Energy & Geopolitical Risk

Volume 3, No. 7 July 2012

Iraq: Fragile Political System

Iran: Road To Nowhere

New Vistas For Consumer-Producer Cooperation

Financial Assistance To Arab Spring Countries

ثِق بها، إعتمِدها.

مَصرف لبنان

Energy & Geopolitical Risk

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COMMENT

The legacy that the US left in Iraq is a fragile sectarian political system, which if it continues much longer, could slip the country into a civil war, similar to the Lebanese experience of the 1970s. Another complication in Iraq is the reappearance of autocratic rule. The weakness of the Iraqi political system has raised the question: what is the role and ambitions of Iran in the country? Mr. Gerald Butt argues that Tehran is happy to maintain good relations with all Iraq's Shi'a factions, just as long as it is able to continue influencing the particular Shi'a leader who happens to occupy the Prime Minister's chair. Furthermore, given Iran's concern about possible developments in Syria and the outcome of talks on the nuclear issue, it seems unlikely that Tehran will seek to bring about change in Iraq that could create more complications there.

The lack of progress in the talks on Iran's nuclear file between the world powers and Tehran , makes it increasingly likely that Western sanctions will be implemented as planned. However, Amrita Sen and Helima Croft argue that if the diplomatic task remains stalled or is deemed dead, then the calls for military action will mount. Iran has emerged as a key foreign policy issue in the US presidential campaign, and senior Israeli officials have repeatedly expressed skepticism about the P5+1 (Security Council permanent members and Germany) talks and continue to drop hints about taking military action. Hence, "oil market participants may have to factor in a higher geopolitical risk premium, as the prospect of an easy off-ramp in the Iranian nuclear dispute appears ever more elusive."

J M Keynes advocated intervention in commodity markets as being in the interest of both producers and consumers by improving the allocation of resources. In the current dynamic world the increased uncertainty of oil prices is detrimental to economic development and growth. Mr. Adnan al-Janabi and Mr. Luay al-Khatib argue that the growth in oil supply and the possibility of Iraq becoming an additional swing producer pose the question: is it now time for price stabilization to be implemented? The authors investigate the theory of commodity market stabilization, cases for increased price volatility by the emergence of more demand and supply variables during 2000-2012, and examine the possibility of producers and consumers cooperating in their common interests. They also analyze the possibility of new financing of spare capacity to stabilize prices.

The Arab Spring has brought major political changes to several countries (Tunisia, Egypt, Libya, and Yemen, as well as an ongoing revolt in Syria). However, the political transformation has not been without economic ramifications. Ms Melanie Lovatt asks Dr. Jassim al-Mannai in an extensive interview what and how much economic assistance has been provided to the Arab Spring countries. The interview also dwells on the impact of the euro zone crisis on the Arab economies, mainly credit terms to Arab projects/businesses, as well as, financial ramifications on the GCC countries due to the toughening of Western sanctions on Iran.

Iraq: Avoiding The Lebanon Experience?

Gerald Butt*

Seven months after the last U.S. forces left Iraq the country's political system shows no sign of functioning in a way that benefits the Iraq people as a whole. Instead, it is shackled by the system introduced by the Americans, in which sectarian rivalry has come to overshadow national interests.

In this respect, the similarities with Lebanon are obvious, and the coming months will show whether Iraq can avoid following the Lebanese experience in the 1970s and slipping into civil war. To avoid this happening, Iraqi politicians will have to demonstrate a far greater commitment to the ideals of statehood based on compromise and power-sharing than they have thus far.

For another complication is what many Iraqis see as the gradual and unwelcome reappearance of a home-grown characteristic of political rule over recent decades: autocratic rule. While Iraq functions better than most other Arab democracies, attempts at power-sharing between political parties with strong sectarian affiliations have failed disastrously over the past seven months, leaving the government largely paralyzed. At the same time, with squabbling within the various groups continuing, Prime Minister Nuri al-Maliki has been able to extend his control over key institutions of power.

With the Defense and Interior Ministries already under his wing, and with control of oil revenue and the budget, the prime minister is in a strong position to impose his own political agenda inside Iraq. Of late this has involved two key goals: to limit attempts by Iraqi Sunnis, who feel marginalized by the Shi'a-led government, to assert their rights; and to side-step the efforts of his political opponents (Sunni, Kurdish and Shi'a) to unseat him from power.

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* *Gerald Butt is a former Editor in Chief of MEES.*

In pursuit of the first goal he has instigated court proceedings against Vice President Tariq al-Hashemi, accusing him of masterminding acts of terror within Iraq. He has also launched bitter attacks on Sunni Deputy Prime Minister Salih al-Mutlaq and Parliament Speaker Usama al-Nujaifi, accusing the latter of lacking neutrality.

Mr. Mutlaq incited the prime minister's wrath by accusing him of acting like a dictator – a view that is shared by most of Mr. Maliki's opponents, especially those in the Iraqiya bloc, led by Iyad Allawi. Haidar al-Mullah, a leading Iraqiya member of parliament, said the time had passed in Iraq when a "dictatorship is born. We have now moved to a phase when dictatorship grows in the hands of the prime minister."

In an attempt to force Mr. Maliki from power, or at very least prevent him from becoming prime minister for a third time, a coalition of opposition groups has been trying various ways of deposing him, but without success. Several meetings have brought together leaders of Iraqiya, the Sadr bloc and the Kurdish Democratic Party led by Mas'ud Barazani. These three parties are resolute in their dislike of Mr. Maliki. But they cannot agree on exactly what steps to take to remove him, or on which Shi'a leader should replace him.

The opposition's stand is weakened, too, by splits within the various groups themselves. Mr. Allawi, while a seasoned politician, has no party power base, and is having difficulty holding together his Iraqiya bloc, consisting largely of Sunni and secular Iraqis. Some within the bloc accuse Mr. Allawi (a secular Shi'a himself) of being motivated more by a desire to secure the premiership for himself rather than for the good of the country.

At the same time, the Kurds are divided over their support for or dislike of Mr. Maliki. While Mr. Barazani is fiercely opposed to the Iraqi prime minister, his rival in northern Iraq, Jalal Talabani (leader of the Patriotic Union of Kurdistan), in his capacity as President of Iraq, has refused to endorse impeachment proceedings against the prime minister.

Then there is the ambivalent position of the Sadr bloc – a powerful Shi'a force in the land in terms of popular support and a member of Mr. Maliki's coalition government. The Sadrists' decision to join the alliance against the prime minister represents a damaging split within the Iraqi Shi'a movement.

All of which begs the question: how does Iran view the political maneuverings? For most Iraqis believe that both Mr. Maliki and Muqtada al-Sadr have strong ties with Tehran. The answer seems to be that Iran is anxious for the status quo to continue in Iraq while the Tehran leadership deals with more pressing regional issues, such as the turmoil in Syria which threatens its strategic link with the Levant and has prompted the flexing of Turkish (Sunni) muscles. So while the lid can be kept on the political cauldron in Iraq, Iran is not concerned about the inter-Shi'a rivalry or the discontent among the Sunni community.

Strong evidence that this is Iran's desire comes from the refusal of President Talabani to accede to demands that might lead to the unseating of Mr. Maliki. If Iran had been backing the removal of Mr. Maliki, the thinking goes, then the president would have acted differently. As al-Hayat columnist Mustafa Zein wrote recently, "Talabani has his own Kurdish considerations, for the region where he holds influence is contiguous to Iran and he takes great care not to antagonize it."

But Tehran's current indifference to the machinations of Iraqi politics should not be interpreted as a long-term loss of interest in the status of its western neighbor. Far from it. For while the violence in Syria is a symptom and an expression of the wider Shi'a-Sunni struggle for regional influence, Iraq will ultimately be the actual frontline of that confrontation. For this is the single Arab state (apart from Lebanon and Bahrain) with sizeable Sunni and Shi'a populations. Iran, therefore, is determined that Iraq's Shi'a majority, having seized power after the defeat of the Sunni-dominated Ba'thists, should never relinquish it.

So for this reason, Tehran is happy to maintain good relations with all Iraq's Shi'a factions, just so long as it is able to influence the particular Shi'a leader who happens to occupy the prime minister's chair. The result is what Sunni Arab Gulf leaders view with dismay and a good deal of alarm: Iraq acting, to a large extent, as an instrument of Iranian policy. This is not the case solely over Syria: it can be detected in oil politics as well, where traditionally Tehran and Baghdad were fierce rivals. At the recent OPEC meeting in Vienna, for example, Iraq joined with Iran, Algeria and Venezuela pressing for steps to be taken to push oil prices higher.

Given Iran's concern about possible developments in Syria and the outcome of talks on the nuclear issue it seems unlikely that Tehran will seek to bring about change in Iraq that could create more complications there. At the same time, splits within groups opposing Mr. Maliki and the latter's proven political dexterity mean he will probably hold on to power for the immediate future.

But all this leaves Iraq in a very grim position, without a strong government and with increasing levels of sectarian violence. In June alone, nearly 300 Iraqis were killed in terrorist attacks. And against the background of this lawlessness, critically sensitive issues remain unresolved, like the future of the disputed city of Kirkuk. All the while, agreement on the vital hydrocarbons law is no closer to being passed; and basic services remain in a state of decay. Also, with relations strained between the Kurdish region in the north and Baghdad, the threats from the Kurds of a move towards independence grow louder, while a number of provinces elsewhere in Iraq are looking to loosen ties with Baghdad.

Perhaps the bigger concern is that when the Syria crisis is finally resolved, then the focus of the regional tension between Sunnis and Shi'a will shift squarely onto Iraq. When this happens it will be a foolhardy commentator who rules out the possibility of the country emulating the catastrophic fate of Lebanon four decades ago.

Iran: The Road To Nowhere?

Amrita Sen and Helima Croft*

No Deal Emerges In Moscow

The Moscow talks between Iran and the permanent members of the UN Security Council plus Germany (P5+1) ended without a significant breakthrough, and the future of the diplomatic track appears to be in doubt. International recognition of Iran's right to enrich uranium and sanctions relief were once again the key stumbling blocks in the negotiations. Iran insists that it has the legal authority to enrich uranium for civilian purposes as a signatory to the Non Proliferation Treaty (NPT). The UN Security Council, however, has issued a series of resolutions calling for Iran to halt all enrichment because of concerns about a possible military dimension to its program and the failure to fully disclose its activities to international inspectors. In recent weeks, Iranian officials have been adamant that the country would not surrender the right to enrich under any circumstances, although they have suggested that they would consider halting enrichment at 20 percent levels and shipping out some of the higher grade uranium stockpiles as a reciprocal gesture. While they have not been as publicly vocal about sanctions relief, numerous press reports indicate that Iranian officials have repeatedly raised the issue of lifting the impending EU oil embargo in discussions with Catherine Ashton, the EU foreign policy chief and lead P5+1 negotiator. The P5+1 team, in turn, has been pressing Iran to agree to a set of confidence-building measures, including freezing 20 percent enrichment, submitting to a more rigorous international inspection regime, and closing the heavily fortified Fordow enrichment site. It has refused to cede any ground on recognizing Iran's right to enrich uranium or removing sanctions before these steps are taken. Following the conclusion of the Moscow talks, Ashton stated "The choice is Iran's. We expect Iran to decide whether it is willing to make diplomacy work, to focus on concrete confidence building steps, and to address the concerns of the international community." Although the Iranian nuclear negotiator indicated that he was hopeful about the technical follow-up meeting scheduled for July 3 in Istanbul, it remains unclear what can be accomplished as long as both sides remain wedded to their positions.

