

What is the threat of a Mideast war to the status of world oil supply?

by William Engdahl

With the political climate heating up in the Middle East in recent weeks, it is useful to make a brief review of world physical supply and production of crude oil.

As of best estimates from July 1, the forward stocks of crude on land for the members of the Organization for Economic Cooperation and Development (OECD) were more than ample. According to the latest official International Energy Agency (IEA) estimates, countries of the OECD (which excludes Eastern Europe, China and most of the developing sector) held an impressive 99 days of forward stocks. The only time stocks were higher in the past decade was in 1981-82, amid the world oil "glut" and global economic recession which followed the usurious U.S. interest rates of 1979-81. The highest stocks recorded in the 15-year history of the IEA, were in 1981, with 106 days consumption. By comparison, during the Iranian "oil shock" of 1978-79, stocks were only 79 days.

Notably, Japan, one of the strongest importers of OPEC crude, whose industrial economy is totally dependent on imported oil, has by far the largest forward stock reserve of any OECD economy except West Germany, some 132 days as of April, the latest data available. Western Europe also holds significant reserves. West Germany holds 135 days; Western Europe as a whole has an average of 98 days' supply. When expressed in terms of total IEA member-country net imports, total OECD reserve stocks as of July were more than five months' import cover, or 151 days.

A look at the production picture

Much has been said of late about prospects that oil prices may begin to rise to levels of \$30-35 per barrel. The standard argument, used by oil analysts such as the "bullish" Mehdi Varsi of London merchant bank Kleinwort Benson, is that North American and Soviet crude output has already begun what will accelerate as a downward course; combined with expanding world demand, this will create supply shortfalls and force prices higher. Varsi predicted in March that demand would push the world price to \$25 by 1992, and upwards thereafter into the \$30 range.

Since that time, world oil prices have steadily dropped. According to the latest reports from the Middle East, while

Dubai crude is trading in the range of \$13.30 on the spot markets, other Gulf crudes are going for as low as \$12 or even \$11 a barrel. This is uncomfortably close to the lows of 1986. Prospects are equally grim for a resolution of Organization of Petroleum Exporting Countries' massive quota-cheating at the July 25 Geneva OPEC meeting.

The production situations in the United States and the Soviet Union have both drawn attention as a potential source of future supply tightness. U.S. domestic production has dropped from 10 million barrels per day (mbd) in 1987 to 8.6 mbd this June, a fall of 1.4 million bpd, or 14%. The United States now imports approximately 50% of its daily consumption, which came to 8 mbd in 1989, and has been steadily rising as domestic output has declined.

The Soviet Union, plagued by growing problems of obsolete equipment, low morale, and reservoir depletion, has seen production fall from what British Petroleum estimates to have been its peak of 12.8 million barrels a day in 1987, when they were desperate to increase cash flow after the oil price collapsed in 1986. By 1989, Soviet output had fallen to an estimated 12.5 mbd according to British Petroleum, and Western analysts expect this could drop below 12 million this year.

The impact of this Soviet production shortfall will be little felt in OECD markets, however, as domestic economic difficulties hit Soviet internal demand, and OPEC supplies remain abundant. But a dramatic wave of internal labor unrest could cause a significant deterioration in production, and could alter the picture, although this unrest in both the oil and gas regions, according to informed Western petroleum industry observers recently in the U.S.S.R., is not yet evident. Total U.S.S.R. exports of crude in 1989 to Comecon states and OECD totaled 3.5 mbd. If we add together the U.S. and Soviet declines—the world's two largest producing nations since 1987—the shortfall is a bit over 2 million barrels per day as of this past January.

OPEC increases its output

This combined shortfall has been more than made up for by OPEC increases. During the same two-year period, output from OAPEC—the Organization of Arab Petroleum-Export-

ing Countries—has increased by 3.5 million barrels a day to 16.6 million last year, the highest since 1980. And OPEC as a whole, which adds in such countries as Nigeria, Indonesia, and Venezuela, presently is pumping an estimated 80% of its present capacity. Most of the remaining 20% is in the hands of Saudi Arabia.

