

Lecture 4: Markets, Cartels, and Consumers

History of US Interest History Since End of WWII

- US political commitment in Middle East:
 - Soviets left and so did British military force in Middle East in Persian Gulf, US has only had forces on a permanent basis since the gulf war in 1990
- Why the Persian Gulf?
 - OIL (the US needs OIL a lot)
 - Keep Persian Gulf so that oil can flow to US allies and eastern Asia
- Korean War in the 1950's increases demand for oil:
 - Consumes a lot of fuel
 - Japan's demand increases
- Marshall Plan: to pump aid into Western Europe to rebuild it and to stop communist spread into these countries.
- Project Ajax: to encourage the overthrow leader of Iran and keep communism out of Middle East/Persian Gulf.
- US gives aid to Saudi Arabia, Iran, etc.
 - Sell them arms
 - Military training
- US interest: Doesn't want any one country to control the oil supply in the Persian Gulf, no matter what kind of countries/governments they are
 - US wants to play countries off of each other to make sure that no one country gets too much control.

Later 1950's - Enter Eisenhower

- In Egypt, Syria, and Iraq, governments are affiliated with overthrows of the power coups d'etat – Nasser gains power in Egypt.
- In addition to disassociating with less powerful countries, Eisenhower is interested in keeping out the Soviets and setting up allegiances/alliances with the conservative monarchies - royal families.

1954-70 - Enter Period of Arab Cold War

- The other side - the Arab nationalists develop socialists/radical Arab regimes which become very anti-American (partially due to the US-Israel relationship).
- Nasser engaged in a radical radio debate- starts making public announcements with out seeing them through. Nasser pushes himself, through his own rhetoric and actions, into a complicated place

1967 - Six days war- Jordan, Syria, and Egypt

- US view this as a pre-emptive war- places the Israeli/Arab conflict more on the forefront in the region.
- Israeli's win war decisively (taking West Bank, Gaza, Golan Heights)
De-legitimizes Arab nationalism.
- After 1967 "façade" of Arab nationalization falls apart.
- Up until this point the US is still not very physically involved with their military force - British are pretty involved.
- However during WWII- the British took a hard hit they being to retreat from their colonies- India, Ghana, Kenya, etc.
- Eventually it announced that it was pulling out all forces that were located west of the Suez Canal.
 - Who will step up to be the ME police?
 - Saudi Arabia, Iraq, or Iran
 - Probably not the US - distracted by Vietnam
- Nixon Doctrine - pointing out that the US cannot afford any heavier military involvement abroad - no more deploying forces in long term land struggles - no more Vietnams.
- What to do for Persian monarchy? – Idea of twin Pillars - Iran and Saudi Arabia -
 - 1971 - 2500 birthday anniversary - Iran announces that it is ready to step up to be the police man - they buy tons of arms/planes from the US.
- 1978 - Camp David accords - Cold peace deal between Egypt and Israel to determine the possession of the Sinai Peninsula.
- 1978 - Shah of Iran confronted, overthrown – bloodily but quickly. Ayatollah Khomeini kicked out of Iraq (big mistake).
- From France, through video broadcasts becomes the spokesman and later the leader of the Iranian revolution. Highly covered by US media - Nightline with Ted Koppel - Supply shock- Oil price shock.
- 1980 - Iran military was purged, not sure who was in charge of the government - Iraq decides (Saddam) that Iran would be a weak sheep to pick off – especially with the military power they have developed from their oil sales. This kicks off the **Iran – Iraq War** 8 year war.

1980 – Iran/Iraq War

- Neither side wants to give in easily
- People are willing to die to set off minefields, cities hit with missiles
- Soviet Military intervention in Afghanistan:
 - Soviet supported coup d'etat in Afghanistan

Cite as: Flynt Leverett, course materials for 17.906 Reading Seminar in Social Science: The Geopolitics and Geoeconomics of Global Energy, Spring 2007. MIT OpenCourseWare (<http://ocw.mit.edu>), Massachusetts Institute of Technology. Downloaded on [DD Month YYYY].

- The communist parts of Afghanistan are fractured
- Large Soviet ground forces
 - Take out the Afghani leaders and instate Soviet leaders
- Fear that the Soviets won't stop with Afghanistan, either through Pakistan or Iran in order to get more open water ports - something that the Soviets have very little of and which keeps them out of power.
- US begin to plan how they would send forces into Iran incase that the Soviets decide to invade: could potentially come from Azerbaijan, Turkmenistan or Caspian Sea.

Under Carter- January 1980

Carter Doctrine: Rapid deployment - declares that the US is ready to apply US military force into the Middle East region to defend the southern oil fields of Iran. The plan is to stop the soviets in the Zagros Mountains before they reach the oil fields.

