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The Oil Weapon De-Mystified

DOUGLAS J. FEITH

Whether the Arabs' oil wealth deserves to be called a "weapon" is a question not answered by the simple observation that Arab oil-exporting countries have parlayed oil into political power. By obediently neglecting plans for strategic petroleum reserves, apologizing for the televising of "Death of a Princess," and estranging themselves for Israel, the governments of oil-importing nations do not establish that there is an oil weapon — only that there are politicians who think there is.

If the term "oil weapon" has any meaning, it is that oil-importing nations need to pay for oil with more than just money — in other words, that importing nations serve their economic interests by accommodating the Arab oil states politically. This is a complex proposition, raising for Americans the following questions: Do the Arab oil states have the ability to punish the United States (or reward it by withholding punishment)? Are the costs (political and economic) of attempting to administer such punishment affordable by the Arab oil regimes, and are such costs likely, in their view, to be compensated by the political concessions the attempt to punish may produce? Does the United States suffer less damage by offering to adjust its national policies to please the oil-rich Arabs than by not doing so, and risking that they will try to do America harm? And finally, can a politics-for-oil deal between the United States and Saudi Arabia, for example, really be struck? — that is, does a mechanism exist to ensure that once the Saudis are bought, they remain bought, upholding their end of the deal without insisting that the United States deliver more consideration than was originally agreed upon? The answers to these questions determine whether or not it makes sense for U.S. policymakers to seek political accommodations with the wielders of the "oil weapon." The common line of reasoning on this subject — that Saudi Arabia has oil that Americans want to buy and therefore the United States should strive to cooperate with the Saudis politically — is both bad economics and bad politics.

Crude and Punishment: The 1973-74 Arab "Embargo"

The issue of punishment by the Arab oil states leads one to ask: Have these states ever successfully used their oil wealth to punish the United States for political "misbehavior"? What is their ability to do so now? And what is the likelihood of their trying?

The only occasion on which Arab oil states claimed they were using oil to punish a politically uncooperative United States was during the Yom Kippur War of October 1973 and the five-month period immediately thereafter. The upheaval in the world oil market that occurred at that time, though known popularly as the "Arab oil embargo," comprised in fact three distinct phenomena: an announced embargo against the United States and the Netherlands, a cutback in daily oil production, and an oil price increase.

The embargo failed to inflict special supply shortfalls on the designated "victims." The multinational companies that distribute Arab oil did abide by the ban on shipments to the United States and the Netherlands. At the same time, however, they shifted around supplies of non-Arab oil so as to spread the total supply shortfall thinly among many of the oil-importing nations.[1] That redistribution, combined with the production increases the non-Arab oil producers instituted at the time and the leakages of Arab oil (especially refined products, as opposed to crude oil) through the embargo "wall" alleviated the crisis.

1. Emilio G. Collado, Director and Executive Vice President of Exxon Corporation, reported, in testimony before the U.S. Senate Subcommittee on Multinational Corporations, that Exxon "complied with all of the producing countries' embargoes as they ordered. . . ." He stated, however, that Exxon "distributed the crude oil to our affiliated companies on as equitable basis [sic] as we could and this entailed very large adjustments within Europe but very small impacts on the United States. We did not bring any more here. We brought virtually as much as we had before. . . . The net impact on the major trade movements was quite small but the big readjustment frankly, was among the countries of Europe where we had to do a major reallocation given the impact of the embargoes and how it changed some of our flows." Hearings on Multinational Corporations and United States Foreign Policy ("MNC Hearings"). Part 9, June 6, 1974, p. 142. For a statement of the Chairman of Royal Dutch/Shell regarding how his company arranged for oil-sharing among its customers, *see The Economist*, December 8, 1973, p. 8. A similar shuffling of barrels of oil took place when the oil trade between Iran and the United States was terminated in November 1979 following the seizure of the U.S. Embassy in Tehran. That trade cut-off had no significant effect on the oil supplies of the United States or of any other importing nation.

During the October 1973-March 1974 embargo period, crude oil supplies in the United States grew tightest in February 1974, and even then they were only 5.1 percent lower than the daily average for the first three quarters of the preceding year.[2] That 5.1 percent drop represented a decrease in total U.S. energy supplies of merely 2.5 percent. Measured against projections of crude oil demand that were made before the embargo, the shortfall in supplies was roughly the same (11 percent to 14 percent) for the United States and for each of the major countries of the West European Common Market.[3] That the Common Market states responded to the embargo announcement by hastily issuing a joint resolution antagonistic to Israel afforded them no supply advantage. Indeed, the Netherlands, singled out by the Arabs for full embargo as a pro-Israel and thus politically "hostile" nation, experienced less of a supply shortfall than did France and Britain, the countries that led Western Europe's pro-Arab political initiative.[4]

In the words of Harvard economist Hendrik S. Houthakker, "the 1973-74 embargo was largely ineffectual in cutting off oil supplies to the embargoed countries."[5] In the same context,

2. *See* MNC Hearings, *op. cit.*, Part 9, p. 186.

