



For nearly three decades, oil prices have been controlled primarily by the oil cartel – OPEC, through the control it has on majority of oil producing countries. That may no longer be the case if America succeeds in its objective of having a major say in Iraq's affairs. Iraq's oil industry is capable of far higher production and could break the Saudi hold on OPEC. A fresh price war among producers is not ruled out because OPEC might be forced to change its policy of defending prices and its market share.

OIL

Prognosis of Post-war Era

After Saudi Arabia in the Middle East, Iraq possesses the world's second-largest oil reserves, estimated at 112.5 billion barrels, or 11% of the world's total—more than five times the size of US reserves. However, despite sitting pretty on such huge reserves, the beleaguered country currently supplies only 3% of the world's oil. The country has massive untapped reserves; about 90% remains unexplored. Oil production costs are among the lowest in the world, making it an extraordinarily profitable source. It also controls nearly 3.1 trillion cubic meters of natural gas to rank among the top 10 gas powers, but most of this wealth has remained untapped. It is not a surprise that there is not an oil company in the world that doesn't eye Iraq. More than a decade of UN sanctions have taken their toll on Iraq's oil reservoirs.

Under the sanctions, Iraq was not assigned OPEC (Organization for Petroleum Exporting Countries) quota and the oil-for-food program regulated its exports. Under this scheme, Iraq was allowed to sell up to 2 million barrels per day, provided the revenues were used for humanitarian assistance to the Iraqi people and the repayment of Iraq's war debts to Kuwait.

In the last 20 years, Iraq was unable to expand its exploration program because of the 1980-88 Iran-Iraq war followed by UN sanctions, in place since 1990. Despite UN's additional funds for oil spare parts, Iraq does not have modern recovery techniques that would allow it to raise production without damaging its reservoirs.

On the other hand, the oil industry by an extension—the American industry; surprisingly out of the five companies that dominate the world oil market, four are based in the US and Britain. Exxon-Mobil, Royal Dutch-Shell, British Petroleum, Chevron-Texaco and the fifth, TotalFinaElf, a French-Italian company.

The US outpaces any country in consumption and imports over half of what it consumes, its market makes up a quarter of the world's demand for oil. With just 3% of the world's population, it consumes more than 25% of crude oil; about 20 million barrels a day, up from 15 million two decades ago, roughly equal to its share of the global economy. The US economy runs on oil and in fact no other commodity exerts as much leverage over its financial health.

Going by these facts, it shows the crucial role played by oil prices in the US economy. If oil prices touch \$40 a barrel and stay there for a couple of months, the US economy will be back to recession. Economists calculate that every \$10-a-barrel oil price increase that sticks for a year reduces economic growth by 0.5%. There is the impact of oil prices outside the US. Countries such as Japan, Germany and France import all of their oil, so they are highly vulnerable to price increases.

However, the International Monetary Fund estimates that a \$10 a barrel rise in the price of oil sustained over a year—roughly what happened last year—reduces global GDP by 0.6%. The impact varies from 0.8% of GDP in the US, the euro area and the developing countries of Asia—more in major importers like Korea, India and Thailand.

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Politics behind oil

For nearly half a century, the US has been steadily increasing investments in the Gulf region. The investments have included direct and indirect forms of intervention, massive arms transfers to allies and the acquisition of military bases. In the wake of Iraq's invasion of Kuwait, Iraqi and Kuwait oil supplies were lost and oil prices spiked. Saudi Arabia pleased world oil markets by stepping up its production close to 60% in 1989-91. Following the Gulf war in 1991, the US supplied Saudi Arabia and allied Gulf States with massive amount of highly sophisticated armaments.

Though reasons behind America's present war against Iraq, as the economic superpower articulates, are eliminating Iraqi weapons of mass destruction, the continuation of the war on terror, and the promotion of democracy in the region. Critics of war suggest, as they have always said, that the primary objective of the US was not the removal of Saddam or his alleged weapons of mass destruction, but Iraq's primary economic asset: Crude oil reserves.

Indeed, the US relies on the imports to meet almost 60% of its oil needs, a figure that is expected to go up in the next few years, and Iraq's figure being second only to Saudi Arabia in untapped oil reserves, it is tempting to dismiss the war as a war for oil.

