The Political Economy of Middle Eastern Oil

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The Middle East is the geographic "center of gravity" of the world oil industry. Oil is of integral importance in both the foreign and the domestic politics of nearly every country in the region, oil importers as well as oil exporters. This chapter examines the political economy of the Middle East's most lucrative resource.

Second only to enough arable land to feed a population, oil is one of the most valuable resources any country can possess. It can be used directly as a fuel and, if there is enough to export, oil is a source of foreign exchange. But to many oil producing developing countries, the blessing has often turned out to be a curse, an invitation to major power intervention, political corruption, militarization and, paradoxically given its income value, foreign debt. Oil wealth has also distorted national economies and interfered with development strategies.

The curse of oil is often linked to a colonial past, but its social and economic impact differs from other forms of colonial exploitation. Oil production is localized. Its technology and capital intensity also isolate it from the rest of the economy, making it less shattering to local life patterns than a shift from subsistence agriculture to cash crops. The relative ease with which foreigners were able to control oil exploitation in their own interests made it less necessary for them to repress local populations or replace local officials than in places where plantation economies were created by colonialism. Yet oil money also changed the balance of power between state and society in oil exporting countries, giving many local rulers the ability to suppress popular institutions and thwart traditional checks on their authority. Thus, on the whole, oil has decreased legitimate political participation in the region as a whole.

Although oil imperialism was onerous, it was not the worst fate possible for a colonial dependency. In the Middle East, oil contributed to the geopolitical attractions drawing imperialist powers to the region. But it also eased the eventual transition from colonialism to national independence for many states. This paradox is rooted in the structure of the international oil industry and the peculiar history of oil in the Middle East.

Industry Structure

The oil industry can be thought of as a continuous process that pivots on the extraction or **production** of oil from the earth. **Upstream** from production are **exploration,** the search for oil-bearing lands, and **development,** the construction of production infrastructure like oil wells and gas separators. **Downstream** from production are **transportation,** including pipelines, tankers, and railroads; **refining,** which turns crude oil into usable products like gasoline and fuel oil; and **marketing**--gasoline/petrol stations, among other things.

Although oil exploration today is generally a high tech operation, it is still possible, though far less likely than in the past, to find oil with a small capital investment. Exploration equipment and services are usually rented rather than owned, and "wildcat" discoveries by small operators can occur. It is also relatively cheap for small operators to enter the marketing phase of the industry because large amounts of start-up capital are not required. Development and production, however, usually require large investments in fixed capital, the expensive machinery necessary to produce oil. Some transport modes, such as pipelines, also require very large investments in fixed capital while others, such as oil tankers, require much less. Refining also is capital intensive. Some refineries are small and relatively unsophisticated, but they cannot produce the most profitable oil products and could not survive outside of protected markets.

Because of the global reach and natural segmentation of the oil industry, variations in the pattern of ownership produce types of firms whose structure and interests differ widely from one another. A firm whose operations encompass the entire process from exploration and development to marketing are said to be **vertically integrated**. Those operating in more than one country, say those that produce oil in one country and refine and sell it somewhere else, are called **multinationals**. The large vertically integrated multinationals were traditionally known as **majors**. Other firms were called **independents**, although their need to acquire supplies or services from other firms and/or their restriction to a single country market indicate that this term was something of a misnomer.

The Oil Industry in the Middle East

This picture of the oil industry gives us some idea of where the "choke points" are, the points of political and economic leverage where an actor such as a firm or a country can exert significant control over the entire process. One obvious choke point is production. Whoever controls the land controls the oil under it. In the nations of the Middle East, as in many other countries, mineral rights belong to the state. Oil companies must negotiate with governments to get **concessions,** or rights to produce oil, in exchange for lump-sum payments, rents, and/or

royalties, payments per unit (barrels or tons) of oil produced.

In most of the United States, mineral rights go with land ownership and oil companies can pick and choose among individual "sellers" of rights to explore for or produce oil on their land. But even though there may be more than one oil company "buyer," in reality each seller faces a concentrated market and none has leverage unless an individual's holdings are extremely large and/or strategically located. These structural criteria show why land owners in the United States are at a disadvantage in their bargaining with oil companies as compared to governments in the Middle East. This is true today but it was not always the case. Before the second world war, Middle Eastern countries had to compete for oil company investment in much the same way as ranchers in Texas or Oklahoma. The large companies were more afraid of a glut of oil than oil shortages. Under the **"Red Line Agreement"** of 1928, the three largest, Exxon, Shell, and BP,* along with a few smaller partners, agreed that none of them would explore for or develop new oil in the old Ottoman Empire unless all the partners consented. Countries inside the Red Line had difficulty getting these companies to find the new oil that could increase national income because the Red Line companies were reluctant to do anything that might increase world oil supplies and thus depress prices.

Oil company partnerships and concession patterns also limited the leverage of governments in the Middle East. Instead of one government being able deal with several oil companies competing to operate in various parts of its territory, each government generally faced a single **operating company**, often a **joint venture** or partnership, on the other side of the bargaining table. Joint ventures are common in the oil industry because of its capital intensity and because oil investments are highly risky. Individual **parent companies**, like Gulf and BP, set up operating companies, like the Kuwait Oil Company (KOC), which they jointly owned. Even though two separate parents invested the capital and took the profits from Kuwait's oil, their business in Kuwait was conducted by a single company, KOC. Such partnerships allowed the large multinational oil companies to exercise more control over total world oil supplies by providing them with information about one another's production. They also discouraged competition among the partners to develop new concessions elsewhere, and provided a means to coordinate their global operations.

Kuwait's ability to choose which company would get its concession was limited by the British government, which had signed treaties with Kuwait giving it the final authority to determine who would exploit any oil found there. The British would not permit the Kuwaitis to contract with a non-British company, though the amir held out for a company that had at least one non-British partner. After the concession was granted, Kuwait's autonomy was even more limited. The terms of its contract with KOC gave the company exclusive rights for 90 years to find and produce oil over the entire land area of the country. If the government were to try to get better terms from another company during the period of the KOC concession, that company would face legal challenges from BP and Gulf. Even more of a threat was the possibility of intervention by one of the **home governments,** Britain and the United States. If Kuwait should try to remove KOC from its privileged position, it could expect one or both to react unfavorably.

This is what happened in the early 1950s in Iran. The Iranian government, under Prime Minister Mohammad Mossadeq, nationalized Iran's oil in 1951. Iran's concession was unusual for the Middle East in that there was only one parent company, BP. When its holdings were nationalized, BP obtained court orders enjoining other companies from buying oil from the Iranian government. Afraid of the example that a successful nationalization might set for other Middle Eastern oil exporting states, the British and American governments worked to destabilize and eventually to overthrow the Mossadeq regime. The restoration of the Shah in 1953 following a brief period of ouster also reinstated foreign oil companies as managers of the nationalized Iranian oil company. However, instead of restoring BP to its former position as sole owner, the Iranian government sought a "Kuwait solution." The Shah invited non-British participation in the National Iranian Oil Company (NIOC). When NIOC was reorganized, American companies and the French national oil company, CFP, were given 60 percent of the shares, and BP was left with only 40 percent.

