Oil Markets and Economic Sanctions

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I would like to present a brief analysis of the impact of the current and proposed US oil sanctions policy on domestic and world markets which is, of course, different from evaluating the pros and cons of this policy.

Sanctions Have a History

Oil trade sanctions or embargoes have been a frequent policy tool in the post World War II period, both by importing and exporting countries. The first post-war embargo was imposed in 1951 by the British Navy on Iranian exports during the crisis over the nationalization of the Anglo-Persian Oil Company. The next embargo was initiated by several major Arab producers who refused to export oil to the US, the UK and Germany from June to Sept. 1967 because of these countries' support of Israel during the Second Arab-Israeli War. Neither of these embargoes had much of an impact on the world market which had enough spare capacity to cope with both disruptions.

The third embargo, imposed by most Arab oil producers in October 1973 at the start of the 3rd Arab-Israeli War, took place at a time when there was virtually no spare capacity in any oil producing country. It lasted only 5 months but it triggered a historic change in the world oil market, economically and politically. The next embargo was imposed by the US on imports from Iran during the 1979-81 hostage crisis.

Current Sanctions

Currently, the US has oil sanctions against three countries: It is a participant in, and the strongest supporter of, the UN sanctions on Iraq oil exports since August 1990; it has imposed sanctions on imports from Libya since 1982 and on investments in Libya since 1986; and it has had an embargo on Iranian oil imports since 1987 which was expanded in 1995 to include all US business transactions with Iran.

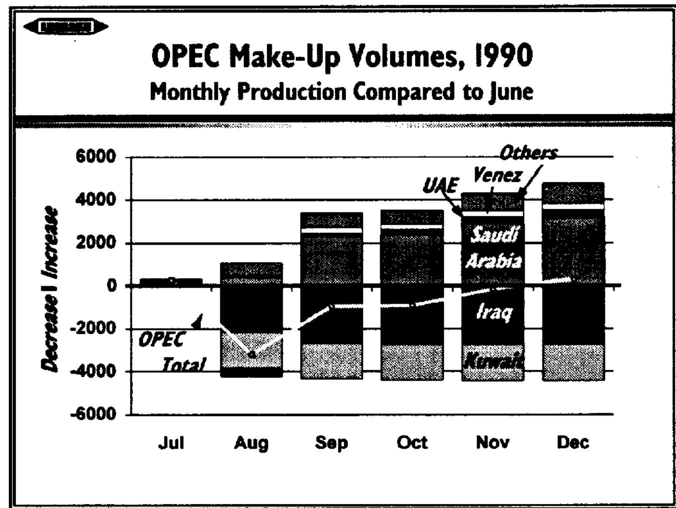
Both the Administration and the Congress now want other countries to join in the US embargoes on Iranian and Libyan oil exports or, at least, cease investing in the two countries' oil and gas sectors to reduce their export potential over time. The proposed legislation is an acknowledgment that our unilateral sanctions policy had very little effect on the sanctioned countries but put US firms at a competitive disadvantage by denying them access to these countries' oil production and trade.

Since all of these sanctions affect the same market, even though each has its own rationale, let us briefly examine each as part of a proposed comprehensive US policy.

Iraq: Multilateral and Effective

First, let's look at Iraq, where sanctions on oil exports are multilateral, fully implemented and in existence for nearly 6 years. When these sanctions were first imposed by the UN on Iraq and occupied Kuwait in August 1990, they represented a loss of 4.5 million B/D or 7% of world oil supplies. Prices of course soared in the face of these reductions and also the fear of additional disruptions by military actions in the Gulf region. However, as we now know, the actual and potential excess capacity in Saudi Arabia, and, to a lesser but still significant extent, in several other OPEC countries, soon replaced all lost exports from Iraq and Kuwait. By December 1990 OPEC production was back to its July level and once the fighting stopped prices dropped almost immediately to their pre-invasion level even while Kuwait wells were still burning and sanctions on Iraq were fully implemented. The market reacted rationally to the restored flow of oil, the perceived end of military threats on existing production and the assumption that Kuwait exports would be restored fairly quickly.

