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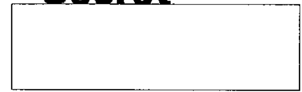
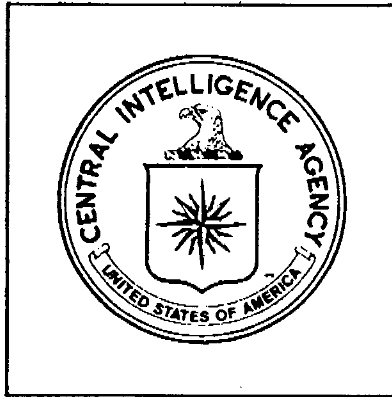
TAB 25X1





THE ARAB OIL CUTBACK AND HIGHER PRICES: IMPLICATIONS AND REACTIONS

Secret

19 October 1973

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A. The Oil Weapon and Its Effects

On 17 October the Organization of Arab Petroleum Exporting Countries (OAPEC) decided to cut oil production.

- Production will be reduced by not less than 5% a month until an Israeli withdrawal from occupied territories is completed and the "legal rights" of the Palestinians are restored;

- The Arab countries also promised to maintain oil deliveries to "friendly" countries that give Arabs "effective material help"; and

- Threatened a total embargo of countries that used their armed forces to aid Israel.

Many parts of the statement were left deliberately vague in order to allow each Arab country a degree of freedom to act according to its own best interests. This ambiguity – similar to that of OPEC decisions in the past – is intended to give the OAPEC agreement greater durability by giving each country greater flexibility. All of the states are obliged to cut production by 5% a month, but the way is open for some to make larger cuts. The Arabs did not define those "friendly" countries that will continue to receive normal imports from the Arab World. They probably will cut back shipments to neutral states such as the United Kingdom and Japan and may cut back shipments to such states as France and Italy that are "tilting" their neutrality toward the Arabs. In any event, the final interpretation of the definition is left to the individual producing country.

At least in the first months, the Arab monthly production cutback will probably be between 5% and 10%, but closer to the 5% rate. Saudi Arabia has reportedly already cut current production by 10%. Some other countries – such as Iraq, which is unable to export most of its production because of the closure of eastern Mediterranean ports – may make a virtue of necessity and make very large initial cuts. An all-Arab cutback of between 5% and 10% would represent a loss of between one million and two million barrels per day (b/d).

Several countries, including Libya, Abu Dhabi, Kuwait, and Saudi Arabia, have either announced or threatened a total embargo against the United States. However, the United States receives only about 1.6 million b/d of Arab oil (including products refined in Europe and the

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Caribbean). Thus, even if the embargo were effective, the effect on the United States would be relatively small, and, after the first month, the brunt of the cutback would fall on Europe and Japan. Moreover, the US companies that produce most Middle East oil might be able to shift supplies among themselves to avoid the embargo. The companies would, of course, hesitate to do this for fear of jeopardizing their relations with the producing countries as well as with Western Europe and Japan.

It seems inevitable that Western Europe and Japan will bear the brunt of the progressive cutbacks. Western Europe is dependent on Arab oil for 70% of its consumption, and Japan depends on the Arabs for 40% of its supply. The producer states recognize that it is "unjust" to punish Europe and Japan more severely than the United States, but see no other alternative. The Saudis have informed representatives of the major West European nations that they will be expected to pressure the United States. They have also suggested to the Japanese that they make a statement before the UN General Assembly to the effect that Japan desires an early settlement to the war and that it supports the Arab position.

From the point of view of United States vulnerability, it is perhaps fortunate that this particular crisis occurred now rather than a few years hence. It had been predicted that we would be importing nearly 5 million barrels per day of Arab oil or 21%-22% of our consumption by 1980. With this level of exports an Arab cutoff would severely affect our economy. Even now there are domestic as well as foreign pressures for policy changes as a result of the current cutoff. In any event, the rapid increase in the price of imported oil should dampen our consumption and make other domestic energy sources more attractive, for example oil from Colorado shales and coal gasification.

Although the West European countries are attempting to form a common position regarding the oil cutback, division tendencies may prove too strong. Joint contingency plans exist, but, because of the different countries' different views of their own advantage, the plans may not be used efectively. Individual countries also have developed plans for dealing with a crisis on a national basis. Some reportedly are updating rationing systems worked out during earlier crises and have stocks of rationing books ready for distribution. At the same time, a few European countries, notably France, still entertain hopes that the Arab oil production cutback will not apply to them.

The immediate impact from war damage and production cutbacks will vary considerably among EC members. The shutdown of three eastern Mediterranean pipelines already has dropped Italy's oil imports by some

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24% and France's by 14%, while affecting other members' imports only moderately or not at all. Because of the large difference in shipping distances, those nations such as West Germany that depend most heavily on North African oil will feel the pinch of a production cutback much sooner than those such as the Benelux countries that depend on Persian Gulf supplies (see the table). Italy already has imposed an embargo on refined oil exports outside the EC – a move detrimental to US supplies that may be emulated by other Community members if the supply situation worsens.

Over the next few months, the impact of reduced oil imports will be partly mitigated by reserve stocks maintained by the EC nations. All have about a two-month supply on hand, and France reportedly has a 90-day reserve. Arab oil, however, accounts for between 63% and 78% of EC members' oil imports and a similar share of their total consumption. As a result, a 5%-10% cumulative monthly reduction in production by the Arab states, together with already interrupted pipeline deliveries, would soon force EC nations to draw heavily on reserve stocks. If current consumption levels were maintained, these reserves might be depleted within six months, and total available supplies could be reduced to one-half of normal. Conservation measures could delay the depletion of reserves by at most another few months.

