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THE POLITICAL ECONOMY OF THE MIDDLE EAST
- CHANGES AND PROSPECTS SINCE 1973

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The Political Economy of the Middle East
- Changes and Prospects Since 1973

IV. Regional Changes Since 1973
Resulting from the Petroleum Crisis

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TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION	3
The meaning of shortage	3
Lessons of the 1973-74 "embargo"	5
The myth of "access", "assurance of adequate supply", etc.	6
The harmful myth of the Saudi - U.S. "special relationship"	7
Conclusion: the only real problem	9
II. WORLD OIL SUPPLY AND DEMAND	10
Background to forecasting	10
Table I: Past and Projected Oil Consumption and Production	11
World economic growth 1972-87	12
Income-energy-price relations	13
The often upside-down world of supply	16
Communist exports	21
Questioning the consensus	23
III. THE MULTI-GOVERNMENT OIL CARTEL	24
Political objectives irrelevant	24
In search of optimum price	25
Two types of excess capacity	25

	<u>Page</u>
Macro-economic effects	26
Saudi Arabia, cartel backstop, and the need for cartel agreement	27
Along the ad hoc trail: three problems	28
Three legends about Saudi Arabia	30
IV. THE MIDDLE EAST IN THE FUTURE WORLD OIL MARKET	32
Feedback of oil price increases on economic growth	32
Cartel prospects	33
Two dangers to the cartel	34
The "price crunch" of 1983 or 1988 or 199x or...	36
Lessons from Iran	38
V. OPTIONS FOR U.S. POLICY TOWARD MIDDLE EAST OIL PRODUCERS	39
The record on agreements and understandings	41
"OPEC is good for you"	42
VI. CONCLUSIONS	44

INTRODUCTION

Economic relations of the United States with the Middle East are dominated by the production and export of petroleum. Perhaps our most important contribution to understanding this market is negative. If we can show up the non-problems, we can face the real problems--like Columbus, unafraid of falling off the edge of a flat earth, and ready to tackle the hazards of a long voyage into uncharted waters.

Foremost among the non-problems is the shortage or "gap" between oil supply and demand. Once we get rid of this ghost, we are also rid of "access," "availability," "long-term assurance of supply" and that cherished phantom, the "special relationship" of the United States and Saudi Arabia. They are all fictions. But belief in fiction is a fact, and the belief does us no good and much harm.

The meaning of shortage. Policy makers in consuming countries are firmly convinced of a great oil shortage coming. In 1972, the State Department predicted a shortage of 20 million barrels daily (MBD) by 1980; indeed by 1976 our position "could be nothing short of desperate." Of course, in 1973, "exaggerated talk of an energy crisis greatly strengthened the bargaining power of the Arab states." International Energy Agency (IEA) predicts a world oil shortage of only 14 MBD-in 1985; more recently, and more modestly, of 8 MBD-(plus or minus 4).¹ We

¹New York Times, May 27, 1972; Oil & Gas Journal, May 15, 1972; Petroleum Economist, November 1973; New York Times, March 17, 1977, Petroleum Economist, September, 1978.

cannot begin to count the recent warnings of "catastrophe" and "crisis" in the mid-1980s as "the world's oil wells start to run dry and a physical scramble for energy develops."¹

The "gap" is like the horizon, always receding as we go toward it.

A shortage persisting for months or years can exist when, and only when, the price is held persistently below the level that would clear the market and equate demand with supply. The natural gas shortage in the United States is the outstanding example.

When the market does not clear, the product is allocated not by price but by favor and influence, or public authority. Some buyers get more than they want, others must shut down factories, stop motor vehicles, shiver in the dark. Unless prevented by government, the seller can extort all kinds of conditions over and above the price.

But persistent shortage is impossible in world oil because nobody has the power and the wish to hold the price of oil below the market-clearing level. To believe in a persistent or chronic gap, one must assume that the sellers will, year in year out, insist on giving away a large fraction of the money they could make. Even if the producer nations were so foolish, product prices would soar, with huge profits to refiners and marketers. The producers would promptly capture those profits by raising crude oil prices.

But if oil is allocated by price, there is no shortage, and favor and influence are worthless. During the so-called "embargo" of 1973-74,

¹New York Times, October 6, 1977. The phrase "scramble for scarce petroleum supplies" occurs in the Wall Street Journal and in a New York Times editorial, both October 7.

we had a clear "special relationship" with Saudi Arabia: their special enemy. Let us see what difference it actually made.

Lessons of the "embargo." The Arab producers cut back output, thereby inflicting economic injury on the whole consuming world. The "embargo" against the United States and the Netherlands was a sham, even if we disregard evasion and transshipment, because non-Arab production exceeded U.S. imports, as it still does. As Arab oil was diverted from the United States elsewhere, non-Arab oil was diverted from elsewhere to the United States: a swap of customers. In theory, in any place where total supply (imported plus domestic) diminished more, the price would rise more. The higher price would be a magnet to draw in more supply until prices equalized again. Since everyone in the trade knew this, there would be a continuous shift to American customers, with the reduction in total supply at every moment tending to be the same everywhere. This actually happened. Non-Arab producers did well by doing good, diverting oil to "embargoed" countries. The oil companies deserve credit for working out the complex logistics of swapping customers, but not for the inevitable result: everybody suffering roughly the same reduction. Comparisons are very inexact, but if we take actual oil consumption versus an estimate of what it would have been, absent the cutbacks: Japan lost only 3 percent, the special enemy (United States) lost 11 percent, Western Europe lost 19 percent, including "preferred," "friendly" Britain and France, 12 and 21 percent. Or comparing actual consumption in January-April 1974 with the same months of 1973: the United States lost 7 percent, Japan actually gained

1 percent, Western Europe lost 11 percent.¹

Another test is the draw-down of crude oil and product inventories in nine large consuming countries, from end-September 1973 to end-March 1974. The reduction in this country was 4 percent. Three countries did better, and five worse, including the British (11 percent) and French (12 percent).² That was the benefit of their "special relationship."

The myth of "access," "assurance of adequate supply," etc. The embargo was a very severe test and proof: "access" is a non-problem. All a buyer needs is access to enough money to pay for the oil. Some Middle East producers spit venom at the United States. Others profess to like us, mostly. Neither attitude has any effect on oil supply and price.

Our policy makers live in a different world. Its feverish political-dramatic atmosphere is conveyed perfectly by a high ranking official: "It's hard to bare our teeth at the Arabs when we're groveling for their oil."³ Which is more undignified--and irrelevant--baring one's teeth or groveling? Be that as it may; one doesn't see much with belly to the ground.

But the "groveling" is only one side of the coin; the other is an ego trip for the statesman. By his skillful diplomacy, his masterful

¹Robert B. Stobaugh, "The Oil Companies in Crisis," Daedalus, Fall 1975, p. 202. Federal Energy Administration, Office of International Energy Affairs, "U.S. Oil Companies and the Arab Oil Embargo: The International Allocation of Constricted Supplies," prepared for the use of the Subcommittee on Multinational Corporations of the Committee on Foreign Relations, U.S. Senate, 94th Cong., 1st Session (1975), p. 8.

²National Foreign Assessment Center, International Energy Statistical Review, May 17, 1978, p. 19.

