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## Economic considerations regarding the first oil shock, 1973 - 1974

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### Abstract

*The oil shock of 1973-1974 was an economic and politic important event that produced controversies in the years that followed. No event in the last decades of the 20<sup>th</sup> century was as visible as the fourfold increase of the oil price in 1973-1974.*

*Due to different opinions and the topic itself there are many theories and point of views related to the oil crisis. This paper aims to analyze the first oil shock and to brig to attention the existent theories on the topic.*

OPEC success showed at the beginning of the 70s, as the rising oil demand exceeded production. Moreover, producing countries began to ask for ever more concessions. Muammar-al-Qaddafi, taking over power after the military coup in Libya, obtained a 20% due increase and an agreement to split profits 55-45%.<sup>1</sup> This move led to new requests, which resulted in increased oil price and exporting countries' profit.

As oil market was ever straitened, the Arab world began to use oil as a weapon to reach its economic and political goals. This was mainly achieved through the oil embargo during the war between Egypt and Israel, in October 1973. Saudi Arabia refused to increase production in order to stop the price from decreasing, unless the US supported the Arab case. Arab oil Ministries decided to set an embargo in order to reach their political goals. Production was to be reduced by 5% monthly, until the West gave up. The countries which adopted a "friendly" attitude towards Arab states were not to be affected. When President Nixon suggested that a \$2.2 billion military aid be given to Israel, Arab countries set the embargo against the US (afterwards extended to the Netherlands, Portugal, and South Africa).

The official oil price was set by OPEC members at \$11.65/barrel. The price increase was without precedent in the oil history, from \$3/barrel to 11.65/barrel. The embargo caused a deep economic world recession.<sup>2</sup>

The Arab embargo was set at a time when American oil production was decreasing, while demand and import were increasing. OPEC production decrease, together with minimal world excess production capacities, created oil shortage on the market and, consequently, increased price. At the end of the embargo, six months after it was set, the price was four fold and OPEC controlled world oil market.

Immediately there were reactions in the market:

- Refineries changed oil suppliers, starting to import from other available sources.<sup>3</sup>
- Imports from Arab members of OPEC were begun again immediately after the embargo<sup>4</sup> and started to grow until 1977. Though exploitations in the North Sea and Alaska had become

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<sup>1</sup> Yergin, D, *The Prize – the epic quest for oil, money and power*, 1991, p.580

<sup>2</sup> US GDP decreased by 6% in the next two years; Japanese economy contracted for the first time after the Second World War.

<sup>3</sup> Iran appeared to be a stable source, on the long run. Iran increased its sales towards the US, in order to cover for the import losses from Kuwait and Libya.

<sup>4</sup> The embargo ended in March 1974.

important, OPEC quota in American imports rose from 26% in 1973 to 36% in 1977 (when a very important quota was recorded, afterwards reached only in 1994).

- The refining industry began to develop oil processing technologies and methods to reduce oil consumption and to enhance operational efficiency.

The embargo led to massive increases in the price of refined products. Between 1972 and 1975, period in which OPEC returned to the production level before the embargo, consumers paid on average 57% more on gas. The high increase in energy price recorded is considered to be the cause for the 1974-1975 economic recession.

Considerable efforts were made, after the embargo, to preserve energy and to pass from oil to alternative energy sources.

A result of this embargo was also the creation of the International Energy Agency in 1974 by the US and other 20 states. The purpose of this Agency was securing oil supply. Thus, member countries developed plans with regard to creating strategic reserves necessary in times of oil supply interruptions. Law was also improved in the years following the embargo, in order to stabilise oil market.

The 1973-1974 oil shock was an important economic and political event, which led to controversies and debates in the years and decades that followed. No other economic event in the second half of the twentieth century has drawn attention worldwide in such a way in which the four fold increase in oil price between 1973-1974 has.

Following the diversity of the issue and opinions, there are many points of view and theories regarding the oil shock.

#### **A. The traditionalist point of view regarding the oil crisis.**

Economists' analysis often comprises referrals to the oligopolistic structures of oil companies, to the collective decisions of OPEC and to the demand-supply interaction on the international oil market. Though there are differences between these theoreticians, however the approach of the 1973-1974 crisis is similar from the theoretical and methodological points of view. Here are some examples:

Raymond Vernon<sup>5</sup> argues that an energy crisis is the result of reduced oil cost, as compared to other sources of energy. Consequently, he states that as the consumers' incomes increase, beginning the 50s, their demand for energy grew accordingly. Since oil was cheaper than other sources, oil demand increased faster than that for other sources of energy, and this fact, combined with the supply interruption, led to the 1973-74 crisis.

