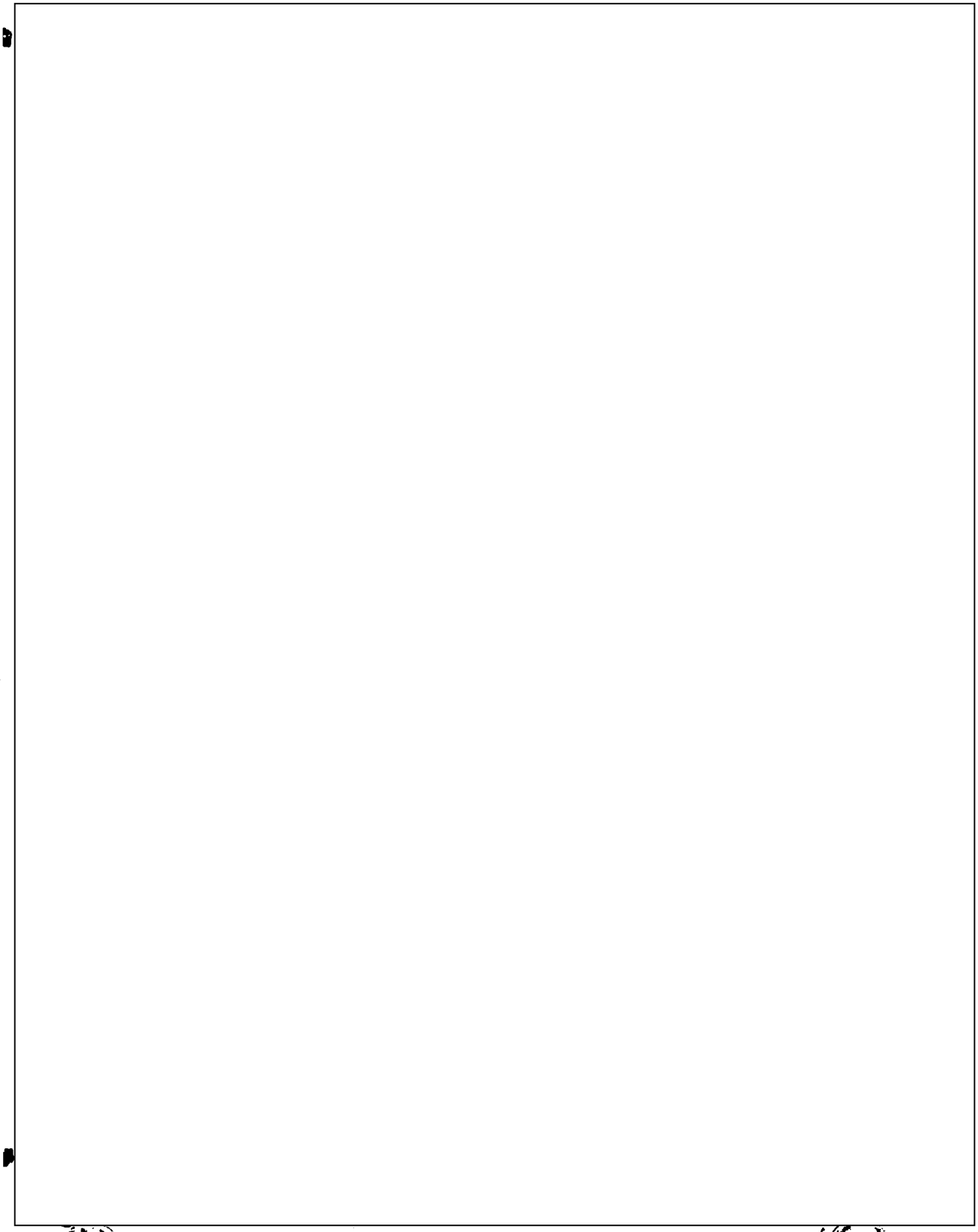


APPROVED FOR RELEASE
DATE: APR 2005

(b)(1)
(b)(3)

