

# Liquidity of capital involved in your business economics essay

[Economics](#)



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In physical trading of goods usually the full value has to be paid to the seller on the spot or after a short period of time if the seller knows the buyer very well but in case of a future contracts a small deposit is the capital required for the buyer and the seller to trade. This means the capital required to do the business is much less, sometimes more than twenty times less, and the money you put in risk is much less than physical trading.

### **Chances of loss:**

Trading financial markets like any other business exposes you to risk that may cause in loss of money. What is interesting about it is that in financial trading you are able to calculate your risk using simple statistics and mathematics and limit it to your appetite. One of the most important services we provide you is helping you with this calculation. But in physical trading you are exposed to many different types of unpredictable risks that is impossible to be calculated. No one has ever seen or heard that a future contract is broken, spoiled, stolen, destroyed as result of earthquake or gone out of fashion.

### **Liquidity of capital involved in your business:**

In physical trading of goods from the time the buyer buys the goods to the time he becomes a seller and has its money returned back to him, days, weeks, and even months can pass during which his money is exposed to unpredictable risks and is not accessible to you. As a consequence the physical trader will witness lots of profitable business opportunities simply passing by because he does not have access to his money. In financial

trading you can pull out all or part of your money out of the business within a second if it is required.

### **Chances to make money:**

In physical trading of goods usually you have to buy the goods first and then only you can sell them. This means that you will benefit from the rise of the price only and in case of a fall in the price no way to have any profit. There will be only loss. But when you trade future contracts you have the right to sell before buying. So you can have profit even when the prices head south. It is clear that in financial trading the chances to make money are twice compared to physical trading.

### **Standardization of products:**

In physical trading quantity and quality control is a very important issue that requires serious attention. That is the reason why traders pay attractive amounts of money to inspection companies or spend on travel expenses to inspect the goods they buy and despite all efforts and money they may not receive what exactly they intended to buy. But in a financial market such things never happen due to the fact that what the buyer buys and the sellers sells has been thoroughly specified by the quantity and quality in the contracts specification.

### **Elimination of chances to be cheated:**

In physical trading of goods the buyer or seller may try to cancel or alter the deal they agreed upon initially because of change in prices or any other reason. In financial trading the deal once clicked is guaranteed by the market supported by the deposit both buyer and seller have with their broker.

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## **No business overheads:**

In physical trading there are expenses that cannot be avoided whether the business is running on profit or on loss. Rents, salaries and government fees are simple examples and there is always a start up fee involved that is money you pay without any return. In financial trading no set up fees and/or overheads exist. The only expense is a small fee you pay to your broker only whenever you trade. There are more advantages in financial trading over physical trading such as the fact that you can do your business at the comfort of your home or any other place where you can access the Internet or a telephone line. Business opportunities are open to you more than five and half days a week round the clock when you feel like doing it. You may decide to choose it as your second job while working elsewhere or leave your investments to us and just enjoy the profit.

## **KEY ISSUES IN OIL TRADING**

### **Capacity Levels and Supply**

A matter of concern is future capacity availability at all stages in the oil industry value chain. In terms of the upstream, while the depletionist's arguments based upon reserve constraints can be dismissed; there is a danger that predictions of crude shortage may prove true. It is generally agreed that a great deal of money needs to be invested in exploration, development, and production to sustain an increase in crude oil supplies. Leaving aside issues of exaggeration in the forecast, there must be serious doubts that enough will be forthcoming from the International Oil Companies (IOCs). This is not for lack of funds. The high prices enjoyed over the last 2 years have given the IOCs record years in financial terms. In the past, such