They further add that the real reason is an oil currency war, to prevent further OPEC momentum towards the euro as an oil transaction currency standard. To regain control over the Iraq oil market, which the US and Britain lost when the Iraqi Government



The effects of regime change on world oil markets will depend very heavily on whether Iraq remains in OPEC.

Justin Wolfers and Eric Zitzewitz

*Assistant Professors of Economics
Stanford Business School
US*

nationalized its oil industry in 1972, is the key to maintain their dominance over this critical economic resource. Thus, the US is seeking to promote alternatives to Saudi Arabia and thus gain over OPEC price setting mechanism. However, Glen Burns, Editor, *INS News*, Sydney, contradicts this view. He says, "the US oil industry will find it difficult to reduce the dominant position that Saudi Arabia holds in the foreseeable future. They have the bulk of the world's reserves and after the war, even if the United States gains additional oil reserves, it appears it won't be enough to challenge Saudi Arabia."

Whatever the reasons behind the war, Yale University's Prof. William Nordhaus factors in the impact on oil and the world economy to reach a high-end estimate of \$1.92 tn. He further adds, followed by the quick victory in Iraq, the stability in the region could lead to increases in oil production capacity in Iraq, Iran and other countries will put downward pressure on oil prices.

An El Dorado for the US?

Once UN economic sanctions on Iraq are lifted, the question which

would emerge is, who will control Iraq's vast oil reserves? In a post-war Iraq if a pro-US government takes over the reins of the country, whose chances are strong, it could be a bonanza for US oil companies. Iraq's vast oil reserves remain a powerful prize for oil companies. However, development of those Iraq reserves will not be a small project. After years of havoc, Iraq's oil infrastructure will require tremendous hard work and billions of dollars in investment. The oil industry is in terrible shape, the pipelines are leaking lakes of oil, refineries are dumping toxic waste, in short, it is a broken down industry.

Oil production, currently 2 million barrels a day, even in the best-case scenario, this cannot reach more than 2.5 million barrels a day by 2005. Current Iraqi production capacity is not an immediate threat. It will be years before they can pump significant amounts of oil. However, Dr. L Y Yueh, Economics Department, London School of Economics opines that the operations of the Kirkuk oil fields are expected to revive within weeks and can produce 9 million barrels per day—nearly half of Iraq's pre-war production levels.

Oil experts say, in the long-term the country has great-untapped oil reserves and its output could eventually reach 6 million barrels a day. The American Academy of Arts and Sciences estimates that over 10 years, war and the reconstruction of Iraq could cost as much as \$2 tn—almost the equivalent of the entire annual federal budget.

The US oil companies have been stuck on the sidelines because of Iraq's oil rush. Even if Iraq wanted to engage US oil companies in the rebuilding of

Iraq's oil infrastructure, UN sanctions as well as US laws have barred US oil companies from dealing with Baghdad. According to a report by the Council on Foreign Relations (CFR) and the James Baker Institute of Rice University, Iraq's oil is not the prize it seems from afar.

In short, the Iraq war would further disrupt Iraq production, resulting greater power for OPEC. Another report from Center for Strategic and International Studies (CSIS) observes that, after a regime change, there would be many competing claims for money that would slow investment in oil, buying food, financing reconstruction, and keeping the pace. Iraq also has debts of over \$100 bn. Some oil experts say it is unlikely that US companies will be left empty-handed, going by US oil industry's unusually strong ties with the White House.

Critics say the oil companies are driving Bush's war. The *Wall Street Journal* reported on January 16, this year, that officials from the White House, State Department and Department of Defense have been meeting informally with executives from Halliburton, Slumberger, Exxon-Mobil, ChevronTexaco and ConocoPhillips to plan the post-war oil bonanza.

However, a lot depends on just what kind of government will be in power when UN sanctions are lifted and also largely on the extent to which post-war Iraq respects the pre-war exploration contracts; most of which are with European rather than US oil companies.

