It is popular wisdom today that market forces can handle any disruption in oil supplies, no matter its size or duration. This complacency, shared by the oil industry and consumer governments alike, finds justification from the case with which markets responded to the sudden loss of 4.5 to 5 million barrels per day (b/d) of Kuwaiti and Iraqi production in the aftermath of Iraq’s invasion of Kuwait. This relaxed attitude exists despite the fact that the oil market has become commodified and globalized, meaning no single consuming country can insulate itself from oil price shocks, no matter what its level of self-sufficiency.

Yet, it is a big leap of faith to assume that since markets functioned in 1990, they will be able to cope with a future crisis in a changing geopolitical backdrop. Rather, at the time of Iraq’s invasion of Kuwait, oil markets were experiencing a major supply glut that greatly ameliorated the abrupt disappearance of Kuwaiti and Iraqi oil. No such major surplus of oil inventory and productive capacity exists today, as evidenced by the 35% gain in oil prices over the course of 1996. Oil prices have eased in recent weeks following the reentry of limited Iraqi exports and the seasonal downturn in crude oil demand, but markets remain vulnerable to a major short-term supply disruption. A sudden imbalance in demand and supply of equal magnitude to the Gulf war would generate an even larger and more rapid price response today than in 1990.

There are several reasons why oil markets are more exposed to a potential crisis than any time since the 1970s. Western oil companies under pressure to show a strong return to investors have shed the practice of carrying extra inventory, leaving world stockpiles at historic lows. Moreover, rising world oil demand and continuing sanctions against Iraq have reduced OPEC’s 4 to 5 million b/d of spare shut-in capacity to little more than 2 million b/d, all of it sitting in three countries—Saudi Arabia, Kuwait, and the United Arab Emirates. And constraints on available drilling and pipeline equipment, as well as economic, legal, and political risk obstacles or lack of access to investment capital due to nationalistic concerns or embargoes levied by other nations, could slow down continued growth in world oil supplies. This is particularly troubling at a time when future global oil consumption requirements are being driven higher by Asia’s economic boom. Careful consideration must also be given to factors that could potentially change the geopolitics of oil into the next century.

OPEC’s New Dynamic

A host of factors, including sanctions policy, has limited the playing field within OPEC, leaving the role constraining production in the hands of only a few members. Several major competing OPEC producers such as Iran, Libya, and Iraq no longer have the ability immediately to increase export levels. Therefore, they do not push for the kind of self-interested market share increases that fed the market surpluses seen in the 1980s, when domestic pressures and competition for political power and regional leadership prerogatives pitted the major Gulf producers against each other in a struggle to delineate who was entitled to increase output under OPEC’s production quota allocation system during times of market strength. Each player wanted to maximize the gain...
in its market share in a complex zero-sum interaction, which generally resulted in quota cheating and oil price competition that benefited consumers. By contrast, the reduction in spare capacity inside OPEC has meant that a majority of players, including Iran and Libya, are in a position where higher prices are the only means of enhancing revenues. Under such circumstances, countries such as Libya or Iran (and possibly some day Iraq, once the embargo against its oil exports is lifted) have every incentive to use political or other means at their disposal to convince the Gulf Arab players with spare capacity not to use it.

The absence of market share rivalry has put a spotlight on Saudi policy and the kingdom’s close relations with the West. In particular, Iran and other Islamic opposition groups have accused the Gulf leaders of seeking higher production rates to accommodate Western economic interests at the expense of the needs of local populations. Such accusations have created internal pressures against a moderate price stance. The stakes are high, since with low inventories and no market surplus, the fate of oil prices in times of crisis becomes overwhelmingly dependent on the ability and willingness of Saudi Arabia to make incremental oil available to the market.

It could be that no one is worried because, after all, Saudi Arabia is there to fill any vacuum. But the political elite of the Middle East face challenges today that could be as complex as ever before. Populations in the Middle East could more than double by 2005, potentially placing overwhelming demands on infrastructure and basic services and resources such as health, education, food, and water. Leaders in the region worry that failure in the Middle East peace process will aggravate localized problems of social unrest and revolutionary politics. And within the next ten years or so, the older generation of Gulf leaders must pass the reins of power on to a younger generation where the field of politically ambitious candidates is wide and potential for conflict is great.

Leaders in Saudi Arabia remain preoccupied with the state of national finances and the massive debt incurred by the Desert Storm operations. There is increased popular criticism of the U.S. military presence, and greater activism of Islamicist groups opposed to the regime is a serious source of concern to the Saudi leadership. The middle classes in Saudi Arabia are pressing for political and economic reforms and for wider economic opportunity, and there is a rise of a large, idle class of students inside the kingdom that could provide momentum for Islamic opposition movements. Urban unemployment continues to plague the middle class. In addition, wealth accumulated by the private sector has created a separate funding source for such movements. Because of these issues, the Saudi regime is operating under a series of political, economic, and financial constraints.

