surprised if this occurred within the next month or so, although they could choose to wait until next spring. Earlier this year [redacted] the Saudis believed a \$6 to \$8 price cut was needed to underpin the market. [redacted]

If Riyadh moves to cut prices, there is a substantial chance that the market would slip completely from Saudi control. Given the financial pressure other oil exporters face, we believe they would be tempted to at least match the Saudi price cuts in an attempt to

maintain their market share. For Nigeria, for example, cutting prices \$3 per barrel is worthwhile from a revenue standpoint if sales increase by 140,000 b/d. If Western governments and international oil companies respond by shifting purchases to countries that lower prices, a downward spiral could develop. Moreover, with oil prices declining, oil firms would almost certainly move to reduce inventories rapidly, thus adding fuel to the price ratchet [redacted]

In this kind of scenario we do not know how far or how fast oil prices might fall. For the sake of argument, calculations in this report were made on the simplified assumptions of an OPEC average-weighted price drop to \$20 or \$25 per barrel. Because of the wide range in actual prices among oil exporters—reflections of quality and transportation differentials—we calibrated individual country oil prices to account for this spread. Another simplifying assumption we have made is that oil market shares will remain constant over the course of the adjustment period. It should be noted that the current OPEC average-weighted price is \$32.42 per barrel with the country average ranging from a high of \$35.49 for Algeria, whose exports are heavily weighted by high quality crude, to a low of \$29.58 for Venezuela. [redacted]

Impact on OPEC

The economic, political, and financial position of most OPEC countries would be seriously damaged in the event of a sharp decline in oil prices. Lower oil prices would raise demand for OPEC oil because of both reduced conservation and the stimulative effects on economic growth in oil-importing countries. It would take at least several years, however, before the positive effects on demand for oil made up for the price-related revenue losses. The exact price-demand trade-off is difficult to gauge because only aggregate data are generally available. Using past relationships our calculations indicate that at \$25 per barrel demand for OPEC oil in 1983 would be 1 million b/d higher than would otherwise be the case; at \$20 per barrel the gain would be 1.5 million b/d. Table 1 summarizes our calculations on demand for OPEC oil and OPEC oil revenues under alternative price assumptions. The calculations assume OECD baseline economic growth next year of 2 percent, roughly consistent with recent OECD projections. [redacted]

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Table 1
Oil Exporting LDCs:
Revenue Impact of Oil Price Cuts, 1983^a

Oil Production (thousand b/d) ^{a b}	Exports (thousand b/d) ^b	Price per Barrel (US \$/b) ^b	1982 Oil Revenue (billion US \$) ^c	1983 Oil Revenue Estimates				Required 1983 Oil Production To Maintain 1982 Revenue		
				\$20 per barrel		\$25 per barrel		\$20 per barrel (thousand b/d) ^f	\$25 per barrel (thousand b/d) ^f	
				2 percent OECD growth (billion US \$) ^d	3 percent OECD growth (billion US \$) ^d	2 percent OECD growth (billion US \$) ^e	3 percent OECD growth (billion US \$) ^e			
OPEC^g	20,134	16,965	32.42	202.3	140.9	146.2	171.7	178.3	30,755	25,294
Algeria	978	836	35.49	10.9	7.7	8.0	9.4	9.8	1,499x	1,230x
Ecuador	208	118	32.84	1.4	0.4	0.5	0.5	0.6	286x	249x
Gabon	155	143	29.68	1.6	1.2	1.2	1.5	1.5	242x	196x
Indonesia	1,343	844	33.53	10.4	4.4	4.7	5.2	5.6	1,901x	1,631
Iran	2,576	2,076	28.66	21.9	14.4	15.0	17.5	18.2	3,893	3,225
Iraq	810	570	34.83	7.3	4.0	4.2	4.8	5.1	1,172	989
Kuwait	962	798	32.03	9.4	6.5	6.7	7.9	8.2	1,460	1,202
Libya	1,602	1,494	35.25	19.4	15.0	15.5	18.3	18.9	2,524x	2,043
Nigeria	1,381	1,134	34.98	14.6	9.9	10.3	12.0	12.5	2,093	1,728
Qatar	336	324	34.30	4.1	3.3	3.4	4.0	4.1	535	431
Saudi Arabia	6,423	5,790	32.21	68.6	51.3	53.1	62.6	64.9	10,020	8,152
UAE	1,291	1,195	33.87	14.9	11.4	11.8	14.0	14.5	2,027	1,642
Venezuela	2,069	1,634	29.58	17.8	11.4	11.9	13.9	14.5	3,103x	2,576
Other Oil-Exporting LDCs										
Mexico	2,800	1,600	28.50	16.4	11.0	11.0	13.7	13.7	4,067x	3,554
Egypt ^h	670	390	32.60	4.7	2.8	2.8	3.5	3.5	920x	792x
Angola	135	100	34.00	1.2	1.8	1.8	2.2	2.2	192x	161x
Malaysia	285	240	36.00	3.2	2.2	2.2	2.7	2.7	569x	490x
Brunei	200	150	35.00	1.9	1.3	1.3	1.7	1.7	292x	244x
Oman	330	300	34.00	3.6	2.4	2.4	3.0	3.0	502x	408x
Trinidad and Tobago	200	150	33.00	1.8	0.9	0.9	1.2	1.2	293x	245

^a Oil production (including NGLs).

^b Second half of 1982 data.

^c Second half of 1982 oil revenues at an annual rate.

^d Oil revenues generated at an average weighted OPEC oil price of \$20 per barrel given aggregate OPEC production number and assuming 2 percent and 3 percent 1983 OECD real growth.

^e Oil revenues generated at an average weighted OPEC oil price of \$25 per barrel given aggregate OPEC production number and assuming 2 percent and 3 percent OECD real growth.

^f Oil production (including NGLs) required at an average weighted OPEC price of \$20 per barrel and \$25 per barrel to equal annualized oil revenues in column 4. An "x" in column 9 or 10 are those countries exceeding their maximum sustainable capacity.

^g Because of rounding, components may not add to total shown.

^h These estimates include Egyptian oil that is exported by foreign oil companies under production-sharing agreements. Egyptian petroleum and balance-of-payments data exclude the value of this oil as well as the capital outflow it represents. Thus, these estimates significantly exceed oil exports reported in Egyptian data.

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Revenue Losses. OPEC oil revenues would approximate \$210 billion next year if OECD growth averages 2 percent and oil prices remain at current levels. If oil prices drop to \$25 per barrel revenues would decline by \$40 billion to \$170 billion; at \$20 per barrel the revenue loss would reach \$70 billion. Even these calculations probably understate the loss since our methodology incorporates a larger short-run demand response to oil price reductions than is likely to occur. A recent Department of Energy study, for example, indicated that as much as half of US oil savings in the past few years occurred in nonmanufacturing sectors. Oil usage in these sectors is less sensitive to the business cycle and, consequently, is unlikely to respond much to any acceleration in economic growth caused by lower oil prices. [redacted]

Table 1 identifies what individual OPEC countries would earn next year if oil prices decline. If nothing else changed and if OPEC countries were able to maintain recent import patterns, their current account deficit in 1983 with oil at \$20 per barrel would approach \$100 billion. This is compared to the \$15-20 billion deficit we are projecting for 1982. In most cases the deficits would be enormous and unsustainable. Nigeria and Indonesia, for example, would reach a deficit of \$11 billion and \$17 billion; the Saudi deficit would reach \$18 billion. Even if OECD economic recovery were to accelerate, deficits would remain massive well beyond 1983. According to our calculations, demand for OPEC oil would have to rebound to near the 30-million-b/d level—a 50-percent increase over current levels—before revenues return to 1982 magnitudes. [redacted]

Country Adjustment. We cannot project the adjustment process with any precision. Since their borrowing capability would be reduced, most oil exporters would face the prospect of very large reductions in imports. At best we think they might be able to absorb half the revenue loss through foreign exchange drawdowns and perhaps some increased borrowing (table 2). The balance of the adjustment would have to be through reduced imports. The economic austerity associated with import cuts of such magnitude would almost certainly spark some degree of political instability. Appendix A assesses how individual OPEC states would be affected by a price decline. [redacted]

Non-OPEC Oil-Producing LDCs

A sizable number of non-OPEC oil-exporting LDCs would also experience major revenue losses from an oil price decline. In terms of size, the largest losers would be Mexico and Egypt. Without massive and immediate financial support Mexico would face a disastrous international financial situation; Egypt would face serious problems as well. For both countries we are concerned not only about the internal economic and political response but also the external ramifications. Mexico could threaten the stability of the international financial system, not only because of the financial loss that banks could incur, but also because of the impact on bankers' willingness to lend to other Third World countries. In the case of Egypt the situation is further complicated because of Cairo's role in the Middle East peace process. [redacted]

In addition to this group of established non-OPEC LDC oil exporters a number of other newly emerging LDC oil producers would face internal problems because their leadership has pinned economic development expectations on the windfall from increased oil exports. Among this group of a dozen or so countries, Cameroon, Ivory Coast, and possibly Sudan would be most affected since they have the best prospects for developing a large oil-export sector at current oil prices. [redacted]

Potential Impact on Nonoil LDCs

Among the developing countries, the oil-importing group has the potential for benefiting substantially from an oil price decline (table 3). They will be affected in several ways:

- On the positive side, they will gain directly from lower oil-import costs and indirectly through the price-induced increase in industrial-country growth.
 - On the negative side, their export earnings and other hard currency they get from OPEC will fall as the oil exporters introduce belt-tightening measures.
- On a net basis the impact should be beneficial, but this is not a foregone conclusion. These countries are now in a precarious economic and financial position and they will have to get through the first 12 to 18 months of a price decline, a period likely to be marked by international financial uncertainties brought on by the price shock. [redacted]

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Table 2
Oil-Exporting LDCs:
The Price Collapse Scenario

	1982 Current Account Balance (billion US \$)	Projected Change in 1983 Import Volume Associated With Oil Price Decline ^a (percent)	
		\$20 per barrel	\$25 per barrel
Algeria	-2.9	-6	NEGL
Ecuador	-1.4	-20	-19
Gabon	0.3	-29	NEGL
Indonesia	-7.6	-18	-16
Iran	4.5	-10	-1
Iraq	-20.6	-14	-12
Kuwait	5.0	-16	-8
Libya	-5.6	NEGL	NEGL
Nigeria	-6.5	-14	-7
Qatar	3.0	-32	-11
Saudi Arabia	15.0	-39	-27
UAE	3.7	-39	-26
Venezuela	-2.5	-20	-11
Mexico	-6.0	-18	-9
Egypt	-2.2	-10	-6
Malaysia	-3.7	-46	-21
Oman	0.8	-24	-12
Trinidad and Tobago	0.4	-23	-17

^a Assuming one-half the revenue loss is absorbed by reserve drawdown and increased borrowing; the balance from import reductions.