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* *Amrita Sen and Helima Croft, Barclays Commodities Research(www.barcap.com), 2 July 2012*

IAEA Inspectors Refused Entry To The Parchin Facility

The Moscow stalemate followed a similarly unsuccessful round of meetings between Iranian officials and representatives of the International Atomic Energy Agency (IAEA) earlier this month. The IAEA team failed to secure access to sensitive military sites where Iran is accused of conducting nuclear weapons-related experiments, notably the Parchin facility. The lead IAEA inspector, Herman Nackaerts, told reporters that the Vienna talks were "disappointing" and provided "no progress." Last month's IAEA report has compounded concerns about the Iranian nuclear program. UN inspectors reported seeing hundreds of newly installed centrifuges at the Fordow enrichment site. The Israeli government has repeatedly cited enrichment at Fordow as an important red line because the facility is built into a mountain and cannot be easily targeted by bunker-busting bombs. It has repeatedly vowed to take action before Iran enters a "zone of immunity" by transferring the bulk of its centrifuges to Fordow. The recent IAEA report also notes that Iran's stockpile of 20% enriched uranium has grown to 319 pounds from 242 pounds one year ago. While enriching at 3.5-5.0% is widely seen as consistent with a civilian nuclear power program, Iranian officials contend that they must enrich at 20% to produce fuel rods for the medical research reactor at Tehran University. Iran would need to enrich at 90% levels for an actual weapons program. However, by making the leap from enriching at 3.5% to 20.0%, Iran is seen as only a few technical steps away from being able to enrich at weapons-grade levels. The international inspectors found trace levels of 27% enriched uranium, but the IAEA report suggests that it may have been accidental, occurring for "technical reasons beyond the operators' control."

The lack of progress in Moscow makes it increasingly likely that the EU oil embargo and the US Central Bank sanctions will be implemented as planned. The impasse also raises the prospect of additional economic sanctions in the second-half of 2012. Moreover, if the diplomatic track remains stalled or is deemed dead, we believe that calls for military action will mount. Iran is already emerging as a key foreign policy issue in the US presidential campaign. Mitt Romney has repeatedly called for Obama to take a tougher line with Tehran and over the weekend said that the president seems "more frightened that Israel might take military action than he's concerned that Iran might become nuclear.". In addition, one political action committee has already produced a television spot criticizing the White House for allowing Iran to enrich enough uranium for five nuclear weapons and warns that "It is time to act, before it is too late." Members of the US Congress are also growing increasingly impatient with the lack of movement on the diplomatic front. Forty-four US senators wrote to Obama last week saying that he should consider halting the talks if no tangible progress was made in Moscow. Similarly, senior Israeli officials have repeatedly expressed skepticism about the P5+1 talks and continue to drop hints about taking military action. On Sunday, Israel's Vice Prime Minister Moshe Yaalon stated that Israel "could find itself facing the dilemma of 'a bomb, or to bomb'," Israeli President Shimon Peres also publicly questioned whether enough progress was being made at the talks to justify their continuation. While the Obama White House continues to show no desire for a military strike, it also publicly took the containment option off the table during Prime Minister Netanyahu's visit to Washington in March. Thus, it may find itself facing a difficult decision if an acceptable diplomatic deal is not quickly devised and Iran moves closer to achieving nuclear weapons breakout capability. Similarly, oil market participants may have to factor in a higher geopolitical risk premium, as the prospect of an easy off-ramp in the Iranian nuclear dispute appears ever more elusive.

Oil Market Oblivious To The Failure Of Iranian Talks

Despite the failure of the Iranian talks so far, oil markets have taken little notice. Macro concerns have continued to pressure prices in a market in which the general perception is one of oversupply, as the return of Libyan production, together with Saudi Arabia continuing to pump more than 10 mn b/d, has more than compensated for the small loss in Iranian barrels thus far. While various estimates of the amount of Iranian output actually lost are being put forward, the average of the third-party estimates we use (IEA, EIA, MEES, Platts, Reuters, Bloomberg, EIG) points to a reduction of just 300 thousand b/d, to around 3.2-3.3 mn b/d, since the end of last year. Shipping consultancies point to a much larger cut, and despite a pick-up in exports to Asia in May, the overall loss amounts to around 0.8 mn b/d compared with the end of 2011. The true extent of the loss of Iranian output remains unknown. Anecdotal reports suggest that Iranian floating storage is almost 50 mn barrels and rising, while the IEA notes a further 20-25 mn barrels held at onshore facilities, pointing to some trouble in placing their crude in the market. But there are also reports that Iranian VLCCs have been bunkering off the coast of Indonesia before being broken down into smaller vessels and sent through to China. The problem is compounded by the fact that Iranian vessels are routinely switching off their tracking devices, rendering the timely measurement of exports problematic.

Current Shortfall From Iran Is Around 200-300 Thousand b/d; Could Rise To 1 mn b/d In Q3

The full implementation of the most severe sanctions to date on Iran's oil and banking sectors is just two weeks away. In the meantime, Iran is reportedly offering longer credit terms to some customers, effectively giving buyers a price discount on crude purchases. Assuming that some of Iran's exports continue to find their way, particularly to China, the key question is how much Iranian volume will actually be lost. From July 1, the EU embargo would imply that no crude imports from Iran would come to Europe, and that alone constitutes around 0.7-0.8 mn b/d of volume. So far, Europe seems to have reduced imports by around 300 thousand b/d. Meanwhile, the US has now exempted 17 more countries from sanctions, effective 28 June, after demonstrating that they have reduced imports of Iranian crude significantly. As of now, India, Japan and South Korea, large buyers of Iranian crude, have been exempt from US sanctions. The waiver is for 180 days and is intended to give countries more time to reduce imports from Iran. In Q1 2012, Japan and South Korea have reduced imports y/y from Iran by 31% and 23%, respectively. India has committed to an 11% reduction in Iranian imports, while preliminary data for May show a 20% reduction compared with the 2011 average. Not surprisingly, the International Energy Agency (IEA) expects that the implementation of full sanctions would ultimately lead to a cut of some 1 mn b/d in Iranian supplies in the second half of the year "as storage tanks both onshore and offshore reach maximum capacity unless the country finds alternative outlets." We agree and expect a reduction of 0.8 mn b/d-1 mn b/d of Iranian production in the second half of 2012.

Loss Of Shipping Insurance Could Push The Loss Of Exports Higher

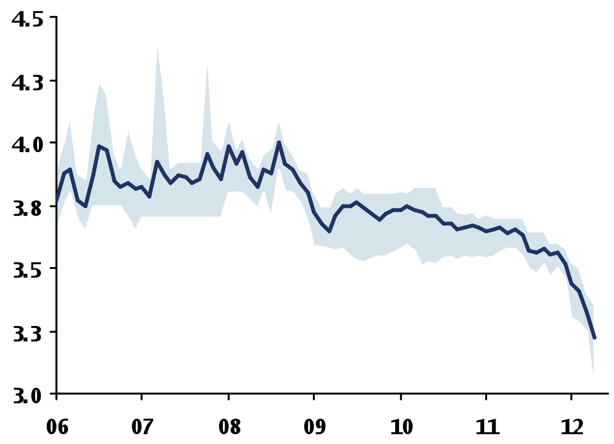
An indirect effect of the EU sanctions can result in a much larger loss of Iranian exports. This relates to a ban on insurance cover for ships carrying Iranian oil, because much of the world's ship insurance is tied to EU-based P & I (protection and indemnity) clubs. After lobbying from Japan, Brussels agreed in March that the third-party liability and environmental cover provided by these P & I clubs would be available until the end of June. Nonetheless, Asian ship owners are still hesitant about sending vessels to Iran because of difficulty in obtaining other forms of necessary insurance. For example, the modifications introduced in March make clear that contracts for insurance covering damage to a ship's hull or its cargo may not be signed after March 24, when the latest version of the EU sanctions legislation was published.

Although the Japanese government is likely to pass a bill that would compensate buyers of Iranian crude for the loss of insurance cover, complications from carrying Iranian crude remain. The possibility that future additional US sanctions could block ships from loading or unloading cargo in US ports if ships have visited Iran in the preceding 180 days is creating further uncertainty.

The Loss Of 1 mn b/d Of Iranian Supplies Tightens Balances In H2

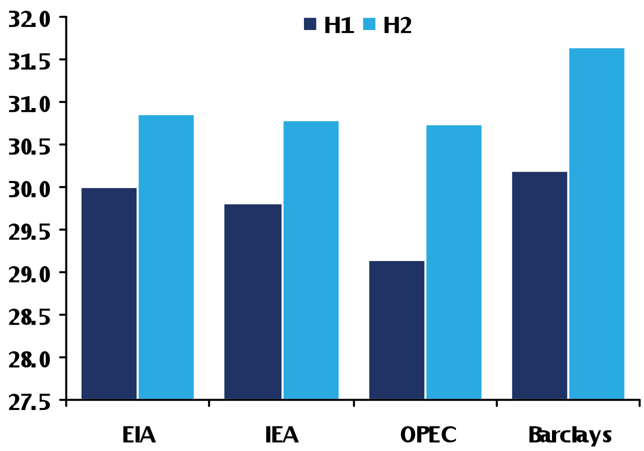
Even working with a loss of 1 mn b/d, oil balances look vastly different to what they appear now. The call on OPEC crude in the first half of this year is around 30.2 mn b/d. Actual OPEC output in the first half is set to average 31.4 mn b/d, almost 1.2 mn b/d above the call. The call on OPEC crude in the second half of 2012, however, is on average 1.0-1.5 mn b/d higher relative to the first half across consensus and essentially stands at OPEC's current production levels. Given the lack of spare capacity in the market, arguably, the loss of 1 mn b/d of Iranian imports could easily bring actual OPEC production substantially below the call on its crude, resulting in larger inventory draws than the consensus currently expects. While current levels of high production have undoubtedly resulted in inventory builds, in our view, the increase in inventories around the world has not been large enough to meet the increase in demand, once it rebounds. There is a general belief in the market that the world is awash with crude, as OPEC production continues to run well above its call. However, OECD inventories have only risen by 270 thousand b/d over the same period and, even at the end of May, remain below the five-year average for the eleventh straight month. We estimate around 1 mn b/d of inventory build in the non-OECD in Q1 and are on track for a similar build in Q2. Within that, China leads the group with almost 0.5 mn b/d of inventory builds, Saudi Arabia at around 0.3 mn b/d and India at 0.25 mn b/d. These builds, though, are not similar to an OECD inventory increase, as these, in large parts have, gone towards filling the SPR and towards greater operational and commercial requirements as new refineries have started up. Thus, the mounting loss of Iranian volumes in the second half , providing that the macro outlook holds up, could provide a fair amount of upside to prices, given the complete lack of geopolitical uncertainty in current price levels.

■ **Figure 1: Iranian oil production, mn b/d**



Source: IEA, EIA, MEES, Platts, EIG, Reuters, Bloomberg, Barclays Research

■ **Figure 2: Call on OPEC crude, mn b/d**



Source: EIA, IEA, OPEC, Barclays Research

The Need For Cooperation Between Consumers And Producers

Adnan al-Janabi and Luay al-Khatib*

Abstract

Oil price volatility has always created pressure upon both developed and emerging economies. High oil prices have been blamed for economic downturns in the global economy, while oil producers have suffered wide fluctuating incomes. Price volatility has worsened since 2000 for a variety of reasons such as geopolitics, speculation, terrorism, natural disasters, revolutions, economic growth, recession and accidental disruptions of supply. Price volatility makes planning for both producers and consumers difficult and results in an inefficient allocation of resources in the industry, creating bottlenecks in production. It magnifies investment risk and deters much needed capital investment.

