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REPORT TO THE SUBCOMMITTEE ON THE NEAR EAST AND SOUTH ASIA COMMITTEE ON FOREIGN AFFAIRS HOUSE OF REPRESENTATIVES

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A Summary Of European Views On Dependency Of The Free World On Middle East Oil

B-178334

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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AUG.29,1973

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-178334

The Honorable Lee H. Hamilton
Chairman, Subcommittee on the Near
East and South Asia
Committee on Foreign Affairs H1119
House of Representatives

Dear Mr. Chairman:

This is a summation of European views on the dependency of the free world on Middle East oil.

Your letter of March 16, 1973, requested that we furnish background information and develop lines of questioning for witnesses for Subcommittee hearings scheduled for the remainder of the year. One subject area identified was that of oil negotiations with the governments of certain Persian Gulf countries and their implications for the United States. Your office subsequently requested that our European Branch make inquiries and obtain views in Europe concerning two oil-related issues:

--Oil negotiations and European views and concerns on the negotiations, issues, and stability of supply.

--The impact of Arab oil money on the international monetary scene, as viewed from European monetary centers.

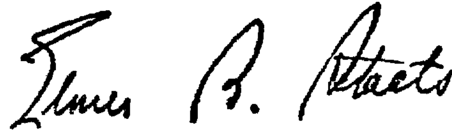
Members of our Frankfurt staff met and discussed these two issues with 26 government, banking, and oil industry officials in Germany and England. Some of these officials asked that we not identify them or their firms. Consequently, we decided that all individual sources of information would remain anonymous.

Consistent with your request for background information, this report summarizes views and information obtained in Europe solely from interviews. It contains none of our views, evaluations, or conclusions. Since our choice of individual European spokesmen was dictated by accessibility, not necessarily their expertise, this summation--although in line with the broad stream of official thinking--may not be totally

representative of European views. Moreover, European views on this subject may change very rapidly because new developments occur in the Middle East almost daily.

On May 4, 1973, an advance copy of this report was furnished to your office for use in preparing for oil-related hearings then scheduled for May and early June. The Subcommittee's office found the information useful and asked that a formal report be submitted for inclusion in the published record of the hearings. This report is in response to that request and will not be made available for general distribution until it is included in the record or we receive your authorization.

Sincerely yours,



Comptroller General
of the United States

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ABBREVIATIONS

GAO	General Accounting Office
NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Companies

UNITED STATES GENERAL ACCOUNTING OFFICE

A SUMMARY OF EUROPEAN VIEWS ON DEPENDENCY OF THE FREE WORLD ON MIDDLE EAST OIL

INTRODUCTION

On March 16, 1973, the Chairman of the Subcommittee on Near East and South Asia, House Committee on Foreign Affairs, requested GAO to furnish background information and to develop lines of questioning for witnesses for Subcommittee hearings scheduled for the remainder of the year. One area on which these hearings would focus concerned oil negotiations with the governments of certain Persian Gulf countries and their implications for the United States. The Subcommittee's office subsequently requested that GAO's European Branch make inquiries and obtain views in Europe concerning two oil-related issues:

--Oil negotiations and European views and concerns on the negotiations, issues, and stability of supply.

--The impact of Arab oil money on the international monetary scene, as viewed from European monetary centers.

Members of the European Branch's Frankfurt staff met and discussed these two issues with 26 officials, representing the U.S. Embassy in Bonn and the U.S. Consulate in Frankfurt; Iranian, American, and British banks in London; German banks in Frankfurt; major international oil companies in London; and the British Government in London. The bankers and oil company officials interviewed asked that GAO not identify individual spokesmen or their firms. Consequently, we decided that all individual sources of information would remain anonymous.

The Frankfurt staff summarized views of the European officials, drafted suggested questions for witnesses, and forwarded the document to GAO's International Division in Washington, D.C.