³Direct quotation, in Wall Street Journal, October 21, 1977, article on editorial page.

blending of firmness and conciliation, he will induce the producers, particularly Saudi Arabia, to produce "enough to meet our needs." The truth is, no matter what the Saudis and others produce, the price will rise high enough to where anybody paying it can have all he wants. Conversely, whatever the price, at that price the amount supplied will equal the amount demanded. So the producers will let us have "enough to meet our needs," no matter how much they produce, at whatever price, with whatever effects. The statesman assures us of "access" to "adequate supplies" just as surely as the rooster's crowing brings up the sun, and he believes in his mission with all the sincerity in roosterdom.

The harmful myth of the Saudi-U.S. "special relationship."

Consuming countries are worried that the United States will preempt Saudi Arab output through the "special relationship," leaving them to bear the burden of physical shortage, with all its costs in unemployment and hardship. The fear of shortage explains the craving for self-sufficiency, incessantly confused with the safeguards against sudden interruptions or cutbacks. One harmful result, to be explored later, is the reluctance to produce oil or gas or uranium, in order to make sure that there will be "enough for our needs" in the 21st century, or the hereafter. Wealthy countries like the United States, Canada, Australia, and Norway, can afford this folly, but even the Indians abuse themselves by hoarding oil and coal in the ground, and importing high-price foreign supplies instead.¹

¹Economist, London, June 3, 1978, p. 87.

The second result of the delusion is more serious. The Administration has urged our friends to delay the building of breeder reactors and nuclear reprocessing plants. But "for Japan and West European countries, most of which lack large supplies of coal and oil, the ... breeder reactor is the principal hope of obtaining adequate energy supplies."¹ The key word is, as usual, "adequate," not lower-cost. American assurances of future nuclear fuel supplies are discredited by our shrill warnings of energy "shortage" and our refusal to ship Alaskan oil to Japan. Here too the lesson of the "embargo" has not been learned: an effective market makes it unimportant which particular supplier ships to which particular customer--the matching or pairing depends on what pattern of shipments is cheapest. Were there no delusion of impending physical shortage, the refusal would appear as senseless as in fact it is.

Yet the reluctance to export is logical. In a shortage, the real value of the product, which is the price that would rule in an uncontrolled market, is greater than the controlled price. It follows that the buyer is paying, and the seller is getting, less than the stuff is really worth. To export it is a gift to the undeserving foreigner. It is all a rational deduction from the unexamined premise of "shortage".

¹New York Times, October 4, 1977, p. 53, and also September 9, 1977. See also the joint statement in Keidanren Review no. 43, February 1977, by Federation of Economic Organizations, Japan Atomic Industrial Forum, and Committee for Energy Policy Promotion: "...In view of the actions of the oil producing countries in the Middle East, increasing imports of oil by the U.S.A., and other trends, it is all too uncertain whether Japan will be able to secure such a huge amount of petroleum." See also Michel Grenon, *Ce Monde Affame d'Energie* (Paris, 1973); Guy de Carmoy, *Energy for Europe* (Washington, American Enterprise Institute, 1977), pp. 37, 55, 80, 93, 117. It would be impossible to collect and list all these worries about "adequate" supplies.

Conclusion on "gaps" and "shortages" and "access." Nobody should, though some will, misinterpret this paper as saying: "price will solve the problem." Price is the problem--the only problem. We need to look at the real world, where the forces of demand, supply, and monopoly determine the price.

II. WORLD OIL SUPPLY AND DEMAND

Background to forecasting.¹ Oil consumption in the non-Communist world (NCW) today is about 50 million barrels daily (MBD). See Table I. It forms essentially one big market--as the "embargo" reminded us again. The price at which oil crosses frontiers is everywhere the same, once we allow for quality and location differentials. The Middle East (including Libya and Algeria) is important because it has for some years accounted for 45 percent of NCW output, not because it supplies much more of one country's consumption (and less of another's).

Forecasting is an unavoidable, difficult exercise. Table I shows the usual procedure. The first step is to estimate NCW consumption, usually at constant prices. The second is to estimate non-OPEC supply (including the minor supplement of Communist exports), which is preferred for reasons of security, lower cost, balance of payments, etc. Then net demand on OPEC, line 5, is a residual which may reflect and amplify all the errors in the component series. The CIA calculation of net demand on OPEC, 44 percent higher than the oil company's, is almost certainly far wrong, bearing in mind both logical error and nearly two years' experience. But far more important than who is right or wrong is to get the concept straight. Demand on OPEC (line 5) sums up everything outside the control of the cartel. OPEC supply is the cartel response: the amount they choose to provide, to suit their interests. OPEC supply is

¹ This section draws extensively on a paper "World Supply and Demand", presented at the 50th Anniversary Meeting of the Canadian Society of Petroleum Geologists (June 26, 1978), to be published by the Society.

Table I
Past and Projected Oil Consumption & Production
(in million barrels daily - includes natural gas liquids)

	Historical		1985 Projections		
	1973	1977	(Prelim) Jan.- Sept. 1978	Central Intelli- gence Agency (CIA)	Oil Co.
1. Total non-Communist ¹	49.5	50.8	50.1	70	60
2. Non-OPEC supply	18.2	19.0	20.4	21	26
3. Communist exports	1.0	1.6	1.6 ²	-4 ³	*
4. Other output	17.2	17.4	18.8	25	*
5. Net demand on OPEC (line 1 less line 2)	31.3	31.8	29.6	49	34
6. (Arab plus Iran output)	(24.0)	(25.1)	(23.5)	(*)	(*)
7. OPEC capacity	37.7	38.9	39.9	38	sufficient

N.B. Detail may not add to total because of rounding.

* Not Stated

¹Inventory buildup or drawdown can make actual consumption vary as much as 5 percent above or below this amount. The shorter the time period, the greater the possible error.

²Assumed the same as 1977. For Soviet crude oil exports to Western Europe, the largest single component, it is correct for the first half of 1978.

³Subsequently reduced to (-2.5).

Sources: Historical, CIA, except OPEC capacity, which is as estimated by Petroleum Intelligence Weekly, plus actual production of natural gas liquids.

not something immovable, to which we can adapt ourselves -- quite the contrary.

Let us look first at total NCW consumption (line 1). From 1950 to 1973, NCW income increased around 5 percent annually, total energy use a little less. Oil use grew about 7.5 percent per year, partly because it was cheaper and displaced other fuels, partly because oil-using activities (automobiles, trucks) grew faster than energy uses in general. Middle East oil, the cheapest fuel, grew at 12 percent per year. Since 1973, the economic growth rate has been around 2.5 percent per year; energy about 1.2, oil almost flat. We trust this drab picture will not continue long, and we will now try to "look through" it, to see what we may reasonably expect as to non-Communist consumption, supply, and the position of the OPEC producers, of which the Middle East is the greater part.