As it is, nonoil LDCs are in serious economic trouble. In 1981 nonoil LDCs turned in their worst economic performance in three decades (figure 1). Aggregate GDP growth was only 1.6 percent; we expect a weaker performance this year with growth at about 0.8 percent (table 4). The low growth performance of recent years has depended heavily on continued rapid buildup of foreign debt. The aggregate medium- and long-term debt of non-OPEC LDCs is expected to reach \$425 billion by the end of 1982. This compares to \$262 billion in 1979, before the sharp runup in oil prices brought on by the Iranian Revolution (table 5).

The OPEC Connection. An oil price decline would reduce oil-import costs for the nonoil LDC group as a whole. The savings would approximate \$16-17 billion with oil prices at \$20 a barrel. Brazil would be the biggest gainer with oil-import costs declining by about \$4 billion, enough to sharply reduce current account pressures on Brasilia. Other large gainers would be India and South Korea—their oil-import costs would decline sharply. Thailand and the Philippines would save more than \$1 billion each while the oil bills of Chile, Pakistan, and Morocco would decline by as

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Individual Non-OPEC Oil-Producing LDCs

- *Mexico is already in the midst of a financial crisis. The new government will have a hard time imposing the austerity needed to bring financial order to the economy without disrupting the internal political balance. Recent International Monetary Fund and World Bank projections indicate that without IMF support Mexico would be forced to reduce imports by \$5 billion in 1983, in addition to the nearly \$10 billion reduction absorbed this year. Even under the best of circumstances, Mexico would have to forgo any import growth next year. Imposing an oil price decline that would cost Mexico approximately \$5 billion in foreign exchange would place President de la Madrid in a desperate position. He would probably have to weigh the pros and cons of debt repudiation.*
- *Egypt has relied heavily on oil export earnings to finance improvements in living standards and consumer welfare. Oil now accounts for one-fourth of total foreign exchange earnings. Egyptian direct revenue losses from a decline in oil prices to \$20 could approach \$2 billion; indirect losses from reduced remittances from workers in the Persian Gulf would also be substantial. An oil price decline, therefore, would force Cairo to take tough austerity measures that would endanger the political fabric in Egypt. As it is, Mubarak and Prime Minister Muhi al-Din are extremely wary of undertaking economic policy reforms that risk upsetting domestic political stability. Cairo probably would attempt to blunt the impact of reduced earnings by seeking all US economic aid for balance-of-payments support.*
- *Syria, Malaysia, Angola, Brunei, and Oman would also be sizable losers in a price-decline environment. Syria would lose as much as \$300 million in revenues, making the Assad government more reliant on its external supporters. Angola might avoid major revenue losses if oil-production increases now planned actually materialize. In the case of Malaysia, we believe that resulting financial problems would lead to economic retrenchment as well as a slowdown in implementing plans for improving regional defense. As it is, low raw materials prices have reduced foreign exchange receipts, although Malaysia is in better financial health than most oil-exporting LDCs. A recovery in the industrial countries would, of course, boost Malaysia's traditional exports.*
- *We believe that Cameroon stands the best chance of handling a decline in oil prices, largely because of the country's strong agricultural sector. Nevertheless, a substantial decline in oil prices could create serious problems for Cameroon's new President, who is grappling with taking control after the sudden departure of his predecessor. The government is counting on relatively large boosts in oil income to ensure the completion of its ambitious development plan. Moreover, officials view oil money as crucial to satisfying popular expectations of improved living standards. According to Embassy reports, there is already under way a substantial urban migration that is straining public services and contributing to inflation and corruption.*
- *Other LDC oil exporters that would lose include Peru, Tunisia, and Argentina. The losses for Peru and Argentina would amount to \$270 million and \$25 million. They would also both experience some loss in exports to OPEC states.*
- *Sudan. We believe that significantly lower oil prices, which will reduce Sudan's oil-import bill, will have a small impact in the near term. Sudan is not able to service its foreign debts and is experiencing periodic shortages of petroleum products due to*

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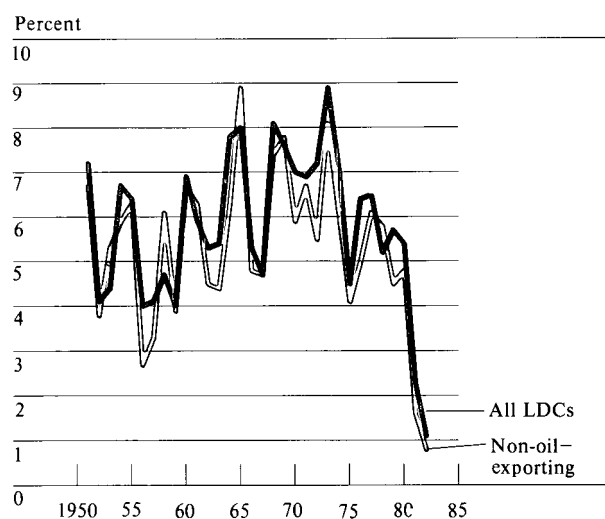
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its lack of foreign exchange. Lower oil-import costs could be offset, however, by increasing difficulties in securing economic assistance from Arab Gulf states and reduced remittances from Sudanese workers in Persian Gulf countries. Over the longer term, lower oil prices will reduce the profitability of developing recent oil discoveries and may lead Chevron—the major foreign investor—to reconsider its development program. Production is not slated to begin until 1986 at the earliest.

- *Ivory Coast would also be hurt by lost oil revenues. According to oil company assessments, the Ivory Coast could export as much as 150,000 b/d by 1985, and, at worst, would be self-sufficient in 1983. Some oil industry experts claim that oil potential is being deliberately downplayed because President Houphouet-Boigny does not want to encourage rising expectations in the face of the economic austerity that the Ivory Coast is now undergoing. To the extent that the oil revenues are reduced, the risk of a military government eventually replacing the aging President will increase. As it is, the country's current economic problems and popular dissatisfaction could pave the way for outside meddling in the event of a succession crisis.*
- *Other LDCs with oil-production aspirations include Guatemala, Ghana, the Philippines and, to a lesser extent, Zaire, among others. The last two face serious financial constraints that might be alleviated by oil. In neither instance, however, do we believe that oil production/exports would translate into much domestic economic development because of a limited resource base and political/bureaucratic constraints.*

Figure 1
LDCs: Aggregate Real GDP Growth Rates^a



^a Weighted by 1981 GNP.

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much as \$400-500 million. In the case of Morocco the savings would be roughly in line with the amount of financial aid it receives from Saudi Arabia. We believe that much of this aid would be at risk.

Other partial offsets to the lower oil-import cost would be the loss in remittances from foreign workers employed in oil-exporting countries, especially in the Persian Gulf. We estimate that at least \$10 billion are involved with Pakistan, India, Egypt, and Jordan—the major recipients of such earnings. In East Asia, the Philippines and South Korea also earn sizable amounts from this source. Table 6 summarizes the amount of funds earned from worker remittances by selected LDCs and the general source of these earnings. According to published statistics, South Korea also earns about \$3 billion annually from construction contracts with oil countries, mostly in the Gulf. We believe all of this activity would be sharply curtailed by a price decline.

¹ See appendix A.

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Table 3
Financially Troubled Countries:
Foreign Exchange Impact of An Oil Price Decline

	Net Oil Imports, 1981 (thousand b/d)	Net Oil Import Bill, 1981 (million US \$)	Foreign Exchange Savings Over 1981 Oil Import Bill (million US \$)		Reduction In Exports to OPEC (million US \$)		Net Foreign Trade Impact (million US \$)		Current Account Balance, 1982 (million US \$)
			at \$20/b	at \$25/b	at \$20/b	at \$25/b	at \$20/b	at \$25/b	
Bangladesh	35.6	460	200	135	15	10	185	125	-1,440
Bolivia	0.6	6	0	0	5	5	5	5	-250
Brazil	738.0	9,600	4,210	2,865	300	155	3,910	2,710	-10,600
Chile	56.4	917	515	410	40	20	475	390	-2,600
Argentina	-7.6	-81	-25	-10	60	30	-85	-40	-2,700
Costa Rica	14.3	172	65	40	5	0	60	40	-100
Dominican Republic	40.8	558	260	185	20	10	240	175	-550
India	415.2	6,295	3,265	2,505	185	95	3,080	2,410	-3,800
Ivory Coast	0.9	45	40	35	20	10	20	25	-2,000
Jamaica	44.1	450	130	50	5	0	125	50	-550
Kenya	46.4	450	110	25	5	5	105	20	-690
Morocco	84.7	1,070	455	300	30	15	425	285	-1,820
Nicaragua	13.0	183	90	65	0	0	90	65	-364
Pakistan	96.4	1,260	555	380	140	75	415	305	-1,424
Panama	28.3	289	80	30	5	0	75	30	-355
Peru	-53.7	-661	-270	-170	20	10	-290	-180	-1,670
Philippines	217.7	2,885	1,300	900	45	30	1,255	870	-3,000
South Korea	535.0	7,280	3,375	2,400	540	285	2,835	2,115	-1,500
Sudan	21.2	380	225	190	35	20	190	170	1,165
Syria	-50.9	-640	-270	-175	30	15	-300	-190	-4,480
Thailand	211.7	2,915	1,370	985	155	80	1,215	905	-2,700
Tunisia	-53.0	-677	-290	-190	30	15	-320	-205	-570
Uruguay	35.0	482	230	165	25	15	205	150	-390
Zaire	-0.8	30	25	20	5	0	20	20	-283
Zambia	14.8	236	130	100	5	0	125	100	-600

Aside from these potential losses, we believe that the nonoil group would also have to absorb a reduction in exports to the oil exporters as retrenchment measures are put in place (table 7). We cannot evaluate with much precision how this would be sorted out among the LDCs. The losses, however, could be sizable. Using the simplifying assumption that OPEC as a group reduces imports by about half the revenue loss they face and that nonoil LDCs share proportionately in the cutback, nonoil LDCs' exports to the OPEC

group would decline by \$2-3 billion. Taken together—potential OPEC aid cutbacks, reductions in earnings from worker remittances, and reductions in exports to OPEC—we believe that these cutbacks would offset one-third to one-half of the \$16-17 billion saved in oil-import costs. We do not know how this offset would be distributed, but the North African, South and Southeast Asian, and West African countries would probably be most affected.