TOP SECRET

Central Intelligence Agency

Washington DC 20505

DIRECTORATE OF INTELLIGENCE

27 September 1983

IRAN-IRAQ WAR: INCREASED THREAT TO GULF OIL EXPORTS

Summary

The delivery of five French Super Etendard aircraft to Iraq would increase significantly the possibility of a disruption of Persian Gulf oil exports vital to the West. If Iraq receives the Super Etendards--which we believe is likely--and is unable to significantly ameliorate its financial difficulties within the next few months, it almost certainly will attack oil tankers calling at Iran's Kharg Island. By attacking Iran's oil lifeline, Iraq would hope to force Iran to the negotiating table or, failing that, to force Western Powers to intervene in the Gulf to ensure the safety of all oil exports, including those from Iraq.

This memorandum was prepared by [redacted] *of the Office of Near Eastern and South Asian Analysis, and by* [redacted] *of the Office of Global Issues. Comments are welcome and may be addressed to Chief,* [redacted] *Division,* [redacted]

[redacted]

Copy 24 of 31

[redacted]

TOP SECRET

[redacted]

Prolonged closure of the Gulf would have economic repercussions for the West even more severe than those of the 1973 and 1979 supply disruptions. Closure of

2608

the Straits of Hormuz would prevent 3 or 10 million bpd now being shipped from the Persian Gulf. According to our analysis, oil prices would rise by approximately $8 per barrel and OECD growth would decline by .5 percentage points for each 1 million bpd net reduction in Gulf oil exports per year. We estimate that a prolonged closure of the Gulf in early 1984 could double and possibly triple the price of a barrel of oil depending on the length and scope of the cutoff. We also estimate that a major increase in oil prices would have a severe impact on the international financial system, which already is strained by the LDC payments problem. In our judgment the initial oil price shock would be particularly destabilizing for those banking centers and countries with high exposure LDCs that do not export oil.

* * *

Iraq's Predicament

The war with Iran is slowly strangling Iraq's economy. It has severed two of Iraq's three oil export routes, reducing annual revenue by two-thirds, and saddling the economy with war-related costs that may reach $1 billion per month. We estimate that Iraqi foreign exchange reserves will fall to between $3-4 billion by the end of 1983 from $35 billion before the war, Baghdad has been forced to defer some $4 billion owed this year to foreign suppliers. Iraq's current account deficit this year will be an estimated $15 billion, its ambitious development program has been shelved, and imports have been sharply reduced.

Iraq, faces the prospect of a current account deficit in 1984 nearly as large as this year's unless it takes the political risks of deeper cuts in imports of consumer goods. Meanwhile, its reserves will be further depleted and the Gulf states probably will be less able than this year to provide financial support.

The cause of Iraq's financial bind is insufficient oil exports. The loss of its Persian Gulf oil export terminals at the beginning of the war and the closure of the pipeline across Syria in April 1982 have reduced Iraqi oil export capacity by 80 percent. Iraq's one oil export route, the pipeline across Turkey, has a current throughput of about 800,000 bpd.

Iraqi Strategy

Iraq now believes that attacking Iran's oil lifeline is its only hope for ending the war or reopening the Gulf to Iraqi oil exports Baghdad's objectives in attacking Iran's oil lifeline reportedly would be to force Iran to the negotiating table or to compel the Western powers to

2609

guarantee free passage for Iraqi oil exports in the Gulf.

[redacted]

[redacted]

Iraqi Options for Increased Oil Exports

Reopen Gulf oil terminals. Iraq has purchased and stored in Bahrain four temporary floating oil export terminals called single-point mooring buoys. Two of the buoys, with a capacity of 1 million bpd could be installed in 4-6 months. The two remaining buoys could be installed within a year, increasing Iraqi Gulf export capacity another 1 million bpd.

Reopen the Pipeline Across Syria. The pipeline has a capacity of 1.2 million bpd but was closed by the Syrians in April 1982. The Syrians are unlikely to reopen the pipeline on their own initiative as long as Saddam Hussein remains in power, and Iraq does not have the military capability to force them to do so. The Soviets and the Gulf states have approached the Syrians on Iraq's behalf but without success. Syria is now receiving oil from Iran worth $1.8 billion annually.

