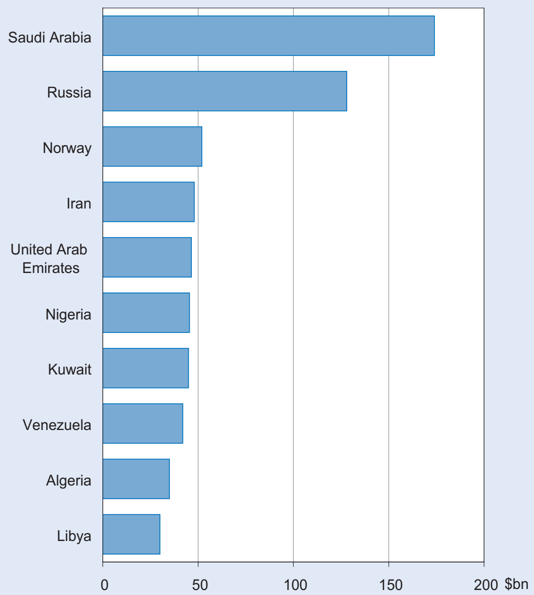
A NEW FLOOD OF PETRO-DOLLARS?

According to the *Economist*, oil exporters could earn $700 billion this year from selling oil to foreigners. This includes not only the Organisation of Petroleum Exporting Countries (OPEC) but also Russia and Norway, the world's second- and third-biggest earners (see chart 1 below). The International Monetary Fund estimates that oil exporters' current-account surplus could reach $400 billion, more than four times as much as in 2002. In real terms, this is almost double their dollar surpluses in 1974 and 1980, after the twin oil-price shocks of the 1970s and early 1980s.

What is happening to all these petrodollars? In essence, they can either be spent or saved. Either way, some of the money can be recycled to oil-consuming economies and thus soften the impact on them of higher oil prices. If oil exporters spend their bonanza, they import more from other countries and thus help to maintain global demand. If they save their windfall, but invest it in global capital markets, they can finance oil importers' bigger current-account deficits – in effect, lending the increase in fuel bills back to consumers. And by increasing the demand for foreign financial assets, they can boost asset prices and push down bond yields in oil-importing countries. This in turn can help support economic activity in these economies.

TOP TEN OIL EXPORTERS IN 2005



Source: US Department of Energy; The Economist estimates.

In Russia, the government has taken the sensible step of setting up an oil stabilisation fund, which will be used to reduce its large foreign debt. That said, the country has been more eager than members of OPEC to spend its extra money. Around two-thirds of the increase in Russia's export revenues since 2002 has gone for imports.

In most of the Middle East, governments are being more cautious than usual with their extra revenue. The IMF estimates that governments have on average spent only 30% of their extra oil revenue since 2002, compared with 75% in the 1970s and early 1980s. Their average budget surplus has increased from 2% of GDP in 2002 to nearly 15% this year. Middle East oil exporters have greater capacity to spend petrodollars at home than in the 1970s and 1980s, because their populations have been rising rapidly and because their infrastructure needs upgrading after many years of dwindling government revenues. As well as spending more on health, education and infrastructure, the Middle East also needs to invest in oil production and refining capacity, to ease future supply shortages and so stabilise prices.

The energy shock of 2005 is different from past shocks. While sharply higher oil prices may have generated a huge revenue windfall for Middle East oil producers, the reflow back into dollars through the petro-dollar effect is largely missing. Stephen Roach, a Morgan Stanley economist, gives several reasons: (1) A significant portion of the oil revenue has been plowed back into surging domestic equity markets. (2) Booming domestic real estate projects have also absorbed a large portion of the windfall. (3) Post-9/11 security concerns are seriously hampering Middle Eastern capital flows into dollars. (4) Saudi Arabia, the region's and the world's largest oil producer, has a public sector debt problem. (5) There is deepening concern over the dollar outlook in the Middle East. US capital inflow data very much corroborate this intelligence he picked up in the Middle East.

If oil prices remain high, so will oil exporters' surpluses. The IMF forecasts an average annual current-account surplus of $470 billion over the next five years (assuming an average oil price of $59 a barrel). The oil exporters will have to play a role in helping to reduce global imbalances. Importing more and letting their currencies rise, as well as increasing government spending and liberalising their economies, would be steps in the right direction.

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