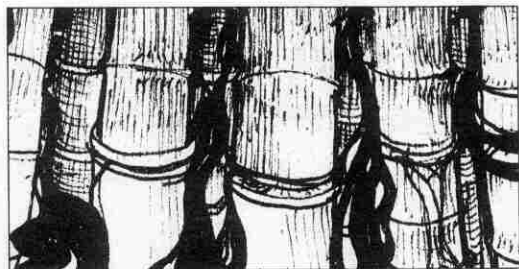


THE OIL SHORTAGE THAT WASN'T



True or false: The Arabs hold Western foreign policy hostage to our need for oil.

False—unless we make it so.

RICHARD MINITER

FOUR MONTHS ago, nearly everyone expected that if fighting began in the Persian Gulf oil prices would go through the roof. As the January 15 deadline approached, the price of oil climbed in step with mounting fears of an impending oil shortage. On the first business day of 1991 oil was \$28.44 per barrel. When the New York Mercantile Exchange closed on January 16—just hours before the bombs started falling—oil prices had hit \$32 per barrel. But the first casualty of war turned out to be high oil prices: when U.S. commodity markets opened the next day, the price of oil had fallen a sharp \$10.56, to \$21.44 per barrel—just about where it had been on August 1 of last year (\$21.54). The price of oil plummeted when traders realized that the air war was going well and that oil stocks in industrial countries were at record levels.

That was the last thing the pundits had expected. “Failing a last-minute Mideast miracle, higher gasoline prices over the next few days look like a sure bet,” the *Wall Street Journal* worried on January 16. “Prices will definitely go up,” Bill Ligon, manager of the Texas Service Station Association, told the *Journal*. Though the price appears stable, a significant

threat to oil supplies “will wake up the market pronto,” said Cheryl J. Trench, executive vice president of Petroleum Industry Research Foundation.

It was not surprising that people believed these predictions. The dramatic increases in gas prices after Iraq invaded Kuwait had made a deep impression on many Americans, and they expected a similar price rise when warplanes filled the skies of Iraq.

Prices in Perspective

THE AUGUST price rise should be put in perspective, however. Gas prices were set to rise before Iraq invaded Kuwait. OPEC had reached an agreement in late July to raise the price of crude oil some 40 per cent. If hostilities had not begun, industry analysts calculated, the price of gasoline, heating oil, and other petroleum products would have gone up by 10 cents per gallon anyway.

It was the embargo on Kuwaiti and Iraqi crude oil that set off the sharper price rise. The embargo dislocated about four million barrels of oil per day and was the greatest oil shock to America since the 1956 Suez crisis. The U.S. lost only 1.6 million barrels per day during the 1973–74 Arab oil embargo, and 3.7 million barrels during the Iranian crisis in 1979.

What’s remarkable is how relatively painless this current oil shock was. True, gasoline prices increased by an

average of 25 cents per gallon, but most consumers did not have to wait in long lines, and most service stations did not run out of gas. The reason is that this time we did not have an “energy policy.”

Still, one relic of the 1970s did come back to haunt us. Some policy-makers began again to talk about “energy security,” meaning foreign-policy concessions to oil kingdoms. In the 1970s America was repeatedly pressured by “experts” to back away from its pro-Israel stance in order to “guarantee” its supply of oil. The influence of this factor can be found in the U.S. sale of F-15s and AWACS to the Saudis, the quiet toleration of Saudi interference with U.S. arms shipments to North Yemen, an anti-Egypt tilt during the Egyptian–Saudi rivalry, a somewhat pro-Arab tilt in the Arab–Israeli conflict, a pro-Iraq tilt during the Iran–Iraq war, and the current intervention in the Persian Gulf.

Would appeasing Arab interests in fact make U.S. oil imports stable? Hardly. Oil prices are stable because markets work and because what the Saudis really want is not short-run high prices but long-run price stability. This is because, as former Saudi oil minister Ahmed Zaki Yamani explained to his countrymen in 1981, “If we force Western countries to invest heavily in finding alternative sources of energy, they will. This would take no more than seven to ten years, and

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would result in reducing dependence on oil as a source of energy to a point which will jeopardize Saudi Arabia's interests."

This policy occasionally puts the Saudis at odds with their neighbors. Yamani made this clear in a recent *Time* interview. When asked about Iraq's oil strategy, Yamani responded: "I wonder if Iraq has a strategy. Saddam may only have temporary oil policies, depending on his large financial requirements."

Those who believe oil sheikhs are less interested in riches than in making political statements are deluding themselves; those who say that political concessions are necessary to keep oil prices low are simply trying to peddle an agenda which includes price controls at home and concessions to the PLO abroad. The strangest people echo this regulatory agenda. When asked recently what the U.S. should do, Yamani said: "Well, I think you should encourage exploration. You have to establish good relations with the producers and have a stable supply of oil for yourself and the Western alliance. You have to be more cautious about how to consume energy."