Consistent with the request, the report summarizes views and information obtained in Europe solely from interviews. It contains no GAO views, evaluations, or conclusions. Since GAO's choice of individual spokesmen was dictated by accessibility, not necessarily expertise, the summation--although in line with the broad stream of official thinking--may not be

totally representative of European views. Moreover, European views on this subject may change very rapidly because new developments occur in the Middle East almost daily.

On May 4, 1973, an advance copy of the report was furnished to the Subcommittee for use in preparing for oil-related hearings then scheduled for May and early June. The Subcommittee's office found the information useful and asked that a formal report--fully attributed to GAO--be submitted for inclusion in the published record of the hearings. This report is in response to that request.

The principal conclusions drawn by the majority of European officials interviewed are described in the following pages. Highlights are as follows.

--The energy crisis and increasing dependency on Middle East oil are real problems for both Europe and the United States, which cannot be avoided or greatly alleviated before the early 1980s.

--Immediate action is necessary to prevent the energy crisis from extending beyond the early 1980s.

--Europeans have adjusted to their historic dependency but are becoming more concerned, particularly over U.S. policies on the Middle East and energy.

--Cooperation among major oil-consuming nations is highly desirable but difficult to achieve.

--Middle East oil riches are an important factor in world financial markets and played a large role in the recent massive selling of dollars. Protection of value, however, not maliciousness, motivated the movement of oil wealth into other currencies.

--Accumulated oil wealth and the excess liquidity of major oil-producing countries must be considered in any new international financial arrangements.

--Both oil and oil-derived wealth are potential economic weapons of growing strength, although the actual or threatened use of such weapons has been limited to date.

CHAPTER 1

DEPENDENCY ON MIDDLE EAST OIL

The free world is rapidly running into two problems of resource dependency--dependency upon oil, a limited resource, and dependency specifically upon Middle East oil. The oil-supply situation for the major consuming countries is now desperate and is expected to worsen. The next 5 to 10 years will be difficult, and there is little that can be done about it. What is done now will determine whether the free world's difficulties remain short term or continue beyond the next decade.

RESERVES OF ENERGY SOURCES

Oil reserves in various forms are sufficient to more than meet the world's energy needs well into the next century and should see consumers well into the nuclear energy era.

On the other hand, there is a definite shortage of energy available in usable forms today, and this shortage is expected to grow until the late 1970s and possibly into the 1980s. As the free world's appetite for oil increases, the Middle East--particularly Saudi Arabia--takes on greater importance as the primary source for increased production.

Recent figures show that the United States imports about 29 percent of its total oil needs, of which about 9 percent is obtained from the Middle East. But by 1980 at least 40 percent will be imported, with about two-thirds coming from the Eastern Hemisphere, primarily the Middle East. Europe already depends on the Middle East for over 80 percent of its oil and Japan for over 90 percent.

The Soviet Union is apparently self-sufficient with its own oil sources and may have large reserves beyond its foreseeable needs. Russian leaders are optimistic because of the Siberian oil fields' tremendous output. However, great quantities of the Soviet Union's oil reserves are in such remote locations that development would be costly and difficult. Moreover, the Soviet Union may find itself not totally independent of Middle East oil if Soviet leaders decide to modernize[1] the country's industrial base, as they evidently wish to

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[1]Modern Western economies show a correlation between the dynamics of growth in industrial production and oil consumption. In this respect, the Soviet Union and its satellites lag far behind in oil consumption.

do. It has been reported that Communist Eastern Europe, with Soviet encouragement, is looking increasingly to the Middle East for both gas and oil.

China is thought to have large reserves, but the quantity is unknown.

IMPLICATIONS

The implication and significance of such dependency upon one part of the world, and a rather unstable one at that, are quite clear. European officials interviewed felt that Europe as a whole is probably not so alarmed as the United States because such dependency has been a fact of life for Europeans for well over a decade; the United States only recently passed from a position of surplus to dependency. These officials stressed that Europe is concerned, though, and is becoming more concerned. According these spokesmen, the obvious implications of such dependency are:

--The Arab countries may threaten to limit production or cut it off altogether unless consuming countries change their foreign policies, e.g., the U.S. position on Israel.