EC Nations' Dependence on Arab Oil, by Source, 1972

Percent of Total Imports

	Persian Gulf by Pipelines (Now Inoperative)	North African by Tanker (7-day Delivery)	Persian Gulf by Tanker (35-day Delivery)	Total Arab Crude
Italy	24	19	26	69
France	14	18	46	78
United Kingdom	5	15	48	68
West Germany	4	39	29	72
Benelux	6	4	53	63
Denmark	....	1	66	67

The Effects of a 5% Cutback Over Time

The following 5 graphs show the cumulative effects of a five percent all-Arab production cutback on the United States, Western Europe, and Japan under different conditions.

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Clearly such a production cutback, if it persisted for a number of months, would require some belt tightening. But, the analysis shows that by moderate belt tightening and drawing down existing stocks of petroleum, we can avoid a serious crisis this winter. This posture is illustrated best by Figure 5, which shows that a 5% reduction in consumption in the United States and a 10% reduction in consumption in Western Europe and Japan, together with stock drawdowns and a 300,000 barrel per day combined, surge in the United States and Venezuelan production, even Western Europe and Japan would not face a real crisis for some time.

This does not mean that there would not be dislocations and regional problems in the United States as well as in Western Europe. For example, heating oil problems in the United States east coast would worsen somewhat.

Moreover, the United States would come under considerable pressure to share to some extent with Western Europe and Japan if they should come to believe that their supplies were to be cut back for several months. In this event our own belt tightening might have to be greater than the 5% shown in the illustration.

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Figure 1

Time Paths of Consumption, Under No Sharing, No Stock Withdrawals, No Rationing, and a Five Percent per Month Cutback in OAPEC Exports

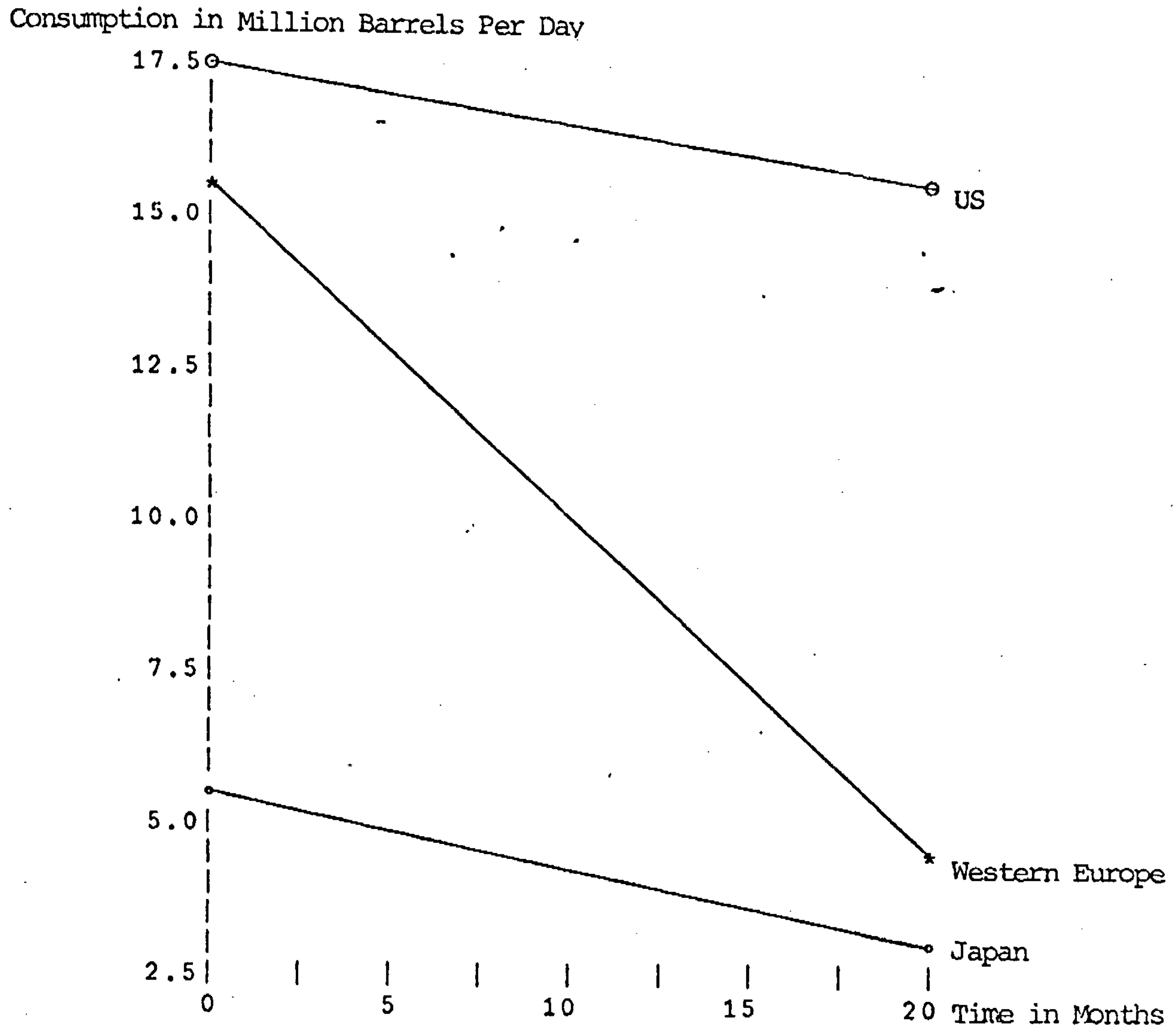

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Figure 2

Time Paths of Consumption, Under Consumption Sharing, No Stock Withdrawals, No Rationing, and a Five Percent per Month Cutback in OAPEC Exports