Figure 1

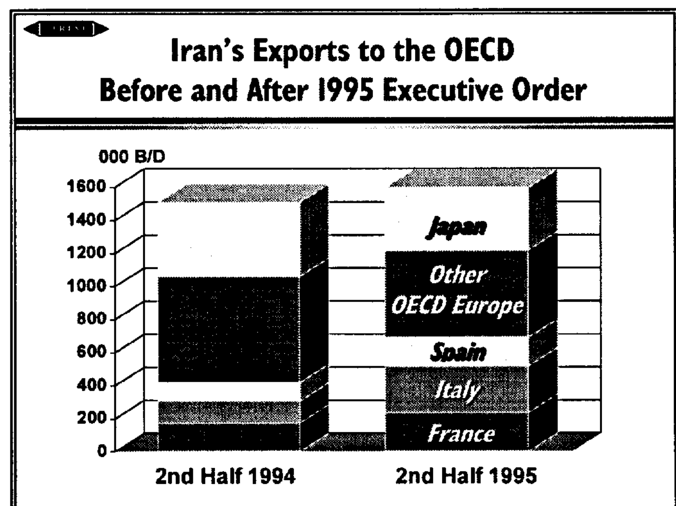


However, as long as the UN sanctions continue to keep Iraqi oil off the market OPEC's available spare capacity remains much lower than it was in 1990. It is currently around 3.5 million B/D. About 200,000 B/D of this total is located in Iran, currently the prime target of US advocates for multilateral sanctions.

Iran: Unilateral Ineffective; Multilateral Coerced?

Let us look at Iran. While neither current government policy nor the proposed Congressional legislation contains any direct measures to block Iranian oil exports to markets other than the US, the Congressional advocates of Iranian sanctions would clearly welcome such a development. The Administration is reserved in its support but has frequently expressed

Figure 2

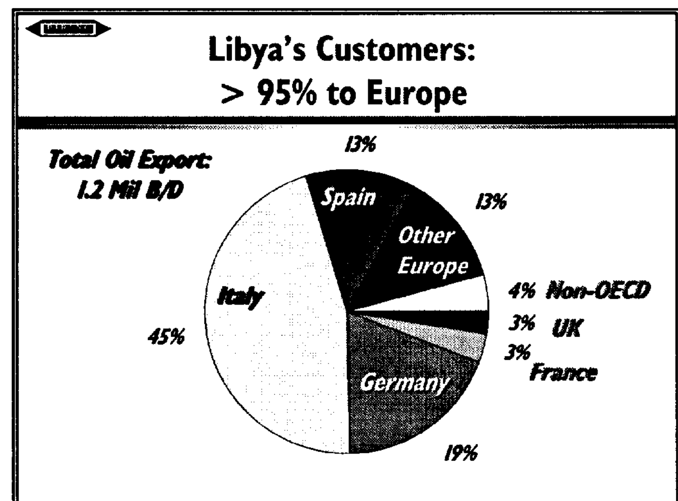


the hope that other countries will join the US embargo of Iranian oil exports to render it more effective by making it multilateral. Also, under H.R. 3107 currently under consideration in the House, any foreign company making significant future investments in the Iranian oil and gas sector may thereby be precluded from selling any oil or gas (or any other product) from anywhere to the US This could first and foremost affect TOTAL, the largest French oil company, which is currently investing in Iran and has large operations in the US The French government is unlikely to remain indifferent if this were to happen.

Libya: Interdependence with Europe

Libya, which was added to both the Senate and the House bill this year, currently exports about 1.2 million B/D. US companies played a major role in developing the Libyan oil industry from the 1950's until 1986 when they were barred by the US government from operating in Libya. Libyan imports into the US have been banned since 1982 as part of a US policy to isolate Libya because of its support of international terrorism. However, other countries did not go along with this US policy, then or now.