--Recognizing their oil as a limited resource, oil-producing countries may decide to limit production to stretch their income from oil over a longer period. Kuwait and Libya are now limiting production to a level rate. Saudi Arabia has talked about it.

--Radical elements may gain control of the major pro-West producers (Saudi Arabia and Iran) and severely restrict production or divert it to Communist countries exclusively. Two major producers, Libya and Iraq, are already controlled by radicals who have stated that both the oil and the revenues from oil sales should be used as political weapons.

--The producing countries have organized themselves into the Organization of Petroleum Exporting Countries (OPEC) and, through negotiations with the international oil companies, have obtained large increases in the price of crude oil, part ownership of production facilities, and a share of production.

--If supplies remain limited and the consuming countries do not also organize, they will be forced to bid against one another for oil and will thereby force prices even higher.

--A restriction or cutoff of oil could paralyze the economies of the consuming countries in a matter of days.

ALTERNATIVES

For the present and immediate future, there is no alternative to the free world's dependency on Middle East oil. Development of alternate energy sources will require 7 to 10 years. Whatever action the free world takes now will determine its medium- to long-term prospects. Some solutions to the energy crisis are as follows.

--Increase domestic production of crude oil. Currently there are only two sources for such increased supply: the Alaskan North Slope and the European North Sea Bed.[1] Other sources may well be discovered through continuing exploration in the United States and on its continental shelf. Development of the North Sea is proceeding but has been delayed in Alaska because of environmental concerns over the proposed pipeline to transport oil to refineries in the United States. If work on the pipeline started immediately, production from the Alaskan fields would still be 4 years in the future. Either or both of these sources would only temporarily relieve pressure on consuming countries.

--Practice greater energy conservation. There is considerable room for energy conservation in the United States and Europe, but doing it on an organized basis presents real problems. Some obvious areas are using only automobiles that give good gas mileage, using rapid mass transit in lieu of private automobile commuting, etc. Nearly all Europeans interviewed were highly critical of the U.S. Clean Air Act because the automobile engine modifications adopted to meet pollution standards under the act result in consumption of up to twice the amount of fuel to produce the same amount of energy.

--Develop alternative sources of oil. Refined oil products can be produced from coal, oil shale, and tar sands but at great expense. Development of these sources will probably not start on a large scale until prices of crude oil rise to the point that other

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[1]The Alaskan Slope is estimated to have at least 10 billion barrels of oil and the North Sea Bed at least 7 billion barrels. Full exploration, however, could significantly raise their oil yield.

sources become economically competitive. Oil reserves in the form of shale in the United States and tar sands in Canada are very large--comparable to crude oil reserves in the Middle East. Producing oil from shale, in particular, requires vast amounts of water, which, in itself, may present another conservation problem.

Latin American countries, such as Venezuela and Ecuador, are rapidly increasing their crude oil production and exports. Their known oil reserves, however, are not expected to sustain significant exports beyond 1980.

--Develop nuclear power sources. Most Europeans interviewed felt that nuclear power is the long-term solution. Any solution using oil or coal energy can be considered only interim. Nuclear energy sources, in addition to being far more efficient, have hardly been tapped. Other sources of nonpolluting "free" energy, such as geothermal power and solar, wind, and tidal energy, should be developed as quickly as possible.

The Europeans stressed that the United States and perhaps Canada are the only countries having all these options. Europe has no large deposits of oil shale or tar sands which could satisfy even its present petroleum demands.

