OPEC: The Quest for Alternative Financing for Development

BY IZ OSAYIMWESE

There are many correlations in OPEC countries between oil prices and revenues, domestic and external investments, development in OPEC countries and OPEC development assistance to other countries. At the same time, growth in long-term world demand for OPEC oil requires more investment to increase production. Against this background, the author looks at how increased economic globalization and innovations in world financial architecture could help in meeting oil production needs and providing alternative funding for development. The author headed the OPEC Economics and Finance Department in Vienna. At Lincoln University in Pennsylvania, USA, he is Research Professor, Department of Economics and Business Administration, and Director of the Center for Banking, Finance and Entrepreneurship.

INTRODUCTION

The fundamental goal of the Organization of Petroleum Exporting Countries (OPEC) is to secure for its member countries fair shares of the value of their oil endowments, for the purpose of accelerating economic development and improving the welfare of their people. Since its inception in 1960, OPEC's epic relationship with the big international oil companies, the major oil-consuming countries, and the non-OPEC net oil-exporters is replete with efforts to achieve this goal.

Most member countries derive more than 80 per cent of their foreign-exchange earnings from oil and gas exports. In turn, receipts from the oil and gas sector account for at least 70 per cent of government revenue. Unsurprisingly, the performance of their national economies is closely linked to the fortunes of the domestic oil and gas sector. Investment in oil and gas determines the potential for the sector to provide or leverage financial resources for economy-wide development. Judged by a number of measures, OPEC member countries have made varying degrees of economic and social progress over the past 30 years. Arguably, several reasons can be adduced for the limited progress to date. Perhaps less debatable is the idea that it is now time to review the existing sources of development finance, and the modalities for it in OPEC member countries.

OPEC has evolved over the years and has become a market phenomenon. Since the early 1970s, a significant degree of "re-integration" has been achieved in the oil industry of the world, as between OPEC member countries and the major international oil-producing companies. However, a gulf still persists between OPEC countries and the governments of major oil-consuming countries. This suggests that geo-strategic considerations have played a greater role than is explicitly taken into account, keeping the structural changes that occurred in the world oil industry from having their full beneficial effects. The result, this paper argues, is the imposition of geo-strategic costs on OPEC member countries.

DEVELOPMENT FINANCING IN OPEC COUNTRIES

OPEC participates in development financing at two levels. First, individual member countries finance domestic capital investment from a combination of domestic savings and external borrowing and aid. Second, as a group, OPEC countries provide concessional finance for development projects in non-OPEC developing countries.[1] OPEC's development assistance is provided through the OPEC Fund for International Development, established in 1976 as a multilateral agency with a mandate that combines some elements of the activities of both the World Bank and the IMF.

Before the steep increase in crude-oil price in 1973/1974, it can be argued that domestic development financing in OPEC countries was characterized by the shortage of investment opportunities and needs, relative to the supply of domestic savings. The share of gross domestic investment as a percentage of gross domestic saving was 71 for OPEC in 1965.The figure was much lower for the traditional "low-absorber" countries like Saudi Arabia and Kuwait than for the "high absorbers" like Algeria, Indonesia, and Nigeria. The growth rate in investment surged during 1974-1980 in all member countries, compared to the 1965-1973 levels. In 1989, the gross domestic investment/saving ratio increased to 81 in OPEC from the previous decade's level. This partly reflected lower public savings due to the fall in oil revenue when the oil market collapsed in 1986. However, investment was lower during 1981-1989 in some countries where there was unsustainable expansion in public investment in 1974-1980. The ratio of 74 per cent in 1997 partly reflects the continued increase in investment in physical, social, and human infrastructure in some key member countries, albeit at a slower pace.

It should be emphasized that the oil and gas industry is highly capital-intensive. With the transfer of property rights over national hydrocarbon resources to member countries in the early 1970s, the onus of developing and sustaining the industry fell on OPEC economies. Armed conflicts involving four OPEC countries during the 1980s and in 1990/1991, the decline of the real price of crude oil, and continued pressure for political and social change within many member countries have strained government finances, reduced national saving, and delayed crucial investment in oil and gas. Yet the required levels of investment in the industry have increased due to the maturing of some fields and the need to adopt advanced technology for competitively exploring, finding, and developing oil. For the reasons given above, OPEC countries have problems generating sufficient domestic savings to fund investment at the right time in an industry that is still crucial to creating a base for sustainable development in those countries. Thus, the quest for alternative development financing is a necessity, at least in OPEC; given the recurring call for a new

