THE OIL CRISIS: HOW IT HAPPENED

Everyone knows that oil prices have plummeted in recent weeks, but few people actually know why. Mexico has its own ideas on this matter.

The sudden collapse of world oil prices could not have come at a worse time for the Mexican economy. Soon after prices began to drop, it became all too clear that the careful planning by Mexico's top economic advisors to guarantee the country's international financial obligations had been for naught. But that's not all. The oil crisis will not just have devastating effects on Mexico's economy, but its long-term social effects could also transform the country as we know it today. With this in mind, VOICES OF MEXICO asked Erik Salas Klimt, an oil specialist now working for the Ministry of Energy, Oil and Nationalized Industry, to give us an analysis of what his agency believes is the evolution of events that led to the current crisis. In the next issue we will continue our oil series with an article on the effects of the crisis on Mexico's economy today. Mr. Salas Klimt's views:

Perforation in Tampico. Photo by Rogelio Cuellar.

Mexico's oil exports will continue to play a crucial role in the country's economic and financial strategy for the rest of the century. Earnings from oil exports represent Mexico's only possibility for overcoming its current crisis and moving forward on the path to development. This means that Mexico must link the problem of falling oil prices to its foreign debt obligations. It also means that any strategy for growth must take into account the necessary resources both to reactivate the economy as well as to guarantee the reestablishment of past income levels for the majority of the population

The Main Actors

After 1973, the steady increase in world oil prices led oil companies to open drilling and extraction projects in areas that had not been profitable before. This later became a key factor in diversifying sources outside of the OPEC cartel. One of the International Energy Agency's proposed goals was to break the developed countries' dependence on OPEC producers. The new oil supplies came increasingly from non-OPEC members, mainly Mexico, Canada, Norway and the United Kingdom.

The appearance of new oil-producing countries on the world market meant that OPEC members were increasingly forced to recognize their new role as partial suppliers. For every barrel of oil the new producers put on the market OPEC sold a barrel less. OPEC tried in vain to counteract this tendency.

Discussion of this new situation was a priority item on the agenda at the OPEC Minister's Conference held in March of 1982. The Organization set a production ceiling of 17.5 million barrels a day for its members. It was also announced that the price of Arabian light crude, used as a reference point in setting prices, would be frozen at $34 a barrel until 1985.

OPEC's problems in reaching an agreement surfaced at later meetings. In Vienna, in December of 1982, the Organization was unable to agree on production quotas for its members even though a production ceiling was set at 18.5 million barrels a day. Nor was an agreement reached when OPEC ministers met a month later in Geneva, and internal divisions and disagreements began to come to the surface. Most members felt that Saudi Arabia was keeping the lion's share of the market to itself. Nigeria, Venezuela and others threatened to cut prices to increase their share of the market. Sheik Ahmed Zaki Yamani, the Saudi Arabian Oil Minister, retorted that if they wanted a price war they'd get one. But none of the threats were actually carried out, and OPEC members refrained from taking action against other member countries.

On February 18, 1983, the British National Oil Corporation, BNOC, took the lead by announcing a $3 cut in its per barrel price of Brent-type crude. Norway followed suit by reducing the price of its Ekofish crude, also pumped from the North Sea. Then Nigeria, an African OPEC member, lowered the price of its Bonny light crude by $5.5 per barrel. Bonny light has a similar quality and market conditions to North Sea oil, and the slash meant that it now underpriced Great Britain and Norway by 50 cents a barrel.

Obviously, the price of Arabian light crude couldn't be sustained at $34 a barrel for very long. The danger of an impending price war convinced both OPEC members and their competitors that they had a serious problem on their hands. By March of 1983 everybody concerned recognized the need for changes in prevailing price structures.
The demand for OPEC crude fell to under 15 million barrels a day, and Saudi Arabia's output dipped below the 4 million barrels mark. By March 1983 OPEC was facing the most difficult situation in its twenty year history.
Falling prices had become an obvious trend from the time that overproduction began to deteriorate prices on the spot market, particularly for African light crudes. Price trends had been consistently negative since mid-1981, judging by the netback value of a barrel of refined oil in Rotterdam.
When OPEC Ministers met in Vienna in July of 1984, they outlined a new policy that took into account a diversified market supply that included large producers who were not members of the Organization. The most important result to come out of that meeting was a decision to set up contacts with independent producers to find ways and means for joint efforts to stabilize market conditions and shore up prices.
But in October of that same year Great Britain and Norway reduced the price of their oil, arguing that prices had already fallen on the spot market. This signaled the failure of OPEC's negotiations. Some observers believed that the market's situation did not warrant bringing prices down, especially since winter was just setting in and demand for fuel would be up. On the other hand, this downturn in prices contributed to further deteriorating market conditions.
This is not to say that decisions by North Sea oil producers are the only ones affecting market conditions. The lack of coherence between OPEC's decisions and the actual policy carried out by some of its members has also contributed to the situation. Nonetheless. the price of North Sea crude is a key factor in the market's stability. Pressure has mounted on BNOC crude because clients can buy the oil on the spot market for $3 or more dollars below the official price. To this we must add the lack of discipline on the part of some important OPEC members. Both have been important factors in determining market conditions over the last several months.

