Case Study

OPEC: AN INTERNATIONAL CARTEL

Before 1973 very few Americans had heard of OPEC (the Organization of Petroleum Exporting Countries) though it had been formed a decade earlier during the 1960s. Its goal was to organize an effective oil monopoly and reduce or eliminate competition in the marketplace. OPEC efforts to "corner the market" in oil had been largely unsuccessful prior to 1973 due primarily to the nature of a cartel. To be effective in eliminating competition, a cartel like OPEC must 1) control the bulk of the market, 2) members of the cartel must reduce their own nation's production, and 3) members must not produce more than the agreed amount/or sell their oil below the price fixed by the cartel.

OPEC nations were able to fulfill the first criterion for success since the bulk of the world's crude oil was controlled by its member nations. However, the temptation not to reduce production and instead overproduce and sell their oil below the fixed price was too great for some OPEC nations. As a result, OPEC's policy was not successful.

In 1973, however, the Yom Kippur War erupted between Arab nations and Israel. This conflict helped unite the Arab nations and created a determination among OPEC nations to renew their efforts to control world oil production and prices. This new OPEC unity resolve allowed the cartel to nearly triple the price of oil after 1973. Only in recent years, since the mid-1980s has OPEC begun to lose its grip on the world oil market. Why? What happened?

Economists generally agreed that three of the factors that can cause a collapse of a cartel are: (1) the increased availability of substitute products (2) decreased demand for the cartels' product, and (3) increased production of the product by nonmembers. Although many economists believed that one or more of these factors would cause the OPEC cartel to collapse after the 1973 Yom Kippur War, OPEC held firm. And it was aided by the inability of the United States and other nations to establish a policy to create alternate energy sources and/or develop and encourage other oil sources. As a result, OPEC in the 1970s and early 1980s steadily increased the price of oil. Between 1979 and 1980, following more political turmoil in the Middle East, OPEC prices soared from $12 a barrel to $36 a barrel. This sharp price hike fueled inflation in the United States and many other nations. It also created a massive conservation effort and switch to alternate fuels, leading to reduced oil consumption, a worldwide oil glut, and eventually a cutback in production by the OPEC nations. The result of the collapse in OPEC oil prices to less than $15 a barrel by 1987 has been felt worldwide.

Today OPEC is attempting to regain some of its solidarity. Saudi Arabia has been urging member nations to re-establish price stability. Its goal of "stability" is a price of $20 a barrel by 1992, then an increase to $25 a barrel, with nearly a 50 percent expansion in OPEC exports above 1986 levels. Worldwide reaction to the latest OPEC efforts to stabilize prices at these levels per barrel amount has been negative. Most economists believe that world consumers of oil will be able to conserve and use oil and other energy sources more efficiently. Nations might be best served by simply bypassing OPEC's "stability" pitches and going with free market price determination.

1. Explain how OPEC was able to control world prices for oil. _____

2. How has the OPEC cartel affected the United States economy? _____