U.S. REFINERY CAPACITY DEFICIT

In the eyes of Europeans, the United States has largely brought its current energy crisis upon itself and is likely to draw Europe into the crisis with it. For a number of years, few new refineries have been built in the United States, although consumer demand for refined oil products has risen sharply. As a result, U.S. demand now exceeds domestic refinery capacity and production. The shortfall is covered by importing refined products from Europe, which has a slight surplus in refinery capacity. U.S. competition for oil products in the European market is resulting in steadily increasing prices for European consumers. Moreover, the loss of its surplus capacity makes Europe more vulnerable and likely to have shortages of its own.

According to European spokesmen, construction of refineries in the United States has been blocked by groups concerned with environmental damage, as has construction on the Alaskan pipeline. They maintain that the U.S. Government has allowed these groups such latitude that overall U.S. interests have been damaged and adverse effects are being felt in Europe and elsewhere. They cite, for example, the mushrooming of offshore refineries near the United States in such locations as Puerto Rico, Nova Scotia, and the Bahamas--which are increasingly concerned about their own environments and resent the U.S. practice of exporting its pollution problems to them.

SUGGESTED QUESTIONS

1. What would be the effect upon the United States of an immediate curtailment of all oil imports, both crude and refined?

2. How could both government and private groups effectively manage the effects of such a curtailment?

3. Is the United States prepared for such a disaster? What is the estimated U.S. oil reserve, excluding military supplies? (Perhaps the Office of Emergency Preparedness has some data.)

4. Is it desirable for the United States to establish 30- to 90-day oil reserves as the European nations have?

5. In view of the current and probably continuing shortages of oil products, is it desirable and will it be necessary to impose rationing?

6. Are U.S. oil companies actively exploring for other sources of oil and natural gas (other than in the Middle East)? If not, why not? If yes, where and how much effort is being devoted? Are there legislative or regulatory barriers to such work?

7. How much effort are private companies expending on developing means of commercially producing oil from sources other than crude oil? Are there legislative or regulatory barriers to such efforts?

8. What is the status of our development of nuclear energy as a substitute for oil?

9. Has a thorough cost-benefit analysis been made of the effects of the Clean Air Act as it pertains to automobiles? Though no one can argue against the need to clean our air, it does seem to be at odds with the need to conserve oil supplies. Perhaps we are past the point where incremental costs exceed incremental benefits.

10. How secure are the present regimes in Iran and Saudi Arabia? Can--and do--the radical Arab States and the Soviet Union export subversion to these relatively conservative countries? What is the probability of the pro-West Arab governments' being overthrown?

11. Why is U.S. refining capacity below its needs? What must be done to enable us to catch up with demand and prevent shortages due to inadequate refinery capacity?

CHAPTER 2

CONSUMER NATIONS NEED TO COOPERATE

European government and oil officials alike expressed a feeling that the major oil consumers must organize and cooperate for their own protection. Some of the world's major oil-producing countries--Abu Dhabi, Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, and Venezuela--have pooled their power and formed OPEC. These countries control 85 percent of the oil available for export to the free world's consumer countries. OPEC's primary accomplishments have been to deter price competition among members, increase profits, conserve oil reserves for future production, and gain "participation" arrangements with the oil companies. Through concerted action, members have not only substantially raised oil prices but also lessened oil companies' control in OPEC countries.

Because of OPEC and a possibly limited oil supply, Europeans anticipate a tendency for consumer countries to try to outbid one another for available oil and thus drive prices higher. Some countries have already demonstrated a tendency to try to negotiate exclusive rights to a guaranteed oil supply from a particular supplying country. Examples cited were arrangements of France and Italy--and possibly Germany--with Iraq and Libya. According to recent news articles, Japan is doing likewise. And, of course, the potential special arrangement mentioned by all spokesmen was Saudi Arabia's suggestion that its oil might be better reserved for the United States. On the other hand, Saudi Arabia more recently suggested it might cut the U.S. supply off unless support for Israel was significantly diminished or terminated.