Figure 3



Because of its Mediterranean location, Libya has become Italy's largest and nearest oil supplier, currently accounting for 30% of Italy's total oil imports. Similarly, Italy is Libya's largest oil export market, while AGIP, Italy's national oil company, is a large producer in Libya as are the major French company Elf Aquitaine and several large German firms. AGIP also has an undersea natural gas pipeline project from Libya to Sicily under active consideration. These investments are currently slightly hampered for all companies in Libya by the UN Security Council's sanctions on air traffic to and from Libya and on shipments of certain oil pumping equipment to Libya.

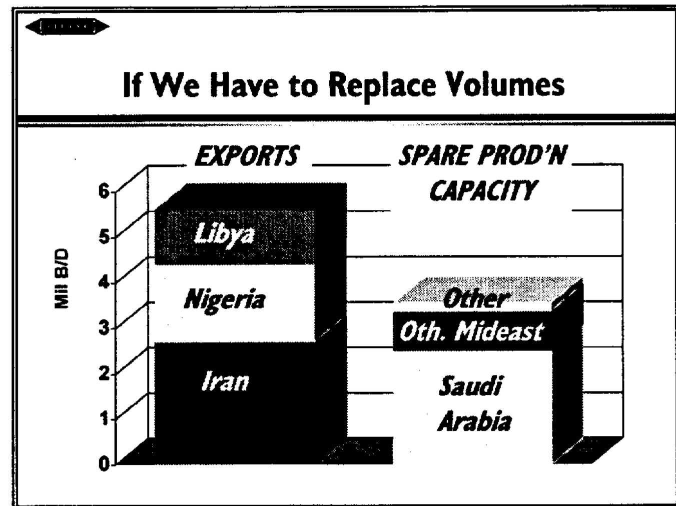
Economics and logistics clearly favor continuation of Italian investment in Libya's energy sector, and Italy and its European Union *confreres* have vociferously protested the US's planned imposition of secondary sanctions.

The Cost of Multilateral Sanctions

If exports from both Iran and Libya, which together total nearly 4 million B/D, were substantially curtailed by US legislation coercing our allies into a multilateral embargo-by-proxy while the Iraq sanctions are still on, it would take most of OPEC's remaining spare capacity (70% of which is in Saudi Arabia and 13% in Kuwait) to offset the loss. Even then there would

probably be a sharp price increase with all the attendant negative impacts on the balance of trade and inflation in the US and other oil importing countries, particularly in the developing world.

Figure 4



Yet, it is by no means certain that Saudi Arabia, Kuwait and the other OPEC members with spare capacity (there is virtually none outside OPEC) will actually make their capacity readily available to offset the loss in Iranian or Libyan exports. In 1990, the basis for the sanctions on Iraq was a UN Security Council resolution, as was the military action against Iraq. Saudi Arabia was part of the UN coalition and had good reason to belong to it because it felt threatened by Iraq's invasion of Kuwait. Saudi Arabia's and Kuwait's response to US-imposed sanctions on Iranian oil exports could be quite different, given the fact that Iran has not been charged with violating any UN convention nor is it viewed as a political "pariah" by most other countries, and is a member in good standing of OPEC. It should be recalled in this connection that even in 1990, several OPEC members initially opposed the idea of suspending production quotas to offset the loss of Iraq/Kuwait oil.

Thus, cumulatively, these sanctions could create supply constraints even if their impact on each targeted country is limited. This would certainly be the case under current and near-term market conditions. With oil stocks in the US and abroad exceptionally low and projected world demand rising about 2.5%, or 1.8 million B/D, for the remainder of this year as well as next year, according to the IEA, any significant extraneous supply reduction would have a disproportionate impact on prices. Such a development could also strengthen support for Iraq's position on the removal of sanctions. Any success in restraining Iranian and Libyan oil exports could generate pressure from importing countries to lift the sanctions on Iraqi exports as those consuming countries with no stomach for continued sanctions feel the pinch of increased oil prices.

