

**SYMPOSIUM**

**INTERNATIONAL PROBLEMS OF PETROMONEY:  
AFTERMATH OF THE ENERGY CRISIS**

*Petrodollars—The Recycling Problem:  
Some Introductory Remarks*

*The Petrodollar Energy Crisis:  
An Overview and Interpretation*

*Recycling the Petrodollar:  
Current Problem, Future Opportunity*

*The European Community and the  
Recycling of Petrodollars*

## EDITOR'S PREFACE

The following four articles were prepared in anticipation of the Twelfth Annual Regional Meeting of the American Society of International Law, which was to have been held at the Syracuse University College of Law on April 5, 1975. Unfortunately, a paralyzing snowstorm on the weekend of the meeting forced a cancellation of the proceedings.

The four papers published in this issue outline the proposed discussion. The remarks of Mr. Sassoon were prepared as an introduction to a session on the necessary role of international financial institutions, while the article by Dean Alnasrawi which follows was scheduled as the keynote, presenting his overview of the petrodollar problem. Professor Pattillo, originally scheduled as a member of the panel discussing petromoney investment problems in the United States and elsewhere, subsequently submitted an analysis of balance of payments problems generated by the new petrofunds. Completing this section is the presentation scheduled to open the afternoon session, an analysis by Professor Herzog of the response of the "European Community" to the petromoney imbalance. The economic analyses of these articles, especially those of Mr. Sassoon and Dean Alnasrawi, are based upon data available at the time of conference.

The College of Law International Law Society would like to express its appreciation to those persons yet unmentioned who had graciously agreed to attend the Twelfth Annual Regional Meeting: Associate Professor Jon E. Bischel; Pierre De Ravel D'Esclapon, Esq.; James G. Evans, Jr., Esq.; Associate Professor George M. Frankfurter; Professor L.F.E. Goldie; Assistant Professor Douglass J. Klein; Professor Eric Lawson; Howard Mennell, Esq.; Lester Nurick, Esq.; and James E. Price, Esq.

# THE PETRODOLLAR ENERGY CRISIS: AN OVERVIEW AND INTERPRETATION

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## I. HISTORICAL PERSPECTIVE

Any meaningful analysis of the current petrodollar situation requires an understanding of the evolution of relationships between oil companies and the governments of the oil producing countries during the first half of this century, due to the great influence these relationships have had on the present situation.

### A. *The Concession Agreements*

Traditionally, oil producing countries had to deal individually with the oil companies operating in their territories regarding various aspects of oil production. Once an oil concession had been obtained, the host government had no control over the development of oil resources nor over the price at which oil was sold. Its role was confined to that of a mere recipient of a stipulated sum of money per unit of output. In the oil producing countries of the Middle East, these concessions were obtained by one or more of the seven major international oil corporations: Exxon, Texaco, Mobil, Gulf, Standard Oil of California (Socal), British Petroleum (BP), and Royal Dutch-Shell Group (Shell). In the early part of this century, these major firms obtained, either individually or jointly, the concession agreements which gave them virtually total control over the oil resources in the Middle East. Thus, in Iran, BP was the sole operator of that country's oil industry until 1951. In Kuwait, the concession was obtained by Gulf and BP. In Iraq and Abu Dhabi, the groups included all the majors except Texaco and Socal. In Saudi Arabia, the concession was obtained first by Socal, which later admitted Texaco, Exxon, and Mobil. Oil operations in each country were carried out by a subsidiary owned by the major firms. The main features of these concessions may be summarized as follows:

1. The duration of the concession extended over several decades. Thus, the concession of Iraq Petroleum Company (IPC) was to last from 1925 to the year 2000; Aramco's concession period was 60 years from 1933; Kuwait Oil Company (KOC) had a concession

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for 75 years from 1934; Iran's original concession was to last 60 years from 1933.

2. The concessions covered either most of the territory of the state (for example, Iran and Saudi Arabia) or the state's entire territory (for example, Iraq, Kuwait, and Abu Dhabi). In commenting on these two features, Professor Stocking wrote that "never in modern times have governments granted so much to so few for so long."

3. In return for these privileges the governments were, as mentioned earlier, the recipients of a fixed amount of revenue per unit of output.

The asymmetry between the rights and obligations of the oil companies can be explained by a number of historical facts, two of which stand out as the most important. First, the oil companies were backed by the military presence and/or the political power of their home governments. The IPC concession, for example, was obtained at a time when Iraq was under the British Mandate, and Kuwait was a British protectorate when the concession was granted to BP and Gulf. Second, aside from the British influence in the Middle East, the governments, or more precisely the ruling oligarchies, lacked virtually any knowledge of the importance of oil or its relevance to their economies. Nor had they any significant knowledge of the workings of the international oil industry.<sup>2</sup> In Iran, long a pawn in the international rivalries of Russia and Great Britain, the monarchy which granted the concession was described by Sir Arthur H. Hardinge as "an old, long-mismanaged estate, ready to be knocked down at once to whatever foreign power bid highest or threatened most loudly its degenerate and defenseless rulers."<sup>3</sup> In Saudi Arabia, the concession was granted by a ruler who was described as "not a modern or medieval man but the last of the great figures of the Old Testament."<sup>4</sup> Even in the absence of military presence and political domination, the two parties to the concession

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1. G. STOCKING, *MIDDLE EAST OIL: A STUDY IN POLITICAL AND ECONOMIC CONTROVERSY* 130 (1970).

2. According to N. al-Pachachi, in 1935 Iraq's oil department was run by a director, who did not have a high school diploma, and a junior clerk. As late as 1951, when Iraq negotiated its 1952 profit sharing agreement with IPC, no one had heard of posted prices, not to mention technical and economic studies. al-Pachachi, *The Development of Concession Arrangements and Taxation in the Middle East*, *MIDDLE EAST ECONOMIC SURVEY SUPP.*, Mar. 29, 1968 [*Middle East Economic Survey* will hereinafter be cited as MEES].

3. A. HARDINGE, *A DIPLOMATIST IN THE EAST* 280 (1928), quoted in G. STOCKING, *supra* note 1, at 123.

4. *Id.*

agreements were far from equal in their bargaining power or knowledge of the oil industry, as well as in their understanding of the intricate workings of the modern multinational corporations or the complexity of legal documents framed by attorneys skilled in corporate and contract law.<sup>5</sup>

Given the long term consequences of this disparity in bargaining power and knowledge, the political and economic consequences of the Great Depression and World War II, the rising importance of Middle Eastern oil to the world economy, and the enormous profits which the oil companies were able to accumulate and transfer to their home countries, the people of the Middle East came to view the concession agreements as instruments which deprived them of an equitable share in their own wealth. Hence, it was inevitable that conflicts should arise. The points of conflict focused on the size of the area under concession, the duration and exclusive nature of the concessions, pricing and output policies, government revenues, cost accounting methods, the surrender of rights of taxation, fixity of legal terms, settlement of disputes, and the sovereignty of a foreign oil enclave within a sovereign state.

### *B. The International Petroleum Cartel*

Long before the Organization of Petroleum Exporting Countries (OPEC) became known to the world, the international oil industry was dominated by seven vertically integrated major companies (the majors) which controlled over 90 percent of the world oil production outside the United States and the Union of Soviet Socialist Republics and the bulk of its transportation, refining, and marketing facilities. The American majors were also in control of a sizable part of the American oil industry. As early as 1928, the dominant majors (Exxon, BP, and Shell) entered into cartel arrangements to eliminate competitive pricing by fixing market shares, controlling output growth from various sources, exchanging oil to lessen cross-hauling, agreeing whether to eliminate or bring in competitors to the cartel system, and ultimately agreeing to sell crude oil and products at a fixed price regardless of source or production cost. Prices at the U.S. Gulf Coast terminals, as published by Platt's Oilgram, constituted the basis for price quotations throughout the world. In order to integrate the American oil output with the cartel's policy to regulate world output to maintain prices, an attempt was made to have the

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5. *Id.* at 125-26.

U.S. Government regulate output. Failing that, the industry persuaded oil producing states to adopt a series of regulations controlling oil production. The state regulatory agencies were empowered to prorate the estimated demand for crude oil among all producing fields and wells. Demand was estimated on the basis of current prices, so that additional production would not undermine the existing price structure.<sup>6</sup> The Connally Hot Oil Act<sup>7</sup> enforced state regulations by prohibiting interstate sales of crude oil produced in violation of state restrictions.<sup>8</sup> Thus, the prorating mechanism which stabilized U.S. crude prices served at the same time to stabilize prices throughout the world, since U.S. Gulf Coast prices were the prices at which oil was sold on the international market. It is interesting to note in this connection the anomaly in this situation that consumers in Iraq were charged prices based upon quotations at the U.S. Gulf Coast, regardless of the facts that (a) the crude oil was produced in Iraq; (b) it was produced at low cost; (c) it was refined in a nearby refinery; and (d) the products were marketed by a local company.<sup>9</sup>

The majors which sought an orderly development of oil production through market allocation and price stabilization were able to solidify their control through the utilization of two important devices. The first was the joint ownership of producing companies in the oil producing countries in the Middle East and Venezuela. This technique could not but help the majors to coordinate and control output. Second, in order to allow new oil to enter the world market through the majors' integrated channels, long term contracts were concluded between certain majors. The provisions of these contracts, which specified where such crude was to be marketed and the terms of its sale, had the effect of tightening the joint control of the majors over the international oil industry.

### C. Forces of Change

A number of significant developments which took place in the

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6. AD HOC COMM. ON THE DOMESTIC AND INTERNATIONAL MONETARY EFFECT OF ENERGY AND OTHER NATURAL RESOURCE PRICING, HOUSE COMM. ON BANKING AND CURRENCY, 93D CONG., 2D SESS., OIL IMPORTS AND ENERGY SECURITY: AN ANALYSIS OF THE CURRENT SITUATION AND FUTURE PROSPECTS 70 (Comm. Print 1974) [hereinafter cited as OIL IMPORTS AND ENERGY SECURITY].

7. Interstate Transportation of Petroleum Products Act, 15 U.S.C. §§ 715-715I (1970).

8. OIL IMPORTS AND ENERGY SECURITY, *supra* note 6.

9. SUBCOMM. ON MONOPOLY, SENATE SELECT COMM. ON SMALL BUSINESS, 82D CONG., 2D SESS., THE INTERNATIONAL PETROLEUM CARTEL: STAFF REPORT OF THE FED. TRADE COMM'N 95 (Comm. Print 1952) [hereinafter cited as THE INTERNATIONAL PETROLEUM CARTEL].

1950's had the effect of first solidifying the control of the majors over the world oil industry, but at the same time undermining it, and thus altering the pattern of relationship between the companies and the governments.

In the final stages of World War II, it became clear that the United States would no longer continue to be a major exporter of oil. It also became clear that Europe would need increasing amounts of oil for the rebuilding of its economies, and the only major region capable of meeting these oil needs was the Middle East. The Middle East was also to be called upon to meet the rising needs of other parts of the Eastern Hemisphere, especially the phenomenal increase the Japanese demand for oil. In order to forestall an unregulated growth of that region's output, a treaty between the governments of the United States and the United Kingdom was concluded in 1944.<sup>10</sup> The Anglo-American Oil Agreement had, broadly speaking, two major objectives: (1) to enable U.S. oil companies to have more access to Middle East oil; and (2) to recommend how supply could be correlated with demand so as to further the orderly conduct of the international petroleum trade.

Given the fact that there was more Middle East oil than there were markets for it, it was obvious that production allocations were going to be made . . . . The problem, therefore, was not whether but who would control that international allocation mechanism. As it turned out, the failure of the Anglo-American Oil Agreement delegated this global function to the major international oil companies.<sup>11</sup>

In 1946, the Venezuelan government decreed an income tax of 50 percent on the difference between cost and sale price of oil, a precedent which was to be followed in the Middle East in later years. In the same year, Exxon concluded that its sources of oil in the Western Hemisphere would not be sufficient to meet its market needs in the Eastern Hemisphere. Because of the fact that Aramco's oil was cheaper and because of the fear that its owners (Socal and Texaco) would use it to build their own facilities, Exxon and Mobil came to the conclusion that Socal and Texaco should be persuaded to use their marketing facilities in return for a piece of Aramco. In

10. Petroleum Agreement Between the United States and Great Britain, done Aug. 8, 1944, U.S.C. CONG. SERVICE, 78TH CONG., 2D SESS. 1404, 1405-08 (1944).