Why would Yamani urge Americans to seek non-Saudi sources and consume less oil? If his advice were taken seriously it would cost the Saudis billions. But Yamani knows how to reinforce the prejudices of Westerners. And he knows a plea for "good relations" and a "stable supply of oil" will subtly remind Americans of their interest in Saudi Arabia.

But while Yamani has consistently told the West what it wanted to hear, he has sung a very different tune at home. During the 1981 AWACS debate, Yamani told Leonard Silk of the *New York Times* that his country "has been moderate in [its] demands on the price of oil because Saudi Arabia desires military hardware from the United States." Yet at a press conference in his own land, Yamani said: "I see no connection between the OPEC price decision and the AWACS issue. . . . Certain OPEC [members] refused to lower their prices to reflect market realities."

Throughout the 1970s America repeatedly overpaid, with diplomatic

concessions, for an already precious commodity. One "expert" pushing the political-concessions line was Walter Levy, who consistently made predictions in the pages of *Foreign Affairs* which just did not pan out, such as: "Around the mid 1980s or early 1990s, when the specter of imminent oil shortages begins to haunt the world, the opportunities for large advances in the real price of oil are almost certain to become decisive."

Levy made this prediction while acknowledging that the price of oil fell 20 to 25 per cent in real terms from 1974 to 1978. He attributed this to "restraint exercised by Saudi Arabia with the support of Iran and a few other OPEC members." Levy argued that OPEC had allowed its profits to be trimmed by one-quarter out of the goodness of its heart.

Nor was Levy the only one who got it wrong. George W. Ball, a former

absorptive capabilities." While Ball feared that all the oil kingdoms combined could spend no more than \$40 billion a year, Saudi Arabia alone spent \$200 billion on public projects between 1975 and 1980.

Despite a record of failed prophecies, Ball continued to push his view that political pressure must be applied to Israel to ensure a stable oil supply. "Unless we make prompt and serious progress toward solving the Palestinian problem, we can expect to see our energy needs increasingly held hostage to our Middle East policies," Ball wrote in 1980.

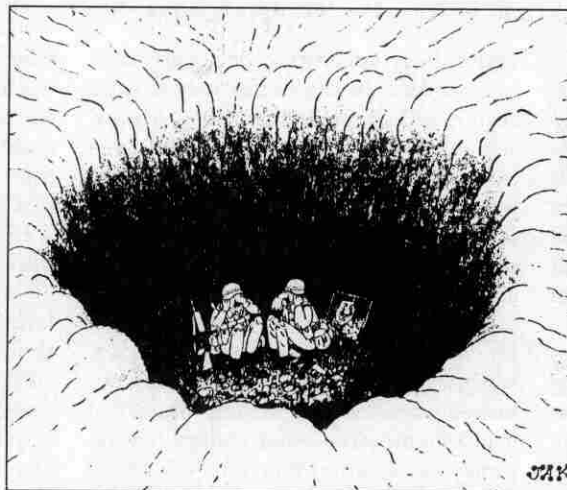
The Saudis' Little Gift

THE VIEW that political forces wholly controlled the price of oil led to some interesting opinions. It was widely reported in 1980, for example, that the Saudis increased oil production as an "Independence Day gift" to President Carter. The market explanation is less exciting, but built on solid evidence. Supply and demand drive oil prices; politics can only cause short-term price spikes. After both the 1974 and 1979 price increases, oil prices fell sharply in real terms. As a result of the twin price spikes in 1979, demand for OPEC oil fell and OPEC production had to fall with it, from a peak of 32 million barrels per day in 1979 to 24 million per day in 1981. As world demand continued to shrink, OPEC was forced to cut prices and squeeze profits.

During the war between Iran and Iraq, the oil production of those two nations was severely restricted. Yet this conflict did not touch off a supply shortfall or a price increase. Other oil producers, especially Saudi Arabia, took up the slack.

At least one of the warring nations feared that it would permanently lose market share. As early as 1981, Iran's oil minister, Mohammed Gharazi, threatened that even if the Islamic Republic "has to resort to force" to win back its share of OPEC production, it would, once the war with Iraq ended. History has a way of repeating itself in the Middle East: Iraq's dispute with Kuwait also involved OPEC production quotas, among other things.

Meanwhile oil-importing nations



"I don't know about you, Tariq, but I don't feel half as fanatical as I used to!"

U.S. under-secretary of state, has a history of urging closer ties with Arab oil producers and warning that catastrophe would come if his advice wasn't followed. In 1973, Ball worried that "the U.S. import bill for oil may be something like \$18 billion by the early 1980s." He said this was "a very alarming figure," and that our import bill should be closer to \$6 billion. By 1980, the U.S. import bill was over \$100 billion—and the economy didn't collapse.