J.M. Keynes advocated intervention in commodity markets as being in the interest of both producers and consumers by improving the allocation of resources. In the current dynamic world the increased uncertainty of oil prices is detrimental to economic development and growth. The growth in supply and the possibility of Iraq becoming an additional swing producer pose the question: is it now time for price stabilization to be implemented?

This paper investigates the theory of commodity market stabilization, accounts for increased price volatility by the emergence of more demand and supply variables during 2000-2012, and examines the possibility of producers and consumers cooperating in their common interests. It also seeks to evaluate the possibility of financing spare capacity to stabilize prices.

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Luay al-Khatib, CEO and founder of the Iraq Energy Institute, and advisor to the Iraqi Parliament's Oil and Energy Committee.

Introduction

Oil price fluctuations have a considerable economic impact upon the world economy. Oil price shocks have been quickly followed by economic downturns in the major economies, and oil producers are often seen as the cause of economic recession. With each oil shock and the onset of a subsequent recession there is a renewed interest in international cooperation to regulate energy markets as both producer and consumer countries suffer. The fact that oil price volatility has increased since 2000, creating further economic instability through fluctuating costs of production, rates of inflation and investment risk, is a matter for concern. Oil producing nations suffer fluctuating incomes which disrupt their economic development, making the case for oil price stabilization seem stronger than ever. Emerging spare capacity in low cost producers Saudi Arabia, Kuwait and UAE, who are likely to be joined by Iraq in the near future, means that the possibility of creating buffer stocks has never been more real or practical. The acknowledgement of the problem of price volatility in commodity markets and the recognition of its possible solution are far from new. It is just that neither the producers nor the consumers have accepted their common interests, and both have failed to learn the lessons of economic theory.

Keynesian Theory

J M Keynes suggested in a series of writings in the 1920s and 1930s that countries whose incomes were largely dependent upon the export of primary commodities would experience undesirable fluctuations in incomes due to price fluctuations. Such income instability was undesirable for both primary producers and industrial economies, as it amplified the fluctuations in the trade cycle. Keynes advocated government intervention via buffer stocks to stabilize price fluctuations, as the incentives for the private sector to hold sufficient stocks were negligible due to the high cost and the risk inherent in predicting future prices.

Keynes claimed that excessive price fluctuations interfered with production planning for both the producers and the consumers of primary commodities. Volatile free markets were in fact operating against the interests of both producers and consumers.

"When prices rush up, uneconomic and excessive output is stimulated and the seeds are sown of a subsequent collapse... Assuredly nothing can be more inefficient than the present position by which the price is always too high or too low and there are frequent meaningless fluctuations in the plant and labor force employed. "(J M Keynes, The Policy of Government Storage of Foodstuffs and Raw materials Economic Journal , September 1938. Pp 459,460). The recent experience of high-cost oil production from reserves such as the tar sands of Alberta, Canada springs to mind here.

The Call For Oil Price Stability

Calls for oil price stability come from producers and consumers alike. Commentators in the USA blame oil producers and high oil prices for economic recessions and call for energy independence to insure against price fluctuations. In Africa both producers and consumers call for stable oil prices in order to permit viable economic planning.

The present boom and bust cycle is not healthy for the oil trade, since it not only discourages investment in the oil industry but also inhibits research and development. Most importantly, the introduction and application of high technology and scientific innovations in the industry will decelerate and significantly decline. When the market is not steady with regard to price and production, both producers and buyers cannot undertake long-term planning for the industry. This encourages capital flight and makes it difficult to attract fresh capital needed for investment and innovation.

In Africa price instability affects not only oil producers but also non-producers. The non-producers argue that energy takes the lion's share of their budget and they would be able to make more realistic budget and economic plans if they were able to predict the market. Therefore oil price stabilization is good for everyone. (Emeka Chiakwelu, Modern Ghana 15.6.2009).

Oil price volatility has increased since 2000 according to Tom Therramus. His statistical studies show not only increased volatility but also a degree of correlation and causation with fluctuating rates of inflation and investment. It is hardly surprising that many developing countries attempt to protect themselves from oil price fluctuations via price controls.

Extensive price controls and subsidies on refined product prices across most of Asia and the Middle

East ensure that households and firms are insulated from the rise in oil prices. However, in the major economies of Asia the cost of such price controls has now become prohibitive, and as they have been gradually removed or reduced the call for oil price stability has increased. However, as Darbouche and Fattouh (2011) have pointed out, the Arab uprisings will make MENA oil producers even more reluctant to rid themselves of price subsidies on oil and gas products out of fear of popular discontent.

OPEC 's High Price Collaboration

In reality, attempts have been made to try and ensure oil price stability for more than fifty years. OPEC's 1960 constitution states in article 2B that *"the Organization shall devise ways and means of ensuring the stabilization of prices in international oil markets, with a view to eliminating harmful and unnecessary fluctuations."* Has OPEC therefore failed in its mission to maintain price stability, or have geopolitics, war, the rise of non-OPEC producers, speculative investment and pressure to maintain a high oil price from both inside and outside OPEC led to price fluctuations and a general rise in the price of oil?

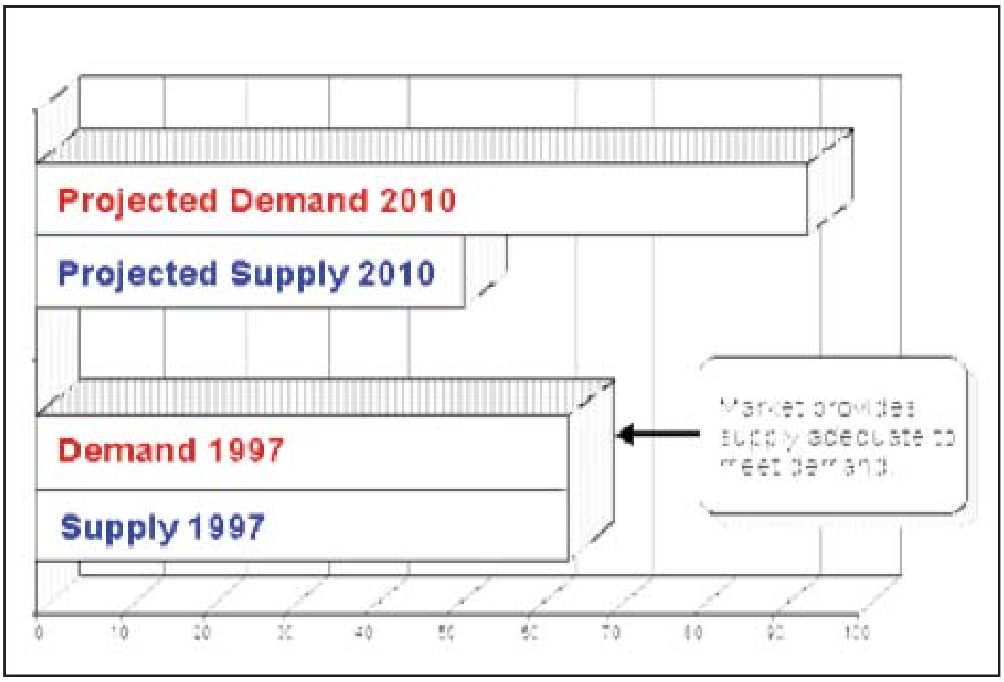
Undoubtedly the major fluctuations in prices have usually been beyond the control of OPEC and the result of geopolitical conflicts, regional wars and latterly speculative financial activity. Although OPEC has been labeled a cartel by western commentators, it has failed to act as one, as Chalabi points out. It has failed to maintain its market share by allowing self-defeating pricing and production policies to reduce its influence on the market. It has let prices rise at the behest of high-cost non-OPEC oil producers such as the USA, leading to the development of expensive offshore oil fields such as the North Sea and Gulf of Mexico. Even expensive and environmentally sensitive fields such as Alaska have become potentially viable as a result of such policies. Expensive onshore reserves like tar sands and shale oil have come on stream, while low-cost Middle Eastern fields remain neglected and underdeveloped as high prices and increasing revenues from current capital investment have been sufficient to satisfy OPEC members and meet their fiscal requirements. Resources have been wasted as large amounts of gas have been flared and waste management techniques have been ignored, leading to environmental damage.

OPEC members have had few incentives to plan to meet long-term demand trends, as large revenue surpluses and political considerations have encouraged a high price strategy. OPEC members have until recently failed to take seriously long-term investment to increase production capacity, looking instead to maximize short-term revenue from existing capacity. Disparate goals have usually made the negotiation of any agreement extraordinarily complicated and often adversarial, leading to the maintenance of the status quo rather than seeking solutions to the instability of the market by investment in capacity building. Chalabi is critical of this situation, claiming that *"with the exception of Saudi Arabia, OPEC has done nothing to reinvest its colossal oil revenues in drilling activities, which have remained stagnant, if not in perpetual decline, ever since OPEC first took over the industry from the oil companies in 1973."* (Chalabi, 2010)

It is quite apparent that OPEC has failed to act as a cartel, losing market share to higher cost producers when it has the potential to keep prices low via expanding production, and the arrival of new producers with lighter oil has only served to reduce its market influence and share. In a tight market subject to supply chain disruptions due to geopolitics and wars, Saudi Arabia has maintained its position as the market's swing producer, attempting to dampen price fluctuations by adjusting supply. But even this role became ineffective during the speculative investment bubble of 2008, when prices were driven up in the futures market by speculators intoxicated with peak oil theory. The Arab Spring has also led Saudi Arabia to become much more conservative about its role as swing producer.

Forecasting Or Just Guessing?

Oil economists and market commentators have been surprisingly accurate at predicting long-term demand for oil but spectacularly wrong at predicting supply. The industry has displayed a long-term price elasticity of supply that is unitary, as supply has kept up with increases in demand - a fact that seems to be lost on peak oil theorists.