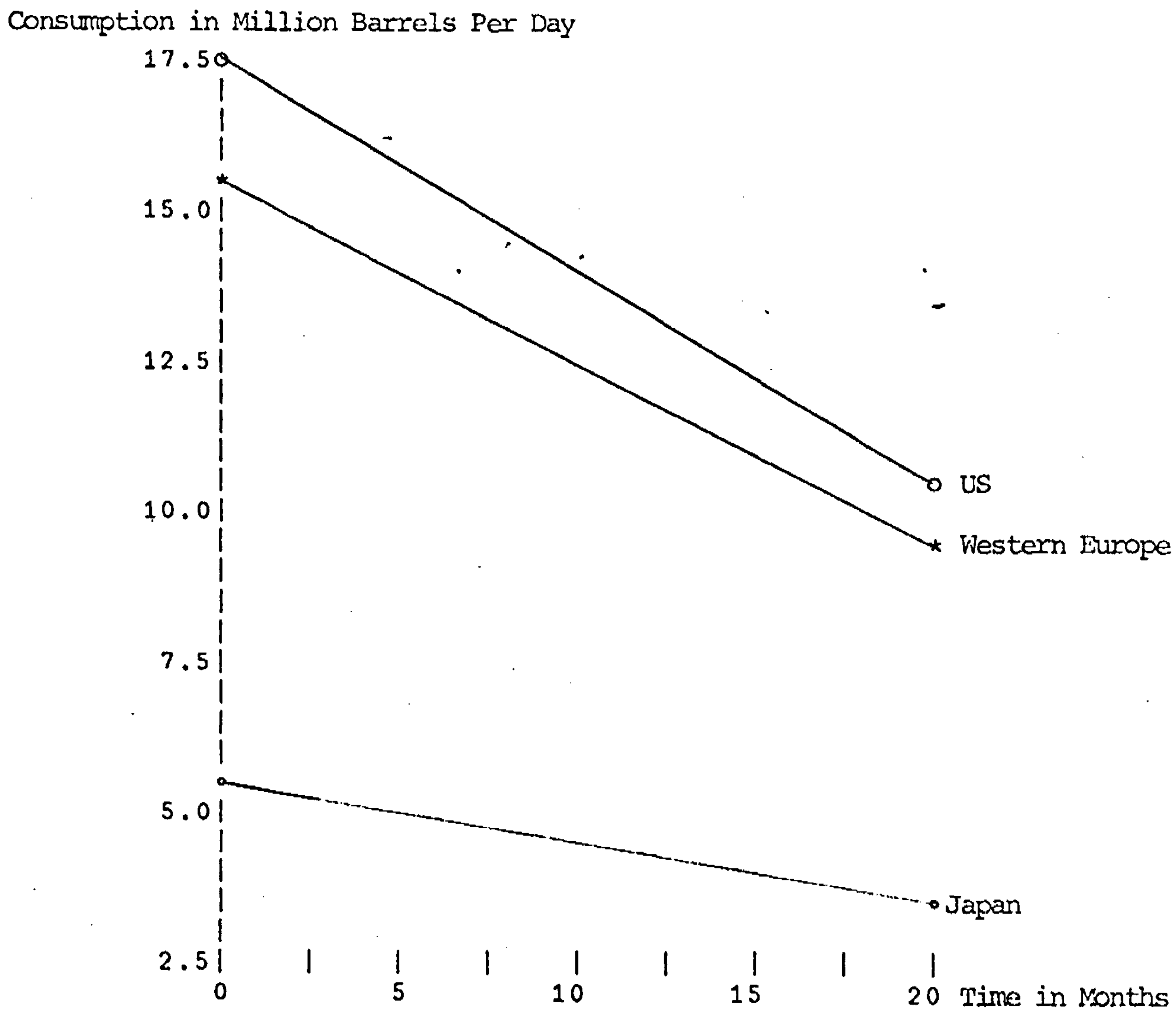

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Figure 3

Time Paths of Consumption, Under Import Sharing, No Stock Withdrawals, No Rationing, and a Five Percent Cutback per Month in OAPEC Exports

