



International Monetary and Financial Committee

Eleventh Meeting
April 16, 2005

Statement by Mr. Alipour-Jeddi
On behalf of the Organization of the Petroleum Exporting Countries

**Statement Mr. Alipour-Jeddi
on the behalf of OPEC**

International Monetary and Financial Committee
Washington, D.C.
April 2005

OPEC would like to reiterate to the delegates attending the IMFC its ongoing commitment to maintaining market stability at prices considered reasonable by both consumers and producers. In this context, OPEC Members are working towards ensuring that the world continues to receive steady supplies of crude oil, which are vital for economic growth.

Such efforts were more challenging in 2004 when the world economy grew a remarkable 5%, triggering an exceptional rise in oil demand of more than 2.6 mb/d. The main engines of the growth in GDP and oil demand in 2004 were China and the USA. China recorded impressive GDP growth of 9.5% and an oil demand increment of 17.2%, while the USA saw 4.4% GDP growth and a 2.4% rise in demand.

This unexpected surge in demand put strong pressure on the growth in oil supply. In effort to meet this rise in demand, OPEC increased its production ceiling by 3.5 mb/d during the year 2004, with OPEC production surpassing 30.1 mb/d in September. As this increase was greater than the rise in global oil demand, commercial crude oil stocks in the OECD countries ended the year at comfortable levels well within the 5 year average while Strategic Petroleum Reserves (SPR) in the USA also increased to close to its maximum capacity. These efforts contributed significantly to the easing of oil prices in the fourth quarter of 2004.

However, as prices resumed their upward trend at the beginning of the year, OPEC Member at the March Meeting in Isfahan further increased the production ceiling by an additional 0.5 million barrels per day and authorized its President to add a further 0.5 million barrels should oil prices remain at current levels or rise further.

In addition to the strong world economic growth and higher-than-expected demand, two other factors have also contributed to the upward price trend in 2004. The first is that there is a growing mismatch between the type of crude needed on the demand side and the type of crude available on the supply side. The increasing trend toward more stringent product specifications for gasoline and diesel in the major consuming countries coupled with a lack of the necessary refinery capacities has heightened demand for light sweet crudes. Meanwhile, the recent supply increases have placed more heavy sour crudes on the market. These diverging trends have led to a widening price differential between light-sweet and heavy-sour crudes, as upward pressures are being primarily focused on the lighter benchmark crudes, such as WTI, while many of OPEC's typically heavy crudes had seen substantially lower prices. Indeed, this price differential peaked at a record level of \$17 per barrel in October of last year (WTI versus Dubai). The wide differential has provided

a golden opportunity for those refiners who have made the necessary investments to upgrade their conversion capacities, which allows them to utilize the heavier sour crudes to produce the high-demand light products such as gasoline and diesel. Differentials are set to remain wide for the next 2-3 years given the increasing demand for lighter products.

The second factor is related to the significant rise in OPEC production in 2004. An unintended result of Member Country efforts to cool off the market was that OPEC spare capacity reached levels below 5%, or 1.4 mb/d, in the third quarter of 2004, heightening concerns about a sufficient capacity cushion in the event of a major supply disruption. In order to alleviate these problems, OPEC Member Countries began in the second half of 2004 the implementation of plans aimed at increasing spare capacity, which is expected to reach more than 3 mb/d towards the end of the year from 2 mb/d currently. Further capacity expansion is underway for 2006.

Assuming that oil demand would continue its steady growth, OPEC is committed to making the necessary investments to maintain spare capacity in the years ahead. However, it cannot be overstressed that investments in the upstream alone will not be enough. While some discussions have focused solely on the upstream sector, for these investments to have their intended effect, substantial investments are also needed in the downstream sector, particularly in refining capacity. It has been said that end consumers do not use crude, they use products, and if there is a lack of sufficient refining capacity to utilize the type of crude that is available, then there will be dislocations and continued price volatility, despite the substantial investments being considered on the upstream side.

Regarding downstream capacity, utilization rates in key refining centres are already close to a realistic maximum of 95% of capacity. Refinery capacity expansions are even forecast to fall behind current oil demand growth estimates, with a particular lack of conversion capacity additions. As such, refining margins are expected to remain extraordinary health until early 2007, possibly even longer depending on how quickly new capacity comes onstream.

An additional factor supporting oil price volatility is the increase activities of non-commercial speculators in the futures market. The size of the futures & options trade in paper oil is many times larger than the physical trade in crude oil. Consequently, NYMEX & IPE have become the dominant institutions setting benchmark crude prices. Speculative paper oil trade has magnified the upward movement in crude oil. Several factors, including fear of a supply shortfall, have fed speculative buying.

As a further point on the above two issues, it is worth remembering that the text book function of the financial markets is to mobilize resources and invest them efficiently in those projects that are commercially feasible and produce goods and services that the economy needs. In the recent years, very large amounts of money have flown to commodity, hedge funds, and in particular oil paper assets. Despite the large flow of funds into short-term speculative

portfolio investments, the financial markets have in the past and are continuing to under-invest in the downstream sectors of the oil industry in both the developed and developing countries, whose economies need growing volumes of petroleum products. We draw the attention of the IMF and the World Bank to these issues and hope that better financing for downstream projects could complement efforts by oil producers to expand upstream capacity to ensure a sufficient supply to the market.

The rise in oil prices in 2004 had rather a moderate effect on world economic growth. The main reason is that the upswing in the world economy has been very strong since mid-2003 and coincided with the boom in the Chinese economy. Considering 2005, sustained high energy prices are a risk factor for inflation as the full effect of the rise in crude prices late last year may not yet have worked through to final prices, not to mention the more recent record high oil prices. For the OECD as a whole the very strong improvements in economic activity, profits and liquidity since 2002 have eased the adjustment to the higher oil prices — indeed this adjustment has been continuous and gradual, considering that the OPEC Reference Basket price first broke \$30/b in this cycle in January 2003. Developing countries face a more difficult adjustment process as the share of energy in the total import bill is higher, a situation that is a cause for concern.

As always, OPEC Member Countries will continue to closely monitor the market and stand ready to make the timely and necessary decisions to ensure adequate supplies consistent with robust economic growth, in particular in the emerging economies of the developing world.