Global Oil and the World Economy

LESS TO WORRY ABOUT THAN MEETS THE EYE

BY STEVE A. YETIV

Picture a staggering spike in oil prices, long lines at gas stations, and global economic malaise. Is this what’s in store for the future?

Avoiding serious disruptions in oil supplies and oil price spikes has been vital to human welfare since the oil era began in earnest after World War I. Indeed, there has been no dearth of imagined, anticipated, potential, and real threats to and concerns about oil stability. Intelligent analysts have argued periodically that the Saudi regime could fall, to the detriment of the global economy. Other thinkers have pointed to such things as weapons of mass destruction wielded by autocrats, transnational terrorism against U.S. and foreign oil production facilities, the Palestinian-Israeli conflict as a trigger for a broader Middle East war or for the use of the Arab oil weapon, or OPEC (Organization of Petroleum Exporting Countries) opportunism in oil pricing. Of course, fears have now arisen that a U.S.-led war with Iraq will destabilize the Middle East and spike oil prices more than temporarily.

But how valid are these fears about oil stability? Not nearly as valid as most people think, if my book project on the subject is on target.
The Long View

Naturally, we should take some of these threats seriously as we head into the 21st century. But the real story of global oil is about longer-term developments that have changed the Middle East, world politics, and the behavior of OPEC and global oil markets in combined ways that have not been well understood or appreciated. I argue that these developments have made it easier to avoid and to contain serious disruptions in oil supply and serious oil price spikes. While some of these developments are technical, let’s take a look at four that are more straightforward.

Cushions Against Oil Crises

The global economy has increasingly been able to count on sources of oil in the event of political or security shocks. Since the mid-to-late-1970s, the world economy has increasingly been able to rely on two related oil norms: Saudi Arabia would oppose serious cuts in oil production pushed by other OPEC members, unless warranted by seriously depressed oil prices, and would put more oil on the market if oil was cut off from other suppliers. In fact, the Saudis did so when Iraq invaded Kuwait in 1990 and when Baghdad, in what it portrayed as sympathy with the Palestinians, shut off its oil spigot in April 2002 for one month. Riyadh has promised to do the same in the next Gulf War.

Moreover, while Gulf oil is crucial to meeting future global oil demand, the rise of non-OPEC oil producers over the past two decades has allowed for increased and diversified sources of oil. Take Russia. For the first time ever, after starting to ramp up for such production in the mid-1990s, it put nearly as much oil on global markets in February 2002 as did Saudi Arabia.

The end of the Cold War and September 11 also caused a tectonic shift in U.S.-Russian cooperation. Moscow has become increasingly eager to offer Russia as a supplier of oil to the United States and beyond, especially if supplies from the Middle East are interrupted. In an unprecedented move, U.S. and Russian oil companies have been cooperating seriously in the oil sector, including how to use U.S. high technology to produce and deliver Russian oil at cheaper costs. During the Cold War, Soviet energy was sold mainly to the Soviet bloc. But, partly with American help, Russia has been building significant pipeline capacity which, I believe, will be able to export over 40 percent greater Russian energy to the world by 2007. That is an important shift for global markets.

Furthermore, the strategic oil reserves of industrialized states have also increased meaningfully from 1975 to 2002, though they have fallen from their 1986 peak. They represent a structural change in global oil markets and a cushion against an oil crisis. Indeed, oil prices had risen before the 1991 Gulf War (as they have in 2002) but dropped precipitously when then-President George Bush, along with other leaders, announced a coordinated release of oil reserves on the eve of the U.S.-led attack on Iraq on Jan. 16, 1991. These reserves would allow the United States and other industrialized states to withstand a serious cutoff of foreign oil for several months. They could not even do so for days in 1973.

Constraints on Oil Pricing and Opportunism

Ever since the Arab oil embargo, global markets have been concerned that one or more OPEC states would use the oil weapon, or that OPEC hawks would succeed in pushing for oil production cuts that would spike oil prices. Yet, I argue that developments over the past two decades have made this less likely.

For a variety of reasons, it has become more difficult and risky for them to lower production significantly enough to generate higher oil prices. If OPEC or its member states threatened an embargo or sought a significant production decrease, Russia and other oil producers could take market share. That is especially threatening because Russia’s now privatized oil companies are willing to put oil on the market at significantly lower prices than the Saudis. OPEC very much wants to maintain market share, because it has already lost significant share since the 1970s. Increased oil market competition places limits on how far Gulf states can go to lower oil production, in the absence of market cooperation from non-OPEC actors. That adds a stabilizing element to markets.