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high oil prices would have encouraged ever greater investments in exploration and production, thereby creating a self-adjusting mechanism by increasing supply. However, in recent years this has failed to materialize. As explained above, the IOCs, in their struggle to maintain shareholder value, are returning money to the shareholders. In 2004 BP is expected to have returned over \$6 billion. To put this in perspective, in 2003, BP invested \$9.7 billion in exploration and production activities. In similar vein, ExxonMobil is also expected to return some \$6.4 billion to its shareholders. The danger is that the short-term benefits to share price will be at the expense of future investment in maintaining and developing crude capacity. There are several reasons why returns are sufficiently poor to justify returning funds to the shareholders. Existing fiscal regimes have become so progressive in recent years that, at prices much above \$30 per barrel, the bulk of the windfall accrue to host governments rather than the IOCs. Also, access to low-cost reserves, which could improve returns, is limited. Some 53 per cent of world proven oil reserves lie in four countries. Of these, Kuwait and Iran are trying to encourage IOC investment but the process has stalled because it has fallen foul of domestic politics. Saudi Arabia refuses to allow investment from abroad in upstream oil, and Iraq is such a disaster area that no serious investment is likely for a long time to come. The other major opening has been in Russia, but, as explained earlier, there are also problems as this develops. A consequence of the mega-mergers of the late 1990s is that the IOCs have been shedding labour to cut costs. Thus they have now become managerially constrained and lack enough staff to manage new projects effectively. Also, the service industry has been squeezed, as the large IOCs

have increased their monopoly power and as the growing use of e-commerce has also cut service-industry margins. Thus the service industry, which is losing money, has not been investing in capacity and capacity is tight. This means that, even if the IOCs decided to try and spend the money on new investment, there is insufficient capability in the service industry to accommodate more projects. As to other sources of investment funds, as described above, many of the NOCs in the major producers are currently capital constrained. Governments are increasingly suspicious of their rent seeking behaviour and, in any case, have locked themselves into a high-spending world. Thus the revenue is required for other things and investing in new capacity which may bring down price makes less sense. Thus NOCs in the producer countries may not fill any gap arising from IOCs' unwillingness to invest. Simple economics argues that high prices produce a supply response creating a self-correcting mechanism. However, this tends to neglect the lead times. In upstream oil, the lead times for new capacity from negotiations on acreage to first oil can be between 5 and 8 years. Thus, any crude shortages resulting from the current outflow of potential investment funds could be around for some time, together with their resultant high oil prices. Furthermore, this lack of investment will have an impact on all stages of the industry including refining, transportation, marketing, and distribution. There is a serious danger that short-termism, driven by the demands of the stock market, may prove to be seriously damaging to oil supplies and prices. Several policy solutions are, in theory, available. Home governments of the IOCs cannot order them to invest more, but they can try and persuade. This could be done by offering industry-specific tax breaks on investment.

Alternatively, they could penalize returns to shareholders, although this is an extremely unlikely option, since it effectively undermines the basis of a market economy. However, in a global world economy, there is always the temptation for government to free ride and leave difficult solutions to others. Such policy solutions could only be effective if there were some form of collective decision by the home governments, possibly under the auspices of the G8. Individual home governments could also ensure that there is no collusion between the IOCs to restrain capacity. The minerals industry in the 1980s went through a similar process to oil. Mineral prices were poor and company profitability weak. The industry stopped investing, capacity became tight, prices and profitability rose. However, preferring this world to the previous world, the mineral companies allegedly limited investment to keep supplies tight. There is a suspicion that this was achieved through a degree of collusion and a number of anti-trust cases are pending. An alternative option would be to bring political pressure to bear to try and improve access to upstream acreage. An obvious example would be for the USA to remove sanctions against Iran as it has done for Libya. Restoring Libya to international respectability is leading to a feeding frenzy by oil companies to invest in that country's upstream. Saudi Arabia might also be amenable to pressure. There has been a long history of the Kingdom sacrificing its stance on oil policy in return for perceived foreign policy benefits. International efforts to stabilize the desperate situation in Iraq might also assist. However, such a policy option smacks of a revival of the old imperialist days which many would regard as undesirable. Consumer governments, who may also be home governments, have several policy options. If they are also

producers, they could relax fiscal terms to encourage more investment in their upstream. They could also follow the example of some of the larger Asian oil importers and encourage upstream investment by their own companies abroad. This is clearly a pattern which they followed during the period of higher minerals prices described earlier, and there are signs that India and China are following suit in oil. One possible negative consequence of such moves, to be discussed below in section IV (ii), is the danger that the investors pay little or no attention to the consequences for the host country. These range from promoting ‘resource curse’ to embedding extremely unpleasant regimes.

