

The OPEC Summit in Caracas:

A Testing Time for Oil

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Brief Analysis

Does this week's summit of the Organization of Petroleum Exporting Countries (OPEC) in the Venezuelan capital, Caracas, mark the return of OPEC as a force in world politics and economics? Not really, though oil market conditions this winter may put OPEC members in a powerful position.

Background: OPEC's Role In the late 1990's, OPEC seemed to be on the verge of extinction. Plentiful supplies of oil meant that the price was around \$10 per barrel in early 1999; the world economy appeared to be thriving on cheap energy, with the United States particularly benefiting. But OPEC cutbacks in production, increased demand in Asia, and more cautious investment by international oil companies has tightened supply, forcing the price to about \$35 a barrel last week.

OPEC's aim is to give its citizens a better standard of living by maximizing revenue from oil, specifically, by using controls on production levels to keep the world price of oil high. Its 11 member states produce only around 40 per cent of world oil output, which is around 76 million barrels per day. But OPEC members export more than 20 million barrels a day, about 60 per cent of internationally traded crude, so the cartel's actions have a disproportionate impact on the world price. It also has a curious membership with many contradictions. Among Middle East states, its membership consists of U.S. allies Saudi Arabia, Kuwait, the United Arab Emirates (UAE), and Qatar; generally friendly Algeria; and U.S. antagonists Iran, Iraq, and Libya. Oil is often one of the few subjects they do not disagree about fervently; for instance, in recent weeks, Iraq has been condemning Saudi Arabia and Kuwait in the most vitriolic language for allowing U.S. and British air patrols to enter Iraqi air space. Even within OPEC there is often deadlock. Saudi Arabia wants its man to be the next secretary-general, Iran insists on its own candidate, and Iraq has vetoed both. The only non-Middle-Eastern OPEC members are Nigeria, Indonesia, and Venezuela, Gabon in West Africa, and Ecuador in Latin America used to belong but withdrew several years ago).

Despite claims of common purpose, economic logic suggests great differences. Iran, Nigeria, and Indonesia have large populations needing high government spending. All three countries prefer a high oil price. But Kuwait and the UAE have small populations and large reserves-- over 100 years' worth at current production levels-- suggesting a preference for a lower price so that the internal combustion engine remains a crucial component of world energy

demand. Saudi Arabia alone has 25 per cent of the world's oil reserves. Its stated policy calls for "a balance in the world oil market that preserves the interests of oil-- exporting countries, ensures continuing world economic growth, and stabilizes supplies and prices at reasonable levels"-- aims which are currently at odds with reality.

The Caracas Summit and Oil Prices It is far from clear how much discussion there will be in Caracas about price and production levels. Although supported by their own oil ministers and experts, the heads of state will probably avoid policy. The summit is only the second in the cartel's existence; the previous one was in Algiers 25 years ago. It is being billed as essentially celebratory and ceremonial. Five of the eleven heads of state will not be there anyway. Iraqi leader Saddam Hussein and Libya's Mu'ammar Qaddafi both are too worried about their personal security and that of their regimes to leave home. The rulers of Saudi Arabia, Kuwait, and the UAE are too infirm to travel. One of the few leaders looking forward to the event is President Khatami of Iran, who sees the summit as another opportunity to affirm the Islamic Republic's increasing world profile. Under the circumstances, President Chavez will probably be delighted just to have the meeting take place.

Ironically, the timing of the OPEC heads of state meeting coincides with the International Monetary Fund annual meeting, this time in the Czech capital, Prague. The IMF gathering is usually a forum for mutual self-congratulation by world finance ministers and central bankers, especially the twenty-four most important who make up the IMF International Monetary and Financial Committee. But in its communiqué Sunday, the Committee bluntly warned, "current oil prices, if sustained, could hamper global growth, add to inflationary pressures, and adversely affect prospects for many countries"-- a statement signed by the central bank governors of Saudi Arabia and Algeria. The Committee "note[d]" the U.S. decision Friday to release oil from its strategic reserves, suggesting, "some other industrial countries may be in a position to examine the possibility of doing so" as well. Indeed, European Union countries meet Friday to decide whether to release some of their stocks.

The Caracas meeting is coming on the foot heels of political unrest in the last few weeks in most European countries about the high prices consumers pay for oil; prices are kept high mostly by fuel taxes, given an extra boost by the shrinking value of the euro (oil is traded in dollars). The protests were mostly quickly and easily defused in France, which cut taxes for those hardest hit by the oil price increase, while the protests hit harder at politicians' popularity in Britain, which took a tough line. In other words, concessions and government intervention in markets already distorted by OPEC seems to have worked best politically in Europe-- a lesson evidently taken to heart by the Clinton administration.

This winter could still see a grim energy scene. In a typical year, world oil demand is around 4 million barrels per day higher in winter than in summer. There is not the extra capacity in the world to raise output 4 million barrels per day above the production levels of this last summer. Plus, the stocks of refined oil, which typically rise during the summer, are at low levels. If there is high oil demand this winter due to cold weather or continuing robust economic growth, the oil markets may have to be balanced by curtailing demand through the mechanism of sharply higher prices, unless governments release enough from their strategic reserves to bridge the gap.

Next Steps President Clinton's decision last Friday to order the release of 30 million barrels from the 570 million barrel Strategic Petroleum Reserve led oil prices to drop Monday to about \$30 a barrel. But traders are reacting to rumors and (European) consumers are panic buying. The price of crude oil could resume its climb, exacerbating concerns about a slow down in the world economy and rising debts in developing countries. Saddam Hussein remains a wild card, particularly if he decides some action while he thinks the United States is distracted by the presidential election campaign.

U.S. allies like Saudi Arabia, one of the few OPEC members with significant spare production capacity, should be encouraged to adopt a public position to supply more. This can conflict with the preferred Saudi tendency not to go against the local consensus or being half-hearted in signals to the market. Discrete techniques can be used to

remind Riyadh of the importance of the U.S. security relationship with the kingdom.

In mid-November the Saudis are planning a conference bringing together 50 oil consumer and producer nations. Intended as a routine attempt at establishing an international dialogue, the meeting may take on a new significance. Exchanges are likely to be sharp, with producers complaining that consumers have taken advantage of a decade of low prices to increase oil taxation. Consuming nations are likely to be divided in what their response should be.

OPEC needs to be told that its interests are best served by a prosperous world economy and by oil's reputation as a good energy source-- both of which are more likely when oil is cheap. Many analysts forecast a slowdown in demand growth next year which, combined with increasing non-OPEC supply, could bring prices down to \$22 per barrel by next summer, but OPEC's action needs to be this side of winter.

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