World economic growth will probably be slower in the next decade than up to 1973. We can set aside mythical energy or raw-material "crises" and the more likely indirect effects of high oil prices, to be discussed later. But countries outside North America will tend to approach the American growth rate because they have accomplished certain once-for-all changes. Much unproductive or semi-unemployed labor has been moved off marginal farms and out of marginal retailing-artisan jobs into productive industry. Women have moved into the paid labor force. Population growth in the developed countries is today barely positive, and still decreasing. Catching-up with the more productive North

American economies has been slowing down. Productivity has everywhere decreased its growth rate. All in all, disturbing influences aside, one would expect worldwide long-term economic growth, after 1972, to approach the American long-term growth rate, 3.5 percent per year. To take the strongest case: of the sources of Japanese growth of 9.56 percent per year in 1961-71, 3.24 percent points are "sustainable", 6.32 are "transitional."¹

Income-energy-price relations determine consumption. Much is made today of the incremental energy elasticity, i.e. the percent change in energy use related to the percent change in national income. For various countries, these ratios scatter all over the place, and it really makes no sense to compare increment with increment. During 1973-77, for example, energy use in the U.K. declined somewhat, while income grew somewhat. Surely nobody will apply this coefficient to forecast that the higher the income, the lower the consumption.

But it makes sense to compare the ratio of total energy use to total income, and changes in that ratio. In effect, we hold income constant and ask for the effects of changed prices or other factors. Between 1972 and 1977 in the big consuming countries (U.S., Canada, Japan, E.E.C.), energy use per unit of gross national product decreased about 8.0 percent, with very little variation among countries.⁽²⁾ A pretty mild response, but then the stimulus was not all that strong. We talk about

¹Edward F. Denison and William K. Chung, How Japan's Economy Grew So Fast (Washington, Brookings, 1976), p.116.

²Energy consumption, from BP Statistical Review 1977; real GNP from Economic Report of the President 1977.

the crude oil price quadrupling. (In fact it increased by a factor of nearly 14 in 1970-77.) But the inflation-adjusted or "real" price of oil products, to consumers, has risen surprising little--roughly 60 percent. This severe damping is because "real" transportation and refining costs, and "real" consumer-country taxes, have been stable or even declining.

This result is consistent with the work of the M.I.T. world oil project, with which I am associated. If we hold energy prices constant in relation to prices of other factors of production--labor and capital--and of all other objects of consumption--food, clothing, shelter, etc.--then the demand for energy increases a little bit less than the growth in world incomes.

If we hold income constant, the consumption of energy is strongly affected by the price. Everybody knows that the amount of energy consumed per unit of national product varies greatly. We are often admonished to look at how the Swedes and West Germans, with allegedly the same income per head (actually, about a fourth less), use so much less energy. If we dump out the moralistic exhortation, and just look at the facts, we can account for much of these differences in consumption patterns by variations in price.

But the price effects work slowly. First there is advice: turn down the thermostats, turn off the lights, call off the trip. Then we get down to business: change the capital stock of energy-using equipment. First retrofitting: insulate buildings and machines; install heat exchangers, sensing devices and computer controls to save energy and increase its use only where and when and as it is needed; and so on. Even more important is to design and construct new buildings and

equipment. The new Citicorp building in New York will use about half the energy a building of equal size would have a few years ago. But new buildings, and the new plant and equipment installed in a year, are a very small percent of the total in use. Of course, automobiles turn over a lot more rapidly than buildings. But the consumers are not nearly as quick to look to money savings, and they do not design automobiles, nor negotiate with designers. The half-life of the energy-saving process should approximate that of the capital stock, and be in the region of seven to ten years.

For the large industrial countries, as just seen, energy use per unit of national product has been declining by 1.67 percent per year (i.e., $.9833^5 = .9192$). If incomes grow at 3.5 percent per year, energy use will grow around 2 percent ($1.035 \times .9833 = 1.018$). But the decline in the energy-income ratio will in time slow down.¹ Oil use should grow a bit more slowly than total energy use. Of course, the precision of these or any other numbers is apparent not real. But the oil-company forecast of oil consumption in 1985 is at least compatible with what we know; the CIA's is not. Oil consumption growth will not much exceed a third of the pre-1973 rate.

We should also, but have not yet, factored in: further crude oil price increases, to be discussed below; consumer-country conservation regulations, the only important example thus far being U.S. gasoline mileage requirements; or consumer-country tax increases, or equivalent. The requirement that a consumer use a second- or third-choice fuel (or a

¹"World Supply and Demand," op. cit., App. 1.

more expensive energy-saving automobile) raises his energy costs and has the same effect as a tax, but it is politically acceptable because it doesn't look like a tax.

Whatever the level of demand, providing adequate reserves is no problem. Sheik Yamani, who is not expected to understate consumption growth, has forecast a 47 percent rise in OPEC output in 1977-87.¹ That is cumulative output of 136 billion barrels. OPEC proved reserves end-1977 were 449 billion. Even assuming no discoveries, the amount of reserves that could be added in known Middle East fields alone was estimated in 1975 as between 300 and 550 billion.² But reserves available will not necessarily become actual reserves and producing capacity; moreover, capacity does not necessarily mean production. It is time to ask what governs the supply of crude oil.

The often upside-down world of supply. The world of demand is orderly. Higher incomes mean more energy consumed; higher prices mean less.

In contrast, the supply response to higher prices is almost wildly diverse, because it is often deflected or governed by political forces. In some places, higher prices tend to bring forth more supply, in some

¹H.E. Sheikh Ahmad Zaki Yamani, "Keynote Address," 50th Anniversary Meeting of the Canadian Society of Petroleum Geologists (June 26, 1978), to be published by the Society.

²Z.R. Beydoun and H.V. Dunnington, The Petroleum Geology and Resources of the Middle East (London: Scientific Press Ltd. 1975), p. 84. Compare the estimate of 550 billion barrels by 1985 in fields known in 1970. M.A. Adelman, The World Petroleum Market (Baltimore: Johns Hopkins Press, 1972), p.71.

places definitely less. And in any given country that relation will change over time.

Canada supplies a cautionary tale. The 1973 price increase promised a surge in industry profits, intolerable to public opinion. The province of Alberta and the federal government were between them claiming rather more than 100 percent. So we witnessed the rather amazing spectacle of a steep decline in Canadian drilling. The governments relented, and now drilling is up sharply. Some large gas discoveries have been made, but actual reserves have not increased as much as they could because the national government wants to hoard gas to insure "enough for our needs," thereby discouraging exploration and development. The huge heavy-oil deposits (one trillion barrels in place) are now definitely worth developing at current prices. This is the payoff to a decade of R&D work. But until a tax system is decided, there will be no production.

In the United States, there has been a continuing rise in drilling. But price controls have almost certainly prevented it from being as great as it might have been, and have turned it to less productive uses. Half of the "windfall profits" would go to the Treasury, but we seem willing to give them up to prevent the oilmen from getting the other half. Possibly even more important has been the reluctance to allow leasing for exploration in new areas, partly because of genuine concern for the environment, but partly for fear that somehow the oil companies are going to reap indecent profits from these new areas. Since competitive bidding is an efficient way of getting above normal profits for the Treasury, this fear makes no sense at all.

There have been similar developments in other countries of private enterprise, such as Australia. In Great Britain the goal is self-sufficiency.¹ Then the higher the price, the less is demanded, and the less supplied. Norway, a small democratic country, wished to limit the impact of overflowing oil revenues. Hence there was a strict relationship: the higher the price, the less the leasing. But Norwegian oil and gas production is proving less than expected, they have overspent expected revenues, and now they are stepping up leasing and exploration. Here as elsewhere, foreign exchange deficits and resulting external debt service have been the most important single factor in turning a country's policy around.