The one company-one country pattern of concessions through much of the Middle East helped to make the region the **marginal supplier** of oil to the international market, that is, the source of however much oil was needed to balance global supply and demand. This balancing act was made possible by the participation of all the very large companies, whose production holdings stretched across the globe, in one or another Middle Eastern concession. The solution of the Iranian crisis in the 1950s made this control even easier because the reorganized NIOC was the first

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* Throughout this chapter, to reduce the confusion that might arise from the frequent name changes of the various oil companies operating in the Middle East, these companies will be referred to by their modern names rather than by whatever names they might have been called at the time of the particular events discussed.

operating consortium in the Middle East that included every one of the major oil companies, the "seven sisters" who dominated the industry from the end of the second world war until the oil revolution.[**]

Joint participation in Middle Eastern concessions enabled oil companies to share information. Even more important for supply management was the leverage the companies could exercise against the **host governments**. Once they had decided what total supply should be, the companies could regulate production by increasing or decreasing **offtake** in a few countries whose governments could not easily retaliate against them. The one company-one country pattern did not hold in Libya, whose oil was discovered and developed much later than that of most of the Gulf countries. As we shall see, this enabled the Libyan government to spearhead the assault on the oil companies that triggered the oil revolution of the 1970s.

The large oil companies refrained from competing with one another over concession terms to avoid setting an example that might persuade other governments to try to get better terms as well. They also agreed to avoid competing in other ways, such as in setting prices to transport oil and prices for oil products like gasoline. The regulation of oil company competition was outlined in another 1928 cartel arrangement, the **"As Is Agreement."**

The As Is agreement, ostensibly global in nature, actually required the individual negotiation of little As Is arrangements in each regional market but it was not rigidly followed anywhere. Large companies challenged it on occasion but the most constant violators were small companies who behaved as though nothing they did could affect the overall price structure of the cartel regime. These **free riders** were also instrumental in the collapse of the old oil regime in the 1970s.

International Oil Politics Before the Oil Revolution

The international oil cartel was able to suppress production and reduce competition some of the time in some markets even during the 1930s, when world demand for oil dropped to very low levels because of economic depression. The great depression also eliminated entire oil companies, reducing supplies in the hands of free riders. Exports from two major oil producing countries declined sharply from other causes. Oil exports from Mexico, which had been an important producer in the early 1920s, dropped for geological reasons later in the decade and dropped even further as a result of a **boycott** after Mexico nationalized its oil industry in 1938. Meanwhile, less Soviet oil was sent to foreign markets as the result of policy. Soviet leader Joseph Stalin reduced Soviet oil production because of a decision to emphasize other fuels. Reduced oil supplies from Mexico and the Soviet Union eased competitive pressures in international oil markets during a period of very low demand worldwide.

At the same time, governments and corporations in many developed countries worked together to regulate production to protect their domestic industries and foreign investments. Regulations were even applied in the United States, where the anti-trust tradition was strong but not so strong as to counter either the threat of business failure in the 1930s or the cold war politics of the period following the second world war. Oil policy during the cold war found the majors and their home governments continuing to cooperate for their mutual benefit. The majors developed an ethic of oil statesmanship to justify their interference in politics and markets and to explain why they relied on their home governments for assistance. The home governments, in turn, expanded their use of oil companies as foreign policy surrogates in relations with host governments.

During the second world war, oil was at a premium because of military needs, and oil companies made money despite domestic price controls and losses of production from the war theatres. The war stimulated exploration and development and resulted in an expansion of total world production capacity. Although it was not physically necessary to produce and refine all the oil that the new infrastructure could provide, there was no easy way to decide which companies would cut back and by how much once the war was over.

The problem was even harder to resolve when competing companies were based in different countries. For example, the conflict between British and American companies over which would be permitted to sell oil in the British Empire and Commonwealth contributed to other financial conflicts between the two governments in the immediate post-war period. The **sterling-dollar problem** was settled in favor of companies in the stronger country, the United States. US domestic oil producers lobbied vigorously to open sterling markets to "dollar oil." They wanted to avoid competition from US-based oil multinationals which might, if they could not sell their cheap foreign oil elsewhere, import it into the US market, depressing prices and thus the profits of higher cost domestic producers. In this way, the clashing interests of domestic and multinational firms based in the United States also contributed to the erosion of the old oil regime.

By the end of the second world war, foreign oil was widely regarded as an important ingredient of national

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[**] These seven companies were BP (British), Shell (British and Dutch), and Exxon, Mobil, Gulf, Texaco, and Chevron (American).

power. Even the United States, a nation with a long tradition opposing government participation in business, had considered buying part of the Saudi Arabian concession, developed originally by Chevron and Texaco, to guarantee access to strategic supplies of foreign oil. In the end, tradition and company preferences prevailed, and it was Exxon and Mobil rather than the US government which joined Chevron and Texaco to form Aramco after the war.

Other countries, with fewer inhibitions about state participation in strategic industries, had long been involved in securing oil supplies for their strategic and economic needs. These states saw control of foreign oil as integral to their international power and prestige. Their activities, especially in the Middle East, also helped to bring down the old oil regime.

<u>Serpents in Eden</u>

Economic theory tells us that an industry where firms make huge profits soon attracts new firms whose competitive behavior reduces profits for all. This is exactly what happened in the international oil industry. The success of even imperfect cartel arrangements made oil vastly profitable and oil companies among the world's largest and richest firms. As a result, the seven oil majors were increasingly faced with competition from small private firms like Occidental and Getty. These independents were politically active and willing to do whatever was necessary to protect their interests. For example, when NIOC was reorganized, a group of US independents demanded and received a share of the lucrative Iranian concession.

Competition also came from state-owned firms. The French oil company, CFP, stepped up its aggressive quest for concessions after the ending of the Red Line Agreement in 1946. CFP expanded its efforts to find and develop oil in French colonies such as Algeria and also took six percent of the reorganized NIOC. The French government had always seen the old oil regime as an Anglo-Saxon threat to French autonomy, mostly because none of the majors was French. The importance of Algerian oil to France's image of itself as a great power and to the nation's energy autonomy added to the status considerations that made the French resist the struggle for Algerian independence so fiercely and for such a long time.

The Italian national oil company, ENI, was another aggressive competitor for concessions. It challenged the oil regime dominated by the majors by offering concession terms that were much more liberal than the norm, but the threat from ENI was diminished by the company's bad luck: its exploration efforts were rarely successful.

A Japanese company, the Arabian Oil Company (AOC), was more successful. AOC is owned by a consortium of Japanese firms that depend on imported oil. AOC purchased a concession off the shore of the Neutral Zone. This territory, jointly controlled by Saudi Arabia and Kuwait, lay outside the land-based concessions held by Aramco and KOC. AOC offered much better terms than either country was getting from its on-shore concessionaire. The willingness of AOC and other independents--like ENI--to sign contracts favorable to the host governments encouraged Middle Eastern governments to ask all their operating companies to liberalize contract terms.