THE THREAT OF IRAQ AND IRAN

The threat from Iraq and Iran has not been eliminated by the U.S. policy of “dual containment” of the two rogue states. Instead, dual containment has increasingly identified the U.S. as serving as a military “protector” of the Gulf states, especially Saudi Arabia. This role has attracted increased internal and external criticism of the Gulf regimes. Dual containment has also been costly in terms of lost oil production capacity investments, the strengthening of radical forces inside Iran, and the stimulation of special military ties between Iraq, Iran, and China.

Concerns remain that Saddam Hussein will roll across his border again some day. At the same time, a destabilizing breakdown in order inside Iraq also cannot be ruled out. Intercine fighting over black-market businesses and other spoils continue to weaken the regime substantially, raising the possibility that Saddam could lose control of power. Iran also poses a threat to stability through its ideological challenges to the legitimacy of neighboring regimes and through its abilities to threaten the free flow of oil through the Strait of Hormuz. Iran’s support for radical fringe Shiite movements, while not likely to destabilize substantially the governments of the Gulf, has caused political unrest and terrorist attacks and as such can require costly security measures that also tend to reduce the support and popularity of local regimes. There have also been minor attacks on petrochemical facilities blamed on such groups, highlighting the potential for sabotage. U.S. military installations have been targeted in the past, and opposition groups could shift their focus to oil facility targets should such a strategy prove advantageous.

While the U.S. and Western allies can respond
effectively to outright military adventurism in the
Gulf region, fashioning effectual policy responses to
internal instability or anti-Western ideological move-
ments will be far more difficult. The Western powers
have exhibited the will and capacity to respond to
events such as an Iranian or Iraqi military threat to the
free flow of oil from the Gulf. Internal upheavals may
pose different, more thorny, problems however. And,
the chance of such turmoil increases as the region
moves toward the transfer of power from the cur-
rent generation to the next as the century turns. U.S.
policy toward the Middle East Gulf is being driven today
primarily by military concerns. But while Gulf secu-
ritv remains in the vital interests of the U.S. policy
toward the region must look beyond military issues to
economic, political, social, and cultural change, with
special consideration given to the role of religious
groups. We must assess what the U.S. can and should
do in the face of generational and regime change in
the Gulf and in Iraq.

THE IMPORTANCE OF DIVERSE SUPPLY

From the energy security point of view, oil im-
porting countries benefit when global oil production
flows from as diverse a base as possible. Such diversity
reduces reliance on any one particular country or
gеographic center, thereby lessening the potential for
a large-scale disruption from any one area. Increased
reliance on a handful of Middle East oil producers
also enhances the potential for the exercise of mo-
nopoly power, especially during a supply disruption,
and experience has shown that consumer government-
held stocks can play an important role in maintaining
market stability.

Development of natural gas resources worldwide
also enhances consuming countries' abilities to limit
the risks of dependence on a concentrated oil supply
center. Competing non-OPEC gas is reported to be
eroding OPEC markets by as much as 200,000 b/d
per year. The share of oil and oil liquids has declined
from 49.5% in 1973 to 39% in 1993 while the share
of natural gas has increased from 18.2% to 21.5%
over the same period in part in response to off-budget
subsidies for both the production and use of natural
gas. Middle East gas trade remains an area with great
potential for the region as well. The Middle East is en-
dowed with approximately 20% of the world's proven
reserves of natural gas. The creation of a regional gas
grid that would extend to the Levant and into Turkey,
and include Israel, could provide a major impetus to
forward the peace process and stabilize regional rela-
tions.

The stakes for developing diverse sources of
oil and gas supplies are high since lasting oil price
increases can have a dampening effect on economic
prosperity and reduce real incomes in energy import-
ing countries because they must export a larger share
of overall economic output in order to pay for the in-
creased cost of oil imports. Oil price gains also poten-
tially increase incomes of countries that would use the
wealth to facilitate hostile military or terrorist activi-
ties. Moreover, prolonged oil price volatility may also
pose risks to the economy by diverting real resources
toward activities that deal with the risks arising from
the uncertainty.

However, while the threat of yet another oil mar-
ket shock may be great, for a number of reasons, the
effect of such a crisis on real output in the industrial-
ized West may be considerably less than experienced
in the 1970s. Vast improvements have been made in
energy efficiency in many countries, particularly in
the OECD, and there have been new, more efficient
technologies within the petroleum sector, as well, that
shorten the time in which new assets can be discov-
ered and brought into production. Also, consumer
governments are better prepared to deal with sudden
oil price changes given new tools of strategic oil stocks
and improved knowledge of the benefits and limita-
tions of fiscal and monetary policy response.