In Indonesia, the price explosion led to huge profits for a national company, which led to profligate waste. The receiver in bankruptcy, the government, was in dire need of cash, and carried through a unilateral revision of its contracts with foreign companies. This dropped exploration sharply. The government is now reversing course, but time has been lost. Similarly in Malaysia, the fear of giving away too much has delayed oil development for two years, though it is now getting back into stride.

In many countries, with revenues running at several times past levels, governments can meet all their commitments with less than the capacity already in place. Venezuela is an especially interesting case. During the last decade of private operation, exploration was at a very low level, understandably so in view of the coming nationalization. But

¹Economist, November 25, 1978, p. 11).

the number of new-field exploratory wells in Venezuela fell from ten in 1973, to two per year in 1975-1977. During the first five months of 1978, only one new-field exploratory rig was at work. The reserve base is running down. But the man in the street understandably thinks "I'm all right, Jack" or the Spanish equivalent thereof, and is reluctant to spend money for uncertain prospects of capacity which will not be used for some time to come. Similarly, the vast hydrocarbon accumulation of the Orinoco Belt (three or four trillion barrels in place) is today only a geological fact. As in Canada, years of research and development will be needed to make it into an economic asset. Hence its current reserves must be put to zero.

In Mexico,¹ some geologists' new concepts led to deeper drilling in an old province and tremendous results. Here too the high oil prices produced two contradictory pressures. Mexican believers in the "gap" were at first dominant. Mexico could afford to hold oil far into the 21st century, so that the country never had to "do without." Others argued that the oil and gas were a potential national asset which ought to be made actual. That is now official policy, but the opposing school is still powerful, and there is much opposition to large scale exports.

On the basis of published reports, Mexican fields already found would permit a buildup of proved hydrocarbon reserves (about two thirds liquids, one third gas) to about 45 billion barrels. But time is needed for a vast deployment of men and machines. An estimate, presumably by

¹The following is based on a current research project, and uses only published data.

the CIA, of 4-5 MBD of oil alone by 1980 or 1981, seems much too optimistic.¹ Attainable for 1985 might be about 5 MBD of petroleum liquids plus half as much in equivalent gas, provided the policy of hoarding does not gain the ascendant as the foreign-exchange position improves, and provided also that the United States government refrain from (1) high-level confrontations over the price of natural gas, or (2) condescending "help" which the Mexicans do not need, or (3) scare talk about wells running dry worldwide which, if it has any effect will make them more reluctant to produce, or (4) attempts at "linking" of Mexican exports with everything else that can be dragged in for high-level superfluties.

This quick survey helps us to understand why the worldwide growth in well drilling and completions, and in inflation-adjusted or "real" production expenditures, has been relatively modest since 1973. Incentives for exploration are weak today. Especially since contracts were used for bonfires in 1970-73, a good discovery means that the sovereign landlord will revise the contract unilaterally; non-discovery means dead-weight loss. An oil company needs to calculate the likely return on all ventures taken together. The odds on finding may not have changed recently, but the odds on making a profit, all else being equal, are much less. Thereby the whole world is poorer, because oil and gas that would be found and developed, to the profit of both companies and governments, may remain forever unexploited.

¹New York Times, November 29, 1978, p. D1

Communist exports. For the Soviet Union (and other East European countries) the CIA forecast of large net imports in 1985 is far off base. They cannot pay for large imports, nor need they. Soviet and East European consumption has been notoriously high relative to GNP, because they have no markets to enforce economical use. But dictatorships can squeeze out substantial savings. Coal and nuclear will not be slowed by environmental protests.

Soviet oil, to be sure, has no bright near-term future. It has for years been beset by sharply rising costs. Since the CIA report, production grew at 5.4 percent in 1977, and by 4.5 percent in the first half of 1978: 3.6 percent growth is now planned for 1979.¹ This continuing slowdown holds, as yet, no hint of the impending sharp turndown predicted there.² Furthermore, if Soviet officials expected a downturn, they ought to be preparing domestic and foreign opinion for it, and so far they have not hinted at it.

Soviet gas production will grow at an accelerating rate. It is clear now that the Russians have, over the last 10-20 years, gradually mastered much of the harsh environment of Tyumen Province, to the point where they have made a major start on turning its vast gas resources into reserves. The industry consensus is that total Soviet hydrocarbon

¹Oil & Gas Journal, December 11, 1978. The decrease in planned oil growth is precisely offset by the increase in planned gas growth.

²A recent forecast has Soviet oil production doubling by 1990, and exports to Western Europe of 3.7 MBD in 1985. At least one American oilman has found this credible, Oil & Gas Journal, October 16, 1978. Such numbers are startling, and I am not qualified to appraise them.

exports will more likely grow than diminish.¹

In China, even the years of turmoil did not prevent the rise of oil output from 0.2 to a current 2.0 MBD (and 913,000 bd equivalent in natural gas), and modest exports. In a radical change of course, the new regime is now zealously seeking much more foreign technology and even participation, and large exports of both oil and coal. Meyerhoff and Willums, in their admirable survey, rightly scorn "the wild undocumented claims" comparing China to the Middle East. They estimate that proved reserves can be expanded to support production of 6.6 mbd; but we cannot tell how much new capacity can be put in place by 1985. A responsible estimate for 1985 exports is 800 tbd, of which 600 tbd to Japan. This may be too low; in Japan, the 1987 target is 860 tbd.² Exports in 1990 should be much higher, drawing on fields unknown today and on substitution of local coal and even local manure-to-gas generation for exportable coal and oil.

It is a grievous error to suppose that domestic "needs" will dominate Soviet or Chinese oil use, leaving a "surplus" for exports. This ignores comparative cost and benefit. Oil or gas exports at current prices allow imports of goods and of technology which can do a lot more for the economy than reserving an "adequate" amount for home use. On

¹Oil & Gas Journal, May 28 and September 18, 1978.

²A.A. Meyerhoff and Jan-Olaf Willums, "Petroleum Geology and Industry of the People's Republic of China, U.N. ESCAP, CCOP Technical Bulletin, vol. 10, 1976, pp. 103-312; Jayson Mugar, in New York Times, May 6, 1978, p. 29; Economist (London), February 18, 1978, p. 85; September 23, 1978, p. 95; Oil & Gas Journal, October 2, 1978, p. 72; Minister of International Trade and Industry Komito, quoted in Tokyo Shimbun, September 10, 1978.

balance, the odds are for larger Communist exports in 1985 than in 1977, but the percentage of NCW supply will remain modest, probably near today's 3 percent.

Questioning the consensus. The CIA report is the extreme statement of a consensus view: there is over-capacity today, but soon it will turn into shortage, and then the price will rise. The date of the crossover, where "demand" exceeds "supply," is officially 1983.¹ Unofficially, it has kept sliding toward 1990, or past it. But that is only a detail compared to agreement on a basic major premise: if excess capacity continues, prices will be stable; if not, they will rise.

This consensus does not agree with history. In 1970-73, through alternating surplus and tightness, government take at the Persian Gulf went from 90 cents to \$3. In December 1973 the Persian Gulf governments issued their communique explaining why they thought \$7 per barrel was a reasonable take.² By November 1974 that figure was above \$10. Yet excess producing capacity in 1974 was almost as great as it has been in early 1978. Since then, there has been excess capacity and more price increases. This would be impossible in a competitive market; we need to look closely at the monopoly which rules oil today.