11. SUBCOMM. ON MULTINATIONAL CORPORATIONS, SENATE COMM. ON FOREIGN RELATIONS, 93D CONG., 2D SESS., MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY 42-43 (Comm. Print 1975) [hereinafter cited as MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY].

a rather complicated transaction concluded in 1947, Exxon received 30 percent and Mobil 10 percent interests in Aramco for \$102 million plus \$125 million for similar interests in the Trans Arabian Pipeline (Tapline), which brings Arabian crude to the Mediterranean. By joining forces with Socal and Texaco, Exxon and Mobil were able not only to eliminate a serious potential disruption, but also to set the stage for the phenomenal growth of Saudi Arabian oil output.<sup>12</sup>

In 1950, Aramco concluded an agreement with the Saudi government which allowed the government to impose a 50 percent income tax rate on Aramco's profits. In 1951, the government of Dr. Mossadegh nationalized the Iranian oil industry following a bitter dispute with BP. The nationalization measures and the Aramco-Saudi agreement prompted the operating companies in Iraq and Kuwait to adopt the 50/50 profit sharing arrangements with certain modifications.

The Iranian nationalization crippled its economy since Iran was unable to attract any buyer for its oil. Output declined from 700,000 barrels a day (BD) in 1950 to 28,000 BD in 1952. The international oil cartel was very successful in its boycott of the nationalized oil. The loss of Iranian oil to BP was offset by increasing output in Iraq, Kuwait, and Saudi Arabia. In 1953, the government of Dr. Mossadegh was overthrown and a year later a consortium of oil companies re-entered Iran. While BP was the sole proprietor of the concession before 1951, its equity share in the new consortium was reduced to 40 percent, with the remaining 60 percent distributed among the five American majors (35 percent), Shell (14 percent), Compagnie Française des Pétroles (CFP) (six percent), and the other five percent given to a small group of independent American oil companies.<sup>13</sup>

The seven majors together with CFP in 1954 had control over 95 percent of the oil produced in Iran and Iraq and 100 percent of the oil produced in Saudi Arabia and Kuwait. This position of con-

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12. The Aramco concession has been fabulously profitable. Aramco's net income in 1973 was \$3.3 billion, of which \$2.6 billion was paid as dividends to its four American owners. Exxon's share of the dividend was \$789 million, or 32 percent of Exxon's total earnings of \$2.4 billion. See *Hearings on Multinational Oil Corporations and United States Foreign Policy Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations*, 93d Cong., 2d Sess., pt. 7, at 206, 232 (1974) [hereinafter cited as *Hearings on Multinational Oil Corporations and United States Foreign Policy*]. In 1974, Exxon earned \$3.1 billion, a 28 percent increase over 1973. See *PETROLEUM INTELLIGENCE WEEKLY*, Feb. 3, 1975, at 6 [*Petroleum Intelligence Weekly* will hereinafter be cited as *PIW*].

13. See G. STOCKING, *supra* note 1, at 157-58; *MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY*, *supra* note 11, at 72-73.



rol enabled the majors to reintroduce the Iranian oil into the world market by slowing growth elsewhere in the region. Given the fact that, by 1954, oil had already become an indispensable source of current and developmental revenue for oil producing countries, it was clear that the majors were in a strong position to exert enormous power over the economic and political destiny of these countries. It should be remembered that in any negotiation or confrontation, each of the producing countries was forced to face a most powerful cartel, one that was in turn backed by the diplomatic and military forces of its members' home governments.

While the 1954 Iranian consortium agreement had the effect of strengthening the position of the majors, other developments had the opposite effect. These developments include the entry of newcomers offering better fiscal and other terms to host governments, the re-entry of Soviet oil into the world market to compete with oil from conventional sources on nonconventional terms (barter and non-dollar payments), and the emergence in producing countries of oil technocrats who were able to question some of the operational principles and practices of the oil companies. By the mid-1950's, oil imports had become a significant element in the U.S. market. Given the existence of the prorating system, the percent of production in Texas, for example, had to be reduced from 100 percent in 1948 to 63 percent in 1950, and to 47 percent in 1957 when import quotas were imposed on a voluntary basis.<sup>14</sup> In 1959, the import quota system was made mandatory to preserve the prorating system and to maintain domestic prices above foreign crude prices. The import controls insured not only that most U.S. needs would be met from domestic sources, but that most incremental demand would be met from these sources as well. The quota system had several important consequences. These included the denial of an opportunity to oil producing countries to expand output (especially Venezuela, which had become dependent on U.S. oil needs), the depletion of U.S. oil reserves, and the transfer of income from oil consumers to oil producers within the United States due to the higher prices of U.S. oil.<sup>15</sup>

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14. AD HOC COMM. ON THE DOMESTIC AND INTERNATIONAL MONETARY EFFECT OF ENERGY AND OTHER NATURAL RESOURCES PRICING, HOUSE COMM. ON BANKING AND CURRENCY, 93D CONG., 2D SESS., DEVELOPING COUNTRIES AND THE UNITED STATES IN THE WORLD ECONOMY: PROBLEMS AND PROSPECTS 66 (Comm. Print 1974) [hereinafter cited as DEVELOPING COUNTRIES AND THE UNITED STATES IN THE WORLD ECONOMY].

15. P. ODELL, OIL AND WORLD POWER: A GEOGRAPHICAL INTERPRETATION ch. 2 (1970). It was estimated that in 1969 consumers paid about \$5 billion more for oil products than they would have paid in the absence of import restrictions. See CABINET TASK FORCE ON OIL IMPORT

One of the most important ramifications of the U.S. import control system for the international oil industry was its impact on the behavior of the newcomers. These oil firms entered the world market in the 1950's in order to insure crude supplies for their own refineries in the United States and elsewhere. Once the U.S. market was closed in 1959, it was only logical that they would sell their low cost crude at less than the majors' posted prices. Although the market outside the majors' control was narrow, it was still wide enough to exert a downward pressure on world prices outside the United States. This and the re-entry of Soviet oil forced the majors to sell their own oil to nonaffiliates at a discount in order to protect their market shares and to expand them if possible. But to sell at less than the posted prices and to compute government revenue at the posted prices meant that the majors were forced to accept less than 50 percent of the profits. From the majors' point of view, this situation was unsustainable. In other words, the governments had to absorb part of the discount by having to accept lower per barrel revenue. Thus, in February 1959, the majors announced a reduction of 18 cents per barrel in the posted price of Middle East crudes (from \$2.08 for Arabian oil), followed by another reduction of 10 cents per barrel in August 1960 (from \$1.90 for the same oil). These reductions had the effect of reducing the per barrel revenue for Arabian oil from 82 cents in 1955 to 75 cents in 1960, or a drop of nine percent. It is obvious that no government would willingly tolerate such a situation in which foreign enterprise unilaterally determines the size of its revenue. These arbitrary price cuts served as a warning to the oil producing countries that, in the absence of cooperation among themselves, further reductions in the posted prices could take place, thereby endangering their current budgets and development programs.

#### *D. Prices and Profits Before OPEC*

Posted prices (prices published by oil companies at a seaboard terminal) became, with the adoption in the early 1950's of the profit sharing agreements, the basis for computing company income and government revenues. The setting of these posted prices was the exclusive prerogative of the companies; the other exclusive prerogative, it will be recalled, was the control of output. As the Middle East's low-cost output began to rise, in order to enable it to pene-

trate markets which had been traditionally supplied from Western Hemisphere sources or supplied by other fuels (mainly coal), Middle East posted prices were gradually reduced to compensate for freight cost from the Middle East to points of destinations in Europe and the United States. Since the American market was protected by prorating and quota systems, the differential between posted prices in these two markets continued to widen from an initial 62 cents per barrel in 1948 to \$1.40 per barrel in 1961. This resulted from a series of price changes which had the effect of raising U.S. domestic prices (from \$2.68 in 1948 to \$3.28 in 1961) and lowering Middle East prices (from \$2.08 in 1948 to \$1.80 in 1961).

As to the profitability of the Middle East oil concessions for the period 1948-1960, it was shown that the average per barrel revenue for the host governments was 67 cents compared with an average of \$1.10 per barrel for the companies. Total government revenue for the same period amounted to \$9.3 billion, while the net earnings of the companies amounted to \$14.2 billion. Of the \$14.2 billion, the companies reinvested \$1.3 billion in fixed assets in the region and transferred \$12.8 billion abroad. The ratio of net income to net fixed assets was computed to be 67 percent per year for the same period.<sup>16</sup>

## II. OPEC'S FIRST DECADE

The erosion of posted prices in the Middle East and Venezuela relative to U.S. prices, and the powerlessness of any single government to arrest such erosion, made it necessary for oil producing countries to attempt to coordinate their efforts in their dealings with the majors. Although the nationalization of the Suez Canal and its shutdown in 1956 had demonstrated a potential for bargaining power on the part of oil producing countries, it was not until after the price cut of August 1960 that the Organization of Petroleum Exporting Countries was created.<sup>17</sup>

16. C. ISSAWI & M. YEGANEH, *THE ECONOMICS OF MIDDLE EASTERN OIL* 188-89 (1962).

17. OPEC was founded by Iraq, Iran, Kuwait, Saudi Arabia, and Venezuela. Qatar joined OPEC in 1961, Indonesia and Libya in 1962, Abu Dhabi in 1967, Algeria in 1969, Nigeria in 1971, and Ecuador in 1973. In addition to these 12 members, Gabon was admitted in 1974 as an associate member.

It is interesting to note that some oilmen were worried that the 1959 price cut would push oil producing countries into an exporters' bloc. It is also worth mentioning that the creation of OPEC encountered the hostilities not only of the oil companies and Western governments, but also that of the Soviet Union. The latter suspected OPEC of being a front for the international oil companies. See *The Birth of OPEC, and How It Grew: An Interview with Juan Pablo Perez Alfonso*, *BUS. WEEK*, Jan. 13, 1975, at 78-79.

OPEC's First Conference stated in its first resolution that member countries could no longer remain indifferent to the attitude heretofore adopted by the oil companies in effecting price modifications, that they should endeavor by all means available to them to restore prices to the levels prevailing before the 1960 reductions, and stressed that, in the future, consultations with governments should be undertaken prior to any price modifications. It is important to note that the same resolution established the principle that member countries were to refrain from accepting any offer of beneficial treatment from the companies at the expense of each other's interest.<sup>18</sup> The enunciation of this principle was intended to mitigate against company attempts to divide OPEC by offering incentives to some and putting pressures on others.<sup>19</sup> Although OPEC reaffirmed its price resolution in subsequent conferences, it failed to evolve a collective bargaining position, and the attempt to restore prices to their pre-August 1960 level was abandoned in 1963. Instead, OPEC concentrated its effort on two other issues: (1) expensing of royalty; and (2) elimination of marketing expenses.<sup>20</sup> When the companies unilaterally decided to reduce marketing expenses from one percent of posted price to one-half cent a barrel, royalty expensing became the sole issue for long and difficult negotiations. After a series of conferences and meetings to study company initial offers, modified offers, improved offers, last minute offers, and final offers over a period of more than two years, the royalty issue was settled in a rather anticlimactic manner.<sup>21</sup> This was so because OPEC's original position would have increased government revenue by 19 cents per barrel, while the final settlement resulted in a per barrel increase in revenue of 3.6 cents per barrel,

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18. For a more detailed analysis see Alnasrawi, *Collective Bargaining Power in OPEC*, 7 J. WORLD TRADE L. 188 (1973).

19. See *The Birth of OPEC, and How It Grew*, *supra* note 17.

20. Royalty under the concession agreements was fixed at 12.5 percent of the posted price of crude and was credited by the companies against their income tax liability to the producing countries. Thus, under the 50-50 profit sharing system a company tax liability would be one-half posted price minus production cost, less royalty. Royalty expensing, on the other hand, would change a company tax liability to one-half posted price minus cost, including royalty. Thus, the expensing of the royalty would increase company tax liability and government revenue by an amount equal to one-half of the royalty. See generally SHELL, *THE OPEC ALLOWANCES* (1968).

21. For the articulation of OPEC arguments concerning royalties see OPEC, EXPLANATORY MEMORANDA ON THE OPEC RESOLUTIONS 5-8, 11-14 (1962). As to the course of negotiations see *OPEC and the Oil Companies*, MEES SUPP., Aug. 28, 1964; OPEC, *OPEC AND THE PRINCIPLE OF NEGOTIATION*, 7-17 (1965); F. ROUHANI, *A HISTORY OF OPEC* 217-43 (1971).

which rose to 5.4 cents per barrel in 1966 after allowing oil companies certain discounts off posted prices (8.5 percent in 1964 and 6.5 percent in 1966).

