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PRIME MINISTER

THE OIL PRICE AND THE UK ECONOMY

I attach a note by my Department which examines in some depth the implications of a falling oil price for the UK economy, and the question of our relations with OPEC. It would be helpful to have an early discussion of this paper by Ministers most closely concerned as a background to international discussions of the fall in the oil price and its policy implicatons, and to our own policy decisions.

2. The conclusions which I draw from the paper are as follows:-

(i) The moderate fall in the oil price which we have now seen will help world economic recovery but it is desirable both for the world and for the UK that the fall should go neither too fast nor too far. There is a real risk for the UK that the dynamics may be perverse, bringing in the adverse effects more rapidly than the benefits.

(ii) There is little the UK alone can do to ensure the fall is gradual. A link between ourselves and OPEC would probably be ineffective and would represent a major departure from our existing policies, risking a break in our links with the other industrial countries.

(iii) The successful pursuit of the Government's economic strategy requires that we maintain output and sales of North Sea oil. This is of great importance for revenue, PSBR and balance of payments reasons, and therefore also as part of the counter inflation policy. It is not in our interests to cut our oil production. Short of drastic action through new powers we lack the means to do so on any significant scale. And we cannot afford to undermine confidence in our readiness to rely on the market economy to develop North Sea oil by claiming to know better than the companies the balance of advantage between present and future production of the oil.

(iv) However, while it is beyond our power to do much to keep oil prices up we should not add to the pressures driving them down. Our stance should be one of acquiescing in downward market adjustments while keeping a low profile in relation to OPEC. We should do what we can to encourage a market psychology consistent with avoiding a sharp fall in the price.

3. I am copying this minute to the Chancellor of the Exchequer, the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, Sir Robert Armstrong and Mr Sparrow.

Secretary of State for Energy
16th March 1983

CONFIDENTIAL

THE OIL PRICE AND THE UK ECONOMY

Note by the Department of Energy

1. The purpose of this paper is first, to survey the implications of a falling oil price for the UK economy; secondly, to consider our relations with OPEC in the light of that survey; and finally, to look at the implications of this analysis for the line we might take in major international discussions in the coming months. The Department of Energy have been assisted by the Treasury in preparing the paper, but responsibility for the views expressed in it rests with the Department.

OIL AND THE UK ECONOMY

2. The advantages and disadvantages of a fall in the oil price for the UK economy can be summarised as follows:-

3. Advantages

(i) A lower oil price helps growth in the industrialised world. Rapid post-war growth was helped by cheap energy, and dear energy contributed to the recession. A lower oil price improves the terms of trade of the OECD countries and so raises the standard of living in industrial countries generally (but not the UK, see 4(ii) and (iii)). It operates like the removal of a tax. It is pure gain to economies like Germany and France which produce no oil, but consume much energy. It will help the US economy to grow and increase world trade. The OECD suggest that a 10% decline in oil prices would raise OECD growth by one third to a half

... per cent

per cent over the succeeding couple of years.

(ii) It means higher growth in the UK also. But because our exports are heavily weighted towards energy producing and self-sufficient countries, the effect comes mainly from the lower sterling exchange rate which accompanies a lower oil price and the benefit might not be sustainable. If costs, especially wage costs, rise to offset the devaluation, the gain to competitiveness is lost after a time. The Treasury think that $5 off the oil price boosts our growth by one quarter to one half per cent a year over 2 years. But a falling exchange rate is a mixed blessing (see 4(iii) below).

(iii) It reduces world inflation. The fall in the oil price is indeed one of the consequences of the decisions taken by major Governments at and after the Tokyo Summit not to accommodate the inflationary effects of the 1979 oil price increase. A fall in the real oil price was inevitable as part of that process. The lower oil price, in itself, will help to reduce inflation in the UK, and operate in the opposite direction from the fall in the exchange rate. A 15% fall in the sterling oil price (equivalent at present to $5) could reduce UK prices by about 1%; but if the exchange rate falls the sterling price of oil would fall less - and other import prices could rise, at least partly offsetting the price reduction.

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(iv) It helps many developing countries. The development process is greedy of energy and most developing countries have less scope than developed ones for substitution or saving away from oil. Countries like Brazil, Pakistan and the Phillipines benefit substantially. Their actual or threatened debt problems are assisted. So, over a period, are those of Eastern Europe. These countries have more freedom to grow and less need to restrict.

(v) Lower oil prices will tend to put up the exchange rates of Japan and Germany. That may help the structure of world trade by reducing their tendency to flood the world with their exports. However, raising their exchange rates will further lower their inflation and their overall competitiveness may not be much affected beyond the very short term. For the UK, the benefits under this heading should not be double counted; they are the same benefits as those in (ii) above.

4. Disadvantages

(i) If the fall goes too far, it will halt most new energy investments, and reduce the momentum of conservation and fuel switching. Most observers believe that a fall to say $20 would boost the residual demand for OPEC oil by enough for OPEC to regain control over the price in a year or two. The price would then become vulnerable to political upheaval in OPEC countries. Oil markets could be pressing against capacity after about 4 years.

... over

(ii) Mexico and Venezuela are among the world's major debtor countries. Countries like Iraq and Indonesia also have heavy debts. Oil LDC's generally are bound to cut imports as well as drawing down financial reserves. There could be major new strains on the international banking and monetary system here and a major offset to increased growth. The UK, which exports disproportionately to oil producing countries and has a strong interest in the stability of the international banking system, could be adversely affected.

(iii) The overall terms of trade of the UK are worsened, both because the sterling exchange rate falls and because the UK is a net exporter of oil. This implies a longer term loss of national wealth. In the short term we enter a J curve and the current account of/the balance of payments deteriorates (even though the volume of net exports may rise).