## **(ii) Resource Curse and Future Supply**

There is a further threat to future crude oil supplies—resource curse—which carries important policy implications. Common sense and economic theory argue that large windfall profits from oil projects should enrich a country and its population. While money cannot buy happiness it is a good down payment. Large inflows of foreign-exchange revenue should overcome capital shortage and lack of investment. However, there is strong evidence that the reverse is true and that large oil revenues damage the economic base of a country and tend to aggravate poverty rather than alleviate it. This phenomenon has been labeled ‘resource curse’. This has been partially as the result of the World Bank’s ‘Extractive Industry Review’ forced by a number of non-governmental organizations (NGOs) to consider the Bank’s role in funding oil, gas, and mineral projects in developing countries. It is also partially a consequence of growing concern about corporate social responsibility. There is a real danger that concern about ‘resource curse’



could inhibit future investment in upstream capacity by responsible IOCs, aggravating the potential capacity constraint. There are multiple policy issues which follow. All are geared to answering the question as to how a 'curse' can be avoided and how a 'blessing' can ensue; since there is growing evidence that 'resource curse' is not inevitable. The answer lies in the distinction between 'developmental' and 'predatory' states. A developmental state has two components—ideological and structural. The ideological component is when the ruling élite adopts 'developmentalism' as the prime objective and legitimacy is derived from the ability to deliver development i. e. growth and poverty reduction. The élite then establishes an ideological hegemony—via the ballot box or less desirable means—over society. The structural component involves the capacity to implement wise and effective policies to deliver development. Apart from technical capabilities, this also requires a strong state to resist pressures from powerful, short-sighted private interests. It also requires a 'social anchor' to restrain temptation to use its autonomy in a predatory manner. Key to the analysis is the realization that 'developmental states' can still fail. While the 'right' ideology and limits to predation might be in place, the capacity of the state to implement effective policies might not be enough to manage certain problems. Such problems may be driven by exogenous shocks, mistakes, or just old-fashioned bad luck. In this context, the aim should be to try and enhance the capacity to employ policy. Clearly, both the international financial institutions and the IOCs have a role in capacity building, although the primary responsibility must lie with the country itself. A predatory state, by contrast, is one where the ruling élite is only interested in plundering the

economy for its own ends. There are no counterbalancing forces, social anchors, or other constraints on its kleptocracy. Here the options to use policy to reverse the situation are limited. One option is for the IOCs not to invest. The problem with this solution is that there will be other companies, notably some NOCs, who will invest. The only other solution is for some form of coordinated and cohesive international moves to prevent investment and to seek to change the behaviour of the ruling élite or, indeed, change the ruling élite. This is extremely complex and controversial. First, who decides who is predatory and upon what criteria? Second, the history of such multilateral action is not encouraging in terms of cohesion. Equally, the sort of unilateral action we have seen in Iraq has been a disaster, and a disaster that is likely to get far worse. However, despite these difficulties it is an issue which needs to be resolved if we are to get the levels of investment in upstream capacity that the oil markets will require in the future.

### **(iii) Market Control and OPEC**

As indicated at the moment, because of relatively tight markets, OPEC is insulated from its traditional problems of trying to manage the market. Furthermore if new capacity fails to materialize, as suggested this could continue for quite some time. However from this view of the future several key issues emerge which have serious policy implications. The first issue is what policy responses are possible if high oil prices continue and appear to be damaging levels of economic activity. Some policy solutions have already been discussed namely, encouraging greater investment by IOCs and NOCs, preventing IOC collusion, and encouraging greater opening of acreage. An alternative possible policy response discussed concerns the reaction of the