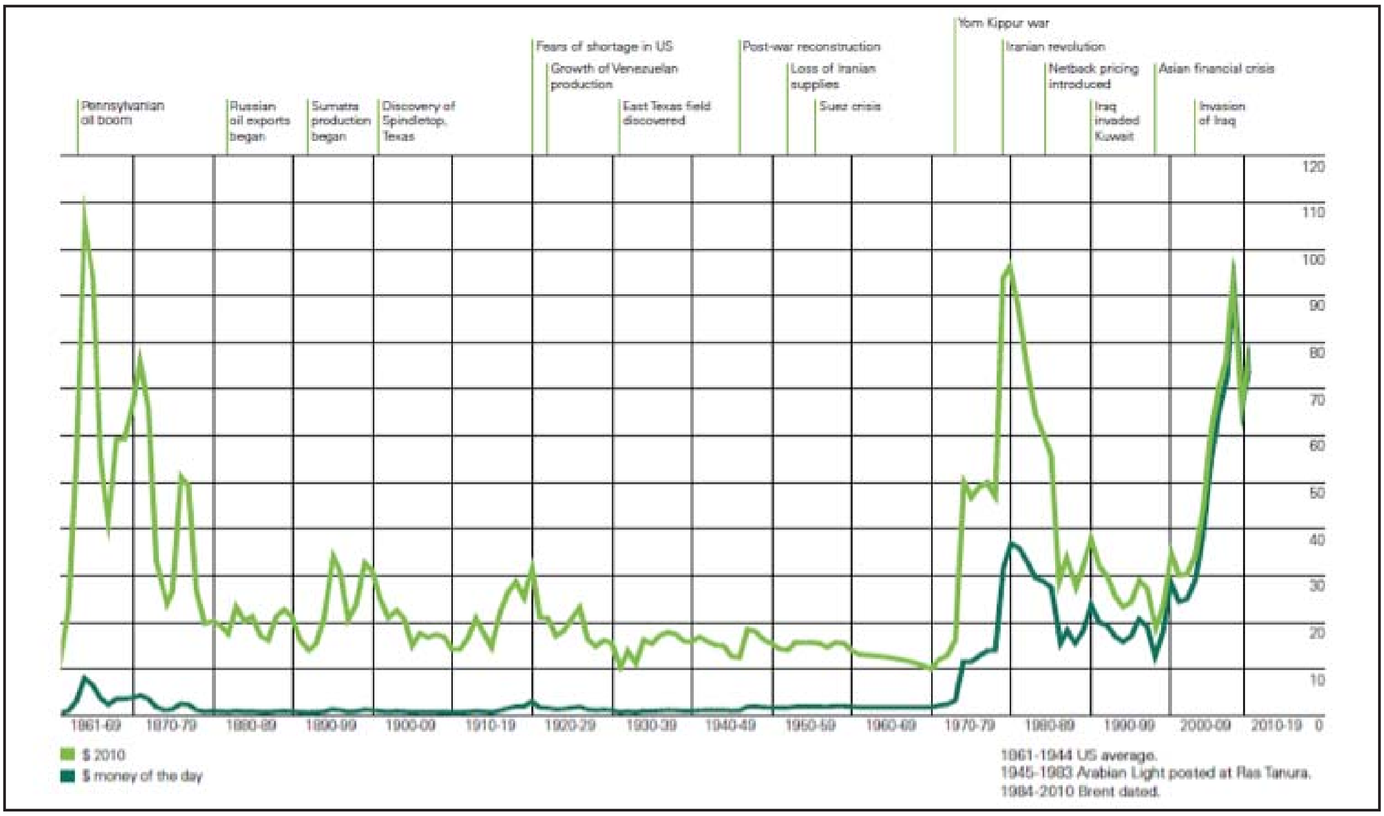


1997 Oil Predictions and 2010 Projection, source: www.iraqenergy.org

The failure of many economists and market commentators to predict price or production capacity with any accuracy stems from a failure to understand how commodity markets work, despite extensive writings on the subject by Keynes in the 1920s and 1930s. Keynes highlighted the need for intervention because of the adverse effects of price fluctuations upon both the producer and consumer. Market analysts can be spectacularly wrong, yet they often influence short-term pricing, adding to volatility. For instance, eminent economic commentators in the 1980s were confidently predicting that North Sea oil revenues would wipe out the UK's national debt by 2010.

Oil Price Volatility

Recent studies show that oil price volatility has increased since 2000, and the chart below both confirms that fact and highlights price volatility from the 1960s on, when OPEC came on the scene. Within a few years the industry moved from the posted price set by the cartel of major oil companies to referencing oil prices on an Arabian light price determined by OPEC. The system remained volatile and resulted in the price hikes of the late 70s and early 80s and the collapse of the mid-80s. From month to month and year to year price variations of $20/B, and sometimes of $30-40/ B, were common. And a really damaging spike occurred in 2008, when prices rose to $147/B and then fell to under $40/B, with a variation of almost $100/B. On the basis of traded oil in the market, which is more than 50mn b/d, that adds up to a huge number, and the result was disastrous for consumers and producers alike.



Oil Price Volatility – BP Statistics, 2011

Despite the fact that the Saudi Arabia's surplus capacity is used to determine prices as a means of stabilizing the market, fluctuations continue to occur as speculators move in when Saudi surplus capacity falls below 4mn b/d. Speculative forecasting based on inventory levels is commonplace in the industry, as Ye, Zyren and Shore (1997) have pointed out: "Because petroleum inventory levels are a measure of the balance, or imbalance, between petroleum production and demand, they reflect changing market pressures on crude oil prices, and thus provide a good market barometer of crude oil price change in the short run. " Over the years, various models have been developed to forecast prices and even price volatility (Sharma 1998). "Forecasting volatility is fundamental to the risk management process in order to price derivatives, devise hedging strategies and estimate the financial risk of a firm's portfolio of positions" (Sharma 1998). Models based on future price options have usually failed to predict the oil market with any accuracy, and those who defend these models claim that there is a wide range of possible events and variables which makes the market difficult to predict.

Studies in the 1990s such as Verlegar ("Adjusting to Volatile Energy Prices", 1994, Institute of International Economics) dismissed Keynes' proposition. "Schemes to establish permissible bands for price movements are rejected as costly and impractical, as is the concept of a buffer stock." Verlegar supported Friedman's traditional speculative stabilizing theory (1953), arguing that the development of the futures market and hedging was bringing about a degree of price stability and that further development of the futures market would ensure a degree of price stability as future prices would regulate supply and investment in the industry. His free market approach was deemed to be the way forward. Empirical data would suggest that the futures market had a relatively stable long-term equilibrium price of $20-22/B in the early part of the century, but after 2004 prices rose and long-term prices reflected rising spot prices. (Bassam Fattouh, March 2011: "Uncertainty, Expectations, and Fundamentals: Whatever Happened to Long-Term Oil Prices?")

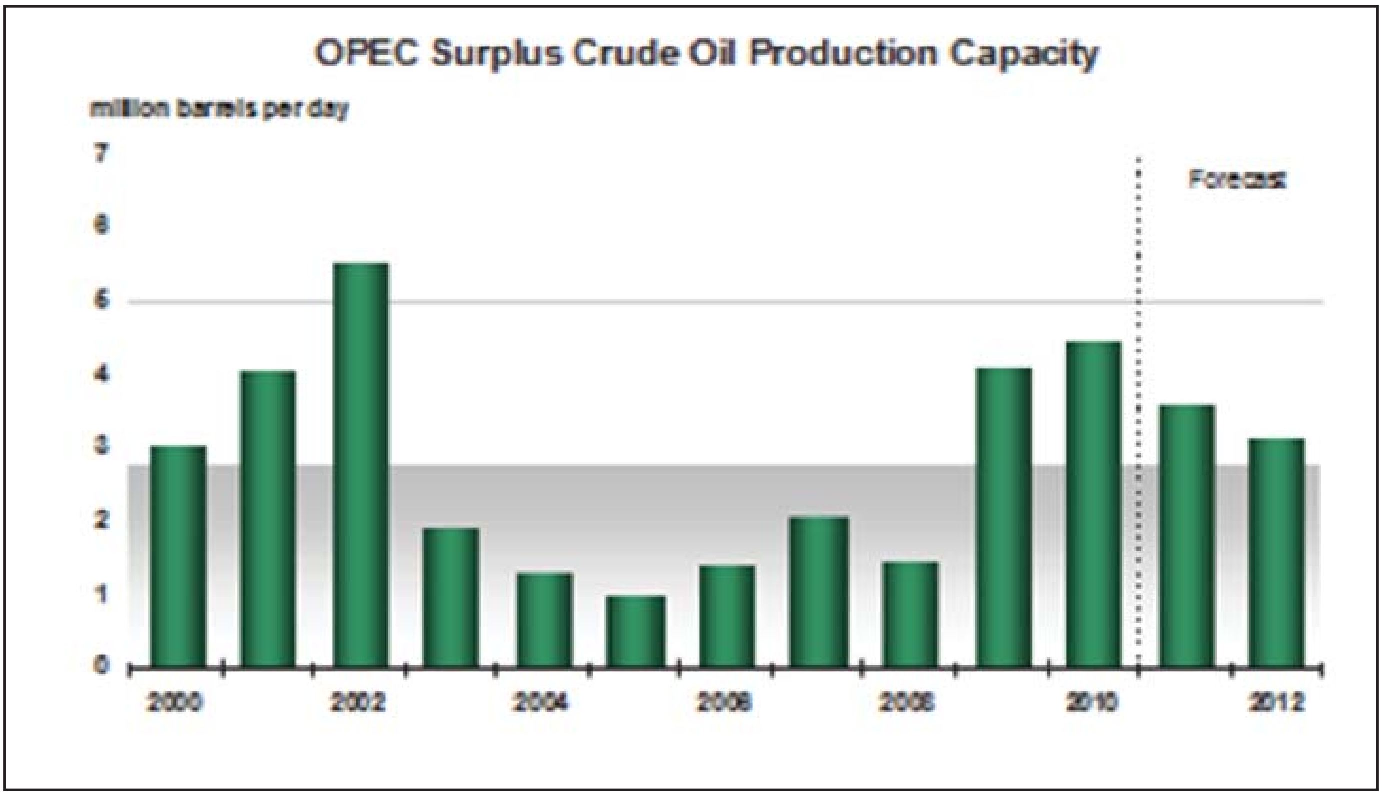
Long term lower future prices became a thing of the past as commentators and speculators adopted a "buy now" philosophy. Irrational speculators and the herd mentality appeared to justify the views of Lux

(1995) and others who claimed that self-fulfilling prophecies of irrational behavior distorted commodity markets and created speculative bubbles that did not reflect the fundamentals of supply and demand. Theories centered on speculation and the herd mentality seemed to be borne out by the oil market between 2004 and 2008. Other studies, such as those of Bahattin Buyuksahin, support Freidman's view that "speculative activity does not affect prices...speculative activity actually reduces volatility." Regardless of whether speculative activity reduces volatility or not, the level of volatility experienced in the oil market has widespread economic consequences that substantially affect the world economy.

From 2005 to 2008, speculators feeding on a diet of peak oil theory and doomsday scenarios of oil shortages due to insatiable demand from China and India forced prices up to unprecedented heights. Although the subsequent collapse was predicted even by free marketers as markets adjusted to compensate for speculation in the long term, the damage had been done, bringing on economic recession as aggregate demand fell and rising energy and transport costs reduced purchasing power.

Once again, Keynes' predictions on the workings of commodity markets rang true. He claimed that in markets where prices were rising, purchasers would accelerate their purchases in the expectation of further price rises and therefore stoke demand. In falling markets the opposite held true, with purchasers postponing purchases in the expectation that prices would fall further. Such a scenario led only to widening price fluctuations in commodity markets, which in turn dissuade producers from increasing investment in the market due to the higher risk factors.

The evidence is strong. The chart below shows that surplus production capacity declined drastically after 2002, and when in 2004 it was almost less than 2mn b/d, speculators attacked. Speculators are not refiners and they neither produce nor consume oil. They enter the market when they think prices will rise, and that is when spare capacity is reduced to less than 4mn b/d. Every time spare capacity has fallen in the past it was followed by a price hike which may reflect real buyer demand but more often than not can be attributed to speculators.



EIA: Short-term Energy Outlook, April 2011

The case for intervention strengthens as oil price volatility impacts on world economic growth. Since 2000, with Saudi Arabia acting as swing producer, OPEC has made significant adjustments to supply, sometimes several times in a year. OPEC has aimed to keep spare capacity at some 6mn b/d, but as demand grew, spare capacity has often been less than half this figure and shortages in a tight market have only been averted by judicious action by the Saudis.

