 January 20, 2023

What the World Should Learn from the Oil Crisis 50 Years Ago? (2): Market Response

Ken Koyama, PhD
Chief Economist, Managing Director
The Institute of Energy Economics, Japan

My previous report "A Japanese Perspective on the International Energy Landscape (619)" reviewed the half century since the first oil crisis and discussed lessons for the international energy market from historical and panoramic viewpoints. This report discusses details of the international oil market's response to the oil crisis, considering what to learn from the short to long-time viewpoint.

As noted in the previous report, the first oil crisis was triggered by the fourth Middle East War, called the Yom-Kippur War, as a grave geopolitical security factor and was greatly influenced by the Arab oil embargo invoked in the course of the war. Apart from the geopolitical event, however, we should not overlook the tightening supply-demand balance in the international oil market before the crisis. From the 1960s to the early 1970s, global oil demand expanded rapidly, leading the world's surplus oil supply capacity to decline and concentrate in the Middle East. The United States, which had had great oil supply capacity and been viewed as the last resort of supply for the international oil market, became a net oil importer in the 1960s, with domestic oil production growth failing to catch up with domestic demand growth. For oil supply, the world then depended heavily on the Middle East, on the Organization of the Petroleum Exporting Countries and on Arab oil-producing countries.a

In such situation, the international oil supply-demand balance was tightening, pushing up crude oil prices. As the oil market became a seller's market, the balance of power in the market tilted from oil-consuming countries to oil-producing countries. On the supply side, the balance of power tilted from the Seven Sisters oil majors to governments of oil-producing countries. This was the background factor behind the OPEC offensive in the early 1970s. Under the first oil crisis that a came in such situation, oil-consuming countries had nothing to do in response to the crisis over a short term. They had no choice but to be bombarded with oil-producing countries' strategies. While it was indispensable to develop crisis response capacity, oil-consuming countries just began to stockpile oil in view of the 1956 Suez crisis. Hit by the oil crisis then, major Western oil-consuming countries pushed each other out of the way to secure oil supply. Such exclusionary procurement practice was seen not only at the country or company level but also at the consumer level. Long lines of cars formed in front of gas stations, leading gasoline to be sold out at many stations. Plagued with a sense of crisis, consumers, companies and governments went on to hoard petroleum products, inflating oil demand substantially and thus pushing up prices. Exclusionary procurement, hoarding and panic buying dramatically worsened the market chaos caused by supply interruptions.

As a matter of course, what we should learn from the consequence is that it is extremely important to avoid or suppress exclusionary procurement, hoarding or panic buying in response to any crisis. As noted in the previous report, the International Energy Agency was created to reconstruct oil-consuming countries' cooperation destroyed through the first oil crisis and enhance their crisis response capacity. It is important to enhance international collaboration and cooperation frameworks anew in line with international energy market realities. Remembering that exclusionary procurement and hoarding destabilize the international energy market, thereby exerting great negative impacts on energy-consuming countries and citizens and on the entire global economy, we should reaffirm that responsible governments are required to behave coolly and suppressively in consideration of global interests. It is important to develop specific measures to secure international cooperation and collaboration in line with current issues and energy market realities.

From the medium to long-term viewpoint, I would like to note that it is important to expand supply capacity, secure surplus supply capacity and diversify supply sources. Crude oil price spikes through the oil crisis and dependence on the Middle East or OPEC behind the crisis turned around the awareness of energy policy and industry stakeholders throughout the world. As a result, industrial countries took leadership in advancing energy-saving policies to suppress oil consumption and in promoting nuclear, natural gas, liquefied natural gas, new and renewable energy and other substitutions for oil. In addition, the promotion of non-OPEC oil development made great progress in the international oil market. As major countries were required to develop non-OPEC oil resources outside the Middle East, international oil majors, which lost assets due to the nationalization of resources in the Middle East, expanded investment in oil development, supported by high oil prices. Symbolic achievements of such investment included the successful oil development and rapid oil production expansion in the British and Norwegian North Sea and the development of the giant Prudhoe Bay Oil Field in Alaska.

As a matter of course, such new oil development and production took some time, failing to achieve any oil supply expansion right after the first oil crisis. Projects that use new technologies for developing giant oil fields in frontier regions take a longer lead time before full-fledged production. North Sea and Alaskan oil production expanded in the 1980s. However, such achievements became a key factor to help reverse a rise in oil-consuming countries' dependence on the Middle East and OPEC over the medium to long term. The rate of the world's dependence on OPEC oil supply continued rising until the early 1970s, hitting a peak of 50% in 1973. The rate then peaked out and fell to 41% in 1980. As non-OPEC oil production expansion was combined with energy conservation and the promotion of substitutions for oil to dramatically ease the supply-demand balance in the international oil market, OPEC cut production to defend crude oil prices, leading the rate of dependence on OPEC to plunge to 27% in 1985. Saudi Arabia, which took leadership in cutting OPEC production as a swing producer, failed to tolerate a decline in its oil market share and increased production to raise its market share, resulting in a heavy fall in crude oil prices in 1986.

In this way, the international oil market experienced dramatic changes from the tightening supply-demand balance to the easing balance and from price spikes to plunges in 10-plus years from the first oil crisis. The experience has led oil market stakeholders to share the perception that "the most effective cure for high prices is high prices." It has been understood that the biggest driver of such dramatic changes is investment. Investment in energy conservation, substitutions for oil and large-scale non-OPEC oil development has altered the supply-demand balance in the international oil market over the medium to long term. Investment remains an important influencer for the international energy market. In responding to the current energy crisis, investment is important for market stabilization measures in various areas from the medium to long-term viewpoint. Particularly, investment in expanding supply capacity and diversifying supply sources is important. It is questioned how to promote appropriate, indispensable investment to stabilize the entire international energy market including fossil fuels, consistently with the new important challenge of decarbonization, which had not existed at the time of the oil crisis.

Another important viewpoint is the stabilization of the Middle East, which has the largest surplus oil supply capacity. Since the oil crisis, the stabilization of the Middle East has been the most important challenge for the entire international energy market. Since then, the United States has maintained and enhanced its engagement with the Middle East, deepening its special relationship with Saudi Arabia. In 1979, Washington announced the Carter Doctrine, which clarified the United States' engagement with the stability of the Middle East. In the current situation, including the Ukraine crisis, the division of the world, decarbonization trends and the flagging relationship between the United States and Saudi Arabia, initiatives to stabilize the Middle East are required to be reconstructed or enhanced.

Contact: report@tky.ieej.or.jp
The back issues are available at the following URL
http://eneken.ieej.or.jp/en/special_bulletin.html