

CONFERENCE
The Day After: Planning for a Post-Saddam Iraq

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Oil and the Iraqi Economy

By Patrick Clawson

The most important point to make about oil and the Iraqi economy is that these issues are not driving U.S. policy towards Iraq. The U.S. government's concerns are about Iraqi weapons of mass destruction (WMD) programs, its potential support for terrorism, and threats against neighboring states. These latter issues are the ones cited by President George W. Bush, by cabinet secretaries, and by officials at the working level. Oil has barely been on the administration's horizon in considering Iraq policy, as reflected in the paucity of statements about the matter.

The low priority assigned oil in the making of U.S. policy towards Iraq fits a pattern for U.S. policy worldwide. Over the last decade, Washington has given progressively more priority to counter-terrorism and anti-proliferation and progressively less priority to energy security and to assisting U.S. oil companies. Energy policy issues debated in the United States in the last decade have been overwhelmingly issues of domestic U.S. policy, mostly having to do with environmental considerations, from CAFE (corporate average fuel efficiency) standards to ANWR (Alaska National Wildlife Refuge) oil production. Other than the Kyoto Treaty--which is really a debate about the environment rather than about energy--the only international energy issue on which the U.S. government has engaged in years has been the promotion of the Baku-Tblisi-Ceyhan oil pipeline, and that has been mostly for the purpose of consolidating the stability of the Caspian Basin states and blocking Iran, not for the impact on world oil markets or on U.S. oil companies. Indeed, U.S. oil companies have been complaining vociferously that Washington has hurt their business prospects by imposing tough U.S. sanctions, which lock them out of countries with large oil reserves, such as Iran and Libya. The mood in Washington has been distinctly unfriendly to the oil companies' concerns; consider last year's lop-sided vote in Congress to extend the Iran-Libya Sanctions Act or the continuing pressure for restrictions on oil companies' activities in Sudan.

It is fashionable among anti-American circles--such as American university campuses and Middle Eastern intellectuals--to assume that U.S. foreign policy is driven by commercial considerations. These same circles hold fast to a nineteenth century vision of how economies work, in which "business follows the flag," that is, American firms invest in countries with which the United States has a special political relationship. These views are hopelessly out of date. In fact, international oil companies would much prefer that their business be de-politicized, with investment decisions being made on business

considerations rather than political grounds. After all, most major oil field developments these days are done by consortia, which generally involve firms from different companies. And the oil companies are increasingly international, rather than tied to one country. It is fitting that the largest producer of oil in the United States is British Petroleum. And when I fill my car with gas, I could patronize a station owned by Lukoil (Getty) or one by Petrolieres de Venezuela (Citgo). I know of no U.S. policymaker who is concerned that only two of the world's six largest oil producers are based in the U.S. In short, U.S. foreign policy is not driven by concern for promoting the interests of specific U.S. firms; there is broad consensus that the U.S. government's proper role is safeguarding U.S. national security and promoting the general welfare, not the interests of specific firms.

Much the same can be said about policymakers from other countries. Policy differences about Iraq reflect many factors, but it is easy to exaggerate the importance of oil. Consider the stance of the Russian government, which is often said to place above all else commercial concerns, especially those of the powerful oil and gas industry whose oligarchs have been such a force in Russia. Moscow would have good reason to lobby for Russian oil companies' interests in Iraq, given the contracts signed by Saddam's governments for massive oil field developments. It is symptomatic that in the debates about Iraq, the Russian government has by most accounts raised the issue of applying the same tough standards to the threat of international terrorism from the Georgian-based Chechen insurgents. In other words, Moscow put more priority on a national security concern than on oil industry interests.

To be sure, oil is one of the reasons the West is concerned about Iraq. But the reason is primarily indirect, namely, that with ample income from oil export, Iraq could be in a position to acquire WMD and a powerful conventional military with which to threaten its neighbors and U.S. allies. But this is a concern about the uses to which Iraq puts its money, not a concern about how Iraq earns its income. It is a mistake to think that what is driving Western policy towards Iraq is oil supply.

No "Oil Shock" to the World Economy from an Iraq War

The relative lack of U.S. government concern about an "oil shock" from an Iraq war makes excellent sense. It is difficult to paint any scenario under which an Iraq war would cause disruptions to the world economy.