The need of rapid reconstruction of the West after the Second World War, on one hand, and the existence of cheap oil sources in the Middle East, on the other hand, resulted in the substitution of coal industry in Europe. As Romano Prodi and Alberto Clò mentioned in an article in 1975, this substitution determined:

- coal market strict control
- the lack of common energy policy and of separate rules for the market of oil and that of coal
- the lack of adequate legislation in order to limit the entry of multinational oil companies on the European market.

Therefore, European market was invaded by cheap Middle Eastern oil and the dependence of European economies to imported oil was gradually set.

Vernon states, also, that market entrance of the so-called independent oil companies, in the 50s and the 60s, was another cause of the 1973-74 crisis. The vulnerability of the

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<sup>5</sup> Vernon Raymond, *An Interpretation*, DAEDALUS, 1975

“independents” to OPEC led to the break of negotiations with regard to oil posted price and to the production conditions<sup>6</sup>.

Edith Penrose<sup>7</sup> outlines that an important role in developing the crisis had OPEC’s negotiating power rise with regard to oil companies. Also, US rising dependence to Middle Eastern oil, in general, and to Arab oil, in particular, added to a background of conflicts related to the setting of the Israeli State.

A similar idea is presented by George Lenczowski<sup>8</sup>. He states that the oil companies’ dominant position with regard to oil producing countries can be related to three factors: the existence of a buyer’s market, US self-sufficiency as oil producer and consumer and the dominant position of the main oil companies. All these factors were turned upside-down at the beginning of the 70s.

US position as importer at the beginning of the 70s is one of the often met explanations. The high growth rate of American economy in the 60s led to a rise in oil consumption, which, associated to the decrease of the real oil price, resulted in a higher oil demand. Price decline was so important that in 1969 it was 10% below the figures recorded a decade earlier. Thus, the dependence of US economy to sources of energy, especially of foreign ones, increased.

John Blair (in a book published in 1976: *The Control of Oil*) places the 1973-74 oil crisis in historic context, referring to the two Suez Canal crisis and comparing them to the Arab oil embargo in 1973. At the time of the first crisis of Suez in 1957, oil reserves had been made. Consequently, no increase in oil price was recorded. Also, during the Arab-Israeli war in 1967, there was immense excess supply in the US which annihilated oil supply interruptions in Europe.

But, before 1973, US excess reserves and production capacity exhausted, and American economy became dependent of imported oil. Therefore, the energy crisis was the logical consequence, according to Blair, of US limited and declining reserves.

Other traditional points of view trying to explain the oil crisis wander from the demand-supply ratio and focus on the expectations of those who act on this market.

In a paper from 1979 (*Economic Theory and Exhaustible Resources*), P.S. Dasgupta and G.M. Heal take into consideration a series of factors which, according to them, have led to the change of attitude on the market<sup>9</sup>. Such a factor is the change in position of the US on international oil market: from a country with sufficient energy resources, the US became an oil importing country. This situation determined recognising OPEC states and their power to negotiate on the international market. Another factor, which contributed to the attitude change, was the grown importance of neo-Malthusian ideology and the idea of resource protection. This led to a change in the financial position of oil producing countries and in their want to obtain increased incomes, either through production or price growth. The second option was the one used at the beginning of the 70s.

To synthesize the traditional points of view regarding the oil crisis, the following should be remembered:

1. The law of supply and demand is the most important in this analysis.
2. OPEC ability to set the price is considered to have played a decisive role.
3. The dependence of the American economy of foreign oil and, especially, of OPEC oil, which created severe scarcity and endangered oil supply security, is considered an important factor.

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<sup>6</sup> The pressure made by Libya over the Occidental Petroleum company during the 1970 negotiations related to the degree on posted price increase and to the according profit quota, combined with oil production restrictions due to the danger of nationalisation, were often considered to be the causes for the increase in oil price.

<sup>7</sup> Penrose, E. *The Development of Crisis*, DAEDALUS; 1975

<sup>8</sup> Lenczowski, G., *The Oil Producing Countries*, DAEDALUS, 1975

<sup>9</sup> Bina Cyrus, *The Economics of the Oil Crisis*, St. Martin’s Press, 1985, p. 3

4. The unexpected, sudden nature of price change and the adjustment issue is what led to the crisis.
5. The crisis is considered to be the result of change in perceptions of those involved in the oil market and not of change in the realities of that time.

A common error of those who second these traditionalist points of view is the lack of separation between the causes and effects of the oil crisis.