3. *See* Hans Maull, *Oil and Influence: The Oil Weapon Examined* (International Institute for Strategic Studies, Adelphi Paper No. 117, 1975) pp. 6-7; *The Economist*, January 26, 1974, p. 62; *Business Week*, March 2, 1974, p. 17. The figures "11 percent to 14 percent" are somewhat misleading because they suggest that the actual shortfall in supply — the extent to which actual demand exceeded actual available supply — was greater than it was. Those who made the pre-Yom Kippur War demand projections had no way of knowing that oil prices would increase fourfold in the last quarter of 1973; if they had, however, their projections would have been scaled down to account for the drop in demand caused by the price increases. Duly scaled down projections would yield shortfall figures smaller than "11 percent to 14 percent."

4. *See* Maull, *op. cit.* p. 7; *The Economist*, January 26, 1974, p. 62.

5. Hendrik S. Houthakker, *The World Price of Oil: A Medium Term Analysis*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976) p. 33. Professor Houthaker observed: "The disruption of the U.S. petroleum market in the early months of 1974 was real enough, but resulted largely from official mismanagement and public hysteria . . . ." Economist M. A. Adelman of the Massachusetts Institute of Technology has written: "[M] ost of the impact [of the so-called Arab embargo] was due to higher prices, not lack of supply . . . [M] uch of the disruption was due neither to the higher prices nor to the lack of supply but rather to

regarding the Arab embargo, the journal *Petroleum Economist* used the phrase "almost irrelevant,"[6] while Professor Guy de Carmoy of France chose "on the whole ineffective."[7] The signal lessons of the Arab embargo are (1) even when the Arab oil states stand relatively united with a common political purpose, it is beyond their capability to discriminate effectively between "friends" and "enemies" in connection with a supply squeeze, and (2) it is greatly in the interest of the oil-importing nations to minimize the control which exporting nations exercise over the oil distribution networks.

The drop in world supplies of oil during the embargo period resulted, of course, not from the ban on shipments of Arab oil to the Americans or the Dutch, but from the production cutbacks effected by most of the Arab oil states. The regimes that ordered cutbacks made a point of announcing that their motives were political rather than economic. Accordingly, they declared that, beyond those cuts that were to take effect immediately (in October 1973), further reductions of 5 percent would be implemented each month until Israel withdrew completely from the areas it won in the June 1967 war and "the legitimate rights of the Palestinian people are restored."[8]

The production cutbacks yielded enormous economic value to the members of OPEC, a predictable (and predicted) outcome that casts doubt on the Arabs' claim that that action was politically motivated. The cutbacks, by creating confusion and measurable (although short-lived) supply shortfalls, allowed leading OPEC countries to sustain the 70 percent price rise – Saudi "benchmark" crude oil went from $3.01 to $5.12 per barrel[9] – which they imposed in October 1973. The cutbacks

the explosive combination of controlled prices and no rationing. Supply might have been equated with demand by letting prices rise, *or* by levying a gasoline excise tax, *or* by rationing. When we kept prices frozen without rationing, the mile-long gasoline lines followed as the night the day." MNC Hearings, *op. cit.*, Part 11, January 29, 1975, p. 17 (italics in original).

6. March 1974, p. 98.

7. Guy de Carmoy, *Energy for Europe: Economic and Political Implications*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1977), p. 104.

8. Declaration of Organization of Arab Petroleum Exporting Countries, quoted in Shmuel Yaari, "The Basic Economics of Arab Oil Actions," *Middle East Information Series*, XXVI-XXVII, Spring/Summer 1974, p. 80.

9. *See The Economist*, January 5, 1974, p. 65.

caused panic among consumers, which led to a ravaging of oil inventories throughout the West and a drastic increase in spot market oil prices. In November 1973, for example, Nigeria and Iran held oil auctions in which they realized \$16.80 and \$17.40 per barrel respectively. Thus made confident of their economic strength in a market with tight supply, the OPEC countries adopted an additional 120 percent price rise – "benchmark" crude going from \$5.12 to \$11.65[10] – in December 1973.

When pondering the assertion that the Arab decision to reduce oil production was essentially political in nature, one should bear in mind that (1) the Saudis and others violated the monthly reduction plan as soon as it became clear that the December 1973 price increase would stick;[11] (2) even with the cutbacks in the fourth quarter of 1973, OPEC's total 1973 production exceeded its 1972 production by more than 12 percent, suggesting that the cutbacks were required, as a business matter, to offset the unusually high production of the first three quarters of 1973;[12] (3) the Arab oil states terminated their reduction plan and their embargo against the United States without having won satisfaction of their political demands;[13] and (4) even after the political justification was removed, a number of Arab states continuted to reduce their oil production.[14] Why, under the circumstances, should one view the Arabs' 1973 production cutbacks as any more "political" than the cutbacks made by Nigeria in 1974 (22 percent, as measured against the daily average for the preceding year)[15] or Venezuela in 1975

10. *Ibid.*

11. Saudi Arabia actually increased its crude oil production each month from December 1973 through March 1974; Abu Dhabi increased production throughout the first quarter of 1974; Libya increased its production in January 1974 and maintained in both February and March of 1974 a higher production level than it maintained in November-December 1973. *See* MNC Hearings, Part 9, p. 185. *See also The Economist*, February 16, 1974, p. 74.

12. *See* John M. Blair, *The Control of Oil*, (New York: Pantheon Books, 1976), pp. 266-68.

13. As Hans Maull put it, "The fact that the oil weapon was sheathed again before any of the stated Arab objectives had been achieved underlines that its success was not unqualified." Maull, *op. cit.*, p. 10.