Prof. Stephen G Cecchetti, Department of Economics, The Ohio State University, US, says, "If Iraqi oil resources are to be used to benefit the Iraqi people, as the Bush administration says they

US oil companies will not gain any particular benefit. Should prices rise, then all oil companies' benefit, and the US companies will be no exception

I expect in the coming years oil price will stay relatively stable in the lower end of the OPEC price-band (\$22-28 per barrel) as it has been shown that the actions in this war have no real impact on the supply-side.

Alexander Wostmann

Director, Content

Alexander's Gas & Oil Connections
Germany

should be, the outcome for American oil companies will be neutral. My hope is that the organization of production and ownership will mirror that of the state-owned, but privately run, Mexican oil company Pemex. If, as I believe, oil prices remain in the \$20 to \$25 range for the next few years, American oil companies will not gain any particular benefit. Should prices rise, then all oil companies will benefit, and US companies will be no exception. But we can all hope that this does not happen, as it would have dire consequences for everyone else."

However, any production decisions of Iraqi oil are still under the jurisdiction of the UN Security Council, based on the sanctions against the Saddam regime, which the US so forcefully brokered over the years. Ironically, these same sanctions must now be lifted and their removal is subject to the votes and vetos of countries such as France, Russia and China, which not only opposed the war but also have very large interests of their own in the Iraqi petroleum industry, already in place.

OPEC – Fading power?

With the end of the Saddam regime, US has achieved its twin goals: Removing Saddam from power and reducing oil cartel power in manipulation of prices, engineering embargoes and otherwise harmed consumers. A revitalized Iraqi oil industry will pose new problems for the mighty OPEC, whose 10 members curved up Iraq's production quotas when UN sanction took hold. OPEC's manipulation once held the world to ransom, prompting the 1973 oil shock, which sent the world economy into turmoil. Now the trend has changed, the future direction of oil prices lies out of its hands. The cartel's leaders have been openly telling the world that their days of power are numbered.

During 1970s, OPEC controlled half the world's oil market, this may have been even true years ago, but OPEC's share has been in steady decline. The cartel is on the verge of losing its ability to set world prices, a power known in economics as price leadership. If that market share drops below 30%, OPEC's dominance could officially become a mere relic of history.

By some estimates, a rebuilt Iraqi oil industry can produce as

much as 6 million barrels a day, second only to Saudi Arabia as top OPEC producer, would be devastating for the Saudi-controlled oil cartel. A fresh war among producers is not ruled out because of the fact that OPEC might be forced to change its policy of defending prices in order to defend its market share.

Analysts say as Iraqi production rises, oil prices are likely to fall unless OPEC cuts back elsewhere. The Iraqi people would be better-off from higher revenues and people around the world would benefit from a significant drop in oil prices. But it is not clear how closely Iraq will cooperate with OPEC once sanctions are lifted. Justin Wolfers and Eric Zitzewitz, Assistant Professors of Economics, Stanford Business School, US, observe, "The effects of regime change on world oil markets will depend very heavily on whether Iraq remains in OPEC. Of course, if Iraq remains in OPEC, then this will suggest a return to something closer to 'business as usual' in the long-run, although Iraq may ultimately negotiate a somewhat larger quota. Even if Iraq does leave OPEC, there is a chance that increasing Iraq supply would still be somewhat offset by lower OPEC production." But in the short run, very little oil will come from Iraq without significant investment.

Stability of the oil market will continue to depend on the ability of OPEC to control production—the end to political strife in Venezuela, and the stability of the Persian Gulf region.

However, Glen Burns says that Iraq will be in the same position as Saudi Arabia, it will want to keep the oil prices higher, to protect its long-term future. OPEC will continue to play a part; and that Iraq can join OPEC. The outcome of a post-Saddam regime, if it happens, is unclear. If Iraq doesn't join OPEC, outstanding oil

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As for the notion that once the war is over, prices will fall, this can happen if speculators keep increasing their very high short positions on the crude contract.



Matthew R Simmons

Chief Executive Officer
Simmons & Company International
(Investment Bankers to the
Energy Industry)

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contracts are likely to be honored and any new capacity won't reach the market for many months, after the war to allow time to rebuild Iraq's oil capacity.