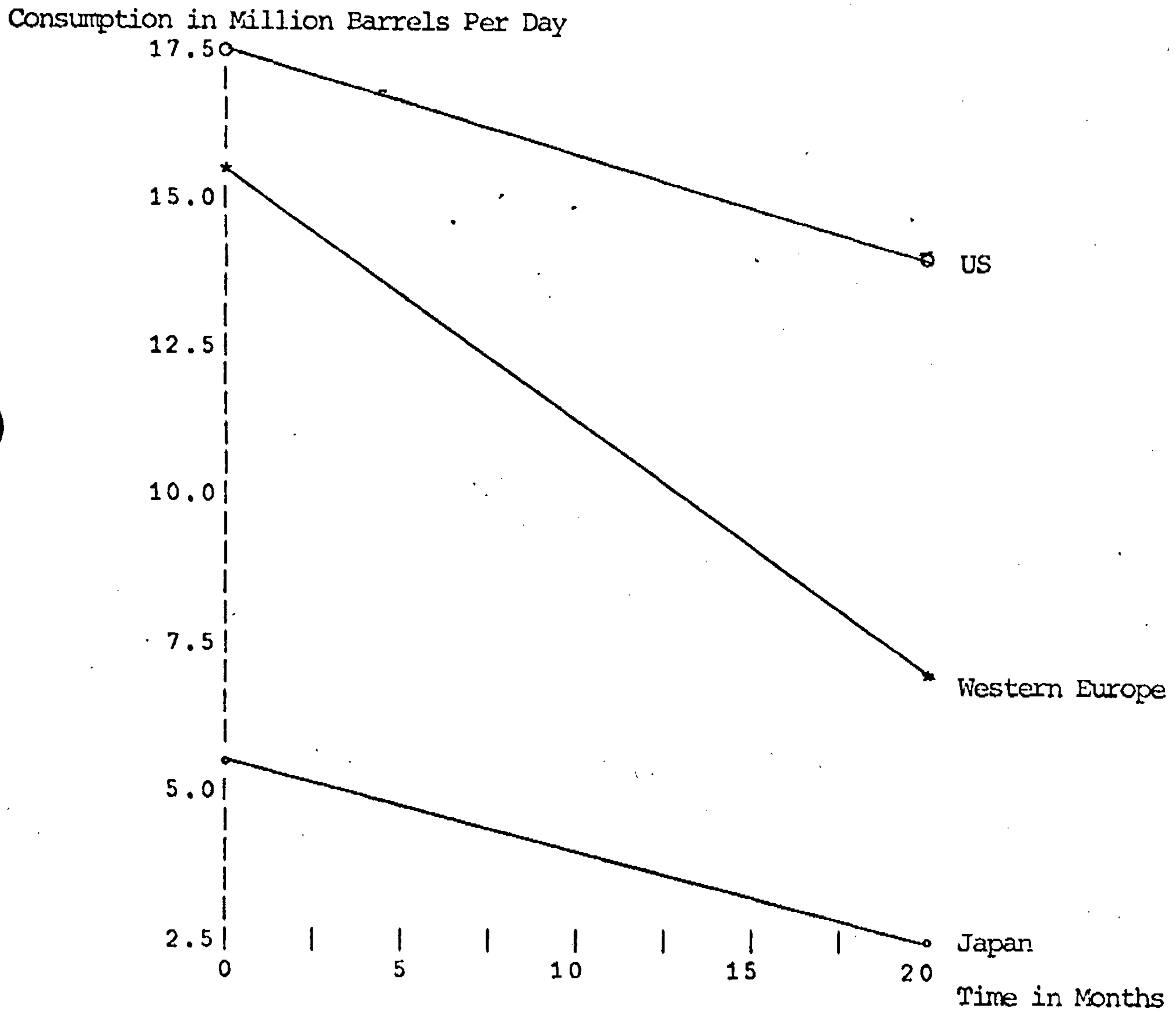

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Figure 4

Time Paths of Consumption, Under No Sharing, Stock Withdrawals to Cover Import Losses Until Stocks are Depleted, No Rationing, and a Five Percent per Month Cutback in OAPEC Exports

