

Tightening World Oil Markets Increase Political Risk

by [Patrick Clawson \(/experts/patrick-clawson\)](/experts/patrick-clawson)

Apr 27, 2000

ABOUT THE AUTHORS



[Patrick Clawson \(/experts/patrick-clawson\)](/experts/patrick-clawson)

Patrick Clawson is Morningstar senior fellow and director of research at the Washington Institute for Near East Policy.



Brief Analysis

A robust world economy is driving up oil consumption, while supply is growing slowly. The global safety margin, from oil stocks and excess capacity, is shrinking. By later this year, world oil markets could be in a rather delicate balance--a balance vulnerable to a political shock, such as might be engineered by Iraqi president Saddam Husayn. A further, substantial oil price increase could hit the U.S. economy, which has so far been robust enough to absorb an increase in the average price of U.S. imported crude oil from \$11 per barrel in early 1999 to \$26 in early 2000.

The Narrowing Safety Margin. World economic growth is driving up demand for oil. In the April 2000 Short-Term Energy Outlook, the U.S. Department of Energy (DOE) estimates that world demand for oil in the last quarter of 2000 will on average be 77.4 million barrels per day (mbd), 1.2 mbd higher than in the last quarter of 1999. Furthermore, the demand in the last quarter of 1999 was met by drawing down stockpiles by 2.4 mbd (companies incorrectly expected oil prices to fall, so they drew down their stockpiles as much as they could). Since stockpiles cannot be drawn down much further, oil production will have to rise sharply if the projected demand is to be met.

With demand up, stocks low, and prices high, it would seem that oil companies would react by increasing output. In fact, they have moved slowly for three reasons. First, the international oil companies (IOCs) have been preoccupied by the aftermath of the mergers that swept the industry last year; they have been too busy reorganizing to invest much. Second, the IOCs have been reluctant to invest because they expect prices to fall; Royal/Dutch Shell Chairman Mark Moody-Stuart says he will undertake projects only if they are profitable at \$14 a barrel (half the current price), and he is more comfortable with projects profitable at \$10 a barrel. Third, IOCs have suffered by comparison to the red-hot technology companies whose stocks rose so much in 1998-99. For example, rather than spend its money on searching for new oil, BP-Amoco has announced plans to repurchase ten percent of its stock at a cost of \$30 billion; Shell and Texaco are also rebuying stock. Due to the slow pace of investment, total non-OPEC production is forecast by DOE to be only 45.9 mbd on average in the last quarter of 2000, an increase of .8 mbd from the last quarter of 1999.

In short, while the medium-term outlook is for the IOCs to invest--providing ample oil at lower prices than at present--OPEC is temporarily back in the driver's seat. DOE estimates that the call on OPEC oil will average 31.3 mbd in the last quarter of 2000, up 2.6 mbd from the same time last year. Other estimates are for an even higher call on

OPEC oil, perhaps as much as 33 mbd, depending on how well the world economy does and whether oil stocks need to be rebuilt. OPEC can supply that amount of oil. But the question is whether it will. Until now, the problem facing OPEC was how to share the pain of holding oil off the market, which led OPEC to reach out to major non-OPEC exporters like Russia, Mexico, and Norway so they too would limit output. But the dynamics are changing. Before long, the world will need nearly all the capacity that OPEC has to offer. Including 3 mbd of a kind of oil called natural gas liquids which is outside of the OPEC quota system, OPEC members may be able to produce 33-35 mbd (more for short periods, less on a sustained basis). Since by late 2000, the world will need 31.3-33 mbd, there is not much of a safety margin.

Potential for Iraqi Mischief Making. As the world oil market tightens, the leverage of secondary producers increases. If the market becomes as tight as DOE forecasts, Iraq could pose a concern. Iraq is currently producing all-out at about 2.3 mbd; indeed, that level is so high that it is damaging Iraqi oil fields. Until now, Saddam Husayn's periodic threats to suspend oil exports in protest against the United Nations (UN) sanctions have rung hollow, because other producers had the spare capacity to replace Iraqi oil. Saudi Arabia alone could have filled the breach; the kingdom would almost certainly have been politically prepared to do.