Even the majors found themselves having to compete for new concessions. Some companies decided to sweeten the terms of the concessions they already held in order to maintain good relations with their hosts. Many were asked to **relinquish** territory they were not developing so that the host governments could sell concessions there to someone else. All of this increased the costs of doing business and reduced company profits.

At the same time that competition for concessions was increasing oil company costs, competition in other segments of the market squeezed oil company profits. Shortly after the end of World War II, the Venezuelan government threatened to nationalize foreign oil operations unless its concessionaires would split their profits on Venezuelan oil 50-50 with the government. Mindful of Mexico's nationalization in 1938, companies owning concessions in Venezuela agreed to this demand. Soon after, Middle Eastern governments began demanding the same terms.

The four US companies who were partners in Aramco asked for and obtained a reinterpretation of a 1926 tax law provision enabling them to deduct such payments to foreign governments from their US tax liabilities. This favorable tax treatment was available to every US firm operating abroad, but BP was not able to pass all of its foreign payments onto taxpayers in Britain. For this and other reasons, BP resisted demands for 50-50 profit sharing in Iran. This triggered the 1951 nationalization, the loss of 60 percent of BP's concession, and the inclusion of several independents in the reorganized NIOC. The industry as a whole became less stable because of the addition of more free riders to the roster of firms operating internationally.

Another unexpected source of competitive pressure on the oil companies came from the Soviet Union. Long a major oil producer, the Soviet Union found its trade with the west constricted by US cold war policies. As a result, it had increasingly to rely on oil and gold sales to earn foreign exchange. Under Nikita Khrushchev, the Stalinist policy of reducing emphasis on oil production was reversed, and total Soviet oil production doubled in the five years following Stalin's death in 1953. As part of his policy of peaceful coexistence, Khrushchev expanded

Soviet oil sales to Western Europe beginning in 1956 and, by 1960, the Soviet share of that market had gone from two to six percent. This may seem like a small proportion, but the tripled Soviet market share, in the context of severe competition from other sources, added significantly to the financial pressures on oil companies in the 1950s.

Perhaps the last straw for the international oil companies was the 1959 decision of the US government to impose a quota on US oil imports. The US market was the biggest in the world and doubly lucrative because the high cost of domestically produced oil gave sellers of lower cost foreign oil the potential to reap greater than normal profits. But as we have seen, the US domestic industry was politically very strong in the post-war era. It had been able to force a settlement of the sterling-dollar crisis that benefitted itself even though the settlement also strained US-British relations. US domestic producers were equally powerful in imposing a similar solution to the foreign oil import crisis of the 1950s.

US multinational oil companies had long been encouraged by the US government to invest in foreign oil. Their access to the US market reinforced other incentives to invest abroad. When profits from their international operations were squeezed by higher concession costs and competition from independents for customers, multinationals with marketing outlets in the United States looked toward US oil sales as a source of deliverance. In the high-cost domestic market the multinationals, along with independent refiners and marketers, were the free riders.

Cheap imports threatened the domestic price structure, and firms dependent on US production were afraid that they would lose their market shares and perhaps even go out of business altogether if imports were expanded. Domestic firms appealed for relief to the Eisenhower administration, which asked companies to limit their oil imports voluntarily. But the hard-pressed multinationals were unwilling to give up the possibility of increasing their profits through crude sales to the United States, and continued to import oil in spite of the voluntary import limits. The domestic producers, citing national security and the risk of becoming dependent on foreign oil imports, soon demanded real protection and, in 1959, the voluntary quotas became mandatory. The multinationals could see which way the wind was blowing and tried to prop up their declining profits by cutting costs another way, by reducing payments to host governments.

<u>The Formation of OPEC</u>

In the early 1950s, the oil majors developed the **posted price** system to help host governments estimate their anticipated oil revenues more easily. The oil companies set these prices for host governments to use in calculating the amount of taxes the companies would have to pay. Very little oil was actually sold at posted prices. Posted prices were accounting devices rather than prices in the sense that most of us use the term.

When posted prices were introduced, company profits on foreign operations were very high. Posted prices were not adjusted to match the small deviations in the real prices at which crude oil traded because, over time, these deviations simply canceled one another out. Stable posted prices soon became an accepted industry norm. Host country governments lobbied for profit sharing and improved concession terms rather than demanding increases in posted prices to increase their shares of oil profits.

But as concession costs increased and competition from independents ate away at profit margins, the majors began to look at posted prices as a means to improve their financial situation. In February 1959, after consulting one another (but not their hosts), the companies lowered posted prices and thus their tax obligations to host countries. An immediate outcry arose from every affected host government. When the first Arab Oil Congress met later that year, representatives of the governments of Latin American and Middle Eastern oil exporting countries got together for the first time to plan concerted action against the oil companies.

Coordination between the oil exporting governments was not easy to accomplish because of structural differences among national industries and because all oil exporting countries competed against one another for investment and production shares. The Venezuelan industry was organized in a multiple operating company concession pattern instead of the one company-one country pattern common in the Middle East. The age of its industry meant that less efficient equipment, oil depletion, and political leverage gained through experience, also increased the cost of producing oil in Venezuela as compared to the Middle East. Venezuela's geographic position gave it a cost advantage in transportation to the United States, its most important customer, but as tanker sizes increased and the center of gravity of the industry as a whole moved from the western to the eastern hemisphere, this advantage became much less significant.

Economic competition between Venezuela and Middle Eastern oil exporters was heightened by the way that the 1959 reductions in posted prices were made. Prices were reduced much more in parts of the Middle East than in Venezuela because BP saw the situation as an opportunity to gain an advantage over US companies by breaking the As-Is-mediated connection between world oil prices and the US market. This made Venezuelan oil even less competitive than it already was, and companies producing in Venezuela took only a month to reduce posted prices there a second time to match the reductions BP had imposed in Kuwait, Qatar, and Iran. The second round of price reductions in Venezuela were even more destabilizing to the country's fiscal position, and reinforced the conviction of government officials that the growing interdependence between Venezuelan and Middle Eastern oil production and sales warranted a coordinated approach to protect all oil exporting countries.

The first attempt to achieve this coordination, the Oil Consultation Commission (OCC), failed. Its lack of success was due in part to the transplantation of ongoing competition and conflict among Middle Eastern states, chiefly Iran, Iraq, and the United Arab Republic (a short-lived union of Syria and Egypt), to the OCC arena. But when the oil companies, still enmeshed in their own internal conflicts, imposed yet another round of reductions in posted prices in August 1960, five oil exporting governments tried once more to set aside their political differences to cooperate to salvage their economic interests. These five, Venezuela, Saudi Arabia, Iran, Iraq, and Kuwait, formed the Organization of Petroleum Exporting Countries, OPEC, in September 1960.

OPEC's Early Years

OPEC's aims from the very beginning included helping host governments to gain more autonomy and control over their oil. These aims were set out in OPEC's first resolution, which called for the stabilization of crude oil prices, the restoration of posted prices to their pre-February 1959 levels, a requirement that oil companies consult with host governments before they altered posted prices, and the development of a program "to ensure stable oil prices by, among other means, the regulation of production."