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Table 4
Non-Oil-Exporting LDCs:
Comparative GDP Growth Performance, 1982

Better than the group average	
Benin	Pakistan
Botswana	Senegal
Burma	Singapore
Cameroon	South Korea
Ethiopia	Sri Lanka
Hong Kong	Swaziland
India	Taiwan
Jordan	Thailand
Kenya	Uganda
Lesotho	Yemen Arab Republic
Mauritania	Yemen, People's Democratic Republic
Mauritius	Republic
Niger	Zimbabwe
Near the group average ^a	
Bahamas	Malawi
Brazil	Mali
Burundi	Morocco
Central African Republic	Nepal
Colombia	Papua New Guinea
Congo	Paraguay
Cyprus	Rwanda
Fiji	Suriname
Guinea	Tanzania
Ivory Coast	Upper Volta
Jamaica	Zaire
Madagascar	
Worse than the group average	
Angola	Haiti
Argentina	Honduras
Bangladesh	Lebanon
Barbados	Liberia
Bolivia	Mozambique
Chad	Namibia
Chile	Nicaragua
Comoros	Panama
Costa Rica	Philippines
Dominican Republic	Sierra Leone
El Salvador	Somalia
Gambia	Sudan
Ghana	Togo
Grenada	Uruguay
Guatemala	Zambia
Guyana	

^a Countries in this group are expected to come within 1 percentage point of the group's weighted average GDP growth of 2.4 percent.

The OECD Connection. Nonoil LDCs also would benefit from the stimulative effects an oil price decline would have on industrial-country economic growth. Assuming the OPEC current account deficit

Table 5
Selected LDCs: Changes in Credit Ratings ^a

Improving Terms (1982 spread at least 0.1 percentage point less than 1981 spread)	
Algeria	Peru
Colombia	Sri Lanka
Indonesia	
Stable Terms (1982 spread less than 0.1 percentage point different from 1981 spread)	
Bangladesh	Nigeria ^b
Brazil	Panama
Chile	Philippines
Ecuador	South Korea
India	Taiwan
Ivory Coast	Thailand
Malaysia	Trinidad and Tobago
Morocco	Venezuela
Stiffening Terms (1982 spread at least 0.1 percentage point greater than 1981 spread)	
Argentina	Papua New Guinea
Congo	Paraguay
Hong Kong	Uruguay
Jamaica	Zambia
Mexico	

^a Changes are determined according to the LDC's weighted-average spread for 1982 as opposed to 1981. Data as of June 1982.

Subsequently, several of these countries have experienced a substantial decline in their creditworthiness.

^b Because of substantial front-end fees.

is allowed to increase to roughly \$50 billion, OECD economic growth would be perhaps 1.5 to 2.0 percent above what it otherwise would have been. Additional LDC exports to the OECD under these conditions would be as much as \$10 billion.²

While these indirect effects of an oil price decline will help the LDCs, the benefits will materialize only with

² Our analysis of the impact of a decline in oil prices is based primarily on econometric simulations using the CIA's linked policy impact model of the world economy. We believe that this model provides a rough measure of the orders of magnitude involved and highlights possible country differences. We recognize that no model can gauge with precision the actual impacts.

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Table 6
Selected LDCs: Foreign Exchange Earnings
From Worker Remittances, 1980

	Gross Foreign Remittances (million US \$)	Origin
Bangladesh	300	Middle East
Egypt	2,695	Saudi Arabia, Iraq, Libya, Kuwait, Jordan
India	1,850	UAE, Oman, Kuwait, Qatar, Saudi Arabia
Jordan	790	Saudi Arabia, Kuwait, UAE, Libya
Pakistan	2,050	Saudi Arabia, Libya, UAE, Oman, Qatar
Philippines	725	Middle East
South Korea	540	Middle East
Sudan	200	Middle East
Syria	500	Middle East
Thailand	230	Middle East

a lag. Moreover, the impact will not be evenly distributed among this developing-country group. One reason for the lag is that it will take time for the positive effects of lower oil prices to work their way through the industrial economies, since most of the initial pick-up in economic activity will be concentrated in the consumer sector. Moreover, any gain from increased raw materials sales will take time to occur, in part because of the large inventory surplus for many LDC raw materials. In the case of copper, for example, stocks of non-Communist countries still amount to 1.5 million tons, [redacted] (table 8). This equals 15 to 20 percent of annual copper consumption by non-Communist countries [redacted]

We would, therefore, expect a delay of six months to a year in LDC export responses to stronger OECD growth. OECD demand for key LDC agricultural exports such as sugar are not sensitive to the business cycle in industrial countries, according to studies on the sugar market. Beyond this, the excess capacity available for most raw materials sold by LDCs would further dampen much of a price response. Some LDCs continued to expand their copper capacity long

Table 7
Financially Troubled Countries:
Share of OPEC Import Market, 1981

	Million US \$	Percent
Argentina	287	0.18
Bangladesh	72	0.05
Bolivia	31	0.02
Brazil	1,486	0.94
Chile	198	0.13
Costa Rica	15	0.01
Dominican Republic	95	0.06
India	914	0.58
Ivory Coast	114	0.07
Jamaica	13	0.01
Kenya	28	0.02
Morocco	152	0.10
Nicaragua	1	NEGL
Pakistan	715	0.45
Panama	12	0.01
Peru	101	0.06
Philippines	263	0.17
South Korea	2,678	1.70
Sudan	168	0.11
Syria	146	0.09
Thailand	762	0.48
Tunisia	145	0.09
Uruguay	132	0.08
Zaire	14	0.01
Zambia	15	0.01

after demand by non-Communist countries began declining. As a result, the capacity of these exporters is roughly 60 percent greater than current exports, according to industry data. A similar situation exists for bauxite and iron ore. As a result of these capacity surpluses, competition among producers will limit the speed of any price rises. [redacted]

This is not to say that the business cycle advantages to all nonoil LDCs will materialize slowly. If past business cycles are a guide, the LDCs providing

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Table 8
Selected Raw Materials: Current Market Status

*Thousand metric tons
except where noted*

	Non-Communist Countries' Consumption	Non-Communist Countries' Inventories	LDC Exports	LDC Capacity Utilization (percent)
Copper, refined	7,200 ^a	1,150	1,651 ^b	70 ^a
Bauxite	49,927 ^a	NA	NA	81 ^b
Alumina	20,950 ^a	NA	NA	73 ^a
Tin, refined	161 ^a	NA	155 ^b	70 ^b
Iron ore	614,500 ^c	NA	173,600 ^c	75 ^{b d}
Chromite	6,300 ^c	NA	NA	75 ^c

^a Annual rate based on data for the first half of 1982.

^b 1981 data.

^c 1980 data.

^d Brazil, India, Liberia, and Venezuela accounted for 81 percent of LDC production in 1980.

^e Estimate for 1981.

consumer-oriented manufactured goods will quickly capitalize on Western recovery. South Korea, Hong Kong, Taiwan, and Singapore—countries in relatively healthy financial positions—would be the chief beneficiaries. To some extent this pattern of demand for manufactured goods will also benefit Mexico and Brazil, so long as they have access to supplier credit.

For the bulk of the nonoil LDCs, however, the first year after a decline in oil prices could prove to be an uncertain period. Their borrowing requirements will remain high and their accumulated debt will continue to complicate their financial management. They will continue to need large foreign borrowing, at the same time financial markets will be trying to cope with the reverse oil price shock. The banking community is likely to focus on the risk of a major financial collapse in Mexico as well as other LDCs at the same time that they are trying to deal with the financial problems facing Eastern Europe. This situation will be further complicated by a rapid asset drawdown by OPEC states. In considering new loans, bankers will also have to factor in the relative merits of new credits to LDCs versus potential loans within their expanding domestic economies.

Industrial-Country Impact and Options

The LDC-OECD connections will be affected not only by finance and trade but also by the mix of government policies chosen by industrial countries in the aftermath of an oil-price decline. For the OECD an oil price drop would provide substantial leeway for fiscal and monetary policy adjustment. Domestic economic conditions would improve regardless of the policy direction chosen. Maintenance of current policies, as well as a decision favoring expansion, would enhance overall economic trends. Even a decision to become relatively more restrictive would yield economic gains in the eyes of the general public as long as the offsetting policies did not completely negate the stimulative effects of the price drop.