Part of the reason is that the world economy has adapted well to swings in world oil prices. Gone are the days when changes in world oil prices send tremors through the industrial and financial worlds. Oil prices can swing precipitously back and forth with relatively little impact. In 1997, the spot price for Dubai crude was \$18.13 per barrel; in 1998, it was \$12.16; and in 2000, it was \$26.24. There is no evidence whatsoever that the 50% fall from 1997 to 1998 provided some massive stimulation to the world economy or that the 115% increase from 1998 to 2000 through the world economy into reverse. To be sure, the lower oil price delivered a powerful blow to some oil-exporting countries, especially Russia, but the global economic impact was relatively small. The world economy has become much more flexible than thirty years ago; with the greater reliance on market forces, oil price increases are passed through the economy smoothly, and

consumers and producers adjust accordingly. In other words, oil prices are simply not a major impact on economic circumstances in most cases.

The lessened impact of oil price increases was on display during the 1990-91 Iraq-Kuwait crisis. The loss of both Iraqi and Kuwaiti oil production--which together amounted to seven percent of world output--was absorbed without much difficulty, in so small part because of the excess capacity that was quickly brought into production. The spot price for Dubai crude in 1989 was \$15.69 per barrel, which rose only to \$20.50 in 1990 before settling back to \$16.56 in 1991--the much-cited figure of \$40 was a price for only a very brief period in 1990.

The price increase during the 1990-91 crisis would have been even less had the U.S. government been willing to release oil from the Strategic Petroleum Reserve (SPR) prior to the start of the war. At that time, there was strong ideological opposition to a SPR release except in response to a physical shortfall of oil, and the level of shortfall to trigger a release was seen as 15 percent. That opposition has more or less faded away, with there being a greater willingness to use the SPR to combat politically-motivated price increases. There is more interest in active management of the SPR along the lines of the 2000 "swap" in which oil firms were allowed to draw down thirty million barrels of oil in return for pledging to return a greater amount in 2001; the principle underlying the swap was a conviction that oil prices were temporarily at an artificially high level and would soon moderate. It is quite possible that if the price of oil were to rise sharply in response to a confrontation with Iraq, the SPR would be brought into play.

But it is quite possible that a crisis with Iraq would not have enough impact on oil prices to cause any use of the SPR. Three powerful factors are at work which would limit the impact on short-term oil prices of any crisis with Iraq. First is that Iraq has become a negligible player in world energy supplies. Even with the bounce back in recent weeks from the extremely depressed production levels earlier this year, Iraq is still producing less than 2.5 million barrels per day, which is about 3% of world output. And Iraq has been such a volatile producer that world oil markets have long ago adjusted to sharp swings in its output.

Second, world supply conditions are becoming quite ample relative to demand. Non-OPEC supply is likely to increase by 1.0 million barrels per day in the fourth quarter of 2000 compared to the third quarter, while OPEC producers have about four million barrels per day of unused extra capacity (1.9 million barrels per day in Saudi Arabia, .5 million in Nigeria, .3 million in Kuwait, and so on). Therefore any shortfall in Iraqi output might well be replaced quite quickly by other producers. Indeed, *Petroleum Intelligence Weekly* recently concluded that the greater risk is of a price drop rather than a price rise: "It's been tough to find fundamental justification for \$25 per barrel oil--let alone \$30/bbl oil--with no demand recovery evident yet in much of the world, OPEC losing its grip on member and non-member cooperation, and global inventories still reasonably comfortable by historical norms." (*Petroleum Intelligence Weekly*, September 2, 2002).

Finally, there is precious little potential that an Iraq war could disrupt supplies from other producers. It is barely credible that Iraq could even through terrorism disrupt production

in Arabian peninsula countries, even were it so minded, but even if it did so, a lesson of the 1991 Kuwait oil field fires is that reconstruction of war-damaged oil fields can proceed remarkably quickly. And it is very hard to see how intervention in Iraq would lead to domestic turmoil in other Middle East states of such a scale as to hurt oil output. There is little evidence that there will be massive pro-Saddam or anti-U.S. protests--Saddam is not a popular figure in most of the region. And even if there were such protests, the region's governments are quite efficient at remaining on top of the situation.