(iv) The fall in the exchange rate is itself unhelpful to the counter inflation programme and there is room for doubt about whether the benefits of the oil price fall in reducing prices will come through more quickly than the price rises induced by the falling exchange rate. If the price rises come first, and if the exchange rate fall were large, then there could be a twist to wage and price expectations (especially if the PSBR were to be sharply boosted (see (v) below).

(v) The PSBR would be increased unless steps were taken to offset it. A major component of the Government's counter-inflation policy has been the application of North Sea

tax revenue to the reduction of the PSBR. The Government will not wish to see its achievement in reducing the PSBR eroded, but raising other taxes to offset losses of North Sea revenue would eliminate any direct output benefits (and probably any short-term inflation benefit too) from a lower oil price. The scale of the effect on the PSBR would vary with the extent of sterling depreciation against the dollar but a $5 price fall is unlikely to add less than three quarter billion pounds to the PSBR and it could be more than one and a half billion pounds. If the oil price falls sharply, either the exchange rate falls sharply also, when there is a large direct impact on prices, but the PSBR loss is mitigated; or the exchange rate falls less, when the direct impact on prices is mitigated but the PSBR loss is large.

5. Balance for the UK. It may be thought that because the sharp oil price increases of 1973/74 and 1979 were bad for the UK economy, any subsequent fall in prices must be helpful. But sharp changes in price, up or down, demand major adjustments, reflected in large changes in exchange rates, in revenue, in our external trading patterns and in the development of real incomes and living standards. The UK economy is less well adapted than others to respond quickly to sharp adjustments and that need for them is likely to impede the Government's medium term strategy.

6. Over a period of 2/3 years a moderate and gradual fall in the oil price is likely to be helpful to the UK economy. But a steep and fast fall could threaten the stability of the world financial system with damaging consequences

... for

for the recovery of world trade and economic growth. A temporarily low price followed by a bounce back could exacerbate the problems of structural adjustment and could lead to a mal-direction of new investments. At this stage in the counter-inflation programme we do not want to have to live through a sharp adjustment which, even within moderate monetary growth, could involve some build up of inflation flowing from the fall in the exchange rate. That could require a new effort to prevent a reversal of inflationary expectations and a reacceleration of wage increases which could turn the temporary effect on inflation into something more permanent.

7. Putting figures to this risks over-simplification. It may not be too far wrong to say that a $25 oil price would, if it came about by a sharp drop - especially if the market were not wholly convinced it had bottomed- create some awkward fiscal problems in the short term and might result in an undesirably sharp fall in sterling. It could therefore impose a sharp adjustment which it would be preferable to avoid. A fall to a $20 price or below would present even more serious problems. On the other hand a fall in the price to $25 in real terms which occurred gradually over 3 or 4 years e.g. as a result of inflation or a fall in the dollar, should present the UK with far fewer problems

8. UK Influence on Output and Prices. UK oil output, still less UK net exports, are not on a scale which can have a significant effect on the balance of world supply and demand. Any cut we could make would have minimal effects and be rapidly taken up by others. By contrast, US output at 8½m barrels a day is four times ours and Russian output is about 11m barrels. If however the UK were considering support for OPEC efforts to maintain prices and restrict production e.g. by parallel action, the Government would want to be satisfied that a chosen reduction in UKCS output really would be of benefit to the UK economy; and would need to take powers to

... enforce

enforce that reduction.

9. Although there are means by which the Government could try to have some influence on the level of output, that level is in practice controlled by the licensees. The Government would need to be on very strong ground if it were to impose its views about the level of production against their opposition, particularly in view of the assurances recently given that no such attempt would be made in the period up to 1985. There would be little prospect of securing the agreement of the companies to restrict output unless they were convinced that it was in their interests to sacrifice present income to achieve a better return in future. That would be a highly speculative proposition, and the chances of getting the many consortia of British and foreign companies which exploit the North Sea to accept such a proposition would be slight. Moreover, the attempt to influence them would undermine the confidence of the international oil industry in our readiness to rely on the market system for the development of North Sea oil. The Government have taken the view that the market system is the best way to exploit these resources and itwould hardly be in our long term interest to depart from that now.

10. Short of taking powers to override the assurances given on production levels, there are a number of possibilities (for example royalty oil banking, approach to profile variations and to new licence applications) which might eventually enable the Government to reduce the level of production somewhat , but most of them could only have an impact after some months or even years. It is not possible to be certain how effective these methods would be, especially if the companies were reluctant to cooperate. The Government would of course have to be confident that it had a better view than the companies about the prospective returns from delaying oil production. The Government would also have

to be prepared to accept postponement of North Sea revenue. Shutting in about 1/8th of North Sea production (about 0.3 mbd) for a year, would cost £1-1½ billions. Strictly as a cash trade-off, this would only be worth doing if it was thought that this scale of action by the UK could produce an oil price $5 higher than it otherwise would be.

RELATIONS WITH OPEC

11. The conclusions in paragraphs 6 and 7 raises the question whether there is anything the UK can do to reduce the risk of a very sharp fall in the oil price. That in turn leads one to examine our relations with OPEC. Should the UK associate itself in some way with the efforts of OPEC to settle a new oil price? There have been indications that among non-OPEC producers the Mexicans have been inclined to move in this direction.

12. There is also a separate question about whether this is the time to initiate a new consumer/producer dialogue on oil price and supply. The European Parliament recently passed a resolution expressing concern about sharp fluctuations in oil prices; urging a dialogue with oil exporting countries and other consumers, with a view to preventing fluctuations in the oil price; and saying that it was essential to establish guaranteed long term prices for oil. Venezuela has already indicated n interest in a problem-sharing dialogue. It is unlikely however that there would be any serious support for so interventionist an approach from the United States or Germany.