14. *See* Houthakker, *op. cit.*, p. 26, citing CIA, *International Oil Developments*, February 12, 1976.

15. *Ibid.*

(25 percent)?[16] That the Arabs *said* it was political illustrates a critical fact about the "oil weapon": When an oil policy decision of an Arab regime affects the United States for good or ill, and a pretext can be found to call the decision a political reward or punishment, the regime calls it so; when no such pretext exists, the decision is justified forthrightly as an economic matter.

The Sting

OPEC, when it quadrupled its crude oil prices during the last quarter of 1973, took advantage of the pandemonium created by "oil weapon" bluster. But the price hikes themselves were no more political than is the desire to have more money. The lack of relation between the Yom Kippur War and the OPEC price rise initiated during that war is acknowledged even by commentators who are otherwise inclined to discover political motives behind Arab oil policies.[17]

OPEC oil prices began to climb steeply well before the Yom Kippur War. The big push began in 1970, following the revolution in Libya; the price of a barrel of "benchmark" crude rose from $1.80 in late 1970 to $3.01 just before the Yom Kippur War. Within OPEC, it was not the Arabs but the Iranians and the Venezuelans who led the campaign to raise prices in late 1973. Indeed, if the embargo period price explosion proves anything about the relation of oil to politics, it is that politics takes a back seat to economics – even with the Arabs, and even during a hot period in the Arab-Israeli conflict.

That price explosion contradicted the claim that the sole (or even chief) purpose of the cutbacks was to punish Israel's friends. Moreover, it caused the most hardship in relatively poor countries and in countries that import a larger share of their oil supplies. Another of its effects, therefore, was to harm the staunchly anti-Israel, oil-poor Third World even more than Western Europe (which still equivocates in its condemnations of Israel), and to harm Western Europe even more than the relatively pro-Israel United States. During an interview in 1975,

16 *Ibid.*

17. *See* George Lenczowski, *Middle East Oil in a Revolutionary Age*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976), pp. 34-35.

Italian journalist Oriana Fallaci mentioned to Sheik Yamani, Saudi Arabia's oil minister, that the 1973-74 OPEC price increase "harmed the European countries, India and Japan, not the United States, to be precise." The Sheik replied: "There can be no doubt. As compared to the European and Japanese economies, the American economy benefited from that increase . . . . (T)he United States imports far less oil than Europe and Japan and, moreover, is better able to bear a price increase." Given the undeniable economic fact that Saudi oil pricing policies affect various nations without regard to those nations' political stand on the Arab-Israeli conflict, Sheik Yamani felt compelled to admit that "the Palestinian problem" has "got nothing to do with the price of oil."[18]

The oil market speaks plainly: Nations that render political concessions to the Arab oil regimes are spared neither price nor supply headaches when those regimes' business considerations impel a cut in oil production or an increase in prices. It is noteworthy that from 1974 to 1978 — a period of relatively good relations between the United States and Israel — the real dollar price of OPEC oil actually fell, while in 1978 and 1979 — a period when Washington began to pressure Israel strenuously, courted the PLO, and sought to win the Saudis' goodwill by consenting to sell them F-15s — OPEC oil prices skyrocketed. This is not to suggest that a direct relationship exists between the intensity of U.S. efforts to please the Saudis and the rate at which America's oil woes increase; it does suggest that the link between U.S.-Saudi political cooperation and cheaper oil is a figment of theorists, at odds with the lessons of both history and economics.

The 1973-74 Arab embargo nonetheless proved an unqualified *political* success, insofar as it alchemized economic fears in the importing nations into sympathy for the Arabs' campaign against Israel and into general diplomatic solicitude for the Arabs. It is not widely appreciated that that success came despite, and not because of, the actual economic effects of Arab oil policies. Sheik Yamani surely apprehends, however, that it was folly on the part of the importing nations — discomfort and injury caused those nations by the panic of ill-informed officials and citizens — that accounted for the political success of the

18. *The New York Times Magazine*, September 14, 1975, pp. 28, 36.

"oil weapon" more than the Arab oil states' actual ability to inflict the punishment on political opponents. The Arabs have been fortunate that the United States has not called their bluff. And they appreciate the importance of not pushing their luck; despite the vagaries of U.S. foreign policy over the years, they have not since 1973 even tried to use their oil wealth to punish the United States.

Petrodollars and Oil Supply

Presumably, if the "oil weapon" were the dread and handy instrument of policy it is commonly thought to be, it would not lie around unused for years on end. After pondering what this lack of use implies, one is left with the question: How might the Arab oil states make political use of oil today in their dealings with the United States? Phrased more precisely: In what ways can Arab states realistically be expected to adjust their policies regarding oil prices, supplies (embargo or daily production levels), or petrodollars so as to penalize the United States for lack of political cooperation?

Of those three items —price, supply, and petrodollars — the last is most obviously not useful as a political weapon. There are only four things that an oil state can do with its revenues: Buy goods or services, invest in foreign business enterprises, make deposits in banks, or bury the cash in the sand. The sand option is the only way to take petrodollars out of circulation. Thanks to inflation, however, it would amount to burning money: an outcome beneficial to the country that issued the currency and damaging to the oil state. No threat there.