Once the royalty issue was settled and the price issue abandoned, member countries found themselves without a rallying point for the exercise of their collective bargaining power until 1971. In this interim, OPEC members were drawn in two different directions. The first was to attempt to agree on general principles of common interest with respect to oil policy. The second was to embark on individualized policies intended to maximize benefits without coordination with other countries. Thus, while Iran was successful in raising output and Iraq was attempting to develop its oil resources, Libya, on the other hand, was concentrating its efforts on improving per barrel revenue, especially in the area of posted prices.

Libya's price negotiations deserve a special treatment, since they provided a prelude to subsequent developments. Although Libya protested the low level of her posted prices as early as 1961, negotiations did not begin until 1967. The 1969 Libyan revolution drew particular attention to this dispute which was finally settled in September 1970. The Libyan price settlement was an important landmark in government-company relationships, in that it was the first successful attempt by a single government to raise posted prices. In the course of its negotiations with oil companies, the Libyan government seemed to have been helped by a number of important developments in the international oil economy. These developments included not only the continued closure of the Suez Canal, but also the closure of the Trans-Arabian Pipeline beginning in May 1970. Actual demand for crude oil surpassed previous forecasts, causing a supply-demand imbalance to emerge. In the United States, signs of impending fuel shortage were emerging. Pollution-conscious countries were increasingly interested in the low-sulphur Libyan crude oil. The Libyan government for its part ordered, as of May 1970, a series of cutbacks, which by September of that year had the effect of reducing Libyan output from 3.6 million BD (or MBD) to 2.8 MBD. Finally, the Libyan strategy in singling out Occidental Oil Company for negotiation (which, unlike the majors, had no alternative sources of supply) proved to be successful. Thus, by September 4, 1970, an agreement was reached, which was followed by similar agreements with other operating companies. The main provisions of these agreements were: (a) posted prices were increased by 30 cents per barrel and by a further two

cents per barrel each year over the following five years; (b) Libya's claim that oil had been underposted was settled by raising the income tax rate from 50 percent to 54 percent; and (c) the adoption of a new gravity differential system.<sup>22</sup>

The Libyan settlement seemed to have set in motion a number of developments which proved to be irreversible. Coming on the heels of an already rising crude and product-price structure and at a time when freight rates were at their peak, the increase in company tax-paid cost was immediately passed on to the consumers. Moreover, as soon as the majors had agreed to raise Libyan posted prices, they announced an increase in Iraq and Saudi Arabia Mediterranean prices of 20 cents per barrel. This was followed in November by an increase in the income tax rate in Iran, Kuwait, and Saudi Arabia from 50 percent to 55 percent, accompanied by a nine cents per barrel increase in the price of heavy crude at Persian Gulf terminals. These increases, like the previous ones, were passed on to the consumers. Before dealing with the impact of these developments on OPEC's behavior in the 1970's, it is necessary to review very briefly the interrelationship between the majors and their home governments.

#### A. *The Majors and Their Governments*

The majors' home governments (United States, United Kingdom, France, and the Netherlands) have all played significant roles in enabling their oil companies to acquire oil concessions, to penetrate markets, and to deal with oil producing countries. Depending on the situation and the historical context, these governments have at times cooperated with each other and at times opposed one another. In both situations, the posture of the government was determined by its economic and foreign policy interests as conceived by policy makers.<sup>23</sup> The core of each government's policy, depending on the situation, was either to restrict exploitation to its corporate citizens, hence limiting access to foreign companies (as was the case with the Dutch and U.K. governments), or to back their corporate citizens in penetrations into areas under the control of other govern-

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22. See MEES, Sept. 11, 1970, at 1-3.

23. This section relies heavily upon the following: *Hearings on Multinational Corporations and United States Foreign Policy*, *supra* note 12, pts. 3-7; MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11; SUBCOMM. ON MULTINATIONAL CORPORATIONS, SENATE COMMITTEE ON FOREIGN RELATIONS, 93D CONG., 2D SESS., THE INTERNATIONAL PETROLEUM CARTEL, THE IRANIAN CONSORTIUM, AND U.S. NATIONAL SECURITY (Comm. Print 1974); THE INTERNATIONAL PETROLEUM CARTEL, *supra* note 9; H. O'CONNOR, THE EMPIRE OF OIL (1962).

ments (as was the policy of the U.S. and French governments). In either case, the governments involved employed the standard clichés of national security, national economic interests, open door policy, war alliances, discrimination, free trade, etc. The history of the struggle to control Iraq's oil through the ownership of IPC and the restrictive clauses of the arrangements between its owners (BP, Shell, Exxon, Mobil, and CFP) demonstrated how insincere the references to open door policy and free competition were. In the words of one of IPC's partners, "[T]he incorporation of IPC and the execution of the red-line agreement marked the beginning of a long term plan for the world control and distribution of oil in the Near East."<sup>24</sup> Evidence of the intimate interrelationships between the majors and the U.S. Government is abundant, thanks to Congressional hearings and investigations, and is very relevant to the analysis of the petrodollar situation.

The U.S. Government backing of the American oil companies in the Middle East took an unusual form during World War II. Due to war conditions, Aramco was unable to produce enough oil to provide the funds needed by the Saudi Arabian government. Aramco owners (Texaco and Socal) were successful in persuading the U.S. Government that it should provide the needed funds. Since the Lend-Lease assistance<sup>25</sup> had been authorized only to democratic allies, the Roosevelt Administration solved the problem by asking the British to divert a portion of their \$400 million to help King Saud stabilize his country. But since the British had begun to consolidate their position in Saudi Arabia, as well as presenting themselves as the real benefactors, both Aramco and the U.S. Government were convinced that the concession was in danger. This led President Roosevelt in February 1943 to decide that the U.S. Government should provide the financial assistance directly to the Saudi government by a directive to the Lend-Lease Administrator which stated that "in order to enable you to arrange Lend-Lease aid to the government of Saudi Arabia, I hereby find that the defense

24. From a memorandum prepared by the Compagnie Française des Pétroles in 1947, quoted in *THE INTERNATIONAL PETROLEUM CARTEL*, *supra* note 9, at 112.

25. See 15 U.S.C. § 713a-9. The Lend Lease Administration and the Board of Economic Warfare, referred to in the text of this statute, were consolidated with the Foreign Economic Administration on September 25, 1943, by Exec. Order No. 9380, 3 C.F.R. 42 (Supp. I, 1943). The Foreign Economic Administration was subsequently terminated, and the functions of the Board of Economic Warfare were transferred to the Department of State on September 27, 1945, pursuant to Exec. Order No. 9630, 3 C.F.R. 119 (Supp. I, 1945), as amended on May 27, 1946, by Exec. Order No. 9730, 3 C.F.R. 134 (Supp. I, 1946).

of Saudi Arabia is vital to the defense of the United States."<sup>26</sup>

The Aramco merger of 1947 (when Exxon and Mobil joined Texaco and Socal) was not discouraged by the U.S. Government. Again, during the era of the Marshall Plan, when large amounts of aid went for petroleum, the Economic Cooperation Administration (ECA) was told by Secretary of State Dean Acheson in 1950 that:

It is ECA policy in every petroleum transaction an American company must be involved. Not only are firms incorporated and residing in the U.S. eligible to receive ECA financing but ECA procurements for petroleum further contain the following provision: "deliveries from sources other than the United States and possessions will be eligible only if made by American owned and operated companies."<sup>27</sup>

Given the fact that the five American majors were expanding their output in the Middle East, it is evident that the Marshall Plan's aid was used to enable American companies to penetrate the European markets.

The State Department's effort did not confine itself to furthering the interests of the American majors throughout the world, but extended to frustrating the attempt by the Department of Justice in 1952 to criminally prosecute these majors for their violation of the antitrust laws of the United States. The Government's statement of claims against the companies said that it appeared that the uninterrupted extension and continuance of the basic cartel agreements had resulted in a world-wide pattern in which seven of the major oil companies: (1) controlled all major oil producing areas outside the United States; (2) controlled all foreign refining operations; (3) controlled patent know-how and technology covering the refining processes; (4) effectively divided world markets; (5) maintained non-competitive world prices for oil and its products; and (6) controlled foreign pipelines and world tanker transportation facilities.<sup>28</sup> In the judgment of Secretary Acheson, however, "the institution of these proceedings against the company cartel would not help the achievement of the foreign policy aims of the United States in the Middle East and has the possibility of seriously impairing their attainment."<sup>29</sup> The Secretary went on to say that "the alleged conspiracy

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26. In return for this direct help, Aramco offered to set aside a separate petroleum reserve from which the U.S. Government could be supplied at preferentially low prices. See MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11, at 37-39.

27. *Id.* at 83-84.

28. *Id.* at 64; THE INTERNATIONAL PETROLEUM CARTEL, THE IRANIAN CONSORTIUM AND U.S. NATIONAL SECURITY, *supra* note 23, at 6-16, 35-36.

29. THE INTERNATIONAL PETROLEUM CARTEL, THE IRANIAN CONSORTIUM AND U.S. NATIONAL



involves control of the major oil-producing areas . . . . This will, of course, strengthen the movement for renegotiation of the present concession agreements and may give encouragement to those groups urging nationalization.<sup>30</sup>

It will be recalled that the Iranian government had nationalized BP in March 1951. The State Department was attempting to find a solution which would introduce the American majors into Iran and reintroduce the Iranian oil into the world market. But these companies could not be induced to enter Iran while they faced grand jury investigations and criminal proceedings. Although the National Security Council and the Departments of State, Defense, and Interior recommended that the grand jury investigation be terminated, the Attorney General maintained as of January 1953 that the facts then available strongly suggested that the Sherman Act had been consciously and persistently violated by activities long since determined by the Supreme Court to be illegal. The Attorney General went on to say that the cartel should be prosecuted criminally if there were to be equal justice under the law.<sup>31</sup> This conflict within the Executive branch was settled by President Truman, who ordered that the criminal investigation be replaced by civil litigation.<sup>32</sup> After the Eisenhower administration assumed office, the State Department took over from the Attorney General the problem of finding a solution to the Iranian problem. The State Department, in cooperation with the British government (following the overthrow of Dr. Mossadegh in August 1953, finally found the solution to the Iranian problem in the form of the Iranian Consortium, which was created in 1954.<sup>33</sup>

In 1958, when the monarchy in Iraq was overthrown, the U.S. Government gave strong consideration to military intervention to undo the coup. A decision was reached, however, that intervention in Iraq could not be justified as long as the revolutionary government respected Western oil interests. This near intervention led one author to comment that "[g]unboat diplomacy was clearly in line

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SECURITY, *supra* note 23, at 5.

30. *Id.*

31. *Id.* at 33.

32. *Id.*

33. It is interesting to note that, on January 14, 1954, the National Security Council decided that "the security interests of the United States requires United States petroleum companies to participate in the international consortium." And pursuant to this decision, on January 20, 1954, the Attorney General rendered an opinion to the President that the proposed consortium plan, when viewed in connection with the security requirements of the United States as determined by the National Security Council, would not in itself constitute an unreasonable restraint on trade. *Id.* at vii.

with the State Department's commitment to pipelines and profits."<sup>34</sup>

Finally, it should be mentioned that every one of the joint venture arrangements established by the majors in the Persian Gulf region was submitted in advance to the State Department for its approval.<sup>35</sup> The relationship between the U.S. foreign policy and the majors was assessed in the Report of the Subcommittee on Multinational Corporations, *Multinational Oil Corporations and U.S. Foreign Policy*.<sup>36</sup> In this Report it is noted that the system of oil allocation—between oil producing countries—was administered by the multinational oil corporations with the assistance of the U.S. Government. The system was premised on two basic assumptions: (1) that the companies were instruments of U.S. foreign policy; and (2) that the interests of the companies were basically identical with the U.S. national interests.<sup>37</sup> The Report identifies the U.S. foreign policy objectives as: (1) that the United States provide a steady supply of oil to Europe and Japan at reasonable prices for post-World War II recovery and sustained economic growth; (2) that stable governments be maintained in pro-Western oil producing countries; and (3) that American-based firms be a dominant force in world oil trade. The Report goes on to state that these three U.S. foreign policy goals were largely attained during the 1950's and 1960's.<sup>38</sup>

### B. Overview

1. The concession agreements which gave the seven majors the exclusive right over production and pricing policies reduced host governments to mere silent and passive tax collectors. In each producing country the government was, by the nature of the joint ownership system, forced to face at least one of the large multinational oil corporations which in turn were backed by their home governments.

