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THE POLITICAL ECONOMY OF ENERGY: IRAN COMPLICATES THE SITUATION

Ever since the Arab oil embargo of 1973-74, which was accompanied by the massive oil price increases imposed by OPEC, the question of oil has been foremost in the minds of foreign policy makers, Middle East strategists, energy experts and concerned citizens. The issues tend to be rather complex and even obscure to the uninitiated. Moreover, the experts are often at odds with one another. Hence it is no wonder that a good deal of confusion and misunderstanding exists on this subject.

The energy problem is particularly perplexing for Israel and its supporters because of the commonly held view that the actions of the petroleum producers are related to the Arab-Israeli conflict. Thus many people have been led to believe that unless the conflict can be settled to the satisfaction of the Arabs the western world will suffer in terms of energy supplies, energy prices, or both. The implications for foreign policy are obvious. Nevertheless it can be shown that whatever energy crisis besets North America, Western Europe and Japan is largely independent of developments in the Arab-Israeli conflict. Were the conflict to be settled tomorrow the energy crisis would not be changed in any major way. Nevertheless, the existence of the energy crisis does give the Arabs a certain amount of leverage with respect to the conflict. The effectiveness of this leverage is largely a function of the willingness of Western governments to resist Arab pressure. Consequently a proper assessment of the oil situation is required in order to evaluate the credibility of foreign policy threats.

Recent developments in Iran make a current assessment of the problem essential. The reduction of Iran's oil exports to zero may well have a significant effect on the world oil picture. Moreover, the prospect that when Iran again exports oil Israel will be excluded poses some new problems. The Shah, whatever his shortcomings, had been willing to sell oil to Israel at the market price and in fact supplied approximately 70 per cent of Israel's petroleum needs. With that source cut off, Israel has had to develop new sources, any of which would require higher transit costs. Furthermore, the status of Eilat as Israel's port of entry for oil is now in doubt.

The International Oil Outlook

The conventional wisdom for the past few years is that the world was rapidly approaching a situation where oil might be in

shortage. In fact the crisis that made it possible for OPEC to raise prices so dramatically was brought on by the rapid rise of demand in Western countries, without a corresponding increase in supplies. Whereas the 1960's had been a period of excess supply with resultant low prices, the early 1970's were characterized by excess demand. The producers took advantage of that situation and the Yom Kippur War to squeeze the consumers successfully.

In the aftermath of the war and the embargo, analysts predicted that by the middle of the next decade the world might face an even more serious crisis of excess demand unless something were done to reduce general energy demand or to switch from oil to alternative fuels. However, subsequent developments have lessened the likelihood of a crisis during the 1980's and pushed the projected day of reckoning back to the 1990's.

The main factors that have changed the situation are the lower than anticipated growth in demand in western countries and the discovery of additional petroleum reserves in various places, especially in countries that are not members of OPEC. The increase in price combined with growing awareness of the need for energy conservation have caused energy analysts to revise their forecasts for demand downward by about 4 mbd for 1985 and 5 mbd for 1990.<sup>1</sup> Of course any forecast is subject to later revision, but this is certainly an encouraging development. Some experts have even lower estimates.<sup>2</sup> On the supply side, substantial upward revisions of Mexico's reserves, which may exceed 200 billion barrels, promise increased production from that source during the next decade, while gradual increases can also be expected from Alaska and the North Sea. In addition, the reserves of OPEC member Iraq have been revised upwards to about 100 billion barrels, thus enhancing the cartel's capacity and encouraging instability within that group. Finally, high prices can be expected to stimulate exploration in other parts of the world, a process that eventually is expected to bear fruit, especially in parts of the less developed world. As a result, the medium term petroleum outlook is not one to cause undue alarm.

Unfortunately political developments in Iran may have a considerable impact on that relatively optimistic picture in the short term. Prior to its political breakdown, Iran was producing some 6 mbd, which made it OPEC's second largest producer, behind only Saudi Arabia. Among other things, the Iran experience accentuates the uncertainties regarding oil. In particular it should serve as a warning to policy makers that even Saudi Arabia may be in jeopardy as a dependable source. Despite the evident importance to the developed world of steady supplies from producers, western governments have proved to be notably reluctant to take steps to ensure the protection of their vital interests. It remains to be seen whether the turnaround in Iran will cause any change in thinking by those responsible for the direction of government policy.

