What is OPEC and Have OPEC's Decisions Been Effective in Stabilizing the Oil Market and Maintaining High Oil Prices?

During the 1950s, oil companies had sought to maximize their profits and chose to attain this goal by increased production rather than through higher prices. As a result, the oil supply began to surpass the world’s demand for oil. Companies began to face discounted prices for their Middle Eastern product. This situation resulted in multinational oil companies reducing market prices that adversely impacted the revenue of the Middle Eastern governments (Yergin 514-515). Unhappy with these declining oil prices, representatives from five countries—Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela—established the Organization of the Petroleum Exporting Countries (OPEC) in 1960.

According to OPEC’s Secretariat, the newly created organization’s primary objectives focused on establishing unified petroleum policies for the OPEC members, fostering an environment for fair and stable oil prices with the intent to eliminate harmful fluctuations, ensuring “an efficient, economic, and regular supply of petroleum to consuming nations, and a fair return on their capital to those investing in the petroleum industry” (Secretariat 6). Attempting to achieve these goals from its creation in 1960 to the present, OPEC expands to eleven member countries and oversees their oil interests through price and production management.
The oil market is extremely volatile and reacts to many factors as is evidenced since OPEC's conception. Some of the influences include strife within the oil producing countries, short run and long run reactions to oil prices and production, production cheating by the OPEC member countries, economic recession, and political instability through warring factions. These factors impact OPEC’s pricing and production decisions and result in short run successes, but from a long run perspective, a successful outcome has been impossible to achieve.

During the 1960s, OPEC asserted only limited power in attempting to realize its economic objectives to increase the member countries’ revenue and influence oil prices. Its limitations may be attributed to three items. First, contracts existed between OPEC’s member countries and the multinational oil companies that assigned oil reserve rights to the companies. Secondly, the world oil supply exceeded demand so there was no market for increasing prices or production. And, finally, political issues obstructed decisions being made by OPEC (Yergin 523-524). In OPEC: The Failing Giant, Mohammed Ahrari writes, "OPEC remained a weak and ineffective institution. The challenges faced by the fledgling organization—price stabilization, prorationing, and expensing of royalties—were enormously complicated and were frequently in conflict with the economic interests of a number of member states" (30).

The OPEC member countries took a more active role in influencing the world oil market throughout the 1970s. This decade established OPEC as a "leading force in the world oil market and the sole setter of its pricing" (Chalabi). The OPEC nations were aligned in a common objective to gain additional revenue through increased oil prices, and they jointly reduced oil supply to accomplish this goal (Mankiw 105). OPEC's impact on the oil market from 1970 through 1974 demonstrated that it possessed the ability on a short run basis to control crude oil prices through supply manipulations. Crude oil prices quadrupled from a 1972 level of $3.00 per
barrel to nearly $12.00 per barrel by the end of 1974. This unprecedented increase in oil prices was directly related to the OPEC member countries' decisions to establish the Arab Oil Embargo during the Yom Kippur War (Williams).

As illustrated in figure 1, the price of oil rose significantly during the 1970s but increased dramatically from 1978 through 1980. This price increase can be attributed to the internal dissension experienced in Iran and Iraq. The oil industry provides a commodity that responds to crises such as the events in these two countries. Iran and Iraq curtailed oil production considerably during this time, and the oil supply decreased. Crude oil prices more than doubled from the 1978 level of $14 per barrel to $35 per barrel in 1981. In the long run, the economic market response to these high oil prices would be a reduction in demand. Consumers and industries reacted with increased energy efficiencies and OPEC's attempts to recover would fail as would be evidenced in the oil market during the upcoming 1980s (Williams).

Fig. 1. U.S. and World Events and Oil Prices 1973-1981, WTRG Economics.
As figure 2 depicts, the oil revenue boom for the OPEC member countries of the 1970s was replaced by a decline in oil prices and revenue in the 1980s. The years 1982 to 1985 experienced plummeting oil price levels at about ten percent per year (Mankiw 105). OPEC's response to these careening oil prices focused on stabilizing prices through prescribed production quotas for each of its member countries. As is often the case in a cartel, OPEC members such as Saudi Arabia cheated and produced beyond their quotas. This action decreased oil prices and undermined the organization's goal to earn monopoly profits. As Saudi Arabia increased oil production during 1985 and 1986, crude oil prices fell in mid-1986 to below $10 per barrel (Williams).

During the 1980s, OPEC members failed to understand that oil demand would decline drastically and that production by non-OPEC countries would increase dramatically. In response to OPEC strategies, revenue had doubled for OPEC members from a 1978 level of $130 billion

Fig. 2. World Events and Oil Prices 1981-1998, WTRG Economics.
to $280 billion in 1980. “But the $280 billion led them directly back to $130 billion again in 1985 and to well under $100 billion in 1986 [. . .]. Having assimilated themselves into a high price policy, OPEC failed to maintain oil prices at the determined level” (Skeet 210). Just as events in the late 1970s had precluded OPEC from stabilizing and maintaining high prices in the oil market, the 1980s will end on a similar note. OPEC would be envisioned as a failure from a cartel perspective (Skeet 211).