Oil prices: Post-war scenario

As pre-war surge ended, the oil prices plunged currently to four-month lows or less than \$25 a barrel after almost reaching \$38 a barrel in the trading week of February 24-28, 2003. Unlike in the past, the war on Iraq has had far less impact on oil prices; timing and the fact is that Saddam has not managed to wreak havoc in the oilfields as he did in 1991.

As the war ends like a cakewalk, once the Iraqi oil starts flowing into the world markets, nudging prices will be back to low double-digit level. Justin Wolfers and Eric Zitzewitz predict that "oil prices are almost certainly going to fall back to pre-war levels, once it becomes clear that not only the military, but also political disruption dissipates." They further add, "Our calculation is that oil prices are probably about \$11 per barrel above levels they would otherwise

Estimated Impact of Oil Price
Increase of \$10 a Barrel

	Real GDP change
World	-0.6
Industrial Economies	-0.6
US	-0.8
Euro Area	-0.8
Japan	-0.4
Others	-0.2
Developing Countries	-0.4
Latin America	-0.2
Asia	-0.8
Europe and Africa	+0.2

Source: www.globaldimensions.com

be at, with the delicate situation in Venezuela is also a factor. Moreover, our guess is that this process of re-equilibration will be relatively quick, with the war premium disappearing within about a year of the end of hostilities."

If one goes back to history, oil prices soared when Iraq seized Kuwait's oil fields in August 1990. The benchmark US crude oil rose from just over \$21 a barrel in August to more than \$40 in October, as the administration began preparations to retake Kuwait. But from that peak, oil prices began falling, and the launch of the allied offensive in February 1991 cut \$10 a barrel off the US crude prices. By the end of that month, oil prices were below \$20 again.

It is true that oil prices plunged quickly after the Gulf war. World oil markets and the supply equation are very different today; oil experts say that in this crisis, President Bush faces challenges in global energy markets that his father did not. In the earlier Gulf crisis, gasoline prices did not increase as much as crude oil prices because gasoline inventories were adequate.

This time, however, consumers are not as fortunate. Gasoline prices have closely tracked the climb in costs of crude oil from which the gasoline is made. The average pump price of \$1.71 per gallon on March 10, 2003 was the highest ever for this time of year, 49 cents above the level of a year ago, says the Energy Information Administration, US.

However, Justin Wolfers and Eric Zitzewitz opine that "there will be a dramatic price collapse—but initially only to pre-war levels. And whether a long slow decline drawn out over a year or so is dramatic, or orderly, is of course a

question of personal taste. In the much longer run there is still some discussion about whether this war will increase Iraq's supply enough to have an impact on world prices. Our assessment is that there will be some impact, but that it will be relatively small, and the long-run (10-year) effect may be to reduce oil prices a further \$1-2 per barrel, which strikes us as small." The longer-term view is that oil companies have little to worry about; demand is steadily increasing, while supply is constant, meaning that the prices will rise. Any sudden changes in oil supplies if they happen will be short-term and appears unlikely. Nevertheless, Stephen predicts that oil prices are likely to fall back to somewhere between \$20 and \$25 a barrel from the current level of \$28.

They further add, there is no flood of Iraqi oil and there is likely to be none for the coming years. The price is under pressure because everyone has been hoarding oil over the last months and as the war seems to be almost over without too great an impact, there is just an enormous amount of oil in storage, floating or fixed.

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The oil economics

High oil and gasoline prices are of great concern to world economy. Since they weaken consumers' ability to spend on other things and raise costs for businesses. All the big oil spikes in the past 25 years or so have resulted in recessions, and some economists have worried that the recent spike could result in another one.

The recent drop in prices, then, should be something of a relief. But the spike already may have contributed to a dramatic slowdown in growth earlier this year, helping to drive consumer

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There is unlikely to be an oil price shock

at this time. Oil prices are not rising but falling, further reducing the scenario of a supply shock.



Dr. L Y Yueh

*Economics Department
London School of Economics*

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confidence to lows not seen in about a decade. High prices will continue to depress the world economy, and is severe enough to place the economy in recession, until the economy is able to react to this reality. Stephen echoes similar views, "If oil prices were to double or triple, the problems would be severe. While oil is less important today than it was 30 years ago, a significant increase in energy prices does have an immediate and large impact on the world economy. The weak growth would turn into an almost immediate recession."