2. The company cartel wielded tremendous economic and political power due to its ability to manipulate production volumes through its allocation system from various sources and through a multitude of inter-company arrangements.

3. The U.S. Government helped the five American majors to solidify their position and expand their markets. In order to stabilize

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34. R. ENGLER, *THE POLITICS OF OIL: A STUDY OF THE PRIVATE POWER AND DEMOCRATIC DIRECTIONS* 264 (1961).

35. *MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY*, *supra* note 11, at 16.

36. *See generally id.*

37. *Id.* at 14.

38. *Id.* at 2.

prices in the United States, state governments resorted to prorating, which was helped first by federal legislation and then by the import quota program. Furthermore, the U.S. Government looked at these majors as instruments of foreign policy.

4. The structure of crude oil prices was such that, in order to stimulate the demand for their products, oil companies were able to gradually reduce Middle East oil prices, enabling them to prevent substitution and to capture the rising demand for energy in the last two decades. It is candidly admitted in the developed countries that the low cost of this form of energy made a significant contribution to their real economic growth in the postwar period.

5. The relatively low level of the price of oil resulted in an increase in the often wasteful use of this depletable resource and in a rise in the rate of dependency of many economies on oil. Since oil was plentiful in the Middle East, this led policy makers to neglect non-oil, indigenous sources of energy and discouraged oil companies from seriously searching for oil outside the OPEC area, notwithstanding Alaskan and North Sea explorations.<sup>39</sup>

6. Middle East oil proved highly profitable, giving oil companies an average annual rate of return of 67 percent for the period 1948-60. Even as late as 1972, the ratio of earnings to net book value for the U.S. oil companies operating in the Middle East was close to 77 percent. Of the \$2.2 billion earnings in that year, only \$99 million was reinvested in the host country, and the remaining \$2.1 billion was transferred to this country.<sup>40</sup>

7. OPEC in the 1960's played a marginal role in the international oil industry. Its main objective was to improve member countries' per barrel revenue. Its success in this regard was very modest indeed. Its negotiations with the oil companies over the royalty expensing issue led it to examine the very principle of negotiation itself.<sup>41</sup>

8. The changing market conditions in 1970 and the Libyan government's successful negotiation of a raise in posted prices gave strong impetus to the Caracas resolutions and led to the successful Tehran collective negotiations in 1971.

39. In this connection, Professor M.A. Adelman proposed in 1967 that Europe should close down its coal industry and turn its employees into pensioners and increase its oil stockpiles to meet future interruption. The net effect of his proposal was an annual saving of \$3 billion. See M. ADELMAN, *THE WORLD PETROLEUM MARKET* 265-75 (1972).

40. See 54 *SURVEY OF CURRENT BUS.*, Aug. 1974, pt. II, table 10A, at 18-19.

41. See generally OPEC, *OPEC AND THE PRINCIPLE OF NEGOTIATIONS* (1965).

9. Finally, it should be remembered that OPEC is composed of countries with substantially different political and economic systems. They have, however, two things in common. First, they are all underdeveloped countries, and second, they have the general objective of improving the economic returns from oil.

### III. OPEC'S SECOND DECADE—THE 1970'S

#### A. *The Caracas Conference*

It will be recalled that the immediate impetus for the oil producing countries to form OPEC was the 1960 price reduction effected by the oil companies. In spite of several resolutions that these reductions should be restored, oil producing countries were unable to achieve this objective. The developments which took place in 1970 forced oil producing countries to re-examine their position and to embark on the first serious experiment in collective bargaining with the oil companies.

The December 1970 OPEC Conference in Caracas adopted a number of resolutions, the most important of which was Resolution 120,<sup>42</sup> which set out to accomplish the following objectives: (1) the establishment of a minimum tax rate of 55 percent on company net income; (2) the elimination of existing disparities in posted or tax reference prices in member countries; (3) a uniform increase in prices to reflect the general improvement in the conditions of the international petroleum market; (4) the adoption of a new system for the adjustment of gravity differential; and (5) the elimination of OPEC allowances.

To attain these objectives, the Conference selected a negotiating committee and set a specific timetable for the negotiations. It would be redundant to detail the negotiations since they were abundantly documented elsewhere.<sup>43</sup> It should be noted that while these negotiations represented OPEC's first collective attempt to raise prices, the companies—majors and non-majors—agreed upon a joint strategy which was encouraged by the State Department and facilitated by the Department of Justice's issuance of a Business Review letter providing the companies with anti-trust clearance.

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42. For the text of Resolution 120 see MEES SUPP., Jan. 1, 1971.

43. For a detailed weekly review of the negotiations see the January and February 1971 issues of *Middle East Economic Survey* and *Petroleum Intelligence Weekly*. See also F. ROUHANI, *supra* note 21, at 9-28; MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11, at 126-34.

The Tehran Agreement<sup>44</sup> was finally concluded on February 14, 1971, after an extraordinary OPEC Conference which threatened to legislate the Caracas objectives and to place embargos on those companies which refused to comply with the new legislation. The agreement which confirmed the then existing concession agreements was to last for five years. The financial terms of the agreement provided: (1) a stabilization of the income tax rate at a rate of 55 percent; (2) a uniform increase of 33 cents per barrel in the posted prices of crude oils exported from Persian Gulf terminals; (3) another uniform increase of two cents per barrel for freight disparity; (4) further uniform increases of five cents per barrel effective June 1, 1971, and January 1, 1973, 1974, and 1975; (5) an increase of 2.5 percent in posted prices effective June 1, 1971, and January 1, 1973, 1974, and 1975; (6) elimination of existing OPEC allowances; and (7) adoption of a new system for the adjustment of gravity differentials. In terms of government per barrel revenue, these terms add up to a gain of 30 cents per barrel in 1971, rising by another 20 cents per barrel in 1975.

It should be noted that the Tehran Agreement which dealt with exports from the Persian Gulf was followed by agreements with Libya, Iraq, and Saudi Arabia to cover these countries' exports from the Mediterranean seaports. Another agreement was concluded with Nigeria. These agreements recognized the locational advantage of these countries over the Persian Gulf countries, but otherwise embodied the same provisions as those of the Tehran Agreement; hence, the use of the term "Tehran and related agreements" in subsequent sections.

It should also be noted that both Algeria and Venezuela have legislated price increases, and Indonesia has followed its own path outside the framework of the Tehran Agreement in raising prices.<sup>45</sup>

### *B. OPEC and the International Monetary Crisis*

It is interesting to note, in retrospect, that, while the Tehran and related agreements were being negotiated, a crisis destined to put an end to the international monetary system as it had operated since the end of World War II was in the making. The crisis culminated in forcing the U.S. Government to suspend, on August 15, 1971, convertibility of the dollar into gold and other reserve assets,

44. For the text of the Tehran Agreement see OPEC, *SELECTED DOCUMENTS OF THE INTERNATIONAL PETROLEUM INDUSTRY* 391-94 (1971).

45. 1971 OPEC ANNUAL REVIEW AND RECORD 9-10.

hence allowing its value in terms of other currencies to float. Since the currencies of major European countries appreciated relative to the dollar—the currency in which posted prices are expressed and revenues computed—OPEC sought an upward adjustment in these prices to offset the decline in the value of the dollar. OPEC's initial position was that the Smithsonian Agreement<sup>46</sup> of December 1971 had resulted in an effective devaluation of the dollar of 12 percent vis-à-vis other major currencies. The companies' position, on the other hand, was that, according to the Smithsonian Agreement, the United States had agreed to devalue the dollar in terms of gold by only 8.27 percent. An agreement between the two groups was finally reached in Geneva in January 1972, whereby posted prices were raised by 8.49 percent (raising government take by 11 cents per barrel), and further adjustments, upward and downward, were to be undertaken quarterly according to an agreed-upon currency index.<sup>47</sup>

### C. Participation

Concurrent with these negotiations on the issue of the effects of dollar devaluation, OPEC decided to embark on another and more important set of negotiations concerning the purchase by member countries of equity interest in the operating companies, that is, participation. The participation negotiations were given impetus when Iraq decided to nationalize the IPC concession in June 1972. By the end of that year an agreement was reached according to which governments were to acquire a 25 percent interest in 1973, which was to rise to 30 percent in 1978, and then gradually to 51 percent in 1982. For their acquisition, governments were to pay according to a formula known as "updated net book value"—which is basically net book value adjusted for inflation.<sup>48</sup> The bulk of the

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46. The ministers and central bank governors of the Group of 10 industrialized nations met at the Smithsonian Institution in Washington, D.C., on December 17-18, 1971, to agree upon a new pattern of currency exchange rates. Among the terms of this Smithsonian Agreement were: (1) that the U.S. dollar would be devalued in terms of gold by 8.27 percent; (2) that several other currencies, led by the Japanese yen, would be revalued upward; and (3) that the U.S. 10 percent import surcharge would be removed the week following the Agreement. The Group of 10 communique left each country to announce its new exchange rate. For the text of the Group of 10 communique see N.Y. Times, Dec. 19, 1971, at 56, col. 3.

47. The January 20, 1972, Geneva Agreement which raised government take by 11 cents per barrel was renegotiated in June 1973 to reflect the 10 percent dollar devaluation of February 1973 in terms of gold (from \$38 to \$42.22 an ounce). The 1973 Agreement provided for an increase in posted prices of 11.9 percent over the January 1973 level, yielding an increase of nine cents per barrel in government take. See MEES, Feb. 16, 1973, at 1-2; MEES SUPP., June 1, 1973.

48. It is interesting to note that according to this formula the cost of the 25 percent

oil produced was to revert to the companies according to a buyback pricing formula. This provision was of utmost importance to the companies since "for Aramco partners, the primary negotiating objective of the participation negotiations was insuring their continued exclusive access to the Saudi participation oil."<sup>49</sup> The net effect of the participation arrangements was to increase government take by 11 cents per barrel.<sup>50</sup> Subsequent developments dramatically changed the participation arrangements, as OPEC governments raised their participation first to 40 percent, then to 60 percent, and recently Kuwait raised its share to 100 percent.<sup>51</sup>

#### D. Oil Producing Countries and World Economy

In 1973, the OPEC countries had a combined population of 300 million people and a combined GNP of \$86 billion, or \$316 per capita GNP. In the same year, the GNP per capita for all the less developed countries was \$356. To put things in a different perspective, Canada's GNP in 1973 was \$119 billion with a per capita GNP of \$5,336. In 1974, OPEC's GNP rose to \$148 billion (or 10.6 percent of the U.S. GNP), and the per capita increased to \$537.<sup>52</sup>

The impact of OPEC's behavior should be considered within the existing structure of the international economy. It should be noted that of the nonsocialist world GNP, the developed countries receive 82 percent, while the developing countries (including OPEC) receive the remaining 18 percent.<sup>53</sup> It should also be noted that the bulk of the international trade (over 70 percent) is conducted by the developed countries. Given these two facts, it seems only logical that the international monetary system which was put together by the developed countries had to reflect these countries' economic, fiscal, monetary, and trade policies with all the conflicts, tensions, and compromises which these countries had to deal with over the last 30 years. And since the developing countries are dependent on the developed economies for their exports, imports, and financial flows, it follows that the changes in the developed countries'

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acquisition was computed to be \$500 million for Aramco, \$150 million for Kuwait, \$68 million for Iraq (BPC), \$71 million for Qatar, and \$162 million for Abu Dhabi. See MEES, *Supp.*, Dec. 22, 1972.

49. MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11, at 136.

50. MEES, Dec. 29, 1972, at 1.

51. See generally MEES, Feb. 1, 1974; MEES, June 14, 1974; MEES, Mar. 7, 1975.

52. See IMF SURVEY, Feb. 3, 1974, at 38.

53. See DEP'T OF STATE, THE PLANETARY PRODUCT IN 1973 (Special Report No. 11), table

domestic economies, as well as in trade between them (recession, inflation, real economic growth, and exchange rate fluctuations), are transmitted to the developing countries due to their economic dependency. The impact on OPEC of this asymmetry in the distribution of economic power is very clear. The ratio of oil exports to total exports ranged in 1970 from 39 percent for Indonesia to 66 percent for Algeria, 58 percent for Nigeria, 89 percent for Iran, and well over 90 percent for Iraq, Kuwait, Libya, and Saudi Arabia. The per barrel revenue in the Middle East, which was 86 cents in 1957, declined to 76 cents in 1961, but increased by 1970 to its 1957 level of 86 cents. During the same period prices of exported goods increased by 22 percent in the United States, 14 percent in Canada, 17 percent in the United Kingdom, 14 percent in France, 21 percent in Germany, seven percent in Italy, and four percent in Japan.<sup>54</sup> Thus while these countries' oil import prices declined, OPEC prices of imported goods from these countries increased substantially. The magnitude of the decline can be seen from an index compiled by *Petroleum Intelligence Weekly*. According to this index—which took into consideration changes in currency values in relation to the U.S. dollar—the landed price of oil was much lower in Germany, Italy, the Netherlands, and Japan in 1970 than it was in 1957. And in terms of dollars, the selling price of Middle East oil underwent a long and sustained decline from 1957 to 1970, a decline which amounted to 32 percent. Even with subsequent tax price increases (due to the Tehran and Geneva Conferences), the 1972 Middle East oil prices were as much as 20 percent below the 1957 level in terms of most consuming countries' own currency outlays.<sup>55</sup> Given these relationships and the very high rate of return on investment in the oil industry, one is compelled to conclude that there has been a sustained and massive transfer of wealth from the oil producing countries to the developed countries, thanks to the structure of the international oil industry and the international economy. The net effect of these institutional arrangements was to force these countries to pay higher prices for goods whose production was greatly helped by the constantly declining price of oil.

It should be noted that oil producers recognized as early as 1962 the link between their import prices and crude oil prices as shown in OPEC's Resolution 32 which stated that "Member Countries

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54. 1974 ECONOMIC REPORT OF THE PRESIDENT 93.

55. PIW, Mar. 27, 1972, at 5-6.



shall jointly formulate a rational price structure to guide their long term price policy . . . . An important element of the price structure to be devised will be the linking of crude oil prices to an index of prices of goods which the Member Countries import."<sup>56</sup> OPEC, however, failed to implement this resolution, as evidenced by the fact that seven years and 71 resolutions later a similar resolution was passed. Thus, Resolution 103,<sup>57</sup> which was adopted in 1969, called for the undertaking of a study with a view towards linking posted and tax reference prices to those of manufactured goods of major industrialized countries. By that time, of course, it was evident that inflation in the industrial countries was on its upward course. Although it was not until 1971, when the Tehran agreement was concluded, that world price inflation was recognized as a factor in revenue determination, this recognition was rather minor.

Not only did developing countries suffer from the consequences of inflation, but they also suffered from the consequences of an unstable international monetary system. The stresses, strains, crises, and upheavals which engulfed the system throughout its life are in part a reflection of changes in the relative economic positions of the developed countries and the operations of the giant multinational corporations which dominate the world economic scene. Here again, while the system was attempting to reconcile conflicting interests, the countries of the Third World found that their currencies fluctuated in value, their reserves dwindled, their access to capital markets was hindered, and their development plans were always threatened.<sup>58</sup>

### *E. Oil Supply/Demand Imbalance*

It will be recalled that in order to protect the U.S. oil industry from the disruptive effects of competition, a system of prorating was instituted to regulate output and stabilize prices. Further, in order to insulate the industry from the influx of cheap foreign oil, an import quota system was adopted. As the United States continued to increase its imports, Texas found itself producing 28 percent of capacity in 1964. As demand for oil continued to rise, the idle capac-

56. For the text of Resolution 32 see OPEC, EXPLANATORY MEMORANDA ON THE OPEC RESOLUTIONS 3-4 (1962).

57. For the text of Resolution 103 see MEES, Aug. 15, 1969.

58. These points were discussed in more detail in a paper entitled: Alnasrawi, *The International Monetary System and the Oil Producing Countries*, presented at the Baghdad Second International Seminar, Baghdad, Nov. 1-4, 1974.

ity began to disappear, and by 1972 Texas was producing at 100 percent capacity. In the meantime, the measures which the developed countries adopted in 1971 and 1972 to stimulate economic activity in 1972-73 throughout the industrial world increased developed countries' demand for oil at a time when certain producing countries, especially Kuwait and Libya, had adopted conservation measures to limit the growth of oil output. The shift from natural gas to oil in the United States added another factor to the increased demand for oil and its products. The world was unprepared for the massive buying of oil by the United States for several reasons. First, excess capacity in the Middle East was no longer available. Second, the refining capacity in this country, because of the prorating, failed to expand sufficiently to meet domestic needs. Third, refining capacity overseas was predicated on the limited access to the U.S. market because of the import control program. Thus its removal, in 1973, found the United States competing for oil, a development that had not been foreseen. Thus, while Western Europe increased its imports by 18 percent between 1970 and 1973 and Japan by 35 percent, the United States increased its imports by 81 percent (from 3.4 MBD to 6.2 MBD, or by 2.8 MBD, of which over one-half or 1.5 MBD occurred in 1973 over 1972).<sup>59</sup> This increase in the demand for oil had the obvious effect of exerting a sharp upward pressure on oil and product prices.<sup>60</sup> This in turn resulted in a sharp rise in the majors' profits, ranging from 41 percent for Mobil to 82 percent for Gulf in the second quarter of 1973 over the second quarter of 1972 (the average for the five American majors was 51.8 percent).<sup>61</sup> In August 1973, Venezuela raised the tax export values, and in the same month it was revealed that the Nigerian government was able to sell its royalty oil at a record price of \$5 per barrel, or 71 cents above postings.<sup>62</sup> The significance of the Nigerian sale was not in the predictable repercussions that it was bound to create, but rather in signaling the end of the era when posted prices had traditionally remained above actual sale prices. In reflecting the underlying mar-

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59. Computed from import data in 1973 BP STATISTICAL REVIEW OF THE WORLD OIL INDUSTRY 21.

60. OPEC estimated that product prices charged by oil companies in consumer markets rose from an average of \$21 per metric ton in 1970 to \$52 per ton in 1973, whereas the average government take in the OPEC countries increased from \$7 to \$13 per ton during the same period. See MEES, Sept. 21, 1973, at 2, 3.

61. PIW, Aug. 6, 1973, at 5.

62. PIW, Aug. 20, 1973, at 5. It is interesting to note that government take at the time was about \$2.71 per barrel.

ket conditions, the Nigerian sale also reflected the fact that the traditional split in profits between governments and companies had been altered in favor of the companies.<sup>63</sup>

In addition to the changes in market prices, OPEC was concerned about the sharp erosion in oil revenue purchasing power which resulted from the spiraling worldwide inflation. Inflation was rising at a much higher rate than the 2.5 percent incorporated in the Tehran Agreement of 1971. Given these two forces, all member countries agreed that posted prices and oil revenue should be adjusted to reflect the changing market conditions. As was to be expected, there were differences of opinion as to the approach to be adopted. Some members were advocating as early as March 1973 that the Tehran Agreement should be scrapped and that OPEC should unilaterally set prices—a practice which Venezuela, Algeria, and Indonesia had been using. Other members felt that the Agreement should be preserved, but that OPEC should negotiate a limited revision to compensate for inflation without changing the basic structure of the Agreement. By September a compromise was reached whereby it was decided that an extensive, rather than a limited, revision of the Tehran Agreement should be undertaken through negotiations with the companies. It was also decided that if no agreement could be reached, then the OPEC governments would set new prices.<sup>64</sup>

It is significant to note in this connection that, aside from the fiscal objective, the higher prices were looked at by long range planners in the OPEC countries as a means to relieve the pressure on some of them to produce much more oil than they actually needed to meet their economic needs. Higher prices were looked at as a means: (1) to promote more efficient use of energy; and (2) to stimulate the development of alternative sources of energy which would be essential regardless of what happened to conventional fuels.<sup>65</sup>

With these conditions in mind, on October 8, 1973, OPEC ap-

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63. This is illustrated by the evolution of tax-paid cost (cost of production plus payment to producing government) and actual selling prices. Arabian light tax-paid cost increased by 15 cents per barrel (from \$1.55 to \$1.70) between January 1972 and April 1973, while actual selling price by the companies increased by 46 cents (from \$1.84 to \$2.30). See PIW, June 4, 1973, at 4; MEES, Dec. 28, 1973, at 3. It is estimated that the national profit on realized prices between governments and companies may have changed from 80-20 in the governments' favor at the time of the Tehran Agreement to approximately 64-36 by September 1973. See MEES, Sept. 21, 1973, at 2.

64. MEES, Sept. 7, 1973, at 1-2.

65. MEES, Sept. 21, 1973, at 4.

pointed a ministerial committee to negotiate the revision of the terms of the Tehran Agreement with the oil companies.<sup>66</sup>

#### F. *The 1973 Price Revolution.*

Before the October 1973 price negotiations, OPEC experts had calculated that between 1970-71 and September 1973, oil companies' "netback" (product prices minus all costs and taxes) had increased by \$2.20 per barrel. It was therefore speculated that OPEC would ask for a rise in posted prices of similar amount or an increase of \$2 per barrel over the \$3.11 per barrel of October 1. OPEC also felt that the companies should not raise their prices to the consumers since they had already done so.<sup>67</sup>

When the negotiations started, OPEC's initial position was to ask for a price increase of \$3 per barrel, while the companies' position was to offer 45 cents. Although the industry was willing to improve its offer, the position of their home governments was that the companies should not do so.<sup>68</sup> In light of the subsequent events this decision by the governments of the developed countries turned out to be a major miscalculation. The negotiations were suspended on October 11, and five days later the OPEC governments unilaterally raised posted prices by \$2 per barrel (70 percent above October 1 postings or 17 percent above market prices),<sup>69</sup> thereby raising government take by \$1.28 per barrel.<sup>70</sup> In the meantime, the October Arab-Israeli war was going on. On October 12, the four Aramco owners warned President Nixon that an Arab production cutback was imminent if the United States increased its support for Israel. On October 15, the State Department announced that the United States had begun an airlift to resupply Israel with aircraft and

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66. Resolution 160, dated September 16, 1973. In 1968, OPEC adopted under Resolution 90 a Declaratory Statement of Petroleum Policy in Member Countries. This Policy Statement states that posted or tax reference prices shall move in such a manner as to prevent any deterioration in their relationship to the prices of manufactured goods traded internationally. The Statement embodied another principle, which stated that the operator shall not have the right to obtain excessively high net earnings after taxes, and that the financial provision of contracts which actually results in such excessively high net earnings shall be open to renegotiations. Excessively high net earnings were defined to mean net profits after taxes which are significantly in excess, during any twelve-month period, of the level of net earnings, the reasonable expectation of which would have been sufficient to induce the operator to take the entrepreneurial risks necessary.

67. MEES, Sept. 21, 1973, at 3.

68. MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11, at 148-50.

69. See OPEC Press Release, Oct. 16, 1973, at i-ii.

70. Int'l Oil Companies Press Release, Oct. 17, 1973, at ii.

equipment to replace losses. On October 17, the Arab producers decided on an oil cutback accompanied by embargoes on exports to the United States and the Netherlands. By November, the cutbacks amounted to 20 percent of the September output. The cutbacks and the embargo accentuated an already existing shortage. Hence, while oil in the Persian Gulf was posted at \$5 per barrel, the National Iranian Oil Company was able to sell its oil at prices of up to \$17 per barrel, while the Nigerian government sold its oil at \$20 per barrel.<sup>71</sup> This development encouraged Iran to lead the drive, at the next OPEC meeting in December, to raise posted prices by 130 percent to \$11.65 per barrel, giving governments a per barrel revenue of \$7.00.<sup>72</sup> The Arab states felt that this latest price increase had gone too far and that it tended to dilute the political impact of the cutbacks and the embargo.<sup>73</sup>

These increases led to certain significant economic and financial consequences for both oil producers and consumers. Before dealing with the ramifications of the October/December 1973 price explosions for the world economy, it would be useful to briefly review the 1974 developments in the areas of prices, government take, royalty and tax rates, and company tax paid cost.