Mexico's Role in the Oil Market

There are two main lines to Mexico's oil policy under current market conditions. In the first place we have the traditional policy of defending the natural resources and raw materials that make up most of the exports of the underdeveloped countries. At the same time, our policy seeks to obtain fair prices for our main export commodity, oil. This is also a traditional aspect of Mexican policy, but it is crucial under current circumstances because we need a fair price for our exports in order to deal successfully with our financial difficulties. Thus, Mexican oil diplomacy has sought to develop a policy of dialog and cooperation among both producers and their customers. Consultation and agreements among suppliers and with buyers are a central part of Mexico's strategy in international oil negotiations.
Mexico's contacts with OPEC began in January of 1983. At the time the international oil market was undergoing a dramatic change. Control of the market was passing from producers to buyers. By then Mexico was the world's fourth largest producer, surpassed only by the USSR, the United States and Saudi Arabia. Additionally, Mexico had displaced the Saudis as the main supplier for the U.S. Relations between Mexico and OPEC moved from mutual indifference and sometimes hostility, to dialog and cooperation based on the common goal of defending national interests and stabilizing the market.
Unlike what seems to be the case for other independent producers, Mexico's oil policy contemplates factors that go beyond the immediate situation. The idea that a stable market is vital to the world economy as a whole, and benefitial for both producers and consumers, is at the core of Mexico's policy. In addition to outlining its strategy on the basis of market conditions —rationalizing production to avoid disrupting the market, upholding prices as a means of avoiding waste of a limited resource—, Mexico also tries to build understanding among producers to avoid total anarchy. Our policy calls for cordial and mutually respectful relations with our customers that will guarantee both fair prices for our commodities and the secure supply they need for their own productive activity.
Mexico has had to adapt to extreme, rapidly changing market conditions. When our country first became an important

MEXICO: Production and exports of crude oil 1979-1985
(barrels per day)

PRODUCTION	1979	1981	1982	1983	1984	1985 (1)
South East zone	1 094 058	935 444	852 724	748 710	737 511	n.d
Campeche Sounder	51 744	1 082 505	1 617 406	1 673 829	1 737 908	n.d
Others	315 374	294 165	276 253	243 001	209 052	n.d
Total Extraction	1 461 176	2 312 114	2 746 383	2 665 540	2 684 471	2 718 000
Liquid natural gas	146 971	241 493	254 821	265 221	256 823	270 000
Condensed	9 854	846	1 793	22 739	114 274	n.d.
Total liquid hydrocarbons	1 618 001	2 554 453	3 002 997	2 953 500	3 055 568	2 988 000
EXPORTS						
Isthmus (34°API)	520 626	487 413	680 195	677 900	620 400	541 000
Maya (22°API)	12 209	610 608	811 898	859 100	904 200	797 000
Total exports	532 835	1 098 021	1 492 093	1 537 000		

(1) Figures for the first quarter
(2) Began production in 1979
Source: PEMEX, Statistical Yearbook.

producer and exporter, an international economic boom and an increasing demand for oil led us to believe that benefits from petroleum exports would make it possible for us to overcome underdevelopment. We would move into a period of economic expansion unlike anything we had ever experienced. Yet just a few years later we are faced with the fact that oil is just another commodity whose price is determined by the laws of supply and demand.

The difficult situation facing petroleum exporting nations, especially if they are underdeveloped, became increasingly obvious at the OPEC Conference held in Geneva in August of last year. Rumor had it that Saudi Arabia had started negotiations with its ARAMCO partners on contracts in which the price of oil would be determined on a netback basis. This kind of price structure is based on income estimates for sales on the spot market of the refined products from a barrel of crude oil. This means that standards must be agreed on as to the expected yield after refining.