Asian countries where oil demand growth is strongest—mainly China and India. It is already apparent that the growing Asian consumers of oil will seek to put funds into developing new sources. They may also gain attractive terms since they are much less constrained by ethical concerns when investing in certain countries. Thus there is less competition on the fiscal terms. It also raises fascinating issues to do with the geo-political consequences of such moves. In particular, the Chinese, with their obsession over supply security, will almost certainly seek political influence and control in the countries where they seek to develop crude-producing capacity. It is quite feasible to imagine a world some 5–10 years down the road where China and the United States come head to head in the Middle East over securing political influence to ensure oil supplies, thereby reviving a version of the Cold War. The ability of Saudi Arabia to manage the markets will determine future levels of price volatility. If volatility increases, this will produce a demand for a policy response, both in producer and consumer countries. The option of controlling paper markets, the major source of volatility, is a non-starter. At any hint of government control, the present trading arrangements can simply dissolve into cyberspace outside of any jurisdiction. A more plausible option is to revive the OPEC price band. This was created in 1999 as an automatic stabilizing mechanism. If the price moved outside the \$22–28 band for a specified period, OPEC would automatically increase or decrease production by a specified amount to force prices back into the band. Unfortunately, OPEC failed to honour the automatic nature of the mechanism and thus it became discredited. To further complicate its revival, there are currently demands from several

members to increase the level of price bands and, in January 2005, OPEC formally announced the 'suspension' of the bands. If OPEC did decide to revive them, albeit at a higher level, and did acknowledge that it has to be used without discretion, this could stabilize prices, since it would effectively determine expectations. The problem would be to get agreement within OPEC on a new level for the bands. A policy area which is being explored to help stabilize prices both in terms of volatility and level, is the producer-consumer dialogue. This has a long history going back to the North-South dialogue of the 1970s. In recent years it has been revived, largely as a result of the oil price collapse of 1997-9. However, it is difficult to see how such meetings can produce any realistic option to effect price since, by definition, this creates winners and losers, and potential winners would be unlikely to accept loss. Also while both sides may approve of price stability, consumers tend to favour stable low prices, and producers stable high prices. An alternative option to manage price volatility lies in using paper markets to hedge. Certainly, a number of oil producers, including Mexico and Alaska, have used such paper markets. There are, however, complications. In theological terms, such activities in Islam are regarded as gambling and, therefore, forbidden, although often such problems can be circumvented. Also it is probably unrealistic for large producers to enter paper markets since this could swamp expectations, thus aggravating price volatility. Finally, buying such insurance inevitably costs. In particular, while spending money in such a way looks good if prices move in the 'correct' direction, if they move against the hedge, then this is seen as, at best, incompetence and, at worst, as signs of corrupt practices. A variation on this theme would

be to create stabilization funds which have been used both by oil consuming countries, such as Korea and Taiwan, and by oil producers. However, in consuming countries, where sales taxes on oil products are very high, crude price volatility matters less, since the sales tax acts as a cushion between crude prices and the final price to the consumer. Given the growing tendency, described above in section, for all oil importers to increase their sales tax levels, this implies that price volatility might become much less of an issue for consuming countries. As for stabilization/revenue funds for producers, these too are controversial. The argument is that, if conditions are conducive to independent and effective operation of a fund, then the problems can be managed within the existing fiscal mechanisms, and a separate institution is not required. But if conditions are not conducive, then such funds are prone to corruption and mismanagement and tend to raise unreasonable expectations on spending. A second issue in this section is the observation, made in section II (iii), that supplies are becoming more concentrated in the Persian Gulf. One implication is that OPEC is likely to lose members. During the 1990s, two members—Ecuador and Gabon— left the organization. Technically, this year Indonesia should follow, as it moves from being a net exporter of crude to one of net imports. In both Venezuela and Nigeria there are strong lobby groups who believe they should leave OPEC. If this were to happen, it might in theory make OPEC's ability to manage the market easier, since a smaller group might be expected to be more cohesive. However, counter to this is the observation that if market management involves pain as a result of having to close-in capacity to balance the market, a smaller group implies greater pain for each member.