It was universally felt to be imperative that the free world begin work now to develop energy sources other than oil in general and Middle East oil in particular. The lead times required to perfect the technology and construct the equipment for other sources was felt to be so great (7 to 10 years) that no time could be lost. More pessimistic spokesmen felt that normal economic market forces would not be enough to initiate immediate action by the private sector--the price of crude oil would have to climb much higher to provide economic stimulus to develop other sources. The implication was that organized governmental action and incentives would be needed to spur fast action. In some cases existing legislation may contribute to shortages. For example, the price of natural gas at the wellhead is fixed by the Federal Power Commission pursuant to

law.[1] Industry spokesmen feel that the fixed price is so low as to discourage exploration for further sources.

SOME OBSTACLES TO COOPERATION

According to the officials interviewed, there appears to be in Europe some mistrust of the United States--at least apprehension over its possible actions and motives. Such feelings may be shared by the Japanese as well and are prompted by the following factors.

--With its large oil reserves and tremendous scientific and technical capability, the United States can "go it alone" without Europe or Japan. As one executive expressed it, the United States can achieve the impossible if it sets its will to it. As an example he cited the United States setting itself the impossible goal, in 1960, of putting a man on the moon within 10 years, and then doing it.

--The feeling of dependency upon Middle East oil is new to the United States, but Europe is accustomed to it. The United States may eventually feel unduly threatened and may react selfishly--to the detriment of its friends and neighbors.

--There is a feeling that the United States, in letting its refinery capacity fall behind demand to the point it must be bailed out by Europe, does not have its priorities properly arranged and might not work wholeheartedly at solving energy problems.

--Tying itself to the United States may not be in Europe's best interest if the Arab States withhold oil because of the U.S. stand on Israel. Most Europeans interviewed found the U.S. concentration on Israel difficult to understand. They felt the U.S. dedication to Israel--without balancing support and concern for the Arab States--was somewhat myopic. They did not suggest that the United States do less for Israel but that it

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[1]In late 1972 the Commission adopted an optional pricing method pursuant to which a producer may seek authorization to sell "new" gas--that is, gas not previously sold in interstate commerce or gas from wells drilled after April 1972--at a rate exceeding that determined by the Commission for the geographic area involved. However, the legality of optional pricing was challenged in the U.S. Court of Appeals and has not been resolved. In April 1973 the President proposed new legislation which would deregulate sales of "new" gas by producers.

demonstrate greater concern for the Arab States, particularly since the latter control so much of the world's oil.

Most spokesmen felt that Japan showed a tendency to "go it alone" and take care of itself first. They felt that Japan would not initiate moves to cooperate with Europe and the United States, but if the United States and Europe got together, Japan would probably join with them. It appears from Japan's recent arrangements with the Soviet Union for crude oil and coal from Siberia that Japan is more inclined to help itself than to merely talk about its problem. Japan seems to be reacting to the problem faster than either the United States or Europe.

EUROPEAN STEPS TOWARD COOPERATION

The European countries have cooperated to a degree through the Paris-based Organization for Economic Cooperation and Development (OECD). In accordance with agreements reached through the OECD, each member country is committed to have a 65-day reserve stock of oil (based on the prior year's consumption) and to share it with any other member in case of serious shortages. The developing deficit in refinery capacity in the United States recently prompted the OECD to raise this requirement to a 90-day supply.

Each OECD member must also have a fuel-rationing system ready for immediate implementation, if needed. Officials told us that only England and France had complete ration systems "on the shelf," plus 65-day reserve stocks of oil. They believed that, by comparison, the United States had only a few days' supply of oil.[1] The OECD is also seeking a comprehensive energy policy for its members to cover such issues as European dependency upon imported oil, U.S. competition for oil sources and products, and the impact of United States-Israeli relationships upon Arab oil sources. The OECD is also considering the related issue of whether Europe should develop its own special ties with the Arab countries.