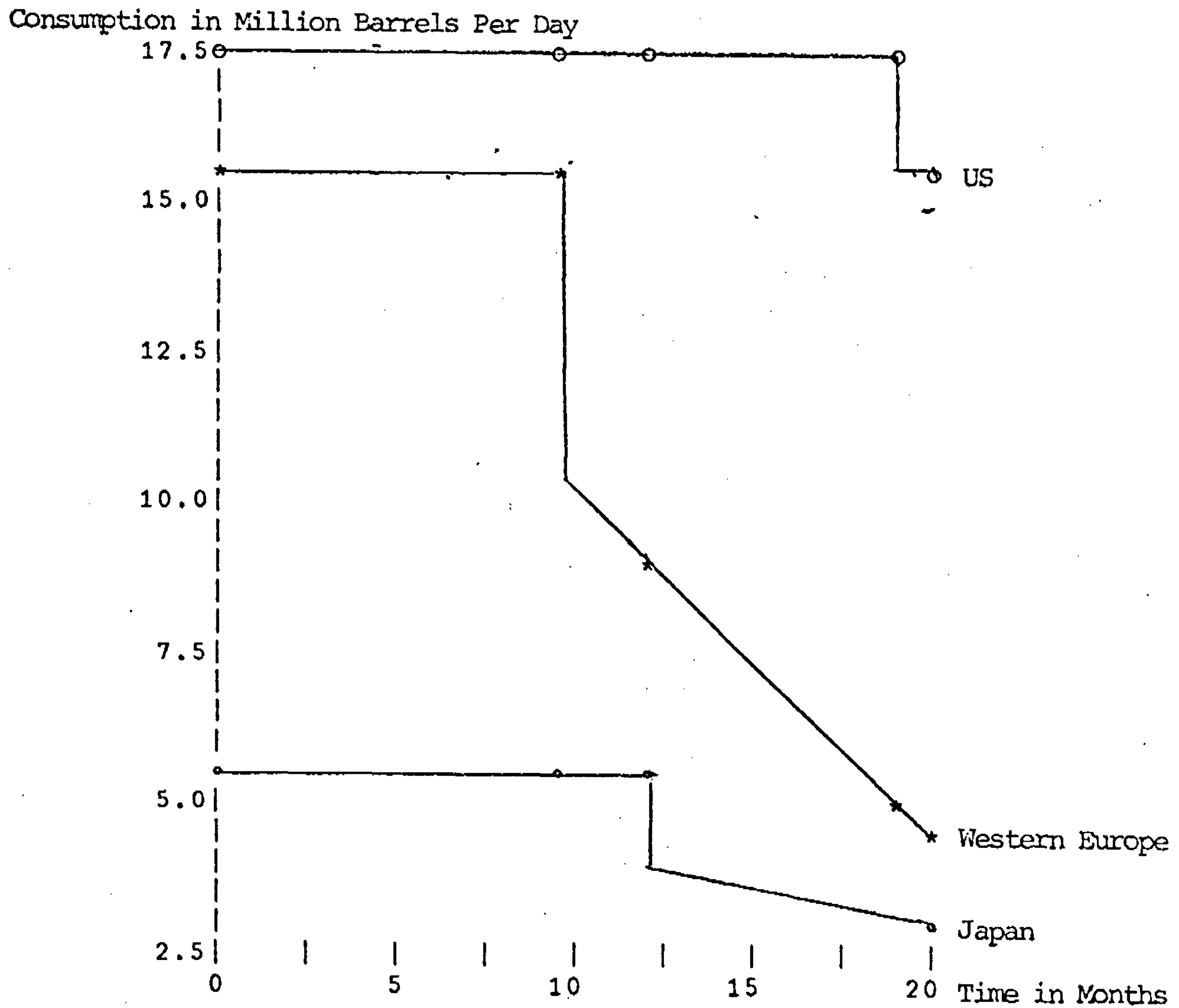

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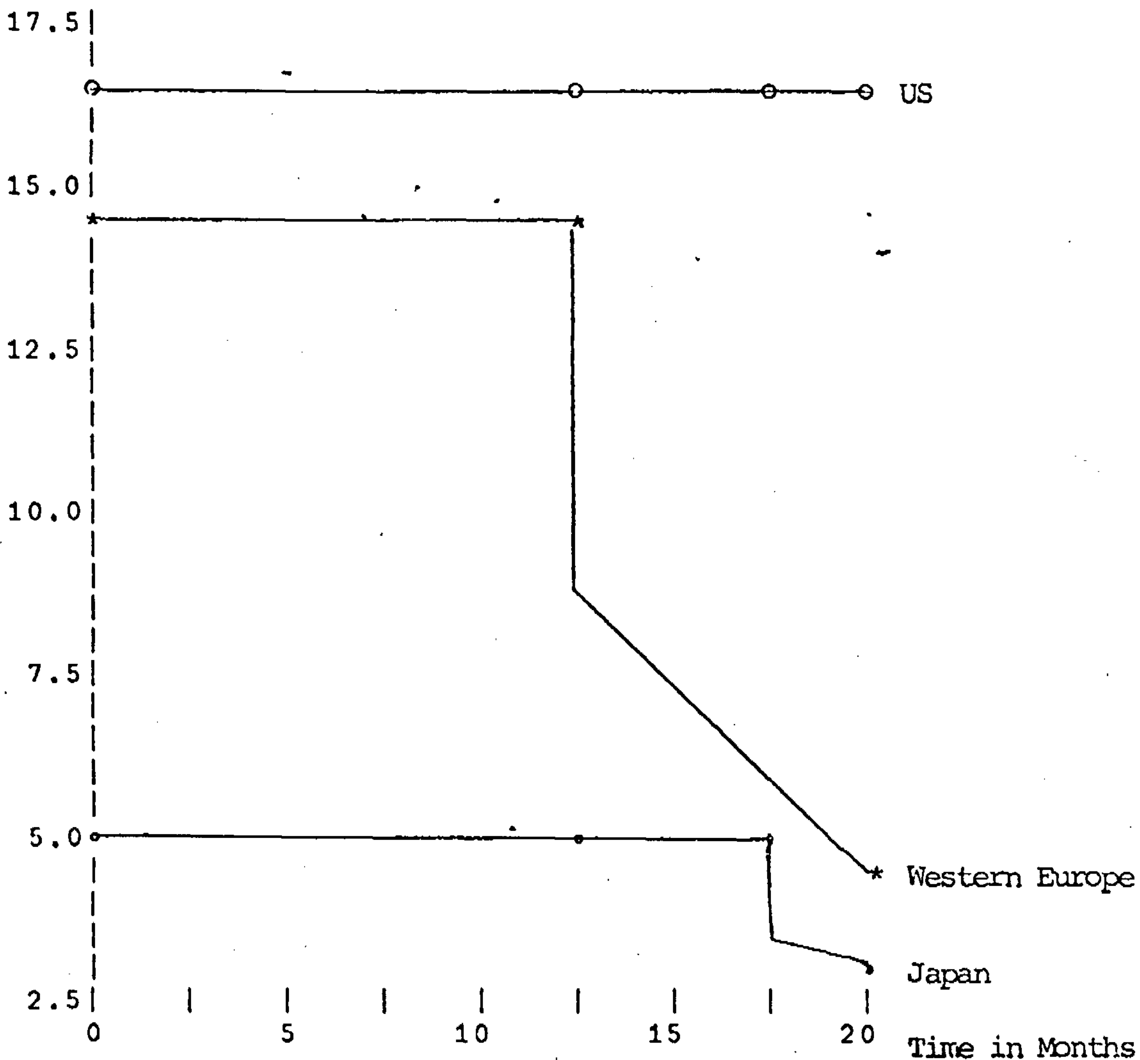
Figure 5

Time Paths of Consumption, Under No Sharing, Stock Withdrawals to Cover Import Losses Until Stocks are Depleted, 300,000 Barrels Per Day Surge in US Production, Five Percent Reduction in US Consumption, Ten Percent Reduction in European and Japanese Consumption, and a Five Percent per Month Cutback in OAPEC Exports



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B. The Impact of Increased Oil Prices

The increase in oil prices will be felt primarily in the United States, Japan, and Western Europe. The oil import bills of the United States and Japan will each increase by about $3 billion, while the additional cost to Western Europe will approach $8 billion. This assumes that deliveries from the Gulf will continue as scheduled prior to the announcement of production limitations.