Furthermore, to the extent that an oil state would, for non-business reasons, withdraw money from an investment in the United States, that investment would become underpriced. When the withdrawn funds are then spent, invested, or deposited in Europe, the Europeans can be counted on to use them to buy up the undervalued U.S. investments the oil producers just abandoned. Unless money is taken out of circulation altogether (*e.g.*, burned), it cannot be kept away from a good investment.

Dollars are, in essence, certificates redeemable for U.S. goods and services. Petrodollars will be so redeemed either by the oil states themselves or through the non-U.S. businesses and banks with which the oil states deal. It is in this light that one should contemplate a threat by an oil state to pass up, for political reasons, U.S. goods or services that it would otherwise have purchased. That threat's execution would yield the following results: (1) Harm to the oil state – if the non-U.S. company could provide the same quality goods and services at a lower price than can the U.S. company which was passed over, the oil state would have bought from that non-U.S. company in the first place; (2) Harm to the particular U.S. company involved – to the extent of its lost profits;[19] and (3) A transfer of dollars from the oil state to that fortunate non-U.S. company, which will then either use the dollars to buy U.S. goods or services or pass the dollars to someone else who will. In any event, no harm comes to the United States as a whole.

Should an oil state threaten to move large amounts of capital out of the United States quickly, and thereby disrupt the U.S. economy unacceptably, the U.S. government has the power to freeze that state's assets in the United States, as was done on November 14, 1979, to Iran in connection with the Tehran embassy crisis. This power represents another constraint on the use of petrodollars as a political weapon.

Addressing the subject of petrodollars and politics, economist Donald A. Wells has written:

> As an investor, the Saudi government has maintained a high level of liquid foreign assets to protect itself against a decline in foreign-exchange earnings, whether this decline be self-initiated or imposed by others. It is therefore unreasonable to regard a large accumulation of liquid foreign assets merely as a residue of savings. The usefulness of these funds suggests that the Saudis will be prudent in their management and *cannot afford to take capital losses in order to manipulate them for political purposes.* Political manipulation would be more feasible if the funds were truly surplus and were not important in the promotion of economic stability and security.[20]

19. This assumes that that U.S. company does not benefit from whatever purchases will be made with the dollars that the oil state has diverted to the non-U.S. company.

20. Donald W. Wells, *Saudi Arabian Development Strategy*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976), p. 60 (my italics). Regarding petrodollars and the world economy generally, *see* Richard Melson and Lawrence Feiner, *Cambridge Forecast Reports* (Cambridge Forecast Group) June 1979, January 1980; S. Fred Singer, "Living with Imports," *The New Republic*, February 25, 1978, pp. 33-34.

Like petrodollar threats, the threat to punish the United States by manipulating oil supplies appears dubious, if not altogether incredible, in light of the existing obstacles to successful manipulation. Foremost among these is the relatively low degree of U.S. dependence on oil imports, much less on oil shipments from any given producer.

The United States derives approximately 42 percent of the energy it uses from oil.[21] Total U.S. imports of oil now amount to less than 7.0 million barrels per day ("mbd") (down from 8.157 mbd in 1979) and compose less than half of daily U.S. oil consumption (the rest coming from domestic production).[22] Saudi Arabia, which exports more oil to the United States than does any other country, accounts for approximately 9.0 percent of U.S. crude oil supplies and approximately 3.8 percent of total U.S. energy source supplies.[23]

Restrictions on Production

The simple threat of embargo has no teeth. As the 1973-74 Arab embargo illustrated, no producer (or set of producers) can impose a supply shortfall on a single importing nation. (Remember also how easily world oil markets adjusted to Iran's 1979-80 oil embargo against the United States.) Moreover, sharing schemes devised by industrialized nations through the International Energy Agency afford participants extra protection against embargo threats. To hit an importing nation in the supplies, a producer must do more than declare an embargo: it must cut its own production.

Production cuts, however, are clumsy as a political tool because they affect adversely all importing nations, not just the special target nation. Indeed, if an Arab state wishes to target the United States for punishment, a production cut would be an especially clumsy tool, for it would, as occurred following the Yom Kippur War, damage the poor (and politically pro-Arab)

21. *See* U.S. Department of Energy, *Monthly Energy Review*, May 1980, p. 6.

22. *See* American Petroleum Institute, *Monthly Statistical Report*, May 1980, p. 6; *Oil & Gas Journal*, January 28, 1980, p. 109.

23. In 1979, the average U.S. supply of crude oil was roughly 14.9 mbd, while imports were roughly 6.3 mbd, and imports from Saudi Arabia were 1.3 mbd. *See* U.S. Central Intelligence Agency, *International Energy Statistical Review*, (CIA Statistical Review); *Oil & Gas Journal*, January 28, 1980, pp. 108-124.

oil-importing nations most, and the United States least. While the 1973 production cuts (and the accompanying price increases) stimulated more astonishment and fear than resentment, it is likely to be the other way around if the Arabs attempt that trick again, especially if they do so for clearly political motives. Were the Arabs now to trounce the world's poor simply in order to tweak the United States, the trounced would likelier blame their misery on the Arabs than on the Americans or the Israelis. The Arabs undoubtedly understand this.[24]

Furthermore, since production cuts affect the supplies of importing nations proportionately, the only way for the Saudi regime, for example, to damage the United States to the full extent of around 3.8 percent of U.S. energy source supplies would be to cut Saudi oil production to zero.[25] Such a move would be reckless beyond any economic actions that even the Ayatollah Khomeini has taken.[26] First, it would amount to a declaration of war against the United States (if not the entire oil-importing world). Second, it would create political unrest within Saudi Arabia; people who have come to expect a steady inflow of large amounts of petrodollars can be expected to grow

24. *See* text accompanying note 18 above.