Economically, OPEC helped its members to make incremental gains in the amount of revenue they earned on their oil. The members were assisted by increased competition in the industry as a whole, and by their divided situation, something that might as easily have caused their efforts to fail. But they wisely decided that it would be difficult for them to coordinate their policies completely in advance of negotiations with their oil companies. So the decision rule within OPEC evolved to one where members would agree on a "least common denominator" position, one that fit every situation and capacity, with the understanding that if any country could gain an advantage on its own that was an improvement on the general goal, others would take that as the new floor for bargaining the next time.

This **leapfrogging** or ratcheting pattern was also dictated by OPEC's political situation. Although OPEC had established itself as an international organization, the United States refused to recognize it and forbade US oil companies to negotiate with it. The United States also discriminated against OPEC members in trade, a strategy that helped to keep Mexico from joining OPEC. This hard-line US position suited the oil companies, which saw an advantage in continuing their accustomed practice of dealing with host governments one at a time. Although leapfrogging enabled local advantages to be parlayed into OPEC-wide gains, the gains were so small and progress toward their achievement so slow that the companies remained complacent about their situation.

OPEC's membership gradually expanded. Eventually it included countries in Africa and southeast Asia as well as Latin America and the Middle East. Political and cultural diversity and the differences in interests arising from diversity also grew. Competition among members remained a problem; it was aggravated by political divisions between conservative and radical Arab states, and between Arab and non-Arab states. One important source of political conflict was the **"oil weapon."**

The Oil Weapon

The deployment of the oil weapon in Arab-Israeli wars dates back to 1948, when saboteurs blew up oil installations, including sections of the Iraq Petroleum Company pipeline, during the struggle for the control of Palestine. In 1956, Arab countries used the oil weapon during the Suez crisis, stimulating oil companies and governments to establish procedures to deal with oil supply interruptions. In 1967, as a result of the Six Day War, Arab governments attempted to use the oil weapon again, imposing an embargo against countries supporting Israel. But none of these applications of the oil weapon was effective.

The lack of effectiveness of the oil weapon had many causes. One was the willingness of other oil producers, including some non-Arab OPEC members, to expand production during embargoes. This was a problem during the 1967 embargo, when Iran and Venezuela joined the United States in stepping up production to compensate for cuts imposed by Arab exporters.

Another cause was the effectiveness of oil companies in diluting embargo effects by careful supply management. The participation of US companies in these ad hoc regimes to manage oil crises was underpinned by anti-trust waivers, and assisted by government policy intended to thwart the political and economic effects of all attempts to apply the oil weapon.

A third cause of the ineffectiveness of the oil weapon was dissention among Arab governments. All Arab governments opposed Israel, but the cost of attacking Israel with the oil weapon fell almost entirely on Arab oil exporters. This asymmetry made non-oil exporters much more enthusiastic about applying the oil weapon than oil exporters.

The conservative Arab oil exporting governments depended heavily on oil revenues. They resented losing income to non-Arab oil exporters, and control over their economies and foreign policies to mostly non-oil exporting Arab countries, some of which tried periodically to topple their regimes. They felt isolated in OPEC and in the Arab League. After the 1967 embargo, three of them established an international organization of their own. The Organization of Arab Petroleum Exporting Countries, OAPEC, was set up to help its members develop joint policies to withstand political pressures from the other two groups.

The 1967 oil embargo was a watershed event in the political economy of Middle Eastern oil. Nearly two months of production cutbacks by Arab governments caused world oil prices to rise. All OPEC members had a vested interest in holding prices up once the embargo was over and normal production restored. Both non-Arab members of OPEC and those Arab states that were militant in their approach to the oil weapon were warned by the establish-ment of OAPEC that OPEC power was dependent on cooperation among the various political and economic interests represented in the organization. Despite internal fragmentation and conflict during the 1967 embargo, OPEC emerged from the turmoil chastened and determined to advance its common interests more vigorously.

The 1967 oil embargo also stimulated at least one European nation to change its foreign policy in the Middle East. France, under Charles De Gaulle, decided to loosen its ties to Israel and to move closer to the Arab governments as a way of guarding French energy supplies. Algerian independence and French dislike and distrust of US leadership of the western alliance made France wary of sacrificing good relations with Arab oil suppliers for the benefit of a US client with no oil.

Other European governments also became disenchanted by US foreign policy positions, especially with regard to the ending of the Bretton-Woods Agreement and US involvement in Viet Nam. The United States was seen as both autocratic and unreliable. One result was that the European Community decided to develop its own energy policy independently of the United States and did so in April 1973. However, this policy was never implemented because of conflicts within the EC and between the EC and the United States.

Oil companies learned a different lesson from the 1967 Arab oil embargo. They continued to be preoccupied by their fears of oversupply despite structural changes in the international oil market brought about by war and a booming world economy. To them, these changes offered opportunities to improve company profit margins. They saw no dangers ahead from supply interrup-tions because they had succeeded so easily in countering the 1967 embargo.

The sense of security enjoyed by the oil companies was a false one, however. The 1967 war closed the Suez Canal. Tankers coming from the Gulf had to make the longer journey around Africa instead of being able to enter the Mediterranean via the canal, vastly increasing transit time and costs. The closure of the canal created an effective tanker shortage with respect to oil shipments to Europe from the Gulf, but the companies initiated no measures to counteract a supply interruption from Mediterranean ports because they didn't think it was necessary.

Oil company complacency was based on OPEC's disarray during the 1967 embargo and on the ease with which Arab production cuts had been replaced by increased production from other sources. The companies were unconcerned by indicators of rising demand for oil world-wide, such as the increasing rate of global economic expansion; the large multinational firms made no plans to step up exploration and development operations to meet future demand. They looked at the prospect of narrowing the supply-demand gap as in their interests, and were skeptical that the global oil market could be disrupted by political pressure.

An important structural change that no one seemed to take seriously was the decline in oil production in the United States. US oil production peaked in 1970, but demand continued to rise. This meant that increasing amounts of US consumption had to come from foreign sources of oil. Another effect of the shift in the US energy balance was that as actual US production approached total production capacity, **excess capacity** under direct U.S. control shrank. Should the oil weapon be used again, there would be no way to increase production from the United States as had been done during the oil crises of 1956 and 1967.

<u>The Libyan Squeeze</u>

In September 1969, a revolution in Libya replaced a pro-western king with a militantly anti-American colonel. Muammar Qaddafy was in an excellent position to get Libya a greater return on its oil resources. Libya was divided into nearly 40 concessions, each with its own operating company. Its high quality oil, light in weight and low in sulfur, was even more attractive because of Libya's location on the Mediterranean. These structural factors enabled Qaddafy, in the spring of 1970, to isolate two companies, one the vulnerable Occidental Petroleum, and demand that they increase payments to the Libyan government or else be shut down. The second company had other sources of oil and could wait out a shutdown--as Qaddafy himself could, having so many other operating companies that would continue to produce oil and make payments to his government. But Occidental had no other oil in the Eastern hemisphere, while it did have contracts with European buyers that included financial penalties should it fail to deliver the oil it had promised.