Furthermore, under current market conditions any significant enforced export reduction will cause a disproportionate price increase. Hence, Iran's and Libya's loss in export revenue would likely be considerably less than their loss in export volume.

Of course, if and when the UN sanctions on Iraq are fully removed, Iraqi exports could offset almost any likely loss of Iranian and Libyan exports for several years. However, if the pace of the two-year negotiations over UN Resolution 986 (Humanitarian Aid) to export just 700 MB/D—about one-fifth of Iraq's export potential—is any indication, the removal of sanctions is a long way off. Thus, anyone advocating further constraints on oil exports must realize that for the time being, it would be additive to the embargo on Iraqi exports.

As I mentioned before, the proposed current sanctions legislation would not directly affect Iranian and Libyan oil exports but would aim to reduce future foreign *investments* in their oil and gas sectors. If passed in this form, the legislation would have little impact in the short term, i.e. the next several years, on the export levels and earnings of the two countries. Hence, they are unlikely to be coerced into changing their policies as a result of this legislation. However, world oil demand will continue to rise well into the next century. The latest EIA long-term forecast has in its Reference Case an increase of over 14 million B/D, a 2% annual growth rate, in world oil supply between 1995 and 2005. Thus, any effective externally-imposed restriction on production in these major exporting countries is likely to cause a tightening of *world* oil supplies, starting at the beginning of the next century, leading to disproportionate price increases. It should be pointed out in this connection that while the impact of the proposed investment constraints would take several years to make itself felt, it would also take several years to reverse it. Thus, there are long-term consequences of the oil sanctions policy currently under consideration in Congress. Eventually, if producer prices rise as a result of the imposed investment constraints, consumers will have to pay more for their oil products.

Nigeria: A Potential Candidate

I have put Nigeria last because, so far, there is no official US policy or proposal that would affect imports from, or investments in, Nigeria. But, as we have heard, there are loud exhortations from a number of activist groups in the US and Europe for sanctions on Nigerian oil exports.

If any form of oil sanctions are imposed on Nigeria, the impact on the US market and the US oil industry would be quite different from that on Iran or Libya. There are no US companies in these two countries and we have not imported any oil from them since the 1980s. By contrast, there are some 10 US oil companies in Nigeria, 5 of them field operators. Last year, Nigeria's total oil exports amounted to about 1.7 million B/D of which 750 MB/D, or 44% came to the US (including shipments to the US Virgin Islands), much of it to the East Coast. The reason is the quality of Nigerian crude. Its uniquely high yield of middle distillate is an important factor in meeting the region's heating oil and diesel fuel requirements. If it became unavailable it would cause a sharp temporary regional price rise.

Figure 5

US Crude Oil Imports from Nigeria, 1995

Importer	East Coast	Gulf Coast	Total
	Volume, in 000 B/D		
BP Oil Supply Company	125	60	185
Sun Company, Inc.	134	-	134
Phillips 66 Company	-	53	53
Shell Oil Company	-	41	41
Amoco Oil Company	3	38	41
Add'l Co's	31	135	166
Total to Continental US	292	327	620
Hess Oil Virgin Islands			130
Total US Imports			750

An effective *multi*lateral embargo on Nigerian oil exports, if it did take place, would cause sharp price increases worldwide for an extended period. A consideration in weighing a US embargo is

that Nigeria might retaliate by expropriating US oil properties and incorporate them into its national oil company.

As I said at the beginning of my talk, I am addressing here only the economic aspects of the sanctions debate. The economic casualties of US sanctions on Nigerian oil could well be the US oil companies rather than the Nigerian government.

Diversify Supply Sources

In conclusion I would like to reiterate the widely accepted precept that diversification of supply sources and peak maintenance of their productive capacity is good for importers since it reduces the risk and impact of supply disruptions. If this is so, is it really in our interest as the world's largest oil importer to actively pursue a policy of curtailing some of these supply sources?