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Klaus Matthies*

The OPEC after Thirty Years

The collapse of OPEC has been prophesied repeatedly since it was first founded in Baghdad in September 1960. Yet in spite of all their differences its members, which now number 13 countries, have so far always managed to establish at least a formal bare minimum of consensus. It may be that recent events have changed all that. Will OPEC's thirtieth birthday prove to be its last?

The present crisis in the Persian Gulf, which in retrospect may well prove to be the third oil price crisis since the early 1970s, differs from its two predecessors in as far as it also represents a serious crisis for OPEC itself. If anything, the organization came out of the price hikes of the 1970s stronger than it went in, but in 1990 this is highly improbable. In earlier times, the member countries had always been able to see to it that the organization stuck to purely economic objectives in its function as a community of interests to achieve sustained increases in oil revenues, and that it therefore remained aloof from any political and military conflicts in which they were involved.

This was the case after the 1973 Yom Kippur War when the oil embargo against the USA and other countries was imposed, in which Arabian members of the organization were involved, but not OPEC itself. Again, the same applied to the eight-year-long war between Iran and Iraq: as far as possible, OPEC disregarded Iraq's attack on a fellow member country. This time, however, when Iraq invaded Kuwait and then declared it part of its own territory and the Iraqi president went on to make threats against other countries around the Gulf, the organization could not stand on the sidelines, for this time the very survival of one or more of its members was at stake.

Were OPEC to break up now, this would put an end to an affiliation of raw material suppliers which has stood apart from similar attempts to control markets in other raw materials in that it achieved a good degree of success over many years. The beginning of this successful phase was in October 1973, following thirteen years in which the existence of an organization

which grew from five to thirteen member countries had gone largely unnoticed by the general public. Admittedly, the quadrupling of the oil price between October and December 1973, from below \$3 to \$11, was only partly OPEC's doing as the organization had initially set a much more moderate price increase as its objective. However, the declaration of the embargo in autumn 1973 and the price explosion on the spot markets simultaneously put an end to the crucial influence of the major multinational oil companies on the price of the product; from then on, government selling prices were set autonomously by the oil-producing countries themselves.

The shift in price-setting authority from the oil companies to the supplying countries themselves marked the end of the concessionary system. On the basis of an OPEC resolution passed in 1968, the Gulf states had already begun to make some inroads into the concessionaires at the beginning of the 1970s, with the intention of developing their own participation in the supply of oil and in raising its price, which had remained low for decades. However, the various agreements which had been concluded to allow a gradual increase in government participation in concessionary rights, output volumes and production facilities rapidly became obsolete as a number of supplying countries took more radical action. Beginning in 1971 in Algeria, Iraq and Libya, oil companies were nationalized or subjected to state majority participation. After the 1973 October War and the oil embargo, the example those countries had set was followed by the Gulf states, with Kuwait in the forefront.

It has often been asked, but never satisfactorily answered, whether OPEC exerted any crucial influence over the world market price for oil by virtue of coordinated activity from 1973 onwards, or whether the

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price increases which occurred were not rather the result of normal market pressures which simply played into OPEC's hands. Naturally enough, the OPEC countries themselves attributed great significance to their own decisions in determining the oil price level, and crises frequently flared up within the organization because of differing views over what policy to pursue on prices and volumes.