Armand Hammer, Occidental's president, first tried to buy oil from Exxon to ship to his European customers in place of the Libyan oil. But Hammer wanted a big discount on his purchases, and Exxon would not give it to him. Hammer refused to pay the usual price and instead paid Qaddafy. This was the rolling pebble that triggered an avalanche. Qaddafy extended his pressure to other companies, and soon all the Libyan operating companies were forced to agree to the higher price. But the effects of the Libyan squeeze did not stop in Libya. In 1971, the Gulf producers, led by the Shah of Iran, demanded that they get higher prices too.

The oil companies wanted joint negotiations so that they could not be picked off one at a time in Teheran as they had been in Tripoli. US companies applied for and received an anti-trust waiver, which guaranteed that they would not be prosecuted for their collaboration during the negotiations any more than they would have been for cooperating during previous oil crises, for which waivers had also been issued. But when they also sought support for their proposal that the negotiations include all the Middle Eastern oil producers, to forestall leapfrogging between the Mediterranean and the Gulf, the Nixon administration refused. The role of Iran as an American client under the Nixon Doctrine protected the Shah from political pressures that could cause him to review his special relationship with the United States.

The split negotiations speeded up the oil revolution. Part of the revolution was already under way--oil exporting countries, beginning with Libya, were demanding and getting higher prices for their oil in spite of the existence of long-term contracts specifying much lower prices. The oil companies judged correctly that separate negotiations would lead to leapfrogging between Teheran and Tripoli. They tried to limit leapfrogging by inserting a clause in the Teheran agreement stating that the prices it specified would be in effect for five years, but that contract was no more effective at protecting the oil companies than the ones it replaced.

The continued deterioration in the US economy caused the US government to devalue the dollar in 1971 and again in 1973. The devaluations reduced **real** oil prices, denominated in dollars, that were specified in the Teheran-Tripoli contracts. After each devaluation, OPEC members demanded revision of the **nominal** prices in the Teheran-Tripoli agreements to compensate for exchange rate losses. The companies were unsuccessful in forestalling their demands by appealing to the five-year clause. Negotiations after the second devaluation were still in progress in the fall of 1973 when other events snowballed the price issue into the larger question of who would control OPEC oil.

The 1973 Arab Oil Embargo

As we have seen, the position of the oil companies had deteriorated long before the oil revolution. By setting procedural and substantive precedents that reduced their authority with respect to the host governments, the Teheran-Tripoli agreements weakened them even further. US oil companies were even in trouble at home. Domestic oil supplies in the highly regulated US domestic market fell behind demand, which shot up at an unexpectedly high rate beginning in 1967. Restrictions on oil imports triggered spot shortages and price increases which, in turn, led to Congressional hearings and widespread public criticism of the oil companies. The supply situation grew so alarming that the oil import quota was lifted in April 1973. Thus the energy crisis which is remembered as the result of the use of the oil weapon in the October 1973 war had, in reality, begun months--if not years--before.

The 1973 decision by Arab oil exporters to use the oil weapon could have been spotted by an effective political "early warning" system. Throughout 1972-73, Arab governments promised openly and repeatedly to use the oil weapon against the United States if a Middle East settlement conforming to United Nations Resolution 242, requiring Israeli withdrawal from the occupied territories, was not achieved. Saudi Arabian officials went so far as to call in representatives of the four parents of Aramco to deliver their message. They said that another war between Israel and Arab governments was imminent and that, when it came, Arab oil would be cut off to supporters of Israel. One parent, Mobil, regarded this warning as so serious that it took out an ad in The New York Times to urge a settlement of the Arab-Israeli conflict. The other Aramco parents relied on private channels to communicate their message.

The Nixon administration did not respond. By the summer of 1973, the exposure of its criminal behavior in what has come to be known as the "Watergate affair" had reached a critical stage in Congressional hearings. But Richard Nixon's political problems were not the only things inhibiting direct US involvement in a Middle Eastern settlement. The official position of the Nixon administration was to avoid direct intervention by US troops or US corporations in Third World countries.

The Nixon Doctrine outlined a strategy based on US reliance on a few chosen client regimes, built up by foreign aid and arms transfers, which would pursue US interests throughout the world without requiring direct intervention by the United States. This was the philosophy behind the "Vietnamization" of the Viet Nam war, and the arming of Israel and Iran in the Middle East. US dependence on Middle East clients meant that the United States could not force Israel to accept UN resolution 242 in 1972 and 1973 any more than it could force the Shah of Iran to accept joint negotiations with the oil companies in 1971.

When war came in October 1973, the Arab governments waited for some sign that the United States would respond. Finally, on 17 October, at the request of the Arab League, OAPEC imposed an oil embargo against Israel's allies. Intended to be effective as a political weapon as the embargoes of 1956 and 1967 had not been, it was designed to be both more extensive and more discriminating--able to keep Arab oil from enemies of the Arab states while at the same time allowing it to flow to friendly nations.

Some aspects of the embargo were very successful. Total supplies of oil to the world market were cut and the effects were translated into local shortages and higher prices in most oil importing countries. Another success was that the general perception of the Arab governments as weak and ineffective was altered by the impact of oil shortages and high prices.

But despite the care with which embargo provisions had been drawn up, and the nominal compliance of even US oil companies in implementing the letter of the embargo, its spirit was system-atically violated so that the targeting plan did not work. Oil supplies were exchanged between and within companies so that Arab oil that could not be sent to the United States or Holland was swapped for oil from non-Arab sources which had no destination restrictions. Thus, all importing countries experienced about the same degree of shortfall whether they supported the Arab states or Israel. The failure of targeting meant that while the embargo did succeed in inflicting hardship on the friends of Israel it also inflicted hardship on the friends of the Arabs.

The most important effect of the embargo was to consolidate the oil price revolution. Bids for **spot** or individual cargoes of crude oil during the crisis reached very high levels. The "price hawks" in OPEC, countries like Libya, Iraq, and Iran, insisted that OPEC members stop negotiating with the companies and simply set their own prices--very high. Others, like Saudi Arabia, supported setting an OPEC price but opposed the size of the price increase advocated by the price hawks. The two groups fought during OPEC's December 1973 meeting and eventually compromised on a price between the two extremes. This price was four times higher than the average price of OPEC crude just a year earlier.

The Oil Revolution

The oil revolution was not simply a price revolution, although that was an important component of it. It also involved a change in the ownership of oil. Prior to 1973, the oil of most OPEC members was controlled by multinational oil companies. These companies decided how much to oil produce and how much money to invest in exploration and the other phases of the host's national industry. Although companies and host governments bargained over prices and production levels, the companies had the last word.

Several oil exporting countries had nationalized their oil industries prior to the oil revolution, but this did not always mean that control of nationalized oil had passed from the companies to the host government. For example, Iran nationalized its industry in 1951, but the restoration of the Shah also restored foreign control over Iran's oil. Subsequent nationali-zations by Iraq and Libya were more effective in transferring actual control of domestic industries to host governments. As other countries nationalized their industries or assumed equity control more gradually through a process known as **"participa-tion,"** decision-making power passed from the multinationals to the oil ministries of the host governments.