¹Secretary Schlesinger, testimony, March 1978.

²Petroleum Intelligence Weekly, December 31, 1973.

III. THE MULTI-GOVERNMENT OIL CARTEL¹

Much of the voluminous discussion about oil supply in the 1980's has recognized that there is no physical or economic barrier to producing all that would be demanded at current prices, and more. The limits to supply are instead in the policies of the producing nations. So far so good, but the discussion tails off into vague allusions to "needs" for revenue, which may not coincide with the "needs" of the consuming nations.

We can make a fresh start from two basic premises. First, the producing nations will produce and sell the amount that best suits their interests. Second, these nations know that in union there is strength, and will act together as far as they can. If so, they are a collective monopoly, or cartel.

Political objectives irrelevant. We assume nothing about the political or other objectives of the OPEC nations. But money serves every conceivable economic or political objective: growth, consumption, investment, armaments, influence, gaining friends and putting down enemies, or whatever. The real problem is how to manage the wealth. But even more important and difficult (or insoluble) is: how to find the way toward maximum wealth.

¹The following draws extensively on two published articles: "The World Oil Cartel: Scarcity, Economics and Politics," in Quarterly Review of Economics & Business, vol. 16, Summer 1976; and "Constraints on the World Oil Monopoly Price," Resources & Energy, vol. 1, 1978.

In search of optimum price. Given the actual (and prospective) state of knowledge, I do not believe anyone can tell what price would be the most profitable, over the short or long run, for the OPEC nations. I do share the consensus that higher-than-current prices would mean higher revenues, i.e., that demand is still in the inelastic range. Why, then, don't these nations forthwith put the price up toward the optimum, where demand is unit-elastic? (Past that point, where a one percent price rise would mean a one percent loss of sales, further increases would mean lower revenues.) Do they fear to raise prices because of excess capacity?

Two types of excess capacity. It is important to distinguish two types of excess capacity. Day in day out, during the first half of 1978, 2 to 3 million barrels daily (MBD) were offered, in excess of purchases. This current surplus put pressure on prices, which OPEC solidarity must resist. Another 7 to 8 MBD could be produced. But fortunately for the cartel, this reserve surplus is in the strong hands of the largest and wealthiest producers. Saudi Arabia is now expanding capacity from near 12 to about 16 MBD,¹ possibly less if demand remains sluggish. Despite oversupply, expansion makes sense. It is a warning that if anyone starts a price war, the Saudis will finish it. Nor is it a bad investment; since the cost is so low.

So long as it is mostly in strong hands, excess capacity is no barrier to raising price toward the point of maximum revenue. Yet from late 1974 to mid-1977, the OPEC nations raised their take only a trifle

¹Petroleum Economist, August 1978; Oil & Gas Journal, June 26, 1978.

faster than world inflation.¹ Since September 1977, they have been confronted by an unexpected deterioration of the dollar, of nearly 10 percent (weighted by this country's trading partners), on top of general inflation. This was an accident, and will be redeemed. Far more important, how does one explain the 1974-77 stability in real price? There is only one new factor to explain the change: the world recession-stagnation.

Macro-economic effects. If we were talking about coffee or bauxite or copper, etc., the producers would go forthwith to their best guess at the monopoly price, recession or no recession. But oil is so large a part of the total flow of world payments that large increases in the price have disruptive and dangerous effects on the whole world monetary and trading system. Higher oil prices in 1974 were great for sellers, even with recession. Still-higher prices, and a sharper recession, would not be better. When and as the world economy improves, there will be a succession of price increases, none of them steep, but in the aggregate large.

But there will be smaller increases even if the world economy remains sluggish. This is because the current-account surplus of the OPEC nations, which tends to make the world banking and monetary system unstable and recession-prone, has shrunk from about \$65 billion in 1974

¹Morgan Guaranty Trust Co., World Financial Markets, February 1978. The Economic Research Institute for the Middle East (Tokyo) calculates that in terms of export prices of manufactured goods, denominated in dollars, real government take per barrel of "marker crude" peaked in the fourth quarter of 1975, declining 9 percent by the fourth quarter of 1977. Middle East Economic Survey, September 25, 1978.

to around \$15 billion this year.¹ The OPEC nations have spent much more of their income than anyone anticipated.² The more they spend, and the less foreign exchange they accumulate, the less vulnerable is the world financial system, and the more free should the OPEC nations feel to raise prices again. Then the world must sweat out another period of waiting for surplus accumulation to moderate, then a fresh price increase and so on indefinitely, step by cautious step.

Saudi Arabia, cartel backstop, and the need for cartel agreement.

There is another reason why the OPEC nations will want to be gradual and moderate. It is a valuable backstop to the cartel, that Saudi Arabia and its neighbors (Kuwait, United Arab Emirates) can if need be retrench deeply and carry the burden of excess capacity while letting others produce all-out. But they would rather not.

Suppose that Saudi Arabia agreed to let everyone else produce all-out, and to restrict their output as much as necessary. Then further price increases would restrain only their production. Others would benefit by the price rise, they would bear the burden. Suppose the "dominant group" of Saudi Arabia and the southern Gulf states account for half of OPEC output, and they are willing to cut back output as needed. Suppose also that the long-run elasticity of demand is in the

¹For 1974-77, Morgan Guaranty Trust Co., World Financial Markets, February 1978. For first-half 1978, the Bank of England Quarterly estimates it at \$6.4 billion; the figure in the text is a rough guess for the whole year.

²With the possible exception of Theodore H. Moran, Oil Prices and the Future of OPEC, (Resources for the Future, 1978).

neighborhood of -0.5, i.e., a proposed gradual 50 percent price increase would lose only 18 percent of sales. The price rise would pay the others handsomely, but the dominant group not at all:

	<u>Before Price Rise</u>			<u>After Price Rise</u>		
	<u>Dominant Group</u>	<u>Others</u>	<u>Total</u>	<u>Dominant Group</u>	<u>Others</u>	<u>Total</u>
Sales volume	50	50	100	32	50	82
Price per unit	1	1	1	1.5	1.5	1.5
Revenue	50	50	100	47	75	122

Unless there can be some arrangement to let everybody benefit from price increases, then make everybody share the burden of restricted output, there will be no price increases. The Saudis can and will veto any price increase from which they do not gain. The cartel is much better off patching up some kind of deal or understanding, rough and temporary, to let everybody share.

The fear of excessive loss of sales is amplified by the great uncertainty about demand. Suppose the industry is geared to 1985 non-Communist output around 60 million barrels daily, and it appears to be approaching a lower figure, say one million barrels daily less. That is well within the normal range of uncertainty. But if Saudi Arabia is down to somewhere near the amount it can tolerate, a one MBD reduction is not to be suffered.

Along the ad hoc trail: three problems. A formal scheme for OPEC allocation or market sharing would be a dangerous divisive exercise every month or quarter, with special meetings added. Hence the OPEC nations

must ad hoc their way from one temporary accomodation to another, knowing that what suits everyone today will gall some partners tomorrow. It is an additional reason for OPEC to go slowly in raising prices, one step at a time.