The situation as of January 1, 1974, was as follows: the government take on the Saudi Arabian *marker* crude oil was set at \$7 per barrel. Given a royalty rate of 12.5 percent and an income tax rate of 55 percent, the posted price for the marker crude was set at \$11.65 per barrel. The cost to the companies was the government take plus production cost, or a total of \$7.10 per barrel (assuming production cost of 10 cents per barrel). Again, effective January 1, 1974, the government of Kuwait reached a new participation agreement with the oil companies which raised its participation share to 60 percent. According to this new arrangement, the tax-paid cost on the companies' 40 percent share of the oil (equity oil) was the \$7.10 per barrel mentioned earlier, but the oil companies were to pay 94 percent of the posted price (\$10.96 per barrel buy-back price) on the oil they extracted in excess of their 40 percent equity share. The buy-back price was the price to be charged by Kuwait to other buyers (that is, independents). The Kuwaiti model, which was followed by the other Persian Gulf producing countries, created an interesting anomaly in the market. It enabled the majors to undercut govern-

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71. MEES, Dec. 28, 1973, at 1.

72. *Id.*

73. *Id.* at 2.

ment sales to third parties, since the cost of the equity oil to the majors was about \$4 per barrel less than the price at which governments were willing to sell their participation crude. This situation was clearly untenable. In order to correct it, a series of actions was undertaken to eliminate the gap between the prices of participation and equity oil. These actions culminated in an increase of the royalty rate from 12.5 percent to 20 percent and the income tax rate from 55 percent to 85 percent, accompanied by a reduction of 40 cents per barrel in posted prices, a reduction in the buy-back price to 93 percent, and a freeze in prices for the first nine months of 1975. Thus, by January 1, 1975, the relationships were as follows: posted price \$11.25, buy-back price \$10.45, average government take \$10.12, and average tax-paid cost \$10.25, thus giving the majors an advantage of 21 cents per barrel over competitors. It should be noted in this connection that, as late as November 1974, the majors continued to receive 95 percent of the oil produced in most of the Persian Gulf states.

#### G. *Consequences of the Price Explosions*

The steep and sudden increase in the prices had important consequences for all the countries of the world. The obvious one was the dramatic increase in the oil revenue of OPEC countries. These revenues, according to the Organization for Economic Cooperation and Development (OECD), increased from \$23 billion in 1973 to \$90 billion in 1974, raising the import cost of consuming countries by \$67 billion.<sup>74</sup> The increase in oil import cost for the OECD countries was estimated to be \$59 billion (United States, \$15 billion; Japan, \$12 billion; and Europe, \$32 billion).<sup>75</sup> The balance, \$8 billion, represents the increase in oil import cost for the Third World countries. Looking at the 1974 oil cost increases from a different angle, we find that for the industrial countries the cost increment represented less than two percent of their combined GNP. For the developing countries, the ratio was 1.2 percent. Leaving aside the Third World countries for a moment, estimates for OECD countries indicated that for 1974 oil imports from OPEC might rise by more than \$55 billion, and exports to OPEC were expected to rise by \$12 billion in the same year.<sup>76</sup> The OECD trade deficit with OPEC had already

74. See IMF SURVEY, Feb. 3, 1975, at 38.

75. OECD, ECONOMIC OUTLOOK, Dec. 1974, at 61.

76. *Id.* at 53.

reached its peak in the second half of 1974 and should have improved thereafter.<sup>77</sup>

The improvement in the OECD trade deficit is expected to result from several factors: a further rise in their export prices; the leveling off of oil prices; and the already visible decline in demand for oil as a result of conservation, recession, and higher oil prices. Within OECD, the impact of the higher prices relative to GNP varied from 1.1 percent for the United States, to 2.4 percent for the Common Market countries, to three percent for Japan.<sup>78</sup> The implication of these differences is that the United States improved its competitive position vis-à-vis its trading partners. It should be mentioned in this connection that, in addition to the much lower dependency of the United States on foreign oil imports, the United States enjoyed a net investment income from abroad of about \$9.7 billion in 1974, \$7 billion of which resulted from petroleum related transactions.<sup>79</sup> Although the rise in oil prices contributed in varying degrees to current account difficulties of importing countries, it should be remembered that countries like the United States, the United Kingdom, France, and Italy were experiencing these problems long before the 1973-74 price increases. The U.S. current account deficit, for example, was as high as \$9.8 billion in 1972; in 1974 it was about \$5 billion, while it showed a surplus of \$0.5 billion in 1973. By contrast, Germany's current balance registered a surplus of about \$9 billion in 1974. The point at issue here is that the impact of the rise in oil prices cannot be singled out, but rather should be dealt with within the context of a country's total foreign transactions. This statement is not intended, however, to deny the existence of another issue, that is, the role of the so-called petrodollar, a subject which will be discussed in the following section.

Another consequence of the price explosion was the contribution it made to the problem of inflation. Estimates of the direct and indirect contribution of the rise in energy costs vary from two percent to 3.5 percent in the United States. According to the Bureau of Labor Statistics, the consumer price index increased by 12.2 percent in the fourth quarter of 1974 over the comparable period in

77. *Id.*

78. Ireland and Denmark were excluded from the Common Market Countries for lack of data on their oil imports. The U.S. ratio was related to the 1974 GNP, while those of Japan and the Common Market were related to the 1973 GNP. The ratios would have been lower had the 1974 GNP data been available at the time of writing.

79. See FED. RESERVE BANK OF ST. LOUIS REV., Dec. 1974, at 12.

1973. Directly purchased energy contributed 11.4 percent, food 24.6 percent, and all other items 64 percent to the rise in the index.<sup>80</sup> For the OECD countries as a whole, it was estimated that the price increases resulting from higher petroleum prices may have accounted for about one-fourth of the overall increase in the consumer price index while food prices contributed anywhere between one-fourth and one-half to the index.<sup>81</sup> It is a well-known fact that inflation had become a serious problem in the industrial countries as early as 1965, but that its rate had greatly accelerated since 1970. Thus, between 1970 and the third quarter of 1973—before the October price rise—the consumer price index had increased by nearly 16 percent in the United States, 27 percent in Japan, 19 percent in Germany, 24 percent in Italy, and 28 percent in the United Kingdom.<sup>82</sup>

Finally, oil prices and OPEC were blamed not only for the inflation problem, but also for the recession in major industrial countries. A distinguished economist recently said that if you turn the present recession (in the United States) upside down and read on the bottom it will say "Made in Washington."<sup>83</sup> The recession, in other words, has been by design. The stage for recession and inflation in the industrial countries during 1974 was largely set in 1970-71. Beginning in late 1969, there was a widespread economic slowdown which called for the usual expansionary monetary and fiscal policies. The stimulative measures which industrial countries adopted in 1971 and 1972 resulted in an unusual degree of simultaneous sharp expansion in economic activity, a development which contributed to the acceleration of worldwide inflation. When it was realized generally that the 1973 rates of economic growth were unsustainable, a shift in economic policy to curb inflation was deemed necessary. This shift, together with supply constraints, led to a sharp decline in the rate of economic growth in the industrial countries. This decline in real output, which was expected to extend into the first half of 1974, failed to curb inflation. Prices continued on their upward trend, reflecting the entrenchment of monopoly forces in these economies. Thus, the 1973 stagnation, which turned into a recession in 1974, coupled with the continued inflation, posed a

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80. 1975 ECONOMIC REPORT OF THE PRESIDENT 48.

81. *Inflation and Stagnation in Major Foreign Industrial Countries*, 60 FED. RESERVE BULL. 693-94 (1974).

82. 1975 ECONOMIC REPORT OF THE PRESIDENT 359.

83. P. Samuelson, quoted in N.Y. Times, Feb. 14, 1975, at 53, col. 3.



most serious challenge to economists, governments, and policy makers in the industrial countries. The question was how to reconcile the conflict between the economic policy objectives of the low rate of unemployment and price stability? The failure of economic policy makers to attain an answer was candidly admitted by Professor Samuelson when he said that no mixed economy—not the United States or United Kingdom, Sweden or Switzerland, Germany or Japan, France or Italy—knows how to sustain full employment with price stability.<sup>84</sup>

#### H. *The Plight of Developing Countries*

I would like to preface my remarks on this subject by referring to an article I wrote in 1972. In it, I said the time has come for oil producing countries to pay attention to the economic development problems of the Third World countries. It is true, of course, that oil producing countries are underdeveloped themselves. It is equally true, however, that part of their revenue is derived from countries some of which are even less developed and certainly poorer than they are. Thus, the recycling of part of their excess reserves into the economies of these poor countries, rather than into the banking system of the rich countries, needs no economic, political, or moral justification. Let us not forget that the existing system of international trade and finance contains within it a built-in bias. It is that the distribution of the benefits is tilted in favor of the few rich countries to the detriment of the many poor countries. It is only appropriate, therefore, that one of OPEC's roles should be to help mitigate some of the adverse effects of this bias.<sup>85</sup>

A recent study by OECD<sup>86</sup> revealed not only my ignorance, but also the fact that certain OPEC countries (mainly Arab) were providing economic assistance to other developing countries (primarily Arab, but also African, countries). The flow of official economic aid from these countries, though modest in absolute terms (between \$480 million and \$530 million during 1970-73), was not insignificant, relative to GNP. Thus, net aid disbursements (exclusive of military assistance) provided by Libya, Kuwait, and Saudi Arabia amounted to 3.6 percent and 2.7 percent of their GNP in 1972 and 1973 respectively.<sup>87</sup> These ratios are well above the one-third of one percent of

84. Samuelson, *Coping with Stagflation*, NEWSWEEK, Aug. 1974, at 69.

85. Alnasrawi, *supra* note 18, at 207.

86. See IMF SURVEY, Nov. 18, 1974, at 357, 360-62.

87. *Id.*

economic assistance provided by the industrial countries to developing countries.<sup>88</sup> Having noted this, it should be readily acknowledged that the 1973-74 price increases added to the already deteriorating economic conditions in which the Third World countries found themselves. First, it should be stressed that, since 1972, expenditures by developing countries (including OPEC countries) for food grains, a good part of which is imported from the developed countries, increased significantly (from \$2.8 billion in 1972 to \$9 billion in 1974). It should be mentioned in this respect that food price rises have contributed significantly to this increase. The export price of U.S. wheat, for example, increased by 219 percent from its 1971-72 level to September 1973.<sup>89</sup> Another factor is the state of economic dependency of developing countries on the economies of the developed countries. It is a well known fact that developing countries' export earnings fluctuate with the cyclical fluctuations of the economic activity in the industrial countries. The 1973 economic slowdown, for instance, resulted in a sharp reduction from the percentage of goods imported by the OECD countries from the developing nations (from 12 percent in 1972 to 5.2 percent in 1973).<sup>90</sup> A third factor in the plight of developing countries was the high rate of inflation in the OECD countries, which has been transmitted to international trade in the form of higher import prices, exacerbated by the fact that barriers against manufactured goods from the Third World countries are greater than those against manufactured goods from industrial countries.<sup>91</sup> Another factor in the plight was the rise during 1973 in the prices of fertilizers which became an essential ingredient for some of the "miracle crops" of the "green revolution," and the physical scarcity of fertilizers available to developing countries.<sup>92</sup> Last, but not least, was the size of official development aid (ODA) flowing to the developing countries. Although ODA increased by 44 percent between 1967 and 1973 (from \$6.5 billion to \$9.4 billion), its ratio to industrial countries' GNP actually declined from four-tenths to three-tenths of one percent.<sup>93</sup> Knowing how important inflation was, it is safe to say that in real terms the increase

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88. 1974 WORLD BANK ANN. REP. 8.

89. DEVELOPING COUNTRIES AND THE UNITED STATES IN THE WORLD ECONOMY, *supra* note 14, at 53.

90. *Id.* at 51.

91. *Id.* at 58.

92. *Id.* at 53-54. It has been estimated that this year's fertilizer shortage will cost India 10 million tons of grain—a year's supply for 50 million people. *Id.* at 54.

93. 1974 WORLD BANK ANN. REP. 82.

in the aid was much smaller than the data might suggest.