Table 1—OPEC: DOMESTIC INVESTMENT AS PERCENT OF DOMESTIC SAVING

Country	1965	1980	1989	1997
Algeria	116	91	100	75
Indonesia	100	63	107	100
Iran	71	..	107	..
Iraq	52	..	..	..
Kuwait	27	..	61	..
Libya	58	..	..	..
Nigeria	116	68	62	75
Qatar	..	..	..	..
Saudi Arabia	29	35	100	63
UAE	..	39	63	..
Venezuela	74	46	48	57
OPEC average	**71**	**57**	**81**	**74**

Source: *World Development Report*, World Bank: 1991; 1998.

international financial architecture, it is also the *zeitgeist*.

Another reason for seeking new financing arrangements for development projects in OPEC countries relates to the current operations of the OPEC Fund. Over the past 23 years, the OPEC Fund has cumulatively committed US$5.2 billion (in loans, grants, and other contributions) and disbursed US$3.6 billion to over 105 countries worldwide for a broad variety of development projects. Member countries' contributions to the International Fund for Agricultural Development and to the IMF are channeled through the OPEC Fund. The eligible beneficiaries of the OPEC Fund's assistance are governments of non-OPEC developing countries and international development agencies that serve such countries. OPEC member countries are not eligible for the Fund's assistance.

The track record of the OPEC Fund is impressive if not stellar.[2] By the end of 1998, the OPEC Fund approved 778 loans amounting to about US$4 billion for development projects and programs, and for balance-of-payments support. The burden of the Fund's development assistance is not uniformly distributed among its member countries, as shown in the table on contributions. Saudi Arabia and Kuwait accounted for over 47 per cent of the paid-in contributions of US$2.87 billion; when Venezuela is included, the share of the three major contributors to the Fund stood at over 64 per cent, as of December 31, 1998. Table 1 above also shows the disparity between pledged contributions and paid-in contributions, especially by some members from the Gulf region.

Evaluation of OPEC's development financing must include the development effort of the Organization of Arab Petroleum-Producing Countries (OAPEC), seven of whose 11 members are also in OPEC. In 1976, OAPEC's official development assistance (ODA) reached US$4.9 billion, rising to US$9.5 billion in 1980, but falling sharply to US$3.4 billion during 1985-1988, when oil prices dropped to their lowest levels (except for 1998). At their peak in 1980, the combined ODA for OPEC and OAPEC was over US$19 billion, compared with OECD's US$27 billion. Since 1976, the percentage of gross national product devoted to ODA has been between two and twelve times higher for OPEC and OAPEC than the OECD percentage (see Table 2).

While OPEC's international development efforts, through the OPEC Fund, are not widely known, it is now a good time to review some of the assumptions underlying the Fund's development assistance. This review should take account of the structural changes that have occurred in the energy industry and the reality—rather than the historical perception—of OPEC's role in the world oil market. Furthermore, the review should reflect the emerging or persistent economic and geo-political problems of member countries.

Table 2—OFFICIAL DEVELOPMENT ASSISTANCE FROM OECD & OPEC COUNTRIES

OPEC total net flows	1976	1980	1985-88 A (average annual)
ODA OPEC ($m)	5,877	9,636	3,514
(% of GNP)	2.32	1.85	0.66
ODA OAPEC ($m)	4,932	9,538	3,425
(% of GNP)	4.23	3.22	1.29
OECD total net flows			
($m)	13,855	27,296	40,697
(% of GNP)	0.35	0.37	0.35

Source: *World Development Report*, World Bank, 1991

Investment in oil and gas will remain for many years a crucial part of OPEC member countries' strategy for achieving economic development. Obtaining finance for upstream investment has been member countries' responsibility ever since they wrested property rights from the international oil companies.

Since 1976, the percentage of gross national product devoted to ODA has been between two and twelve times higher for OPEC and OAPEC than the OECD percentage.

The countries have always differed in their approach to generating capital for oil and gas projects. Traditionally, Nigeria, Indonesia, and the United Arab Emirates have always encouraged foreign participation in upstream activities. Saudi Arabia and Kuwait continue to rely on hydrocarbon revenue to finance oil and gas projects, while excluding foreign investment.

