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OPEC: Iraqi Intimidation and Implications for Oil Prices

Summary

Largely with the help of Iraqi intimidation, OPEC's new agreement represents potentially its strongest accord since oil prices collapsed in 1986. Each member seems to have a quota that it can live with--both politically and economically--for the time being. Most members have already given solid commitments to honor the agreement and several--including Kuwait and Saudi Arabia--have already begun to cut production. Moreover, current oil market conditions suggest that oil prices will likely rise toward the cartel's price target of $21 per barrel by yearend, as long as OPEC holds down production. Another factor likely to help prop up prices in the months ahead is the bullish market psychology that has emerged in recent weeks. [redacted]

More ominous for Western oil consumers is the prospect of continued Iraqi pressure on OPEC to raise oil prices substantially. Largely as a result of Baghdad's recent aggression, OPEC has shifted its emphasis from expansion of market share to one supporting higher prices. The other Gulf Arab producers-[redacted]*-may have a difficult time resisting further efforts to raise oil prices over the next year or so, short of assisting Baghdad financially.* [redacted]

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Recent Developments

Iraq's need for substantially higher revenues to finance its large spending requirements for military and economic programs was probably the primary motivation behind Iraq's recent threats of military action against Kuwait and the United Arab Emirates (UAE). Low oil prices earlier this year seriously hampered Baghdad's efforts to increase revenue. Above-quota production during the first half of the year by Kuwait and the UAE--[redacted]--helped weaken oil prices, which by June had fallen by more than $8 per barrel from the January level of $22 per barrel. By early July, Gulf producers were showing little commitment to production restraint thus reducing prospects of turning prices around significantly in coming months. Because OPEC has no mechanism to enforce production quotas, Iraq took matters into its own hands by threatening Kuwait and the UAE. At the same time, it demanded that OPEC raise its price target from the long-standing $18 per barrel to $25 per barrel. [redacted]

Iraq's efforts were largely successful, as OPEC appears to have come up with potentially its strongest accord on production quotas and target prices since oil prices collapsed in 1986. On the production issue, if members adhere to the new quota of 22.5 million b/d, OPEC output could fall by 1 million b/d from first half 1990 levels. The UAE, for example, will reduce output from about 2 million b/d to its quota level of 1.5 million b/d; [redacted] For the first time in five years, each member has a quota it can live with for the time being--both politically and economically-[redacted] Moreover, OPEC now has a tacit quota-enforcement mechanism--the threat of Iraqi aggression--which will encourage compliance from Kuwait and the UAE for the time being. On the price issue, OPEC raised its reference price target from $18 to $21 per barrel, a level that will enable members to increase revenue--an Iraqi and Iranian priority--and that would be unlikely to have much short-term impact on oil demand growth, a priority of the other Gulf Arabs. [redacted]

The Oil Market Setting

Industry forecasts [redacted] oil demand and supply conditions for the remainder of this year suggest that OPEC will likely approach its price target, as long as production remains close to the new ceiling. Indeed, an upturn in demand during the second half of 1990, combined with only minimal

[redacted]

increases in supplies outside of OPEC, suggests prices will rise toward the new target as long as OPEC restrains its own output. [redacted]

Stronger Growth in Demand. According to [redacted] oil consumption in the market economies will average 52.9 million b/d during the second half of 1990, up 1.1 million b/d--just over 2 percent--from year-earlier levels.[2] OECD countries are expected to account for about half the increase, rising more than 500,000 b/d to 37.8 million b/d:

- o [redacted] US consumption is expected to recover in the second half, rising to 17.4 million b/d--150,000 b/d above second-half 1989.

- o Japanese consumption should rise by 4 percent to 4.9 million b/d on the strength of high economic growth, [redacted]

- o Western European oil use should reach 13 million b/d, up from 12.8 million b/d in 1989, according to several estimates.

LDC oil consumption should rise by 600,000 to reach 15.1 million b/d, with most of the increase coming from the Far East. [redacted]

Little Increase in non-OPEC Supplies. Second-half 1990 non-OPEC oil supplies are likely to increase by 100,000 b/d from year-earlier levels to 28.7 million b/d. A decline in US production--[redacted] at 300,000 b/d--and a drop in Soviet exports of 400,000 b/d will be offset by a number of small increases elsewhere:

- o OECD suppliers will likely increase output by a combined 500,000 b/d with most of the increase coming from the United Kingdom, Canada, and Norway.