NEGOTIATIONS WITH PRODUCERS

The oil-producing countries' organizing into OPEC was a major milestone in their relations with the international oil companies and consumer nations. To date the major accomplishment of OPEC in its negotiations with the oil companies has

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[1]The Administration's Oil Policy Committee estimates that the U.S. oil reserve stock, in terms of total consumption, is less than 60 days but much greater than a few days.

been to obtain higher contract prices for crude oil, a fluctuating price to offset currency devaluations, and a gradually increasing participation in the ownership of production facilities within the host country.

Most of the oil company executives interviewed regarded participation as gradual nationalization that would lead ultimately to control of distribution and marketing as well as production.

Recent developments indicate that OPEC countries will honor an agreement only so long as it is to their advantage. The agreement reached between OPEC and the oil companies during last fall's negotiations provided for automatically adjusting prices by a jointly agreed formula to account for currency revaluations. Immediately following the dollar devaluation early this year, OPEC demanded that prices be renegotiated because the formula adjustment provided only for a 7.2-percent increase and it felt it should get an 11.1-percent increase. Prices are currently being renegotiated. Moreover, OPEC countries have indicated they will now demand higher prices for crude oil because of inflation, which will further increase U.S. import bills.

Oil company executives were generally gloomy about the future of their companies and the industry as a whole. Most felt that rising prices, the increasing tendency for direct government-to-government negotiations, and the need to switch to other energy sources have spelled the end for commercial oil-producing companies.

SUGGESTED QUESTIONS

1. Is the U.S commitment to Israel compatible with the free world's need for Arab oil, in terms of benefits and costs to the United States? Has the State Department or the Department of Defense made a strategic analysis of U.S. Middle East interests and policies?

2. What can and should the United States do to cooperate with Western Europe and Japan to prevent a complete runaway by OPEC members?

3. How would cooperation among governments of consuming countries affect negotiations? Would these governments participate in negotiations or leave them to the oil companies?

4. North Atlantic Treaty Organization (NATO) oil supplies come from North American sources--the United States and Canada.

What effect might the absence of an oil agreement between the United States and Western Europe have upon NATO supplies? Are NATO supplies guaranteed even in the event of a serious U.S. oil shortage?

5. Considering past absence of cooperation and present indications of Japanese and some Europeans' tendencies to "go it alone" and line up exclusive oil rights directly with one or more producing countries, what are the prospects for a firm agreement or understanding of cooperation between the United States, Canada, Western Europe, Japan, and other major oil consumers? Is it too late for such cooperation?

CHAPTER 3

OIL REVENUES EXCEED ECONOMIC NEEDS

OF MIDDLE EAST COUNTRIES

Middle East oil-producing countries have accumulated large international monetary reserves in recent years. This accumulation has resulted from an inflow of oil revenues at a faster rate than these countries can--or choose to--spend or invest their earnings. The most recent (April 1973) International Monetary Fund statistics show the following reserves for the major oil producers.

	1966	1973 (note a)	Reserves to imports (note b)
	(millions)		(months)
Saudi Arabia	$ 748	$3,087	35
Libya	339	2,986	42
Kuwait	1,096	[c]2,235	33
Iran	268	968	4
Iraq	325	785	11

[a]February 28, except for Iraq, which is December 30, 1972, and Kuwait. (See note c.)

[b]Monetary reserves compared to import demand. Based on 1971 imports except for Saudi Arabia, where 1970 data is the latest.

[c]Kuwait Central Bank reserves at February 1973 ($396 million) plus Government holdings at end of first quarter of 1972 ($1,839 million).

On the basis of increasing Western demand for Middle East oil, annual payments to producing countries are estimated to rise sharply to $15 billion by 1975 and $30 billion by 1985. Unless there is a major change in the ability of producing countries to use this wealth, their reserves may rival those of the developed world. It is clear, nonetheless, that the producing nations are emerging as powerful forces in world trade and finance.