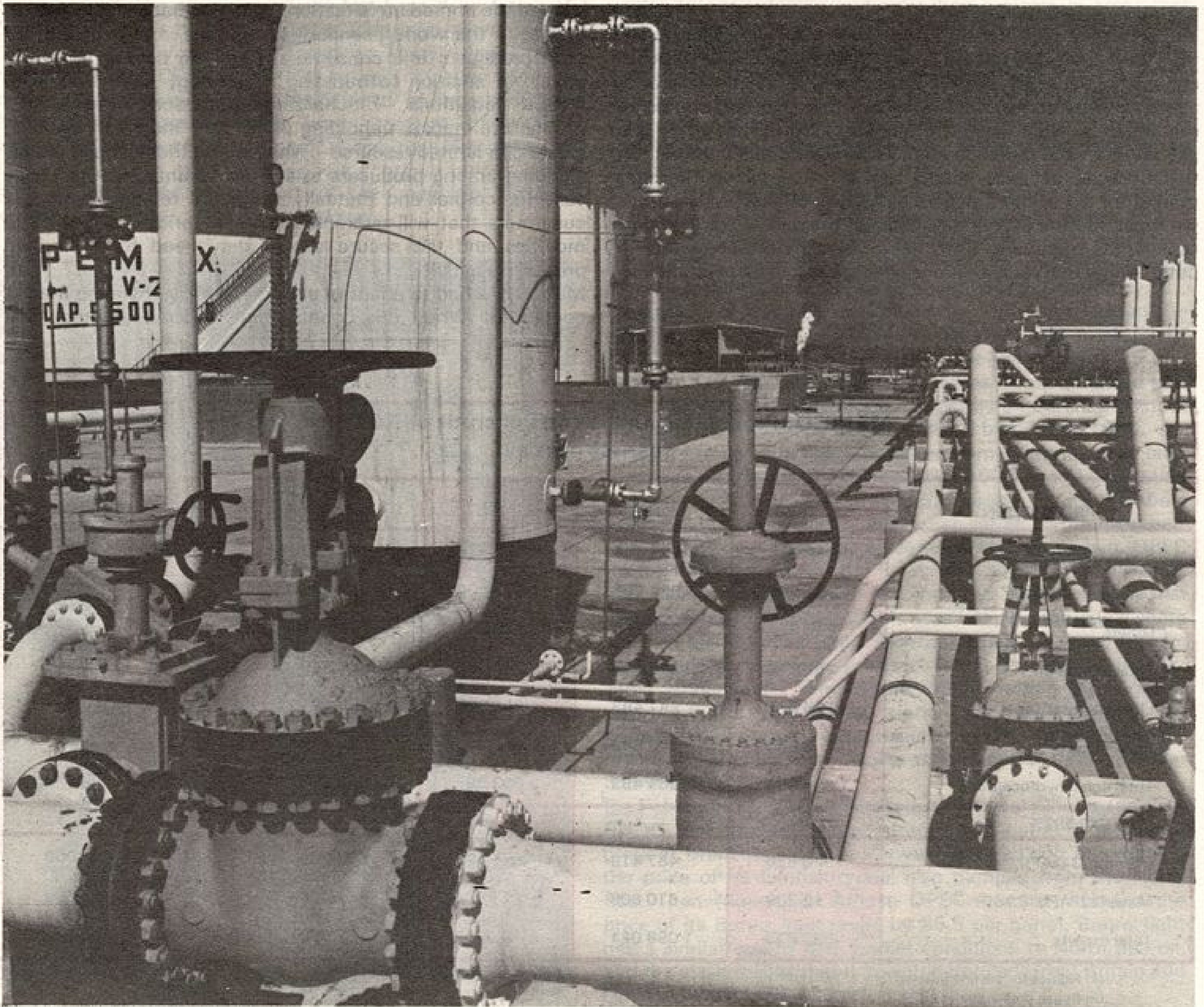
Given a specific market, spot price quotes are applied to the product structure to determine a hypothetical gross income. Then costs for refining, shipping, insurance, as well as the profit agreed on for the refiner, are subtracted. In this type of contract, the producer assumes all costs. The producer also looses any role in determining prices, a key factor in the OPEC system. At the same time, the market looses its transparency as the effective price becomes information that is only known precisely by the seller and the buyer. All of this affects Mexico's policy of strict adherence to official prices and contracts.

