In the 1970s, Opec became a force which the West learnt to fear and respect. Now it all looks rather different.

David Currie

OPEC over a barrel

An OPEC conference

The Organisation of Petroleum Exporting Companies (Opec for short) has finally been forced to acknowledge publicly that its grip over the oil market is slackening. After a period of growing divisions within Opec, manifested in unofficial price cutting by Opec members, the Opec meeting in the middle of March announced an unprecedented 15% reduction in the price of oil. What does this signify? Does it mark the start of the collapse of the oil cartel that many commentators have been predicting for the last decade? Or is it merely a temporary setback, necessary to reconsolidate the cartel? What is its significance for the world economy? And how does it affect Britain, itself largely self-sufficient in oil at least for the next decade?

These issues are best viewed in a longer perspective, rather than against the backcloth of oil-glutted markets of the past year or two. It is helpful to examine first the factors underlying the rise of the Opec cartel, and then to consider whether the conditions for its continued success are currently under strain. We can at the same time consider the effects of the substantial changes in the price of oil on the international economy and its constituent parts.

The rise of Opec

Opec is a coalition of Third World oil producing countries, comprising primarily the Middle East countries, Latin American oil producers (such as Mexico and Venezuela) and African countries (such as Libya, Algeria and Nigeria). It excludes advanced industrial oil producers, such as the USA, UK and Norway. Prior to 1973, Opec had a rather shadowy existence. Oil markets were dominated by the major oil companies, which typically controlled the distribution, refining and, in large part, production of oil, and were thereby able to administer the price of oil. As a result of this dominance (used in favour of oil consumers), together with substantial investment in oil exploration and production, the relative price of oil fell through the postwar period right up to the start of the 1970s.

However, Opec members were demonstrating increasing independence of action. The 1960s saw a wave of nationalisation of oil fields as part of the rising Third World nationalism. Nationalisation did not necessarily, in itself, increase control over production, because of the grip of the majors over refining and distribution. However, members increasingly undermined this grip by establishing their own refinery capacity and selling to the fast-growing independent oil companies that were themselves seeking to compete with and challenge the majors. But these actions were unco-ordinated, and the members took no concerted action to assert the collective influence of Opec.

Two factors — one economic, one political— changed this quite decisively. In 1971/73, the world economy underwent a massive boom. For the first time in the postwar period, all the major advanced industrial countries expanded in step[1]. The prices of all primary commodities

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started to rise sharply in the face of steeply rising demand. This tilted the balance of influence towards commodity producers, in particular increasing the power of Opec members in the oil market. Politically, the Arab/Israeli conflict in 1973 created a cohesive bloc amongst the Middle East members who represented the bulk of Opec. The decision to use the weapon of oil embargo in this political process represented the first wielding of the collective strength of the Opec cartel. Once demonstrated, the collective power of Opec could then be used to raise sharply the price of oil in successive waves. A quadrupling of the oil price in late 1973 was followed in 1979 by a doubling. Whereas the price of oil had stood at around $2 at the beginning of the 1970s, it was above $30 a barrel a little more than a decade later.

Oil companies gained massively from this process because of capital gains on their substantial stock holdings of oil. They did little to resist the consolidation of the Opec cartel; indeed, arguably, the imposition of the 1973 embargo would have been administratively impossible without the active co-operation of the oil majors. Divisions between Western Europe and the USA prevented any concerted response by Western oil consumers.

Saudi Arabia

Why was it that a cartel emerged in oil, but not in other commodities? The dominance of Opec in the oil market was very important. In 1973 Opec acounted for two thirds of non-communist world production of crude oil. This figure in itself understates the dominance of Opec, since the remaining major source of supply, the USA, was committed to serving its home market. Also crucial was the geographical concentration of oil production in the Arab world, providing a cultural and political basis for the operation of the cartel.

These conditions in themselves, however, do not distinguish oil from all other commodities, and were not sufficient for the success of Opec. Central to the rise of Opec was the role of Saudi Arabia as the 'swing' producer of the cartel, holding the cartel together. This role requires it to adjust production to balance supply and demand at the posted price, and therefore to accept large variations in its sales of oil and hence total oil revenues. Only a large producer, relatively unconcerned about its production levels, can assume this role. Saudi Arabia fitted the bill perfectly.

With vast oil deposits, its imperative to spend oil revenues on industrial and social development was less acute than for other member countries; while a desire on the part of its rulers not to disturb its traditional political structures led to a reluctance to use oil revenues for modernisation. Moreover, assuming this role gave Saudi Arabia a power and influence in the Middle East that it had not hitherto enjoyed, thereby sharply reducing the risks of political destabilisation. The success of the Opec cartel also gave Saudi Arabia a world role, both through its central role in the cartel itself and through its burgeoning overseas investments in the advanced capitalist countries. The cushion of reserves and overseas investments enabled Saudi Arabia to accept with equanimity cuts in production when these were necessary to support the Opec price in world markets.