Measuring the Impact. As indicated earlier, a drop in oil prices to \$20 per barrel, assuming no offsetting policy action, would add 2 percentage points to OECD economic growth in 1983 and further increments in the following years. The economic impact of a price drop varies appreciably among individual countries depending in large part on the relative

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importance of imported oil in overall economic activity. Nevertheless, almost all of the short-run macroeconomic effects of lower oil prices are positive for the nonoil-exporting industrial countries: inflation would be less, unemployment lower, current accounts better, government budgetary positions improved, and interest rates lower. For oil-exporting OECD countries, however, the positive impact would be reduced by a loss of export earnings and reduced oil tax collections. On the positive side, Japan and Italy would be most benefited because both countries depend more heavily on imported fuel than the others. The price reduction would add an estimated 3.2 percentage points to Japanese growth and 2.3 percentage points to Italian growth in 1983. In West Germany and France, the gain would be about 1.5 percentage points. [redacted]

Through its impact on real economic growth, the decline in oil prices would improve the budgetary positions of some central governments by helping to reduce their outlays on unemployment insurance and by increasing public revenues. In the United Kingdom, Norway, and Canada, however, budget positions would actually worsen; the revenue increase stemming from higher personal and corporate income tax collections would be offset by lower royalty payments and other oil taxes. London estimates that for each \$1 per barrel decline in oil prices, budget revenues fall by \$360 million. [redacted]

On the inflation front, we estimate that if oil fell to \$20 per barrel the overall OECD inflation rate would slow by almost 2 percentage points the first year. Lower oil prices reduce inflation not only directly but also indirectly by lowering prices of other goods. In particular, crude oil price movements affect the price of most other forms of energy. For the Big Seven as a whole, roughly two-thirds of energy prices move with the price of foreign oil. Even the price of West German imports of Soviet gas would be affected by an OPEC price decline since the contract stipulates that the selling price will reflect changes in the price of heating oil in West Germany. Taking these factors into account, a \$1 per barrel reduction in the price of crude petroleum could lower the OECD's final energy costs by roughly \$21 billion if the price cut is passed through. [redacted]

A drop in the price of oil would have other far-reaching price effects as well. The price of all products using petroleum or petroleum byproducts as a feedstock would be lowered, and the prices of most goods would be affected by a decline in the cost of fuels used in production and transportation. Moreover, the slowdown in inflation stemming from the oil price decline should reduce future wage demands and, hence, the price of goods in general. This would be particularly true in countries such as Belgium, France, and Italy where most wage rates are indexed to inflation. [redacted]

Although the smaller OECD countries, on balance, would benefit from the weakening in oil prices, the Netherlands and Norway would both be hurt. Since Dutch gas prices are linked to the price of oil, a \$4 per barrel reduction would lower its gas revenues by an estimated \$1 billion; if oil prices were to plummet to \$20 a barrel, the Netherlands would lose \$3.5 billion in revenues. Norway, which is currently producing almost 600 thousand b/d of oil, would likewise find its payments position eroded by an oil price reduction; more than 40 percent of Norway's exports are oil and gas. [redacted]

Policy Alternatives. Despite the beneficial economic effects of declining crude oil prices, a number of governments might try to prevent oil prices from falling too sharply because of an overriding desire to maintain pressure for energy conservation and fuel substitution. A number of West European countries can easily counter international oil price trends since oil prices are administered by the government:

- *Rome*, for example, has already limited the drop in the domestic price of oil products; in March the formula governing oil-product price changes indicated that a price decline was merited but no adjustment was made. The additional government revenue accruing from this action has been earmarked for Italy's financially troubled electric utility. We believe Rome thinks it must keep prices high to maintain momentum for the recently approved national Energy Program—a 10-year, \$80 billion plan to reduce oil's share in Italy's energy mix to 50 percent by 1990.

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- *Paris* also has expressed concern that previous gains in limiting dependence on foreign oil could be reversed if oil prices dropped precipitously. The French would probably react to such a situation by imposing higher taxes on refiners. In adjusting prices and taxes, however, Paris would have to assure refiners (whose profit margins have been compressed in recent years) sufficient profits to enable them to modernize their capacity to handle the accelerating shift toward lighter products. The magnitude of the stimulus Paris will allow will depend, in part, on the policies adopted by France's major trading partners.
 - In *Ottawa*, the Trudeau government probably would try to keep prices from falling too far in order to protect the domestic oil industry. One goal of Canada's National Energy Program (NEP) is to make Canada self-sufficient by the end of the decade. To encourage exploration and development, the NEP pegs domestic oil prices to not more than 85 percent of world oil prices. Ottawa is now considering letting prices rise above world levels because of the severe impact of the unexpected fall in world prices. Canada's big energy projects—development of the Beaufort Sea and East Coast offshore deposits and expansion of synthetic and heavy-oil facilities—are not viable at lower oil prices.
 - Facing a large budget deficit and still dependent on oil for almost 70 percent of its energy needs, *Tokyo* probably would increase its petroleum tax to limit the size of an oil price decline. Recent declines in the world price for oil have not been felt in Japan because the depreciation of the yen has more than offset the fall in dollar prices. Refiners have actually been pressing the government for price increases. In the event of a drop in imported oil prices in yen terms, Tokyo almost certainly would raise taxes on oil to help maintain its conservation effort and to reduce the budget deficit that now amounts to about one-third of central government spending. Also, additional revenues would go to increased spending on energy R&D since a portion of the petroleum tax is earmarked for that purpose.
 - While a fall in world oil prices would reduce *London's* budget revenues and set back British efforts to maintain oil self-sufficiency, London is unlikely to artificially hold up prices. London is presently trying to stimulate oil exploration by modifying its restrictive tax stance. These moves, however, would be fruitless if world oil prices dropped significantly because profits on North Sea oil would plummet, forcing many companies to curtail exploration and development expenditures. London has little choice but to accept the going world price for oil. As marginal suppliers to the world market, North Sea producers have little influence on world prices. Attempts to fully offset declining oil prices at the retail level are unlikely because after a number of years of continuous economic decline we believe such a move is politically untenable.
 - *Bonn* also is not likely to take steps to counteract a decline in domestic energy prices even though the decline probably would undermine incentives for energy saving. An oil tax increase probably is out of the question because of other controversial tax increases proposed by the Kohl government. Moreover, the government is satisfied with the progress it is making in reducing the share of oil in total energy consumption.
- Net Policy Impact.** If, on balance, the industrial countries decide to limit the drop in domestic oil prices or use the breathing room to reduce budget deficits and inflation even further, the indirect benefits of an oil price decline to the LDCs would be reduced. A relatively restrictive fiscal-monetary mix would also run the risk of being interpreted by the financial community as a signal to limit lending to the nonoil LDCs. This would only magnify the problem. A restrictive policy response coupled with reduced access to funds would mean that LDC export potential and repayment capability would be less. This would encourage bankers to retrench even further.

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Table 9
USSR: Selected Trade in Crude
Petroleum and Petroleum Products

Thousand b/d

	1980	1981
Gross exports	3,266	3,261
Soft currency countries	2,291	2,341
Communist countries	1,978	2,020
Eastern Europe	1,600	1,620
East Germany	380	380
Czechoslovakia	384	384
Poland	320	320
Bulgaria	300	300
Hungary	186	186
Romania	30	50
Other ^a	378	400
Non-Communist countries	313	321
Hard currency countries	975	920
OECD countries	942	869
Of which:		
France	168	162
Netherlands	145	161
Italy	138	134
West Germany	138	100
Switzerland	53	52
LDCs	33	51
Gross imports	78	98
Hard currency purchases	78	58
Iraq	26	0
Libya	40	40
Venezuela ^b	12	10
Other	0	8
Soft currency purchases from Iran	0	40
Net exports	3,188	3,163
Hard currency countries	897	862

^a Including Yugoslavia, which is not a member of the Warsaw Pact.

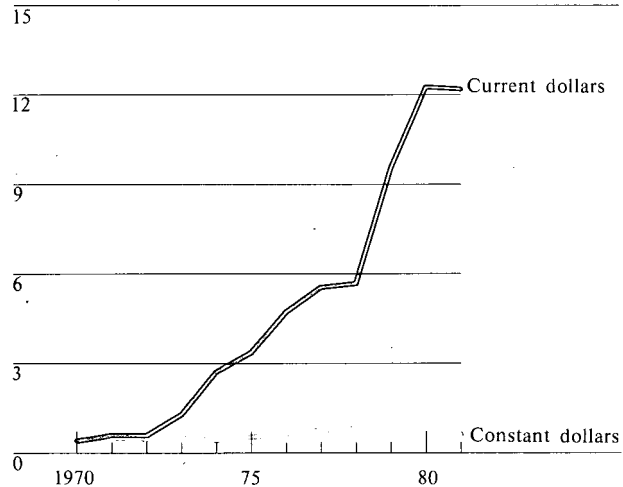
^b Oil swap for delivery to Cuba.

The Soviet Connection

The impact of lower oil prices will affect the Soviets as well. For instance, an oil price decline would cause major hard currency losses since oil exports to the West approximate 1 million b/d and earn the Soviets an estimated \$13 billion, more than one-third of total

Figure 2
USSR: Petroleum Exports to Hard
Currency Countries

Billion US \$



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hard currency revenues (table 9 and figure 2). If oil prices declined to \$20 per barrel, Moscow would experience a \$6 billion decline in these earnings—an amount equal to 20 percent of current annual imports from the West. We do not believe that this loss could be made up through conservation of oil or by cutbacks in deliveries to Eastern Europe to free up additional oil supplies for hard currency sales. The Soviets would also probably lose at least some arms sales opportunities in the oil-exporting countries as they cut back military purchases. We cannot assess the magnitude of this loss, but the amounts could be sizable. Major Soviet arms buyers include Libya, Iraq, Iran, and Syria.

Gas earnings would also decline since gas export prices in the West European market are closely linked to oil prices. The losses on this score with oil priced at \$20 per barrel would be in the \$1.5-2.0 billion range

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in 1983. Total hard currency losses on energy exports, therefore, would reach \$8 billion. An oil price decline would affect East-West trade in natural gas. Lower oil prices, for example, could reduce the amount of gas purchased from the USSR by making oil more attractive to West Europeans. On the other hand, the oil price drop could work to Moscow's advantage in the future. Specifically, the price drop would all but eliminate the prospects for developing alternative gas supply systems to Western Europe by reducing their earning potentials. This, in turn, would leave the Soviets in a position to supply as much as 150 billion cubic meters of gas to Western Europe in the 1990s.

While the Soviets would bear a large direct financial loss from an oil price decline, they may also be presented with some new political opportunities. Any oil-related instability in Third World countries, for example, could provide Moscow and its surrogates with opportunities for meddling that might not otherwise develop. If the repercussions of lower oil prices are not managed properly and instability in key Third World countries increases, one advantage Moscow would have is that Western governments would be forced to focus their attention on the international financial scene.

Some Longer Run Concerns

Even if the global economy gets through the first year of an oil price drop smoothly, there is still a risk that the entire process could reverse itself if there were a major disruption in the Middle East oil flow. A key concern is the relative political, military, and economic position of Iran. As it is, Saudi Arabia and the other Arab Gulf states are deeply worried about the prospect of an Iranian victory over Iraq as well as about Iranian military intentions. With an oil price drop the conservative states may not be able to finance Saddam's war efforts.