13. On relations with OPEC, we have already made considerable efforts, with the help of BNOC, to pre-empt accusations from OPEC countries (especially Nigeria) that the UK was starting an oil price slide. The timing and scale of the recent BNOC proposal to reduce its price from $33.50 to $30.50 largely prevented such accusations. We have been very ready to listen

... courteously

courteously to visitors from OPEC countries and other oil producers, and to explain our position to them. The Saudis in particular understand that we do not control production, and that BNOC must follow the market.

14. An agreement with OPEC, formal or informal, would be a major change of policy. The objections to it can be summarised as follows:-

(i) OPEC would want us to restrict output, even though, as explained above, our output restrictions would have little effect on the world supply/demand balance: and the attempt to do so would undermine confidence in North Sea investment and cost us revenue. We need to sell North Sea output in the interests of the PSBR and of the balance of payments.

(ii) It is difficult to see what confidence we could have in an agreement with OPEC when OPEC has such great difficulty in agreeing among its own members. The odds are that if we cut output, even on a token basis, the shortfall would promptly be made up by countries like Iran, Libya or Venezuela which already have a reputation for disregarding OPEC agreements whenever it suits them. There simply is not a reliable partner for an agreement and there is certainly no reason why we should make sacrifices for OPEC. If OPEC can agree on an effective production programme, we are not needed; if it cannot, it is only in very unusual circumstances that our cooperation would provide the necessary cement.

(iii) Collaborating with OPEC to the point of restricting output would have implications for our relations with the United States and Europe. Hitherto we have identified

ourselves ..

ourselves with the OECD countries on attitudes to OPEC and oil prices e.g. at the Tokyo and Venice Summits. A fall in price below say \$20-\$25 might require us to review our situation; but it would be very surprising if this led us to a policy which risked isolating us from the US and Europe.

(iv) There is the broad point that joining with OPEC to fix the oil price, or restrict output, would run clearly against the Government's market oriented approach.

15. The proposal for a consumer/producer dialogue, which would include an agreement on oil prices, is different because it presupposes an agreement among the major OECD countries . Those who propose a dialogue are not always clear about the content of an agreement and there is a risk that they would change their view if concrete proposals were made. In fact, if prices are to be stabilised. this "dialogue" also involves restriction of output and presumably part of that burden would fall on the UK. A larger part of the burden would have to be taken by US, since what would be involved would be a global commodity agreement implying control over oil markets. There is no prospect of the USA or Germany agreeing to this, particularly as real oil prices are still substantially above the \$17-\$18 of the spring of 1979. The UK could not initiate a consumer/producer dialogue and there is no clear indication of support for it, or organisation for it, on either side; or any advantage in raising false expectations about it.

NEW TAXES ON OIL

16. We may hear argument in industrial countries for increases in taxes on the consumption of oil or oil products so as to give the right long term signals to consumers about the oil price. If prices for oil were

... raised

raised by taxes, investment in other energy sources and in energy conservation in the countries concerned might be maintained at a higher level than otherwise, thus limiting the growth in oil consumption and reducing the risk of a price rebound in the world oil market. There would probably be argument that such action ought to be concerted between OECD or at least between Community countries so as to avoid adverse effects on the competitiveness of industry in particular countries.

17. In a weak oil market however extra oil taxation would drive prices to producers down yet further and would be seen by OPEC as confrontation. If adopted as a general policy it could help produce the steep and rapid price fall which would be against the UK interest. There therefore seems no case for support for it by the UK. Realistically it seems unlikely that such action will be concerted either in OECD or the Community. Some countries e.g.France or the US may take advantage of the scope they see in lower oil prices for raising consumption taxes, but that is likely to happen nationally rather than in concert.

INITIATIVES IN THE EUROPEAN COMMUNITY

18. An initiative to impose consumption taxes on the narrower base of the Community might have less impact on oil prices generally, but would adversely affect the competitiveness of EC exports including those from the UK. Non-oil energy and conservation investments in the Community would be protected but oilfield developments would not benefit. On the other hand, a Community wide oil import levy could hold some advantages for the UK in allowing UKCS oil to be sold at higher than world market prices in Europe. It could also help to redress the UK's EC budget contribution problem. Thus a concerted Community import levy could be preferable to increases in consumer oil taxes on a country by country basis.

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19. The alternative of a Minimum Support Price (or variable import levy) would be complex to administer and riddled with loopholes. Transfer prices of multinational oil companies would be manipulated to avoid levy. Countries like Libya would be very ready to manipulate both prices and invoices to avoid the levy and it would be to the advantage of Community oil importers to collude with them, so eroding North Sea market share. In practice, it is most unlikely that the Community would agree to a concerted oil import levy; meanwhile, we should refrain from being seen to be pushing for such a scheme which would be seen as confrontational by OPEC countries. If the notion of a European import levy or minimum support price were to emerge in the Community we should express interest and then in the various technical groups try to swing the proposals away from an MSP towards a Levy.

MARKET PSYCHOLOGY

20. At present the oil market is not rooted in the cost of production. Like the exchange market, it is a market much influenced by expectations. For example, talk of $7 cuts in the Gulf crude price, which is intended to frighten Nigeria, can prove partially self-fulfilling. The spot market is driven down by such talk and reacts on the term price market. Something can be done to reduce the risk of sharp price movements by refraining from over-emphasizing the possibilities of sharply falling prices and by stressing the factors likely in due course to underpin the market. There could be a slack oil market all through the Spring and Summer of 1983. There could however be some underpinning in the Autumn if the price prospect changes, provided OPEC maintains discipline and de-stocking ends. If the United States and European economies show significant growth in mid-year, that will help. Rigorous enforcement of existing oil stock obligations should apply. Comment ought to be directed towards these possibilities. If it is necessary to comment on the possibility of a sharp fall in the price, the

.... comment

comment should be that there is then likely to be a rebound later. These arguments would contribute something to helping the market during a weak mid-year period.