Forecasts for the year 2000 and beyond reveal
that it is feasible to generate a more diverse world
production profile, but only if efforts are made to
unblock the political, legal, economic, and geographic
constraints that currently thwart development of
vital resources in several oil prolific countries in the
competitive fringe outside the Middle East, such as
Russia, Central Asia, central Africa, Algeria, China,
and Mexico, to name a few. Technology transfer could
greatly enhance available oil supplies in the coming
years, and has already played a major role in staving
off declines in major provinces in the U.S. and North
Sea and boosting the outlook for South American
exports. Further, more proactive investigation should
be made of means to remove barriers to investment in oil and gas resources to influence the outcome of non-OPEC development.

The stakes of this exercise are high. If major political and economic barriers are overcome and several prolific areas open to development like Chad, Central Asia, China, and others, then non-OPEC production could hit as high as 55 million b/d by the year 2000, leaving a glut of oil so big that the full 8 million b/d of Saudi production could be lost and world demand would still be satisfied. Should none of these areas be developed, then as North Sea production slows by the turn of the century, dependence on the Middle East could expand just at the time succession disputes and ideological transition may render the region more volatile than even at present.

THE GEOPOLITICS OF ASIA’S GROWING THIRST FOR OIL

An increased dependence on the Middle East by the year 2000 could also put geopolitical relations in Asia under more strain. In the coming years, the gap between oil supplies produced locally in the Asia Pacific region and Asian consumption is expected to widen substantially, possibly to as large a deficit as 13 to 25 million b/d in supplies that may have to come mainly from the Middle East. China may also become dependent in large measure on Middle East oil supplies as its oil import demand mushrooms from today’s minimal levels to 2 to 4 million b/d into the next century. At the same time, Western Hemisphere counterparts will likely be reducing imports from the Middle East as increased supply from Canada, Venezuela, and elsewhere in South America renders the hemisphere relatively self-sufficient.

The expanding dependence of Asia on energy imports, most likely in great measure from the Middle East, will create new tests for the world political order and could have serious ramifications for future balance of power relations, particularly affecting Japan and China but also with implications for the U.S. It is not difficult to imagine how rivalries for energy supplies might intensify in Asia in the coming years, potentially complicating maintenance of a stable world economic and political order, if Asian countries react to their energy vulnerability by taking aggressive precautionary steps. Building regional institutions that encourage cooperation among the Asian Pacific nations will be crucial as a policy to counter tendencies toward rivalry and competitive military buildups.

RECOMMENDATIONS

* U.S. Policy toward the Persian/Arabian Gulf is being driven today primarily by a preoccupation with military concerns. While Gulf security remains in the vital interest of the industrialized world, U.S. policy toward the region must look beyond military issues to the emerging situations in each of the individual Gulf countries for economic, political, social, and cultural change, with special consideration given to the role of religious groups.

* While the U.S. should be and is prepared to deter and defend against external aggression in the Gulf, we must also assess what the U.S. can and should do in the face of generational and regime change in the Gulf and in Iraq.

* The U.S. needs to gain a fuller understanding of the cultural and political transition period that will emerge in the next decade in the Middle East and the Gulf. Active engagement should be undertaken with potential leaders from the younger generation of political and religious elites to gain clearer understanding of their motivations and ideologies and to build bridges for long-term relations.

* U.S. policy makers must seriously reassess the costs and benefits of imposing oil sanctions on several oil producing countries simultaneously. Effectiveness of sanctions, especially unilateral sanctions, in meeting targeted goals should be rigorously examined and the policy of dual containment should be seriously reassessed. Iran’s influence on the question of exports from Central Asia should also be revisited.

* The U.S., with its global responsibilities, must maintain a firm and consistent policy on Iran. However, the U.S. must recognize that it has not been successful in bringing our allies to the same level of sanctions of Iran. In particular, the U.S. policy has negatively impacted Japanese-Iranian relations and disadvantaged Japan with regard to Iran to other regional powers such as China. U.S. policy does not advocate the overthrow of the Iranian government, and U.S. policies directed at Tehran are not identi-
cal to those aimed at the regime of Saddam Hussein. Thus, the rhetorical use of the term “dual contain-
ment” by the US. is neither helpful nor an accurate
description of policy. The U.S. has in the past and
should in the future leave open the door for a possible
dialogue with Iran. Such contacts should be pursued
openly and without preconditions. Japan could serve
as a useful bridge to engaging Iran into a more open
and constructive dialogue with the West. The possi-
bility of constructive dialogue with the West can help
keep alive the forces of reform in Iran.

