

The Case of OPEC

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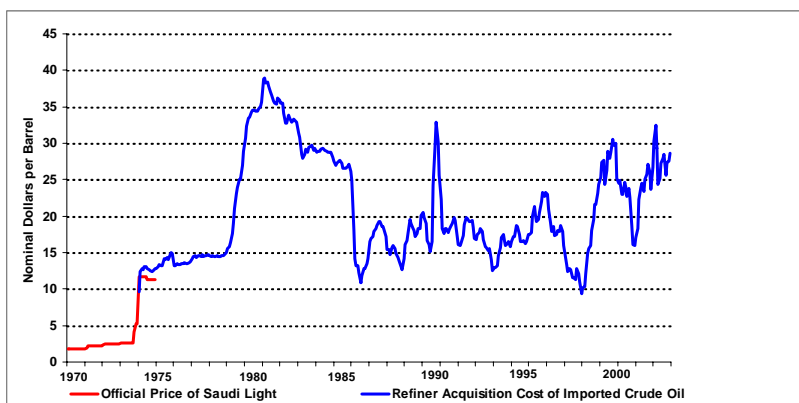
OPEC: At a Glance

- ◆ Permanent, intergovernmental organization, created at the Baghdad Conference on September 10–14, 1960, by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela
- ◆ The five Founding Members were later joined by eight other members
- ◆ OPEC's objective is to co-ordinate and unify petroleum policies among Member Countries, in order to secure fair and stable prices for petroleum producers; an efficient, economic and regular supply of petroleum to consuming nations; and a fair return on capital to those investing in the industry
- ◆ The OPEC Conference of Ministers meets in ordinary session twice a year, and is responsible for the formulation of the general policy of the Organization

OPEC: A Review

- ◆ OPEC's successes stemmed to a large extent from its oligopolistic roots in the oil industry, which has a history and structure different from other commodity businesses
- ◆ The success of OPEC at pushing up oil prices in the 1970s had great impact upon Third World Countries
- ◆ OPEC's success was contingent on high demand, inelastic oil prices, tight supplies, a small number of producing countries, common political interests, a condition of "collective learning", and a sufficient supply of financial reserves

Oil Price Chronology, 1970 – 2003



Source: Energy Information Administration, <http://www.eia.doe.gov>

Key Developments

- ◆ At the end of the 1960s: Major shifts were occurring in the global oil industry
- ◆ High growth rates in the Western economies
- ◆ The dollar devaluations (1971, 1973), the outbreak of war in the Middle East in October 1973, and the resulting oil embargo by the Arab oil-producing states
- ◆ Teheran and Tripoli Agreements of 1971
- ◆ OPEC's world energy "revolution", quadrupling of oil prices in 1973, and subsequent doubling of the prices in 1979, Iranian revolution
- ◆ 1980s: OPEC's decline
- ◆ 1990: Iraq invades Kuwait
- ◆ late 1990s: OPEC's revival

OPEC's Decline ...

- ◆ In the 1980s: Because of OPEC's ability to increase the price of oil, the demand for oil fell as natural gas, nuclear power, and coal substituted for oil
- ◆ World recession and slow growth in consuming countries contributed to the decline in demand
- ◆ Conservation, adjustment, and increased domestic production allowed developed countries to reduce their total demand for imported oil
- ◆ Sluggish demand, sustained oversupply, competition from outsiders, internal political conflicts undermined the oil-producing, price-setting cartel

... and OPEC's Revival

- ◆ Increasing demand for oil in the 1990s
- ◆ Saudi Arabia's chronic deficit and the dramatically decline in its financial reserves triggered concerns about maintaining the price of oil, their market share, and their oil earnings
- ◆ Willingness of OPEC states to cooperate because of social and political demands, and the threat of political instability within the region/cartel

Implications

- ◆ Developed oil-importing countries: Crises
- ◆ Oil-producing states: Adjustments of imbalances
- ◆ OPEC's price rises had a deflationary rather than an inflationary impact on the world economy of the 1980s
 - Liquidity preference of OPEC countries, short-term investment strategy, evade taxes, creating a worldwide liquidity surplus
 - Inflationary fears lead to anti-inflation policies and austerity measures, resulting in tight monetary policies and high interest rates

Questions

- ◆ Which factors influence the price of oil?
- ◆ What will determine the role of oil in the twenty-first century?
- ◆ How does terrorism alter the oil market? What are the consequences?

Which factors influence the price of oil?

- ◆ Supply shortages due to strikes in Venezuela and Nigeria
- ◆ Rebuilding process of pipelines and systems in Irak
- ◆ Geopolitical uncertainty
- ◆ OPEC's quota system
- ◆ Oil inventories of U.S. oil companies
- ◆ Speculative transactions
 - Future markets (NYMEX); forward contracts
 - Hedge funds / transactions

What will determine the role of oil in the twenty-first century?

- ◆ Markets, technology, and government policies; gov't can encourage energy conservation through taxation of oil; environmental policies
- ◆ Geopolitical factors
- ◆ Diversification of energy sources in general
- ◆ Developed countries will remain dependent on oil from the Middle East

How does terrorism alter the oil market? What are the consequences? (I)

- ◆ Dependence on Middle Eastern oil and regimes became more problematic for major consumer
- ◆ U.S. and China accelerate exploration of alternative sources of supply in Russia
- ◆ Improvement of U.S.-Russian relations
- ◆ Economic and political reaction of Saudi Arabia and its dominant role will shape the oil market (see article: Oil Shortage)



How does terrorism alter the oil market? What are the consequences? (II)

- ◆ Although oil may eventually diminish it will continue to play a significant role in the global economy and will remain key for international politics and relations
- ◆ Major role in politics and military relations between oil producing states and Northern oil consumer states and between oil producers and developing countries