WILLIAMSBURG AND ELSEWHERE

21. Reactions to lower oil prices are bound to be discussed in various international fora (European Council, Williamsburg Summit etc). The line which would be helpful to the UK would be that the fall in the oil price that had already occurred was indeed favourable to world growth, but that further sharp falls would create problems and impose difficulties of adjustment. A fall which later led to another price surge because of the failure of energy investment and conservation would be very damaging. But improved growth should itself lead to some stabilisation of the market.

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Weekend box

PRIME MINISTER

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

Mr Lawson has circulated the paper he has been preparing on this subject. A meeting has been arranged for Thursday to discuss it. Since the paper is long, I thought that you might like to see a copy over the weekend.

I have asked Alan Walters to brief you on it. – at Flag C

The propositions in the paper boil down to:-

i) the United Kingdom's objective should be to maintain the present nominal price, which would mean a slowly declining real price over the next two to three years;

ii) there is no future in

- limiting North Sea output;
- closer association with OPEC;
- launching a consumer/producer dialogue;

as a means of trying to influence the oil price;

iii) there is also no future in

- raising the domestic tax on oil consumption to make sure that people do not over-invest in oil-burning capacity during the temporary period while the price is low;
- trying to keep up the BNOC price by proposing an EEC levy on imported oil;

iv) our strategy should be to try to keep up the BNOC price, maintaining a low profile; and underpin the price by talking up the prospects of revived demand later in the year.

A comment by the Foreign and Commonwealth Secretary is attached at flag B

18 March 1983

F.E.R.B.

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B

PM/83/24

PRIME MINISTER

The Oil Price and the UK Economy

1. I should like to make one or two comments on Nigel Lawson's minute of 16 March to you and on the Department of Energy paper on this subject.

2. I do not quarrel with the conclusions drawn by Nigel Lawson and with the general thrust of the paper. But I should like to take further the important question of relations with the more important OPEC countries.

3. The political importance of good relations with the Saudis and the other Gulf States within the Middle East, or with Nigeria in the African context is obvious. In terms of our commercial interests, our visible exports to Saudi Arabia and Nigeria last year were worth more than a billion pounds each.

4. It is, in my view, essential that the leaders of these countries are given no excuse for making us a scapegoat if BNOC are obliged, in the near future, to lower their price offer, particularly if this goes below $30 a barrel. Nigel Lawson's readiness over the past few weeks to receive Oil Ministers from these countries has made a substantial contribution towards ensuring that they are fully aware of the constraints on ourselves and BNOC and to preempt accusations that the United Kingdom is instigating a price war. Your own message to King Fahd was, I am sure, a vital part of the same operation. In the days ahead, I believe that we should make further use of such messages: I am thinking for example of possible messages from yourself to three of the other Gulf Rulers you know personally (UAE, Kuwait and Qatar), who are likely to

/set the

set the tone for their governments' reaction to any move by us. I also think that at the appropriate moment messages from Nigel Lawson to some of his colleagues, eg Yamani of Saudi Arabia, will be necessary. And, depending on the report we get from Cranley Onslow and Gerard Vaughan (who are at present visiting Lagos), a message from you to President Shagari could also be very useful. It is important to get across at the highest level the simple message that, while we are doing everything possible to avoid market de-stabilisation, and want the highest possible price for our oil, BNOC prices need, in the last resort, to reflect market forces.

5. On the question of a producer/consumer dialogue, I would note that, although it is unlikely to gain support from the Americans and the FRG, others (eg the French) may seek to promote discussion of it in various international fora. If it does come up, I think we should listen to others' views: while we should not ourselves promote a producer/consumer dialogue, it would not seem in our interests to be in the lead against the idea.

6. In the longer run, I wonder whether it might not be useful for officials to look carefully at the structure of BNOC and the participation agreement to see if there is any way of making their role less conspicuous in a weak market situation without of course undermining fundamental security of supply safeguards. It is striking that the Americans, who produce far more oil than ourselves, have been immune from the sort of misrepresentation and pressure which we have suffered in recent weeks.

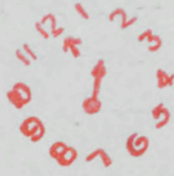
/7. I am

7. I am copying this minute to the Chancellor of the Exchequer, the Secretaries of State for Energy, Industry and Trade, Sir Robert Armstrong and Mr Sparrow.

(FRANCIS PYM)

Foreign and Commonwealth Office
18 March 1983

18 MAR 1983



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cc Mr. Scholar
Sir Anthony Parsons
Mr. Mount

C

MR. BUTLER

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

Department of Energy Memorandum of 16 March.

The main lesson is that we cannot influence the world producer price of oil. We are quite powerless, even to "talk up" the price of oil later in the year. We should save our talk for more mundane political purposes.

What we need to know is not how we would like the oil price to develop (a slow fall is Energy's and Treasury's answer) but how it is likely to develop. There is some vague suggestion that the oil price may fall through the summer of this year, but that it should rise during the autumn. But the paper seems unsure, and the Secretary of State is clearly unwilling to impose his judgement on the oil companies' production programme. I am sure the Secretary of State is right in allowing the oil companies to determine the rate of depletion. It is in their interests to get it right.

The real question, and one over which we do have control, is the extent to which we should use our domestic tax arrangements to raise substitute revenue for that which may be lost by the oil price decline, and on the other hand to arrange taxes on oil or oil products which are designed to give the "right" signals to UK consumers. (I think we can rule out the possibility of a European Economic Community tax on imported oil, for obvious reasons. We are left then with simply domestic tax arrangements.)