An implication of growing concentration relates to supply security. In 2003, 47 per cent of world oil exports came from the Middle East and North Africa. As indicated in section II (i), the political stability in the region is perceived to be a source of concern and has begun the process of forcing governments to consider their policy response. Several broad policy areas are under consideration— reduce oil demand; develop alternative technologies; increase domestic supplies; diversify sources of oil imports; and, finally, build up strategic stocks. 4While such policies can be driven by security-of supply concerns, they carry implications for other energy-policy objectives, such as environmental concerns. The first policy option to solve security problems is to reduce the demand for oil. This, however, is more complex than it might seem. As indicated in section II(iii), since the oil price shocks of the 1970s, oil has been ‘ pushed out from under the boiler’ (i. e. substituted in the static sector). Thus the only realistic option to try and reduce oil intensity lies in reducing its use in the transportation sector. For example, there is undoubtedly considerable scope for further improvements in automotive fuel efficiency, especially in the United States where the spread of sport utility vehicles (SUVs) has effectively undermined the Corporate Average Fuel Economy (CAFE) standards. However, reducing oil use in transport by means of policy will face problems. In terms of aircraft fuel, the international nature of the industry means any individual government would be ill advised to raise the price of jet kerosene either through sales taxes or price control. Aircraft would simply refuel elsewhere. In terms of gasoline and diesel, raising the final price to consumers remains a politically sensitive issue, as illustrated by the fuel protests in Western Europe in 2002. While there is

undoubted scope to reduce gasoline and diesel use by imposing strict regulation of automotive fuel efficiency, this is often seen as unwarranted interference in the role of markets and consumer sovereignty. One option would be to encourage alternative technologies for transport which used different fuels. This could also assist the environmental objectives to be discussed below in section IV (iv). Governments could play a key role—in part through funding basic research but also overcoming market failures. A good example relates to hydrogen-powered cars. Consumers are willing to buy such vehicles, but only if they can be reassured that filling stations will be easily available. Oil companies are willing to invest in such infrastructure but only if there are sufficient customers. This is precisely the sort of market impasse which can only be broken by government intervention, most obviously by the use of discriminating sales taxes (as has been the case to encourage the use of unleaded gasoline) and the provision of tax incentives for companies to invest in the needed infrastructure. An alternative option to address security concerns, assuming the geology permits, is to increase domestic oil supplies. Several policy options are feasible. The first is to open up new areas for exploration. The most obvious example would be in the United States, where this was explicitly recommended by the Cheney Commission in 2001, with specific reference to the Alaskan Wild Life Refuge and other areas. The obvious problem here is a negative reaction from the environmental lobbies. The second option is to improve the fiscal terms for the oil upstream—in particular, in mature areas, to give tax breaks to encourage operators to increase the recovery factor on existing fields. One other option is to try and diversify sources of imported oil. This can be

achieved by allowing markets to function. In general, attempts by governments to secure supplies by attempting to promote bilateral relations with other countries have failed and proved expensive. The case of Japan presents a classic example (Koyama, 2001). The final option is to develop strategic stocks. Since the mid-1970s, this has been achieved through the framework of the IEA's emergency stockpiling system. This was boosted by the development of the USA's Strategic Petroleum Reserve after 1977. More recently, Asian oil consumers have also been developing a strategic stockpiling capability. One of the problems with this is that there is a great temptation for countries to free ride. Given the international nature of the oil market, a release of stocks by any individual will reduce prices, and this will benefit all players in the market. Thus the costs are borne by one country, while the benefits are shared by all (Leiby et al., 2002).

#### **(iv) Competition**

Several policy issues arise in terms of competition in oil markets. One already referred to in section II(iv) is ensuring that breaking up the state control of the sector by privatization and deregulation does lead to competition in the downstream and midstream. One also concerns efforts to overcome the natural monopoly elements inherent in pipelines (Stevens, 1996). As more pipelines emerge, because of the growing need for trade, as outlined in section II(iii), this may become more of an issue than at present. A new area for competition policy consideration relates to the outcome of the mega-mergers started in the late 1990s. There are several areas for concern. The first, already discussed, is the fact that the mergers have increased the monopsony powers of the IOCs in terms of the service



industry. Thus the service industry is facing ever tighter margins, thereby inhibiting the willingness and ability to expand capacity. As developed in section IV(i) above, this could lead to problems in developing adequate capacity to meet expected demand. The final competition issue relates to the Asian Premium outlined in section III(ii). Asian consumers can use policy to avoid the Premium. They could develop strategic stocks to give them confidence to move away from dependence on term contracts. They could also encourage crude oil from other suppliers to enter the region, most obviously encouraging pipeline supplies from Russia. Improving the competitive nature of crude and product markets in Asia would further assist the process. Many national oil markets in Asia retain strong elements of regulation and government interference. Regionally, Singapore is the only spot market in Asia and, compared to its US and European counterparts, the volume of trading is small (Horsnell, 1997). Greater entry into world oil markets would further undermine the ability of the Middle East exporters to impose the Asian Premium. As for the Saudi policy dimension, the key is its willingness and ability to impose destination clauses in its sales contracts. It is not clear why they would be willing to undermine a system which is worth a very large amount of revenue. However, a key will be Saudi entry to the World Trade Organization (WTO), since it seems very likely that the WTO would have serious problems with such destination clauses (Desta, 2003).

