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February 6, 1981

FRBSF Weekly Letter

OPEC After 20 Years

In its first major economic-policy move, the Reagan Administration lifted price controls on domestically produced petroleum last week, and a flurry of retail price increases followed in its wake. This action was a slightly belated recognition of OPEC's twentieth birthday, which was celebrated more officially by the cartel of petroleum-exporting countries at its December meeting in Bali. The birthday celebration and the dismantling of controls make this a good occasion to consider what OPEC has accomplished in the midst of several historic shifts in petroleum supply-and-demand conditions over the past decade.

To many consumers, events of recent years represent a conspiracy by the major oil companies to boost prices. Ironically, the leading oil producers created the cartel 20 years ago because of their belief that the majors were conspiring to *lower* prices. Indeed, the cartel's first triumph arose from its ability to hold the price of the industry yardstick (Saudi Arabian light crude) at $1.80 a barrel, despite the oil companies' attempt to lower the price during a period of worldwide surplus. OPEC's triumphs have come with much greater ease during the past decade, however, because of two basic factors—OPEC's commanding share of total world production, and the industrialized world's increasingly heavy dependence on imported oil.

Background to cartel growth

The OPEC nations account for roughly half of the world's crude-oil production, and for almost two-thirds of the non-Communist world's production. Moreover, the industrialized nations cannot operate today without help from those nations, which supply about four-fifths of all the crude oil that moves through world markets. The U.S. relies on imports for about 45 percent of its total petroleum requirements, while Western Europe (except Norway and Britain) and Japan are nearly totally dependent on imports.

This economic environment has provided a fertile ground for cartel growth. (A cartel is a combination of independent firms or nations that produce the same commodity and that work to control production as a means of supporting the commodity's price and maximizing their income.) Private cartels are illegal in the U.S. and the U.K., but many of them have developed in world markets over the years, for such commodities as wheat, coffee, sugar and tin. OPEC has achieved much greater success than other cartels, however, because of its greater cohesiveness, the lack of substitute materials, and the immense size of its market share.

Background to price shocks

Given the economic environment existing over the past decade, OPEC's power has created two major price shocks—sharp price increases resulting from a curtailment of OPEC production and exports. Prior to 1970, supply disruptions led to only modest price increases, largely because excess capacity existed in the U.S., Canada, and other non-OPEC producing nations. Thus OPEC prices remained soft throughout most of the 1960's, and failed to increase even during the Middle Eastern crises of 1956 and 1968.

But the year 1970 marked a significant change in the structure of the world oil market. U.S. production reached a peak in that year, and then began to head downward. As oil consumption increased in the U.S. and other nations, their dependence on imported oil grew proportionately. At the same time, a new Libyan government successfully boosted prices after nationalizing the oil fields, taking advantage of Libya's high-quality crude and its proximity to its major markets. Even prior to the October 1973 war, OPEC prices reached $3 a barrel—up considerably from the $1.80 quote that had stood for the better part of a decade.

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First shock—and aftermath
The winter of 1973-74 marked an even more crucial watershed for the world and its oil-based economy. During that period, OPEC prices rose fourfold to almost $12 a barrel (see chart). This dramatic price increase was a direct consequence of the Arab-Israeli war, which led the Arab oil producers to embargo shipments to the U.S. and the Netherlands, and to impose a general 10-percent production cutback that affected all major consuming nations. But those actions would not have worked without the major change in the world supply-demand equation that began in 1970, because similar actions had had no effect in earlier Middle Eastern conflicts.

The pendulum began to swing back during the 1974-78 period, as modest OPEC price increases fell behind the increases in OPEC import prices. In other words, OPEC members actually experienced a decline in real unit prices, in terms of what they could purchase with the revenue from each barrel of oil. This shift represented a reaction to the earlier price upsurge, which helped lead to a worldwide recession and near-stability in oil consumption over the course of the 1974-78 recession and recovery.

Second shock—and aftermath
But then came the second oil shock—the doubling of prices to $29 a barrel over the 1979-early 1980 period. The Iranian revolution in December 1978 led to a shutdown of Iran's normal exports of 5.5 million barrels/day, and that shortfall was never made up, although Iran later resumed some shipments and other OPEC nations boosted production substantially. For a while, the supply disruption dramatically affected the world oil market, partly because of the low level of refinery inventories at the time of the cutback.

The pendulum again began to swing back in early 1980, as supply and demand factors came into closer balance. Oil consumption in the non-Communist world actually declined 7 percent in 1980, partly because of the weakness of U.S. business activity, and partly because of a worldwide reaction to higher prices. By September, worldwide inventories reached a record 6.0 billion barrels—roughly 500 million barrels above normal. That oversupply thus helped provide a cushion when war broke out between Iran and Iraq, and reduced world supplies by 3.7 million barrels/day. In fact, the war-caused shortfall declined to 1.5 million barrels/day in December, as the two combatants resumed some shipments while other producers boosted production temporarily. Thus, at their December meeting, OPEC members boosted average prices by a relatively modest 13 percent, to $36 a barrel.