CAPACITY TO ABSORB OIL REVENUES

Oil producers can be divided into two groups: those countries which have basic economic and industrial facilities

and can therefore absorb their oil revenues for development purposes--Iran, Iraq, Bahrain, and possibly Oman--and those countries which, lacking such facilities, cannot absorb their wealth in domestic development, such as Kuwait, Qatar, Abu Dhabi, Dubai, and other ministates in the Persian Gulf.

Saudi Arabia has been characterized as somewhere between these two groups. Its known resources other than oil are few, but it is a large country which possibly can absorb great amounts of capital in resource exploration and development. On the other hand, past performance indicates a probability that it will continue to accumulate wealth. Because of its vast oil reserves, Saudi Arabia is considered the pivotal country in meeting the Western World's increasing demand for oil. It therefore will be the major recipient of future oil revenues and the key producing country involved in any solution to the problem of large capital outflows from the United States and other Western consumer nations.

Libya's current oil revenues have greatly exceeded its ability to absorb them in domestic development. As a result, its monetary reserves have risen more rapidly than those of other major producers. This situation may continue into the 1980s, but Libya's known oil reserves are being depleted and the country is limiting production to bring foreign exchange receipts more in line with its ability to absorb them. In the short run, Libya is probably more inclined than other Middle East countries to use its large monetary reserves for political motives.

SUGGESTED QUESTIONS

1. How have Middle East producers been spending their oil revenues?

    A study published in 1972[1] lists the following ways.

    --Establishing state reserves for use when oil reserves run out.

    --Increasing the wealth of ruling families.

    --Providing more services and luxuries for citizens of Middle East countries.

    --Investing in domestic industries, including some prestigious but costly failures.

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[1] "The Changing Balance of Power in the Persian Gulf," American Universities Field Staff, Inc., 1972.

--Investing in productive enterprises in other capital-hungry Middle East countries.

--Investing in productive enterprises in other parts of the world.

--Contributing to other Middle East countries for political stability.

--Extending development aid to other Middle East countries; to other Islamic states; and, through international institutions, to other developing countries.

--Investing in foreign financial markets.

2. How can oil-consuming countries influence producers to increase investments for productive purposes both at home and abroad?

Suggested solutions include:

--Increasing technical assistance to these countries to identify and develop domestic projects for intensive capital investments.

--Educating the countries to make longer term investments.

--Tying oil payments to reinvestments in the consuming countries.

Treasury Department spokesmen have publicly announced that the Department is seeking to help create the proper climate for investment by the oil-producing countries in the United States. Among several efforts, it will seek to promote U.S. exports of commodities and technical services to these countries. Moreover, it will work with producing countries to develop uses for their reserves that are consistent with a stable world monetary system.

CHAPTER 4

OIL RICHES AND INTERNATIONAL FINANCIAL MARKETS

European bankers believed that Middle East oil wealth played a major role in the February 1973 run on the dollar. These bankers estimated that between 20 and 33 percent of the dollars exchanged for German marks came from oil money. Their estimates, however, were based on a "feel" for what happened in the money markets, not on exact knowledge. According to these bankers, the U.S. Federal Reserve System and the German Bundesbank are in better positions to know the sources of the exchanged dollars.

European bankers did not believe that the oil countries acted maliciously. Instead, they acted to protect the value of their financial assets, most of which were in dollars. The bankers noted that the oil countries were slow to act (some shifts from dollars into German marks were made after the devaluation) and that even the high estimate of oil money movements did not represent a large portion of the oil countries' total dollar holdings.

POTENTIAL IMPACT OF OIL WEALTH

Although they regarded the oil countries' past actions as blameless, bankers expressed concern over the potential impact of these countries' large and growing foreign exchange holdings. The problem is basically one of excess liquidity, but political motives may compound the problem. Some bankers singled out Libya as the one oil-rich country having both the reserves and the political inclination to deliberately disrupt money markets.

Though other oil producers might not use their wealth as an economic weapon, movements in their liquid assets--because of sheer size--influence financial markets. Some London bankers said that it was possible to tell when oil companies made major payments to producing countries because of resulting fluctuations in short-term interest rates in London. They said that short-term rates rise about a quarter of a percent as banks borrow to cover the London-based oil companies' payments. The rates then return to normal as the money finds its way back to the London market.