- The oil price rise will turn an expected $1 billion or so 1974 US trade surplus into a roughly $2 billion deficit

- The Canadian trade balance will be virtually unaffected because Canadian oil imports are roughly equal to exports

- Japan, which imports about 43% of its oil from the Arab countries, will have a 1974 surplus of about $3 billion, compared with a previous estimate of $6 billion.

- The West Germans will pay an additional cost of about $1.8 billion – the highest in Europe – but they will feel the least hardship because their 1974 trade surplus will be on the order of $8 billion.

- Petroleum imports will push the UK trade deficit from about $3.5 billion to almost $5 billion.

- The OPEC action will add $1.5 billion to the oil import bill of both France and Italy. The price increases will reduce the French surplus to near zero. Italy's small deficit in 1973 was expected to narrow further but should now be in the $1.5 billion-$2 billion range.

Some of the impact of higher oil prices in the consuming countries will be offset by greater repatriation of oil company profits and larger exports to the producers, generated by their greater export income. Only part of the worldwide producer revenue increases of $15 billion will be spent, however. The 1974 oil revenues of Saudi Arabia, Abu Dhabi, Qatar, and Kuwait will approach the amounts recently estimated for 1980. These countries have only limited absorptive capacities.

Although the trade balances of the oil importers will deteriorate sharply, the impact on their domestic economies will probably be slight. Oil imports do not compete with domestic production so there should be no initial offsetting loss in jobs. The consuming countries' non-petroleum trade and production will essentially be the same as before the oil price

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increase. Moreover, the sharp rise in crude oil prices should not significantly increase the price of finished goods.

The use to which the oil producers put their reserves could have an appreciable impact on the international exchange rate system and, through the exchange system, ultimately on the volume of exports and imports. If, for example, the producers decide to hold most of their increased receipts in dollars, the dollar will strengthen in exchange markets. A dollar appreciation means more expensive – and therefore reduced – US exports. In effect, the oil producers will be converting their trade surpluses with other consumers into trade surpluses with the United States; or, in another view, the US trade account with Japan, Canada, and Western Europe will deteriorate by the amount of the increase in their oil import bills.

As the oil producers' reserves increase, their threat to exchange markets will also increase. The Arab oil states already have enough liquid foreign assets – around $5-$7 billion – to temporarily disrupt currency markets. Although there is no evidence of any substantial dollar sales during the current crisis, and an attack on the dollar would result in the depreciation of the Arabs' own reserve holding, it is not inconceivable that – if the political and military situation becomes increasingly unacceptable to them – the Arab leadership would move against the dollar. On Thursday, Libya publicly called for concerted Arab dollar sales and withdrawal of deposits from US banks.

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C. Foreign Reaction

Western Europe

There is very little the West Europeans can do in the near term to get their oil deliveries back to strength. They will, of course, continue to distance themselves from Washington's present Middle Eastern policy -- in speeches, in UN votes, and in the denial of overflight and refueling rights for US military aircraft. But no European leader expects such behavior to cause Washington to rethink its position or entirely to save Europe from the effects of the oil embargo. Indeed, the West Europeans probably are overly conscious of their impotence to influence the present situation; they are more inclined to "keep their heads low" in the hope of warding off still greater threats to their energy supply.

At the moment, the West Europeans are eager to discuss oil problems with the United States, hoping naturally that the United States will agree to share supplies (and shortages). But if such agreements are not forthcoming from Washington -- and if oil shortages begin to bite severely -- the Europeans would try at least to keep all the oil they can get for themselves by reducing or eliminating their exports of refined oil to the United States. In such a scramble, they would be more likely to act unilaterally than on a joint European-wide basis.

There is some inconsistency between the European desire to minimize association with US political policy in the Middle East crisis and European awareness that some form of cooperation arrangement for coping with oil shortage must necessarily involve US-European conversation. This inconsistency is both real and apparent. The Europeans will try to resolve it insofar as they can, by working for quiet talks within OECD forum on oil matters, while avoiding political initiatives unless and until the time seems ripe for a mediation role that would not alienate the Arabs.

Over the longer run, the present experience will further encourage the West Europeans to decrease their reliance on the major oil companies and to develop instead their own arrangements with oil producing governments. They would focus on offers of government-to-government agreements that would involve European technical assistance in return for supply commitments, and possibly trade preferences for oil producing states. An obvious side effect of such a policy would be lessened European willingness to join in consumer cooperation schemes on terms favorable to the United States or -- depending on US-Arab relations in the postwar world -- be associated with the United States in oil cooperation schemes on any terms at all.

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Japan

The Japanese have always sought to avoid taking sides in contentious situations involving Middle East oil. In the last year, the Japanese have refused to join an oil consumers organization, for fear of antagonizing the oil producers in OPEC. There has been an ongoing debate in Japan for some time over the merits of multilateral versus go it alone approaches to assuring oil supplies.

