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## THE POLITICAL, ECONOMIC, SOCIAL, CULTURAL, AND RELIGIOUS TRENDS IN THE MIDDLE EAST AND THE GULF AND THEIR IMPACT ON THE ENERGY SUPPLY, SECURITY, AND PRICING

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 ease 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 of 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 reigns 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. Internecine 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 Shi'ite 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 movements 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 current generation to the next as the century turns. U.S. policy toward the Mideast Gulf is being driven today primarily by military concerns. But while Gulf security 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 importing countries benefit when global oil production flows from as diverse a base as possible. Such diversity reduces reliance on any one particular country or geographic 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 monopoly 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 relations.

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 importing countries because they must export a larger share of overall economic output in order to pay for the increased cost of oil imports. Oil price gains also potentially increase incomes of countries that would use the wealth to facilitate hostile military or terrorist activities. 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 market shock may be great, for a number of reasons, the effect of such a crisis on real output in the industrialized 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 discovered 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 limitations 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

\*US. 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 containment” 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 possibility 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 bypassing 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 political implications of a spur connecting Kuwait to the formerly Iraqi line would have to be examined carefully. The use of Drag Reduction Agents to be stored in Saudi Arabia could accomplish similar enhancement of throughput capacity of existing pipelines that bypass Hormuz.

\*The US. should support the governments of the Middle East region in promoting political reform, 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 movements.

\*The US. should intensify its central role in advancing the Arab-Israeli peace process. Resolution of that conflict will help diffuse anti-Western sentiment 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 increase 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 strategic 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 a dialogue with China on matters of energy cooperation, 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 benefit, 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 identify 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 in 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 improve in accuracy as the open process allowed for improvements and refinement in data.

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