The oil companies were criticized for being nothing more than "tax collectors for OPEC" rather than independent actors in the international oil market. Few companies cared. The higher prices made for vastly higher profits, and the nationalizations did not cut off or even reduce the revenues of most oil companies operating in the Middle East. Many of them took their profits and invested in exploration and development outside of OPEC. They bought other oil companies and invested in other energy sources such as coal and nuclear power. Some bought firms in industries totally unrelated to energy. One even tried to buy a circus. State-owned national oil companies took their places. Some host governments already had state firms and others created them expressly for the purpose of taking charge of their newly nationalized industries.

The shift in corporate ownership led to a restructuring of the industry as a whole. Now that crude oil prices were set by OPEC, the multinationals were unable to use oil production as the phase of the industry that subsidized all the rest. In the past, companies would set **transfer prices**, the prices at which oil was sold between subsidiaries of the same company, to show very high profits on crude sales and very low profits on refining and marketing. Because tax rates were lower in producing countries than in consuming countries, they could save money on taxes if it looked as though they were earning most of their profits overseas rather than in the United States, Europe, or Japan.

After the oil revolution, the price of crude oil was a real price paid by the companies, not just a fictitious price that enabled them to avoid tax liabilities. As a result, the other phases of the industry had to earn real profits. Obsolescent equipment had to be replaced and the downstream phases of the industry had to be **rationalized** so that companies could make profits on all their operations, not just on producing and trading crude oil and earning management fees. The large oil companies began selling off unprofitable refineries and gasoline stations. Some were bought by the national oil companies of OPEC countries, which were eager to have their own marketing outlets in oil importing countries.

Another effect of the vastly higher OPEC price structure was that equity holdings anywhere else in the world enabled oil companies to make **windfall profits**, the difference between the marginal cost of what they produced and the OPEC price at which oil was sold. Increasing production in the United States and elsewhere outside OPEC became a company priority, even though US regulations limited the amount of windfall profits companies could reap and other governments began to charge higher royalties and fees for oil produced in their countries.

But higher oil prices also depressed demand. Most of the 1973-74 price increases were eaten away by inflation by 1978, but consumers still felt that they were paying more for oil because the nominal prices of oil products stayed about the same. Even so, consumption, which had dropped in 1974 and 1975 soon began to rise again, and before the second round of huge price increases during the Iranian revolution, consumers were using about the same amount of oil they had used in 1973 before the oil embargo.

Oil and Politics in the Middle East

High oil prices and the increase in national autonomy and control over oil did not take oil out of Middle Eastern politics. OPEC's power in the international industry increased its appeal as an arena for the pursuit of political goals. Ongoing ethnic, religious, and territorial disagreements between Iran and several Arab Gulf nations were often expressed as a conflict over oil prices. Yet no single cause motivated any of the conflicts within OPEC. For example, Arab states, chiefly Libya, Algeria, and even Iraq, occasionally joined Iran in pressing for oil price increases, and Saudi Arabia and its allies among the smaller Gulf states opposed all of them. Thus, the Arab-Iranian conflict often cut across other ongoing regional conflicts such as the "Arab civil war" between traditional and revolutionary regimes.

Disagreements over oil prices are usually thought to arise from basic differences in economic interests. Price hawks like Iran and Algeria have relatively large populations needing oil revenues, but their oil reserves are limited. If they could force prices to very high levels they could still sell nearly all of their oil before less expensive substitutes would replace it. Price moderates like Saudi Arabia have small populations and too much oil to be able to sell it all before substitutes for high cost oil could be found. Therefore, the Saudis support smaller price increases.

Yet even this is much too simple a rule of thumb. Libya, and sometimes Kuwait, were price hawks too. Neither has a large population and Kuwait can expect to produce oil for 200 years at present rates of production. Another illustration of the inadequacy of simple economic explanations for the positions on oil prices taken by individual OPEC members was the defection of the Shah of Iran from the price hawk coalition in December 1978. Weakened and beset by illness and domestic unrest, he joined the Saudis in a coalition to freeze prices in a bid to attract regional allies. Politics is as important as economics in OPEC price conflicts, and goals change with changing circumstances. The Iranian revolution aggravated conflicts within OPEC over oil prices and organization leadership. The government of the Ayatollah Khomeini saw raising oil prices as a way to attack the United States as well as a means to increase Iran's national income and foreign exchange reserves. Iranian price militancy was effective in raising oil prices so long as the panic set off by Iran's revolution kept world oil prices high. Throughout 1979, Iran and other price hawks imposed extravagant price increases that pulled the prices of more moderate OPEC members up in defensive emulation. But when prices weakened in 1980, Iran also proved to be an aggressive price cutter, despite government denials.

Iran's aggressive nationalism in oil marketing was matched by its aggressive nationalism in regional politics. Iran hoped to be able to export its revolution to other Islamic states, and OPEC meetings soon became places for revolutionary exhortation and guerrilla tactics. Iraq was a favorite target because of its large Shi'i population, the convenience of its location on the western border of Iran, and the history of enmity between the two countries. Relations between Iran and Iraq had been strained for some time, and rivalries surrounding oil and oil revenues added to other sources of conflict.

Iraq's oil power, long obscured by oil company policy limiting expansion of supply capacity in selected parts of the Middle East, promised to overtake Iran's. Iraq was more successful in its economic development policies than Iran, and its growing economic and political strength made it confident that it could force a revision in its favor of the 1975 settlement with Iran of the long-running border dispute between them. In September 1980, Iraq attacked Iran, setting off a long war marked by extreme brutality on both sides to civilians and soldiers alike.

The effect of the war on OPEC was also devastating. Meetings became acrimonious shouting matches. With OPEC facing competition from rising production in Britain and Norway, and rising exports to Western Europe from the Soviet Union, this First Gulf War impeded efforts to coordinate production and maintain a united OPEC front in a seriously deteriorating market. Even the day-to-day operations of OPEC were affected when neither Iran nor Iraq would accept a Secretary General from the other country, and the organization had to be run for several years by the Assistant Secretary General--an Iraqi.

<u>The Price Bust</u>

The most serious effect of the First Gulf War for Middle Eastern oil exporters was that it prevented accommodation within OPEC that might have enabled it to withstand assaults on its price structure from outsiders. There were three main threats to oil prices then in addition to price cutting by OPEC members themselves. Two were responses to the huge price increases of 1979. Consumers stopped buying so much oil and oil companies did their best to increase supplies, especially supplies originating outside of OPEC.

Oil exploration and development that had been initiated or stepped up as a result of first the 1973 and then the 1979 price increases soon paid off in rising supplies from the North Sea, non-OPEC developing countries, the Soviet Union--so attracted by high prices that it reneged on contracts to sell oil to its clients in Eastern Europe in favor of selling at OPEC prices in western markets--and even the United States. As demand fell, companies bought oil first from these sources and only afterward from OPEC. In 1979, OPEC production had recovered to about the same level it had been in 1973, 31 million barrels per day (MBD). In 1980 this dropped to 27 MBD and by 1983 it hit 17.6 MBD. OPEC as a whole had become the marginal supplier of oil to the world market.