Japan's policy in regard to the present petroleum supply situation rests almost entirely on the hope that the current Middle East crisis can be defused before severe sanctions are enacted by the Arabs. Tokyo is being urged by the Arab states, with Saudi Arabia taking the lead, to issue an official statement supporting the Arab position in the current conflict. The Arabs have avoided accompanying such requests with threats of a serious disruption in the flow of oil to Japan. Nevertheless, the implied threat of economic blackmail has not been lost on the Japanese. The Japanese are extremely reluctant to abandon their neutral position on the Middle East primarily because of the serious impact such a step would have on relations with the United States, in particular with regard to existing plans for bilateral cooperation in the field of energy-petroleum sharing. Foreign Minister Ohira, on 19 October, sought to sidestep an Arab request for direct political support when he told a group of Arab envoys that Japan favors settlement through the United Nations and noted that Japan supported the 1967 Security Council resolution calling for Israeli withdrawal from occupied Arab territory.

Tokyo's political tightrope walk will have difficulty surviving an indefinite prolongation or heightening of Arab pressure. If backed to the wall by credible Arab threats of a cut off of oil, the Japanese will probably give in. As a contingency measure, the Japanese Government is already studying drafts of a statement supporting the Arab position that could be used in such a forum as the UN General Assembly. But Japan would first make a last ditch effort to secure assistance from the United States in the form of diversion of some US oil supplies to Japanese needs.

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ANNEX

Selected Tables

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Estim[illegible] World Oil Trade a/, 1973

Thousand Barrels Per Da[illegible]

	Total Consumption	Domestic Production	Total Imports	Total Arab	Saudi Arabia	Abu Dhabi	Kuwait	Iraq	Libya	Algeria	Other Arab	Iran	Venezuela	Indonesia	Canada	Nigeria	Others
United States	17,300	10,900	6,300	1,600	600	150	150	50	350	150	150	400	2,000	250	1,100	550	400
% of Consumption	100	63.0	36.4	9.2	3.5	0.9	0.9	0.3	2	0.9	0.9	2.3	11.6	1.4	6.4	3.2	2.3
Western Europe	15,500	400	16,000 b/	11,300	4,350	600	1,750	1,300	1,700	750	850	1,900	500	Negl.	0	1,250	1,050
% of Consumption	100	2.6	103	72.9	28.1	3.9	11.3	8.4	11.0	4.8	5.5	12.3	3.2	Negl.	0	8.1	6.8
Japan	5,400	Negl.	5,400	2,300	1,250	300	650	50	Negl.	0	50	2,050	Negl.	900	0	Negl.	150
% of Consumption	100	Negl.	100	42.6	23.2	5.6	12.0	0.9	Negl.	0	0.9	38.0	Negl.	16.7	0	Negl.	2.[illegible]
Canada	1,750	1,850	900	150	50	50	Negl.	Negl.	50	0	Negl.	150	450	0	0	100	5[illegible]
% of Consumption	100	106	51.4	8.6	2.9	2.9	Negl.	Negl.	2.9	0	Negl.	8.6	25.7	0	0	5.7	2.[illegible]
Sub-Total	39,950	13,150	28,600	15,300	6,250	1,100	2,550	1,400	2,100	900	1,050	4,500	2,950	1,150	1,100	1,900	1,6[illegible]
% of Consumption	100	32.9	71.6	38.3	15.6	2.8	6.4	3.5	5.3	2.2	2.6	11.3	7.4	2.9	2.8	4.8	4.
Communist Area	9,850	9,300	500	400	Negl.	Negl.	0	200	100	50	50	100	0	0	0	0	0
% of Consumption	100	94.4	5.1	4.1	Negl	Negl.	0	2.0	1.0	0.5	0.5	1.0	0	0	0	0	0
Others	7,200	34,550	4,900	2,850	1,750	50	550	300	0	150	50	1,100	450	100	0	100	30[illegible]
% of Consumption	100	480	68.1	39.6	24.3	0.7	7.6	4.2	0	2.1	0.7	15.3	6.2	1.4	0	1.4	4.
TOTAL	57,000	57,000 c/	34,000	18,600	8,000	1,150	3,100	1,900	2,200	1,100	1,150	5,700	3,400	1,250	1,100	2,000	1,9[illegible]
% of Consumption	100	100	59.6	32.6	14.0	2.0	5.4	3.3	3.9	1.9	2.0	10.0	6.0	2.2	1.9	3.5	3.

a. Table allocates imports on direct and indirect basis, i.e., refined products from export refineries are traced to source of crude. The estimates are yearly average for 1973 and therefore differ from point in time estimates. For example, US dependence on Arab oil has increased through the year and nearly 2 million b/d in October.

b. Western Europe's oil imports exceed consumption because it exports substantial quantities of oil outside Europe.

c. Includes US production of natural gas liquids of 1.7 million b/d.

