

Research Department
Federal Reserve
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San Francisco

January 7, 1977

Five-Percent Solution

The OPEC nations imposed another price increase last week-end—which is not exactly news, especially in view of the fact that the price of oil at the Persian/Arabian Gulf had already increased eight-fold since the beginning of the decade. What is news is that the cartel split over the size of the increase, with two nations refusing to go along with the plans of the other members to raise prices by 10 percent now and by 5 percent more at midyear. Instead, Saudia Arabia (along with the United Arab Emirates) posted only a 5-percent increase, and suggested that it might try to enforce its price decision by raising its production ceiling, which is now 3.3 million barrels/day below full capacity of 11.8 million barrels/day. Since Saudi Arabia accounts for almost one-third of OPEC's total capacity, its 5-percent solution carries considerable weight in the world's oil market.

On the sidelines stood the Western oil-consuming nations, waiting to see how much strain this latest price increase would place on their still-fragile recovery from the 1973-75 recession—a recession brought about in part by the OPEC-caused 1973-74 oil crisis. They might gain some insight into the market's future behavior if they studied the background to that historical turning-point, as described in a number of recent studies, notably the analysis by Harvard University's

Raymond Vernon in the Fall 1975 issue of *Daedalus*.

The crisis was signaled by the emergence of a group of unindustrialized oil-producing countries with both the aspirations and the power to control the international oil market. Their bid for power could perhaps have been foreseen in Mexico's nationalization of foreign-owned oil companies in 1938, in Venezuela's role in organizing OPEC in 1960 after it had failed to gain preferential access to the U.S. market—and perhaps also in the abortive efforts by the major oil companies to gain some sort of stabilization agreement from the exporting nations in the 1970-71 period. Even so, few observers actually foresaw the sudden cutback in supply and the sharp escalation in price which occurred during the 1973-74 crisis—or the ability of the cartel to make its price decisions stick.

Supply/demand shifts

Yet, the supply and demand conditions which evolved during the period after World War II placed petroleum in a somewhat special category. As people's incomes grew throughout the world, the demand for most sources of energy (coal, hydro, nuclear, oil and gas) grew as well. But demand grew faster for oil than for any of those other sources, primarily because oil was much cheaper to obtain than practically

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anything else. When oil could be produced at 10-20 cents a barrel—as in large parts of the Middle East—no other energy source could come close to competing.

Of course, the sales price of the world's oil reflected much more than low Middle Eastern production costs. Producing countries caused prices to rise by imposing taxes on the oil companies; in the Middle East, these taxes jumped from about 90 cents a barrel in 1969 to about \$10 a barrel in 1974. For a while, importing countries also caused prices to rise by imposing tariffs and import quotas on foreign oil, primarily to protect domestic coal and oil producers. But despite all their efforts, Europe's high-cost coal industry and America's high-cost oil industry gradually lost their position in world markets. The situation didn't register at first on the public mind, especially in view of the U.S. oil industry's ability to bring underused capacity into play during the Suez crisis of 1956 and the Six Day War of 1967.

By the early 1970's, however, the monopoly potential of Middle Eastern oil was heightened by the sharp worldwide increase in demand for energy in general and for oil in particular. Energy demand soared as a massive boom swept the major industrial countries of the world. Petroleum demand soared for that same reason, but also because of various restrictions affecting the energy industry—such as (in the U.S.) delays in developing nuclear

power, price ceilings on natural gas, controls on auto emissions, and delays in exploiting Alaskan and offshore oil sources.

Vulnerable independents

Another key element in the developing crisis was the rise of the "independent" oil companies that stood outside the long-dominant group of major firms—the "Seven Sisters" of Exxon, Gulf, Texaco, Mobil, Socal, British Petroleum and Shell. The independents originally had been compelled to build their refinery and distribution business on the basis of relatively expensive crude oil—oil acquired sometimes from high-cost U.S. sources and sometimes from the majors themselves. But the independents inevitably cast their eyes on the extraordinarily cheap Middle Eastern oil. Eventually they were able to break into that market, beginning (with U.S. government help) with their inclusion in the Iranian oil consortium of 1954.

