Prime Minister 2
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CONFIDENTIAL

MR NORGROVE

24 January 1986

THE OIL MARKET

Now that the anticipated slide of oil prices has occurred, there is a widespread tendency to see them descending to some floor level at which equilibrium will be re-established. On that presumption, Yamani's talk of oil prices falling below $15 per barrel sounds alarming. Perhaps fortunately, things are not that simple. Until OPEC contrive a credible new form of self-discipline and reassert a grip on the oil market, I foresee a period in which oil prices will be unusually volatile - varying perhaps in the range $15-25 per barrel.

The first point to bear in mind is that oil producers only produce on demand, ie when there are buyers ready to lift the oil. Although there may be short-term deviations between world oil production and consumption, the system is self-correcting, albeit not as smoothly as when the Saudis fulfilled the balancing rôle in support of high oil prices.

During the recent mid-Winter period, world oil production has exceeded the underlying level of consumption by roughly 2 million b/d. Now that prices are tumbling, buyers on the margin will be hanging back expecting lower prices in the future. With fewer buyers in the market, marginal production must perforce be shut back. Today's rate of production may already be below the rate of consumption. Unfortunately, that is unlikely to be of much help in the immediate future because so much oil is already on the water, destined for the major markets of Europe, North America and the Far East. For the next month or two, this is likely to exert a continuing downward pressure on oil prices.

However, another important consideration is the extremely low level of oil stocks throughout the oil industry - for good commercial reasons. This means that there is nothing to cushion the impact of sudden panics in the market. Any one of a number of factors - a snap of cold weather, a flare-up of the Iran/Iraq War, or the sudden switching of heavy industry and power stations from coal or gas to cheap fuel oil - could bring the buyers rushing into the market and lead to a sharp upturn of oil prices, only to be followed by a subsequent fall.

Meanwhile, what, if anything, can we do to encourage OPEC members to reassert a grip on the oil market in support of stable highish prices? The siren voices urging co-operation from non-OPEC producers are already being heard as close to home as Norway. Our policy line is to sit poker-faced and assert that OPEC oil members alone have both the self-interest and the means to manage the oil market in support of higher prices. After all, OPEC accounts for 14 million b/d of the 20 million b/d of oil which is traded internationally. Certainly, it would seem counter-productive to let producers like Nigeria, Iran and Iraq believe that relief is nigh in the form of non-OPEC co-operation.

The one snag in this policy line is that Saudi Arabia has got out on a limb over its declared insistence on a gesture of support from the UK. No OPEC initiative could succeed without Saudi Arabia, so there may come a time when it serves our interest to cast around for a face-saving symbolic gesture to the Saudis; but certainly not until Saudi Arabia's OPEC partners have become painfully aware of the paramount need for credible, sustainable self-discipline on their part. At that point, it might, for example, be worth expressing the belief that the rate of UK oil production in 1986 and 1987 will not exceed that in 1985; on current plans and forecasts, this will happen in any case.

Risk of slippery slopes here.

JMW.

JOHN WYBREW

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OIL WORRIES BATTER STERLING

OIL PRICE WORRIES HAVE ONCE AGAIN PUT THE SKIDS UNDER STERLING TODAY.

THE POUND SLUMPED TO 1.3905 DOLLARS, DOWN 60 POINTS, AFTER FALLING BELOW 1.39 AT ONE STAGE ON REMARKS BY SAUDI OIL MINISTER SHEIKH YAMANI THAT A PRICE OF LESS THAN 15 DOLLARS A BARREL IS PROBABLY UNLESS OPEC AND NON-OPEC PRODUCERS CO OPERATE TO BRING SOME ORDER BACK INTO THE MARKET.

THE POUND SLIPPED TO 3.4060 GERMAN MARKS (3.4111), WITH THE TRADE WEIGHTED INDEX AT 75.1 (75.3).

MEANWHILE, THE PRICE OF MARSH BRENT OIL TRADED AS LOW A 18.60 DOLLARS A BARREL ON THE ROTTERDAM SPOT MARKET.

DEALERS SAID THE ONLY THING HOLDING STERLING UP WAS THE APPARENT INEVITABILITY OF AN INCREASE IN UK BANK BASE RATES, TODAY OR TOMORROW.

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PRESS ASSOCIATION NEWS AT 1PM

... OIL PRICE COULD FALL TO 15 DOLLARS A BARREL UNLESS OPEC AND NON-OPEC NATIONS CO-OPERATE, SAYS SAUDI OIL MINISTER SHEIKH YAMANI. POUND DIPPED TO 1.3905 DOLLARS AFTER THE WARNING.