Other developments also weakened oil prices. After the 1973-74 oil embargo, most of the developed countries belonging to the Organization for Economic Cooperation and Development got together to form the International Energy Agency (IEA). The IEA required each member to maintain a 90-day strategic oil reserve in case of oil supply interruptions. If a member were to have its oil supplies fall below 7 percent of requirements, it could apply to the IEA and draw supplies from strategic stocks.

Strategic stocks were too low to be useful during the 1979 crisis. Indeed, the crisis itself pushed oil importers and oil companies to acquire stocks, contributing to the upward pressure on prices. Afterward, many individuals and companies found that, given the fall in consumer demand for oil and their frantic purchases of stocks in 1979 and 1980, they had much more oil than the 90-day supply they needed to meet IEA requirements. In 1983 and again in 1985, large amounts from excess stocks were dumped onto the market, pushing prices downward.

In 1983, OPEC so feared the loss of customers, revenues, and control over the market, that it lowered the price of its **marker** crude, the reference crude against which the prices of other crudes were set, by $5.00 per barrel. It also decided to make mandatory a production regulation scheme that it had adopted as a voluntary measure to restrict production the year before. Its intention was to punish price cutters inside and outside OPEC by reducing their oil incomes, and to halt or reverse the drop in oil demand by reducing prices. Neither plan succeeded.

US monetary policy from 1981 through most of 1985 affected exchange rates by keeping the value of the dollar, the currency for which virtually all crude oil was sold, very high. Dollars acquired through oil sales could be traded for pounds, yen, marks, francs, and other **hard currencies**, maintaining the purchasing power of oil sellers even after the price cut. Price cutters and price defenders all complained at the oil price reduction but few actually suffered unless they were forced to make purchases as well as sales in dollars.

Consumers outside the United States experienced the reverse. Higher and higher dollar prices meant that real prices for oil in local currencies remained constant or even rose despite the OPEC price cut. There was no incentive to increase oil consumption on the part of these consumers, though US consumers, whose dollar economy enjoyed the full effects of the price reduction, did react as OPEC expected and bought more oil. But this increase in total demand was not enough to solve OPEC's problems because of the ineffectiveness of its production controls.

The production control regulations were complicated and contained many loopholes. For example, very heavy crudes and **condensates**, liquids precipitated from natural gas, were not counted as oil production. The cutoff of Iraq's pipelines by Iranian bombing led to extra production by Kuwait and Saudi Arabia "on Iraq's account," but the amounts produced tended to be more than Iraq's share and were not cut back when Iraqi exports were resumed. Poor global economic conditions encouraged barter and other **countertrade** arrangements that took place outside normal oil sales channels, making it hard to find out which country was exporting how much oil and to whom. Several OPEC members cheated by producing more oil than they were entitled to under the quota system, while non-OPEC members continued to behave as free riders on the OPEC price structure.

The main responsibility for holding OPEC production to the ceiling decided upon by the group as a whole belonged to Saudi Arabia, the **swing producer**. Saudi Arabia was also a primary target of Iranian political pressure, and the combination of declining oil production and the perception of a continued threat from Iran pushed the Saudis to push back. After months of warning, the Saudis "turned up the faucet" on their oil production in October 1985. A price that was wobbly but holding at about $25.00 per barrel at the end of 1985 became $12.00 per barrel and not holding six months later. The consequent drop in oil income was painful for all oil producers. In January 1986, officials of the Mexican government visited other oil exporting countries to coordinate efforts to try to stem the fall in oil prices, but it was as though a plug had been pulled out of a full bathtub and the whole OPEC price structure just slid down the drain.

Although prices rose a little over the next few years, they seldom reached OPEC's new target level of $18.00 per barrel and continued to be exquisitely vulnerable to events and rumors of events. Persistent depressed demand coupled to the low prices that OPEC members were able to charge for oil exports affected every member country. Budgets contracted and even the "**low absorbers**," those countries whose populations were small compared to their incomes, had to make painful financial adjustments which included foreign borrowing. These adjustments coincided with fiscal strains on Arab Gulf exporters because of their war loans and payments to Iraq during its war with Iran, and further reductions in income when Gulf shipping became a target in the "tanker war."

Yet the end of the war in 1988 did not bring relief to strained economies and civil societies anywhere in OPEC. Oil demand and prices remained depressed while domestic populations grew restive. Even relatively wealthy Kuwait experienced domestic unrest. Citizen protests against the continued suspension of the parliament and civil liberties provisions of the constitution, initiated by the amir in July 1986 ostensibly because of external threats arising from the war, became widespread in 1989. High prices and a depressed local economy contributed to criticism of the regime's economic policies and charges of corruption. The government felt pressed to satisfy the population's economic demands as a way to mute the political demands it was even less happy to deal with. That year, Kuwait's oil production consistently exceeded its OPEC quota. And Kuwait was not alone. Other Gulf exporters, most notably the United Arab Emirates but also Saudi Arabia, were also overproducing.

Overproduction by OPEC members contributed to the market factors that depressed world oil prices. But Kuwait suffered from a special disability in taking this initiative in its oil production policy. Its boundary with Iraq had been contested since the 1930s, and years of diplomatic efforts and billions of dollars in loans and grants had not been enough to persuade Iraq to drop its claims to Kuwait. Continuing to produce at levels above its OPEC quota made Kuwait vulnerable to Iraqi retaliation.

Iraq's economic problems, which included huge war debts to foreign banks as well as to Kuwait and other governments, were also pressing. It was convenient for Iraq to point to Kuwait as the source of its problems, and to be able to clothe its invasion of Kuwait as an "oil war," a war to remove Kuwait's oil weapons, overproduction and stealing Iraqi oil produced along the disputed boundary. But just as many other conflicts in the Middle East are about a lot more than oil, so was this one. Saddam's problems required a quick infusion of cash. His diplomatic probes during the six months prior to the invasion convinced him that no power capable of stopping him would intervene if he were to invade Kuwait and take what he needed. His expectations that even Kuwaitis would welcome his actions, and that a quick victory in Kuwait would help him domestically, persuaded him that his attack on Kuwait would not suffer the same result as his attack on Iran had nearly a decade earlier. But Saddam was wrong and his 1990 invasion of Kuwait was reversed seven months later by a multilateral force led by the United States.

The Iraqi invasion and the subsequent Second Gulf War introduced two new oil weapons into world politics. The first was the one cited by US president George Bush when he said that the United States had to fight to keep Middle Eastern oil from being controlled by Saddam Hussain. From Bush's perspective, a goal of the Second Gulf War was to preserve an oil market where the major oil exporting countries participate individually rather than under the hegemony of a regional military power. From Saddam's perspective, one goal was to create just such a hegemony under his leadership.

The second oil weapon was an ecological one. Saddam promised to release Kuwaiti oil into the Gulf and to destroy Kuwait's production, processing, and export facilities, if the multinational forces were to attack Iraq, either at home or in Kuwait. In the end, these threats became realities as the allies struck to drive Iraq out of Kuwait. This demonstrates once again the strategic inferiority of oil weapons to deter undesired behavior when the stakes include the survival of a nation or its current regime.