Cracks in the fabric

From the moment Opec assumed in 1973 its price-fixing role as a cartel, commentators have been predicting its collapse. Yet it has remained remarkably resilient. To be sure, the real price of oil dipped sharply from 1974 through to 1978 as inflation in the advanced capitalist world bit into the real purchasing power of any given $ price of oil. But this erosion was restored in 1979 and avoided subsequently as Opec came to adjust the oil price in line with inflation. The very real gains that Opec had yielded for its members gave it cohesiveness, since members had so much to lose from its breakdown. Success cemented the cartel, based on the foundations of Saudi Arabia's position.

Nonetheless, conditions for the cartel became less propitious. Political differences, notably between Iran and Iraq (and other Middle East countries more generally), emerged sharply after the downfall of the Shah in 1978. Initially this tended to boost oil prices, since Iran's oil production

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fell very sharply. But the collapse of the Iranian economy has made Iran even more dependent on oil exports, leading recently to Iran exporting at the expense of other Opec members.

Also acting to diminish the grip of Opec has been the decline in total oil consumption. This has been in part a consequence of more energy-efficient, less oil-guzzling processes installed by oil consumers as a response to the high price of oil. It has also been in part a result of the world-wide slump, which has depressed output and hence oil consumption. Thus total consumption of the non-socialist bloc, which was 47.9 million barrels a day in 1973, has risen more slowly than before to 50.9 million barrels a day in 1978, but had fallen to 44.5 million barrels a day by 1982.

More crucial than the decline in total demand was the still sharper fall in Opec's market share. The high oil price made profitable non-Opec sources of supply, such as the North Sea, which gradually came on steam in the latter part of the 1970s and early 1980s. Hence non-Opec supplies have moved contrarily to overall demand, growing rapidly from 18.1 million barrels a day in 1973, to 29.2 million barrels a day in 1982. In order to maintain the higher price of oil, Opec has been forced to accede to a declining market

[1] For an analysis of this, see David Currie, 'World Capitalism in Recession' *Marxism Today* April 1980; reprinted in revised form in S Hall and M Jacques (eds) *The Politics of Thatcherism* Lawrence and Wishart 1983.

share. Thus whereas in 1973, Opec accounted for around two thirds of production, by early 1983 this had slipped towards two fifths. This slipping market share clearly diminished the capacity of Opec to manage the market.

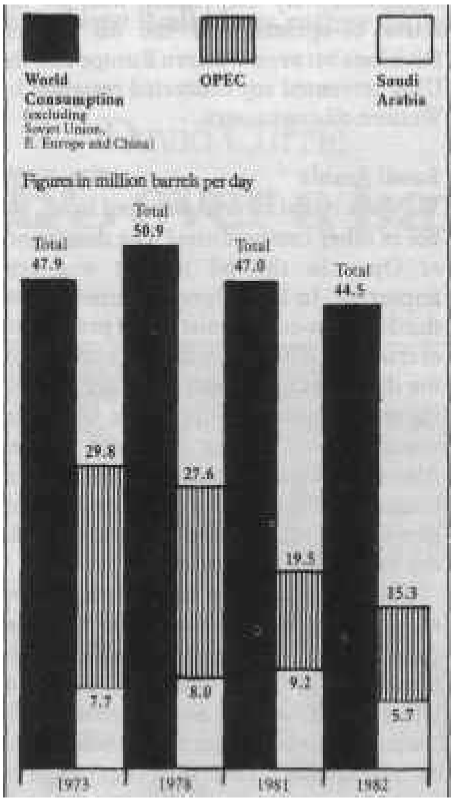
A compromise of a kind

Moreover, the crucial role of Saudi Arabia as the swing producer came into doubt as its production levels plummeted. It is locked into deals to supply liquid petroleum gas to Western countries, and this gas is a joint product along with oil. Further production cutbacks to sustain the $34 a barrel price became increasingly unrealistic since they threatened these commitments. Saudi Arabia's interest was therefore very much for a lower price and a sharing of cuts in production quotas.

Since the early part of 1982, these pressures on Opec have been manifest in market prices. Prior to that, the price in the Rotterdam spot market (where consumers usually satisfy their marginal oil needs, often at a premium) was well above the Opec official price (which Opec members are supposed to charge on supply contracts). Since 1982, the spot price has fallen below the Opec official price. Thus in early 1983, the spot price was $29 a barrel as against the official Opec price of $34 a barrel. This has induced consumers to escape from contracts with Opec suppliers, to purchase more cheaply on the spot market. Moreover, as the expectation of falling oil prices has developed, so the oil companies have cut purchases, preferring to destock with a view to buying cheap oil later. Thus the oil companies have been destocking at a rate of around 3.5 million barrels a day, putting further downward pressure on the oil prices.

