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The High Oil Price and the Recycling of OPEC Petrodollars

Looming dangers for the international financial markets?

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High oil prices have made OPEC earn record revenues during the last couple of years. Due to the low absorptive capacity of oil-exporting economies, a good portion of this income is invested in international financial markets. During the last period of high oil prices, the oil shocks of the Seventies, recycling of petrodollars brought turmoil to financial markets and triggered the first international debt crisis at the beginning of the 1980's. An analysis of today's situation indicates that current oil revenues do not yet have harmful impacts on the stability of international financial markets. However, due to the situation of world crude oil market in 2005, dangers may be looming in the not so distant future.

Oil prices have been on a rampant up-ward path since early 2004 (when prices were last seen below $30), hitting all-time nominal heights above $70/bbl in the wake of Katrina only marginally below their 1980 peaks of $80–90/bbl, depending on the deflator used). While some calm has entered the market since, prices may stay high for quite a while.

This development raises two questions for international leaders: firstly, what are the impacts of high prices on oil-consuming economies? And secondly, on the income-side of the equation, what will happen with the enormous revenues flushed into oil exporters' pockets? Can the recycling of these petrodollars yet again cause problems for world financial markets as was the case in the Seventies?

Political debate has focused primarily on the first question.[*] Quintessentially it can be said that, in spite of the decreased vulnerability of advanced countries to price spikes, some kind of setback can be expected. However, not much attention is being paid to the second question, even though alarm bells should be ringing as a result of current exploding oil revenues, since petrodollar recycling in the Seventies led to the first international debt crisis.

Size of the revenues

Without much publicity, OPEC oil revenues have been boosted over the last couple of

[*] See also SWP-Comment 49/04: »The surge in oil prices—is a new oil crisis looming?«, November 2004, at http://www.swp-berlin.org/common/get_document.php?id=1078

Table
OPEC Oil Revenues

$bn, 2005$	*1980*	*1998*	*2005^e*
Algeria	26.1	6,4	29.8
Indonesia	30.1	3,5	−0.4
Iran	26.6	11,9	41.0
Iraq	54.8	7,6	19.3
Kuwait	38.0	9,1	36.9
Libya	45.1	6,7	23.9
Nigeria	48.4	9.9	37.7
Qatar	10.9	3.9	17.0
Saudi Arabia	211.7	39.7	150.1
UAE	38.2	10.9	39.0
Venezuela	36.8	13.5	35.5
OPEC	566.7	123.1	429.8
MENA-OPEC	451.4	96.2	357.0

e estimates.

Source: US Energy Information Administration.

years, reaching $430 billion in 2005 (assuming 2005 WTI crude oil at $55/bbl). This is not only a result of the oil price increase but also reflects heavily expanded oil production on the back of surging world demand (OPEC production rose 20% in the last three years). Consequently, 2005 revenues are expected to be $90 billion above last year's and a stupendous 250% higher than in low price year 1998. A good one third ($150 billion) will be pocketed by Saudi Arabia alone, which has profited from its large export increases.

In total, 2005 OPEC revenues will not yet equal the $567 billion of its record year 1980 but are coming ever closer. However, on per capita basis, oil earnings have been in a free fall over the last decades, plummeting to $800 in 2005, a loss of almost 60% compared to 1980. This fact should be kept in mind when thinking about social stability, as it also holds true for the less population-intensive Middle East/North Africa (MENA) region, where oil earnings dipped from $5250 to $2250 per person. While this drop is mainly attributable to population increases (84% in MENA-OPEC), it also owes to the fact that the value of oil in real terms decreased constantly over the last decades.

Petrodollar conundrum in 1970's

The oil price shocks of the Seventies heralded a fortune-ridden decade for OPEC countries, bringing total oil revenues to around $3.0 trillion during the period from 1970–1980 (real 2004 dollars). These revenues triggered massive state-financed activities in oil exporting nations that reached unprecedented and more often than not wasteful extent. Records show huge spending on infrastructure of questionable use, inflated state consumption, and waste and corruption documented in a comical variety of anecdotal evidence.