The end of the Second Gulf War has left world oil markets in a state of uncertainty. Iraq's oil has been kept out of the market by a boycott since its invasion of Kuwait, and little has seeped out except to its immediate neighbors. But when Iraq is finally rehabilitated politically, Iraqi oil will pour onto the market, crowding out production from countries which eagerly raised production in response to the boycott. The reconstruction of Kuwait's oil industry proceeded much more quickly than most had anticipated. Now Kuwait produces about 2 MBD and continues to expand its production capacity. Excess capacity is a another oil weapon, one that can be used against other producers. OPEC members with surplus capacity continue to produce over their quotas even though oil prices were severely depressed until very recently. The reintroduction of collective discipline over production is a stated goal of several members, but has not progressed far enough to change OPEC policy.

The Second Gulf War influenced oil markets on the consumer side as well. The Iraqi invasion of Kuwait touched off a rapid increase in oil prices but political paralysis prevented the IEA from releasing oil stocks. The entire burden of price stabilization fell on the shoulders of OPEC members. Those who were able did increase production and the market stabilized at lower prices after several weeks. In January 1991, in conjunction with the allied counterattack, the IEA did initiate a planned release of stocks to keep the market from skyrocketing upward as it had the previous August and September. But IEA action proved to be too heavy-handed, and prices actually plummeted. As a result, some producers and consumers called for a dialogue to help coordinate their actions so that markets would not fluctuate to the injury of both sides. But as in the past, no real accommodation between these two groups has been made.

Meanwhile, the breakup of the Soviet Union and the desperation of the impoverished new governments of the successor states are setting the stage for a new "oil rush." Despite high costs for oil and gas exploration and development world-wide, the proliferation of nations seeking investments and companies with capital to invest promise to keep profit margins down as producers struggle to capture and hold customers. At the same time, concerns about global warming and other effects of oil pollution are pushing consumers to find other sources of energy. These pressures too will limit the degree to which oil prices can rise in the absence of a general world-wide economic recovery.

Oil and Money in the Middle East

I began this chapter by saying that oil is a blessing for those countries that have it. One of the chief blessings of oil comes from its easy convertability into foreign exchange. The higher oil prices that resulted first from the oil revolution and then from the revolution in Iran raised the earnings streaming into oil exporting countries to flood levels. We all know that floods, whatever their other qualities, are also disasters, and this flood was no exception. It too brought both good news and bad news.

The good news was that a huge amount of money was suddenly available to oil exporting countries to use for their economic development, their military defense, and to increase the welfare of their people. The bad news was that the money came too fast and was neither steady nor predictable. In 1973, economists worried that rising oil prices would cause a depression in oil importing countries and that higher oil incomes would be virtually unusable by the oil exporting countries, especially the Arab states along the Gulf with their small populations and very large oil revenues. But both worries were overstated. The "unusable" dollars that concerned these economists turned out to be a chimera. Nicknamed **"petrodollars,"** the cash balances of oil exporting countries soon found their way into the international banking system where they were **recycled** as loans to oil importing countries.

Oil money was a mixed blessing in the domestic economies of oil exporting states. Sudden increases in imports and the flood of new money aggravated domestic inflation rates. Oil exporters soon learned to spend their new money as fast as it came in so that, by the time of the second round of price increases in 1979-80, many had started to amass foreign debt of their own, debt incurred to raise money for investment and to pay for an explosion of arms purchases. Arms purchases were an especially perverse development of the oil price increases of the 1970s. The diversion of excessive amounts of oil revenue to buy weapons took resources from the domestic economies of states like Iran and Iraq whose rural populations suffered extreme deprivation. Oil money financed both Gulf Wars and made Saddam Hussain a greater power in his region than he would have been otherwise because it enabled him to buy weapons systems and war materials that he used to the detriment of his countrymen and his neighbors but could not have produced so rapidly or extensively on his own.

Some states, like Kuwait and Bahrain, made efforts to redistribute oil revenues across their populations by subsidizing housing, utilities, education, and medical care. Some capital redistribution was effected through property transfers. In Kuwait, the state purchased land from citizens at highly inflated prices, while in Bahrain the government sold housing to citizens at low prices. But oil money also supported conspicuous consumption, corruption, and gross waste. Kuwait's "underground" stock exchange, the Suq al Manakh, was little more than a casino. Its collapse in 1982 resulted not only in a huge loss of capital but also in a loss of confidence in the government, which was slow to intervene because of involvement by high officials and members of the ruling family. Subsidized and pampered native populations in many Gulf states lost interest in low status jobs, requiring the importation of hordes of **guest workers** to make local economies work. Despite its heightened fear of foreigners since its war with Iraq, Kuwait has resumed its imports of labor, though fewer guest workers now come from other Arab countries and few among the formerly extensive Palestinian workforce remain.

In foreign policy, oil money increased the autonomy of oil exporting countries, making it less necessary for them to bind themselves as clients to an extra-regional patron state in order to obtain economic or military assistance. Although the oil-rich states of the Middle East have been criticized for "wasteful" development projects, most have done no worse than their oil-poor peers whose economic decisions are overseen by foreign bankers and officials of patron governments. Significantly, the influx of oil money into the Middle East enabled countries such as Egypt to discard its client relationship to the Soviet Union in favor of more egalitarian relationships with Arab oil exporting countries. Oil money also enabled Saudi Arabia to loosen its Israeli-mediated military dependency on the United States. Thus, oil money has hastened the breakdown of the tradition of Great Power Primacy in the Middle East that had long shaped the region's politics in the images desired by outsiders.

Conclusions

_______Oil has given a number of Middle Eastern countries the economic independence to try development strategies and to form political bonds that are foreclosed to poorer states. It has also served as a substitute for conventional--that is, military--attributes of power, forcing other nations to reexamine their own foreign policies in the light of long term economic interests. Thus, it has helped to break down the post-war dominance of the super powers by providing incentives for greater independence on the part of their alliance partners and extra-regional clients and dependencies.

But oil also instilled a false sense of power and a false sense of long term economic security in the minds of policy makers in oil exporting states. Few used the fat years following the two enormous oil price hikes to prepare for the lean years that came after. In 1978, financial analyst Walter J. Levy mourned "the years that the locust hath eaten," the years when money was spent, borrowed, and lent, as though the golden faucet would never fail. Now the ravages of rapid changes in income, both up and down, are visible everywhere in the Middle East.

The most unfortunate result of the oil revolution was the role of oil revenues in financing two highly destructive regional wars in the Gulf, and the arming and training of forces committed to Islamist revolution from North Africa to Southeast Asia. Yet even here, the results are ambiguous. Among the casualties of the Second Gulf War is an Arab nationalism that had impeded the development of independent foreign policies with partners outside the region and also with Israel. Along with the progress in the Middle East peace process, these changes promise to affect the regional balance of interests and power in profound ways.

Despite the opportunities that oil has conferred, its exploitation has also exacted high social, political, and economic costs. Uncertain what new regional order will rise on the debris left by recent rapid political changes in the Middle East, we can only speculate whether oil has been a blessing or a curse to its nations and their peoples. A similar analysis of the energy politics of other regions is likely to reveal equally ambiguous effects and equally obscure prognoses for the futures of oil exporters and importers alike.