But that safety margin is disappearing. If DOE is correct, Iraq's oil could be essential to maintaining balance in the market. If Iraq were to cease exporting oil in October 2000, oil prices could shoot up. That could feed inflation, deflate confidence of stock market investors, and encourage politicians at home and abroad to criticize U.S. policy toward Iraq.

Saddam may well be tempted to cause trouble in world oil markets. He would enjoy being able to portray himself as powerful enough to shake the world economy, and he might see this as his best opportunity to get rid of the UN sanctions that so irk him. Iraq has large stockpiles of humanitarian goods from the much-enlarged UN oil-for-food program that would be a cushion if oil income were cut off. Anyway, Saddam has never minded inflicting suffering on the Iraqi people. And there is precedent for Saddam causing trouble during U.S. presidential transitions: he started an air battle in January 1993, and he invaded the Kurdish area in September 1996.

Saudi Arabia's Key Role. While Iraq may be the main potential mischief maker, Saudi Arabia is the primary mover and shaker in the oil market. Saudi Arabia is the world's largest exporter and producer of oil; its output now is about 8.1 mbd, without natural gas liquids. The Saudi kingdom also has most of the world's spare production capacity; it could produce somewhere between 1.8 and 2.2 mbd more on a sustained basis (on a temporary surge output for a few weeks, it could instead produce 2.2 to 2.4 mbd more).

If a global oil shortage crisis does come about in the fall, and the Saudi government is unable to rectify the supply-demand equilibrium in the oil market due to production constraints, this will prove highly embarrassing for the kingdom's government-owned oil company, Saudi Aramco. After Crown Prince Abdallah's September 1998 invitation to U.S. companies to return to the kingdom, Saudi Aramco made clear that it wanted IOC involvement to be limited to areas like petrochemicals and refining ("downstream"), rather than to include oil production ("upstream") on the grounds that the kingdom has too much spare production capacity already. Under the chairmanship of Saudi oil minister Ali Al Naimi, Aramco has vigorously lobbied the crown prince, Defense Minister Prince Sultan, and Foreign Minister Prince Saud Al-Faisal (who is also the chairman of the Supreme Petroleum Council's Special Committee on Foreign Investments). Any shortage of capacity would vindicate the school of thought led by Deputy Oil Minister Prince Abdulaziz bin Salman that favored IOC's immediate participation in oil production.

For perspective, consider that during the last two weeks, chief executive officers of eleven IOCs (seven of them American) have been meeting in Jeddah with the Saudi foreign minister and the members of the ministerial committee that he chairs. The negotiations center on the planned investment of \$30 billion to \$40 billion in natural gas, petrochemicals, and combination electricity/desalination plants. Oil production has not been part of the

discussions. Were Saudi Arabia to decide it needed to increase output by 2 to 3 mbd over the next five years, the amount of investment needed could be an extra \$50 billion, including associated facilities.

Policy Implications. Both the United States and its Persian Gulf allies have reason to avoid an oil crisis, especially one engineered by Saddam Husayn. The U.S. government, the IOCs, and Saudi Arabia (the country most able to increase capacity quickly) should confer about what could be done to raise oil production capacity quickly. Furthermore, the U.S. government should consider how to make more active use of the Strategic Petroleum Reserve (SPR) in the event of a politically motivated supply shortfall. At present, there is so little consensus about when to use the SPR that any release becomes highly politicized. At the same time, Washington needs to ensure that rogues like Saddam know that if they try to provoke a world oil crisis, they will be worse off for having done so.

Patrick Clawson is director for research at The Washington Institute. Nawaf Obaid is the author of [The Oil Kingdom at 100: Petroleum Policymaking in Saudi Arabia \(templateC04.php?CID=32\)](#) (The Washington Institute, 2000).

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