*Inasmuch as Iran has the military power to
interdict or threaten to interdict free passage through
the Strait of Hormuz, it gains considerable political
leverage. Improved contingency planning for bypass-
ing the Strait of Hormuz could deprive Tehran of
this influence. A substantial infrastructure exists that
could be supplemented to ensure that as much as 10
to 13 million b/d of Gulf Arab oil could bypass the
Strait. Additional throughput levels could be obtained
by building spurs and incremental pumping capacity to
the existing 5.1 million b/d Petroline and connecting
Kuwait’s fields to the 1.65 million b/d former
Iraqi Ipsa-2 pipeline across Saudi Arabia to the Red
Sea. In the latter case, the serious military and politi-
cal implications of a spur connecting Kuwait to the
formerly Iraqi line would have to be examined care-
fully. The use of Drag Reduction Agents to be stored
in Saudi Arabia could accomplish similar enhance-
ment of throughput capacity of existing pipelines that
bypass Hormuz.

* The US. should support the governments of
the Middle East region in promoting political re-
form, privatization, and broader participation in the
economic system to diminish the manifestations of
social injustice and economic deprivation that give
rise to extremism. In doing so, we must be sensitive to
the complexities involved and remain attuned to the
unique cultural aspects of each society job creation
and economic diversification will play an important
role in diffusing support for extremist religious move-
ments.

* The US. should intensify its central role in
advancing the Arab-Israeli peace process. Resolution
of that conflict will help diffuse anti-Western senti-
ment among Muslims and undercut the influence
and spoiler potential of the Islamist extremist groups
throughout the region.

* The U.S. should help foster the development of
regional trade within the Middle East and support
efforts to establish regional trade in natural gas and
water that would provide economic benefits to the
Palestinian National Authority and other nations of
the Middle East and promote stable relations based
on cooperation and integration.

* The US. should affirm in the strongest terms its
commitment to peaceful resolution of territorial issues
and matters of energy security within the Asia-Pacific
and assist with the formation of regional institutions
that encourage cooperation among Asian nations to
counter tendencies toward rivalry and competitive
military buildups. The U.S. should take an active role
in engaging China into this process.

* The International Energy Agency should in-
crease its membership to extend beyond the OECD
to include the emerging economies of Asia including
China.

* The IEA and US. Department of Energy should
lay the groundwork for providing know-how on stra-
tegic oil stockpiling and emergency response measures
to Asian countries and function as a medium for
transferring energy conservation technology.

* The U.S., Japan, and the IEA should engage in
dialogue with China on matters of energy coopera-
tion, including joint research on coal liquefaction
and other clean-coal technology, biomass and solar
technologies, and hydroelectric power. Collaboration
in construction of large-scale energy infrastructure
such as long-distance pipelines would also be of ben-
efit, particularly those that would transport natural
gas to China’s industrial areas and to South Korea and
elsewhere in the region.

* Energy policy makers should continue to iden-
tify and pursue options to promote the development
of oil and gas resources outside the Middle East. In
view of the sharp increase in demand expected in
the Asia- Pacific region, special attention should be
paid to removing political, legal, and other barriers to
the more rapid and extensive development of fields
in Asia or near Asia, such as resources in China and
Indonesia. Investigation should be made of means to
remove existing barriers—whether they be fiscal, legal,
or political—to investment in oil and gas resources
outside the Middle East. Trade activities that promote
technology transfer in the oil sector should be encouraged. This can be done in many ways, including (a) educating countries on the means and benefits of improving investment incentives in the energy sector; (b) continuing to develop diplomatic initiatives that assist with the removal of political, legal, and technological barriers to investment in oil prolific areas such as Russia, Central Asia, Indonesia, China, and Mexico; and (c) promoting and encouraging the participation of the private U.S. and European drilling service industry in assisting development of oil fields and technology transfer to oil producing countries that cannot or will not consider production sharing/joint venture participation by private oil companies.

* Consuming countries benefit from the existence of strategic stocks and privately held stocks, especially in calming futures markets in the early stages of a crisis. Such stocks should be maintained.

* Recognizing there is still no general consensus in the profession on the mechanism through which oil price shocks are transmitted to the economy, the weight of evidence supports the view that monetary and fiscal policy can be used judiciously during oil price spikes to limit the impact on output. In particular, in conditions involving a one-time oil price increase of prolonged duration, accommodative monetary policy or fiscal policy has been found to help ease the impact on output and employment. Very short-term spikes do not pose serious risks to the overall economy, nor does a very gradual gentle rise in oil prices over a long period of time. Further study on how to cope with sustained price variability would be beneficial.

* Transparency is a cornerstone to the effective operation of the free market. IEA member efforts during Desert Storm operations to provide open and accurate information about oil supplies, inventories, and other important data were instrumental in keeping markets calm in the early stages of the Gulf war. The IEA must remain a viable institution for consultation and information exchange, both formal and informal. Efforts to reduce its budget should be minimized, and the information and forecasts generated by the agency should be made more transparent and open through disaggregation of data and open exchange of methodology and information. Through this process, the IEA forecasts would rely improve in accuracy as the open process allowed for improvements and refinement in data.