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Prime Minister

Much of this is pretty speculative - but worth reading through.

MES 9/12

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8 December 1982

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

At his meeting with the Prime Minister on 2 December, the Chancellor offered to provide a note by officials on the short-term prospects for the oil market and the possible implications, for the UK and the world economy, of a fall in the oil price.

The Chancellor has now asked me to send you the attached note. Like the JIC assessment circulated on 26 November, it emphasises the uncertainty of the short term outlook, given doubts about OPEC's intentions. It has not been seen in other Departments, though it takes into account recent discussions with eg. the Department of Energy.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

OIL PRICES

In recent weeks considerable speculation has arisen that the world price of oil may fall in the near future. This note examines the prospects for such a fall and considers the possible effects on the UK economy.

2. Since 1979 oil consumption in the non Communist world has fallen sharply. At the same time there has been a rise in non-OPEC supplies (including net exports from Communist countries) and a sharp reduction in stocks. Consequently OPEC, as the world's residual supplier of oil, has seen its output fall from over 29 million barrels per day (mbpd) to about 19 mbpd this year.

3. This sharp drop in the demand for its oil has put severe pressure on OPEC. Last March it seemed likely that the world oil price might fall sharply, but the OPEC countries succeeded in stabilising the market by agreeing to limit their combined production to 17½ mbpd.

4. This agreement is now looking increasingly fragile. A number of OPEC countries - Venezuela, Nigeria, Libya, Iran - have been offering discounts which have enabled them to increase their production above their agreed quota. The official world price of crude oil of \$34 per barrel (for Saudi Arabian light crude - the marker crude) is observed only by the Saudis and their Gulf allies; prices charged by the rest of OPEC are several dollars per barrel lower. More of the burden of restraining production therefore has fallen on the Saudis and they have responded by threatening to reduce the marker price if the rest of OPEC does not toe the line.

5. The increased bickering and cheating on quotas within OPEC has lead to speculation that a fall in the world oil price may be imminent. Given the large excess of potential supply over current (and likely prospective) demand then, if OPEC loses control of the oil

price, the latter could fall very sharply indeed. Spot market prices of crude oil have fallen by several dollers per barrel in recent weeks.

6. It is now reported that OPEC are scheduled to meet in Vienna on December 19, though Ministers may convene a little ahead of that date. It is impossible to predict what the outcome of that meeting will be. Both parties in OPEC will probably indulge in verbal sabre rattling in the run up to the meeting. While any public statement by OPEC countries during that period will need to be taken with a pinch of salt, they are likely to unsettle not only the oil market, but possibly other commodity and financial markets as well.

7. Our belief is that the Saudis will do their utmost to preserve the $34 per barrel marker but there are clear indications that they are finding the current situation increasingly intolerable. Fear of what may happen once the price begins to fall may well cause the other OPEC countries to move back into line. However, if the other OPEC countries are prepared to do nothing to raise the prices and/or to adhere more closely to their quotas, the Saudis may feel obliged to cut the marker price.

8. How much the Saudis may cut the price is also very uncertain. A cut of $2 per barrel might do a good deal to prevent future erosion of their output but would not compel the other OPEC countries to react immediately. A larger cut of, say $4 per barrel, would present a much sterner warning of Saudi determination but would carry a much greater risk of retaliation. A series of leapfrogging price cuts could easily reduce the world oil price to $20-25 per barrel.

9. Our guess would be that it will not fall anything like this far at least in the short erm. Fear of a bout of competitive price cutting which could leave all the OPEC countries worse off should lead them to act with caution and restraint. The risk of an early cut of several dollars per barrel is rather more substantial.

THE PRICE OF NORTH SEA OIL

10. At present the price of North Sea oil is very competitive with the price of other comparable crudes. In fact it is effectively about $3 per barrel lower than the price of marker crude. A cut of several dollars per barrel in the price of marker crude might have little or no direct effect on the North Sea price. Beyond this point the North Sea price would fall pari passu with that of the marker. The effect of falls in prices of other OPEC crudes will vary with crude oil concerned, but we would share in any general erosion of oil prices which followed a cut in the marker price.

EFFECT ON THE WORLD ECONOMY

11. The exact impact on the world economy will depend on a number of factors including the response of Governments' monetary and fiscal policies. Given unchanged financial policies a sustained reduction in oil prices will lower world inflation and increase world output. If oil prices fall as far as $25 per barrel (from the present average OPEC price of $32 per barrel) output might be about 1 per cent higher and inflation 1 per cent lower by the second year after the fall.

12. A sharp reduction in oil prices would have repercussions on the financial position of developing countries. Most countries would be assisted by a fall as their oil import bill is reduced and as the resulting increase in OECD activity boosts their exports. However, some countries would be in markedly worse shape.

13. Nigeria is already facing a large cutback in imports next year as nearly all of its export earnings come from oil. A further drop in revenues would make the necessary reduction in imports around 40%. Three quarters of Mexico's export revenues are accounted for by oil

exports and so an oil price fall would considerably worsen an already precarious position. Other countries in difficulty would include Algeria, Indonesia, Venezuela, Ecuador and Libya. Saudi Arabia would be forced to run even larger current account deficits for the next couple of years and the Soviet Union's trade balance would also worsen.

THE IMPACT ON THE UK ECONOMY

14. The UK ~~will~~ would be affected both directly by the fall in world and North Sea oil prices and indirectly via the impact on the world economy. As in the rest of the world the impact will depend on the stance of economic policy. The behaviour of the exchange rate will also be crucial.

15. Analysis in the Treasury suggests that, other things being equal, a 10 per cent drop in the oil price (equivalent to $3 to $4 per barrel,) might be associated with a fall in the effective exchange rate of the order of $1\frac{1}{2}$ per cent in the medium term. But this depends very much on the state of expectations about future oil price movements, and the extent to which the movement in question has already been discounted. The short term impact will also depend on the market situation at the time. And both short and longer term effects can easily be overlaid by other factors. For example, in February/March this year the BNOC $4 a barrel cut announced on March 2 seems to have had a smaller impact on the exchange rate than might have been expected, even allowing for some discounting in adv~~ance; but it~~ may have been overlaid by other factors. More recently market sensitivity may have been greater: a $\frac{1}{2}$ per cent fall in the exchange rate on the morning of 6th December seems in part to have reflected an increased expectation that the forthcoming OPEC meeting could result in lower oil prices.

16. Assuming that the sterling effective exchange rate reacts in the way the Treasury analysis suggests then an early fall of around 10 per cent in the average world and North Sea oil price ~~would reduce~~

It would increase the PSBR perhaps by around £½ billion in 1983-84 and something approaching £1 billion in 1984-85. It would worsen the current account of the balance of payments by something like £1 billion in 1983 but somewhat less in later years (if the improvement in competitiveness following the fall in the exchange rate was maintained). The level of output might increase by about half of one per cent by 1985. The rate of inflation over the next year or so would be reduced but may increase thereafter.

17. If the Saudis were to hold their price at $34 a barrel, but if all other oil prices (including the North Sea price) were to fall the impact on the world and UK economies would not be that different. This is because Saudi Arabia accounts for only about a third of OPEC output and a sixth of world output.

18. A fall in North Sea prices alone will tend to reduce UK domestic prices and boost output - but by less than in the case where all oil prices are lower; the impact on the PSBR will tend to be greater because there is less of an offset to lower North Sea revenues from other taxes. However, such a fall could only be small or temporary or both.