25. Even were Saudi Arabia to cut its production to zero, this would not actually result in a drop in U.S. energy source supplies of 3.8 percent. The effect of such a production cut would be to tighten world oil supplies generally and push all oil prices up. The world's richest countries would be relatively well-situated to satisfy their oil needs while the poor, as usual, would take it on the chin.

26. In the enlightening interview with Saudi Prince Fahd published (in Arabic) on January 11, 1980, in the Beirut newspaper *Al-Hawadith*, the following exchange occurred, revealing the cautious Saudi leader's concern about "backfire" from the "oil weapon": Question: "Pending the elaboration of a joint strategy by the States which reject the Camp David agreement, has the Kingdom [of Saudi Arabia] drawn up its strategy? No matter how much we try to beat around the bush, oil is a basic card, if not the trump card, in the Middle East game. What is your strategy for using this card or weapon?" Prince Fahd: "Our view is that the subject of oil is so important and dangerous as to make us keep it away from childish talk and arguments. It would be the easiest thing for us to appear on television or let ourselves be swayed by talk and press statements and say what we imagine would please the people. Oil is not a personal weapon that is the property of one party; it is a basic material on which our life and the lives of others depend. Therefore, we must protect it from the unruly currents so as not to find ourselves in a situation where we would lose control of it."

uneasy or perhaps even revolutionary if that inflow is interrupted for political reasons. Third, it is not clear how many oil wells can be shut in without causing inordinate damage (from water seepage, for example). Fourth, apparent willingness on the part of Riyadh to use oil as a weapon would encourage terrorist threats aimed at compelling the House of Saud to press various ideological demands on the oil-importing nations. Likewise, Riyadh's willingness to bestow economic rewards on "friendly" customers would invite from those customers an endless stream of demands for bribes.

To the extent that Saudi Arabia, in an attempt to punish the United States, could win cooperation from fellow Arab OPEC states willing to cut their own production, supplies would tighten even more in the world oil market, to the disadvantage chiefly of the Third World poor. The effects on the United States would be relatively minor.[27] In any event, as a practical matter, such cooperation is not in prospect. The development plans of most of the Arab oil states are even more delicate than those of Saudi Arabia; they are in an even worse position than Saudi Arabia to bear the shock of an interruption of oil revenues. In the view of virtually every Arab oil regime, the costs of such cooperation – measured by, among other things, the risk of revolution (that is, death to the rulers) – are certain to outweigh the value of the chance that the United States will change its foreign policy under pressure. Furthermore, it is improbable in the extreme that the Arab oil states would agree on political tactics; even during the Yom Kippur War, Iraq refused to join in the production cuts and Libya refused to enforce the embargo strictly. Both Iraq and Libya boycotted the mid-embargo (November 1973) Arab summit conference in Algiers.

The constraints on the political use of oil prices are similar to those on the political manipulation of supplies. The nature of the world market is such that an oil state cannot raise its prices

27. In 1979, U.S. crude oil imports from Arab states amounted to roughly 3.2 mbd. *See Oil & Gas Journal*, January 28, 1980, p. 124. In December 1979, the current trend away from reliance on such imports was underway and the average for the month was approximately 2.7 mbd. This December 1979 2.7 mbd figure represented approximately 5.5 percent of total U.S. energy source supplies. *See* CIA Statistical Review, *op. cit.*, June 24, 1980, p. 5.

for one nation alone. Here again, therefore, is the standard problem: The Arab oil states could not use an oil price increase to punish the United States without damaging themselves economically, devastating their "friends" in countries that are poor and relatively highly dependent, and thereby risking a net political loss for the Arab world. Indeed, an attempt to use price as a political weapon would probably generate more anti-Arab antagonism than would any other political oil ploy, for it would look inevitably like greed rather than statesmanship.

Recent history teaches that if an oil state thinks it can increase its wealth by raising oil prices, it will raise them. The Arabs must view with contemptuous amazement those people in the oil-importing world who actually believe oil price increases result from Arab disapproval of a foreign nation's diplomacy.

'Moderation' as Self-Interest

It is frequently suggested that the Saudis, because they do not "need" the extra revenue (whatever that means) are willing to forego the best price for their oil (or the economically most advantageous oil production level) out of friendship for the United States. this allows the argument to be made that, even though harmful punishment of the United States may be impractical, Saudi Arabia is in a position to reward the United States for good political behavior. Proof of the Saudis' friendship and their willingness to reward U.S. political concessions is said to emerge from the fact that Saudi Arabia consistently assumes, within OPEC counsels, a relatively "moderate" attitude toward oil prices. Such reasoning, however, miscontrues what occurs at OPEC's semi-annual price-fixing conferences.

The oil cartel comprises thirteen nations that differ from each other in economically significant respects — population, volume of oil reserves, unused oil production capacity, size of foreign currency reserves, extent of foreign investment, amount of foreign trade surplus or deficit, and degree of political stability, among other things. The differences among its members complicate the cartel's essential function, which is to keep the world oil market's supplies less plentiful than they would be if the OPEC countries competed freely against one another for markets. By making supply "tight," the cartel helps ensure that its customers feel compelled to pay the price OPEC officially asks of them.