Iraq's Post-Saddam Oil Policy: For Iraqis to Decide

Post-Saddam, Iraq's ample oil reserves raise the prospect that it could become a much more substantial oil producer. From a technical point of view, Iraq could increase output to 4.5 million barrels per day within less than three years, on the way up to 6.0 million barrels per day within five to six years and 8.0 million within eight to ten years. Iraq's present reserves are large enough to sustain output at the eight million barrels/day mark, and there is excellent reason to expect that additional exploration will turn up extra reserves.

Even as a relatively modest producer of three to four million barrels per day, post-Saddam Iraq will be a tough competitor for Saudi Arabia. If Iraq develops a business environment attractive to IOCs, then IOC investment could flood into the country, while IOCs would be less interested in working in a less hospitable Saudi environment. Over time, Saudi Arabia's unique position as the swing producer, which can single-handedly influence world oil prices would deteriorate; Saudi Arabia would become AN important oil producer instead of THE important oil producer. Surely these considerations are part of Saudi thinking about a policy of regime change for Iraq.

To return to the issue of the potential for the Iraqi oil industry, the main determinant of how much oil Iraq produces will not be its reserves--which are certainly ample. Much more important will be the business environment for international oil companies (IOCs). The post-Saddam Iraqi government will have to make many complex and politically loaded decisions about its relations with IOCs. There will be many in Iraq who will want to tear up the contracts signed by the Saddam government with Russian, French, and Chinese oil firms for investments to begin once UN sanctions are lifted. Some Iraqis will argue that Iraqi engineers and technicians can handle on their own the expansion of the oil industry; there will be arguments against allowing IOCs to play a large role. Even in the event of a decision to allow IOC investment, there will still be a host of subsidiary issues to decide, such as local content requirements.

Political objections to involvement by IOCs would certainly be in the tradition of Iraqi history. Iraq has a long tradition of proud nationalist refusal to cooperate with foreign oil companies. Oil was discovered in 1927, but production did really not begin until after World War II because of a stubborn confrontation about relatively minor concessions Iraq demands from the foreign license holder. Then Iraq got into another major dispute with the Iraq Petroleum Corporation about the development of an important oil field--a dispute which effectively prevents the large-scale development of the North Rumaila field discovered in the late 1950s (only in the 1990s has it begun to live up to a fraction of its potential). So the current twelve-year long dispute with the West, which has so

hampered Iraqi oil development is the third time which Iraq has let nationalistic political reasons get in the way of highly lucrative oil development. In each of the three cases, Iraq blamed the West for being obstructionist. This does not augur well for the future.

Indeed, for seventy-five years, modern Iraqi nationalism has defined itself around the issue of control of oil and resistance to foreign oil intervention. If a U.S. military occupation government of Iraq announces that it is going to privatize Iraq's oil resources, there could well be a strong nationalist backlash. This could seriously compromise the goodwill the United States would earn by overthrowing Saddam. To be sure, privatization is in the interests of the Iraqi economy and the Iraqi people; ownership by the government has hurt the oil industry and, more importantly, empowered dictators. The concentration of oil income in the hands of the government has made the middle class dependent on the government to the point that free politics have not been possible. But it would be a mistake to impose the right solution on Iraq by fiat; the Iraqi people must be won to realize the errors of the past proto-socialist nationalism and to accept free enterprise. Hopefully over time, the issue of foreigners in the oil industry would become less sensitive, but this has for decades been "the third rail "of Iraqi politics.

There has been much speculation about the role for Russian, Chinese, and French oil companies in post-Saddam Iraq. It would seem unlikely that companies from these countries would try to develop a giant oil field on their own. The trend in the oil industry is to seek consortia partners, if for no other reason than to spread the market risk as well as the political risk. For similar reasons, it is likely that any U.S. or British oil firm active in post-Saddam Iraq would want consortia partners in any large investment. The 21st-century oil industry does not work primarily on the basis of special privileged positions based on politics. It would therefore be unlikely that Russian, Chinese, and French oil companies would be locked out of Iraq post-Saddam. That said, it would be natural that a new Iraqi government would want to redefine the terms and conditions of the agreements reached by its predecessors. And it would be entirely appropriate, both economically and politically, if that new Iraqi government decided on an "open door" policy under which all IOCs could bid on strictly business terms, without regard to national politics. Such an arrangement would almost certainly result in U.S. and British firms getting much of the business, but that is a reflection of their weight in the world oil industry, not of special political factors.