If the fall in oil prices is known to be both steep and transitory, and it is known that the oil price will bounce back to even higher levels, as appears in all the Department of Energy forecasts, then there is a good case for transitory tax on oil products. This will stabilise revenue receipts and will do little or no harm to the planning of energy-consuming projects and lines of production.

If, however, the decline is seen to be both steep and permanent then it may be unwise to increase taxes on energy in order to make good revenue or to induce economies in energy consumption. We should allow the lower price of energy to be reflected in the market. Furthermore, there will be an automatic increase in the tax incidence on gasoline since the tax is fixed in money terms indexed to the

/inflation rate;

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inflation rate; and so as the price of oil falls and the final price falls, the tax will be an increasing fraction of the final price. This is a built-in increase in relative tax incidence. But these questions need further investigation.

However, to reiterate, none of these taxes would have any effect whatsoever on world oil prices and they would have a miniscule, probably unobservable effect on world production and consumption.

[My personal judgement is that we have only seen the first phase of the fall in the real price of oil. In the absence of political turmoil and dislocation in the Middle East, the fall, although not monotonic, will continue for some years. The expected breakdown in OPEC's quotas should see a sharp fall within a year.]

Conclusions

1. Although we can have no effect on world oil prices, it would be interesting to know D/Energy's view of their likely path for the next few years. [You may, however, take the view, as I do, that D/Energy's forecasts have been so bad they are worth little or no effort.]

2. The calculations of the consequences of a persistent low oil price, or of a low-then-high profile, need to be sharpened both logically and empirically (see my attached critique).

3. D/Energy and Treasury should work out the best tax regimes contingent on 2. above.

4. Confirm the policy of leaving the oil companies to determine their production levels.

AW

ALAN WALTERS
18 March 1983

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18 March 1983

ALAN WALTERS

CRITIQUE OF THE DEPARTMENT OF ENERGY NOTE:
THE OIL PRICE AND THE UK ECONOMY

Much of the first part of this note is concerned with predicting the advantages and disadvantages of a lower oil price on the UK economy. It does not much help as far as policy is concerned since we cannot control the oil price.

But some of the analysis seems to me to be wrong. The first error is to suggest that a lower oil price helps growth in an industrialised world. It doen't. It increases the level of real incomes. It is a step and does not affect growth per se. There would be a once-and-for-all increase and then a decline. But the rate of growth of output through time would not be affected by this step change. The nomenclature of "growth" is at least misleading.

Under para 3(ii) they seem to be suggesting that a lower sterling exchange rate due to the lower oil price would induce greater growth in the UK. This begs many questions about first the effect of the oil price change on the exchange rate, secondly the effect of the exchange rate on output of traded goods and non traded goods, and thirdly the effect of a relative price increase of traded goods on the absolute prices of labour and domestic resources. By the time I have got through this operation I have lost any impetus I once had. Is there anything left?

Under para 3(iii) they say it reduces world inflation. I cannot see why. It transfers real income to the oil consuming countries, mainly perhaps OECD countries. If they maintain their same monetary policies, then there will be a reduction in their price levels. Again, it's a once-and-for-all change and it has nothing to do with inflation. But if the oil exporting countries keep their monetary policy unchanged and suffer a reduction in real output, then their inflation rate will increase in the same proportion, if monetary policies are unchanged then I cannot see how it will affect the world price level or world inflation. Similarly, it is a non sequitur to say that the decisions taken by major governments after the Tokyo Summit not to accommodate the inflationary effects of the 1979 oil price increase caused inevitably a fall in the real price of oil. The decision to maintain more or less constant monetary and fiscal stances affects the nominal price level as a whole. The real price of oil is a consequence of demand and supply in the oil market, not of monetary policy.

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Energy

MR WALTERS

ccs Mr Coles
Mr Scholar

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

I attach Mr Lawson's paper on this subject. I am arranging a meeting of Ministers to consider it next week, probably on Wednesday.

I wish that there was more numerical analysis in the paper, e.g. to demonstrate that the effect of a fall in the oil price on UK exports through restriction of demand from oil producers is sufficient to outweigh the increased demand from oil consumers, particularly the EEC countries and the United States; and that the harmful effect on inflation through the impact on the UK exchange rate exceeds the beneficial effect of the reduced oil price. These propositions are asserted, but we have to take the analysis in support of them for granted.

I take it that questions which Ministers will have to decide are whether they agree that

i) the UK's interest is a slowly declining real oil price, which presumably means trying to maintain the present nominal price over the next two to three years ?

ii) that we have no effective means of achieving it by limiting output or closer association with OPEC or trying to launch a consumer/producer dialogue, and that all we can do is to keep a low profile and try to keep reductions in BNOC's oil price as small as possible ?

iii) that it is not worth pursuing ideas of influencing domestic behaviour by a tax on oil consumption while the price is low, or of protecting BNOC oil prices by proposing

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an EEC levy on imported oil;

iv) that we should try to underpin the oil price by talking up the prospects of revived demand later the year.

I am sure that the Prime Minister would find it find it useful if you could find time to brief her on these points.

F.E.R.B.

16 March 1983

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ec N.O.

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ

01-211-6402

Robin Butler Esq
Private Secretary to
the Prime Minister
10 Downing Street
London SW1

16 March 1983

Dear Robin,

THE OIL PRICE AND THE UK ECONOMY

My Secretary of State has today circulated his paper on this subject, as he undertook to do at the Prime Minister's meeting on 10 March.

He has asked me to say that he would be grateful if time could be found for it to receive an early discussion among Ministers. Now that OPEC has concluded its long meeting in London and the oil market has begun to assess the outcome, the Government will need to have agreed their position on the issues raised in the paper. Mr Lawson believes that this will be an important part of the background to a number of urgent decisions which are likely to arise in the near future. One of these decisions may indeed concern a further price adjustment by BNOC on which, in the light of the discussion of his paper, Mr Lawson would propose to consult the Prime Minister, Chancellor and Foreign Secretary in the usual way.