The OPEC countries produce less oil each day than the total amount they would produce if they did not coordinate. They all thereby become much wealthier than they would otherwise be.[28] This arrangement requires, however, that world demand for oil remain high enough to allow for tight supply without forcing individual OPEC countries to cut production below their "minimum" levels – that is, below the level at which they receive their optimum oil revenues. If high oil prices and/or an economic recession in the oil-importing world reduce demand for oil to a point where the oil-exporting countries can benefit from cheating against the cartel, such cheating will occur. In order to bring in higher revenues, the cheaters will cut their prices (through such techniques as easier credit terms, for example) and increase their sales.[29]

The individual economic circumstances of the thirteen members of OPEC yield a different "perfect" or preferred price for oil for each member at any given time. The benefits of the cartel are such that each member has a large interest in cartel unity (or something closely approximating it) on the crucial issue of price. Each member nonetheless also has an interest in trying to set the cartel price as close as possible to that member's

28. More-revenue-for-less-production holds true, of course, only to a point. If production is cut below the optimum level, then, even though the cut causes oil prices to rise, the oil producers suffer a loss in revenue simply because they are selling too little.

29. This is, evidently, what happened during the 1974-75 recession, which accounts in part for how Iraq and, to a lesser extent, the United Arab Emirates, managed to increase their production in 1975, despite declining world oil consumption, increasing non-OPEC production, and an overall decrease in OPEC production. *See* U.S. Central Intelligence Agency, *International Oil Developments: Statistical Survey*, September 9, 1976, reproduced in U.S. Congress Joint Economic Committee *Hearings on Multinational Oil Companies and OPEC: Implications for U.S. Policy*, (94th Congress, 2d Session, June 1976), p. 287; E. Kanovsky, *Middle East Oil in the 1970's: An Economic Analysis* (unpublished manuscript) March 1980, pp. 12-13. While the cartel can apparently survive a small amount of cheating ("small" in relation to OPEC production as a whole, though highly profitable for the cheater-nation), a substantial decrease in world oil demand or a substantial increase in non-OPEC energy sources could stimulate enough price-cutting and market-stealing by cartel members to damage fatally the "pro-rationing" scheme which gives rise to the cartel's power over prices. *See* S. Fred Singer, "A National Energy Policy," *Middle East Review*, Spring 1977, pp. 50-51.

"perfect" price. This basic economic truth is commonly ignored, and its neglect accounts in large part for the readiness of politicians, journalists, and others to explain the Saudis' relative "moderation" on oil prices as a political gesture entitling Saudi Arabia to our gratitude.

The Saudi Perspective

The Saudis estimate their "perfect" price at any given time in light of the following factors:

(1) Optimizing current revenues. The Saudis do not aim simply to maximize current oil revenues; they favor a price that yields not the highest current revenues but the highest revenues consistent with the other interests listed here below.

(2) Protecting the value of Saudi Arabia's large reserves of oil in the ground. Unlike the other OPEC countries, Saudi Arabia could produce oil as fast as it can sell it and large oil reserves would still remain in the ground there thirty years from now. If oil prices rise too high too fast (that is, if world supply shrinks too quickly), thereby making economic and urgent the development of non-OPEC sources of oil and non-oil sources of energy, the Saudis themselves will "pay" for those higher prices through the loss of value of their oil in the ground. Oil states with small reserves can anticipate selling off virtually all their oil in the near term in any event, since several years will necessarily pass between the time when (i) high oil prices render economical a large-scale shift away from OPEC to other energy source suppliers and (ii) such a shift can actually be accomplished. But the Saudis simply have too much oil to afford to ignore how excessive prices (that is, sharply reduced production) today would damage the oil market in the medium and long term.

(3) Guarding the value of the dollar. While the Saudis' ability to spend is impressive (far greater indeed than many putative experts predicted a few years ago),[30] they still hold a sub-

30. It is not surprising that many a commentator in the early Seventies guessed wrong about how high oil prices could rise, how much revenue the oil states could garner, how much they could manage to spend in a year, and how disruptive to the international financial world would be their petrodollars "surpluses." The extent to which certain commentators were wrong, however, calls attention to the role of misinformation, ignorance of basic economics, and erroneous political preconceptions in creating undue

tantial portion of their oil revenues as cash in the bank. If high oil prices damage the dollar, the Saudis' gain in oil revenues will be offset, at least in part, by the devaluation of their dollar holdings.[31] Oil states like Nigeria, Algeria, and Venezuela, which tend to spend more than they earn (and do not possess large foreign currency holdings), naturally worry less than Saudi Arabia about the effect of high oil prices on the dollar.