Build New Pipelines. Building pipelines across Saudi Arabia, Kuwait, Jordan, or Turkey would require several years. Iraq has held discussions with the Saudis and Jordanians. We see little chance of progress soon. A key obstacle is financing. Improvements to the pipeline across Turkey will increase its capacity to about 950,000 bpd by the end of this year, providing additional annual revenue of about $2.5 billion. [redacted]

Another possibility is that Iraq will attempt to resume oil exports from the Gulf, using the threat of attacks by the Super Etendards to deter Iranian interference [redacted]

2 6 1 0

A Possible Attempt to Reopen the Gulf to Iraqi Oil Exports

Baghdad may plan to use the Super Etendards primarily to dissuade the Iranians from interfering with a resumption of Iraqi oil exports from the Gulf. If Iran attempted to interfere with Iraq's oil exports from the Gulf, Iraq would use its Super Etendards to strike at Iranian tankers. This scenario would permit Baghdad to justify its strikes as retaliation for Iranian escalation of the war.

Iraqi Options for Stopping Iranian Oil Exports

2611

2 6 1 2

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

2613

TABLE 1

Persian Gulf Order of Battle

Super Etendard-Exocet Weapons System

The response of the international shipping industry to Iraqi attacks on tankers is uncertain. We believe a reduction in service is certain after the first Iraqi attacks but some shippers probably would resume service to Kharg if the attacks

were intermittent or ineffectual. The depressed state of the world tanker market might encourage owners to accept the risks involved as long as insurance and crews were available. To keep the Kharg run attractive to shippers, Iran would reduce crude prices to offset increases in insurance rates. Companies have been willing to send their ships to Iran's port of Bandar-e Khomeini in the northern Gulf even in the face of repeated Iraqi attacks, some using Super Frelon helicopters firing Exocets.

Iran's Reaction

If international tankers stopped serving Kharg Island, Iran could still export 20 percent of its current level of exports. It could continue to load its own ships at Kharg and shuttle oil from there to anchorages in the southern Gulf, outside the range of the Super Etendard. Iran did this in the early days of the war and was able to ship at least 200,000 bpd. In addition, loading terminals at Sirri and Lavan Islands, at the outer limit of the range of the Super Etendard, can export about 200,000 bpd.

2616

Military Reactions.

2617

Potential Targets on the Iraq-Turkey Pipeline

2618

[redacted]

Harassment of Gulf Shipping. [redacted]

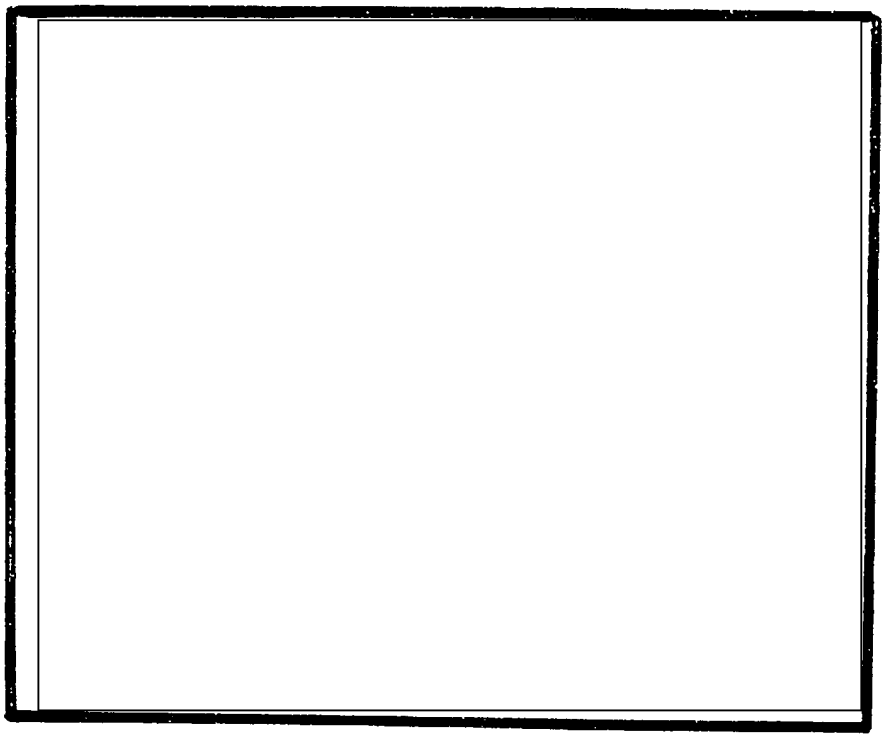
[redacted]