Supply And demand Now Less Predictable

The case for intervention is further strengthened by the rising number of supply and demand variables in the market, which can only increase price instability and uncertainty and create further obstacles to long-term capital investment. On the demand side the current Eurozone crisis and the economic slowdown in Asia make forecasting demand difficult. A further variable is the growth in the adoption of alternative energy options, given the uncertain changing energy policies of the major economies. Not only is total demand difficult to predict, but there is now greater demand for lighter oil because of stricter environmental rules which have created a scramble for African oil at the expense of sour Middle Eastern crudes.

On the supply side there are significant developments in Africa, with the discovery of increasing amounts of light crude and new fields being developed in countries such as Ghana and Uganda. Contributing to supply uncertainty are the potential development of major low-cost oil fields in politically volatile Iraq , the geopolitics of other MENA countries and recent concerns over Iran.

With the most conservative forecasts of demand being 104mn b/d by 2020, security of supply becomes a priority for world economic growth. Four fifths of the increase in demand is predicted to come from developing countries as transport becomes more accessible for their populations. As peak theorists are replaced by plateau theorists, analysts are more positive about meeting demand, but they are less certain about costs and therefore prices. High cost producers will undoubtedly wish to see prices remain high, but new African producers and Iraq will be looking to increase production at any price to increase their revenues. Analysts claim that $80-90/B is a fair price if current and predicted demand is to be met. Others claim that marginal costs are rising and have reached $90/B outside OPEC and Russia. However, price fluctuations have been considerably above this level in 2012 as geopolitics once again impact on the market, and this will probably delay economic recovery in the developed world. The need for Keynesian buffer stocks has never been more apparent than today.

The uncertainty in the market has been reflected in the growth of the strategic reserves of oil in countries around the world. According to EIA statistics, global strategic reserves have risen to 4.1 billion barrels. The 28 member countries of the IEA have built up 90 days of stocks, and even some of the oil exporting nations of IEA such as Denmark and the UK have built up reserves. Hitherto the purpose of such reserves was to cope with shortages in supply, but they now have the additional objective of protecting economies from the speculative overpricing of oil.

The market has remained tight with little spare capacity, and the nature of the many recent disruptions has led to further speculation about future supply and price. The Arab Spring, the Libyan conflict and American attempts to isolate Iran have driven prices upwards, but oil demand has yet to show a significant increase. Bassam Fattouh in "Oil Market Dynamics in Turbulent Times" (April 2011) rightly claims that changes in the price reflect changes in the perception of future geopolitical disruptions, macroeconomic data flows and commentaries, and speculative investment rather than current demand and supply conditions. Buffer stock intervention would eliminate such price speculation.

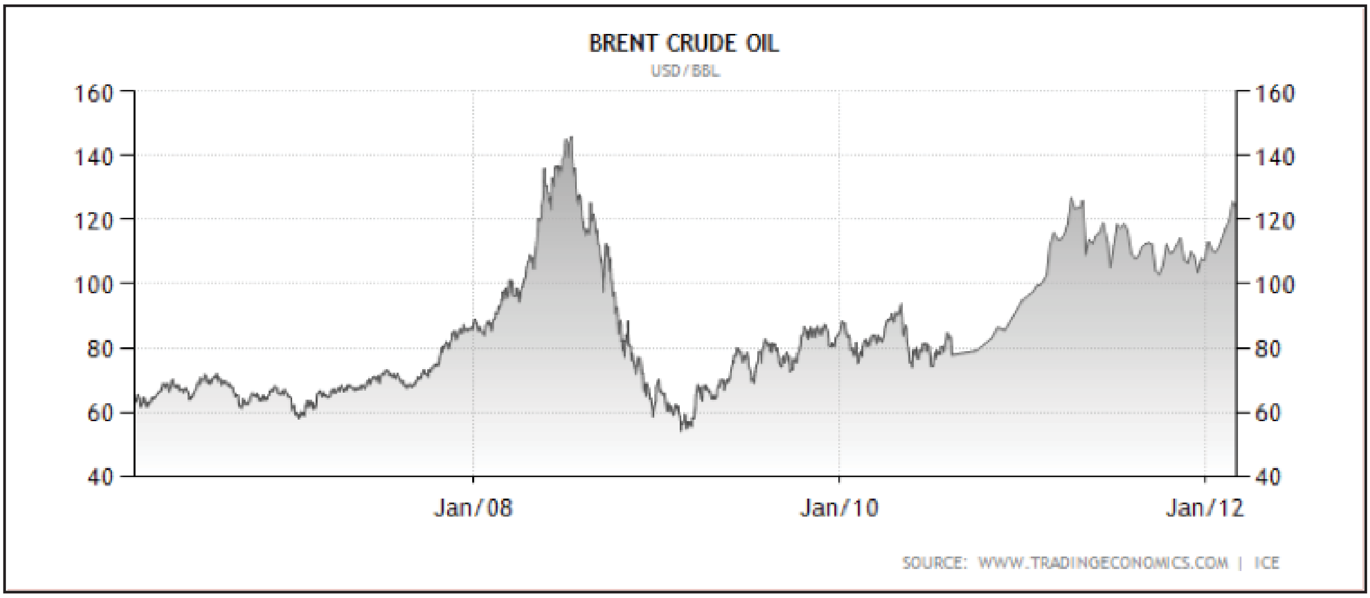
2011/2012 Events Strengthen The Case For Intervention

The events of 2011/12 highlight even more the need for intervention in the market. The Arab Spring, and in particular the Libyan crisis, created abnormal market conditions. In a year of relatively static demand due to poor economic growth in North America and Europe, prices rose considerably due to a shortage of light oil as a result of the Libyan crisis, geopolitical speculation and Saudi reluctance to act as a swing producer, probably in order not to undermine the financial position of fellow Arab countries facing possible uprisings." Furthermore, Saudi Arabia was in need of higher revenues to maintain its expanded budget. Global oil insights estimated the following scenario:

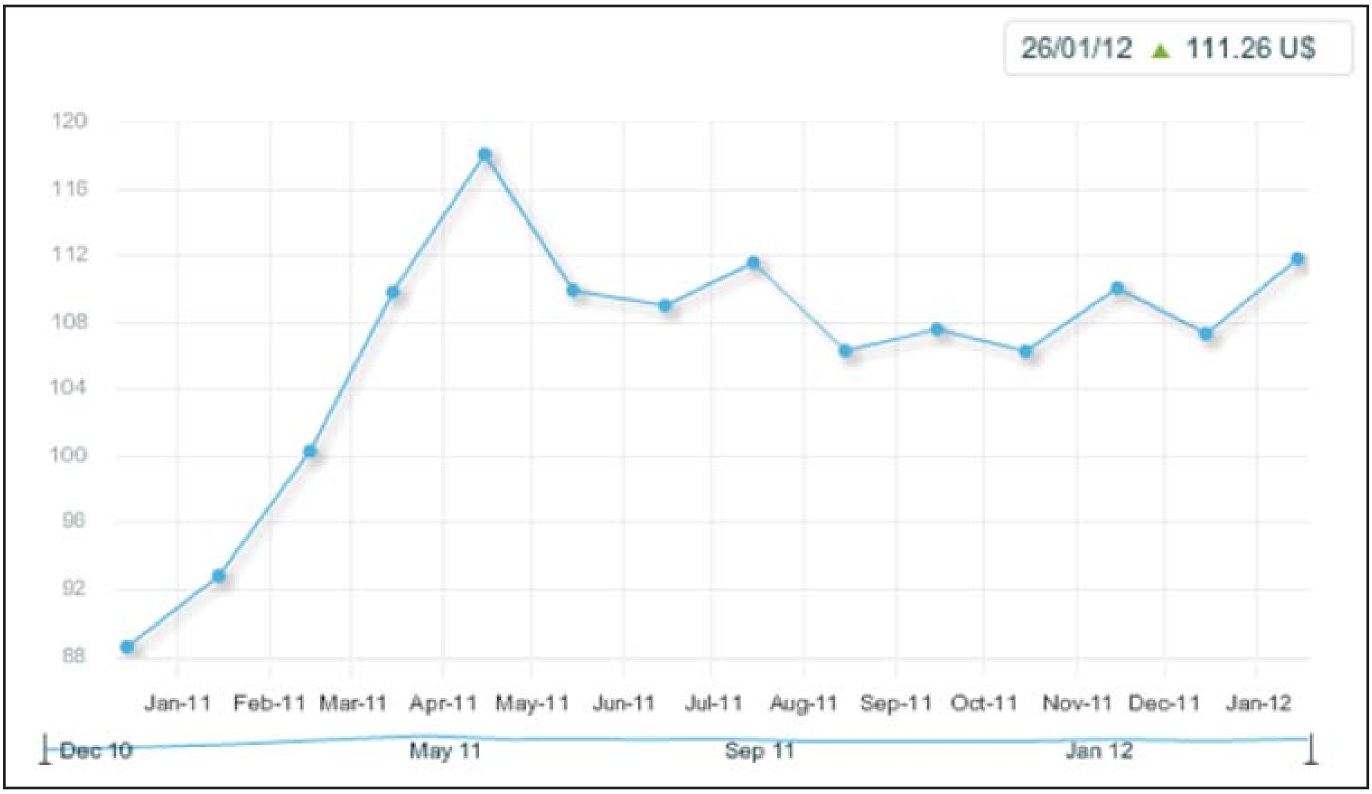
	$bn	$/bbl
To cover current expenditure (less other income) amounting to ...	120	53
... as above, but including capital expenditure of $70bn reaching ...	190	79
all of the above plus a contingency reserve of $10bn to reach ...	201	83

OPEC: The Set Of OPEC Basket Prices Needed By Saudi Arabia in 2011

With some Arab neighbors wishing to see a price even higher than $83/B to meet their expenditures, it is easy to see why the Saudis were reluctant to intervene in the market, especially as any action might have triggered a price collapse due to the speculative nature of the market.



Allied to this were major differences in market analysts' predictions during 2011 about economic recovery in North America and Europe, Chinese demand for oil and whether or not the oil market was oversupplied. The latter was certainly untrue in the case of light oil, where the drop in Libyan output and lower than expected production in Nigeria led to shortages. It also became clear that price speculation based on often dubious geopolitical forecasts had influenced the market and pushed prices up, especially as experienced OPEC analysts were claiming that, with the exception of light oil, the market was well supplied.



OPEC: Oil Price Volatility – Monthly OPEC Basket

Falls in both February and March, 2011 non-OPEC production and March and April OPEC production only seemed to heighten speculation rather than convince the market that demand was static and supply was adequate. Prices remained some $15/B over even the highest marginal cost producer. This was despite forecasts of rising non-OPEC production later in the year despite the fact that production was already up on the previous year. It is widely recognized that the majority of non-OPEC producers produce as much as they physically can regardless of market conditions as they pursue revenue. Rising prices made economic recovery uncertain and were seen by some analysts as reaching a level that choked demand. In June the International Energy Agency (IEA) intervened in the market, releasing 60mn barrels at 2mn b/d over thirty days, justifying the move by citing the inability of OPEC member countries to offset the loss of light, sweet Libyan crude oil and to respond to the expected rise in demand. This was only the third time the IEA had intervened in the market and previous interventions were only agreed on by IEA member states to replace lost supplies in 1991 at the outbreak of the first Gulf war and in 2005 after Hurricane Katrina damaged offshore oil rigs, pipelines and oil refineries in the Gulf of Mexico.