(4) Guarding the value of foreign investments. Unlike those oil states with minimal investments in the oil-importing world, Saudi Arabia must account in its oil policy calculations for the harm that too high oil prices will cause its foreign investments, lest such prices effect a net economic loss for the Saudis.[32]

alarm about the Arabs' "oil weapon." For example, in a "round table" discussion held in September 1973 (less than two weeks before the outbreak of the Yom Kippur War) George W. Ball, a former U.S. Undersecretary of State and a persistent advocate of closer U.S. political ties with the Arab oil producers, observed that "the U.S. import bill for oil may be something like $18 billion by the early 1980's." Mr. Ball termed this "a very alarming figure" and expressed the hope that "instead of $18 billion, it may be in the neighborhood of $6 to $8 billion," figures that Mr. Ball said "we ought to be able to live with." Mr. Ball noted that, "on almost any projection," the Arab states are going to have "earnings far in excess of their absorptive capacities." Paul W. McCracken, moderator, *The Energy Crisis*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1973), pp. 84-85, 102. As it turned out, the U.S. import bill for oil is now just short of $100 billion a year and the U.S. economy has not only not collapsed, it continues to grow. Whereas Mr. Ball worried over whether all the Arab oil states combined would be capable of spending $35 or $40 billion a year, Saudi Arabia alone spent $200 billion on its last (1975-80) five-year plan. *See The Economist*, April 19, 1980, p. 63. Nevertheless, Mr. Ball to this day continues sounding alarms about the "oil weapon" and urging U.S. efforts to pacify the Arab oil regimes through political pressure on Israel. *See* George W. Ball, "The Coming Crisis in Israeli-American Relations," *Foreign Affairs*, Winter 79/80. ("Unless we make prompt and serious progress toward solving the Palestinian problem, we can expect to see our energy needs increasingly hostage to our Middle East policies.")

31. Sheik Yamani: "We know that if [the West's] economy collapses, we'll collapse with you. Money in itself counts for nothing. It only counts if it is put back into circulation and transformed into industry, technology. In other words, unless the countries of the West are prosperous, we can't import your industry and your technology." *The New York Times Magazine*, September 14, 1975, p. 28.

32. As Professor Wells has observed: "Saudi Arabia is going to be a

(5) Averting dangerous political crises. Saudi Arabia has by far the largest unused production capacity and the most positive trade balance of any of the OPEC countries. This gives Saudi Arabia a singularly compelling incentive to guess conservatively when it estimates the highest OPEC oil price the market can bear. If, by overshooting the mark with an oil price increase, OPEC helps induce a price-related drop in oil consumption as well as a general economic recession (as happened in 1974-75 and again in 1979), Saudi Arabia becomes the principal target of pressure from two groups in conflict. The reduction in demand for oil will, if large enough, endanger the cartel; if demand is not sufficient at the new price to allow cartel countries to optimize their revenues, one or more members of the cartel will have to reduce production to help out fellow members, or cartel-destroying price-cutting will occur. At that point, Saudi Arabia can expect intense pressure from within OPEC to bear the brunt of the necessary cutback, since Saudi Arabia can most easily sustain a loss of some revenue.[33] At the same time, however, the oil-importing nations will be campaigning for oil price relief to mitigate their recession. These nations too will direct their exhortations toward Saudi Arabia, because

major financial investor in world markets . . . . With financial assets held throughout the world, Saudi Arabia acquires a strong vested interest in international financial stability . . . . The greater the wealth, the greater the cost [to the Saudis] of disruption and instability." Wells, *op. cit.*, pp. 69-77.

33. Such pressure on the Saudis was in fact the *leitmotif* of the September 1980 OPEC conference in Vienna. By the time of the conference, the OPEC countries had learned that their 1979 price increases had depressed demand so severely that, unless OPEC output fell, the surplus of oil production over oil consumption — the much-discussed "glut" — would force substantial price reductions and could, thereby, destroy a valuable element of the OPEC mystique. The smaller producers called for Saudi Arabia to cut its production to sustain the higher prices those smaller producers want to charge. The Saudis, who have nothing against higher prices as such, saw no appeal in higher prices which could be supported only if Saudi Arabia were willing to sell less oil and realize less revenue. The Saudis are not in the business of making gifts to the importing nations, and they are not in the business of making gifts to their fellow exporting nations. No agreement was reached at Vienna. OPEC's problem of excessive production was then, for the moment, solved by the Iranian-Iraqi war.

its unused production capacity represents their best hope of price relief. A situation in which OPEC is pressing excitedly for lower Saudi production while the oil-importing nations are pressing excitedly for higher Saudi production would represent a threat to the Saudis' control of their own oil policies. Any regime in power in Riyadh, whether Qadhafi-style radical, Iraqi-style Baathist, or ultra-conservative like the current regime, will find it strongly in its interest to avert such a bind by restraining feckless price hawkishness within OPEC.

In short, Saudi Arabia appears relatively "moderate" on oil prices because its "perfect" price for oil, all economic factors considered, happens to be lower than that of other OPEC states — those that have trade deficits, smaller oil reserves, larger populations, less foreign currency holdings and foreign investments, and less unused production capacity. It is no more sensible for U.S. officials to feel gratitude toward Saudi Arabia for its pricing policies than to feel obliged to any other nation for policies that promote that nation's own economic interests. Politics figure importantly in Saudi oil policy calculations only insofar as Riyadh fears the negative political consequences of actions that might provoke harsh responses from foreign powers. History teaches that Saudi oil policy does not compromise economic values in order to reward the world's importing nations for diplomatic concessions rendered. History, moreover, provides no examples of the Saudis sacrificing economic gain in an attempt to punish the United States for actions Riyadh disfavors.