[redacted]

Attacks on Gulf Oil Facilities. [redacted]

[redacted]

[redacted]

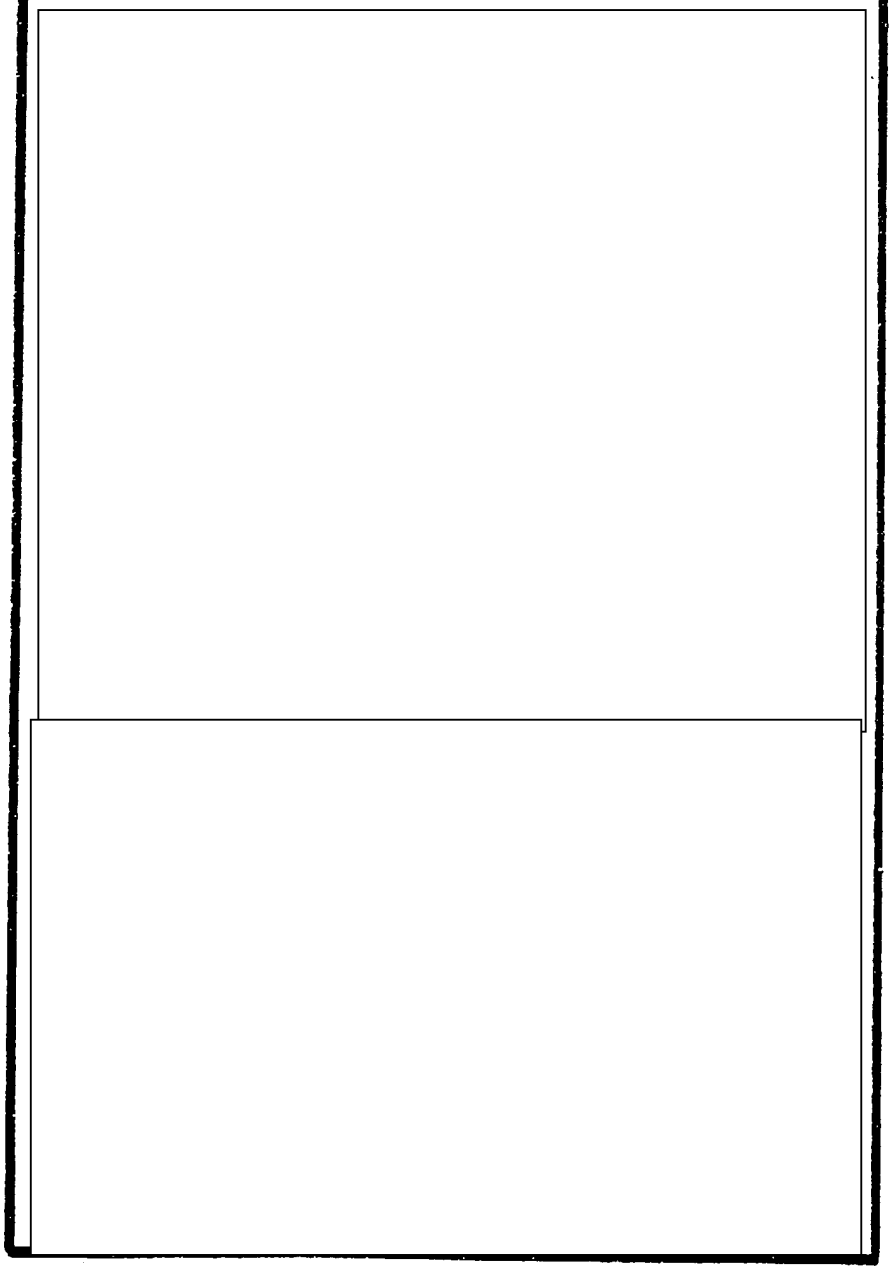


Vulnerability of Gulf Oil Facilities

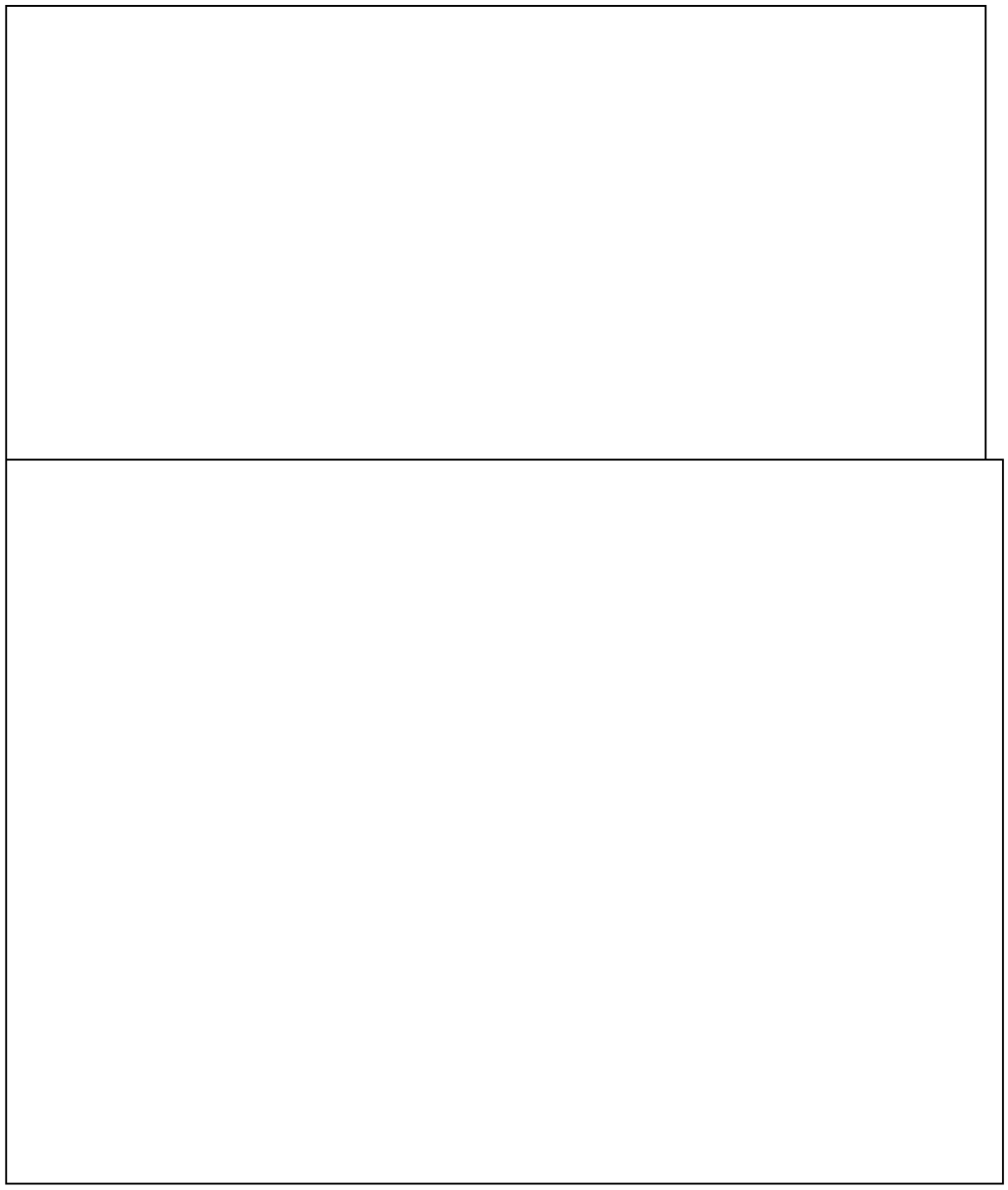
Critical Targets

2621

Oil Facility Restoration



2622



Economic Impact of Closing the Gulf

Prolonged closure of the Persian Gulf could have more severe economic repercussions for the West than the 1973 and 1979 supply disruptions. Given the importance of Persian Gulf oil, there is no way the United States could insulate itself from the economic reverberations of a major reduction in exports from the Gulf. We estimate that each year for every 1 million bpd net loss in oil exports from the Gulf oil prices would increase by about $8 per barrel and OECD GNP growth would decline by .3 percentage points. Moreover, we believe a major runup in oil prices resulting from a prolonged interception of Persian Gulf oil supplies would have severe repercussions on the international financial system

The economic impact of any disruption of Gulf oil exports in the near term will depend heavily on:

- The extent and duration of the disruption.
- The availability of non-Gulf energy supplies from surplus productive capacity.
- The availability of alternative fuels such as coal and gas.
- Worldwide petroleum stock levels and stockholder response.