Situation in 1981
The world oil market remains unstable in early 1981, reflecting the recent run-off in inventories caused by the Iran-Iraq war and the abnormally cold winter in the Eastern part of this country. But many industry observers expect greater stability in supply-demand conditions as the year advances, reflecting such factors as an improvement in weather, a business slowdown throughout most of the industrial world, and the adoption of stricter conservation standards worldwide. Yet even in that situation, OPEC prices could rise 30 percent or more for the year as a whole, as prices ratchet further upward.

The nation's heavy dependence on cartel-dominated foreign sources creates a basically unstable condition, because it exposes the U.S. not only to price shocks but also to possible disruptions in supply. Higher prices for crude oil aggravate the nation's severe inflation, as these increases are passed on to consumers and business firms in the form of higher prices for gasoline, heating oil and other refined products. Higher prices also siphon off income overseas that would otherwise remain within the domestic economy. The situation also threatens national security, because a major supply cutoff could disrupt our manufacturing and military capability.

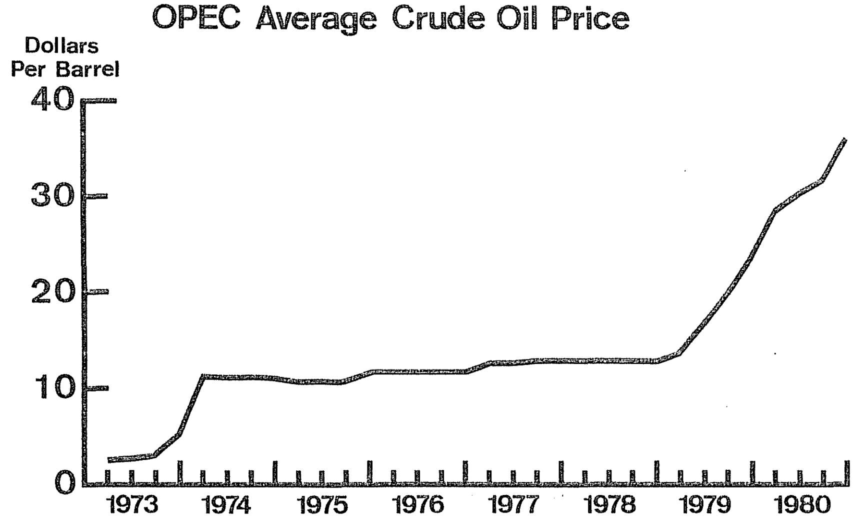
Long-term solutions
To help offset these problems, the govern-

ment in recent years has begun to build up a strategic petroleum reserve, or inventory. The Administration's action last week in accelerating the scheduled dismantling of oil-price controls represents an even stronger reaction to the problem. (Natural-gas prices will not be completely decontrolled until 1985.) Beginning almost a decade ago, the government held oil prices at the wellhead below the price of imported fuel, to protect consumers from having to pay OPEC cartel prices. But this action in curbing price increases had an unfortunate side effect, in that it also stimulated oil imports. If domestic prices had moved freely in accordance with world prices in recent years, the nation would have experienced a greater reduction in consumption and a greater expansion of domestic energy supplies.

Higher energy prices thus have both a good and a bad side. On the one hand, they are inflationary because they help boost the cost of a large portion of the consumer's market basket. But on the other hand, they help reduce the nation's dangerous dependency on unstable energy sources, by encouraging consumers to reduce consumption while stimulating producers to develop more (conventional and unconventional) sources of supply.

Yvonne Levy

OPEC Average Crude Oil Price



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/21/81	Change from 1/14/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	146,768	– 245	9,742	7.1
Loans (gross, adjusted) — total#	124,319	– 200	9,986	8.7
Commercial and industrial	36,989	– 436	3,707	11.1
Real estate	50,682	151	6,626	15.0
Loans to individuals	23,759	– 124	– 593	– 2.4
Securities loans	1,461	172	463	46.4
U.S. Treasury securities*	6,794	32	– 373	– 5.2
Other securities*	15,655	– 77	129	0.8
Demand deposits — total#	41,903	–2,245	– 1,091	– 2.5
Demand deposits — adjusted	30,229	–1,664	– 1,362	– 4.3
Savings deposits — total	29,148	– 90	770	2.7
Time deposits — total#	75,518	1,324	16,195	27.3
Individuals, part. & corp.	65,879	1,338	15,454	30.6
(Large negotiable CD's)	29,619	882	7,977	36.9

Weekly Averages of Daily Figures	Week ended 1/21/81	Week ended 1/14/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	0
Borrowings	321	10	69
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 69

* Excludes trading account securities.
# Includes items not shown separately.

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