PRICES FOR PEMEX'S EXPORT PRODUCTS JULY 1985

DESTINATION	ISTHMUS	MAYA
United States	26.75	23.50
Far East	26.50	23.00
Europe	26.25	22.50

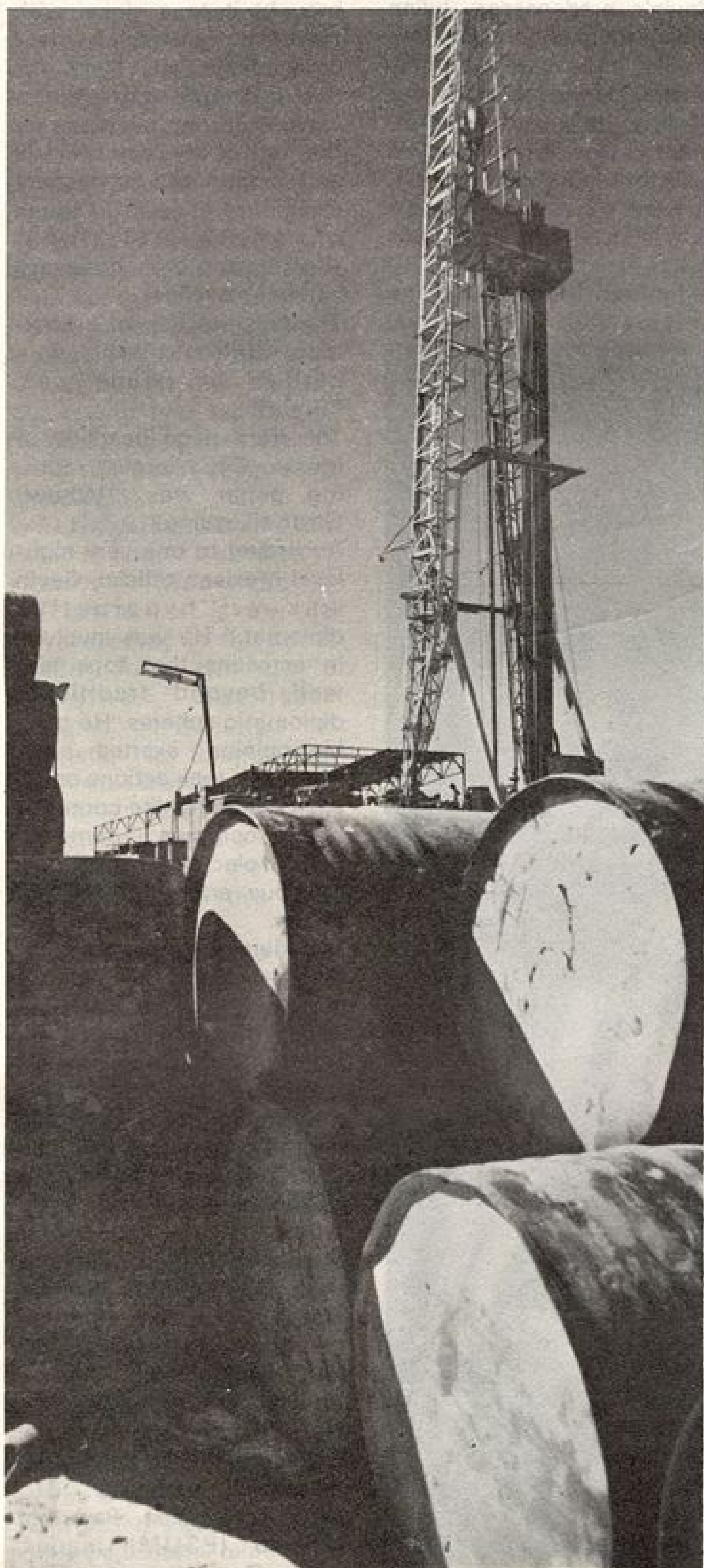
Price quotes: **Free on Board**
Source: PEMEX

The new Saudi policy was explained by Mr. Yamani during a Seminar on Energy held at Oxford University in early September of 1985. He stated that Saudi Arabia was no longer willing or able to shoulder the responsibility for regulating world petroleum supply to actual demand. Minister Yamani pointed out that the problem had taken on global dimensions that went beyond the interests of each individual country, and that over-supply of petroleum was being used by buyers to bring prices down. He also said that producers outside of OPEC were confident that the Organization would adjust its output to keep prices from falling. In the meantime, these independent producers kept their own output at maximum capacity.