The present combination of surplus productive capacity and weak consumption affords OECD countries some protection against a short-term oil supply disruption. Persian Gulf countries have been producing some 12 million bpd in recent months, although present production capacity is about 17 million bpd. Nine or 10 million bpd are now exported from the Gulf, of which about 1

million bpd are sent through pipelines. Free World surplus capacity outside the Gulf that could offset a supply cutback Gulf stands at about 3 million bpd, mainly in Nigeria, Libya, Venezuela, and Indonesia

Western Dependence on Gulf Oil. The Free World depends on Persian Gulf oil for about 30 percent of its needs. The US, however, is not as dependent on Persian Gulf oil as are most of its Western allies and some Third World countries. US imports of Gulf oil this year are about 200,000 bpd. US dependence on Persian Gulf oil has dropped to only 5 percent of total oil imports and 1 percent of oil consumption.

The other countries in the OECD--mainly Western Europe and Japan--received 8 million bpd from the Gulf last year, about 55 percent of their total oil imports and 40 percent of their total consumption. Most of the remainder of the Gulf's oil output is consumed by the Gulf countries or exported to the LDCs.

Managing an Oil Crisis. The United States theoretically could do without Gulf oil by drawing on the 3 million bpd of surplus capacity available outside the Gulf, including 1 million bpd among major producers in the Western Hemisphere. Because of the heavy Free World dependence on Persian Gulf oil, however, the US would not be immune to the shocks of a major disruption of Middle East oil supplies. Such disruptions would lead to a sharing of the burden of the shortfall through adjustments in company distribution systems, intervention of consuming governments, or implementing the formal IEA oil sharing program.

Our analysis indicates that the demand response to rising oil prices and private stock behavior are the main determinants of the price impact of a major, prolonged supply disruption. Price runups following the Arab oil embargo and the Iranian revolution were due in part to demand pressures resulting from stockholder efforts to rebuild and add to inventories. In contrast, the oil market remained fairly stable following the outbreak of the Iran-Iraq war, reflecting falling consumption and the existence of about 400 million barrels of excess stocks that stockholders were willing to deplete.

TABLE 2

Non-Communist Oil Supplies
(millions of barrels per day)

	Available Capacity	Current Production	Surplus Capacity
Persian Gulf			
Iraq	1.0	0.9	0.1
Non-Persian Gulf			
Total			
Net Communist Exports and Refinery Gain			
Total Supply			

2626

Commercial stocks now represent the bulk of oil inventories held in consuming countries. Sizable strategic stockpiles--oil purchased and owned by governments as opposed to inventories held by commercial firms--are located only in the United States, Japan, and West Germany. Non-oil supplies, especially natural gas, also could make a contribution to offsetting oil losses during a disruption, as happened in the United States following the Iranian revolution.