Opec's response to all of this has revealed the cracks in its cohesion. The reversal in the upward trend of oil prices has created serious balance of payments problems for the bulk of the Opec countries that are dependent on oil revenues to sustain crucial development projects. In some, like Iran, these problems have come on top of serious political dislocation. The resulting pressures made it very difficult for members to agree on the allocation of necessarily reduced production quotas, and have led to rather different responses. Some countries, notably Saudi Arabia, have seen the best hope in a lower Opec official price, thereby reducing pressures on the cartel and leaving it intact to reassert its power more forcefully when demand revives. But they found it hard to carry other members, who continued to aspire (unrealistically in

How the balance has changed



Sources: Petroleum Intellegence Weekly, BP Statistical Review 1981

current market conditions) to the combination of high prices and high revenues. Yet others, notably Iran and Nigeria, both facing a desperate need for revenues, saw real individual advantage in maintaining the official Opec price, while undercutting it on the spot market by large discounts. So long as other cartel members played to the rules, this gave the rule-breakers an assurance of high sales and high revenues. But it was a dangerous game for if the others had followed, the cartel would have broken up.

These differences were argued out in a series of Opec meetings in early 1983. Finally at the March meeting of Opec, a cut in the official price of $5 to $29 a barrel was agreed, together with an agreed set of production quotas. This represented a much needed acceptance of market realities. But to prevent Nigeria seceding from Opec, the price of Nigerian oil was set at $30 a barrel with a premium of only $1 over Arab oil, a narrowing of the differential by $0.5, whereas if anything market forces would have generated a wider differential. This should permit Nigeria to sell its full production quota, thereby easing its domestic economic pressures. But the narrowed price differential will continue to generate tensions within Opec.

Which way the oil price?

Despite these problems, it would be wrong to hail the demise of Opec. Although its power to manipulate the oil price has diminished, its influence is still very considerable. The recent $5 price cut may well stabilise the market in the short run by inducing oil companies to stop the market in the short run by inducing oil companies to stop destocking, thereby reviving demand. If this does not happen, a small further cut is likely to do the trick. The oil price may fall further, but not very far. At around $25 a barrel, important non-Opec sources of supply become squeezed out, as, for example, the profitability of marginal North Sea deposits is squeezed.

Nonetheless, a consequence of Opec's weakening grip is that the next few years are likely to see a steady, or slowly declining, real price of oil (measured against manufactured goods). This would be in marked contrast to the past decade. This new trend would have crucial implications for the international economy, which we now consider.

The **international economy**

The fall in the real price of oil will undoubtedly give an important expansionary boost to the international economy, while reducing inflationary pressures. The rising real price of oil over the decade from 1973 acted to intensify the inflationary slump in the international economy in several ways. Governments responded to the inflationary pressures of the rising oil price by contractionary measures. An important number of Opec members sat on their additional oil revenues rather than spending them. Since real expenditures of oil consumers necessarily fell, the net effect was to depress international demand. Moreover, the higher price of oil rendered significant proportions of plant and machinery uneconomic, necessitating

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investment in energy saving, rather than in capacity expanding, methods of production.

The falling real oil price will tend to work in reverse, boosting demand, permitting a more expansionary policy stance by governments, and making profitable the more marginal sectors of industry.

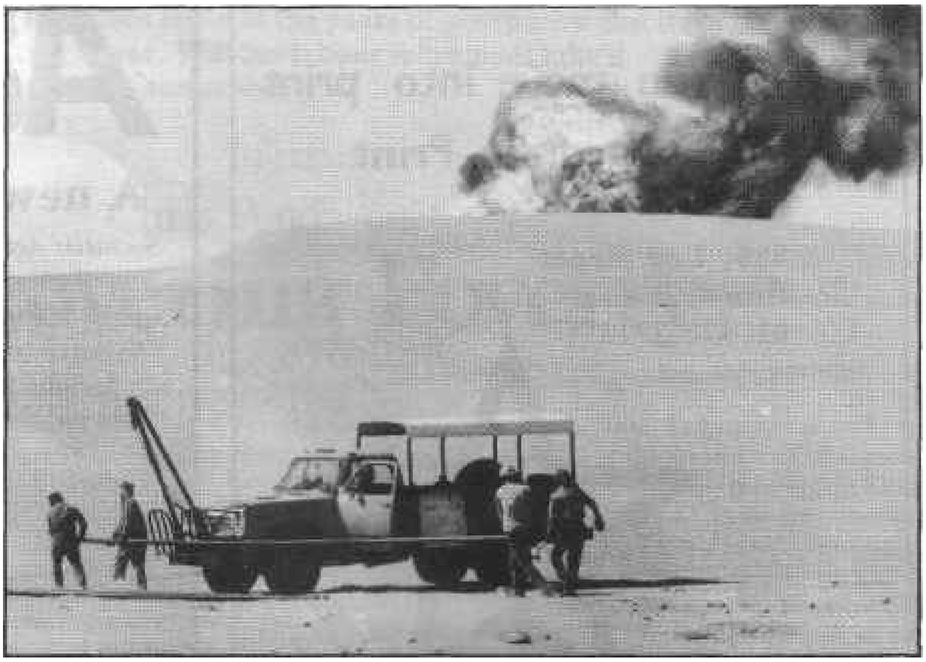
The benefits to the non-oil-producing Third World will also be considerable. Many countries have been forced by the high real price of oil to curtail much needed development programmes to pay for essential imports of oil. Although the oil price increases over the last decade redistributed income to the Third World away from the advanced capitalist countries, the income flowed to the richest, and in many respects, the most reactionary countries within the Third World; and many poorer countries were the losers. Conversely the fall in oil prices will ease pressures where development programmes are most needed.