However, oil revenues were much higher than the absorptive capacity of Middle Eastern economies, lacking industrial development and investment opportunities. Consequently, huge excess revenues were transferred to international (mostly American) private banks, held as currency reserves, or supplied to international lending organisations like IMF and IBRD. These funds, famously coined "petrodollars," were then used by the private and institutional banks for massive expansion of international loans—at highly attractive zero to negative real interest rates due to high inflation. Latin American and other emerging or developing countries jumped at the opportunity and acquired badly needed currency for paying oil price inflated imports. When the loans were used for paying oil imports from OPEC, the petrodollars closed the perfect textbook circle.

Western governments looked at the huge amounts of circulating petrodollar with mixed feelings, fearing a destabilisation of international financial markets. As it turned out, it was not industrialised countries but rather developing world that was devastated in the aftermath: plunging inflation combined with a policy of high-interest rates at the beginning of the 1980's sent whole countries into bankruptcy (Latin America's 'lost decade')—the first international debt crisis emerged.

Petrodollar recycling today

In principle, OPEC's oil revenues can be used for consumption, repayment of debts, domestic investment, foreign portfolio investment, and for holding currency reserves. Relative weights of these uses have changed in the past (see graph 1).

Economic development and population booms have vastly increased the absorptive capacity of OPEC countries. Consequently, domestic investment opportunities and the propensity to consume are much higher today, causing imports to rise with oil revenues. Through this mechanism, petrodollars are partially recycled in non-oil exporting nations. While estimates of the Ministry of Economics show that Germany profits over-proportionately from increase of MENA imports, Chinese exports to MENA

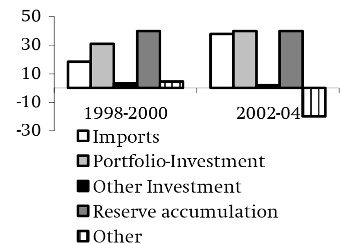
countries have become a major competition lately. Altogether, this effect causes the net transfer of income from oil importers to exporters to be significantly lower today. This is one reason why trade balances of industrialised countries were affected so little by the oil price rise 2003–2004 (reported to be around −0.3% of GDP, a tenth of what it was during the price spikes of the Seventies).

However, a big chunk of the income can not be absorbed domestically, but is invested abroad. Traditionally, the money was invested with American banks and held as US Treasuries—in the Nineties MENA-OPEC placed some $18–25billion per year in the US. Worried that the US might seize these funds in the wake of September11 (having the US International Emergency Economic Powers Act freeze "hostage capital") Arab nations discontinued investment and even repatriated assets held in the US. Presumably some part of oil revenues were invested in the MENA region itself, leading to exploding local stock market indices and housing prices. During 2004, MENA investment in the US picked up again, reversing the post-9/11 trend. With some reserves due to the opacity of financial flows, the IMF estimates oil exporters' capital poured back into the US at a rate of $2.5 billion per month in 2004 (unfortunately, information about high oil price 2005 is not yet available). However, while this is a sizeable amount, it appears meagre if compared to total capital inflows into the US of some $75 billion per month—of which Asia (mostly China and Japan alone accounted for some $30 billion).

In order to assess the extent of impact of oil on the financial markets, it is worthwhile to remember that oil, while it is the world's top traded individual good, has lost relative weight. With world trade multiplying many-fold over the last decades, oil merely had a share of much less than 10% of total world trade in 2003. Consequently, currency and capital movements necessary for or induced by oil trade are not any longer the central pillar of international currency reserves and accumulation. MENA-OPEC countries hold less than 5% of world currency reserves today—compared with a full 35% of the total at the end of the second oil shock in 1980. Furthermore, world financial markets have undergone an extended period of international integration and have become more flexible in handling risks and bottlenecks.