	2012	2011											
	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar	Feb	Jan
Algeria	1,230	1,250	1,250	1,270	1,280	1,290	1,290	1,280	1,280	1,280	1,280	1,260	1,250
Angola	1,720	1,770	1,770	1,700	1,700	1,620	1,650	1,520	1,580	1,500	1,700	1,650	1,640
Iran	3,500	3,520	3,550	3,570	3,590	3,580	3,580	3,610	3,630	3,600	3,610	3,630	3,640
Iraq	2,766	2,852	2,842	2,775	2,783	2,854	2,788	2,796	2,731	2,672	2,519	2,717	2,717
Kuwait*	2,700	2,730	2,690	2,650	2,600	2,550	2,500	2,500	2,490	2,480	2,480	2,350	2,300
Libya	1,100	825	600	365	110	10	30	40	60	150	300	1,380	1,540
Nigeria	2,100	2,050	2,130	2,000	2,250	2,300	2,350	2,250	2,300	2,200	2,100	2,220	2,280
Qatar	790	795	795	800	800	810	810	810	810	790	810	800	790
S Arabia*	9,650	9,800	10,047	9,500	9,450	9,800	9,700	9,350	9,050	8,770	8,600	9,125	8,900
UAE	2,540	2,500	2,490	2,450	2,450	2,550	2,510	2,490	2,450	2,500	2,510	2,470	2,400
Venezuela	2,350	2,350	2,350	2,370	2,370	2,350	2,350	2,300	2,280	2,210	2,210	2,210	2,210
Ecuador	495	495	495	495	500	490	480	480	480	490	500	480	500
Total	30,941	30,937	31,009	29,945	29,883	30,204	30,038	29,426	29,141	28,642	28,619	30,292	30,167
OPEC 11	28,175	28,085	28,167	27,170	27,100	27,350	27,250	26,630	26,410	25,970	26,100	27,575	27,450

MEES Estimates: OPEC Crude Oil Production Jan 2011-Jan 2012, '000 B/D

Though the intervention was small - the equivalent of 3 days of US consumption - its impact upon the market was immediate. Dated Brent dropped $5.65/B on the same day to $108.14/B and then a further $3.25/B the next day. ICE Brent futures flipped from backwardation to contango, only for the Aug/Sept spread to narrow to parity when the IEA said a higher proportion of refined products as opposed to crude would be released in Europe. For physical, as of 27 June cash markets remained backwardated, but the IEA release slashed the Jul/Aug and Aug/Sept spreads from $70-74 cts/B to just 12-15 cts/B.

Half of the intervention stock came from the US Strategic Petroleum Reserve (SPR) which had reached record levels and had been used in the past to help with stock shortages and even budget deficit management. This intervention was the first time price considerations had been the driving force, though the IEA claimed that it was making up a supply deficit. "Today, for the third time in the history of the International Energy Agency, our member countries have decided to act together to ensure that adequate supplies of oil are available to the global market," IEA Executive Director Nobue Tanaka said. "This decisive action demonstrates the IEA's strong commitment to well-supplied markets and to ensuring a soft landing for world energy markets."

The intervention sent a message to OPEC that the IEA could also intervene quickly in the market and that over-inflated prices were not in the interest of the world economies, especially with so many of them in a fragile state of economic recovery. However, some members of OPEC saw this as a challenge. Iran's OPEC Governor Ali Khatibi said on 27 June that the IEA's decision to release oil from emergency stocks was "a dangerous game" and accused the US of trying to put pressure on some Middle Eastern countries. He described the IEA's move as interference in the global market and said it would have no long-term impact on market direction *(Energy Economist/Issue 357/ July 2011)*.

In a period of relatively static demand, the average price of Brent oil has risen from $94/B in 2008 to $109/B in 2011 due to supply constraints resulting from the Arab Spring, the Libyan crisis and lower than expected Nigerian supply.

2012 began with a further surge in prices due to concerns over the Arab Spring and the imposition of trade sanctions on Iran. A nascent recovery in demand added to pressure on prices, with commentators speculating that oil would never return to below $100/B, especially as the marginal cost of a barrel of oil in non-OPEC producers apart from Russia had risen to nearly $90/B. This further volatility in price in 2012 only enhances the case for price stabilization.

The Need for Price Stabilization

Price stabilization would definitely benefit the mono-commodity economies of OPEC and the new African producers. They could avoid Dutch disease by building up sovereign wealth funds abroad, which would prevent the overvaluation of their exchange rates and damage to other domestic industries. The wealth funds would also enable future generations to benefit from the development of these resources. Oil producers have historically experienced widely fluctuating incomes due to price volatility. Anshasy and Bradley (2009) found that "oil price changes have a direct and material impact on government spending growth. In addition, higher oil price volatility can induce government prudence, reducing the growth rate in government spending, especially in inflationary periods." With oil price stabilization, fiscal break even prices could be determined and assured for oil producers, making possible more exact planning of government expenditure and domestic capital formation. Tentative estimates by Ali Aissaoui (2011) of current fiscal break even prices for OPEC members range from $30-$100/B. Currently, many OPEC members want higher prices than break even to ensure a surplus to cover uncertainties in oil prices and in the geopolitics of the region. Therefore the likelihood of oil being overpriced for the remainder of 2012 is high.

With stable prices IOCs and NOCs would be in a better position to plan long-term capital investments rather than scrambling to increase capacity when fiscal deficits appear on the horizon due to price fluctuations. Commentators such as Bassam Fattouh are concerned about tight conditions in the market, the low level of spare capacity and the slowdown in investment in both OPEC and non-OPEC producers, and are predicting oil supply shortages. Intervention means that IOCs and NOCs would be in better position to develop high cost production as the return on capital, though relatively lower, would be more certain." According to Keynes, the reduction of risk is the key to stabilizing commodity markets.

Producer-Consumer Cooperation

However, analysts such as Darbouche and Fattouh suggest "there is a perception that producer-consumer relations cannot be relied upon to smooth the oil market's adjustments to disruptions; indeed their actions could exacerbate price volatility." Though this view may be held by some, there has yet to be significant cooperation between producers and consumers to test such judgments. The varied interests of producers may seem an impossible obstacle to overcome, but prices are well above the marginal costs of even the highest cost producers. Setting a market price band with the emergence of a new swing producer should not be impossible, given the desire for economic recovery. Spare capacity exists in the Gulf Cooperation Council (GCC) states of Saudi Arabia, Kuwait and the UAE. As Darbouche and Fattouh point out, "their reserves are probably the cheapest in the world (with the exception of Oman) to find, develop, and produce.......according to the IEA (2005) estimates of only $3 to $5 a barrel". Though these cost estimates are somewhat dated, the principle holds true: the cheapest producers have the capacity to build up stocks which could give the world stable oil price at the lowest possible cost.

The potential production capacity of the new Iraq coupled with Saudi Arabia's swing producer experience and reserves creates an opportunity to increase spare capacity and to build up sufficient buffer stocks to enable price stabilization. Falah al-Amri, director of the State Oil Marketing Organization (SOMO), told an audience at the Alwiliyah Club in Baghdad that Iraq could well become a swing producer, stating that "our plan is not to flood international markets. This is not our goal. If we have a spare capacity of 2 or 3 million barrels per day, then so be it." This swing capacity allied to that of Saudi Arabia, Kuwait and the UAE could be the foundation on which to stabilize the oil price and ensure that production keeps up with demand in boom times.

Other producers such as Iran, Libya, Venezuela and Russia may also be in a position to contribute to build up spare capacity. Past experience has shown that once spare capacity falls below 4mn b/d speculation sets in. Successful market stabilization will probably require 6mn b/d or more at all times. A viable model of financing spare capacity, which is acceptable to both producers and consumers, needs to be developed. Consumers could invest in developing spare capacity in high-reserve low-cost oil producers rather than spending billions of dollars building up high-price strategic stocks.

A degree of regulation is required. Free markets have never worked for commodities, especially oil. After the collapse of the boom, the world accepted the need for the regulation of banks and financial institutions. It should also accept that the paper market of speculators in the oil industry should be subject to some degree of regulation, because without it the system cannot be managed.

One possible way to stabilize the process would be to create a substantial fund with the following functions: First, to invest in sufficient surplus capacity to manage the market. Whether this investment is a joint venture between producers and consumers needs to be decided upon.

The second function of this stabilization fund is to buy paper barrels when there is a surplus in the market and prices are falling, meaning that they pay money to the producing countries not to produce. The fund buys paper barrels when prices are going down, and when prices rise it sells those paper barrels and uses that spare capacity in a timely fashion to stabilize the market. The fund is thus buying low and selling high and making a profit to pay for the cost of its capital and gaining a return for the producers/investors.

Thirdly, to address the concerns of free marketers, who argue that these markets help us to indicate where future prices may go and that higher future prices are needed to attract long-term capital investment into the industry. Stabilization will turn the uncertainty of the current market into known and measurable risk, enabling return on capital to be forecast more accurately. To go from exploration to production can often take seven years or more, and in the current fluctuating climate returns are much less predictable than under a system of stable prices. Nevertheless, there will be a need to devise and establish a system to indicate long-term price trajectories.

Whatever model is used to manage the market, there is undoubtedly a need for greater cooperation between producers and consumers, as it is a mistake in this globalized world to promote an antagonistic relationship. Keynes pointed out that both parties have an interest in stabilizing the markets and prices.

Key producers and consumers need to talk to each other and cooperate, and the place where that could start is the International Energy Forum (IEF) in Riyadh. To conclude, the IEF should be called upon to bring together OPEC, the IEA and various key countries such as China and India to open discussions on devising a workable model to reduce price volatility and secure supplies. Keynes' buffer stock model could well be the recipe for future market stability, although it would seem we are still waiting, some 85 years later, for the lessons of Keynes to be learnt.

Conclusion

- Oil price volatility has increased since 2000 and forecasting has become more difficult due to the growing number of demand and supply factors, making economic and investment planning riskier.
- Keynes' observation that the commodity markets often work against the interests of both producers and consumers is clearly relevant. The fact that we have already seen market intervention by both producers and consumers separately highlights the need for them to work together.
- Both OPEC and the IEA have the capacity to stabilize the market by devising a suitable intervention model to achieve their common interest in price stability.
- The case for building up Keynes' buffer stocks is undeniable and achievable. The resumption of production from Libya, the emergence of new African producers, increased output from Russia, Venezuela, the GCC and Iraq make it possible to build up substantial spare capacity at a relatively low cost from the producers with probably the lowest costs in the world. It is now time to put theory into practice.
- Such a system would provide budget stabilization during price declines and a moderating effect during price rises.

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AMF Chief Tackles MENA Financial Reform, Arab Spring Fallout*

The Arab Monetary Fund (AMF) is continuing on its mission to further Middle East and North African (MENA) financial reform while at the same time provide support to countries emerging from the upheavals of the Arab Spring. The fund's Director General and Chairman of the Board, Jassim al-Mannai, talked to Energy & Geopolitical Risk about the progress made so far and issues that still need to be tackled. Melanie Lovatt** reports.*

E&GR: The most significant development for your member countries over the last year has been the Arab Spring. Has the AMF changed its activities as a result, specifically in terms of the countries and sectors it supports? In particular what kind of assistance do you foresee offering countries that have been through/are still going through tumultuous changes, such as Tunisia Egypt, Libya, Yemen and Syria.