I am copying this letter to John Kerr (Treasury) and Brian Fall (FCO).

Yours ever,

J D WEST
Private Secretary

Energy : North Sea
Oil Prices
1/80

PRIME MINISTER

I attach a draft of the paper on oil prices being prepared by Mr Lawson, which was mentioned at his meeting with you yesterday. The draft is not yet in final form.

The paper is informative, but does not require any decisions, beyond those taken last night. I suggest that the best time to have a further collective discussion would be when BNOC have got some reactions from their customers to the OPEC agreement and Ministers can take a view on what should happen to their term price of $30.5 after 21 March. It would be convenient to have such a meeting on this coming Thursday i.e. the day before the visit of the Arab League, but I doubt whether there is much point in doing so unless sufficient evidence has accumulated by then to enable a view to be formed on the next move in the BNOC price.

Agree that we should fix a further collective meeting adding the Secretaries of State for Trade and Industry to the group which met yesterday when the stage is reached of being able to take a view on the next movement in the BNOC price?

F.E.R.B.

11 March 1983

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SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

F G R Butler Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

11 March 1983

Dear Robin,

I attach a copy, for your own use, of the draft note on the oil price and the UK economy which you discussed last night with Julian. This has not been approved or even seen by the Secretary of State. He has it in mind that it might be discussed by the Prime Minister, the Foreign Secretary, the Chancellor and himself, and possibly the Secretaries of State for Trade and Industry.

Yours sincerely

C E Brooks

MISS C E BROOKS
Private Secretary

CONFIDENTIAL

THE OIL PRICE AND THE UK ECONOMY

Note by the Department of Energy.

F.C.O.?

1. The purpose of this paper is first, to survey the implications of a falling oil price for the UK economy; secondly, to consider our relations with OPEC in the light of that survey; and finally, to look at the implications of this analysis for the line we might take in major international discussions in the coming months. The Department of Energy have been assisted by the Treasury in preparing the paper, but responsibility for the views expressed in it rests with the Department.

Oil and the UK economy

2. The advantages and disadvantages of a fall in the oil price for the UK economy can be summarised as follows:-

3. Advantages

(i) A lower oil price helps growth in the industrialised world. Rapid post-war growth was helped by cheap energy, and dear energy contributed to the recession. A lower oil price improves the terms of trade of the OECD countries and so raises the standard of living in industrial countries generally (but not the UK, see 4(ii) and (iii)). It operates like the removal of a tax. It is pure gain to economies like Germany and France which produce no oil, but consume much energy. It will help the US economy to grow and increase world trade. The OECD suggest that a 10% decline in oil prices would raise OECD growth by

one third

one third to a half per cent over the succeeding couple of years.

(ii) It means higher growth of the UK also. But because our exports are heavily weighted towards energy producing and self-sufficient countries, the effect comes mainly from the lower sterling exchange rate which accompanies a lower oil price and the benefit may not be sustainable. If costs, especially wage costs, rise to offset the devaluation, the gain to competitiveness is lost after a time. The Treasury think that $5 off the oil price boosts our growth by one quarter to one half per cent a year over 2 years. But a falling exchange rate is a mixed blessing (see 4(iv) below).

(iii) It reduces world inflation. The fall in the oil price is indeed part of the counter inflationary process set in motion by the major Governments at the Tokyo Summit. A fall in the real oil price was inevitable as part of that process. The lower oil price, in itself, will help to reduce inflation in the UK, and operate in the opposite direction from the fall in the exchange rate. A 15% fall in the sterling oil price (equivalent at present to $5) could reduce UK prices by about 1%; but if the exchange rate falls the sterling price of oil would fall less - and other import prices could rise, at least partly offsetting the price reduction.

...over

(iv) It helps many developing countries. The development process is greedy of energy and most developing countries have less scope than developed ones for substitution or saving away from oil. Countries like Brazil, Pakistan, the Phillipines and Korea benefit substantially. Their actual or threatened debt problems are assisted. So, over a period, are those of Eastern Europe. These countries have more freedom to grow and less need to restrict. It reduces Russia's power as a net exporter.

(v) Lower oil prices will tend to put up the exchange rates of Japan and Germany. That may help the structure of world trade by reducing their tendency to flood the world with their exports. However, raising their exchange rates will further lower their inflation and their overall competitiveness may not be much affected beyond the very short term. For the UK, the benefits under this heading should not be double counted; they are the same benefits as those in (ii) above.

4. Disadvantages

(i) If the fall goes too far, it will halt most new energy investments, and reduce the momentum of conservation and fuel switching. Most observers believe that a fall to say $20 would boost the residual demand for OPEC oil by enough for them to retain control over the price in a year or two. Oil markets could be pressing against capacity - making the price vulnerable to shocks - within 4 - 6 years.

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(ii) Mexico and Venezuela are among the world's major debtor countries. Countries like Iraq and Indonesia also have heavy debts. Oil LDC's generally are bound to cut

imports as well as drawing down financial reserves. Ther could be major new strains on the international banking and monetary sytem here and a major offset to increased growth. The UK, which exports disproportionately to oil producing countries and has a strong interest in the stability of the international banking system, could be adversely affected.

(iii) The overall terms of trade of the UK are worsened, both because the sterling exchange rate falls and because the UK is a net exporter of oil. This implies a longer term loss of our economic capacity. In the short term we enter a J curve and the current account of balance of payments deteriorates (even though the volume of net exports may rise).

