

## Pumping up Price

### The OPEC Cartel

In most countries, collusion is illegal because of its harmful effects on the consumer. Thus, cartels that involve private companies operate secretly. However, there is nothing to stop national governments themselves from colluding. No wonder, therefore, that the best-known example of a cartel is an international one. OPEC, the Organization of Petroleum Exporting Countries, is made up of many of the major oil-producing countries, including Algeria, Gabon, Iran, Saudi Arabia, Iraq, Kuwait, Venezuela, Nigeria, Qatar, the United Arab Emirates, Libya, and Indonesia.

#### OPEC in the 1970s

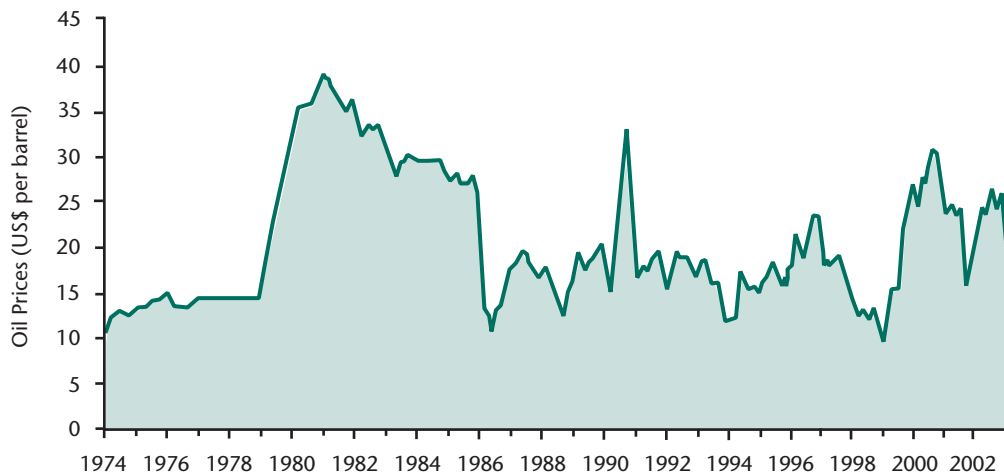
During the 1970s, OPEC members made spectacular gains. Through market-sharing agreements, these countries limited their production, thus driving the world price of oil from under US\$3 per barrel before 1973 to over US\$30 by the end of the 1970s. This famous oil shock had major effects on the world economy. There was a huge outflow of “petro-dollars” from oil-importing to oil-exporting countries. While oil producers benefited, bewildered oil consumers suffered.

OPEC’s success sprang from two main factors. Because the short-run demand for oil is inelastic, OPEC members could cut quantity supplied by a relatively small amount and still significantly raise the world price and their combined revenues. OPEC’s success also hinged on the leadership of Saudi Arabia, by far the largest exporter of oil, whose government preserved the cartel’s power and stabilized price by adjusting its national production levels.

#### OPEC in the 1980s

During the 1980s, OPEC’s influence on world oil prices waned because of three trends. First, the high oil prices of the 1970s had gradually forced consumers to find ways to reduce their oil consumption. In the long run, therefore, the demand curve for oil became elastic, with price changes having a much larger effect on quantity demanded than in the short run. Second, the high prices of the 1970s meant that oil sources previously too expensive to be exploited became profitable. As a result, non-OPEC countries—such as Canada, the United States, and the United Kingdom—tapped these sources, thus raising their production levels and pushing up the total quantity supplied in the oil market. This left OPEC countries with a smaller share of the market. Finally, once oil prices began to fall, some OPEC members responded by secretly selling more oil than they

**Figure A** The World Price of Oil 1973–2002



The price of oil rose from \$3 to \$30 and above during the 1970s and early 1980s. But it then fell back to the \$15–\$20 range, where it remained until the latter part of the 1990s, after which it rose to close to \$30.

Source: “The World Price of Oil 1973–2002” adapted in part from the Statistics Canada publication “Historical Statistics of Canada, Second Edition,” 1983, Catalogue 11-516, July 1999.

were allowed to supply under the joint agreement.

The temptation to cheat is a potential hazard for all cartels. By producing extra output, a member can raise its own revenues. Sooner or later, however, cheating within a cartel becomes common knowledge. Once this happens, it is likely

that the cartel will fall apart as all members disregard the agreement by selling more. Price is then driven back down to its value before the cartel was formed. As OPEC's experience shows, cartels are often only temporarily successful in raising price and profits for the producers involved.

1. Non-OPEC countries supply over half of the international demand for oil, even though they have a much smaller proportion of the world's proven reserves. Explain what effect this imbalance could have on future oil prices.
2. (Policy Discussion Question)
  - a. Summarize OPEC's argument concerning oil prices, as outlined in its article "What causes high oil prices?" (at <http://www.opec.org> and link to "News and Info" and "FAQs").
  - b. Is the argument outlined in the article convincing?
  - c. When considering interests of citizens of an oil-consuming country, there is an important difference between a rise in oil prices due to higher taxes and a rise due to OPEC's price-fixing. What is it?
  - d. What arguments can be made in favour of oil taxation?



<http://www.opec.org> and link to "News and Info".