A military victory over Iraq would reaffirm the faith of Iranian leaders in the validity of their revolution and add impetus to their drive for regional hegemony. The Gulf states know their forces are no match for Iran's and that their oil facilities are extremely vulnerable to Iranian attack (figure 3). Even with AWACS aircraft, for example, the Saudis could not counter a surprise Iranian airstrike on Saudi oil

installations because time and distances are simply too short. Iran's operational fighter-bombers—about 100—could strike anywhere in the Gulf in a matter of minutes from their bases in Bushehr, Bandar Abbas, and Shiraz. Because of this, the Gulf regimes, which are currently under internal pressure to put distance between themselves and the United States, probably would reverse themselves and seek a more formal security relationship with the United States.

Subversion: The More Likely Threat. Even in the absence of direct military action, Iranian subversion is likely.

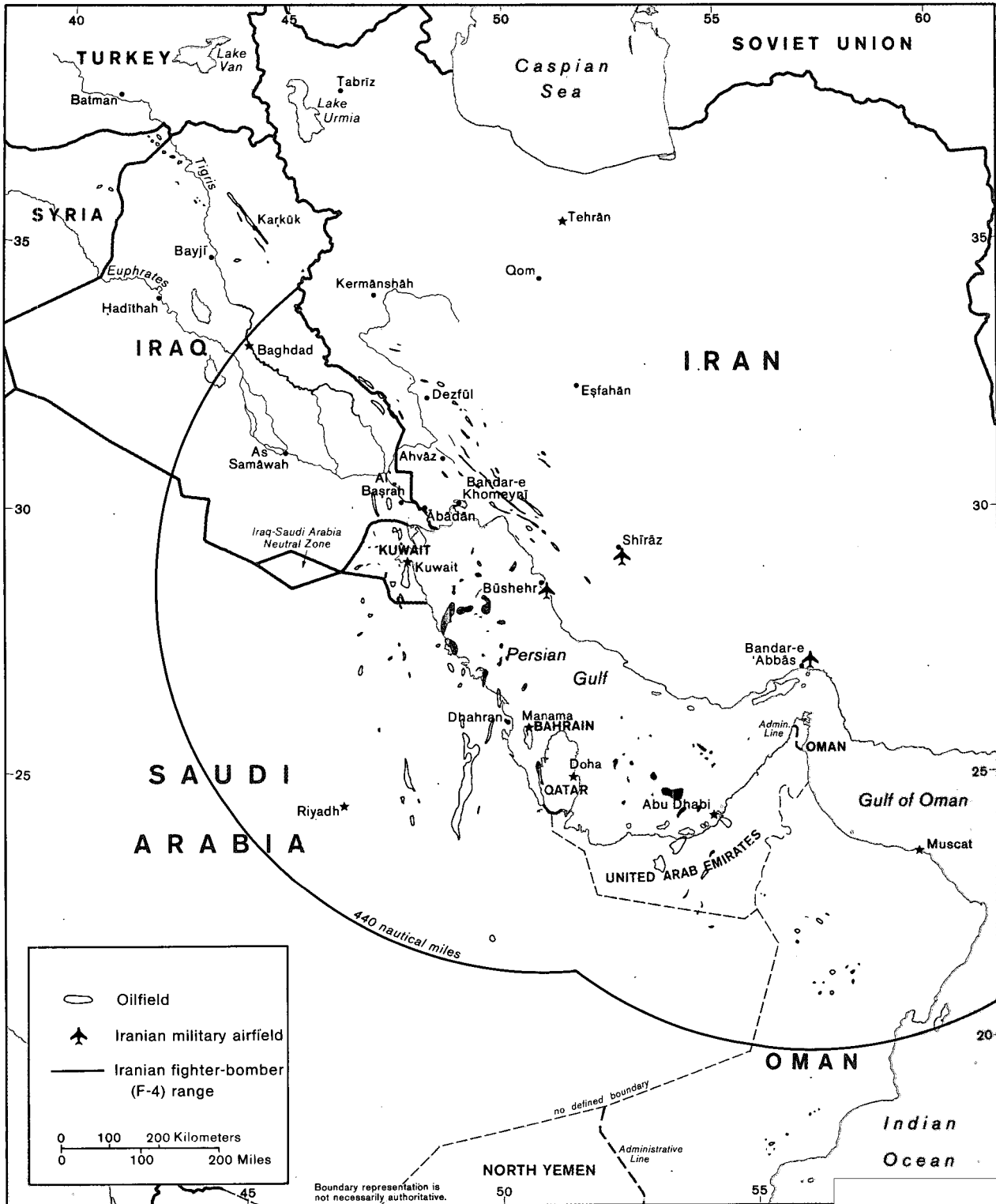
Iran already is encouraging dissident Gulf Shias (figure 4):

- **Bahrain.** One of the poorest Gulf states, Bahrain is the most vulnerable to Iranian-inspired subversion. The Sunni Khalifa family has traditionally relied on repression and co-optation of members of the island's leading Sunni and Shia merchant families to maintain itself in power. In recent years these methods have become less effective in dealing with discontent among Bahrain's 140,000 Shias, who make up 65 percent of the native population but occupy the bottom rungs of the social and economic ladder. Shias increasingly resent the dominance of the largely Sunni ruling elite.
- **Saudi Arabia.** Strong resentment over discrimination and neglect among many young Saudi Shias makes them susceptible to Iranian propaganda. Iranian agitation, for example, provoked demonstrations in several Shia townships on Ashura—a Shia holy day—in November 1979 that left 60 Shias dead and scores wounded, and again in Qatif oasis a few months later. At least some young Saudi Shias subsequently joined the Islamic Front for the Liberation of the Arabian Peninsula, which is based in Tehran, and 13 Saudis participated in the Bahrain coup plot. Because the Shia population is heavily concentrated in the Eastern Province where the oilfields are and makes up almost a third of ARAMCO's work force, Shia dissidents pose a potential threat to the oil facilities. An Iranian victory over Iraq could stir latent discontent.

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**Figure 3
Persian Gulf Oilfields Vulnerable to Iranian Airstrike**



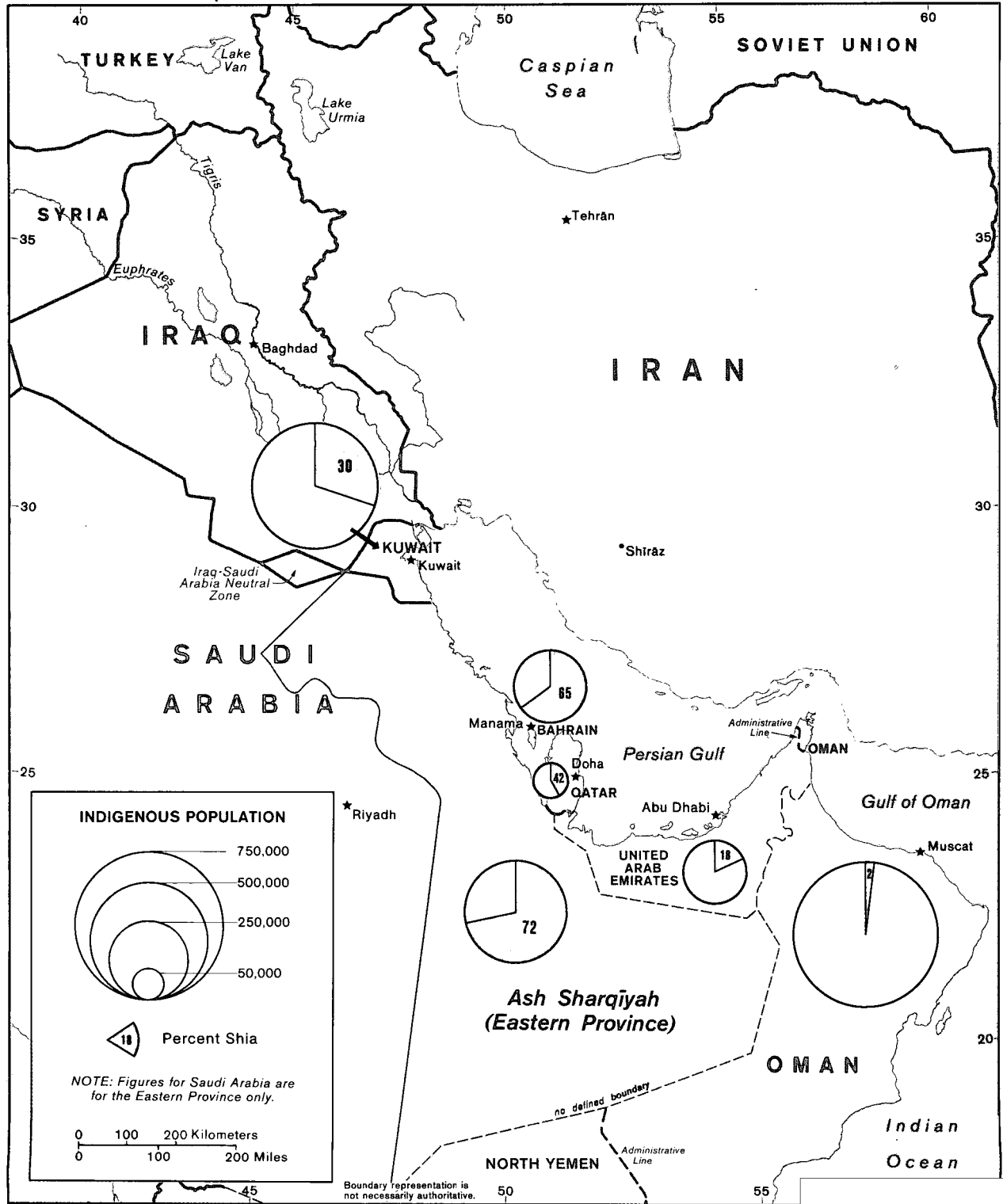
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Figure 4
Shia Muslims in the Western Persian Gulf Region



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Boundary representation is not necessarily authoritative.

