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IRAQ'S INVASION OF KUWAIT: A FIRST VIEW

Comments of

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before the

Joint Economic Committee

of the United States Congress

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- **World oil exports have been reduced by 13% by the Iraqi invasion.**

World oil exports have been reduced by approximately 4 million B/D of crude oil and products as a result of the Iraqi invasion of Kuwait. This consists of Kuwait's total production of 1.5 million B/D, all of which has been shut in since the first day of the invasion, and probably most of Iraqi exports which amounted to 2.7-2.8 million B/D in the first four months of 1990. Along with the decline in oil exports the world has also lost about 700 MB/D of export refining capacity from Kuwait and 150 MB/D from Iraq.

- **Readily available and sustainable spare crude producing capacity by OPEC members other than Iraq and Kuwait is currently slightly less than the 4 million B/D loss in supplies, and not all of it is likely to be used. Without Saudi participation, incremental production may amount to only 1 million B/D.**

The gap could not be closed even if all available excess producing capacity were fully utilized and existing circumstances may make it unlikely that all excess capacity will actually be used. Before Monday's U.S. troop movements, there were questions whether Saudi Arabia, the country with the largest spare producing capacity, would be able to make its nearly 2 million B/D of current spare capacity available to its customers, given the apparent strong opposition to such a step by its aggressive, threatening neighbor. The U.S. presence may strengthen the Saudi resolve. It is also doubtful that the UAE, which is also under threat from Iraq, will increase its output to improve the supply situation and thereby weaken Iraq's position. Similarly, Libya, which has not voted to censure Iraq's invasion at the recent Arab League meeting, may not wish to take any action that would reduce the pain for Iraq's and Kuwait's customers.

Venezuela, on the other hand, the U.S.'s oldest oil trading partner, is likely to make available its excess capacity, which may amount to 500 thousand B/D. Additional volumes may also be available from Nigeria and some other countries. Thus, without Saudi Arabia, incremental production may amount to 1 million B/D, although it would not be of comparable quality to the lost volumes.

- **The low price elasticity of petroleum demand means that after the loss of Kuwaiti and Iraqi volumes on world markets, supply cannot be balanced with demand except through very substantial price increases. Even with the modest offset from incremental production, prices are likely to rise further if the situation does not improve.**

  Assuming that the boycott of Iraq (and Kuwait) continues into the fourth quarter and remains as successful as it appears to be now, the supply/demand imbalance will worsen. The fourth quarter traditionally has higher demand than the warm weather seasons, so the expected call on crude supplies was already above OPEC's recently announced quota level. Under normal conditions these supplies could have come from production or inventory withdrawals.

- **Oil inventories, high as they are, provide only limited relief to the production loss.**

  According to the International Energy Agency, OECD stocks on July 1 were 2.5 billion barrels. At 70 days of forward consumption they are at their highest level since the mid-1980's. However, the current draw on these stocks is likely to reflect the full volume of lost production. In addition, we have to consider the operating minimums, set by the logistics of the distribution system. In the United States, for instance, nearly 80% of current crude oil stocks are required minimum operating volumes.

- **Hence, the market may not be able to correct for the military market intervention of Saddam Hussein without wrenching dislocations. Some modest counteracting market intervention may therefore be necessary from the consuming country governments. In particular, a drawdown of strategic stocks should be considered.**

  Government-owned and compulsory stocks in the industrial nations equal 1.1 billion barrels, with about half of it in the United States. These stocks could be drawn down to offset part or all of the net loss in production. While the U.S. Strategic Petroleum Reserve could be withdrawn at a rate of 3.5 million B/D, our modest direct loss of supplies would dictate a much lower rate. Iraq and Kuwait were supplying 750 thousand B/D of oil to the U.S. Even a drawdown of this size would help calm the market. Since our refineries are operating at their effective maximum utilization rate, an SPR drawdown larger than the loss will back out crude imports, and hence could provide an additional calming effect for world markets. Europe was importing 1.2 million B/D from Iraq and Kuwait, and Japan, 500 thousand B/D. The net loss, of course, will be less, because of production increases as discussed above. Europe and Japan, too, should be encouraged to draw their strategic stocks, thus adding to world supplies, and minimizing the economic damage of the boycott.

▪The rapidly changing events in the area make it very difficult to predict market developments. This much can be said, however: the more successful the industrial countries are in curtailing Iraqi-controlled exports, the more it will hurt these countries. Over time, it will therefore become increasingly important to reduce the pain through a combination of higher oil production from other OPEC countries and the use of government stocks built up for precisely this disruption scenario.

The importance of this course of action goes beyond providing for consumer needs. If we can maintain the boycott, Saddam Hussein's Iraq, whose war-damaged economy is based entirely on oil production and exports, is bound to falter sooner or later.