Moreover, Iran had been depicted as a pillar of stability in the Persian Gulf region, a bulwark against the encroachment of outside interests. Even though the Shah was in the vanguard of those OPEC members who tried to maximize the price of oil in order to finance his dreams of development and the establishment of Iran as a significant military power, his regime helped to deter untoward developments in Saudi Arabia, Kuwait or the Gulf emirates. The vacuum created by his ouster does not bode well for stability in the region. The allure of money and power may well prove to be irresistible for a variety of groups. Yet any further significant reductions in production due to political instability might not only reduce excess OPEC production capacity to zero; they could very well bring on real shortages until serious countermeasures might succeed. Consequently, instead of entering a period wherein the threat of an oil crisis would be minimal for an extended period, the world may now find itself on the threshold of a period of intense danger.

All of the foregoing tends to stress the importance of oil in the world energy situation. This is appropriate because, despite the great ballyhoo about alternative energy sources during the middle part of the decade, such sources are simply not likely to make a significant contribution during the period under consideration. Some progress is being made in terms of coal, natural gas, and nuclear energy, especially after the passage of the natural gas pricing bill in the United States toward the end of 1978. Such changes may have a marginal impact on the world energy situation during the next decade, but not enough to alter the fact that oil is central in world energy planning. Furthermore, more exotic energy sources, such as solar energy, still seem quite far from commercial realization. As a result the age of dependence on petroleum is not likely to end during the 1980's.

If dependence on oil will remain a characteristic of Western economies for the foreseeable future, does this mean that OPEC can continue to dictate the terms under which that oil will be consumed? Not necessarily. It all depends on the ability of the OPEC members to adjust their production to world demand. So long as OPEC has excess production capacity that must be shut in for extended periods, the potential exists for the attempt to pressure the less affluent producers, which are usually the more heavily populated OPEC members, to shave their prices and thus act counter to the interest of OPEC as a whole. Until now countries like Saudi Arabia have absorbed the necessary cuts, thereby enabling OPEC to keep the price high and even raise it somewhat, as was done at the end of 1978.

Prior to the upheavals in Iran, there was reasonable hope that pressures on the wealthy producers to cut production would press them to the point below which they would not want to go. There is some debate among petroleum economists as to the exact location of this point, but a reasonable estimate for Saudi Arabia

might be five to six million barrels per day. Below that level, even Saudi Arabia might become concerned about the loss of revenues, which are needed for various developmental and military purposes. Thus the higher OPEC's excess capacity, the greater the likelihood that some individual cartel members will take steps that would create competition and disunity within OPEC. In effect Iran now has absorbed voluntarily over half of OPEC's excess capacity by shutting down. This development substantially removes the pressure from the other Persian Gulf producers, notably Saudi Arabia and Kuwait, and enables them to increase production while taking advantage of higher prices. Unless Iran resumes production at levels approximating those in effect prior to the crisis, it is difficult to see how effective pressure of the type described could be applied against OPEC. Consequently the economic plans of Iran's new government are crucial. If Iran undertakes economic commitments that will require large amounts of revenue it will have to restore production levels in order to maintain the necessary cash flow. Unfortunately present indications are that this will not happen, at least not to a sufficient extent, partly because of the cancellation of military procurement contracts that reflect a revision of Iran's strategic role, and partly because the new regime, whoever may be in charge, will most surely adopt less ambitious development schemes than those of the Shah's government. As a result, an excellent opportunity for the oil consuming nations to undermine the power of OPEC may have been aborted.

It does not follow, however, that the consumers have to face shortages. So long as the producers agree to increase production, there should be ample supplies of oil, although temporary problems may occur during the process of readjusting schedules and supply sources. Nevertheless the Iran situation does put OPEC in a much stronger situation as the world enters the 1980's than otherwise would have been the case.