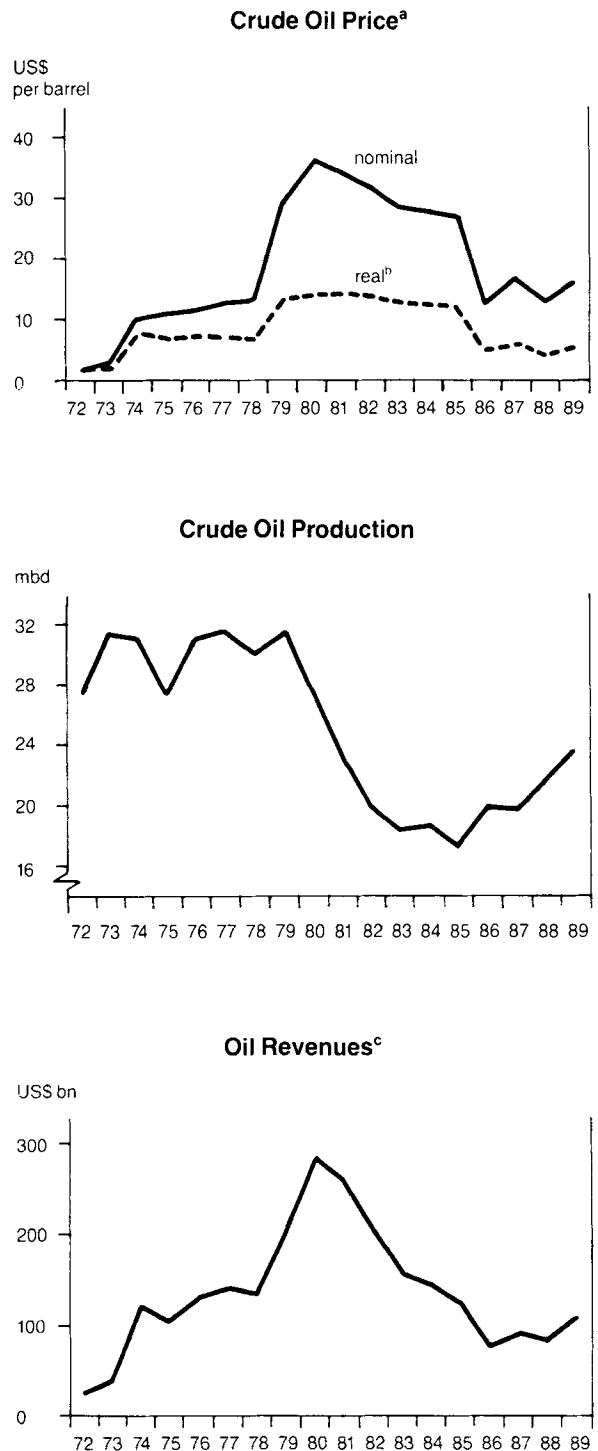
In practice, OPEC's price policy was for the most part determined by Saudi Arabia, by virtue of its large relative share of the member countries' total output. Because it has such large reserves, Saudi Arabia has frequently pleaded for lower prices than most other members in order not to impair its long-term marketing prospects, especially since it is not dependent on maximizing oil revenues in the short term thanks to its position as a "low absorber". Even so, during the second oil crisis when it was possible to raise prices substantially because the supply from Iran fell off sharply, the price of certain grades of crude oil actually exceeded \$40 per barrel for a time.

Limits to High-Price Policy

However, it only took until 1982 for this high-price policy to reach its natural limit, for it was now apparent that the oil market was no exception to the rule that price rises of that magnitude cannot be enforced by the exporting countries concerned without substantial cutbacks in volume. The price hike at the end of 1973 had already made it clear that the world demand for oil is quite elastic. Oil consumption was subdued, and production also increased in non-OPEC countries. Thus the OPEC countries' rate of output initially stagnated during the 1970s before falling sharply from 31.4 million barrels per day (mbd) in 1979 to just 19.9 mbd in 1982. During the next few years, the volume again fell slightly beneath even this low level. Whereas oil export earnings more than doubled between 1978 and 1980 to reach \$285 billion in that year, they had fallen back again by 30% just another two years later. In the meantime, they have again fallen by half, and since 1986 have been below the level attained in 1974 (see Figure 1).

Given the persistently low demand for OPEC oil compared with that of the 1970s, the dominant theme for the organization since 1982 was the need to restrict production in order to achieve price objectives. If the production quotas and official selling prices are compared with actual production volumes and quoted prices on the spot market, it is clear that it did not prove possible to exert the discipline of the cartel for any extended period. Again and again, various individual members broke the agreements they had made in order

Figure 1
OPEC: Oil Price, Production and Revenues, 1972 to 1989



^a Spot price Arabian Light, since December 1986 Dubai (annual averages). ^b Deflated with the unit value index for manufactured goods exports of industrialized countries. ^c Value of petroleum exports (crude oil and products).

Sources: BP, OECD, OPEC.

to increase their own revenues at the expense of other member countries. The main reason that prices did not decline even more heavily at that time was the position taken by Saudi Arabia, which for many years voluntarily took on the role of "swing producer" and balanced out the excess production of other members by cutting back its own. By August 1985, its production was down to 2.3 mbd, which was less than one quarter of the peak it had attained in 1980 and verging on the minimum which was technically possible. In the light of this situation, Saudi Arabia eventually gave up its self-restraint and ceased to charge any fixed price for its oil. The price of Arabian Light, the "reference crude", slumped in the wake of this move from over \$27 per barrel in December 1985 to less than \$8 in June 1986, leaving OPEC in its most serious crisis yet. The organization's volume and price policies had virtually ceased to exist.

Painful Lesson

This painful lesson for the member countries helped bring about new production agreements in 1986, which were intended to enforce the new OPEC reference price of \$18 per barrel (for seven selected varieties of oil) in the market. Even so, proper adherence to that agreement was to remain an unresolved problem right up to the recent past, and the price target was mostly missed, even if sales of OPEC oil did at least pick up from the low-point they had reached in the mid-1980s. In fact, after the price collapse of 1986, world oil demand again began to rise more strongly along with the resurgence in world economic activity. OPEC's share of world production rose from 30% in 1985 to 37% last year.