(iv) The fall in the exchange rate is itself unhelpful to the counter inflation programme and there is room for doubt about whether the benefits of the oil price fall in reducing prices will come through more quickly than the price rises induced by the falling exchange rate. If this were to happen, and if the exchange rate fall were large, then there could be a twist to wage and price expectations (especially if the PSBR were to be sharply boosted (see (v) below).

(v) The PSBR would be increased unless steps were taken to offset it. The scale of the increase would vary with the size of the fall in sterling against the dollar - but a $5 fall in price is unlikely to add less than three quarter billion pounds to the PSBR and it could be more than one and a half billion pounds. As a broad rule, a rise in the oil price is favourable

to the public sector and a fall is favourable to the private sector. The marginal rate of oil taxation is so high that the biggest loser from a fall in the price is the Government. A fall in the exchange rate will help to maintain the sterling value of oil revnues if they decline in dollar terms, but unless sterling depreciates faster than the oil price, the real value of these revenues will be less. The long term revenue prospect for the future is reduced because development becomes less attractive.

5. Balance for the UK

Over a period of 2/3 years a moderate and gradual fall in the oil price is likely to be helpful to the UK economy. But a steep and fast fall could threaten the stability of the world financial system with damaging consequences for the recovery of world trade and economic growth. A temporarily low price followed by a bounce back could exacerbate the problems of structural adjustment and could lead to a mal-direction of new investments. At this stage in the counter inflation programme we do not want to have to live through a sharp adjustment which, even within moderate monetary growth, could involve some build up of inflation flowing from the fall in the exchange rate. That could require a new effort to prevent a reversal of inflationary expectations and a reacceleration of wage increases which could turn the temporary effect on inflation into something more permanent.

6. Putting figures to this risks over-simplication. It may not be too far wrong to say that $25 oil price would, if it came about by a sharp drop - especially if the market were not wholly convinced it had bottomed - create some awkward fiscal problems in the short term and might result in an undesirably sharp fall in sterling. It could therefore impose a sharp adjustment which it would be

preferable to avoid. A fall to a $20 price or below would present even more serious problems. On the other hand a fall in the price to $25 in real terms which occurred gradually over 3 or 4 years e.g. as a result of inflation or a fall in the dollar, should present the UK with far fewer problems.

7. UK Influence on Output and Prices

An essential theme of this paper is that although BNOC may on occasion have been incorrectly seen as playing a price leadership role, in practice the UK has no effective market power in fixing the level of world oil prices. If there were any question of UK becoming part - whether explicitly or by means of parallel action to restrain production - of an OPEC effort to maintain oil prices at artificially high levels, action would require the Government:-

(i) to be satisfied that a given reduction in the output of the UKCS would be of benefit to the UK economy, and

(ii) to take powers to enforce that reduction in output.

8. As emerges from the next section of this paper, it is doubtful whether such action could ever be effective. However, even if action were open to the Government, it is doubtful whether the case for it would be sustained. In practice the rate of output from UKCS fields is controlled by the licensees, and the Government would need to be on very strong ground if it were to impose its views on the appropriate level of production against their opposition. To attempt this would require confidence on the part of the Government that oil left in the ground would now be worth sufficiently more in future to outweigh the current loss of income and the continuing interest burden in the intervening period resulting from the need for additional borrowing to replace that income. It is just possible, in the event of a fall in the price to less than $20 a barrel, that differences in the rate at which future income and expenditure are

discounted might lead licensees to continue production at a time when the Government considered cutting back to the preferable course. However, such a situation seems very unlikely to arise in the near future.

Relations with OPEC

9. The conclusion in paragraphs 5 and 6 raises the question whether there is anything the UK can do to reduce the risk of a very sharp fall in the oil price. That in turn leads one to examine our relations with OPEC. Should the UK associate itself in some way with the efforts of OPEC to settle a new oil price? There have been indications that among non-OPEC producers the Mexicans have been inclined to move in this direction.

10. There is also a separate question about whether this is the time to initiate a new consumer/producer dialogue on oil price and supply. The European Parliament recently passed a resolution expressing concern about sharp fluctuations in oil prices; urging a dialogue with oil exporting countries and other consumers, with a view to preventing fluctuations in the oil price; and saying that it was essential to establish guaranteed long term prices for oil. Venezuela has already indicated an interest in a problem-sharing dialogue. It is unlikely however that there would be any serious support for so interventionist an approach from the United States or Germany or even from France.

11. On relations with OPEC, we have already made considerable efforts, with the help of BNOC, to pre-empt accusations from OPEC countries (especially Nigeria) that the UK was starting an oil price slide. The timing and scale of the recent BNOC proposal to reduce its price from $33.50 to $30.50 largely prevented such accusations. We have been very ready to listen courteously to visitors from OPEC countries and other oil producers, and to explain our position to them. The Saudis in particular understand that we do not control production, and that BNOC must follow the market.

12. An agreement with OPEC, formal or informal, would however be a major change of policy. The objections to it include the following:-

(i) OPEC would want us to restrict output, even though our output restrictions would of themselves have little effect on the world supply/demand balance. With some difficulty and much persuasion we might in fact be able to have some limited effect on output, but in the main the position is that we cannot control it. The attempt to do so would undermine confidence in investment in the North Sea and would cost us revenue. We need to sell North Sea output in the interests of the PSBR and of the balance of payments.

(ii) It is difficult to see what confidence we could have in an agreement with OPEC when OPEC has such great difficulty in agreeing among its own members. In practice, the odds are that if we cut output, even on a token basis, the shortfall would promptly be made up by countries like Iran, Libya or Venezuela which already have a reputation for disregarding OPEC agreements whenever it suits them. There simply is not a reliable partner for an agreement. If OPEC can agree on an effective production programme, we are not needed; if it cannot, it is only in very unusual circumstances that our cooperation would provide the necessary cement.