From the point of view of the supply conditions, the scarcity extended on a short time after the embargo. Temporary penury shouldn't have had, according to economic theory, a long run impact over price. However, reality infirmed that. Therefore, the factors which resulted in a higher post-embargo price are a combination between price setting by OPEC and US dependence to imported oil.

The question is why oil price didn't drop after the embargo? Why the US weren't able to deal with the OPEC challenge?

Although that, after the embargo, the international market was "flooded" with oil, this fact didn't have as effect any price decrease, which implies that the demand-supply interdependence is in itself a consequence of fundamental changes occurring in the oil industry.

Dasgupta's and Heal's point of view, stating that all these are the result of perception change, suggests that there were no objective realities involved, but only subjective perceptions.

Though the majority of these theories have made pertinent observations regarding event description, they weren't able to make theories about the 1973-74 crisis, only describing the consequences of the crisis and its conditions.

## **B. Dependence theories regarding the oil crisis**

The oil crisis is considered by Norman Girvan<sup>10</sup> to be a form of manifestation of economic nationalism in Third World states, in order to gain an "equality position" in their relationship with industrial powers. The 1973-74 crisis was a consequence of the fight for economic independence of raw materials producing countries, in general, and of OPEC countries in particular. The situation created was a riot of oil exporting countries, a riot against inequitable changes between the "centre" and the "suburbs", a riot against the exchange of cheap raw materials from Third World states and expensive imported goods from industrialised countries.

A more detailed perspective, which uses the concept of Third World nationalism, is set by Michael Tanzer<sup>11</sup>. He shifts light upon three interdependent events that have led to energy crisis:

- rising competition between oil companies, which resulted in a price decrease, and, therefore, a decrease of international oil industry profitability;
- environmental concerns and the uncertainty regarding the dominant energy type of the future;
- the „rising” nationalism of OPEC countries, which determined that large firms be less dependant of OPEC countries as a source of oil (they turned towards other sources of energy, which weren't based on oil).

Tanzer argues that large oil companies, once having acquired significant quantities of energy resources (not based on oil), intended to raise the price for every source of energy. A tactics for attaining that goal was creating an „energy crisis”.

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<sup>10</sup> Norman Girvan, *Economic Nationalism*, DAEDALUS, 1975

<sup>11</sup> Tanzer, M., *The Energy Crisis: World Energy Struggle for Power and Wealth*, 1974

This theory combines OPEC economic nationalism notion with the concentrated efforts of large oil companies to increase the price as soon as they re-establish their monopoly in international oil production.

Consequently, the crisis wasn't caused by an oil scarcity on the market, but was started with the only purpose of increasing the price.

Even though the idea of "inequitable trade" is explicitly or implicitly comprised in the analysis of the 1973-74 crisis, economic nationalism is the element of motivation behind the sudden price growth, before and during the embargo.

The "OPEC offensive" against imperialist countries, in order to gain their economic independence, is considered to be the reaction to the prolonged domination relations that have existed between industrialised countries and Third World countries. The period of time after the war in Vietnam created the political conditions to allow Third World countries, especially OPEC countries, to launch their offensive. The crisis is seen as a result of OPEC direct political action.

Supporters of such theories claim that among the causes of the crisis are: social and political conditions in the period that followed after the war in Vietnam, the political decline of the US, the rising involvement of OPEC, the increase of OPEC countries' incomes.

### **C. Conspiracy theories regarding the oil crisis**

These theories are based on the idea according to which the American Government, in collaboration with the oil companies and OPEC, intentionally started the crisis. The argument is based on the effects the crisis had. These were negligible for the American economy, as compared to the effects on European and Japanese economies.

Thus, the 1973-74 crisis outlines the US domination, a domination that showed even since the Second World War through undermining other economies.

This conspiracy theory is often encountered in European economic and political circles. It is focused on the rivalry between the US, on one hand, and Europe and Japan, on the other, in international exchanges.

The conspiracy theory offers a political fragrance to the mechanism of price setting, which is no longer considered to be the objective result demand and supply, but of political will.

The conspiracy theory overbids the conflict between American, European and Japanese economies. This theory offers no economic explanation of the price forming process during the crisis. On the other hand, it is impossible to agree or deny a conspiracy. The evidence isn't evident.

All theories and points of view that have tried to explain the energy crisis are, generally, subjective in nature, and also, to great extent, speculative. These theories mostly referred to its effects and not its causes. All theories consider the crisis as being more the result of voluntary action, rather than an objective social and political phenomenon.

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