Price fixing without allocation has made for some sharp fluctuations in the governments' market shares. The overpublicized squabble over the "two-tier" system in early 1977 was only one incident in a continuing problem. The relative values of various crude oils keep changing incessantly because markets change. Hence, without a system of prompt corresponding adjustments in oil prices, refiners move from one supplier government to another in search of a better deal. The refining is done mostly by producing companies. Time was when the producing margins were wide enough to absorb lower realizations from some countries without pushing them into greater production in other countries. No longer: their margins are now around 21 cents (Saudi Arabia) or 15 cents (Kuwait).

The multi-national companies are therefore, slowly becoming oil buyers. They are still committed to large offtake of most world oil supply, and are held in place largely by the savings of a large continuous flow from production to ultimate sale. (These savings are usually misnamed "access," that same irrelevant slogan.) Hence the companies will not move freely from one supplying government to another, in response to small changes in price. Yet they will move slowly, within limits. For example, there is a current oversupply of light crudes. North Sea production, where company margins are measured in dollars not cents, is maximized at the expense of output in OPEC countries. This destabilizes the price structure.

Thus the cartel nations have three problems which must be solved simultaneously: (1) crude oil price differentials, (2) company producing margins, and (3) governments' market shares. Much thought and computer time has been lavished on them, in vain. But the cartel has managed to live with them, and probably will continue to.

At the end of 1976, for example, Saudi Arabia undercut the others by increasing prices only 5 percent, thereby gaining sales and preference as a possible future price laggard. In mid-1977, they matched the general increase, and came out ahead of everybody else on the price change. There will be many such incidents, each one unpredictable, in the unceasing jockeying for position.

THREE LEGENDS ABOUT SAUDI ARABIA

(1) Saudi Arabia has tried to restrain prices. Nobody alleges this for the period before the end of 1973. During 1974, the public record shows that the Saudis were repeatedly the price leaders upward, the Iranian "hawks" being glad to follow.¹ When, as seen above, it was not good business to raise "real" prices, they remained stable.

(2) Saudi Arabia would rather conserve its oil for future use. "Oil in the ground is worth more than money in the bank." If that were really true, nobody would produce any oil. Then the price would rise immediately, to where oil would be worth producing. So the statement cannot ever be true.

¹Petroleum Intelligence Weekly, December 31, 1973; and March 11, June 17, November 11, and November 25, 1974.

Saudi production of 8.5 MBD (the supposed "ceiling" which so frightens American officials) is about 3 percent of proved reserves, 2 percent of proved-plus-probable, not to mention fields discovered but not evaluated, and prospects identified but not explored. If the Saudis hold to that 8.5 MBD ceiling, a barrel not produced today cannot be produced before 2025 A.D.--or probably much later.

Considering the economic, technological, and political risks, 10 percent is not an excessive discount rate for future oil revenues, and at 10 percent, \$12 from a barrel of oil sold today is better than \$1,200 from a sale in 2025 A.D. Saudi Arabia restrains output today to maintain the price today--a good reason, and the only one which makes sense.

(3) Saudi Arabia would be better off producing less oil, but it produces at current rates to help the world economy. The claim that Saudi Arabia is in business for the public good, for sweet charity, is so extraordinary that it should be supported by extraordinarily strong evidence. None is offered, except endless repetition. In fact, since 1973, while OPEC production has been static, Saudi production has actually increased. Other nations would have been delighted if the Saudis had cut back output, at least moderately, and so lessened the burden of undesired wealth, which is being thrust upon them--they say. In fact, they continue to demand that Aramco lift a minimum amount or pay "heavy penalties."¹ The service contract would have been signed long ago had the Saudis given up that demand.

¹P.I.W., October 16, 1978; and see September 17, 1977.

IV. THE MIDDLE EAST IN THE FUTURE WORLD OIL MARKET

Earlier, we saw why no great surge of OPEC output is to be expected, even at constant prices, since slow growth in non-OPEC production will cut into a very slow-growing market.

Middle East output will expand to whatever the chief cartel nations decide to sell. As we saw earlier (p. 16), providing reserves is no problem. But it costs money to provide them. Given the slow-growing demand, it is doubtful that reserves need be much increased.

Feedback of oil price increases on economic growth. However, we cannot tell whether the growth of Middle East exports will go smoothly or not, because the world economy will continue somewhat shaky. Faced by chronic balance-of-payments deficits, and the inflationary impulse given by higher oil prices, the big consuming countries tend to deflate their economies, push exports and restrict imports.

It is uncomfortable to recall the consensus among economists, that the 1929 recession was so persistently mishandled by monetary contraction and blockages to world trade, that the dominoes kept falling, and there was an unprecedented disaster.

I do not expect anything comparable. But we have not yet emerged from a miniature replica of the stagnation of the 1930s. We must fear a continued dragging of the world economy as the nations adapt badly to the strain on the world monetary system imposed by past and future oil price increases. Good macro-economic management, not a mythical energy or oil shortage, is the policy problem. Not for the first time, I must admit to

sympathy with the complaint of the OPEC nations that we ought not to blame them for what we are doing to ourselves.

Cartel prospects. It is often said that by the middle 1980s (or later) oil will be so scarce that the cartel will be obsolete. This is simply wrong. No matter how scarce anything is, i.e., no matter what its price in a free market, it always pays to monopolize it and raise the price. But the cartel appears to be strong.

The larger cartelists around the Persian Gulf can easily control output by force. Iran can limit shipments through the Straits of Hormuz. Saudi Arabia can occupy close neighbors with current capacity of 6.6 MBD (Kuwait, Qatar, and the U.A.E.). Distances are short, local populations scanty, the terrain ideal for a quick grab if the smaller Gulf producers do not do as they are told. The small necessary supply of conventional arms is already in place.

For this reason, not even a sharp increase of non-OPEC production, nor the most radical conservation, will break the cartel, nor tend to lower world oil prices. At most, they would moderate the rate of oil price increases.

The greater the accumulated wealth of the cartel nations, the less the pressure on any of them to reduce prices to obtain more revenues, also the easier for them to reduce output, perhaps setting off another buying panic, to scare the consumers properly when raising prices. The contrast is dramatic with the copper-producing nations, whose organization (CIPEC) has been quite ineffective. The need of CIPEC

nations for revenue forces them to compete for more sales and hence forces down the price of copper.

Therefore, the cartel's prospects look good, and "real" prices should increase, but the amount is very uncertain. Earlier, we saw that if the smaller cartelists could not be prevented from increasing output to the limit, the larger producers could hold all the excess capacity, but it would not pay them to raise prices as much.

Two dangers to the cartel. Consumer-country taxation of oil products can divert into their own treasuries the sums now going to the OPEC producers.¹ The OPEC nations have long known that the more of what can be extracted from consumers is kept at home, the less is left for them.² Consumer countries may do inadvertently what they would never do deliberately, and year after year raise oil product taxes or levy import tariffs, in an effort to check consumption and imports.

Another danger to the cartel is that the United States, acting alone, could divert large sums from them into our Treasury. We could put import entitlements up for monthly auction by sealed bids, with no limitation on resale and transfer of tickets. Some 200 million tickets, worth nearly \$2-1/2 billion, would be up for grabs month after month.