Stock drawdowns play a major role in reducing the price impact of an oil supply disruption. If oil users anticipate a short-lived disruption and a fairly quick release of oil from stockpiles, the initial scramble to build and hoard inventories that resulted in the severe economic impact of the 1973 and 1979 supply disruptions may be toned down or averted. As a result, the sharp escalation in spot prices and the ensuing rise in official prices may be dampened considerably.

We believe a disruption of oil flows from the Persian Gulf, however, probably would reverse the glut mentality that has gripped the oil market for the last two years. Industry expectations of a price decline combined with the high cost of holding oil caused a large inventory liquidation since the beginning of the year. With current commercial stockpiles near normal levels, we would expect stockholders to be less willing to sharply reduce inventories if there were a supply disruption. In our judgment, there is a good possibility that attempts would be made to add to inventories because of the prospects for higher prices and the uncertainty surrounding the duration of the disruption. This behavior would add to our oil demand estimates and projected supply shortfalls.

Sensitivity Analysis. Despite these uncertainties, we have attempted to assess the sensitivity of price and economic growth to a major supply cutoff We sought to determine how far oil prices would have to rise to balance supply and demand under varying levels of disruption, but particularly if the Gulf were closed. Our analysis revealed that if the Gulf were closed for a year, oil prices could easily double or triple. Depending on the level of demand, the net reduction in exports from a Gulf closure could be between 5 and 9 million bpd. More specifically, our analysis suggests that for every 1 million bpd net loss in supplies for one year, prices could increase approximately $8 per barrel causing a reduction in OECD GNP growth of 0.3 percentage points.

2627

APPENDIX

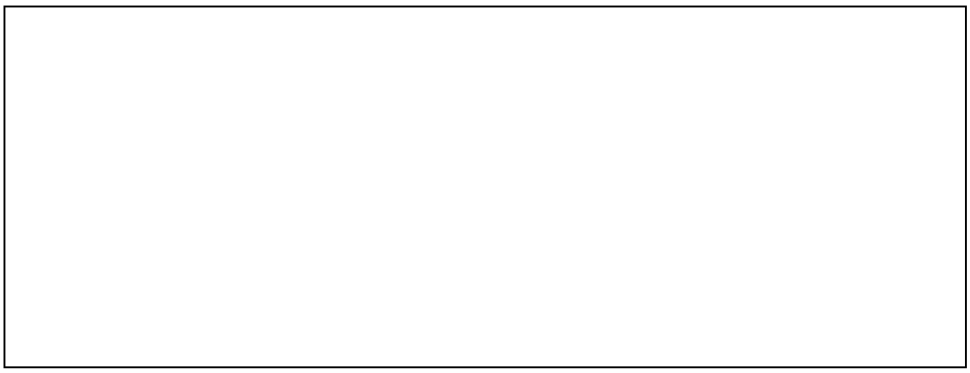
Impact of Oil Supply Disruption on the International Financial System

We believe a major runup in oil prices resulting from a prolonged interruption of Persian Gulf oil supplies would have severe repercussions on the international financial system, which is already strained from LDC payments problems. While on balance commercial lenders would be trading the recovery of one group of troubled debtors for worse conditions in another, the initial oil price shock would be destabilizing in our judgment, particularly for those banking centers and countries with high exposure to non-oil LDCs. Moreover, recent banker experience with LDC debt moratoriums and reschedulings could hamper recyling of surpluses elsewhere to the non-oil LDCs. In addition, unlike the last two major oil price increases, financial surpluses would accrue largely to the OPEC members with high financial requirements for debt servicing instead of the wealthier members who in the past have provided immediate liquidity to the international banking system. OECD governments, faced with the prospect of full fledged recessions, are unlikely to increase aid substantially. We also are concerned that IMF funds may be inadequate to handle large new loan requests at this time and that the prospects for increasing IMF resources are unfavorable.