It is upon these economic conditions (decline in exports, rise in imports, transmitted inflation, deteriorating terms of trade, and relative decline in economic aid) that the rise in oil prices was imposed. However, much of the comment—official and professional—upon the oil price increases since October 1973 seems to have missed—deliberately or unintentionally—the central point: oil prices cannot and should not be blamed for the totality or the complexity of the economic problems of the Third World countries. Personally, I am of the opinion that OPEC should have followed a policy of price discrimination in favor of developing countries. Since such a policy was not adopted, OPEC resorted to the policy of offsetting the higher cost of oil through bilateral and multilateral aid agreements. Thus, OPEC's ODA commitments in the first nine months of 1974 amounted to \$8.6 billion plus \$3.1 billion contributed to the International Monetary Fund (IMF) oil facility and another \$1 billion made available to the International Bank for Reconstruction and Development (World Bank) a total of \$12.7 billion, or 8.8 percent of their GNP, or 20 percent of the so-called petrodollar surplus.<sup>94</sup> It should be noted, however, that actual disbursements are of necessity lower than the commitments cited above. It should be noted also that multilateral commitments by OPEC countries were made to a variety of institutions including the Islamic Development Bank, Arab Bank for Africa, the Special Arab Fund for Africa, the U.N. Emergency Fund, the OPEC Development Fund, and several other institutions.<sup>95</sup>

### I. *The Energy Crisis and Company Profits*

The United States experienced a fuel shortage in the winter of 1972, followed by a gasoline shortage in the spring, prompting most analysts to anticipate supply problems in the winter of 1973-74.<sup>96</sup> It

94. DEVELOPING COUNTRIES AND THE UNITED STATES IN THE WORLD ECONOMY, *supra* note 14, at 32.

95. *Id.* See also IMF SURVEY, Nov. 18, 1974, at 357. One source indicated that in 1974 Kuwait had contracted financial commitments of over \$1 billion with international organizations, Arab, or Third World Countries. This sum represents 11 percent of Kuwait's GNP. During the same year, the bilateral and multilateral financial aid granted by all OPEC countries totalled \$14.3 billion, of which two-thirds was extended by Arab countries. Of this total, about \$7.6 billion was granted in the form of intergovernmental loans at very low interest rates. For most OPEC countries, the aid thus granted exceeded 8 percent of their own GNP. See ARAB OIL & GAS, Mar. 1, 1975, at 17.

96. SENATE COMM. ON INTERIOR AND INSULAR AFFAIRS, 93D CONG., 1ST SESS., AN ASSESSMENT AND ANALYSIS OF THE ENERGY EMERGENCY: A STAFF ANALYSIS PREPARED BY B. COOPER

was in this context that the Arab cutbacks and embargo were imposed in October 1973. The record indicates that profits of the five U.S. majors and five large U.S. domestic companies have significantly increased for the period October 1, 1973, to September 30, 1974. While the majors increased their profits by 56 percent over the twelve month period, the domestic companies enjoyed an increase of 92 percent in their profits.<sup>97</sup> Another set of data indicates that the five American majors experienced an increase in their profit of 95 percent in 1974 over 1972 (from \$4 billion to \$7.8 billion), while the twelve largest American domestic oil companies were able to increase their profits by 165 percent during the same period (from \$1.7 billion to \$4.5 billion). For both groups together the increase was 116 percent (from \$5.7 billion to \$12.3 billion).<sup>98</sup>

#### IV. THE QUESTION OF OPEC SURPLUS FUNDS

The oil price increases created several new conditions for the international financial system. In the short run, the pressing issue was how to deal with balance of payments deficits which can legitimately be ascribed to oil. In the medium and long terms the questions raised by the higher oil prices revolve around the size of the surplus, the form of its accumulation, and its impact on the stability of the international financial system. I shall attempt to deal with each of these issues.

There seems to be a general consensus that OPEC countries balance of payments surplus in 1974 ranged between \$55 billion and \$60 billion. The other side of this coin is that this sum represents the balance of payments deficit of oil importing countries. Each country's deficit would have been eliminated if an equivalent inflow of funds had taken place. Instead, there was a considerable degree of unevenness in these flows. Of the estimated \$60 billion, about \$11 billion (18.3 percent) was directly invested in the United States in the form of bank deposits, money market liquid assets, short and long term government securities, and a small amount in real estate and private securities (less than \$1 billion). In addition, at least \$21 billion was invested in the Euro-currency market (mainly Euro-dollar and sterling), \$7.5 billion was directly invested in the United Kingdom, \$5.5 billion in other industrial countries, \$3.5 billion was

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PURSUANT TO S. RES. 45 3 (1973).

97. MULTINATIONAL OIL CORPORATIONS AND U.S. FOREIGN POLICY, *supra* note 11, at 162.

98. The author has derived these conclusions from issues of the *Petroleum Intelligence Weekly* published in 1974.

lent to international financial institutions (IMF and World Bank), and \$4 billion was given in grants and loans to developing countries. The balance was used for repayment of outstanding debts, net private capital movement, and various types of investment throughout the world.<sup>99</sup> It can be readily seen from this data that the bulk of OPEC petrodollars was channeled into dollar and sterling financial assets in amounts that are in excess of the oil deficit of these countries. There are several reasons for this phenomenon, including the availability of a wide variety of financial instruments (especially in the United States), the size of the money and capital markets, the lack of restrictions on capital inflow, the traditional ties of OPEC money managers to these markets, and (in the case of the United States) the size of its economy and the role which the dollar plays in international transactions. But, the channeling of these funds into the financial markets of the United States and the United Kingdom meant that the money did not go where the deficits were. This situation called for secondary recycling, a task that was left to various financial institutions to handle. It should be emphasized again that solutions to balance of payments problems will have to vary from one country to another depending on the underlying economic forces which determine each country's international position. Thus, while the performance of the German economy is such that it continues to show current account surplus in spite of heavy dependence on oil imports, the United Kingdom's payments position is remedied by capital inflow. Italy, on the other hand, does not have the strong economy which Germany has nor the financial markets of the United States and the United Kingdom. This asymmetry explains to a considerable degree the efforts of France, Italy, and Japan to conclude bilateral trade agreements with oil producing countries to lessen and eventually eliminate their deficits by expanding their export markets.

The first effect of the oil price rise is the size of the surplus which OPEC countries will be able to accumulate. Forecasts as to the size of the surplus depend on the assumptions used. These assumptions include oil prices, rates of economic growth in industrial countries, price and income elasticities of demand for oil, availability and price of substitutes, the cohesiveness of OPEC, and the increase in producing countries' imports for current consumption and development purposes. It goes without saying that the larger

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99. 1975 ECONOMIC REPORT OF THE PRESIDENT 195; IMF SURVEY, Mar. 24, 1975, at 81.

the margin of error in each one of these variables, the more uncertain the estimate of the size of the surplus will be. Thus, the World Bank had put OPEC surpluses after 1980 at an annual rate of \$100 billion, with accumulated external assets growing from \$650 billion in 1980 to \$1.2 trillion in 1985.<sup>100</sup> The World Bank estimates gave rise to doomsday predictions that the oil producers, chiefly the Arab states and Iran, would be able to buy up an enormous portion of the rest of the world unless something were done to stop them.<sup>101</sup> The OECD, on the other hand, computed the surplus at only \$15 billion by 1980, with accumulated external assets of \$300 billion.<sup>102</sup> Morgan Guaranty Trust Company's estimates indicate that the OPEC petrodollar available for investment had already reached its peak in 1974, will decline to \$17 billion in 1978, and turn into a deficit thereafter. External assets will also peak at \$248 billion in 1978, declining to \$179 billion by 1980.<sup>103</sup> Several factors lead me to place more faith in the Morgan Guaranty's estimates than in the World Bank's. These include the facts that: (1) the current absolute decline in oil output and the expected slowdown in its rate of growth; (2) as economic development accelerates in oil producing countries, domestic expenditures and imports will rise; and (3) inflation in industrial countries will wipe out a sizable portion of these funds. Thus, a recent study prepared by the Economic Research Institute for the Middle East (Tokyo) concludes that if prices are allowed to keep rising at an annual rate of 11 percent in 1975, as is estimated by OECD, the import price index in the fourth quarter of 1975 for the OPEC countries will increase by 36.4 percent above its level in the same quarter in 1973. Such development will have the effect of reducing the real value of the \$10.12 barrel government take to \$7.42.<sup>104</sup> To put OPEC petrodollars in perspective, it should be noted that some \$268 billion of short-term assets were held at the end of 1971 by private institutions on the international financial scene and the lion's share of the money was controlled by U.S.-based multinational companies and banks.<sup>105</sup> As to the probable destabilizing ef-

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100. N.Y. Times, Feb. 13, 1975, at 50, col. 3; IMF SURVEY, Jan. 20, 1975, at 30.

101. N.Y. Times, Feb. 13, 1975, at 50, col. 3.

102. AD HOC COMM. ON THE DOMESTIC AND INTERNATIONAL MONETARY EFFECT OF ENERGY AND OTHER NATURAL RESOURCE PRICING, HOUSE COMM. ON BANKING AND CURRENCY, 93D CONG., 2D SESS., BALANCE-OF-PAYMENTS ADJUSTMENTS TO HIGHER OIL PRICES: MANAGING THE PETRODOLLAR PROBLEM 15 (1975) [hereinafter cited as BALANCE-OF-PAYMENTS ADJUSTMENTS TO HIGHER OIL PRICES].

103. MEES, Jan. 31, 1975, at 8.

104. MEES Supp., Feb. 21, 1975, at 1-3.

105. Wall St. J., Feb. 13, 1973, at 2, col. 3.

fects of the petrodollar, both historical and current evidence indicates that the OPEC money managers are rather conservative and not prone to speculative activities. As a matter of fact, OPEC countries holding reserves in dollars suffered losses estimated at \$1.3 billion in the dollar devaluations of 1971 and 1973. Those holding sterling reserves took losses in the 1967 devaluation of the pound.<sup>106</sup> In light of such experiences and in view of prevailing economic conditions, one can easily see why OPEC countries with surpluses have chosen short-term instead of long-term forms of investment. It can also be seen why they are anxious to obtain protection against exchange rate risk. Speculation in the foreign exchange market is no longer free of risks, as was the case under the fixed exchange rate system of the Bretton Woods era. This is so because under the current floating exchange rates system, any massive shift from one currency to another will tend to move the exchange rates fairly quickly, before the shift is completed, causing a loss of value on the funds still held in the depreciating currency. In other words, the threat of sufficiently rapid and extensive rate fluctuations is such that the floating exchange rate system will discourage large destabilizing shifts among currencies.<sup>107</sup> Once these risks are neutralized, it is only logical, from the viewpoint of a money manager, that the governing assumption of his investment policy should be to acquire those assets that are at least as valuable as oil in the ground. Given this assumption, it is rather difficult to differentiate between the objectives of an Arab money manager and any other manager whose investment strategy is to seek a portfolio which should emphasize stability, growth, and diversification.<sup>108</sup>

Given the available evidence and data and relating the size of these funds to the size of international financial transactions, one must conclude that the so-called petrodollar funds do not pose the danger which many people thought (or still may think) they posed to the international financial system. On the contrary, these funds should be viewed as an important source of capital formation at a time when practically every country in the world is in need of such financial resources. It is useful to remember that, in spite of their recently acquired control over their oil resources, the OPEC coun-

106. BALANCE-OF-PAYMENTS ADJUSTMENTS TO HIGHER OIL PRICES, *supra* note 102, at 22-23.

107. *Id.* at 23.

108. See Statement by Gerald L. Parsky, Assistant Secretary of the Treasury, before the Senate Subcommittee on Multinational Corporations, 93d Cong., 2d Sess. (1975).

tries, like all raw material producers, continue to be dependent on the markets of the developed economies for their exports and their imports. This state of dependency will continue, I believe, for the foreseeable future.

Finally, it has been noted that these accumulated external assets, when converted into goods and services, will result in a massive transfer of wealth to the OPEC countries. This is true, of course. This observation, however, confuses the mutual transfer of real resources, which takes place through international trade or the exchange of exports for imports, and the transfer of resources at two different points in time. The conversion of external assets into real resources in the future is simply no more than a postponement of resource transfer. Had the economies of OPEC countries been capable of absorbing all the resources which their oil exports could buy, the problems/issues of petrodollars, deficits, accumulation of external assets, and their future conversion would not have presented themselves in the first place.