According to informed accounts, present OPEC production is still well over 23 million barrels in the face of an estimated 22 million bpd demand, drawing prices steadily lower since the spring. As a result of the surplus of world supply, North Sea Brent crude prices have plummeted from \$22 a barrel in January to slightly more than \$15 per barrel today.

Kuwait and the United Arab Emirates have led the push to flood world markets with excess crude. Iran and Iraq are pumping at peak capacity and badly need large investment in infrastructure in order to expand. The economic impact of the OPEC overproduction thus hits Iraq and Iran severely, which have no margin to pump more in order to increase their cash flow. Some say this is the intent of the overproduction.

Supply disruption scenarios

With such an apparently abundant supply and high output of crude on world markets, what, then, would be the hypothetical impact of a new military outbreak in the Middle East, perhaps between Iraq and Israel initially?

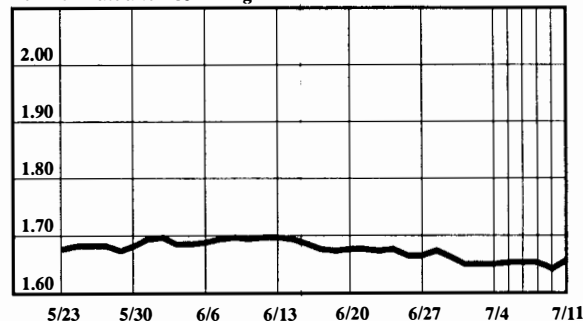
Experts estimate that a first strike by Israel would perforce include knocking out Iraq's main export capability, its 1.5 million bpd capacity pipeline, which runs through Turkey to the Mediterranean. If this were hit, for example, in September when normal maintenance in Alaska and the North Sea brings on tight supply anyway, the loss of Iraq's 1.5 million barrels per day could push prices up by \$3-5 per barrel. But this would have nothing to do with medium-term security of crude supply to world OECD nations. It would be a short-term dislocation. How long a dislocation would last, by all informed estimates, would be a function of how widely the Middle East hostilities expand.

But the real issue is: To what extent could Western Europe and the Pacific growth economies of Asia, centered around Japan, withstand the shock? "This time, unlike during the shocks of the 1970s," notes senior City of London economist Stephen Lewis, "Western Europe and Japan would be far better prepared to absorb the shock. We could expect more direct bilateral moves on the part of European or Japanese governments to establish direct bilateral ties with OPEC producers, not mediating this time through Washington." Indeed, in recent months, with growing worries about the security of their future oil supply, Japan has taken unusual steps to strengthen its ties with OPEC, including an extraordinary invitation last February for Saudi Petroleum Minister Nazer to come to Tokyo to discuss future bilateral trade and petrochemical investment in Japan.

Currency Rates

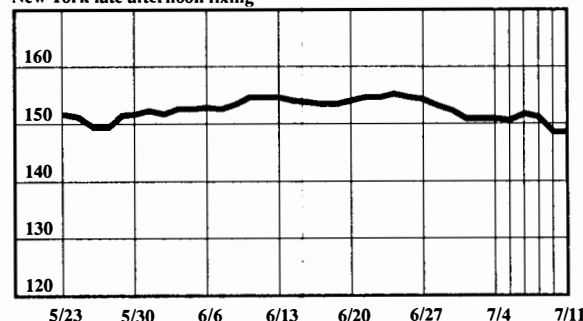
The dollar in deutschemarks

New York late afternoon fixing



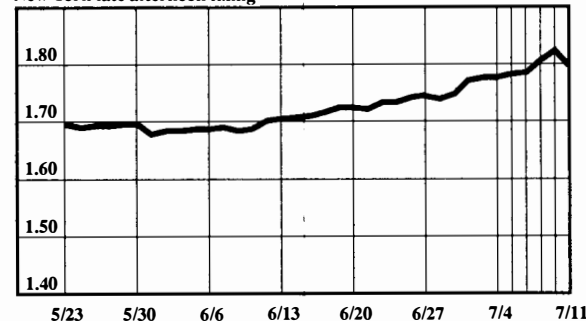
The dollar in yen

New York late afternoon fixing



The British pound in dollars

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The dollar in Swiss francs

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