(iii) Collaborating with OPEC to the point of restricting output would have implications for our relations with the United States and Europe. Hitherto we have identified ourselves with the OECD countries on attitudes to OPEC and oil prices e.g. at the Tokyo and Venice Summits. A fall in price below say $20-25 might require us to review our

situation; but it would be very surprising if this led us to a policy which risked isolating us from the US and Europe.

(iv) There is the broad point that joining with OPEC to fix the oil price, or restrict output, would run clearly against the Government's market oriented approach.

13. The proposal for a consumer/producer dialogue, which would include an agreement on oil prices, is different because it presupposes an agreement among the major OECD countries. If prices are to be maintained it too involves restriction of output and presumably part of that burden would fall on the UK. A larger part of the burden would have to be taken by the US, since what would be involved would be a global commodity agreement implying control over oil markets. There is no prospects of the USA or Germany agreeing to this, particularly as real oil prices are still substantially above the $17-$18 of the spring of 1979. The UK could not initiate a consumer/producer dialogue and there is no clear indication of support for it, or organisation for it, on either side.

New taxes on oil

14. We may hear argument in industrial countries for increases in taxes on the consumption of oil or oil products so as to give the right long term signals to consumers about the oil price. If prices for oil were raised by taxes, investment in other energy sources and in energy conservation in the countries concerned might be maintained at a higher level than otherwise, thus limiting the growth in oil consumption and reducing the risk of a price rebound in the world oil market. There would probably be argument that such action ought to be concerted between OECD or at least between Community countries so as to avoid adverse effects on the competitiveness of industry in particular countries.

15. In a weak oil market however extra oil taxation would drive prices to producers down yet further and would be seen by OPEC as confrontation. If adopted as a general policy it could well help to produce the steep and rapid price fall which would be against the UK and the wider interest. There therefore seems no case for support by the UK for such action. Realistically it seems unlikely that such action will be concerted either in the OECD or the Community. Some countries e.g. France may take advantage of the scope they see in lower oil prices for raising consumption taxes, but that is likely to happen nationally rather than in concert.

Initiatives in the European Community

16. An initiative on the narrower base of the Community would have less disadvantage in terms of its effect on the overall energy price though some would still remain. Non-oil energy and conservation investments in the Community would be protected but at the price of some loss of competitiveness of energy consuming industries. It is doubtful whether new oil field developments would be protected because the oil companies would have little confidence in the durability of such a scheme. A Community wide oil import levy could hold some advantages for the UK in allowing UKCS oil to be sold at higher prices in Europe and there could be budgetary advantages. A concerted Community import levy could therefore be preferable to an increase in consumer oil taxes on a country by country basis. A Minimum Support Price (or variable import levy) would however be complex to administer and there would be loopholes. Because UKCS prices are transparent, whereas many other oil producers' prices are not, there could be discrimination against North Sea oil. Realistically it is unlikely that the Community will agree to a concerted oil import levy and we should refrain from being seen to be pushing for such a scheme because that would seem doubly confrontational to OPEC countries. If the notion of a European import levy or minimum support prices does emerge in the Community

we should respond constructively and in the various technical groups we should try to swing the proposals away from an MSP towards a Levy.

Market psychology

17. At present the oil market is not rooted in the cost of production. Like the exchange market, it is a market much influenced by expectations. For example, talks of $7 cuts in the Gulf crude price, which is intended to frighten Nigeria, can prove partially self-fulfilling. The spot market is driven down by such talk and reacts on the term price market. Something can be done to reduce the risk of sharp price movements by refraining from over-emphasizing the possibilities of sharply falling prices and by stressing the factors likely in due course to underpin the market. There could be a slack oil market all through the Spring and Summer of 1983. There could however be some underpinning in the Autumn if the price prospect changes, provided OPEC maintains discipline and de-stocking ends. If the United States and European economies show significant growth in mid-year, that will help. Rigorous endorsement of existing oil stock obligations should apply. Comment ought to be directed towards these possibilities. If it is necessary to comment on the possibility of a sharp fall in the price, the comment should be that there is then likely to be a rebound later. These arguments would contribute something to helping the market during a weak mid-year period.

Williamsburg and elsewhere

18. Reactions to lower oil prices are bound to be discussed in various international fora (European Council, Williamsburg Summit etc). Prices may stabilise, but the market may still be fragile. The line which would be helpful to the UK would be that the fall in the oil price that had already occurred was indeed favourable to world growth, but that further sharp falls would create problems and impose

difficulties of adjustment. A fall which later led to another price surge because of the failure of energy investment and conservation would be very damaging. But improved growth should itself lead to some stabilisation of the market.

Conclusions

(i) A moderate fall in the oil price will help economic recovery but it is desirable both for the world and for the UK that the fall should be neither too fast nor too far. There is some risk for the UK that the dynamics may be perverse bringing in the inflationary effects more rapidly than the benefits in reduced prices.

(ii) Although we would like to avoid too swift or steep a fall in the oil price, there is little we can do to ensure the fall is gradual. A link between ourselves and OPEC would probably be ineffective and would represent a major departure from our existing policies and risk a break in our links with the other industrial countries.

(iii) The successful pursuit of the Government's economic strategy requires that we maintain output and sales of North Sea oil. This is of great importance for revenue and balance of payment reasons, and therefore also as part of the counter inflation policy. It is not in our interests to cut our oil production and we effectively lack the means to do so on any significant scale.

(iv) However, while it is beyond our power (and contrary to our interests) to do much to keep oil prices up we should not add to the pressures driving them down. Our stance should be one of reluctantly acquiesing in downward market adjustments while keeping as low a profile as possible in relation to OPEC. We should do what we can to encourage a market psychology consistent with avoiding a sharp fall in the price.

1 MAR 1983