



December 22, 2014

SNAPSHOT

Saving OPEC

How Oil Producers Can Counteract the Global Decline in Demand

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Despite a steep drop in oil prices, OPEC decided in November not to decrease production, sending the price of crude oil to a five-year low. The decision was unwelcome among some members of the cartel. OPEC has been feeling the heat from rising shale production in Texas, North Dakota, and other places in North America. Venezuela and Iran wanted to cut output, in hopes of raising prices. But decision-makers in Saudi Arabia, OPEC's most influential member, [decided to defend the group's market share](#) [1], even if at a cost.

If shale were the only problem, Saudi Arabia's strategy might work. But OPEC also faces a larger, more fundamental threat: waning global demand for oil. Demand in industrialized countries fell from 50.1 million barrels per day in 2005 to 45.5 million barrels per day in 2013. Since the decline predated the beginning of the global recession, the shift is likely a result of long-term structural changes in the oil market, such as increased energy efficiency, and not just slow growth.

The International Energy Agency expects the decline in oil demand from the industrialized world to be more than offset by a rapidly increasing demand for energy in the developing world, most notably in China and India. As a result, the agency expects global oil demand to grow until 2040. But many experts say that global oil demand will peak even sooner than that, citing fuel switching, the removal of oil subsidies, and increased energy efficiency. Citigroup, for example, forecasts that oil demand will level off by 2020.

If Citigroup is right, the members of OPEC, whose economies hinge on export revenues from crude oil, are in trouble. But OPEC countries can pursue at least four different strategies to counteract the decline in demand—although none of them will be easy, and none guarantees success.

BETTER TOGETHER

To bring prices up, major oil exporters could first work together to try to reduce global oil supply. But, historically, this sort of collective action has been difficult. Although OPEC introduced a quota system in 1982 to try to limit global supply, in practice, the group has more often adjusted its quota to align with actual production levels rather than the other way around. In a recent study, Jeff Colgan, a political scientist at Brown University, found that from

1982 to 2009, OPEC members cheated on their aggregate quotas 96 percent of the time.

OPEC countries have so much trouble cooperating because they have different goals. The so-called price hawks, notably Iran and Venezuela, have smaller oil reserves—relative to their populations—and want to drive prices up in the short term. But the so-called price doves, led by Saudi Arabia, have ample reserves and the luxury of thinking long term. They can afford to keep prices low in the short term to eliminate the competition from non-OPEC producers and eventually drive prices up again.

Limiting global oil supply, moreover, would provide only temporary relief against a structural slide in oil demand. In the short term, limiting supply might ramp up oil prices—and hence oil revenues—for OPEC. But in the long term, higher prices would likely accelerate the decline in oil demand in the major consuming countries.

THE RACE TO SELL

If the major oil exporters cannot cooperate with one another, they will have to figure out how to maximize profits on their own. In the past, OPEC countries often decided to keep some petroleum in the ground, in hopes that the oil will be worth more later. Given the structural decline in oil demand, however, this strategy is no longer viable. Instead, OPEC countries have an incentive to produce and to sell as much of their oil as they can now, rather than wait for prices to drop even further. If producers start a race to sell, prices could collapse altogether, which might hook consumers to oil again.

Yet there are reasons to doubt this strategy, too. Because of technical constraints, oil producers cannot simply decide to increase their oil production at a moment's notice. They can decide to increase investment in oil exploration and production capacity, but the specter of declining demand makes them unlikely to do so.

EYE ON EFFICIENCY

To extract greater profits from their oil fields without resorting to quotas or price wars, oil-producing countries can strive for greater efficiency in oil production, which would lower the production cost per barrel. A typical oil reservoir has a recovery rate of 35 percent, but a slate of so-called enhanced oil recovery techniques can increase that share. The International Energy Agency estimates that the application of these techniques to large fields around the world would unlock an extra 300 billion barrels of crude oil—more than the entire reserves of Saudi Arabia. But to gain access to state-of-the-art technologies, oil producers must become more open to foreign investment. Most oil-producing states currently rely on national oil companies, which are typically less efficient than foreign firms.

Oil exporters can also reap larger profits by [reducing domestic oil use](#) [2], thereby freeing up more petroleum for export. To reduce fuel use, countries can build more natural gas systems and phase out domestic gasoline and diesel subsidies, which are expensive and encourage wasteful consumption. These policies would have the added benefit for oil-producing states of cutting carbon dioxide emissions and making renewable energy more competitive.

DIVERSIFY, DIVERSIFY, DIVERSIFY

If the above strategies fail, a fourth one has a good chance of success: oil producers may diversify their economies to prepare for a future in which the oil market has shrunk substantially. According to research by the World Bank, countries that diversify their exports enjoy higher long-term growth, whereas those that rely on a limited number of

products do less well.

But few oil exporters have managed to break free of their dependence on oil production. Indonesia and Malaysia have successfully diversified as manufacturers, but they never produced as much oil or gas on a per capita basis as the core members of OPEC to begin with. Dubai has attracted foreign investment in infrastructure, services, and business, but the country's heavy reliance on expatriate labor and skills makes this a unique developmental model that may be difficult to emulate.

Oil-rich countries that produce less oil, thereby offsetting carbon dioxide emissions, could also ask for compensation under the United Nations Framework Convention on Climate Change and the Kyoto Protocol. Article 4.8 in the UNFCCC and Articles 2.3 and 3.14 in the Kyoto Protocol require parties to the treaties to take measures to minimize the impact on energy-exporting countries of emission reduction measures. OPEC countries have argued that this should include monetary compensation for lost oil revenues and assistance for economic diversification. So far, however, their calls have been largely ignored.

In whatever form it takes, the move away from oil should be supported, especially because it is increasingly clear, environmentally speaking, that the lion's share of fossil fuels—including a sizable chunk of oil reserves—should be left in the ground. The OPEC countries face a serious economic threat, but if they diversify their economies, they might come out all the stronger.

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