At the outbreak of the first oil price crisis in 1973, 54% of world production came from OPEC's wells. The loss of market share after that time was mainly a result of its high price policy, for this gave a powerful stimulus to exploration outside the traditional producing regions, even though the costs of prospecting and developing these new fields were in many cases several times higher. Nevertheless, the OPEC countries still maintain their dominant position as far as their resource endowment is concerned, with three-quarters of all proven oil reserves around the world under their territory, and two-thirds of them in the Middle East alone.

Whether or not a sustained shift in market power in favour of the OPEC countries will occur in the medium term – regardless of how the power struggle in the Gulf region develops and what shifts in the political landscape that may bring – depends on a large number of factors. Particularly significant among these is the

trend in oil prices during the next few years. The relatively low price level between 1986 and the onset of this most recent crisis, averaging just under \$17 per barrel for the industrial countries' imports, had a dampening effect on further exploration as well as on efforts to save oil and look for substitutes, and allowed overall oil consumption to accelerate. That trend, which involves a lasting increase in OPEC's market share, would again be brought to a stop by substantially higher oil prices. The faster prices rise, the sooner adjustment problems can also be expected to reduce economic growth in both industrial and developing countries, and that in turn would further reduce oil consumption.

Uncertain Prospects

In the short term, further movements in oil prices, and indeed the fate of OPEC as an organization, depend heavily on what course the Gulf crisis takes. The only thing likely to bring a quick return to "pre-crisis prices" can be assumed to be the eventual success of UN sanctions in persuading Iraq to withdraw from Kuwait without any further military action occurring. In that event, there would also be nothing to stop OPEC continuing in its existing form.

However, any other outcome of the current conflict leaves the organization's future uncertain. That would be true even if the expansion of Iraq's territory were eventually to be accepted and the oil boycott against it brought to an end, for that would give rise to a substantial change in the structure of OPEC with its twelve remaining members. The enlarged Iraq would then come up alongside Saudi Arabia with only slightly smaller oil reserves than the previous clear leader in volume terms. If Iraq were then able to exert a correspondingly greater influence within the organization, the objective of limiting production in order to enforce higher oil prices would become more important since Iraq, a structural "high absorber" – and particularly so given the continuing financial burdens from the war with Iran – would have a great interest in raising its oil revenues in the short term. However, this might conceivably lead to a reduction in OPEC's membership. Even before the most recent crisis, for example, rumour had it that Venezuela, a founder member, was considering its withdrawal, though that was denied in the country itself.

On the other hand, evidence against the assumption that proponents of higher oil prices without regard for any consequences for the world economy might gain the upper hand is provided by Saudi Arabia's decision to allow the deployment of US troops on its territory and to substantially raise its oil production in order to alleviate

the effect on other countries' supplies of the non-availability of Iraqi and Kuwaiti output due to the boycott. Evidently, the governments of Saudi Arabia as well as other Gulf states such as the United Arab Emirates and Qatar have come to the conclusion that their political future and the economic development of their countries can best be safeguarded with the support of the Western industrial nations. The now closer relationship between such producing countries which favour a moderate oil price and the consuming countries, who are obviously interested in secure supplies at a low price, might also give rise to a trend towards more "consumer-friendly" arguments being given a hearing within OPEC.

Possible Developments

However, there can be no prospect of a "normalization" of oil prices as long as the threat of war continues to hang over the Middle East. The same applies to any chances of OPEC being able to function with anything resembling normality. It is open to question whether it will ever again return to the position it was in just before the 30th anniversary of its foundation. As time goes on, scenarios of a quite different nature, in one direction or the other, are quite conceivable.

One such scenario is the final break-up of OPEC. It is uncertain, at the very least, whether the less regulated competitive position on the world oil market would actually be synonymous with persistently lower prices, given that OPEC had not really managed to restrict supply for any longer period in the past. Another possibility is that the OPEC we have known up to now might be replaced by a different sort of organization in which the proponents of a moderate price policy no longer had any significant say. Even if the unfavourable experience major producers have made with a policy of high prices would be likely to prevent them lending their support, such a development would nevertheless once again raise the importance of reducing the dependence on oil, especially oil from the Gulf region, among the importing countries. The fact that relatively cheap oil was available without disruption for a number of years had put the risks involved in the pronounced concentration of energy supplies in the Middle East to the back of people's minds. Under these circumstances, the current crisis will again turn greater attention to the fact that so many economies remain highly oil-dependent, which will undoubtedly also enter into the discussion surrounding higher taxation on energy which has recently been prominent for environmental reasons.

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