- Impressive - not willing to rely on the twin pillars of Iraq, but that we will put US boys on the ground.
- At this point the US has invested in the Middle East

1980's Tanker Wars begin

- Iran decides to take out Iraq's oil
- Supertankers begin to be attacked and blown up/missiles/underwater mines
- Insurance companies are still willing to send ships through the region in order to maintain the supply
- Price of oil actually goes down
- 1988 - Settlement between Iran and Iraq - both countries are pretty much politically/militarily exhausted. Iraq wins this war, but only on a technicality.
- Saddam has oil, not money - wants to sell his oil at a high price so that it can gain the means to re-build. At the same time Qatar and Abu Dhabi are overproducing, which causes OPEC tensions
- Iraq blames Qatar and Abu Dhabi of waging economic war against the Iraqis.
- Kuwaitis are militarily weak but they don't take Saddam's threats seriously. Finally Saddam's forces invade Kuwait and Qatar. Fear is that if Iraq can control the coastal oil fields it may become that controlling superpower that the US wants to avoid.
- US meets with Saudi Arabia - agrees to put forces in Saudi Arabia to protect against invasion Operation Desert Shield, then once they attack it becomes operation desert storm.
- 100 hour war - US attacks and destroys Iraq army in a very short time. Quickly the oil infrastructure is re-built in Kuwait.

1990's

– US Security Policy changes from the 1980's decide to keep both the Iranians and Iraqi's inline – become the policemen of the Persian gulf as opposed to the policy of the 1980's where they just played the Saudi's and Iranians off each other.

- Eventually oil begins to come out of Iraq again, but Iraq was never able to achieve their pre-war levels of oil production and exportation – this causes economic tension.

2001- WTC attack

2001- US invades Afghanistan

2003- US invades Iraq

Down the road

- Depends on how the US-IRAQ situation evolves

IRAN - nuclear issues

- Those are the most likely to influence oil production in the future - we'll see how it plays out.

CARTELS: Theory and Practice

- Difficult to create a cartel with many large producers - It is much easier with an oligopoly because then any action taken by one of the few leaders strongly impacts the situation (prices).

- In the oil market, very high incentive to collude by agreeing to charge a higher price in order to increase everyone's profit - however how high is too high? You want to make more than you would in a competitive market but not price yourself out of the market. The problem with OPEC was that they set it too high.

- They also couldn't get everyone to do what they said they would

- Big incentive for cheating - if everyone is selling at one price and you undercut them, you can make more money

- There are not any institutionalized punishment or moderation mechanisms to make sure that everyone is playing fairly - so guess what? They don't play fairly

- Difficulty setting price - being held accountable for actions - and then you have to allocate and split up who gets to produce how much

- Un-equal political interests: Lybia/Algeria/Iraq looking for large short term profits to ensure re-election or to stall and overthrow. Saudi's are more interested in long term production of oil, not over producing now and then not having it later. There is also concern as to military/political alliances - some are anti-American, some are on the American side

- Early 1980's contraction of demand from US and France and others, for example as cars begin to burn fuel more efficiently. Also some new oil producers pop up, NON OPEC suppliers
- At one point the non-OPEC production has surpassed the OPEC production.
- Iran never really gets on board with the agreement
- On the other hand Saudi's agree to be the swing supplier, they will take supply cuts or increases to balance out the market supply based on the other suppliers
- Saudis get a bad deal
 - Almost all of the countries lie and produce more than their allotted amount
 - Nigeria is especially difficult because they compete with the North Sea suppliers - people cry foul because Nigeria is allowed to produce more based on the North Sea competition
- March 1984 Vienna agreement
- March 1983 London Agreement: to try and fix the Vienna agreement so that it is successful, however it also fails
- Price differential problem based on the different qualities of crude, more cheating occurs
- Saudi's and OPEC get angry and try to send auditors to view the national oil companies' books, which is not allowed.
- What incentive is there to be in OPEC? – to be a part of the decision making process and it is a political lever - you can call in the big guys to protect you and have more weight.
 - If you are not part of it you do get to set your own prices and not spend the whole time bickering and you get to manage your supply as you see fit.
- However at this point Non-OPEC and OPEC begin to have talks and cut deals Recently Sudan, Ecuador, and someone else are looking to join OPEC
- Eventually Saudis and OPEC are not really producing/exporting any oil... By 1985 Saudi's are down to 50% of their potential, burning through money just in operations and maintenance costs.
- Re-start pumping out oil to try to show that they have the power and in hopes of regaining market share. However the other companies match their initiative and it doesn't really work. There is a price fight between OPEC and non-OPEC and within OPEC between Saudi's and the others. Prices slump significantly. Bush Senior goes to Middle East to try to bring the price back up. Consumers are actually considering reasonable prices for oil to be between \$20-30 per barrel which is higher than they would actually have to be.

Late 1980's

- Spot Market: Sharing oil - creating a more unified price – NYSE
 - Then OPEC tries to push this price around and regain their power

Cite as: Flynt Leverett, course materials for 17.906 Reading Seminar in Social Science: The Geopolitics and Geoeconomics of Global Energy, Spring 2007. MIT OpenCourseWare (<http://ocw.mit.edu>), Massachusetts Institute of Technology. Downloaded on [DD Month YYYY].

- Not big oil shock in first gulf war, not during Iran/Iraq war, not during 1990
- 1990: you see high levels of political instability in the Middle East however there is surprisingly little price instability.

Since 2000

- Price/ Demand shoots up
- Production is focused/based out of Middle East again - "Axis of Oil"
- Capacity is reaching the ceiling in a lot of places. Those with larger reserves may be able to achieve the OPEC cartel which has so far not been very successful.