European bankers said that the oil countries traditionally have been interested in short-term, high-yield investments--which means investment in the Euro-dollar market. Some bankers said that oil countries were extremely interest sensitive and

would switch holdings for small interest-rate gains. Other bankers believed that interest rates--and consequently interest earnings--were becoming less and less of an investment motivation, but that, as the oil countries' currency holdings rise, the protection of asset value (against currency devaluations, for example) was becoming increasingly important.

Bankers considered most oil countries unsophisticated in money management, which created a tendency to overreact to monetary crises. Since the oil countries have vast liquid assets, such overreactions could severely upset money markets. These bankers said that, after the dollar devaluation, some oil countries had been selling dollars and buying gold which, in turn, was driving the price of gold to artificially high levels.

European bankers agreed that any new international financial agreement must deal with the oil countries' vast holdings of liquid assets. They were not, however, optimistic about resolving this problem during the upcoming International Monetary Fund discussions in Nairobi, Kenya. One banker noted that the issue was not even on the official agenda.

One suggestion to reduce fluctuations in foreign exchange values is to restrict or even ban central banks' dealings. Several bankers, however, felt this proposal would not be too effective in oil-producing countries because their central banks were unlike those in Western countries. They said that central banks in oil-producing countries were not truly independent financial institutions but were often repositories for the ruling families' wealth. They also observed that, during the February 1973 monetary crisis, Western central banks ceased placing money on deposit in the Euro-currency markets,[1] but Middle East central banks continued. The bankers expressed the opinion that these central banks--merely by transferring funds to private banks--would effectively thwart any international agreement to restrict such activities.

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[1] Composed of key currencies held outside their countries of origin and usually deposited with U.S. or foreign banks in European financial centers, such as London or Zurich. Dollars from U.S. payments deficits are cycled into the markets, which also attract other currencies to generate a further pyramid of deposits. By mid-1973 the markets totaled about $100 billion, of which the dollar component was about $85 billion. Such funds are lent to either other banks or corporate or governmental borrowers throughout the world.

SUGGESTED QUESTIONS

1. What can be done to minimize the potentially disruptive impact of oil riches on international financial markets?

   The bankers presented no clear solutions. They were skeptical of reaching any international agreement which would handle the problem. They saw a need to educate oil-producing countries to invest in less liquid forms than the Euro-currency markets. One banker proposed that an international financial institution could be created to rechannel oil wealth back into productive long-term investments. He felt that this might overcome the oil countries' fears of nationalization or expropriation of their foreign holdings.

2. Is there any trend for oil-producing countries to invest in less liquid assets?

   Kuwait is said to be a decade ahead of other oil countries in its money management policies. Some of its investments include:

   --The Kuwait Fund for Arab Economic Development.

   --Purchases of World Bank bonds.

   --A Kuwait Investment Fund, which makes 90 percent of its investments in productive enterprises outside the Middle East.

   --Portfolio investments abroad.

   European bankers felt that large amounts of the Middle East liquidity would be absorbed by compensation payments to oil companies for production facilities acquired under participation agreements and by investments in Western oil companies and oil-related ventures. An increasing amount of oil money is also being invested in property throughout Europe. Finally, a number of new banks, wholly or partly backed by oil money, are beginning to operate throughout Europe.

3. Can the world's capital markets absorb the projected surplus oil funds?

   Pessimists in banking circles say "No." They believe that the projected currency transfers for oil will have a major impact on the parity of world currencies and that the world's capital markets cannot handle surplus oil income quickly enough to avoid problems.

Optimists believe that world capital markets are elastic enough to accommodate these surplus funds and that much of the capital outflow from the Western oil-consuming countries will, by necessity, find its way back to these countries, which have large and better developed capital markets.

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