The Saudis do have enough excess capacity to flood oil markets with oil and decrease the price so much as to knock out the competition. They did so effectively in 1985-1986. However, their excess capacity is one-third what it was in 1986, though still significant enough to deal with most oil crises. Moreover, they have been running major budget

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deficits since the 1991 Gulf War. They need oil money to prop up their welfare state, to placate their more voluble and larger population, and to meet budget targets. We can project that such pressures will not abate soon.

Furthermore, the rise of environmental pressures to reduce pollution and of high technology for oil exploration and alternatives, has created potential for decreasing the projected rise in the global demand for oil. Some OPEC insiders believe that this potential threatens OPEC and possibly the future of oil as the center of global energy. It also places limits on how far oil prices can rise without triggering alternative energy exploration, which has been made more economically feasible by advanced technology and more politically palatable, especially in Europe, by environmental pressures.

The “Axis of Evil,” Dangerous but Weakened

While changes in global oil markets have added to oil stability, so have strategic changes that have transformed the 21st century Gulf region. Earlier this year, current President George W. Bush described Iran, Iraq and North Korea as an “axis of evil,” partly because they are developing weapons of mass destruction, and, in the case of Iran and Iraq, because of potential ties to transnational terrorism. While these issues are no doubt serious, and must be addressed, Iran and Iraq were far stronger, and more threatening to oil stability, in 1979 than they are today.

Spin time back. Iran’s spiritual leader, Ayatollah Khomeini, had taken power in a stridently anti-American revolution, and sought to export Iran’s revolutionary Islamic model across the Gulf. Saudi Arabia appeared on the verge of falling, with serious uprisings taking place in its eastern Hasa oil province. Multiple ayatollahs running the world’s gas station was not a picture of stability.

Now, Iran’s revolution has run out of gas, so to speak, and its economy and military, like that of Iraq, are much weaker. While both states still pose a range of serious threats, especially in terms of weapons of mass destruction, they are much less able to dominate the Gulf politically or militarily than in the past. Nor are they as influential in oil markets. They are less able, if able at all, to coax others into taking action to raise oil prices or embargo the West, or to eschew efforts to put more oil on the market during periods of crisis.

Strategic weakness has translated into market weakness, and has made it harder for oil hawks to find the leadership, or achieve the collective action, necessary for tipping point power in oil markets.

Global Change and Cooperation

For the first time in many decades, the 21st century Gulf region is free of intense global rivalry. But, more interestingly, the end of the Cold War has left China and Russia far more dependent on the United States for trade and other economic goods than they had been. This represents a seismic shift in global politics. Moscow and Beijing know that all major roads to the global economy run through Washington. My research demonstrates a linkage between their rising dependence on the United States and their proclivity to support U.S. and non-U.S.-led actions that have directly or indirectly stabilized the Gulf, global energy markets, and oil prices. China and Japan, furthermore, are abundantly aware of their increasing dependence on Gulf oil. This makes them more interested in helping ensure oil stability in subtle and more overt ways, as I trace over time. Washington’s role as security guarantor in the region makes it even more important to their long-run economic welfare.

The U.S. ability to play security guarantor, in itself, is of recent historic origin. In 1979, Washington was entirely inept at protecting Gulf oil supplies with conventional forces because, in the post-Vietnam era, it preferred to count on proxies such as Iran and to a lesser extent Saudi Arabia to do so. When Iran fell to revolution, Washington was naked militarily. It was so incapable that President Jimmy Carter threatened the use of nuclear weapons should the Soviets march from Afghanistan, which they invaded in 1979, on nearby Gulf oil fields. At the outset of the 21st century, the United States has numerous capabilities for deterring and reversing regional aggression. Moreover, the Saudis, Kuwaitis, Qataris and others have developed military bases and prepositioning sites that allow for massive U.S.-led operations, some of which would be used if the United States goes to war with Iraq.

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The Future of Oil

Threats to oil stability no doubt exist. But we have exaggerated Middle East and oil instability, and ignored or failed to understand the combined impact of underlying, long-run developments. These developments did not exist in 1973, when the Arab oil embargo threw the U.S. and global economy into recession by quadrupling the price of Middle East oil. Nor did they exist to any degree when the Iranian revolution in 1979 generated enormous instability in the Gulf region and reduced Iran’s crude exports to a trickle, or when Iraq attacked Iran on Sept. 22, 1980, which produced a sudden loss of almost 4 million barrels a day (15 percent of OPEC output). They also did not exist to any notable degree in the early 1980s, when oil prices once again contributed to recession, and they were only partly developed when Iraq invaded Kuwait on August 2, 1990. They now largely do exist, and as I show, do work to prevent and contain a range of 21st century political, economic, and strategic threats to oil stability. That bodes well for the global economy.

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