Cheating by OPEC nations to get more sales would be easy. Tickets could be bought anonymously through front men. A cartel country would

¹For a brief explanation, see Petroleum Economist, September 1977; a formal proof is in "Constraints on the World Monopoly Price," op. cit.

²See, for example, the statement of the Secretary General of OPEC, in Petroleum Intelligence Weekly, May 16, 1977.

sell at the current price, and not even the customers would know the seller was rebating to the U.S. Treasury through buying tickets. Any country needing extra revenues would buy more tickets to sell more barrels, and any country which lost business could recoup itself by buying tickets, jostling other cartelists. Fear of loss would probably be more powerful than hope of gain, for some OPEC nations sell this country a third or more of total sales: Libya (31), Indonesia (36), Venezuela (45), Nigeria (49), Algeria (60).¹ Even with no excess capacity, they have an immediate decision: either they buy tickets or dump on the world market, breaking prices there.

With no interference in industry logistics, and with a handful of employees administering the auction, the United States would pocket substantial revenues. The quota auction would only fail if each and every cartel nation would resist temptation indefinitely, month after month. Only one nation need defect to get the process started.

The Economic Task Force of the then President-elect Carter recommended such a plan.² It has not been heard of since. When it was explained to Secretary Schlesinger, he said: "It would work. But do we

¹Exports to the United States are as reported by D.O.E. Two-thirds of U.S. products imported from the Netherland Antilles are assumed to be from Venezuelan crude, as in 1976, the latest year of available data. Total exports are reckoned as production in the first half of 1978, minus the proportion of domestic consumption to production in 1976, again the most recent year available. The ratio of domestic consumption was probably higher this year.

²Oil & Gas Journal, January 10, 1977.

dare let it work?"¹ The answer is of course No, but the option is there.

Either a tariff or a quota auction would divorce the internal price level of the consuming countries from the world price level. Higher internal prices may be desirable, to reduce pollution and congestion, and encourage the development of new energy sources. But high prices paid to Middle East countries are an unmitigated economic burden. Moreover, the higher the price, the less the security of supply, and the greater the political dangers.

The "price crunch" of 1983 or 1988 or 199X or Official policy statements today de-emphasize the "gap," which "of course" cannot happen in the real world. If so, then "access" and "availability" and the "special relationship" are also unreal.

The perceived danger now is that the current OPEC surplus will soon dwindle and disappear. Then the price rise will be sudden, steep, and disorderly, with nations frantically bidding and elbowing each other out of the way. But this assumes that a certain predetermined maximum amount will be available from OPEC producers. In fact, OPEC looks at the residual demand for its oil (Table I line 5), and makes its decisions accordingly. They will engineer a gradual price rise or a price crunch, as they think best.

¹ Quoted in New Republic, May 21, 1977. Some other parts of the meeting are not accurately reported, to my recollection. See Washington Post, July 10, 1977.

The forthcoming price increases will probably be gradual and moderate. First, the cartel nations need to adapt to uncertain demand and difficult market sharing. It is only sensible to go ahead slowly, testing the markets. Second, it would pay some high cost non-OPEC and OPEC producers to begin postponing new capacity, and it would pay some actually to shut in, years before any price rise.¹ It would take very little of such postponement or cutbacks to wipe out a dwindling current surplus (p. 25) and get the price started rising. For both buyers and sellers it makes sense to make new contracts at higher prices, smoothing out the price increase.

The third reason to expect only moderate price increases is large excess capacity in a few dominant countries. It would be bad for OPEC generally and Saudi Arabia particularly to set off a world economic and political crisis by forcing oil price to gyrate wildly upward while they sit on their capacity. They are large holders of assets in the consuming countries. They had better not try consumer patience too severely. And they can extract economic or non-economic payment for their goodwill.

But--it would not be the first time that an avoidable misfortune, which everyone wanted to avoid, arrived anyway because of mismanagement or everyone waiting on everyone else. The excess producing capacity may not be matched by surface installations, or loading facilities, and it may take months or years to provide them. Given an upward bump in consumption, inventory building, a dollop of panic, and we have a crisis. The cartel mechanism may be wound too tight.

¹See "World Supply and Demand", Appendix 2, for a discussion.

Lessons from Iran (as of December 1, 1978). The lowered production wiped out the current surplus (p. 25), and spot prices rose by roughly 10-15 percent. Reflecting the general belief that Iranian production would be restored before too long, there was only a minor impact, in mid-November, on dealings for the first quarter of 1979.¹

To a limited extent, reserve surplus was made available. Saudi Arabian production increased to about 10 million barrels daily. But when Aramco asked for permission to increase output further, the Saudi government refused.² This was not a reckless act. It was cartel management. If the Saudis and neighbors took off the lid altogether, it might bring back the current surplus and put prices back under pressure. To hold tightly to the ceiling might make the price jump. This fine-tuning will be needed every time there is an unexpected market development. In any given emergency, the odds are in favor of orderly matching of output with demand to keep the price stable and avoid a crisis. The odds on avoiding a crisis every single time during the next decade are not so good. Cartel supply is inherently insecure.

¹P.I.W., November 13, 1978; marketers expected "small premiums" for lighter grades.

²Wall Street Journal, November 13, 1978, p. 4.

V. OPTIONS FOR UNITED STATES POLICY TOWARD THE MIDDLE EAST OIL PRODUCERS

Middle East oil exports to the United States in the 1980s will be lower than today, although total American imports will grow. But Middle East exports in the world market will probably be higher, and hence, U.S. exports to Middle East nations will continue to grow, strengthening their support in this country. The Middle East nations will decide world price and output.

If we rule out the option of using our buying power to weaken the cartel, there is nothing the United States can do to influence these price-output decisions. "Dialogue" and "cooperation" and "exchange of views" waste time and prevent thinking.

Most of these regimes, most notably Saudi Arabia, cannot do without our military protection, but this gives us no bargaining power because we must protect them for our own sake. We could stop selling them arms, or stop the Corps of Engineers and American companies from doing big construction projects, but they can absorb the economic cost of changing suppliers. To forbid or limit their investment in the United States would be not only offensively discriminatory, but also only a minor economic irritant. The industrial nations are not united to control supplies of food or industrial products, hence cannot withhold supply nor raise price. (Nor, in my opinion, should they try.)

We have no carrots any more than we have sticks. Assistance with Middle East economic development is simply payment in kind instead of money--awkward and wasteful as any other kind of barter.

As for political goodwill: when a policy maker says that the world oil shortage began in June 1967, he is simply uninformed. Peace in the Middle East, devoutly to be wished, promises nothing for oil supply or price. In fact, the overflowing revenues of some oil producers have complicated peacemaking. The Saudis and neighbors have "agreed to contribute to a \$3.5 billion kitty to finance Arab opponents of the Camp David agreements...because, they contend, the U.S. sold out Arab interests at Camp David." Mr. Sadat was incensed by the betrayal, as he saw it;¹ but he who pays the piper calls the tune.

Whatever we do to please the oil producing governments is useless because there is no way to insure that they do anything in return. Any agreement we made with these nations on oil would be void for vagueness and redundancy. A promise to produce "enough oil for our needs" is senseless because there will always be enough--at their price. An agreement that actually named prices and outputs would be far out of line with economic realities because we cannot predict supply and demand.

