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Economic Sanctions: Political Rationale and Economic Effect

Opening Remarks by
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You're probably wondering why I've been given such a visible, prominent role in this conference. I too was curious, until I realized that I've also been given only five minutes. I guess it was concluded that how much damage can he do in only 5 minutes - well let's see.

The Political Gravitational Pull Of Sanctions

I was invited to speak to a very distinguished gathering, and during a break a small group was discussing their academic achievements which included graduating with honors from such prestigious universities as Harvard, Yale, Oxford and Westpoint. Not wanting to be left out of this conversation I unintentionally blurted out that I had graduated university in only 3 terms. As soon as I said it I knew that I was in trouble and sure enough, each skeptically looked at me and in unison said, "Come on Larry, 3 terms?" "Absolutely, I said, "Johnson, Nixon and Ford".

Now, I can sense that some of your minds are working overtime here. Don't read too much into this, although I do admit that it's an interesting coincidence that none of these Presidents served a full elected second term. Strangely, six of our last seven Presidents fall into this category.

Speaking of politics, the issue of sanctions is likely to get caught up in the gravitational pull of the presidential election environment, and it will become increasingly difficult to distinguish between the parties. In what some have referred to as "political crossdressing," it's going to become increasingly difficult to tell the players - by the scorecard. We could get into a dangerous political game of leapfrogging with both the Congress and the Republican candidate trying to outdo the Administration. When examining the issue of sanctions it's important to be clear not only what it is you specifically want to achieve, but also how likely is it that you can achieve it and at what price. The dramatic growth in trade as a share of our economic activity makes sanctions an increasingly costly policy tool and will likely inflict more pain on us than the targeted country. Curiously the mere threat of sanctions may be more valuable than their implementation.

Sanctions - Less Than Meets The Eye

It is not surprising that when measured in this context that sanctions -- particularly unilateral sanctions -- have simply not been effective. What is surprising is that this still comes as a surprise to anyone. First, sanctions are typically applied by large industrial democracies against non-democracies, where leaders control, if not the hearts, certainly the minds, the airwaves, the information flow and just as important, the purse strings.

In the one place where there is general agreement that sanctions have worked -- Iraq -- I would argue that it wasn't sanctions *per se* but sanctions plus two very unique additional ingredients found virtually nowhere else that have brought about whatever successes we've achieved there.

The first is a little thing I refer to as a war which helped not only to destroy Iraq's military capability but a substantial amount of its economic infrastructure as well, something that sanctions alone would have taken years if not a decade to achieve and secondly, the right to randomly send outside inspectors into Iraq. Without these additions the "success" of even these sanctions would have been severely limited.

Sanctions And The Current Oil Environment

A cornerstone of U.S. energy policy is diversity of supply. Yet, we now have embargoes on Iraq, Iran and Libya. Who's next? Oil projects in newly emerging areas (Azerbaijan and Kazakhstan to name just two) are very capital intensive and have long gestation periods. They can require billions of dollars in up-front investment and take 5-10 years before substantial oil or gas starts to flow. Yet it is impossible to know over this time frame who your government's friends or enemies will be. Unfortunately, our government is showing an increasing propensity to use embargoes and sanctions as an everyday weapon in our foreign policy arsenal.

Any foreign project has to undergo market and country risk analysis. However, today, a new risk, unique to U.S. companies, must also be priced. A second country risk assessment: your own country. A proper pricing of this risk could render U.S. entities non-competitive in bidding for these foreign projects. Moreover, capital may not be as readily available to U.S. companies if lending institutions price this new risk as well. Accepting our government's assessment of who and what the foreign countries are, the question still remains: would our objectives be better served using private entities as buffers rather than bludgeoning tools of public policy?

Admittedly, if I have any expertise it's in the area of oil markets, so I'd like to say a few words about sanctions and oil before I turn the program to the people you've really come to listen to.

First, the oil markets are undergoing fundamental radical changes. As part of industry downsizing, global inventory management is moving towards a just-in-time inventory mind set. This is being led by the U.S. where commercial stocks are at record lows. The absence of a commercial cushion makes the market very vulnerable to "surprises." Secondly, spare productive capacity today is approximately half the level that existed during the 1980's.

The U.S. currently bans the imports of Iranian and Libyan oil and we've asked our allies to do the same. By coincidence Iranian production of 3.6 million b/d today matches our estimate of world spare capacity. Thus if we were successful in convincing our allies to embargo Iranian oil (forget Libya and possibly Nigeria for a moment) the entire spare capacity would be wiped out overnight even if all other producers with spare capacity agreed to immediately fully increase their output (an optimistic assumption). Under such a scenario you would get an instantaneous sharp increase in crude oil prices, as companies attempt to build up inventories' including a return to a speculative nature to inventory management followed by a small blip in inflation and a reduction in economic activity.

Thus, under the heading of what I've referred to as "Be Careful What You Wish For..."

BE CAREFUL WHAT YOU WISH FOR....

Be careful what you wish for
I'm told the saying goes,
For you just might get your wish
And what you reap you'll sow.

Oil as a political weapon
Is not we're told P.C.
Yet, this type of legislation could result
In a ban on some VLCC's*.

At least that is the oil that
Comes to us from far off lands
Particularly the oil that flows
From Arab & Moslem sands.

A ban on Teheran
Sounds about right,
Yet, this would create an imbalance
and shortfall overnight.

Prices would jump at the retail pump
Creating a political fuss,
Forcing our Fed. Chairman
To do then what he must.

So be careful what you wish for,
For it just might come true.
And then the prospects of a soft landing
Would fall to less than one in two.

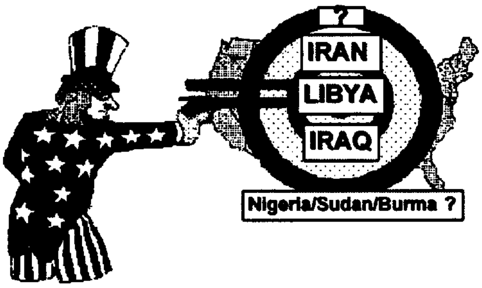
Who's next you ask?
I do not know,
But the answer will come with time.

Lagos, Algiers,
Beijing, Tangiers,
May one day queue the line!

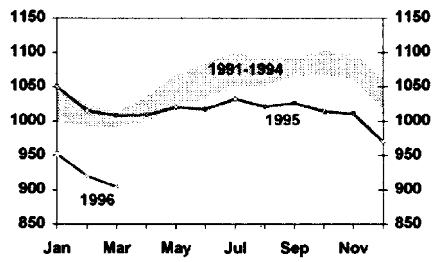
* Very large crude carriers

LJG

Do Sanctions Hit the Mark?



U.S. Commercial Stocks



OPEC Spare Capacity
(MMB/D)

	LATE 1980's	CURRENT
SPARE	7.1	3.6

	PRODUCTION - CURRENT
IRAN	3.6
LIBYA	1.3
NIGERIA	2.0