#### Effects on Israel

Despite evidence to the contrary, there are many who still believe that oil politics and the Arab-Israeli conflict are closely related. A succinct argument against that belief has been made by Singer,<sup>4</sup> who argues that economic realities necessarily limit Arab oil power. He attributes the main difficulties to lack of understanding, misconceptions, and even delusions on the part of the public and policy makers alike. Only as long as the West perceives that it can be threatened by the oil weapon will that weapon be useful.<sup>5</sup> The specific threat of another embargo is vastly overrated, although it continues to provoke the desired response in many quarters. The fact of the matter is that the accumulation of strategic oil stockpiles, such as the one in the United States, gives consumers greater flexibility in coping with short range shortages that an embargo would bring. On the other hand, stockpiles do not eliminate the need for an eventual disposition of the embargo problem, should one occur. Secondly, if it can be assumed

that many OPEC countries will continue to sell to the embargoed nations and that these producers will generally need cash much more than the embargoers will, there will be incentives for the non-participants in the embargo to increase their liftings in order to take advantage of the situation. Thirdly, if the embargo is aimed only at selected countries, it is possible to supply the affected consumers by transshipments from countries not subject to the embargo. Of course an attempt could be made to embargo the entire world, but this would be difficult to apply, would probably result in little more than a price rise, would put severe economic pressure on some of the participants in the embargo, and might provoke retaliation from consuming nations. Fourthly, the general need for cash flow by OPEC members because of their newly developed needs for consumption generally inhibits inclinations toward an embargo. A final consideration, which enhances the success of an embargo, is the likelihood that Iran, under its Islamic regime, would now participate. Although this factor does complicate matters from the consumers' perspective, it does not render the situation impossible.

It should be evident that it is in Israel's interest that people be sensitized to the realities, rather than the myths, of the international oil situation. As long as people believe that Arab success against Israel is a precondition for relaxation of oil-induced tension, an unnecessary source of pressure against Israel will enter into the process of resolving the Arab-Israeli conflict. At the same time Israel is faced with the real problem of finding energy suppliers to replace Iran. In principle this should not be too difficult because of the increased availability of oil in non-Arab areas, especially Mexico, Alaska, and the North Sea. Unfortunately transit costs will be higher than those from Iran, but Israel will not be alone in paying high transit costs, even though there is a certain irony in having to do so while located so close to the major oil deposits.

#### Policy Implications

From the perspective of the consumers the continuation of OPEC's stranglehold on world oil prices is not desirable, even if it might not be disastrous. Therefore it is necessary to pursue policies that will undermine OPEC's position and eventually decrease the power of the cartel. It is evident by now that the consuming countries are so reluctant to initiate direct actions to confront OPEC and break the cartel that speculation along such lines is not very productive. Therefore the general approach that is most feasible is one that utilizes economic considerations. In that light every effort should be made to get Iran back into production, so as to restore a situation where OPEC as a whole would be under pressure to restrain production. At present it is difficult to assess this possibility. In addition all countries, especially the United States, should make serious efforts to reduce consumption of energy in ways that do not have deleterious economic

effects. Conservation and increased efficiency are the obvious approaches. Also the U.S. will have to face the reality of high world oil prices on the domestic scene. At the same time the U.S. government is in a position to act as a consumer counterbalance to the cartel in setting the price for oil. Finally the United States can pursue the development of alternative energy sources with greater vigor than heretofore. The major possibilities continue to be coal and nuclear energy for the foreseeable future.

Energy has come to be a major area of policy interest in most countries since the massive price increases of 1973-74. For too long the consuming countries have accepted the terms imposed by OPEC without much resistance. Attitudes of helplessness have affected postures with regard to the Arab-Israeli conflict. However, the picture is not necessarily bleak and there are steps to be taken that will restore greater balance to the situation. Hopefully a more rational assessment will lead to positive results.

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#### Footnotes

1. Merrill Sheils et al, "And the Glut Goes On," Newsweek (June 5, 1978), pp. 77-78.
2. See for example Arnold Safer, "International Oil Revisited: Could the Experts Be Wrong?", The Economic View from One Wall Street (December 1977), p. 2.
3. "If OPEC Were to Break Apart," Petroeconomic File, No. 18 (July 1978), p. 1.
4. S. Fred Singer, "Unjustified Fears," The Jerusalem Post (July 7, 1978).
5. A fuller discussion of the potential political use of an embargo may be found in "The Blunted Oil Weapon," Petroeconomic File, No. 16 (May 1978), pp. 2-5.
6. M.A. Adelman has long recommended a sealed bidding technique for that purpose. See also Arnold Safer, "Oil Policy: Summary Views," December 1, 1978.
7. Specific suggestions along these lines have been advanced by Elihu Bergman, "An Energy Action Agenda for 1979," remarks at a meeting of Americans for Energy Independence, November 29, 1978.