While developing Iraq's oil industry will be critical for the country's prospects, it is worth noting that oil has been a mixed blessing for Iraq. There have been a number of quite interesting economic studies showing that oil can be an economic curse: oil wealth can distort an economy, leading people to concentrate their efforts on how to grab part of that wealth instead of on productive economic activities. Certainly the rise of Iraqi oil income has coincided with stagnation and decay of the rest of the economy. So the economic benefits of Iraqi oil are open to question. On the other hand, oil has had an important political benefit. Because the economy is so dependent on oil and because that oil income is controlled by the central government, oil plays an important role in holding Iraq together. Whatever the differences among them, Iraqis of all ethno-religious backgrounds want to share in the country's oil wealth. This integrative role of the oil income may in fact be the most positive aspect of the oil riches.

Iraq's Economic Potential Depends on More than Oil

Oil is hardly the only valuable resource Iraq possess in abundance. Perhaps as important to the country's economic future is its wealth of human capital: its well-educated and hard-working people have a deserved reputation in the Middle East. To be sure, this advantage has deteriorated under Saddam's twenty-year rule, with a decline in educational standards at the same time that its neighbors were improving their schools. Nonetheless, the solidly secular traditions of Iraq provide it a natural leg up on countries like Saudi Arabia, where the educational system is subject to the rigid dictates of the religious establishment.

Indeed, Iraq is well endowed with a variety of resources, natural as well as human. It has more water per capita than any other Middle Eastern country, and its land has extraordinary agricultural potential. But resources are not the principal determinant of economic performance; economic policy is. And there the Iraqi track record is depressing. Iraq has a long history of under-achievement. The 1952 World Bank mission provided detailed recommendations in its tome, *The Economic Development of Iraq* (Baltimore: Johns Hopkins University Press, 1952); little happened during the next six years under the monarchy nor during the tumultuous next decade of coups and countercoups. And what was done, was often misguided. It is depressing to read the history of Iraqi industry, with the transition from vibrant private enterprise to state-run firms with modern technology surviving only thanks to heavy protection and generous subsidies--which was admittedly the path recommended by the best economic minds of the time (as well documented in Kathleen Langley, *The Industrialization of Iraq*, Cambridge: Harvard University Press, 1961).

It is not encouraging to realize that these examples of economic policy shortcomings largely predate the Baath coming to power in 1968 or Saddam's assumption of the presidency in 1979. The heavy hand of the state was deadening the Iraqi economy long before Saddam showed up. To be sure, Saddam has made every problem worse. The economic record of Iraq under his rule is truly impressive. He, and the Baath Party before him, have managed to convert Iraq from a country that exported food for three thousand years into a country dependent on imports for seventy percent of its calories (that figure is for 1989, from before the situation got worse under sanctions). Overall, Iraqi income per person rose about three-fold during the twenty years before Saddam came to power (thanks largely to the oil windfall) and then under Saddam have fallen back to below where they started..

Post-Saddam, the advice from Washington--be it from the U.S. government or from the IMF and World Bank--will be to open up the economy, to allow more room for market forces and to facilitate international investment and trade. That will be excellent advice, but it would be a serious error to force it upon the Iraqis.

Iraqis have a long tradition of proud nationalism. If the United States were to invade Iraq, there would be suspicions among some Iraqis that it did not have the best interests of Iraqis in mind. Under those circumstances, it would be best for Washington to err on the side of caution. Given that Iraqis have some quite competent technocrats, it would be well to let them make the key decisions about where Iraq's economic policy should lie.

The rule of law is the single most important requirement for reviving the Iraqi economy post-Saddam. If there is instability or periodic coups, fed by the perception that the new government is too under Washington's thumb, that would undermine the rule of law and the prospects for the economy. To insist too forcefully that Iraq follow the advice of the International Monetary Fund and the World Bank could be politically destabilizing and therefore economically harmful. We have to let the Iraqis decide their own future, even if the decisions they make are not particularly wise ones.