Tampico, Tamaulipas. Photo by Rogelio Cuellar.

Finally, Mr. Yamani indicated that, given the situation, Saudi Arabia had decided to establish prices on a netback basis, and that this policy would remain in effect until February or March of 1986. At that point, Saudi Arabia might unilaterally lower the price of Arabian light crude to $15 a barrel. Falling oil prices throughout February and March of this year have proven Mr. Yamani true to his word.
Market conditions since mid-1985 have led to a fall in Mexican oil exports to 800,000 barrels a day, almost half of the level of its shipments since 1979 (see Table 1). For as long as it was profitable, PEMEX, Mexico's state-owned oil company, kept up its policy of selling its Maya 22 degree API-type crude at official prices and only to final destination. Thus, PEMEX actually increased the price of Maya crude three times between 1983 and 1984, bringing it to $26 a barrel. With OPEC output falling 1.5 million barrels below the level agreed on by members, to 14.5 million barrels a day, refiners were actually able to choose the most convenient type of crude. As a result, Mexico lost its competitive edge, and the volume of its exports began to fall.


Oil deposit in Tampico. Photo by Rogelio Cuellar.

In 1985 Mexico's exports fell even futher because of agreements with OPEC to reduce sales volume by as much as 100,000 barrels a day, in an attempt to prop up prices. Additionally, in July Mexico decided to cut the price of its Isthmus light crude, and to link prices to the final destination of the oil. Thus, the price of a barrel of Isthmus crude ranged between $26.75 and $26.25, while Maya type crude was priced between $22.50 and $23.50. These changes brought both in line with prevailing market prices.
As a result of these measures Mexico's exports achieved a substantial recovery. In a more pragmatic approach, the government abandoned the practice of setting official prices. It was decided prices would be determined on a retroactive monthly basis. This has been carried to the point where prices today are quoted according to daily market conditions.
Since petroleum exports provide 70% of Mexico's foreign currency income and 45% of the government's total intake, oil today is the only means of keeping the economy afloat. In order to meet its international financial commitments without having to resort to new loans or to more budget cut-backs, which would further deteriorate the living conditions of the majority of the people, Mexico tries to keep oil prices as high as possible.
Under the current circumstances the country faces two basic alternatives. One is to continue the pragmatic policy of keeping in close touch with OPEC's most important members, complying with the cartel's policies, and sharing the load of difficult market conditions. The other is to allow market forces to determine prices and to follow their lead in the market, struggling to keep our customers, and selling our oil at whatever the current market price.
In either case Mexico has to take into account that the necessary market adjustments, and its eventual stabilization, are impossible in the short-term. Policy must also contemplate that costs and benefits of these adjustments should be shouldered by both buyers and producers.
Recent events show that there are no simple solutions to the problems of the world oil market. It is also increasingly evident that no solution is possible without the cooperation of all the concerned parties. In administering prices, independent producers'consent to reduce their output is as important as OPEC's cooperation.
The present crisis has meant sacrifices that have not been equitably distributed among producers. In this sense, it's important to keep in mind Mexico's position at the OPEC meeting held in July of '85 in Vienna. Mexico demanded effective solidarity among exporters to stabilize the market, and warned that unless there was reciprocity in the required sacrifices, unless real commitments were made, our country would be forced to take steps to defend its national interests.
Thus far the governments of the developed countries have wrongly supposed that OPEC and other Third World oil producers would continue to uphold prices even at the cost of internal sacrifices and of loosing their share of the market. But the insurance policy that OPEC provided in this sense has expired, and this could have catastrophic effects even for those not directly involved in the oil trade.
Under the present circumstances, the volatile oil market can become a crucial issue for the developed economies when the time comes to pay the cost for today's complacent attitude toward falling oil prices. The bill may come due when by the end of the century the reserves of non-OPEC producers begin to decline. But even before this happens, countries like Mexico might start making unilateral decisions, such as linking the situation in the oil market to their foreign debt payments. The consequences of dealing with problems only from the point of view of short-term conveniences can be bad enough. They could be far worse if linking of the two problems takes place. ★