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- *Qatar.* Qatar's 25,000 Shias are strong supporters of the Iranian revolution and deeply resent the dominance of the Sunni al Thani family, which runs the tiny shaykhdom like a private estate. A few Qatari Shias have received terrorist training in Iran, but there are no known Shia dissident groups in the shaykhdom.
- *UAE.* Shias in the United Arab Emirates are too few to pose a significant threat. The Emirates' 30,000 Shias, concentrated mainly in Dubai and Sharjah, seem more interested in making money than in engaging in politics. We know of no organized Shia dissident groups in the UAE or of any UAE Shias who have undergone terrorist training in Iran. Some Shias, however, have provided safehaven for Shia dissidents from elsewhere in the Gulf and could provide support for terrorist or other subversive activities.
- *Kuwait.* The primary risk in Kuwait is the large number of Palestinians who reside there. In the past the Kuwaitis have managed essentially to buy off this group both directly and through aid to frontline states. While the Kuwaitis should be able to keep things on an even keel internally, their ability to supply large-scale aid would erode. [redacted]

If Saudi Arabia or a number of the smaller Persian Gulf producers were destabilized, the entire complexion of the Gulf market could change. The loss of even half of the 11 million b/d that currently pass through the Strait of Hormuz would quickly drive oil prices back up. [redacted]

Other Strategic Concerns

While a drop in oil prices will create economic opportunities if all goes well, the chance of unfavorable shifts in strategic balances cannot be overlooked. The Persian Gulf is not the only area of concern. Forces will be set in motion elsewhere. While their exact impact will depend on how an oil price drop plays itself out, there are certain political and economic shifts that need to be considered even under the best of circumstances (table 10). [redacted]

³ Reference map at end of paper depicts choke points. [redacted]

Asian Subcontinent. An oil price drop would have pronounced implications for the economic and strategic balance on the subcontinent. Pakistan in particular would risk worsening its economic position because of its heavy reliance on Saudi aid as well as remittances from Pakistanis working in the Gulf (figure 5). Remittances from the 1.5 million Pakistani workers in the Middle East are important to the country's economic well-being and domestic political stability. Indeed, according to Pakistani academic researchers, approximately 12 percent of all Pakistani households benefit directly from the employment of a family member in the Middle East. In addition, 8,000 Pakistani military personnel serve in Saudi Arabia in noncombat, defense-related positions. [redacted]

According to government reports, monetary remittances have increased from \$130 million in FY 1973 to a projected \$2.4 billion in FY 1983, which ends next June. [redacted]

[redacted] unreported cash remittances and consumer items brought in by returning workers boost this figure to the \$3-4 billion range—equal to 85 percent of the value of exports. In the absence of these remittances, we believe that Pakistan would have had to sharply curtail its imports and search for additional external assistance to meet its foreign exchange needs. As it is, Pakistan's medium- and long-term debt exceeds \$10 billion. [redacted]

Foreign exchange losses associated with any Saudi retrenchment could result in internal pressures on General Zia to alter policies. From his perspective, the economic and political balance would be shifted in favor of India, which would see its oil import bill fall sharply. Although India would also experience a reduction in worker remittances from the Gulf and export reductions, on balance it fares better than Pakistan. With economic, political, and financial pressures growing Zia may feel compelled to push ahead on his nuclear program, viewing it as a mechanism to maintain the regional balance. He may take this position even if the United States is regarded as a reliable ally. [redacted]

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Table 10
Regional Distribution of World Trade, 1980 ^a

Percent

Imports From	Exports To:							
	United States	Non-US OECD	Central America	South America	Middle East	North Africa	Central Africa	South Asia
United States ^b	0	61	10	8	7	1	2	9
Non-US OECD	13	65	1	2	7	2	3	6
Central America	58	27	8	3	2	NEGL	NEGL	NEGL
South America	25	44	3	17	3	1	2	2
Middle East	11	64	NEGL	5	5	1	1	10
North Africa	41	55	NEGL	1	1	NEGL	NEGL	1
Central and South Africa	33	57	NEGL	2	1	NEGL	3	1
Asia	20	44	2	1	6	NEGL	2	21

^a Excluding trade of Communist countries.

^b Because of rounding and the exclusion of certain countries, rows will not sum to 100.

Zia may also reassess Pakistani policies toward the Afghan refugee issue. Under the best of circumstances we expect that the Afghan refugees will present a problem of increasing complexity and a growing threat to Pakistan's internal stability throughout the 1980s. We believe that the sheer size of the refugee population—the largest in the world—will strain the government's ability to accommodate the refugees, as well as its ability to limit their threat to political stability. The Census Bureau projects that the refugee population will reach 2.7 million by 1985 and 3.2 million by 1990, assuming that no additional refugees will arrive or be repatriated after 1982. If the flow of Saudi funds were reduced, we would expect Zia to move to limit the size of the refugee population and reassess Pakistani policy on Afghanistan. [redacted]

Sub-Saharan Africa. The West African balance could be substantially influenced by the aftereffects of an oil price decline on key players in the area. A major concern, of course, would be the internal political stability of Nigeria. Beyond this, however, the area has been a focal point for the tug-of-war between Libya and Saudi Arabia. Both the Saudis and Libyans have been involved in the West African

Islamic revival, primarily in support of its fundamentalist aspects. The Saudis support Islamic groups that are politically conservative but fundamentalist in that they seek strict adherence to Islamic law and custom. The Libyans, by contrast, fund radical fundamentalist groups whose political objectives are primarily to promote regional political destabilization. Thus far, the Saudis have had the paramount foreign role in the revival. Saudi influence, however, is extended by millions of dollars each year in financial support. If this flow is reduced or eliminated, it would leave Qadhafi with the upper hand. [redacted]

If the Libyans have a free hand, it would almost certainly result in increased political activity by radical Islamic groups, which could affect not only local political stability but also US relations with West Africa. Although a government with Muslim leadership does not necessarily dictate Islamic policies to its people, those states with predominantly Muslim populations will find it increasingly difficult to resist pressures for a greater variety of Islamic projects and

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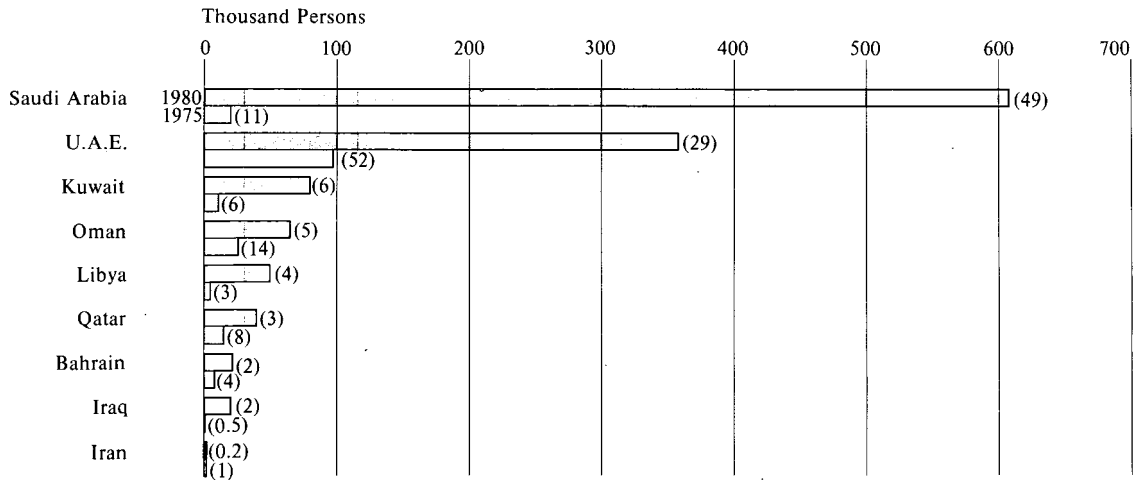
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Figure 5
Pakistan: Emigrant Workers in the Middle East in 1975 and 1980^a

(Percent of Total)



^a Estimates for 1975 are based largely on official Middle East government figures. Estimates for 1980 are based on World Bank funded research conducted in Pakistan and for some countries are higher than those reported by Middle East governments.

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institutions, such as a national Islamic court—argument over which almost disrupted Nigeria's transition to civilian rule in 1979—and state-supported Muslim schools. Yielding to such pressures, however, risks reopening longstanding ethnic and religious jealousies and provoking political violence.

Although Islamic regimes are not necessarily anti-Western, we believe the emergence of a strong, regional fundamentalist Islamic movement—whether politically conservative or radical—could also have important implications for relations with the United States. For example, in Nigeria, where the movement is strongest, we project that the growing influence of religiously conservative Islam over the long run is likely to incline a Muslim-dominated government to pursue policies that are less friendly to the West. At the same time, we expect that some of today's militant Islamic groups will eventually succeed in placing in positions of political influence members with pronounced anti-Western prejudices. These biases could

complicate the degree of support Washington receives from Nigeria and African governments in international forums and for US initiatives on regional and wider African issues.

East Africa may also be affected by external feedback of an oil price decline. If the international transition to lower prices is handled poorly the costs in this financially troubled area could be significant. Since the mid-1970s, East African governments have come under unprecedented stress over the handling of their economies. The entire region is in dire need of money, basic foodstuffs, and producer supplies. This has caused discontent and unrest that, in turn, has given the Soviets, Cubans, and Libyans ample opportunity for meddling at relatively little cost.