Dr Mannai: Since its inception, the AMF has sought to adapt to the evolving needs of its member countries. Responding to the impact of the global financial crisis on Arab economies, the AMF acted in 2009 to upgrade its tool kit and enhance its capacity to respond to the needs of its member countries in a more flexible and effective manner. To that effect, it speeded up loan processing, increased the ceiling on some regular lending facilities to provide a larger amount of financing and created a new lending facility, which is short term for liquidity financing. Furthermore, in cooperation with other financial institutions, the AMF enhanced its ini-tiatives aimed at providing technical assistance to its member countries. In this regard, the AMF has been as-sessing the needs of Arab countries that are undergoing political transformation. It has been in close contact with these countries to provide the appropriate form of assistance, whether financing, technical assistance or credit lines extended by the AMF subsidiary the Arab Trade Financing Program (ATFP). The AMF extended two loans to Egypt in the last quarter of 2011, to support a fiscal reform and enhance public debt manage-ment. Furthermore, the AMF has also sent missions to Tunisia and Yemen to assess their financing and tech-nical needs, and aid packages are currently under discussion with the concerned authorities.

** The 25 June edition of MEES ran excerpts from the interview. The following is a full version.*
***Melanie Lovatt is Senior Editor at MEES.*

E&GR: Are you cooperating with other institutional lenders, both regional (such as the Arab Fund for Economic and Social Development, OPEC Fund, etc) and international (IMF and European Bank for Reconstruction and Develop-ment, etc) in order to help Arab Spring countries emerge from the change much stronger economically? And is it possi-ble that an approach, like the Marshall plan which the US ushered in to help Europe rebuild after World War II, could be implemented to help them?

Dr Mannai: The AMF has always been conscious of the need to cooperate and coordinate with all the rele-vant institutions, in helping its member countries. In this regard, the AMF welcomes efforts underway by bilateral partners and regional and international financial institutions to provide countries with a combina-tion of loans, grants, budget support, and technical assistance aligned to country-owned programs. The AMF is actively participating with other international financial institutions in the Deauville Partnership with the Arab Countries in Transition, which was launched in 2011 by the G8 forum of governments. It was con-ceived to support the democratic transition and to strengthen governance, foster economic and social inclu-sion, create jobs, support private sector-led growth, and advance regional and global integration.

As for the type of plan to be implemented to help these countries, the AMF welcomes any strategy that relies on home-grown reforms and programs and aims at consolidating the efforts of all international institutions and strengthening the cooperation among them. The Deauville initiative seems to be a new approach to the Marshall plan, in a way that the concerned countries and the international community have committed themselves to make a joint and determined effort to create the conditions for stability and prosperity in the Arab spring countries.

E&GR: The IMF asked its donors for $500bn because it sees a growing need for its assistance. In a similar manner, will you be asking your wealthier member countries for extra funding in order to help the Arab Spring Countries? And giv-en that crude oil prices have been relatively stable at high levels do you think the big Arab oil producers will be able to provide assistance? On a related note, what is your outlook for oil prices and economic growth in the Arab countries over the next year, and what do you see as the key drivers for this growth?

Dr Mannai: The AMF has been highly supportive of its member countries. It always aims to adapt to its members' needs by providing them with financial and technical assistance. This holds true for the so called Arab Spring countries. Recently, the AMF provided a loan to Egypt, the largest loan that it has granted to any member country since the inception of the AMF. Also the fund is in the process of providing financial support to Tunisia and Yemen.

The Arab oil producers, which are also the AMF major shareholders, have provided strong financial support on a bilateral basis to Jordan, Morocco, Egypt and Tunisia, as well as other types of assistance. Saudi Arabia, for example, has shipped oil products to Yemen to help it overcome shortages. For crude there seem to be two opposite factors affecting prices. On one hand, the projected slowdown in world demand for oil as result of slower growth of the world economy tends to push oil prices down. On the other hand, uncertainty re-lated to oil supply disruptions could trigger a much larger price spike. The short term impact could be larger if the adverse oil shock spills over to financial markets.

Regarding the economic growth outlook for the Arab countries, the near-term is challenging. To this end we shall distinguish three groups of countries: First, for the Arab oil and gas exporters the outlook seems to be favorable with activity to remain relatively strong, helped by the projected increase in oil prices even though they are undergoing a flat oil and gas production. Secondly, for the Arab Spring countries, which are mostly oil importers (except Libya), the growth prospects are uncertain, in light of the heightened domestic tensions at the political and social levels, and the difficult external conditions, in Europe and elsewhere. The third group of countries, which have also been affected by the political turmoil in the region and are going them-selves through political transformation should achieve moderate economic growth.

E&GR: In addition to funding, do you foresee a greater need for technical expertise, such as help with restructuring economies (implementing better tax systems), arising from the Arab Spring?

Dr Mannai: The AMF provides credit facilities that are geared to support reforms in different areas including financial, monetary and fiscal reforms. Technical assistance provided by the AMF is also based on the needs of Arab countries, and is provided so as to ensure the successful implementation of the reforms. The AMF has been in contact with the countries undergoing political transformation to assess their needs. It should be noted, however, that economic reform and technical assistance will surely be greatly needed in these coun-tries.

E&GR: What plans are you implementing to help Yemen, in particular, which, as one of the poorest Arab countries needs significant amounts of financial assistance? The AMF, along with the IMF and World Bank, said at the end of 2010 it was assisting Yemen with a three year economic reform program, yet then the events of the Arab Spring un-folded in 2011. Is this 2010 program still ongoing?

Dr Mannai: Indeed, Yemen is one of the poorest Arab countries and it needs financial assistance, to meet the many challenges it faces, are huge. Yemen has, over the years, benefited from international community sup-port, as underscored by the positive outcome of the London meeting held in 2009, where donors, in particu-lar the Gulf countries, pledged over $8.1bn in support of reform programs. Yemen is the member country that benefited most from AMF resources. Some 22 loans were granted to Yemen with a cumulative total of about $820mn until end 2010.

The AMF reached an agreement with Yemen Authorities on a comprehensive reform program by end of 2010, supported by a loan with an amount of $200mn. The implementation of the program took place against a background of political turmoil in 2011. As a result, the economic and financial situation in Yemen has de-teriorated. Recently, the Gulf countries initiative has opened the way for a normalization of the situation in Yemen, a new president has been elected and a coalition government has been formed to manage the state over a two year transition period. Surely, the recent advances under the initiative have improved prospects for economic recovery but the context that prevailed during the preparation of the comprehensive reform program in 2010 has changed, requiring a new agreement on a reform program that reflects the priorities of the new government during this interim period. Discussion between AMF and the Yemen authorities are presently underway for a new aid package.

E&GR: Another major development over the last year, outside the MENA region, but impacting the global financial system, has been the escalation of the Eurozone crisis. Has the AMF assistance to its members changed as a result of this crisis? We have heard that it is harder for projects/businesses to get credit lines – is there anything you can do to help MENA overcome the obstacles?

Dr Mannai: The Eurozone crisis has had a minor impact on the AMF member countries, as the financial sys-tem of most Arab economies has little exposure to the banks of the Eurozone. European banks have seen their balance sheets shrink and their cross-border financing activities reduced as result of their heavy financ-ing of the sovereign debt of countries such as Greece, Ireland and Spain. These developments have led the AMF in collaboration with other international financial institutions to enhance their assistance to Arab member countries to introduce prudential and supervisory measures.

The AMF has stepped up its assistance to its members, moreover, the AMF subsidiary, the ATFP, has been active in granting credit lines to its accredited banks in the Arab countries to facilitate the financing of Arab traders' transactions, both between Arab countries and with the rest of the world. The ATFP has been en-couraging banks to use the credit lines it provides to finance cross border trade transactions of small and medium sized enterprises (SMEs), which usually face much harder lending conditions from local banks.

E&GR: Are any financial instabilities arising due to the toughening of sanctions on Iran? We see, for example, that the central banks of UAE and Qatar told lenders to stop financing trade with Iran. Do you foresee an impact?

Dr Mannai: We think that the financial systems of the GCC countries as well as the other Arab countries are relatively resilient. Although Iran is a large trading partner with the UAE and Qatar, a likely reduction of both countries' bilateral trade with Iran won't have significant impact on their economies. These two coun-tries have much stronger trade, investment and financial ties to global markets than with Iran.

E&GR: The AMF's stated objectives are to correct disequilibria in its member states, ease payments between them, en-courage cooperation, promote development of financial markets and provide advice on financial systems. What kind of progress have you made in these areas and what main areas do you still need to tackle?

Dr Mannai: The AMF has, since its inception, sought to assist its member countries in creating macroeconomic conditions for sustainable economic growth and promoting an environment conducive to private sec-tor development. Thus, the focus has been on improving the macroeconomic policy frameworks to enhance macroeconomic stability and achieve positive growth. Progress in these areas has taken place in the member countries, as significant advances were made in terms of budget deficit reduction, control of inflation and improvement in the external sector as reflected in the accumulation of foreign reserves. This progress al-lowed for a reduction of the vulnerability of Arab economies to external shocks, as shown by the resilience they exhibited during the fuel and food price spike of 2008 and the global financial crisis. Moreover, the or-derly development of financial markets, a key factor in accelerating economic and social development in the member countries, has also been a major objective of the AMF. Progress in this area varied among countries, and much remains to be done.

During the past 10 years, the AMF has launched several initiatives jointly with relevant international financial institutions such as the World Bank, the IMF, the ECB and IFC, with the objective of modernizing and improving payment and credit reporting systems, in addition to developing the appropriate legislation as well as the policies and systems in the bond markets. The medium term goal of these initiatives is improv-ing or creating sustainable, successful financial sector infrastructure in view of international best practice. This is aimed at helping improve access to finance and providing market operators with efficient infrastruc-ture to facilitate payments settlement. In this regard, and to assure quality and effectiveness, the initiatives include participation of officials, market leaders and all relevant parties of the relevant countries.

Up to today, 12 countries benefited from the Arab Payments Initiative since 2005, 11 countries from the Arab Credit Reporting Initiative since 2009, three countries from the Arab Debt Markets Development Initiative since 2010, as well as three countries from the Secured Transactions Initiative since 2011. This year the AMF launched a new housing finance initiative with the cooperation of the World Bank. Its objective is assisting member states to establish policy on developing a domestic efficient housing strategy.

The objective of developing an efficient framework for the corporate bond market remains one of the areas that needs more focus from the Arab countries. In this regard, the AMF, with the cooperation of EBRD, has launched a new joint-program to assist certain countries to identify key market development issues and out-line sequenced reforms for the policy makers of the concerned countries.

E&GR: One of your goals is to help with harmonization of stock market practices and financial disclosure in the region. What progress has been made in this area and is the region nearing best international practices or is there still a long way to go?

Dr Mannai: During the past 15 years, the AMF has focused on stock markets in the Arab region, collecting data on their activity on a daily basis, and producing quarterly and annual bulletins. Stock markets in the re-gion have witnessed during the last few years increasing growth in terms of number of listed companies and volume and value of transactions. This growth was made possible by, among

others, important institutional and regulatory reforms as many Arab countries established dedicated authorities to regulate and supervise capital markets (capital markets authorities), implemented efficient infrastructure for trading, clearing and settlement, and developed appropriate procedures for disclosure and dissemination.