History tells that sustained oil-price rises have a big negative impact on economic growth; similar effects were seen after the next big price hike in 1978-79. The continuation of oil prices in 1990s affected to end the long boom which, in the US and parts of Europe and Asia, turned into recession. Since then recovery has been so tentative. This explains why the recent surge in prices has alarmed the world economy. Economists opine that the overall impact on world demand depends on whether oil exporters save their windfall or spend it on imports from oil-consuming countries.

However, on the other side, drop in oil price could also have a domino effect on other sectors of the oil economies, leading to economic slowdown and a growing unemployment problem.

Relative to the major recession-causing oil price hikes in the 1970s, this one is likely to be both smaller in absolute magnitude, but more important and far less persistent. As such, it is unlikely to cause the same sort of economic dislocation that past oil price shocks have caused.

Justin Wolfers and Eric Zitzewitz opine, "we still see first-order macroeconomic impacts flowing from this war—we just aren't sure that oil prices will be the mediating mechanism. Our best estimate is that the stock market has priced in a 15% penalty due to the war (now perhaps closer to 10%). This strips away about \$1 tn from US stock market wealth, and similar effects are seen in other major economies around the world. While oil and gold stocks have done well, this is more than offset by large declines in consumer discretionary spending, and IT, not to mention more generalized losses. These losses are likely to have immediate impacts through consumption and investment on the future course of GDP."

They further add, "Our guess is that this reflects a combination of direct economic effects (consumer sentiment etc.), and political economy effects. The war may have substantially compromised the ability of Bush administration to work effectively in international foray, including not only the UN, but also the WTO, or even in simply bilateral contexts."

On the US front, in the post-war regime, the importance of

reconstruction of Iraq should be noted, of which the situation of its oil industry is a major part but only one part. A plan for reconstruction offers both opportunities and challenges familiar to those who have worked in transition economies, especially to those who have worked on issues of international law.

Beyond this, the key challenges are the damage done to international institutions and relations with its Western allies while at the same time tamping down the fierce anti-Americanism that has sprung up around the globe. Succeeding at those tasks would go a long way toward lessening tensions in the Middle East and elsewhere around the globe and muting criticism of the US for the unilateral approach it took to the war. But failure to do so would likely increase global tensions and further fuel anti-Americanism—an outcome that poses huge risks for business.

Outlook

In the post-Iraq war regime, the global oil industry is on the verge of a major structural change in the way the price of oil is determined. In the coming months, only two producers will set the world price of oil—Saudi Arabia and Iraq. This shift in pricing power will occur because non-OPEC production is projected

to be flat or down in the years ahead, while Saudi Arabia and Iraq will be the only producers that have the resource base to permit an economic expansion of productive capacity. For 30 years now, the price of oil has been controlled primarily by Saudi Arabia.

OPEC members are required to produce only an agreed quota of oil to keep the price high enough to make a good profit but not high

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The Top Ten Oil Economies

	Reserves (billion barrels)	Production (million barrels per day)
Saudi Arabia	261.8	8.8
Iraq	112.5	2.4
UAE	97.8	2.4
Kuwait	96.5	2.1
Iran	89.7	3.7
Venezuela	77.7	3.4
Russia	48.6	7.1
US	30.4	7.7
Libya	29.5	1.4
Mexico	26.9	3.6

Source: BP Statistical Review of World Energy

enough to force the West to seek other suppliers.

However, Iraq's oil industry is capable of far higher production and could break the Saudi hold on OPEC. If Iraq were under western occupation, this could allow the big consuming countries like the US, Japan and Western Europe—to call the shots. Furthermore, there are powerful interests both within the US and outside who don't want to see oil prices collapse.

American oil giants are exploring new fields in remote regions of Alaska, Colombia and Central and South-East Asia that will only be profitable to exploit at prices above about \$22 per barrel. Then there is Russia, a non-OPEC oil power in its own right. The Soviet oil industry collapsed just before the USSR did, but Russia's is now back and already sparring with the Saudis because they have no use for OPEC quotas. So the oil is an issue—in a complex, long-term and very real way. If any one denies this, it is to deny the reality. ◻

N Janardhan Rao

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