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Estimate[redacted]d Oil Trade a/, 1973

Thousand Barrels Per Day

	Total Consumption	Domestic Production	Total Imports	Total Arab	Saudi Arabia	Abu Dhabi	Kuwait	Iraq	Libya	Algeria	Other Arab	Iran	Venezuela	Indonesia	Canada	Nigeria	Others
ited States	17,300	10,900	6,300	1,600	600	150	150	50	350	150	150	400	2,000	250	1,100	550	400
of Consumption	100	63.0	36.4	9.2	3.5	0.9	0.9	0.3	2	0.9	0.9	2.3	11.6	1.4	6.4	3.2	2.3
stern Europe	15,500	400	16,000 b/	11,300	4,350	600	1,750	1,300	1,700	750	850	1,900	500	Negl.	0	1,250	1,050
of Consumption	100	2.6	103	72.9	28.1	3.9	11.3	8.4	11.0	4.8	5.5	12.3	3.2	Negl.	0	8.1	6.8
pan	5,400	Negl.	5,400	2,300	1,250	300	650	50	Negl.	0	50	2,050	Negl.	900	0	Negl.	150
of Consumption	100	Negl.	100	42.6	23.2	5.6	12.0	0.9	Negl.	0	0.9	38.0	Negl.	16.7	0	Negl.	2.8
nada	1,750	1,850	900	150	50	50	Negl.	Negl.	50	0	Negl.	150	450	0	0	100	50
of Consumption	100	106	51.4	8.6	2.9	2.9	Negl.	Negl.	2.9	0	Negl.	8.6	25.7	0	0	5.7	2.9
b-Total	39,950	13,150	28,600	15,300	6,250	1,100	2,550	1,400	2,100	900	1,050	4,500	2,950	1,150	1,100	1,900	1,650
of Consumption	100	32.9	71.6	38.3	15.6	2.8	6.4	3.5	5.3	2.2	2.6	11.3	7.4	2.9	2.8	4.8	4.1
mmunist Area	9,850	9,300	500	400	Negl.	Negl.	0	200	100	50	50	100	0	0	0	0	0
of Consumption	100	94.4	5.1	4.1	Negl	Negl.	0	2.0	1.0	0.5	0.5	1.0	0	0	0	0	0
thers	7,200	34,550	4,900	2,850	1,750	50	550	300	0	150	50	1,100	450	100	0	100	300
of Consumption	100	480	68.1	39.6	24.3	0.7	7.6	4.2	0	2.1	0.7	15.3	6.2	1.4	0	1.4	4.2
OTAL	57,000	57,000 c/	34,000	18,600	8,000	1,150	3,100	1,900	2,200	1,100	1,150	5,700	3,400	1,250	1,100	2,000	1,950
% of Consumption	100	100	59.6	32.6	14.0	2.0	5.4	3.3	3.9	1.9	2.0	10.0	6.0	2.2	1.9	3.5	3.4

a. Table allocates imports on direct and indirect basis, i.e., refined products from export refineries are traced to source of crude. The estimates are a yearly average for 1973 and therefore differ from point in time estimates. For example, US dependence on Arab oil has increased through the year and is nearly 2 million b/d in October.

b. Western Europe's oil imports exceed consumption because it exports substantial quantities of oil outside Europe.

c. Includes US production of natural gas liquids of 1.7 million b/d.

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Economics of the Persian Gulf OPEC[a] Price Increase

16 October 1973

($/barrel)

Company Owned Crude Oil (75%)	1 Oct 73	New Demand	Percent of Increase
1. Posted Price[b] (Saudi Arabian Light 34°)	3.011	5.11	69.7
2. Royalty (12½% of 1.)	.376	.64	
3. Production Cost	.10	.10	
4. Tax Reference "Profit" 1-(2+3)	2.535	4.37	
5. Tax (55% of 4)	1.394	2.40	
6. Government Revenue (2+5)	1.77	3.04	71.8
7. Cost to Oil Company (3+6)	1.87	3.14	67.9
8. Estimated Oil Company Profit	.35	.35	
9. Estimated Sales Price (fob) (7+8)	2.22	3.49	57.2
10. Estimated Transportation Cost[c] (to US Gulf Coast)	1.48	1.48	
11. US Import Duty	.105	.105	
12. Estimated Sales Price (cif, US Gulf Coast)	3.805	5.075	33.4
Government Owned Crude Oil (25%)			
Oil Company Purchases of Government-Owned (22.5%)	2.30	3.65	58.7
Government Oil Sales to Third Parties (2.5%)	3.12	3.65	17.0

a. The Persian Gulf members of OPEC are: Abu Dhabi, Iran, Iraq, Kuwait, Qatar, and Saudi Arabia. Other members of OPEC are Algeria, Indonesia, Libya, Nigeria, and Venezuela. The members of the Organization of Arab Petroleum Exporting Countries are: Abu Dhabi, Algeria, Bahrain, Iraq, Kuwait, Libya, Egypt, Qatar, Saudi Arabia, and Syria.

b. Posted price and tax reference price are synonymous terms.

c. Calculation based on tanker rates of Worldscale 100 which is a representative average, although spot tanker rates are currently much higher; they account for only a small fraction of the oil being transported.

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The shutdown of the three eastern Mediterranean pipelines which mainly serve southern Europe has reduced Europe's oil supplies by about 2 million b/d. Based on very limited information, the following is our best estimate of the destination of crude oil from the closed pipelines:

Destination	Volume (b/d)
Western Europe	1,700,000
Italy	600,000
France	375,000
Benelux	150,000
United Kingdom	100,000
Greece	100,000
West Germany	75,000
Spain	50,000
Portugal	50,000
Turkey	50,000
Austria	50,000
Others and Unidentified Western Europe	100,000
Communist countries	200,000
Romania	50,000
Bulgaria	50,000
USSR	50,000
Other Communist countries	50,000
Other Countries	100,000
TOTAL	2,000,000

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