Despite the progress achieved in financial disclosure, however Arab stock markets still need to better en-hance the non-financial disclosure practices related to corporate governance. To promote harmonization of stock markets practices in the region, in 2009 the AMF and IMF launched a technical assistance initiative. It aims at assessing issues and challenges related to the framework for public debt management and the devel-opment of capital markets, improving the efficiency and enhancing the functioning of the public and corpo-rate debt market, and promoting policies and actions for the region in accordance with international best practices. The cooperation between the AMF and IMF, and the contribution of other international financial institutions such as the EBRD, would definitely contribute to enhance the efficiency of Arab stock markets in the future.

E&GR: What further measures are needed to help develop and deepen the capital markets in the region, and in particu-lar the debt capital markets (be they conventional bonds or sukuk) which are really still in their infancy compared with the US and European norms?

Dr Mannai: The reality is that the investor base for bonds and sukuk is not yet well developed. Sukuk from the region tend to go into the hands of banks and foreign buyers looking for regional exposure. What is lack-ing so far is the full range of institutional investors characterized by pension funds and insurance companies. Specific measures can be adopted to provide a framework within which this type of savings can be devel-oped. There is a deep need for insurance regulation. Government, industry and regional institutions have to work on improving the basis for institutional investors in the region.

E&GR: Do you view currency unification as a possible target in light of the GCC's difficulties in achieving it? And is it still a desirable goal given the lessons being learned from the Eurozone crisis?

Dr Mannai: The GCC countries are still committed to deepening economic links and the majority of these are still considering the enactment of a monetary union. The actual date of the launch will depend on the pro-gress achieved by the Gulf Monetary Council, which is in charge of the technical and statistical issues. GCC currency union is in our view still desirable as it provides potential benefits including the elimination of the exchange rate risks and currency conversion costs, as well as the potential for greater economic integration among members through deepening trade and investment links.

E&GR: What is the AMF's view of Shari'a compliant finance? Does its growth have any important ramifications for the fund's activities? And what about the recent creation of an Islamic equivalent to the benchmark London Interbank Offered rate (Libor)? Is this helping the industry?

Dr Mannai: The lack of an Islamic interbank rate among other issues has been an obstacle for the develop-ment and expansion of the Islamic banking industry. Only in late 2011, after three decades of debate, the idea of having an Islamic interbank rate came to realization during the 18th Annual World Islamic Banking Con-ference in Bahrain. At that meeting, the Islamic Interbank Benchmark Rate (IIBR) came into existence as an initiative from reputable institutions including among them, Thomson Reuters, the Islamic Development Bank, the Accounting and Auditing Organization for Islamic Financial Institutions, the Association of Is-lamic Banking Institutions Malaysia to name just a few. Also some of the major Islamic banks participate in the Benchmark Committee including among them: Abu Dhabi Islamic Bank, Dubai Islamic Bank, Noor Is-lamic Bank, Qatar Islamic Bank, Masraf al Rayan, Kuwait Finance House and CIMB Islamic Bank.

The IIBR rates are established by a panel of 16 major Islamic banks and published daily on the Reuters sys-tem (Sunday-Thursday). Despite the fact that the IIBR methodology is similar to the one applied on tradi-tional LIBOR, IIBR rates differ in the sense that it is based on expected rate of profit, while Libor is based on interest rate.

Though it is somewhat early to evaluate the impact of the IIBR on development of the Islamic finance indus-try, the idea itself is a very positive move and could contribute to further enhance the role of Islamic finance on a global scale. However, there are a few limitations that need to be addressed in the near future, for in-stance, the current IIBR uses only US dollar Shari'a compliant funding, also it covers a limited number of Is-lamic products such as Mudharaba, Murabaha and Wakala. The scope of the IIBR could be enlarged to in-clude other currencies and also the business working days should be standardized internationally to include Fridays.

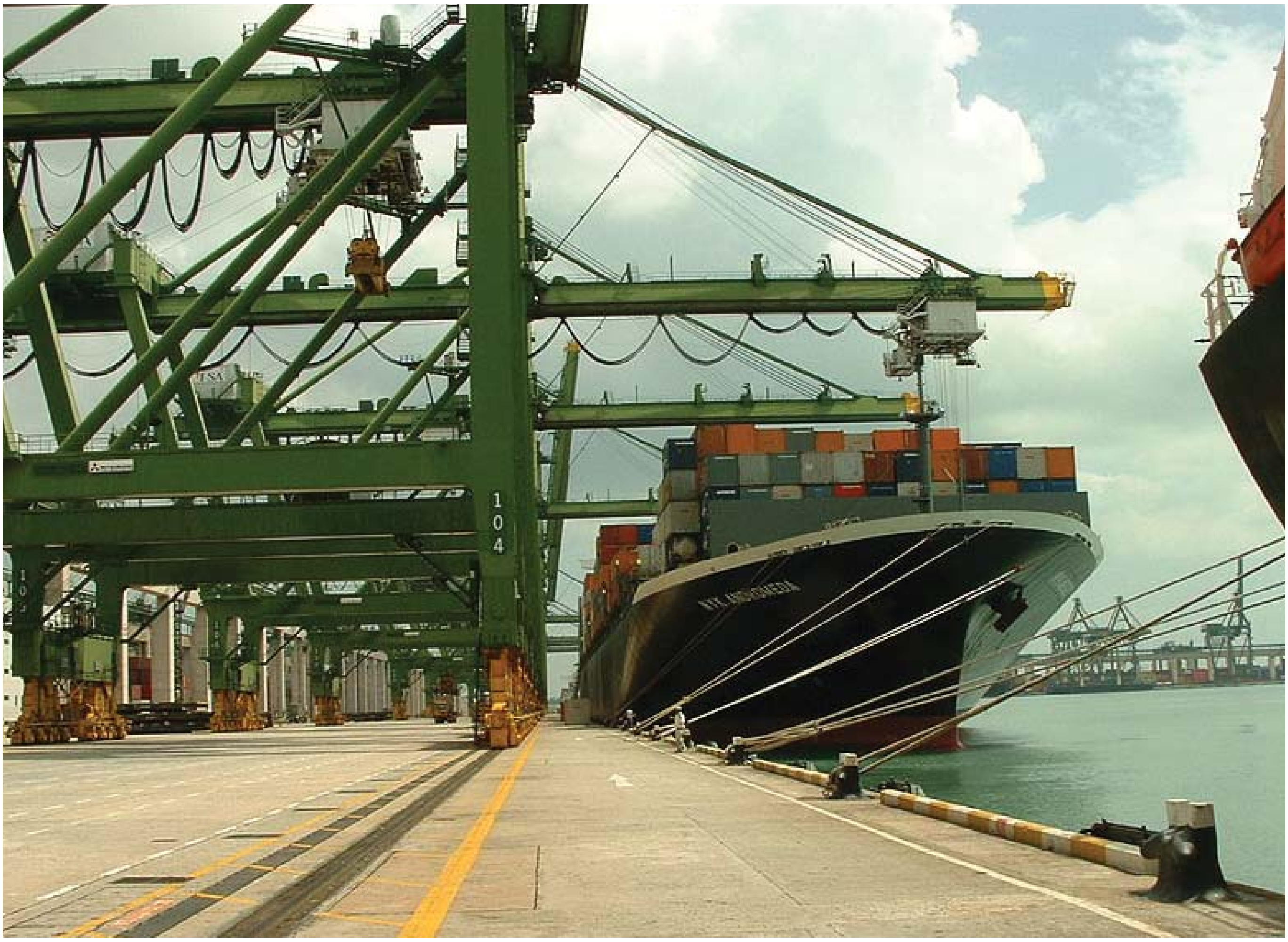
E&GR: I see from the 2010 annual report that the AMF provided loans totaling AAD118mn ($548mn) which was the highest level of annual lending in the last 22 years. How did 2011 compare with 2010? Can you give us a sneak pre-view of your estimates for 2012? (AMF loans are denominated in Arab Accounting Dinars, which are equivalent to three times the IMF's Special Drawing Rights – as of 15 June $1=SDR0.658).

Dr Mannai: In 2011, the total amount of loans provided by the AMF reached a level that is close to that pro-vided in 2010. In 2012, the AMF extended a loan to Jordan equivalent to $34mn. Furthermore, the AMF is currently set to provide three loans to Tunisia and is preparing to extend loans to Yemen. The AMF stands ready to contribute to the financing needs of its member countries in accordance with its loan policy and procedures.

E&GR: Looking back over the last few years, what are the AMF's most significant achievements? Is there anything that, with the benefit of hindsight you would have done differently?

Dr Mannai: The Arab region was characterized by a diversity of economic systems that ranged from public sector-based to centrally planned systems. Over the past two decades, changes have taken place among Arab countries aimed at building the institutions needed to establish liberalized economies that rely more on mar-ket mechanisms. Over this period, the AMF assisted its members by providing policy advice, technical assis-tance and financial support to develop efficient market economies and to integrate their economies into the global economy.

All the Arab countries embraced structural reforms, though they varied in intensity across sectors and coun-tries, to support stable and well managed macro-economies. As a result, there have been considerable achievements. The picture that emerges today is one of convergence of economic policy framework among Arab countries. The AMF takes pride in the considerable success made by most Arab countries in achieving macro-economic stability, liberalizing their economies and building capacity. In addition, major achieve-ments have been performed in the context of the technical assistance initiatives launched with the coopera-tion of various international institutions (IBRD, IMF, IFC, ECB). These initiatives remain very important and have strongly enhanced the financial sector development indicators in the Arab region and improved the economic competitiveness of member countries during the past few years. Another achievement relates to the AMF deposit taking activity that grew by more than 300% to about SDR6.5bn from about SDR1.6bn over the last five years with deposits coming from Arab central banks and organizations. This growth in deposits reflects the increasing confidence of the member states in the AMF.



However, with achievements came also frustrations, related to the fact that the region's economic perform-ance, despite all the efforts, has been below its potential, that unemployment has been persistent and that unequal distribution of income and regional disparities have continued to prevail. Perhaps, the agenda of market liberalization and the focus on macro-economic stability and growth, while laudable, needed to be expanded to include more inclusiveness and transparency.

E&GR: On a technical note, to denominate its funding the AMF uses the Arab Accounting Dinar which is equivalent to three times the IMF's Special Drawing Rights. Are you expecting to continue to use the AAD in the same manner as you have done in the past, or does this need a revamp?

Dr Mannai: The AAD has been pegged to the Special Drawing Right basket (SDR) since its inception (1AAD=3 SDR). The pegging of the AAD to the SDR basket provides significant advantages to the AMF compared to relying on a single currency as it diversifies the allocation of assets over four strong and liquid currencies. In addition, lending to Arab countries in the currencies held in the SDR basket helps maintain a balance in purchasing power which benefits both lenders and borrowers. The allocation to the four curren-cies in the SDR basket allows the AMF to diversify the management of its reserves and investments in a manner to minimize the effects of one currency volatility and risks on the overall value and performance of the portfolios. The SDR basket sets the terms of diversification of assets by currency which minimizes the fluctuations in the value of assets due to changes in the exchange rates of one currency against another.

The currency diversification has also a positive effect on diversifying interest income in various currencies. It is worth noting that the exposure into four currencies widens the scope of investment activities and en-hances the availability of opportunities for investment. Hence, the AMF sees significant value in maintaining the pegging of the AAD to the SDR in the current environment. However, the AMF might open a window for single currency assets from within or outside the SDR basket for loans and investments if finance is pro-vided through means other than capital. The IMF revises the allocation to the SDR basket every five years to reflect the relative importance of the currencies in global trade flows; these revisions help rebalance the components of the SDR and can include addition of new currencies to reflect the evolving economic land-scape.

ENERGY & GEOPOLITICAL RISK

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