Ball told a roundtable discussion group in September 1973 that OPEC countries will earn more in oil profits than they could ever "need." By "almost any projection," Arab states will have "earnings far in excess of their

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were working on the demand side of the equation. Oil that was used to make heat and steam could be cheaply replaced by burning coal and splitting atoms. France now meets about 80 per cent of its domestic electricity needs with nuclear power. (The U.S. failed to take full advantage of nuclear energy for political reasons.) While nuclear-power plants are large capital investments, once those costs are sunk the marginal cost of nuclear fuel is very low—currently corresponding to about \$4 per barrel of oil.

More efficient cars also diminished demand for oil. In 1973 the average new car consumed 13 miles per gallon; by 1990 the figure was 27 miles per gallon. (Although that is not an unmitigated good. Most cars become fuel misers by sloughing off weight, but lighter cars do not survive accidents as well as heavier cars.)

And yet some editorial boards still believe oil kingdoms are immune to market forces. A recent *Washington Post* editorial said: "Unlike the other leading oil-producing countries, Saudi Arabia, with its minimal domestic requirements and its enormous accumulated wealth, has wide discretion in deciding month to month how much to pump."

This theory of immunity to market forces led some Democrats, including Senate Majority Leader George Mitchell (D., Me.), to call for a return to the Carter "War on Energy Dependence." But that war produced only Pyrrhic victories. One battleground in those days was Beverly, Massachusetts. The high school there installed a solar-electric system in 1980 at a cost of \$2 million, hoping to save \$10,000 per year in electric bills. "This would have corresponded to break-even in two hundred years, but hopes of achieving it by the year 2280 were shattered two years ago when the contraption conked out," writes Petr Beckmann in a recent issue of *Access to Energy*.

When it became clear the Bush Administration was going to take pains to avoid the pitfalls of Carter's energy policy, not everyone was pleased. "Gone are the higher mileage requirements for gas-guzzling autos," wrote Tom Wicker in a recent *New York Times* column. "Gone are [new] federal regulations to impose energy conser-



"If you're not a grouch, how come they won't let you in Murphy's Bar during happy hour?"

vation, any suggestion of government intervention in the sacrosanct private sector, all impolitic urgings toward consumer sacrifice." This echoes the common derision of Reagan's energy policy. "Oh, is there a U.S. energy policy?" Yamani said, neatly capturing the conventional wisdom. "I understand that your policy is no policy."

The policy-that-is-no-policy has been an unblemished success, however. Within the first year that Reagan removed oil-price controls and abolished over two hundred other energy regulations, oil consumption fell, oil prices fell in real terms, and domestic oil production increased for the first time in a decade. And the policy-that-is-no-policy produced no gas lines or fuel shortages. Even with the upheaval in the Gulf, American gas prices are now less than 40 per cent in real terms of what they were in January 1981.

While the 1973 Arab oil embargo boosted oil prices, it was the national energy policy that created the other problems. Yamani is quick to point out that there was always "enough oil, a huge stock . . . The gas lines were not done by me."

The \$40 a Barrel Question

ALL OF this raises the question: Can oil ever be used as a foreign-policy tool? Imagine that Saddam Hussein had become able

to dictate Saudi oil policy. That would have given him control over some of the richest oil fields known to man. Saddam might then have expected to hold U.S. diplomacy hostage.

But don't bet on it. To inflict real economic damage, Hussein would have had to cut Saudi oil production by an amount greater than the unused production capacity of other nations—which is not easy or cheap. Meanwhile, other producers would have increased production to grab market share. During the recent embargo, world oil production from the North Sea and Venezuela increased to meet the demand. Revenues from the Saudi oil fields would have dropped by somewhere between \$50 and \$100 million a day. By contrast, the Saudis give about \$70 million a year to the PLO and about \$200 million a year to Syria.

Nor would Saddam Hussein have been in control of a majority of the world's oil. Even if Iraq had come to control the entire Arabian peninsula, Saddam would have had a little less than 22 per cent of the non-Communist world's oil supply.

Finally, the hope that the United States would have conceded, once the oil weapon was wheeled into battle, is faint. During the 1974 Arab embargo the United States did not yield to OPEC's demands. In fact, once the Saudis realized the December 1973 price increases would stick, they increased production for every month of the first quarter of 1974—despite their threats to cut production each month until Israel retreated from the occupied territories.

In short, if the Gulf states are rational they will not try to use the oil weapon, and if they become irrational, it is pointless to exchange political gifts for oil deliveries.

Despite the evidence, many policymakers refuse to learn the lessons of the 1970s. When the Carter Administration was repeatedly reaching out to Arabs and trying to "solve the Palestinian problem," no easing of oil prices occurred. The Reagan Administration was firm in its commitment to Israel, and oil prices fell. The moral of the story is not that closer ties with Israel create oil gluts, but rather that OPEC is more responsive to markets than to politics. □