When entering the Middle Eastern market, each independent had less at stake than any of the majors in safeguarding the existing series of agreements with local governments. Thus, each independent company had little to lose in proposing or accepting an agreement that would cede a larger share of revenue to the host government, so long as Middle Eastern oil remained cheaper than whatever was available from other sources. Yet once

an independent succeeded in establishing a supply of Middle Eastern crude, that source was likely to constitute a larger percentage of its total supply than would have been the case for one of the majors. So whenever foreign oil companies faced a negotiating showdown with a host government, the independents in the group were most vulnerable to the threat of a shutdown in supply—and time and again in the early 1970's, this vulnerability helped the host governments to establish their dominance.

Another major reason for OPEC success was the modernization of the oil-producing countries themselves, along with their increasingly profitable involvement in the world economy. OPEC bargaining strength grew in line with the increase in the number of companies bidding for oil, but also in line with the OPEC countries' own growing capabilities for dealing with the market—for example, their ability to collect and interpret information affecting their bargaining position. Still, the members of the cartel all had their own diverse interests to pursue. Their success in the crisis depended on the willingness of the dominant producer (Saudi Arabia) to curtail its own production, thus creating an umbrella under which all oil suppliers were able to exploit their collective position. Saudi Arabia's production decisions are of course a major factor in today's uncertain pricing picture.

Vulnerable importers

Another element in the 1973-74 crisis was the inability of the oil-importing countries to deal with short supplies and escalating prices in any coherent way. This diversity of reaction created a serious problem for a world that had become increasingly interdependent in the post-World War II period. In Raymond Vernon's words, "With national boundaries open to goods, money, and enterprise, the rich countries were also progressively exposed to crop failures, inflation, depression, and all the competitive drives that any one of them might generate. The international environment had become one giant tuning fork." In that environment, OPEC's blow reverberated around the world.

All of the factors that helped create the oil crisis are (to some degree) still operative, so that we can say the crisis still exists. The rest of the world pays the OPEC nations more than \$125 billion a year for oil, with the U.S. picking up one-fourth of the tab. Costly diversions of capital and labor have been required to build new energy sources at home. The long-term trend toward lower energy costs has been at least temporarily reversed—and this mutation of energy costs has drastically altered the production function of the world's economy, creating the possibility of a prolonged period of reduced economic growth. By those standards, Saudi Arabia's 5-percent solution is only the beginning of a solution.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/22/76	Change from 12/15/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	93,707	+ 448	+ 4,369	+ 4.89
Loans (gross, adjusted)—total	70,315	+ 212	+ 4,345	+ 6.59
Security loans	1,662	- 44	+ 279	+ 20.17
Commercial and industrial	22,981	+ 298	- 468	- 2.00
Real estate	21,415	- 52	+ 1,806	+ 9.21
Consumer instalment	12,108	+ 89	+ 1,539	+ 14.56
U.S. Treasury securities	10,417	+ 439	- 173	- 1.63
Other securities	12,975	- 203	+ 197	+ 1.54
Deposits (less cash items)—total*	93,153	- 619	+ 3,871	+ 4.34
Demand deposits (adjusted)	26,277	- 1,129	+ 2,249	+ 9.36
U.S. Government deposits	375	- 390	+ 16	+ 4.46
Time deposits—total*	64,988	+ 898	+ 1,893	+ 3.00
States and political subdivisions	5,733	+ 347	- 1,638	- 22.22
Savings deposits	30,450	+ 189	+ 8,464	+ 38.50
Other time deposits‡	26,341	+ 208	- 3,531	- 11.82
Large negotiable CD's	10,596	+ 219	- 5,633	- 34.71
Weekly Averages of Daily Figures	Week ended 12/22/76	Week ended 12/15/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	- 45	+ 138	+ 109	
Borrowings	0	7	+ 23	
Net free(+)/Net borrowed (-)	- 45	+ 131	+ 86	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 613	+ 939	+ 1,618	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 165	+ 448	+ 573	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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