It would be in the interest of Iraqis to develop a broad consensus in favor of opening up the economy to market forces and to globalization as quickly as possible. It would be wonderful if Iraq follows the example of Dubai in that regard. That said, it is important that the Iraqis themselves come to that decision on their own, much as a strong consensus has developed in Dubai in favor of that emirate's pro-market policies. If the United States imposes on Iraq "the Washington consensus"--that is, the policies recommended by the IMF and World Bank--then these policies could lack strong local support. As sad experience in country after country has demonstrated, economic reforms are durable only if they are the product of a domestic decision, not if imposed from the outside. And that will be all the truer for such a proudly nationalist and prickly people as the Iraqis.

Debt and Compensation

Even if all goes well regarding the Iraqi economy, Iraq will not be able to make full payment of its foreign debt and war compensation payments. Iraq has not been able to make payments on its foreign debt for many years, and with all that unpaid interest, it is not at all clear how much the debts total by now. Including the unpaid interest and the debts to Arab countries which Iraq thought would be forgiven at the end of the day, Iraq's foreign debt could easily be \$120 billion. In addition to which, Iraq is obligated to pay compensation for damages inflicted during the Kuwait occupation, and the claims of the Kuwaiti oil companies and government--claims not yet adjudicated by the United Nations Compensation Commission--total some \$160 billion. It is hard to see how Iraq could afford to pay in full this stock of debt and compensation, which could total \$280 billion. Just the interest payments would be more than \$10 billion a year. Under an optimistic scenario with Iraq exporting 5 million barrels of oil at \$25 per barrel, Iraq's total export earnings would be \$45 billion a year, from which a \$10 billion interest bill would be about the maximum Iraq could contribute for debt and compensation, with nothing left to pay down the principal. It would not be appropriate to burden Iraq with such heavy payments. Iraq should be allowed to join nearly all other developing countries in paying off its debts at pennies on the dollar. And compensation payments should cease as soon as the claimants other than the Kuwait government and oil companies have been paid in full, which should be soon; payments to date have totaled \$15.5 billion. To show its concern for improving the material well-being of ordinary Iraqis post-liberation, it would be fitting for the United States to announce now that it would support a dramatic reduction of Iraq's debt and compensation obligations once Saddam is overthrown.

There has been speculation that Russia might want assurances that Iraq's debt would be repaid, before Moscow agreed to tacitly support--or at least not object to--U.S. military action against Iraq. Such a desire on Russia's part would hardly be surprising. Russia is not as rich as many of the other creditors of Iraq, such as the United States or Saudi

Arabia or Kuwait, and that therefore that Russia might well want special arrangements made for Russia on the repayment side. It is appropriate for the Russian government to be concerned about this issue, especially since the debt may be as much as five percent of Russia's national income (including interest accumulating since 1991, the debt could be \$12 billion; Russia's national income in 2000 was \$241 billion according to the World Bank). The equivalent amount for the United States would be \$500 billion; were the U.S. government owed that amount, Washington would be most concerned about the matter. So it is rather unfair to criticize Moscow for raising the debt issue. Indeed, it would be appropriate to balance Russian and (post-Saddam) Iraqi interests by agreeing to a global settlement for Iraq's debt that forgave perhaps half the debt, while then Iraq's richer creditors in the industrial and Arab worlds further agreed to a supplemental forgiveness of the other half. That could have the effect of reducing Iraq's debt to a manageable level while simultaneously providing Russia with a substantial payment.

Final Words

When thinking about the problems facing Iraq post-Saddam, it is important to keep some perspective. Saddam has been such a brutal dictator that there is a near certainty that life will be better for Iraqis post-Saddam, even if there are problems establishing the kind of open, market-oriented democracy that would best bring freedom and prosperity to its people. Indeed, it is realistic to expect that a post-Saddam Iraq could over the next decade develop a government respectful of human rights and as representative as the semi-functioning democracies of Muslim-majority OPEC members such as Indonesia, Nigeria, or for that matter Kuwait. None of those are by any means perfectly functioning democracies, but their governments are a whole lot better than what Iraq has now. U.S. intervention to bring regime change to Iraq will be worthwhile even if all the potential problems cited here come to pass.

Patrick Clawson is the deputy director of the Washington Institute for Near East Policy.