#### V. THE CURRENT DEBATE: SOME OBSERVATIONS

Presently there are two sets of debates occurring concurrently: one within OPEC, and the other within the industrial countries through their International Energy Agency (IEA). Although both groups seem to have arrived at certain common positions, differences among the members of each group have by no means been settled. OPEC's position, as reflected in the deliberations at the recent summit conference in Algeria, is as follows: the basic cause of the world economic crisis is the profound economic inequality between developed and developing countries, an inequality which had been caused by foreign exploitation and drainage of the natural resources of developing countries. The problem was further aggravated by inflation, recession, and instability in the international monetary system. The general tendency in developed countries to consume and waste excessive amounts of scarce resources had only exacerbated the problem. Any meaningful dialogue and/or negotiations with the developed countries should not be confined to the question of energy, but should also deal with the problems of other raw material producing countries, the reform of the international monetary system, and international cooperation in aiding economic development.<sup>109</sup> This position, I might add, is an attempt to trans-

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109. See Solemn Declaration by the Conference of the Sovereigns and Heads of State of the OPEC Member Countries, Algiers, Mar. 4-6, OPEC/S1/1.Rev.1, published in OPEC



late into action the International Development Strategy for the Second United Nations Development Decade<sup>109.1</sup> and the Declaration and Programme of Action Concerning the Establishment of a New International Economic Order adopted by the Sixth Special Session of the United Nations General Assembly in May 1974.<sup>109.2</sup> The core of OPEC's strategy towards the industrial countries involves these elements: (1) stabilization of oil prices; (2) a guarantee to supply oil to meet their requirements; and (3) direct recycling of petrodollars to the most affected industrial countries.<sup>110</sup> This last point is important when viewed within the context of the American plan for a \$25 billion safety net which will be discussed below. In return for these three guarantees, OPEC would like the industrial countries to commit themselves to the following: (1) an end to threats, confrontation tactics, and any designs for military and economic aggression; (2) an equitable relationship between oil prices and prices of OPEC countries' imports; (3) appropriate pricing schemes for other Third World raw materials other than oil; (4) a reformed international monetary system which would allow for the active participation in decision making by the Third World; (5) a moratorium on barriers to the free movement of oil or the employment of financial assets; and (6) a serious effort by industrial countries to boost the economic development of the Third World through the transfer of technology and the opening up of markets to the products of Third World industries.<sup>111</sup> Within OPEC, the differences evolve around the issues of production regulation, the timing of oil price indexing to reflect inflation, the administration and employment of surplus funds, and the extent to which OPEC should link oil to other raw materials in its dealings with the industrial countries.<sup>112</sup>

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WEEKLY BULLETIN, Mar. 10, 1975, at 1. For an illuminating analysis of these issues see ARAB OIL & GAS, Feb. 1, 1975, at 3; ARAB OIL & GAS, Mar. 1, 1975, at 3; ARAB OIL & GAS, Mar. 16, 1975, at 3.

109.1. G.A. Res. 2626, 25 U.N. GAOR Supp. 28, at 39, U.N. Doc. A/8124 & Add. 1.

109.2. Declaration on the Establishment of a New International Economic Order, G.A. Res. 3201; Programme of Action on the Establishment of a New Economic Order, G.A. Res. 3202.

110. See MEES SUPP., Jan. 31, 1975; MEES SUPP., Mar. 7, 1975; ARAB OIL & GAS, Mar. 16, 1975, at 3.

111. See MEES SUPP., Jan. 31, 1975; MEES SUPP., Mar. 7, 1975; ARAB OIL & GAS, Mar. 16, 1975, at 3.

112. For an analysis of these conflicts see MEES SUPP., Mar. 7, 1975; ARAB OIL & GAS, Mar. 16, 1975, at 3.

The developed countries, under the leadership of the United States, have changed their position from one which sought a reduction in OPEC oil prices to the current position which seeks to establish a floor price for oil. Their position—except for the United States—has also changed with respect to coping with balance of payments deficits. The initial position was that the IMF oil facility should be significantly expanded to meet the payments needs of both developing and developed countries. The U.S. position, on the other hand, was that such a facility will have the effect of keeping oil prices from falling. While the IMF oil facility is being kept for the present, the industrial countries agreed to adopt the U.S. proposal to create a \$25 billion safety net outside the IMF as a solidarity fund to finance payments deficits and have also agreed on certain measures relating to conservation, oil sharing, and stockpiling.

While tactics have changed, the overall strategy of the American energy policy remains the same, that is, a reduction in demand for oil will force OPEC countries to increase production or lower prices at the time when their ambitious defense and development programs get underway. In the meantime the industrial countries—mainly the United States—are to embark upon a massive and costly effort to develop new energy sources whose cost of production can never compete with the production costs of Middle East oil.<sup>113</sup> This disparity in production cost poses a dilemma. In order to protect the major capital investment that is needed to bring oil prices down, the United States must insure that the price of oil on the domestic market does not fall below a certain level. In other words, in order to bring OPEC prices down major oil importing countries must not allow imported oil, that is, OPEC oil, to be sold domestically below certain levels.<sup>114</sup> This in turn means that domestic prices should be kept at a level that would make capital investment for the development of the higher cost alternative sources profitable. Such a floor price for imported oil, if implemented—through tariffs, quotas, or variable levels—will permanently keep energy prices at a high level. This outcome will be in line with traditional domestic oil policy which sought over the last 40 years to keep oil prices at an artificially high level. The idea of a floor price suffers from a basic

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113. *Energy: The Necessity of Decision*, Address by Henry A. Kissinger, National Press Club, Washington, Feb. 3, 1975. It should be noted that Otmar Emminger believes that the \$25 billion safety net involved reshuffling of reserves, and did not have much to do with the petrodollars.

114. *Id.*

inconsistency, in that a true protection for other forms of energy would be higher than the present oil price, and that a lower oil price would not provide the necessary price for alternative sources.

Aside from the safety net and mutual sharing of oil, the domestic impact of the Ford Administration energy program was assessed to be very similar to the impact of the 1973 OPEC oil price increases at a time when the U.S. economy is suffering from both inflation and recession.<sup>115</sup> In the absence of economic justification for such a policy, one can safely conclude that the motive behind it is the perception that the United States is in a crisis that threatens national prestige and basic foreign policy interests. In commenting on this policy, Professor Samuelson said, "[T]he whole problem can disappear for the immediate time horizon if President Ford will open his eyes and repeat firmly: There is no energy crisis. Repeat: There is no energy crisis. Dr. Kissinger's Ph.D. was earned in the field of political science, not economics."<sup>116</sup>

Aside from the adverse domestic impact, the U.S. energy policy creates serious problems for other industrial countries. There is a widely held belief by many European monetary authorities that the United States had, due to its chronic balance of payments deficits, enormous inflationary impact, and that for several countries the inflow of short-term capital had meant the complete loss of control over money supply. In Germany, for example, monetary policy was practically paralyzed by such inflows—or the threat of them—from 1968 to 1973.<sup>117</sup> Since U.S. energy policy was viewed as a new factor contributing to inflation, it was only natural to question the commonality of interests between this country and its trading partners in Europe. Given the fact that alternative sources were to be developed in this country, the American plan was viewed as an instrument for the development in this country of the higher cost alternative sources which will make the United States a major energy exporter supplying a significant share of the world's energy needs.<sup>118</sup> This, of course, is not the case with Europe. According to Guido Carli, Governor of the Bank of Italy, the energy situation and inter-

115. N.Y. Times, Jan. 19, 1975, sec. 3, at 10, col. 1.

116. Samuelson, *Energy Policy*, NEWSWEEK, Mar. 24, 1975, at 76. In his earlier comment on the Administration's energy program, Samuelson said the program is "the work of boy economist Henry Kissinger." He went on to say that "some are tone deaf to economics. Kissinger is not cut out to understand economics. He is promising us a high price of energy for a long time to come." N.Y. Times, Feb. 14, 1975, at 53, col. 3.

117. O. EMMINGER, *INFLATION AND THE INTERNATIONAL MONETARY SYSTEM* 19 (1973).

118. State of the Union Address, Jan. 15, 1975, 121 CONG. REC. 136 (1975).

ests of Italy, France, and other Western European countries are different from those of the United States, and that European-American interdependence should be reduced rather than increased. Furthermore, the Europeans will have to pay the same high prices, whether to Middle East oil producers or to the Americans with their alternative energy sources, without any appreciable advantage.<sup>119</sup> This conflict of interests between the United States, on the one hand, and Europe and Japan, on the other, may be explained by several factors. First, the United States is much less dependent on foreign oil than other industrial countries. U.S. oil imports constituted 36 percent of its oil needs in 1973 as compared with 100 percent for Japan and close to 98 percent for the Common Market countries. The oil interdependence between OPEC major producing regions (the Middle East and North Africa) and the consuming countries is revealed by the fact that in 1973 the United States' imports from these two regions amounted to 19.4 percent of its total oil imports (or seven percent of total oil consumption), as compared with Japan's 76 percent and Western Europe's 84.3 percent. By looking at the same data from a different side we find that these two producing regions exported five percent of their oil to the United States, as compared with 75 percent to Japan and Europe. This oil interdependency explains why Japan and Western Europe were anxious to conclude bilateral trade agreements with the producing countries. Given the fact that an insignificant amount of oil flows from the Middle East to the United States, and given the reality of the U.S. position as a world power, it follows that the U.S. interest in oil and the Middle East is more political than economic in terms of its deep involvement with Israel and its posture vis-à-vis the Soviet Union. By contrast, Europe and Japan have little at stake in a political sense, but an overwhelming economic interest in that area. Hence, the price for them of any bungled confrontation with the oil producers under the U.S. leadership may prove to be too high.<sup>120</sup> This asymmetry of interests and oil interdependence may explain why OPEC has offered assurances on production, the future stability of oil prices, and the recycling of petrodollars to those developed countries with balance of payments difficulties. Should OPEC succeed in reaching an agreement on the direct recycling of some of its funds to the most affected industrial coun-

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119. N.Y. Times, Jan. 13, 1975, at 43, col. 1.

120. See MEES, Jan. 31, 1975, at 5.

tries, the Kissinger \$25 billion safety net will be at least partially neutralized.

## VI. CONCLUSIONS

1. The energy crisis was the culmination of several long-term forces in the oil industry, as evidenced by shortages which appeared before the politically-motivated cutback and embargo measures imposed by the Arab states in the October 1973 war. These measures had the effect of accentuating an already existing shortage situation.

2. OPEC, which is an intergovernmental body with no supranational authority or power over its members is not, in my view, a cartel. OPEC has not so far sold less than would be in its economic interest in order to raise the price. Nor has OPEC resorted to output controls through prorating or an agreed reduction by a major producer. OPEC's preferred instruments instead have been taxes and/or prices.<sup>121</sup>

3. OPEC's failure in the 1960's to adopt a unified position to raise oil prices led not only to the wasteful use of a scarce resource, but also to massive transfer of wealth to the developed countries due to inflation and international monetary stability.

4. The importance of the size of the so called "surplus funds" or "petrodollars" has, in my opinion, been blown out of proportion. The funds have found their way back to the most important capital markets. The financial markets, through their function of intermediation, engaged in secondary recycling by channeling these funds to those deficit countries which did not receive funds directly.

5. OPEC countries' economic aid to developing countries exceeds by several times that provided by industrial countries relative to GNP. This is true with respect to both aid commitments and actual disbursement.

6. Although oil price increases were sudden and steep, a significant part of the increase—almost one-third—had already been wiped out due to inflation and currency depreciation.

7. OPEC, I believe, can and should play a major role in changing a world economic order in which 72 percent of the population receive 17 percent of the income while the other 28 percent of the population receive 83 percent of the income. OPEC countries, with 10 percent of the world population and less than four percent of its

121. See Mabro, *Can OPEC Hold the Line*, MEES SUPP., Feb. 28, 1975.

income, are part of the Third World, but I must add that they have a unique opportunity to make a positive contribution for the economic development of the less developed countries.

8. In view of the intimate relationship between the major oil companies and their home governments and the role which the majors played as instruments of foreign policy, and in view of the recent shift of economic power to oil producers, it is not surprising to find Dr. Kissinger saying that we should act to regain control of our future and Mr. Simon saying that we should act decisively in the face of our national security threat to regain control of our economic destiny.

9. The central and critical objective of every OPEC country is to use an exhaustible resource as a catalyst for the transformation of their underdeveloped economies into economies capable of providing employment and decent life for future generations. A recent study by the National Academy of Sciences posed the issue very clearly by predicting that the oil reserves in the Middle East will be gone in 30 years at the present and prospective rates of use. The study went on to say that, "The Arab countries are entitled to ask themselves, and us, what kind of economy and culture they will have achieved by the time this transient bounty runs out."<sup>122</sup>

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122. Quoted in *N.Y. Times*, Feb. 12, 1975, at 12, col. 3.