In the 1990s, views and practices concerning foreign investment in oil and gas exploration and development became increasingly favorable—except in Saudi Arabia and Kuwait. Even so, the idea of direct foreign participation in upstream projects is no longer far-fetched in Saudi Arabia and Kuwait. Recently, Kuwait announced a major change in policy that will encourage foreign participation in the northern oil fields. The reasons for this change in attitude included the weak oil price trend since the 1980s, the costly war between Iran and Iraq in 1980-1988, the Gulf crisis in 1990-1991, and the associated internal financial, economic, and political pressures on member country governments.[3] The need for investment in post-sanction Iraq, in Libya, and in Iran to maintain production capacity or develop new reserves has been exacerbated by the US actions against those countries during the 1990s. During the next decade, other OPEC countries are expected to invest heavily in the oil industry to compensate for many years of deferred maintenance and introduce modern oil technology.

INNOVATIVE APPROACHES IN FINANCING

All OPEC countries have more or less binding financial constraints. Saudi Arabia ran current account deficits continually between 1983 and 1995 and recorded minor gains over the past two years. Deficit financing and the high costs associated with the Gulf crisis compelled Saudi Arabia to draw heavily on its foreign reserves and start borrowing from local and international capital markets. As with Saudi Arabia, the Gulf war forced Kuwait to dip deeply into its foreign reserves and borrow to finance the balance of payments deficit. Even the United Arab Emirates, the only OPEC country with no current account deficit so far, should conserve its foreign reserves and not shy away irrationally from foreign borrowing, in the interest of sound macroeconomic management.

In spite of much talk about political risk, OPEC oil, especially from the Gulf region, is still highly desired by the major consuming countries. One estimate is that investment of up to US$161 billion will be needed by the year 2010 to find new reserves, increase production capacities, and meet long-term world demand for OPEC oil. This would raise combined production in Saudi Arabia, Iran, the UAR, Kuwait, Iraq, and Qatar from the 1976 level of 20 million barrels per day up to 30 million barrels. Providing the required increase in crude production capacity would consume 7 to 12 per cent of the six countries' gross oil revenue, or US$147 billion, assuming an oil price of US$17 per barrel, as estimated by the United States Energy Information Agency (EIA).

When the pressing economic, political, and defense needs of OPEC members, in budgetary terms, are combined with the industry imperatives outlined above, it is evident that new approaches to financing development projects, especially those in oil and gas investment, must be sought. Experience over the past 20 years has shown that total dependence on government budget to finance investment in the highly capital-intensive and technology-driven hydrocarbon industry cannot sustain the sector. Other sources of funds must be harnessed, including companies and international financial markets. It is not an either/or choice. Rather, the choice should place a package at member countries' disposal that includes the cutting-edge technology and finance of the major international oil companies, and the potential of a re-designed, informationally efficient, global financial system. All types of risk will have a market in such a system, and all tiers of the global market will be connected, given institutional changes and advances in information technology. The World Bank Group and the IMF will play an integrating role in the new financial system.

Investment of up to US$161 billion will be needed by the year 2010 to find new reserves, increase production capacities, and meet long-term world demand for OPEC oil.

It is widely believed that the international oil companies, at least collectively, can access huge amounts of money for investing in oil exploration, development, and production in OPEC countries, if the conditions for participation are favorable. This belief has proved to be right in view of the marked change in thinking and practice about foreign participation in upstream activities in several OPEC countries, including Algeria, Indonesia, Iran, Iraq, Nigeria, Qatar, and Venezuela.

A conclusion from the above discussion is that the 1990s strengthened the patchy *rapprochement* that started to develop between OPEC countries and the international oil companies during the previous 20 years. The international oil companies do have a major role to play in financing oil projects in OPEC, in spite of their limited internally generated capital and the competition for capital within and outside the oil and gas industry.

Historically, international financial markets have been the primary sources of long-term capital for the international oil companies. These sources include syndicated debt or project finance, equity capital, public debt and bond markets, and the derivatives market since the 1980s. Syndicated debt/project finance is still the most widely used source by the international oil companies, while activity in equity markets increased during the spate of partial or total privatization of national oil corporations (NOCs) in the 1990s. Some governments in OPEC countries (e.g., Nigeria) still seem to be considering the privatization option for their NOCs. The derivatives market is growing rapidly, with an ever-increasing number of innovative financial instruments. The use of derivatives as tools for risk management and for generating capital in the oil industry has spread beyond the international oil companies. Increasingly, OPEC countries and other oil exporters are active in the derivatives market, in sharp contract to the near-hostility with which some member countries viewed the futures and derivatives market for oil in the late 1980s and early 1990s.