The fluctuations in crude oil prices experienced during the 1990s will again demonstrate OPEC’s inability to stabilize the oil market and maintain high oil prices for the long run. Oil prices decreased the beginning of January 1998 and that translated into enormous revenue losses for the OPEC member countries. According to Dr. Fadhil Chalabi, Executive Director of the Center for Global Energy Studies, the reduction in OPEC’s oil exports by 1998 diminished by more than 35% when compared to 1997 levels. In the fourth quarter of 1996, crude oil prices peaked at about $25 per barrel with a downturn in January 1999 reaching a level of $10 per barrel. These losses adversely affected the OPEC member countries’ economies because of their huge financial dependence on revenue from oil markets.

The largest driving force in OPEC’s oil pricing and production decisions focuses on maximizing the revenue for its member countries. That goal has not been realized in recent months. OPEC oil export revenues have decreased dramatically as oil prices fell due to diminished demand subsequent to the US economic recession and the September 11, 2001 terrorist attack. Even with the early 2002 price rebound, OPEC oil export revenues are forecast at $177.7 billion for 2002 and that translates to declines from 2000 levels of 27% and 7% below 2001 revenue levels. These declines place OPEC oil export revenues in real terms at averages comparable to levels realized during the first half of the 1990s, but well below the 1974 through
1984 levels. Failure by OPEC to successfully balance prices and production has translated to economic problems during 2002 for many OPEC member countries (Feld).

On October 24, 2002, the Wall Street Journal reported, "OPEC member nations are cheating on the cartel's self-imposed quotas almost at will, with oil production running 10% above the current official target--and still rising" (Herrick A2). Figure 3 illustrates this point and depicts OPEC's difficulty in maintaining limitations on oil production. In light of the decreased revenue of the past year, OPEC member countries are surpassing OPEC's production quotas to obtain additional profits. However, Erik Kreil of the Energy Information Administration envisions the oil production cheating as necessary but harmful, nonetheless, to OPEC's image. Kreil notes that "OPEC's tactic of increasing production as needed while remaining firm on quotas during the past year worked over the past 6 months. Although the lack of quota adherence has hurt OPEC credibility in the past during times of price weakness, the recent level of OPEC basket prices has enabled OPEC to postpone addressing the issue [...]".

Fig. 3. OPEC 10 Crude Oil Production vs. Quotas, Department of Energy, Energy Information Administration.
While successful at raising oil prices and their revenue in the short term, the OPEC member countries have found it extremely difficult to maintain these high oil prices for an extended time period. Why couldn't OPEC manipulate price and production as it had done in the early- to mid-1970s and maintain high oil prices throughout the next thirty years? This question can be answered in part by comparing the behavior of supply and demand from a short run and long run perspective. The short run demonstrates the relatively inelasticity of both supply and demand for oil. Supply inelasticity occurs due to the inability to rapidly locate additional oil reserves and increased oil extraction does not occur quickly. Demand is inelastic in the short run because the marketplace does not respond immediately to an increase in oil prices because oil consumption does not diminish quickly. In the long run, supply and demand become elastic as oil producers not associated with OPEC react to price increases through expanded oil exploration and additional quantities are extracted from oil wells. Consumers respond to higher prices with diminished consumption levels as was demonstrated during the 1980s (Mankiw 105).

The reactions of supply and demand in the short run and long run demonstrate one of the primary reasons that OPEC has experienced difficulty in maintaining high oil prices since its formation in 1960. In the short run, OPEC’s decreased oil production shifted the oil market supply curve to the left and decreased the equilibrium quantity while greatly increasing the equilibrium price. In the long run, the oil market supply curve also shifts left but results in a much smaller increase in price (Mankiw 106.)

The overall assessment from 1960 through 2002 for OPEC’s success in stabilizing the oil market and maintaining high oil prices while maximizing their profits shows a clear trend. When demand for oil is high, OPEC’s pricing decisions fare well. But, as demand decreases, their
policies were difficult to realize and maintain. “The majority [of the OPEC member countries] failed for most of the time to maximize revenue to the extent that they wished” (Skeet 228-230).

OPEC has been hampered by strife within the oil producing countries, short run and long run reactions to oil prices and production, production cheating within OPEC, economic recession, and political instability through warring factions. But, the most notable factor in OPEC’s failure to stabilize the oil market and maintain high prices is inherent to a cartel. “In any cartel, success in the short run sets in motion events which make maintaining success nearly impossible. A successful cartel raises prices which encourages consumers to cut demand and potential producers to enter the market” (Rousseau). Since its formation in 1960, OPEC has struggled to achieve its goals as rendered in its proclaimed charter. Sometimes, such as occurred in the 1970s, those objectives were realized. However, OPEC has been unable on a long run basis to maintain a stable oil market and maximize revenue results for its member countries.
Works Cited