### **(v) The Environment**

Environmental issues play a crucial role in oil markets and will remain a central dimension of policy because environmental concerns dominate all stages of the industry. In the production of crude, there are issues of access

to 'wilderness' areas plus the negative impact of operations, ranging from gas flaring to the disposal of drilling muds. Environmental policy outcomes in the upstream, all of which will increase production costs and reduce supply, will depend upon the extent to which other policy drivers, most obviously supply security, supersede environmental concerns. In midstream transportation, there are problems of pipeline leakages and tanker accidents. Increasingly, restrictions are being placed upon the specifications for tankers before they are allowed into territorial waters. In the downstream, there is growing regulation restricting refinery operations, notably flaring and closures. Because of the environmental costs of refinery closure, in the future it is extremely unlikely that any refinery will actually close. Rather, they will cease formal refining operations but remain designated as 'refineries'. One important consequence of this will be that statistics regarding refinery capacity will need to be treated with some circumspection. At the same time, concerns regarding emissions as a result of burning oil products are creating serious pressures for tighter environmental policy. The most general and widespread regulations are with respect to sulphur content in diesel. Throughout the world these are being tightened, thus giving something of a boost to gas-to-liquids technology, which produces a sulphur-free diesel. Gasoline specifications are also a subject of policy interest, notably in terms of the 'boutique fuel problem' in the USA. The United States Clean Air Act of 1990 allowed individual jurisdictions to formulate their own gasoline specifications. The result has been a plethora of different gasolines. In 1974, there were five gasoline specifications, today there are over 55. The result has been a fragmentation

of the domestic gasoline market, resulting in very large price differentials between regions. The normal operations of arbitrage between regions or, indeed, with countries outside the United States, have been suspended because of the growing differentiation of the product. Given the political sensitivity of gasoline prices in the United States, this problem is already attracting public attention and there are growing pressures for a rescinding of the ability to specify gasoline on such a micro basis. More generally, in many developing countries the issue is reducing the lead content in gasoline and this will continue to be an increasingly important issue, not least because the negative effects of lead are well established and well understood, and there are many feasible solutions. There are also new pressures for the lowering of sulphur content in heavy fuel oil. Finally, there are the issues related to the emission of greenhouse gases. Based on carbon dioxide (CO<sub>2</sub>) emissions, in a world of a true carbon tax, arguably oil would do rather well, given its lower emissions compared to coal. However, both in the United States and in the European Union, carbon tax proposals have invariably tried to give protection to domestic coal, thereby disadvantaging oil. Similarly, in large coal consumers such as India and China, it is inconceivable that a carbon tax would be imposed resulting in significant increases in oil imports. However, the current high-price-oil world is likely to encourage less oil use and, therefore, less CO<sub>2</sub> emissions. Arguably, the gap between the marginal costs of producing oil and the current price levels are greater than the optimal levels that would be set for a carbon tax. OPEC and the control of the oil market have effectively internalized the costs of the greenhouse-gas externalities. In terms of markets, other policy means to

internalize all these externalities outlined above, either through regulation or some form of permit trading, all involve the industry in greater cost and a requirement for ever greater investment. This creates a serious problem in the downstream, because it has experienced an extremely poor record of profitability. This problem of increased investment to meet green regulations is reinforced when it is remembered that, as explained in section II(iii), the demand for the heavy end of the barrel is on terminal decline, forcing ever more investment in extremely expensive upgrading facilities. The process of tightening environmental regulation in the downstream is likely to aggravate the growing problem of lack of refinery capacity, which, in turn, is encouraging higher refinery gate prices, irrespective of what is happening to the price of crude oil. This could create a public backlash against growing green legislation, especially in areas where oil product prices are already a sensitive political issue.