Finally, while it is true that oil revenues currently sum up to tremendous amounts, accumulated incomes in particular have not reached the levels comparable to the Seventies. During the three decades 1970–80, 1980–90, 1990–2000, OPEC oil revenues reached (in 2004 prices) $3.0 trillion, $2.3 trillion, and $1.7 trillion respectively. The high price period since 2001 earned OPEC some $1.4 billion—a total still significantly lower than in the seventies.

Graph 1
Use of additional oil revenues, MENA OPEC (percent of total revenues)



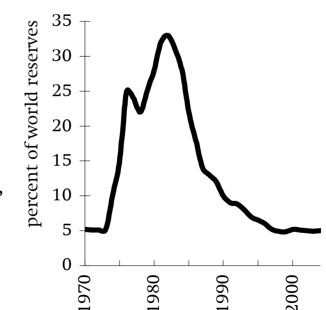
Source: IMF, *World Economic Outlook 2005*.

Conclusion and outlook

Although at tremendous heights, today's OPEC revenues are not likely to engender a return of petrodollars with an impact as sizeable and dangerous for international financial markets as back in the Seventies. However, this conclusion should be tempered by two fundamental caveats:

First, today's high oil prices come during a delicate phase for the US economy, which, as most analysts agree, needs rebalancing sooner rather than later. A robust current account deficit has incrusted in US trade since 1991 and is getting worse every year—latest estimates point to some 6% of GDP in 2005. Rather vast imports of foreign capital are necessary to finance this gap (swallowing around 80% of total world savings!).
At the same time, the US fiscal deficit exceeded 5% of GDP in 2004, on its way to 6% in 2005. Add to this the expansion of real estate prices since 1998, which even Alan Greenspan hints may be a bubble. In this scenario, recent oil price spikes are one more stone in the daunting mosaic of dangers to the US and world economy.
A look at the numbers helps: the monthly US trade deficit in 2005 is around $55–60

Graph 2
Stock of MENA-OPEC currency reserves 1970–2004



Source: IMF, *World Economic Outlook 2005*.

billion—of which $20 billion are attributable to imports of oil during the month of June. This crippling burden is poised to get even more serious with rising oil prices and disruptions in the supply of oil products resulting from Hurricane Katrina.

Second, there is a fundamental difference in the structure of the world crude oil market between today and the seventies. When OPEC raised prices in 1973, oil consumers started a huge quest for oil supply in alternative parts of the world. Their striking success with exploration and production quickly started to undermine the almighty market power of OPEC, which began eroding as a functioning cartel in the beginning of the 1980's until it imploded in 1986. In contrast, today world oil reserves and locations are perfectly well-known and most analysts would agree that oil supply outside the Former Soviet Union and OPEC has peaked (the latter sitting on top of two thirds of world oil reserves)—and will start to decline in the next few years. It is thus inescapably sure that OPEC's position in the market will become ever stronger over the years to come and that high oil prices will not create supply competition from non-OPEC sources, which would eat up OPEC's market share. Consequently, high oil prices and revenues can be expected to persist in the medium term if OPEC sticks to cartel and no-access policy—a situation fundamentally different than that faced during the Seventies. Obviously, that will bring the issue of petrodollars recycling back onto the world's agenda—with higher accumulated amounts.

Last but not least, one word about the involved producing nations. While MENA-OPEC fiscal budgets had been based on price assumptions below $20/barrel, current prices offer strong surpluses, relieving budgetary pressures and offering a window of opportunity for reforms. To what degree revenues will be dedicated to education, infrastructure, fighting unemployment, and, most importantly, towards strengthening the non-oil and private sectors of local economies will decide whether the current oil boom leads to a long-term positive development rather than to the bust experienced in the Eighties. And, as recent events have taught us, the wellbeing of the Western World is inextricably intertwined with that of Middle Eastern countries and their societies.

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