However, these benefits are not without their attendant dangers. In the short run, some countries, notably Mexico, may be pushed closer to international default by loss of oil revenues, and a default may trigger an international banking crisis. But this must be set against the corresponding risk of default by an oil consumer if oil prices stay high. There is also the danger that a falling oil price may lead oil consumers to ease up an energy saving, leading to a rise in energy consumption, tightening Opec's grip on the oilmarket. To avoid a further switchback in oil prices, there is much to be said for governments raising taxes on oil to keep the price to the consumer, and hence the incentive to economise, fairly stable. If the resulting revenues are used to cut indirect taxes on other goods, the needed fall in inflation can be delivered without diminishing the incentive to economise on oil.

The prospects, then, for the international economy are made somewhat brighter by the fall in the oil price, particularly if it is sustained. The effect will be to expand international demand while simultaneously reducing inflationary pressures. But it would be grossly over-optimistic to suppose that this could reverse the current world slump, if only because a significant international expansion of demand would increase oil consumption and push the oil price back up. Some amelioration of the international slump is likely, but the overall trend is for a continuing depression, with grim prospects for unemployment.

The UK

The UK is in a distinctive position amongst the advanced capitalist countries. Being largely self-sufficient in oil, at least for the time being, a change in the oil price does not significantly alter real national income. The diminished export revenues from oil resulting from a lower oil price are largely offset by reduced expenditure on imports of oil. But a fall in the oil price does help to lower inflation, and the UK should benefit from a boost in exports as the world economy picks up somewhat. Moreover,



Inshore oil fields, Abu Dhabi

although overall real income is not altered greatly, its distribution is. A lower oil price reduces the profits of oil companies, particularly those involved in the exploitation of the North Sea, and bites into government tax revenues from North Sea oil production. Simultaneously it redistributes real income to oil consumers, whether individuals or companies.

This redistribution poses particular issues for government fiscal policy. As tax revenues from North Sea oil decline, will the Government allow this relaxation of fiscal policy to stand, giving a much needed stimulus to the economy; or will it pursue the fetish of recent years with the Public

Some amelioration of the international slump is likely

Sector Borrowing Requirement by clawing back the revenues by higher taxes elsewhere. This problem has been observed recently by the sharp fall in the hitherto overvalued exchange rate, so that the price of oil has, if anything, risen over the past year. But over a longer period the problem will assert itself.

A further issue concerns the pricing of North Sea Oil by BN0C. UK economic performance is likely to be strengthened by a lower oil price. Should, therefore, BNOC seek to put downward pressure on the oil price; or should it look after the interests of the oil companies by keeping the price up, thereby maintaining the profitability of North Sea oil production? After agonising discussions between BNOC and Lawson, the energy minister, the interests of the oil companies prevailed. Rather than trigger a price cutting war with Opec that could have reduced the oil price substantially, BNOC chose not to rock the boat.

This episode was played out as a coda to the Opec meetings. Opec's price cut was accompanied by a challenge to Britain that Opec would engage in a price war if BNOC but its price significantly from $30.5 a barrel. This involved a large element of bluff, since Opec could only lose from a price war. But BNOC chose not to call the bluff, but instead after discrete negotiations with Opec (particularly Nigeria) made only a modest cut of $0.75, disguised as $0.5 by a shift in the reference grade of oil. Opec was quite willing to accept gracefully this cut which in no way challenged Opec's position.

Conclusions

In summary, then, the recent oil price fall has been the consequence of a gradual but steady erosion of Opec domination of the oil market. But it would be wrong to herald the collapse of Opec — it is weakened but has not disintegrated. A consequence is a likely stable or gradually declining real oil price over the next few years, helping to give some boost to the world economy. This does not signal an end to the slump that currently grips the international economy. While a lower oil price may help to ameliorate the slump, the elimination of depressed output, redundancies and high unemployment requires a radical change of course that is currently not in prospect.