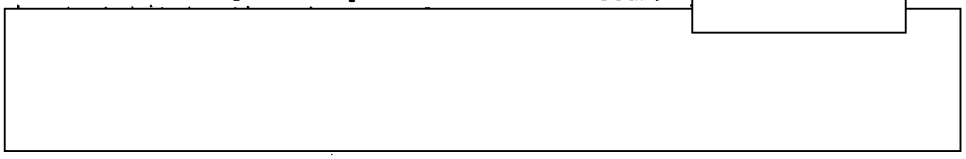
OPEC Members

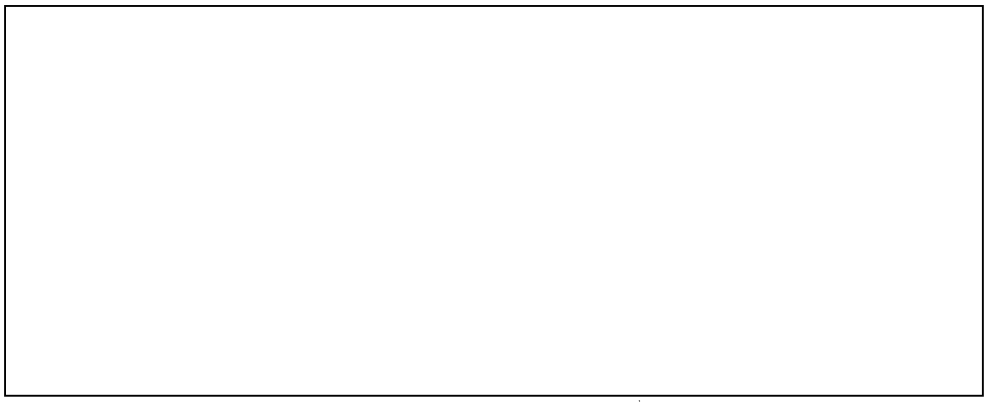
If the Strait of Hormuz were closed, we project that the OPEC current account surplus over the course of a year would range from $60-180 billion assuming the Free World demand shortfall is 5-9 million bpd, oil prices rise $8 per barrel for every 1 million bpd shortfall, and imports of the non-Gulf members are allowed to rise in real terms to 1979-80 levels. This would be in sharp contrast to the $20-30 billion deficit we currently project for 1983-84 with current oil prices remaining stable, and it could surpass the 1980 record OPEC current surplus of $110 billion.

We project that a smaller disruption of Persian Gulf Oil leading to a 1 million bpd shortfall would result in a near balanced current account to a $30 billion surplus depending on the import behavior of non-Gulf members.



Of the six Persian Gulf producers, Iraq could experience financial gains from the closure of the Strait of Hormuz provided currently operating pipelines continue to function and major oil price increases occur.





Despite large foreign reserves, the need for economic stringency under these circumstances will pose difficult questions for these governments concerning domestic spending, asset management, and foreign aid levels. In the past, control over massive oil revenues has been a politically and socially stabilizing factor for these governments, and ruling royal families will have to be cautious to minimize criticism that could question the government's legitimacy.

Non-OPEC LDC Oil Exporters

Non-Oil LDCs

We believe that many of these LDCs will have difficulty obtaining loans to finance their higher oil bills. Given their recent experience with LDC debtors, bankers, in our opinion, will be reluctant to increase LDC debt exposure and risk another round of moratoriums and reschedulings. We are concerned that IMF resources could be inadequate to meet large new financing requests. During past oil price hikes, the IMF helped defray rising LDC oil imports through special lending facilities funded by the wealthier OPEC members. Under this current scenario, however, the traditionally surplus Gulf economies are losing oil revenue and many are in deficit themselves. With relatively low levels of foreign reserves, it is not clear that the non-Gulf oil exporters would be as forthcoming with aid to other LDCs.

We expect that many of these non-oil LDCs would turn to Washington for funding and leadership in handling the oil price crisis. Lacking adequate financing, non-oil LDCs would face severe recessions and growing unemployment, which for many governments has the potential for stimulating serious political and social unrest.

2631