Innovation in the financial services market over the past decade has also resulted in the development of so-called non-traditional financing. The oil and gas industry has traditionally supported the use of non-traditional instruments as a strategy for coping with the effects of low crude oil prices and severe cash-flow constraints. In 1991, Enron Corporation pioneered low-cost financing that included the use of volumetric production payments (VPP) by natural gas producers and end-users in return for instant financing from Enron's funding subsidiary. The innovation in the new instrument is that the financing is "secured by proved reserves, payments being made in the form of a fixed hedged volume of hydrocarbon (gas or oil) over a fixed period." The new financial instrument is non-traditional in the sense that it provides capital to firms that might not have had access to capital from traditional sources—debt and equity markets. The VPP instrument is essentially a form of securitization of hydrocarbon reserves, with hedging. This provides OPEC member countries with another viable alternative to privatization of their NOCs.

ROLE OF MULTILATERAL AND NATIONAL AGENCIES

Funding by multilateral agencies played an important role in financing oil and gas projects in developing countries in the past. The World Bank Group assisted developing countries with oil and gas development up to the early 1970s. But in the high oil price environment of the latter part of the 1970s and early 1980s, multilateral agencies' funding interest in developing countries shifted from oil and gas projects to other economic sectors. In the late 1980s, the World Bank began to promote the privatization of national oil and gas companies in developing and emerging economies. However, since the major multilateral and national agencies do underwrite sovereign risk, they can also facilitate investment in OPEC countries. The change in policy will merely reflect the transformation that OPEC, consuming countries, and the world oil and gas markets have undergone in nearly three decades.

Minor multilateral agencies and regional development banks and funds do not typically finance oil and gas projects, partly because of the huge investment needs. However, these financial institutions can assist OPEC countries by funding other infrastructure projects, thereby helping release domestic resources for oil and gas projects.

In this regard, the OPEC Fund must review its mandate, especially the exclusion of OPEC member countries from its list of eligible beneficiaries of development assistance. Admittedly, the incentive to open up the OPEC Fund's development assistance to the governments of member countries is very weak. Chief among the reasons for this weakness are: imbalance in the contributions of members, with Saudi Arabia and Kuwait bearing disproportionately large shares; the bitter experience of two costly wars involving four of OPEC's reserve-rich member countries in the Gulf; regional rivalry; and age-long mutual suspicion.

But innovative options exist for including member countries in the eligibility list. For example, to reduce the regional obstacles to providing some loan assistance to member countries, the OPEC Fund could consider the private sector rather than governments for loan assistance. Such loans will have a commercial thrust, based on international market standards with an appropriate spread to reflect credit-related risk of the borrower. The proposed change would strengthen the OPEC Fund's desire to expand its private sector window for financing development projects. With a developed private sector window, the OPEC Fund can facilitate syndicated loans, involving regional development banks and international banks.

The policy change that is envisaged is substantive. It is also symbolic in the sense that it will signal the need to change the prejudices about OPEC that have become largely irrelevant. Furthermore, the rapid pace of globalization in capital markets will encourage partnerships among institutions that provide financing for development projects. These should be some of the elements of an effective international financial architecture.

With the major multilateral institutions playing an enabling role, the new financial system should reflect the key lessons of the recent East Asian crisis—that is, the systemic-risk effect on other countries and regions. The new system should identify and quantify the geopolitical risk that oil producers in the Gulf bear, essentially because massive deposits of a strategic natural resource lie within their national boundaries. Financial innovation in the new global system should address appropriately geopolitical and systemic risks, among others.

CONCLUSION

There seems to be a gap in the literature concerning the character of development financing in a redesigned international financial system. As with the emerging financial system, development financing should reflect the trends in economic globalization, financial innovation and consolidation, and the increasing irrelevance of ideological divides, such as among East-West and North-South countries. Furthermore, development financing should reflect the fundamental changes that occurred in the world oil and gas industry after 1974 and the objective role of OPEC in recent years.

The economic performance in all OPEC countries, except Indonesia, largely mirrors the behavior of the oil and gas sector. Oil price volatility often translated instantaneously into sharp fluctuations in foreign-exchange earnings and government revenues, with serious implications for macroeconomic management. Thus, the financing of oil and gas projects is a paradigm for development financing in the member countries' economies. OPEC countries are still far from achieving the goal of transforming their enormous hydrocarbon wealth into human and physical capital for sustainable economic development. To achieve their goal, member countries need to invest massively in oil and gas projects, beyond just maintaining and expanding production capacity. Practically all member countries are financially strained. All of them face, in varying degrees, undue geopolitical risks that limit their access to external financial resources, under the existing international financial infrastructure. Moreover, all OPEC countries have experienced the "Dutch disease" at some time in the past, and one member country suffers an extreme form of the disease.[4] This being a "regional" epidemic, the Dutch disease deserves appropriate response from the custodians of international financial health.