The most obvious tinderbox is the Horn (figure 6). The armed insurrection by separatists in Eritrea and Tigre, the hostilities in the Ogaden, and drought have

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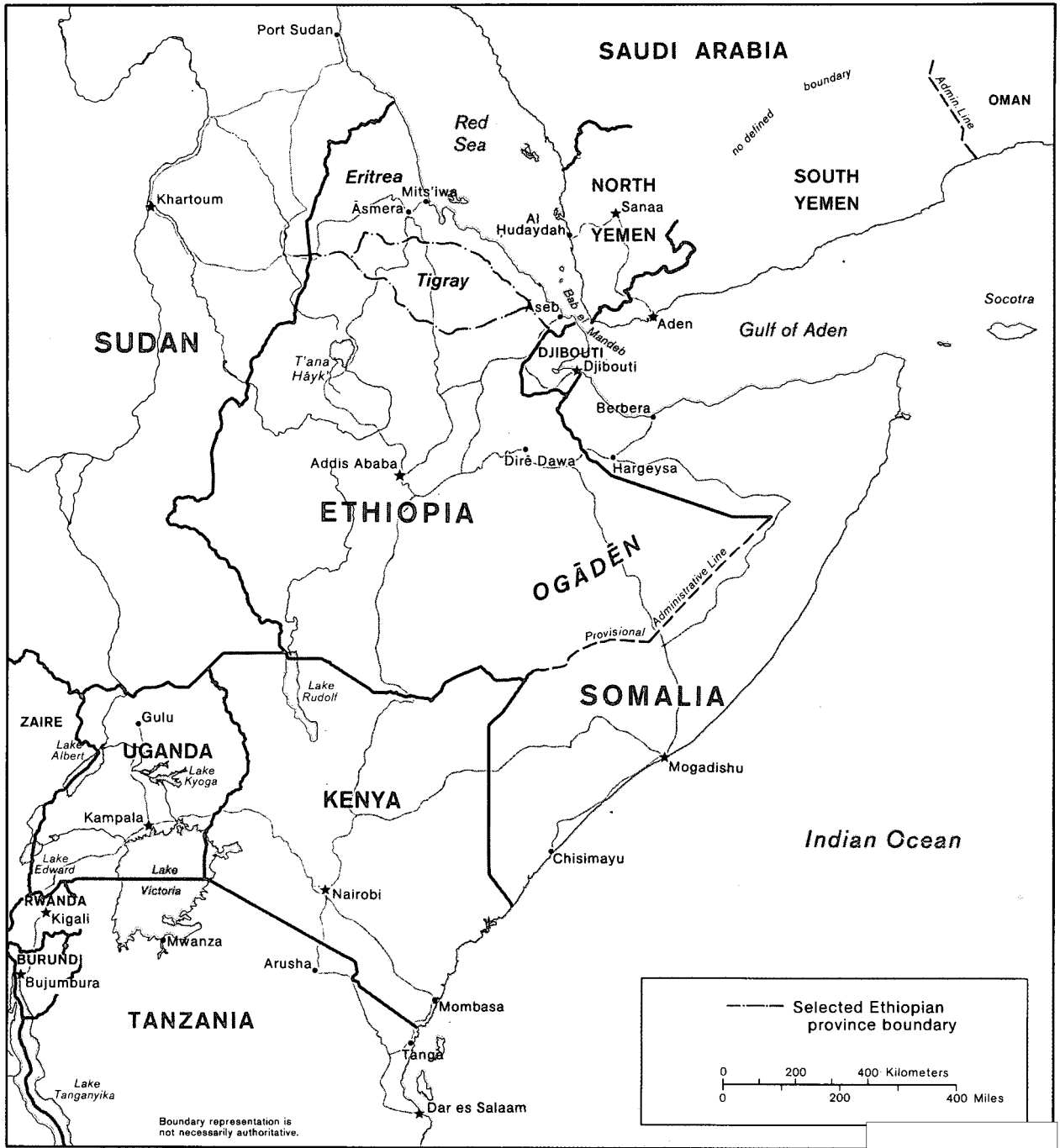
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Figure 6
Horn of Africa



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compounded the chaos that ensued from the sweeping socialist restructuring of the Ethiopian and Somali economies during the 1970s. The area south of the Horn may be even more volatile:

- *Kenya*, once one of Africa's star economic performers, has witnessed a steady decline in its economy. Population growth of 4 percent annually—one of the world's highest—threatens to overwhelm the country's fragile rural-urban balance.
- *Uganda*, devastated by the excesses of the Idi Amin regime, is recovering but still on tenterhooks as President Obote fumbles with bringing the internal security situation under control.
- *Tanzania*, where disillusionment with President Nyerere's socialist experiment is rife, is at loggerheads with the IMF over corrective strategies. [redacted]

Over the next few years, the outlook for political stability and economic recovery throughout East Africa is grim. The area is important both because of its proximity to the Red Sea choke point at Bab el Mandeb—the southern entrance to the Suez Canal—and its access to the Indian Ocean. [redacted]

Southeast Asia. Indonesia, Malaysia, and Singapore are in the early stages of a major defense buildup that will improve their capability to defend the Straits of Malacca (figure 7). The buildup—spurred by the Soviet presence in Vietnam and, for Indonesia and Malaysia, the perception of a longer term threat by China—is intended to improve surveillance and defense capabilities over these straits and their eastern approach, the South China Sea. Total defense spending this year by the three is budgeted at more than 70 percent above the 1979 level. Current financial problems, especially in Indonesia, however, could stretch out implementation of plans for the buildup. If oil prices decline sharply, we believe Jakarta will look abroad for additional assistance and concessionary financing for future military purchases [redacted]

Malaysia's program would also be at risk. The tightening economic situation has already affected the Malaysian defense budget. Prime Minister Mahathir

has indicated to Malaysian defense officials that military spending goals for 1981-85 will not be met. DIA reported in September that there were indications that this fiscal year's defense budget might be reduced as much as 20 percent and that cuts in the next fiscal year may be even greater. In an environment of oil price cuts we would expect Malaysia to implement even steeper defense program reductions.

Central America and the Caribbean. This region is highly vulnerable to the negative feedback effects of an oil price shock. Real economic growth in the Caribbean region fell to 2.5 percent last year, compared to nearly 4 percent in 1977. Central America did even worse, real growth fell from 6.6 percent to a negative 1 percent during the same period. The Caribbean's current account deficit ballooned from about \$200 million in 1977 to an estimated \$1.3 billion in 1981 (excluding the French Overseas Departments of French Guiana, Guadeloupe, and Martinique), while the deficit of Central America deteriorated from \$680 million to \$2.4 billion. Increased borrowing to help finance the worsening current account deficits pushed the regions medium- and long-term external debt from \$8 billion to \$15 billion during the 1977-81 period. In this environment, access to bank lending is crucial. If the oil price decline impairs bank lending to the region, the impact on their fragile economic and political systems would be serious. The region also stands to lose access to some OPEC aid—which totaled \$75 million between 1975 and 1980—mostly from Venezuela. Another downside risk is the loss of potential export markets to Mexico and Venezuela as they retrench (table 11). They may also lose sales to Brazil if the financing problem turns against Brasilia for whatever reason. To the extent that these countries face new political and economic stress, the opportunities for Cuban mischief would increase.

Final Note

This paper has explored the implications of an oil price decline. We have looked at two price scenarios; it is conceivable that the price decline, should it occur,

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Figure 7
Sea Routes Through the Malacca and Singapore Straits



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Table 11
Importance of Trade With Major
Countries of the Region, 1980

Percent

	Share of Exports To:			
	Argentina	Brazil	Mexico	Venezuela
Central America				
Belize	0	0	1.8	0
Costa Rica	0.2	0.3	0.1	0.2
El Salvador	0	NEGL	0.1	0
Guatemala	NEGL	0.1	1.5	0.1
Honduras	NEGL	0.1	0.4	0.4
Nicaragua	NEGL	0	NEGL	0
Panama	0.9	NEGL	NEGL	1.4
Caribbean				
Bahamas	NEGL	1.3	0.2	0
Barbados	0	NEGL	0	0.2
Dominican Republic	0	0	0	8.7
French Guiana	0	1.2	0	6.0
Grenada	0.5	0	0	0
Guadeloupe	0	0	0	0.1
Guyana	0.4	0.7	1.3	0
Haiti	0	NEGL	NEGL	0
Jamaica	NEGL	0	NEGL	1.4
Netherlands Antilles	0.2	1.8	0.3	2.1
Suriname	0	2.7	0	0
Trinidad and Tobago	0.2	0.4	0	0.1

could go well beyond what we have assumed. The steeper the decline the more complex the oil price shock will be to manage. Beyond this, it should be noted that a shortfall in the price of oil will greatly increase uncertainty about the future oil price. In the past several years there has been a consensus in the market that the real price of oil would vary gradually, perhaps slowly upward, perhaps downward. [redacted]

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The uncertainty caused by a downward price shock will create more perceived risk in the market place. It will affect exploration and production decisions of oil companies and the investment decisions of oil-using consumers. Many firms and individuals may respond by deferring major oil-related investments until price uncertainty reduces. This price uncertainty will also be used as an argument for governments of oil-importing countries to act to stabilize the internal price of oil. [redacted]

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Appendix A

Oil Price Decline: OPEC Country Impacts [redacted]

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Nigeria, Indonesia, and Venezuela: Serious Trouble
Nigeria, Indonesia, and Venezuela will be running into increasingly serious financial constraints next year even if oil prices hold steady. If they decline, these countries would have no alternative to extremely tight economic austerity designed to bring their import bill more in line with their earnings and ability to pay. We do not believe that the international banking community would be willing to increase its exposure in these countries much, if at all; this resistance might hold even if severe austerity measures were taken since there would probably be substantial banker concern about the domestic political consequences of economic retrenchment. This is particularly so in the case of Nigeria and, to a lesser extent, Indonesia; how Venezuela's political system would hold up is not certain. [redacted]

Drawing on discussions we have had with bankers and others familiar with these three countries, we do not believe that they have much of a financial cushion to fall back on (table A-1):

- *Nigeria* is already in serious trouble with creditors; foreign exchange reserves are low, borrowing capacity limited, and arrearages are growing. According to Embassy reporting, Lagos has drawn its international reserves down to between \$1 billion and \$1.5 billion—equal to only a month's imports. The same reporting indicates that Lagos had amassed \$2 billion in short-term commercial arrearages by the end of August. These developments have forced the government into more austerity than it wants; an oil price decline would put the present government's staying power in serious question, in our view. Oil presently generates over 95 percent of foreign exchange earnings and 85 percent of total government revenues.
- *Indonesia* is financially better off than Nigeria but Jakarta would have to cut development spending drastically. The technocrats that influence Indonesian economic and financial planning apparently

misread the oil market and have consequently moved slower than they probably should have to dampen government spending. They did use the visit in October of World Bank officials to brief President Soeharto on the worsening economic situation. In these circumstances an adjustment to an oil price decline would be particularly severe. As it is, we believe Jakarta is financing the 1982 deficit through a combination of drawing down reserves and borrowing abroad; indeed, Jakarta has drawn down its official reserves by more than \$3 billion from the \$7.4 billion peak of October 1981. Bank of Indonesia Governor Saleh told reporters in early November that official reserves had fallen to \$4.3 billion by the end of October 1982.