The Canny and the Crazy

Cool-headed evaluation of their economic interests and canny service for those interests have characterized all of the Arab oil regimes, from the Gulf sheikdoms to the radical domains of Qadhafi and Saddam Hussein. It serves the Arab oil regimes' purposes to claim that their oil policies will favor those who cooperate with them politically and will punish those who do not. It also serves their purposes, however, to appreciate the limits on their own power and the dangers involved in trying actually to use oil as a political weapon. Nothing that the Arab oil regimes do suggests ignorance of those limits or indifference to those dangers. On the contrary, their oil policies testify to caution: a trait to be expected in people of great wealth who have so much to lose. Witness the fact that, Qadhafi's bizarre political radicalism notwithstanding, the Libyans have managed their oil trade no less rationally (given Libya's economic interests) than the Saudis have managed theirs. For all of Qadhafi's (undoubtedly earnest) denunciations of U.S. policy, Libya deals extensively with U.S. companies, sells oil directly to the United States, bases its oil trade on the dollar, and attempts no price discrimination against the Americans. The Libyans may be radical, but they are not (at least when it comes to oil) stupid. All of which calls into question the conception of oil as a weapon and the wisdom of U.S. policymakers feeling constrained by what they think pleases or displeases the oil regimes.

Nevertheless, U.S. policymakers do feel so constrained. Current U.S. policy reflects fear that the Arab oil regimes are ready to disrupt the business-like operation of the world oil market out of political pique. As the *Wall Street Journal* recently reported, "within the Carter administration, some experts acknowledge that America's close ties with Israel can *impair relations with Arab countries and access to their oil* unless Israel makes more concessions to achieve a Mideast peace."[34] One searches in vain, however, for an explanation of how the Arab oil states might, in the real world, "impair" America's access to oil imports. No oil exporter can prevent the United States (or any other country) from importing oil. The administration "experts" interviewed by the *Journal* are apparently inexpert about the workings of the world oil trade. And they appear unaware of the prudent and money-minded conduct therein of the Arab oil states, whose rulers give every sign of understanding that they cannot significantly harm or favor their American customers without unwisely risking unacceptable damage to themselves.

So long as those Arab rulers remain rational – protective of their own economic and physical well-being as the proverbial "reasonable man" is protective of his – there is no need for U.S. policymakers to fear the oil weapon. Nor is there any reason to try to cultivate political cooperation with the oil regimes as a basis for trade; if cash is tendered, the oil will flow. Indeed, not only is there no need for a politics-for-oil arrangement with a rational oil regime, but its pursuit is the surest

34. July 15, 1980, p. 1 (my italics).

means of undermining the security of U.S. oil supplies. If Washington grants Saudi Arabia arms and political concessions whenever King Khalid threatens to block the Saudi pipeline, Washington is encouraging such threats. Perhaps the best argument against politics-for-oil deals, however, is that there is no way to enforce them. As economist M. A. Adelman of the Massachusetts Institute of Technology has observed:

> We should give [the Saudis] nothing in return for producing the quantity of oil which suits their interests to produce, because they will produce it anyway. Any promise they make of more supply or steady supply is, as the lawyers say, void for vagueness. Worse yet, there is no way of enforcing it.
>
> Agreements are enforced by competition or by law, or both. If somebody breaks his word, people have no more to do with him. He's out of business. But there is no competition in world oil today. A judge can tell the promise-breaker to pay up, to go to jail, or have his bank account seized, but there is no law against the sovereign state.[35]

It bears re-emphasis: Oil is not a weapon in the hands of a rational oil regime.

If, on the other hand, the rulers of the Arab oil states begin acting irrationally — making punitive production cuts, throwing money down the drain, ruining their own economies, and so forth — that is all the more reason not to seek a politics-for-oil deal with them.

If an oil state decides that it wants, in effect, to blow its brains out all over the oil-importing world, it can do so.

35. Edward J. Mitchell, ed., *Seminar on Energy Policy: The Carter Proposals*, (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1979), p. 15 (statement of Professor Adelman). In this connection, it is worthwhile noting what the Atlantic Richfield Company wrote to Senator Church in response to an inquiry regarding the negotiation of oil supply agreements with certain oil states: "The history of agreements with the Middle Eastern oil producing countries has been one of continued violation whenever it is in the interests of the supplying signatory. On the other hand, our tradition has made us reluctant to violate business agreements simply because they have been less favorable to us. Long-term agreements at current high prices, would likely be honored longer after they became onerous to the U.S. than after they became unsatisfactory to producing countries." MNC Hearings, *op. cit.*, Part 9, June 6, 1974, p. 145.

Ayatollah Khomeini did it with Iran, whose economy, since Iranian oil production dropped from around 5.0 mbd to around 0.5 mbd, is in ruin. Oil in the hands of the Iranian Islamic Republic is an actual weapon, albeit one that cuts the wielder more deeply than the targets. That the irrationality of the Khomeini regime has led to the use of Iranian oil as a political weapon does not, however, militate in favor of maximizing U.S. political cooperation with the Ayatollah. Not to put too fine a point on it, political deals with such people are likely to prove disappointing and wasteful. If a regime is really capable of self-destructive fits of oil weaponeering, Americans must either live without it or act against it, but they should hardly put faith in political bargains with it.

Several years back, Mel Brooks wrote a movie in which a hunted outlaw fended off an advancing throng by grabbing himself at the throat, pointing a gun at his own head, and screaming something like, "If you come any closer, I'll shoot." The throng froze in stupefaction. It was hilarious. The world's similar reaction to Arab oil threats, however, is funny only to the Arabs.