[redacted]

Inventories: A Key to Market Psychology. Oil inventories in the market economies are at normal levels, but heightened concerns about Iraqi threats and expectations of higher prices could lead oil companies to increase oil stocks in the months ahead. Such behavior would contribute to upward price pressure. [redacted]

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[2]For 1990 as a whole, Free World oil consumption is likely to average 52.4 million b/d, the highest level ever recorded, surpassing the historical high reached in 1979. [redacted]

Given the expected demand and non-OPEC supply levels, the market probably could absorb OPEC production of about 24.2 million b/d and support prices near its new target. These levels are consistent with OPEC's new crude oil quota of 22.5 million b/d plus the groups normal 1.7 million b/d production of natural gas liquids (NGLs). [redacted]

Outlook for Production Restraint

Commitment to the new accord is likely to be strong over the next several months. Judging from production plans by member governments, [redacted] and likely continued Iraqi pressure on Kuwait, OPEC production during the second half of 1990 indeed will likely approximate 22.5 million b/d of crude oil and 1.7 million b/d of NGLs. Among the Persian Gulf producers:

- Iran, Iraq, and Qatar have quotas near their oil production capacity levels, leaving little possibility of much overproduction.

- Saudi Arabia plans to cut production in August by nearly 500,000 b/d to about 5 million b/d, [redacted] to demonstrate its support for the new accord. This is about 300,000 b/d below its quota.

[redacted]

Finally, Kuwait [redacted] with a more conciliatory oil policy, [redacted] as long as the threat of military aggression remains. [redacted] Kuwaiti oil production has already begun to fall. [redacted]

Close adherence to the new agreement is also likely among members outside the Persian Gulf. Most of these producers were producing at or below their quotas prior to the meeting, primarily because they are already producing at near full capacity. Only Libya and Venezuela have more than marginal amounts of surplus capacity. Libya is a price hawk and was the most outspoken supporter for Iraq's demand for substantially higher prices at the recent meeting, according to press reporting. Tripoli almost certainly hopes to form a powerful hawkish alliance with Iran, Iraq, and Algeria at future OPEC meetings to push prices higher. For its part, Venezuela hopes to host a summit of OPEC heads of state in the near future [redacted]

Price Implications

With close adherence to the OPEC agreement, prices are likely to average $17-20 per barrel during the rest of the year. Demand and supply factors suggest that prices will hover near the lower or middle part of the range during the third quarter, although market psychology has become more bullish and could give prices an added boost. In any event, prices should be at or above the upper end of the range during the fourth quarter, when demand will be stronger. [redacted]

If ongoing negotiations between Kuwait and Iraq turned sour and Baghdad attacked Kuwaiti oil facilities, oil prices would rise sharply above $20 per barrel. The upward price spike, however, probably would not last for more than a few months--even in the worst case of a cutoff of all Kuwaiti oil production--as long as Saudi Arabia and the UAE offset the lost Kuwaiti supplies.

- o Saudi Arabia and the UAE have a combined surplus capacity of about 2.5 million b/d, more than enough to offset Kuwaiti output.

- o More than 500,000 b/d of surplus capacity exists outside the Persian Gulf, mainly in Venezuela and Libya, although Tripoli might not increase its output in the event of a disruption in Kuwait.

Nevertheless, the market would be significantly tighter under these conditions and subject to upward pressures that could keep prices well above $20 per barrel for an extended period. [redacted]

Looking Beyond 1990: Prospects for Saudi-Iraqi Tensions

OPEC almost certainly will increasingly divide into two camps in coming years. As a result of Iraq's recent aggression, OPEC has moved from an organization that favors expanding market share to one supporting higher prices. [redacted]

Because of its recent successes, Baghdad almost certainly believes it will have a much larger say in future OPEC decisions and may periodically resort to military threats to extort concessions from the other Gulf Arab producers. Higher prices and increased production restraint by others will buy Iraq time to invest more heavily in expanding its own oil sector and position itself to demand higher quotas in the future. [redacted] indicate that Saudi Arabia indeed will resist efforts to raise oil prices much above $21 per barrel over the next several years. [redacted] the fundamental lesson of the 1980s for key moderate Arab producers was that inordinate price increases ultimately undermine world oil demand. Consequently, moderates--primarily Saudi Arabia, Kuwait, the UAE and Venezuela --will likely remain concerned that substantially higher prices will:

- Choke off demand for OPEC oil by stimulating non-OPEC oil production and fostering a diffusion of technologies in consuming countries to increase energy efficiency and alternatives to oil.

- Lower future oil revenue prospects, make it more difficult to work out future production-sharing arrangements in OPEC, and increase tensions in the region.

- Renew public concern about energy security in the industrialized countries and increase sympathy for a carbon tax and other environmental policies that would further weaken oil demand.

[redacted]

- Providing Iraq large sums of money in the form of grants or aid in return for Iraqi flexibility on oil policy issues, especially if demand growth slows with higher prices. While expensive, it would at least allow the Gulf producers to sustain oil market conditions that are favorable to their long-term interests.

- Accelerating the moderate expansion of their oil production capacities--especially in Saudi Arabia and the UAE--to ensure they retain some economic leverage over Iraq. This would be the most risky option but might remind Iraq of its own vulnerabilities and encourage some moderation. [redacted]

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Exemptions: (b)(1), (b)(3)