Most important of all, an agreement can only be enforced by competition or law or both. If anyone persistently violates his word, people will go elsewhere, and after a while he is out of business. Or a court will order him to perform or go to jail, or lose his assets. But the oil monopoly has suppressed competition, and sovereign states are beyond any law. Any agreement is truly "inoperative." The record of our currying favor with oil producing nations proves it.

¹Wall Street Journal; December 14, 1978, p. 14. New York Times, November 21, 1978, p. A11.

The record on agreements and understandings. When the Libyans opened Pandora's box in 1970, the United States government insisted on giving them what they wanted. The then managing director of Royal Dutch/Shell has stated that this insistence was never explained to him. It has never been explained to anyone else. But the apparent aim, to insure the goodwill of Saudi Arabia and other producers has been the great obsession of American policy makers. Our State Department claimed credit for the Tehran agreement of February 1971, effective for five years. It lasted about five months, and after repeated violations, it was finally repudiated by the Saudis in September 1973, before the Middle East war.¹

The Saudi boycott of the United States in 1973 was a violation of their treaty of commerce, which the Nixon administration covered up, along with the withholding of Saudi oil from the United States Navy. The then ambassador to Saudi Arabia urged American citizens to pressure our government into acceding to Saudi demands, and he warned publicly that fuel oil would be critically short at the U.S. East Coast in a matter of days if the boycott continued. This wild misstatement was likely to panic uninformed citizens who knew only that lack of fuel oil meant lack

¹Multinational Corporations and American Foreign Policy. Hearings before the Subcommittee on Multinational Corporations of the Committee on Foreign Relations, U.S. Senate, 92d Congress, 2d Sess. On Libya, see vol. 5, p. 6; vol. 8, pp. 771, 773 (1975). (Hereafter cited as Church Hearings.) See also M.A. Adelman, The World Petroleum Market, op. cit., Ch. VIII; Anthony Sampson, The Seven Sisters (1975), pp. 211-215. See also "A Diplomatic Situation Where Oil and Hauteur Just Didn't Mix," Washington Post, March 14, 1976, and "How OPEC Came To Power," Forbes, April 15, 1976. Platt's Oilgram News Service, February 18, 1971. Middle East Economic Survey, September 7, 1973.

of electric power and loss of jobs.¹

In June 1974, two days after our government signed an executive agreement for Saudi-American economic cooperation, the price was raised, retroactively, by \$1.35. On at least two later occasions, the Secretary of State said he had assurances of lower prices; both times the price went up.² The Saudis were the price leaders upward (above, p.). In mid-1974, they announced an auction to bring down prices, were praised widely, and then cancelled the auction. Our government believed that OPEC would lower prices "because it was under the thumb of the Saudis and the Saudis believed in lower prices. Sadly...prices still went up." Soon thereafter, in October 1974, another promise: they would not permit output to be reduced. By March 1975, disappointed American officials were complaining that the Saudis had "pulled the rug from under them" by allowing reduced production.³

This record of broken promises proves not any original sin or Saudi bad character but only that we cannot hold a sovereign monopolist to his word.

OPEC is good for you. Our government ignores the past, and we are condemned to repeat it. In 1972 the State Department called for \$10 oil-about \$14.25 in 1978 dollars.⁴ Today: "Huge Oil Price Rise Benefited U.S." One of the chief alleged benefits, incidentally, was a stronger

¹Church Hearings, vol. 5, p. 6; New York Times, Nov. 10, 1973

²New York Times, June 9, 10, 11, 1974; New York Times, October 13, 1974; Oil & Gas Journal, October 21 and December 23, 1974.

³Economist, August 23, 1975, p. 63; Oil & Gas Journal, March 17, 1975.

⁴New York Times, April 16, 1972.

dollar. Since the Administration says it wants higher oil prices, it is logical to have "unprecedented closeness in the Middle East."¹

It is equally logical to "caution that the United States cannot shift to Mexican oil so fast that it disrupts carefully nurtured relationships in the Middle East."² Why we should slow down imports from Mexico deserves a little reflection and discussion.

Despite this "unprecedented closeness"--or maybe because of it--the disturbances in Iran caught the U.S. government by surprise, like the 1969 revolution in Libya, and others past and future. (In a forthcoming publication, Professor Robert B. Stobaugh quotes "an experienced Saudi watcher...with years of exposure to different strata of Saudis, including the highest levels of the royal family": "'I judge the Government's chance of survival for a half dozen years to be quite good and for a dozen years, fairly good. But there could be a successful revolution this evening.'")

We have been quite unable to influence events in Iran, as in Libya, Saudi Arabia, or elsewhere. Moreover, no Middle East producer government is democratic. Opposing interests and opinions can only be settled by force. Therefore "closeness" with any government merely makes us the enemy of those out of power.

¹ Washington Post, July 10, 1977; "A Hard Choice: More Recession--or More Expensive Oil," by James Cook, Forbes, March 20, 1978; "A Primer on International Energy Policy," The Energy Daily, April 3, 1978.

² New York Times, November 29, 1978, p. D1.

VI. CONCLUSIONS

In some obvious sense, the United States and the Middle East are "interdependent," though the word, as usual, means different things to different people. But there is nothing we can do (unless we deliberately undermine the cartel) to influence the price and supply of Middle East oil. Lower imports will simply mean lower Middle East output to maintain the price. The richer the producing nations become, the easier for them to reduce output; hence the greater the insecurity of supply.

We can, however, do much to improve the atmosphere in which both oil policy and macro-economic policy is formed, in this country and elsewhere. (1) Avoid protectionism, and don't deflate the economy to reduce oil imports. (2) Repudiate the scare talk, which grows increasingly farfetched, of shortages and gaps and the wells drying up. (3) Avoid sermons or entreaties to OPEC on how they owe us enough oil at a not-too-high price, as well as the bluff and bluster that made us so ridiculous in 1974. (4) Admit that there is not now and never was any Saudi-American special relationship. Our friends in Europe and Asia will at first probably view this avowal as a Yankee trick, to avoid a fair sharing of the "special relationship." The easy way would be to sell them shares of the Emperor's new clothes. But, long term, honesty is the best policy.

* * *

In 81 B.C., some Chinese scholars were permitted to argue to an imperial Lord Grand Secretary that the government salt and iron monopolies should be abolished. The gist of a lengthy dialogue:

The Scholars: We have set forth the difference between peace and danger, profit and harm...

The Lord Grand Secretary:...Poverty-stricken bumpkins and their stupid wives know nothing of the cares of statecraft.¹

Not much has changed in 2060 years.

¹Esson M. Gale, ed., Discourses on Salt and Iron: a Debate on State Control of Commerce and Industry in Ancient China (reprinted 1973), pp. xix, 37.

The enclosed paper was solicited by the Congressional Research Service in the Summer of 1978 for a compendium volume to be published in 1979. A draft was delivered in November, and the present (final) report shortly thereafter. After several un-returned telephone calls, I was told in June 1979 that the paper would be excluded from the compendium because C.R.S. had been unable to obtain a balancing or opposing view. It is a flattering suggestion, that nobody can be found to state an opposing view. Perhaps however, Congress and the public should be allowed to make up their minds. At any rate, it is sent to you for what interest it may have.