The IMF, the World Bank Group, the OPEC Fund, and other multilateral and national agencies, including their investment guarantee and loan insurance branches, have a new or intensified role to play in the required response. An alternative financing for development in OPEC and other countries will entail cooperation and partnerships among countries and international financial institutions, and innovative funding arrangements. For the emerging international financial system to be truly innovative, its constituent parts as well as the way they are linked operationally must also be innovative.

To sum up, the OPEC member countries, through the OPEC Fund, have played a significant role in development financing to date. The Fund can play a greater role in the future. It can expand its private-sector window in both non-OPEC and OPEC countries, and increase its grant program as well as support for the development efforts of the UN, the IMF, and the World Bank Group. However, it should be emphasized that the Fund was established under the most optimistic assumption about the future trend in crude oil prices—that the upward pressure on prices during the 1970s would be sustained. The validity of that assumption was short-lived. Rather, OPEC countries have witnessed a low oil-price trend, volatile government revenue, and increasing budgetary strains since the 1980s. Their resources for domestic economic and social development are increasingly limited. Consequently, the OPEC Fund's potential for a significantly larger development financing is limited. The huge cost of the Gulf war—which is basically a part of the real cost of the region's vast hydrocarbon reserve and production—drastically reduced the foreign asset-base and the investment income of two of the three largest contributors to the Fund.

In light of the constraints highlighted above, and barring a repetition of the golden years of high oil prices, a significantly expanded program of development financing by the OPEC Fund seems unrealistic in the foreseeable future. However, a leveraged role by the Fund is feasible and desirable in a favorable international monetary and financial environment. In a globalizing economy, with increasingly integrated financial markets and institutions, no country or group of countries should be priced out of or shut off from the international financial market, for non-market reasons. Continued financial innovation will ensure that there is a market for every type of risk. An integrated international financial system, supported by continued progress in information technology, will have substantial economies of scale to make the market for risk work well. In the desired system (paraphrasing the IMF's Managing Director, Michel Camdessus), "international resources *for development financing* will be put at the disposal of all needy countries at the lowest possible cost." ■

REFERENCES

- Amuzegar, Jahangir, *Managing the Oil Wealth: OPEC's Windfall and Pitfalls*, I. B. Tauris, London and New York, 1999.
- Deaton, Angus, "Saving in Developing Countries: Theory and Review," Proceedings of World Bank Annual Conference on Development Economics, Washington, DC, 1989.
- Humphries, Michael E., "Competitive environment of oil and gas financing," *Energy Policy*, 1995, vol. 23, No. 11, pp. 991-1000.
- Hunter, Shireen, *OPEC and the Third World: The Politics of Aid*, Indiana University Press, Bloomington, 1984.
- Knott, David, "OPEC States Seeking More Foreign Investment in Petroleum Sectors," *Oil & Gas Journal*, July 29, 1995.
- *Oil & Gas Journal*, May 1, 1998, "Where Will Oil Industry Financing Come From?," NOIA panel.
- OPEC Fund for International Development, *Annual Report*, Vienna, Austria, 1998.
- *Petrostrategies*, "EIA Says Gulf Nations Will Have to Invest Heavily in the Upstream to 2010," vol. 10, No. 477, March 11, 1996, pp. 1-3.
- Varzi, Mehdi, "OPEC After the War 1991," *Oil and Money: The Geopolitical and Commercial Dimensions*, International Herald Tribune, November 1991.
- Walters, Peter, "The Magnitude of Financial Requirements for the Upstream Industry and Ways to Meet Them," *Centre for Global Energy Studies*, 3rd Annual Conference on Oil Production Capacity: Investments, Relationships and Policies, London, 5-6 April, 1993.
- World Bank, *World Development Report*, Washington, DC, 1991, 1998.

NOTES

[1] There are at least 30 major multilateral, regional, or sub-regional development banks and funds. Of this number, about 10 are from the Middle East.

[2] The OPEC Fund's long-term track record contrasts sharply with Shireen Hunter's somewhat premature assessment, published barely six years after the agency was established (see References).

[3] Excluding the United Arab Emirates, all OPEC countries experience financial strains, as their current account balance, foreign asset draw-down, and increased borrowings in local and international financial markets show.

[4] The "Dutch disease" describes a condition when a country's traditional industries are declining or internationally uncompetitive because the discovery of natural resources has created a prosperous new industry.