- *Venezuela* would be unable to pursue its domestic economic development program and would have to cut sensitive social programs in the event of a sharp oil price decline. Caracas might be able to limit spending cutbacks; at oil prices of \$20 per barrel, however, the options would be limited because its external creditworthiness has fallen. Venezuela has already been attempting to restructure half of its \$19 billion public debt to a longer term maturity. The Falklands conflict and four years of economic stagnation have made some creditors leery of Venezuela. [redacted]

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[redacted] A price decline in our view could force a quick debt rescheduling as well as internal political problems for the government. [redacted]

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Libya, Iran, and Algeria: Some Flexibility

With tighter central government control over their economic and political system, Libya and Iran probably have more flexibility in dealing with a sharp oil price decline than many of the others. Moreover,

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Table A-1

Billion US \$

Selected Oil Exporting LDCs:
International Reserve Positions

	Official Foreign Assets, Yearend 1981	Estimated Imports 1982	Oil Revenue Decline ^a	
			US \$20/b	US \$25/b
Algeria	6	12.0	3.2	1.5
Ecuador	1	2.3	1.0	0.9
Gabon	NEGL	0.9	0.4	0.1
Indonesia	6	19.2	6.0	5.2
Iran	10	10.6	7.5	4.4
Iraq	21	20.7	3.3	2.5
Kuwait	67	8.8	2.9	1.5
Libya	12	15.5	4.4	1.1
Nigeria	4	16.0	4.7	2.6
Qatar	13	1.4	0.8	0.1
Saudi Arabia	144	40.0	17.3	6.0
United Arab Emirates	33	9.2	3.4	0.9
Venezuela	14	13.4	6.3	3.9
Mexico	5.9	15.0	5.4	2.7
Egypt	1.5	9.8	1.8	1.1
Malaysia	3.4	1.1	1.0	0.5
Oman	1.4	2.5	1.2	0.6
Trinidad and Tobago	3.3	1.8	0.9	0.6

^a Based on real OECD growth of 2 percent in 1983.

because of import reductions already in train, Libya and Iran would have less need for import cuts than most other OPEC members:

- *Libya* would lose about \$5 billion from an oil price decline. [redacted]

[redacted] The Qadhafi regime has already implemented a series of austerity measures to slow the foreign exchange drain. The retrenchment may be adding to existing disaffection generated by unpopular measures enacted last year. In our view, however, Qadhafi has the wherewithal to keep the domestic situation in firm control. In any event, given Qadhafi's ties to Moscow, he will remain in a position to work with the Soviets if oil-related opportunities for political gain arise in Africa.

- *Iran* is in a better position than most to absorb an oil price decline; one reason is that import levels remain quite low because of continued clerical interference with the management of the economy and because of the limited development objectives of the Khomeini government. We expect Tehran to run a \$4.5 billion current account surplus this year; consequently, Iran could probably handle the revenue losses associated with an oil price decline without much additional austerity. From a financial standpoint, Iran remains fairly healthy. By the end of 1982 Iran's liquid foreign exchange reserves should amount to \$6 billion or more. [redacted]

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[redacted] Iran's foreign exchange position has improved. The governor of the Iranian Central Bank recently said that Iranian foreign exchange reserves were on "a steady trend upward."

- *Algeria* has already taken economic austerity measures to minimize recent cash flow problems and avoid a sharp deterioration in the current account this year. Algeria has slowed import growth, dipped into foreign exchange reserves, and postponed investment spending. Unless the domestic economy remains carefully managed, however, Algeria would run into trouble if oil prices fall. It now has the largest foreign debt of any Arab country, totaling \$18 billion at the end of 1980, according to the latest IMF estimates. Even though Algeria sharply reduced new foreign borrowing in 1980 and 1981, debt service payments have continued to climb because of principal payments coming due from earlier loans and high interest rates. As of October foreign exchange reserves (excluding gold) declined to \$2.6 billion—approximately three months' worth of imports. [redacted]

The Iraqi Case

Iraq is now surviving only on the strength of some \$20 billion in aid from other Persian Gulf Arab countries, primarily Saudi Arabia. Even so, we estimate that Baghdad has had to draw down official foreign assets by an estimated \$25 billion since the end of 1980; these reserves currently stand at about \$5-6 billion. To limit the financial drain, Baghdad is now curtailing some of its development program. The problem is that much of Saddam's popular support has hinged on his ability to insulate the consumer from the war. Even if other Gulf Arab countries maintain previous levels of financial support, Baghdad would have to reduce imports by about one-fifth in order to limit the 1983 current account deficit to the roughly \$20 billion we are projecting for 1982. We do not believe this could be accomplished without major domestic political ramifications. [redacted]

Saudi Arabia

Saudi Arabia has a wide range of options, thanks to its massive foreign asset position. If Riyadh attempted to maintain current development spending patterns,

the current account deficit would swell to about \$25 billion. Financing these, together with other foreign exchange commitments, including aid to other Arab and non-Arab countries, would require a \$28 billion asset drawdown. We do not believe the Saudis would do this. [redacted]

Development spending is already being curtailed. We believe that spending cuts would have to be carefully managed or the government would run the serious risk of sparking dangerous internal political dissension. One area we believe the Saudis would cut is the ARAMCO crude oil development program. [redacted]

[redacted] We believe that the additional cuts, if undertaken, would result in as much as a 1 million b/d erosion in Saudi oil production capacity over the next five years. If they cut the program entirely because of an oil price collapse, the capacity decline would be greater. [redacted]

In addition to internal spending reductions we believe that an oil price decline would lead to substantial cutbacks in Saudi aid. Riyadh normally spends about \$6 billion annually in bilateral aid, mostly to other Arab states, including almost \$1 billion to Syria, \$700 million to Morocco, and \$500 million to Jordan. In addition, Saudi Arabia has provided \$9 billion to Iraq over the past three years (table A-2). Riyadh's interest in pulling in its aid commitment is suggested by its recent decision to reduce the size of the \$1 billion loan reportedly committed to Nigeria in exchange for Lagos's agreement to stay within its oil production quota set in March. [redacted]

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Table A-2
Saudia Aid: Size and Importance of Aid

Million US \$
except where noted

Recipient	Current Account		Saudi Aid Disbursements, 1980	Saudi Aid as a Percent of Total Aid Received in 1980
	1980	1981		
Arab states				
Bahrain	128	211	10	24
Egypt	-500	-1,994	350	14
Jordan	-935	1,316	515	20
Lebanon	475	850	60	18
Mauritania	-277	-360	180	62
Morocco	-1,525	-1,942	670	39
North Yemen	-478	-727	290	29
Oman	1,144	1,182	50	16
Sudan	-854	-740	365	32
Syria	-4,519	-4,175	880	19
Tunisia	-285	-489	50	11
Non-Arab Islamic states				
Bangladesh	-1,521	-1,397	75	6
Djibouti	13	-4	30	15
Guinea	-74	-105	10	10
Pakistan	-1,010	-882	315	20
Somalia	-74	-50	145	20
Turkey	-3,660	-2,300	210	11
Other states				
Liberia	-86	-69	10	9
Sri Lanka	-800	-654	65	14
Zimbabwe	-283	-554	5	1
Special case				
Iraq	7,500	-17,800	3,000	42

Other OPEC

Among the other OPEC countries, Kuwait is the largest and most important. Kuwait has an adequate financial base to see itself through a substantial decline in oil prices. [redacted]

[redacted] at the end of 1981 the Kuwaitis had \$67 billion in foreign assets that will earn about \$7 billion in interest and dividends in 1982. Imports run about \$9 billion annually. The UAE also is in a position to absorb price declines. Smaller OPEC countries that would suffer serious damage include Gabon and Ecuador. [redacted]

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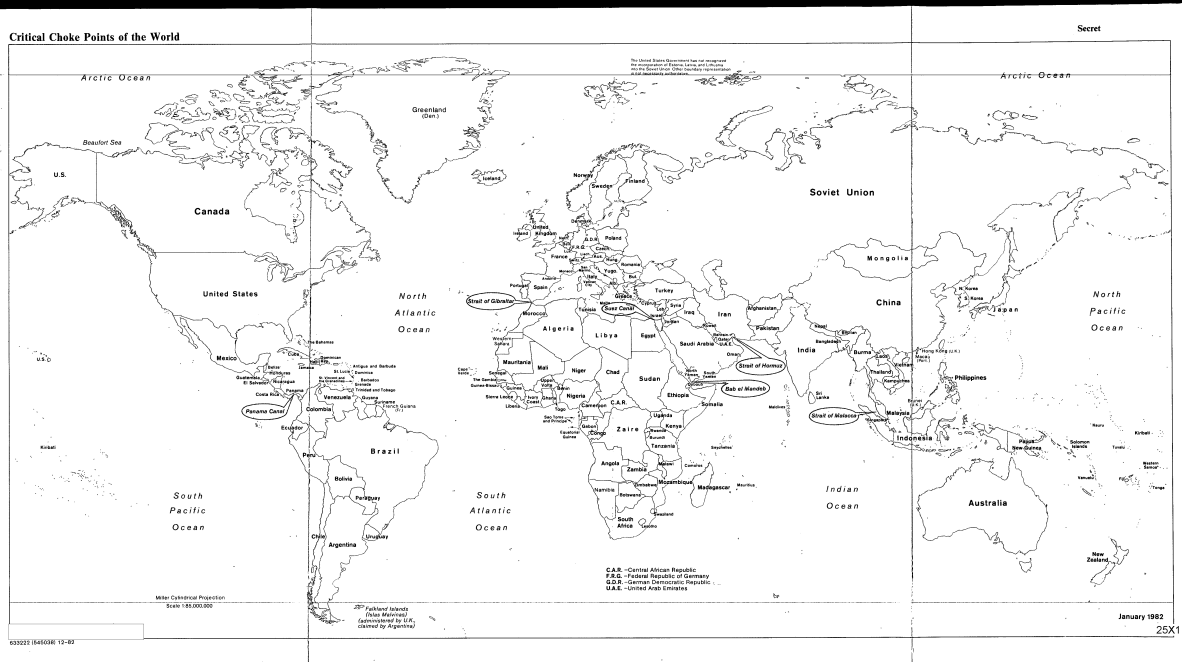
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