Sorry Saddam, Oil Embargoes Don't Hurt U.S.

Wall Street Journal August 29, 1990

Saddam Hussein is an evil man who has no qualms about hurting innocent people. But many Americans believe that if he were to succeed in extending his control to a large part of the Arab world, he could severely damage the oil-dependent U.S. economy. No less an authority than Henry Kissinger has claimed that an unchecked Saddam would be able to "cause a world-wide economic crisis."

But is it true that Saddam Hussein can impose large costs on our economy? Economic analysis of the oil market answers with a resounding, No. The annual cost to the U.S. economy of doing nothing in the Gulf would be less than half of 1% of the gross national product. The vaunted oil weapon is a dud.

One thing Saddam cannot do is cause oil shortages and gasoline lines. Only the U.S. government can do that. As long as the government avoids imposing price controls, any cutback in supplies that Saddam causes will translate into higher prices, not shortages. That is the lesson learned from the 1970s. Countries like the U.S. that impose price controls caused Soviet-style queues. Countries like Switzerland that avoided price controls made it through the 1970s with no lines.

That's no surprise. If governments let oil prices rise, people eliminate marginal uses while continuing to use oil where it is most valuable. They take fewer trips to the stores and fewer driving vacations, but don't stop driving to work. Utilities switch from oil to natural gas. People insulate their houses and close off unused room. In a thousand different ways, oil users make subtle adjustments that -- voila -- cause the amount they consume to equal exactly the amount supplied. The market works.

Of course, Saddam does not have to create gasoline lines to hurt the U.S. increases in the price of oil, even without shortages, hurt the U.S. economy. But they hurt less than most people think.

Take the worst case that has any plausibility whatsoever. Assume that Iraq holds

onto Kuwait and grabs Saudi Arabia plus the United Arab Emirates. Iraq would then control virtually all Middle Eastern oil production, except for Iran's.

The Middle Eastern oil fields had been producing about 12.3 million barrels per day before the price run-up in late July. They will go on producing something: Saddam may be evil, but he is not stupid. He does not want to seize the oil fields only to leave them idle. He wants them so that he can sell their oil.

If Saddam sold the same 12.3 million barrels per day as were being sold before the invasion of Kuwait, the effect of his actions on the world price of oil would be zero. Oil would sell for the pre-crisis price of about $20 per barrel.

Obviously, Saddam doesn't intend to sell the same level of output. By controlling the outputs of four major OPEC cartel members Saddam would gain monopoly power over Persian Gulf oil. He would no doubt use this power to cut the combined production to drive up the world price of oil. The revenue-maximizing level of output from the Persian Gulf fields is no less than 8.3 million barrels a day -- a 4 million barrels per day production cut.

That is less awesome than it sounds. Remember that Saddam is operating in a market in which world output is about 60 million barrels per day. The loss of 4 million barrels is thus a 6.7% cut in world output. Granted that in the short-run the demand for oil is fairly inelastic. Small cuts in production can therefore cause large increases in world prices. Adopting the grimmest end of the economists' range of estimates of elasticity, a 6.7% cut in world production would cause a 35% rise in price, to about $27 per barrel from the pre-crisis price of $20.

Before the crisis, the U.S. was importing about 8 million barrels of oil a day. If the U.S. were to import the same amount rather than increasing domestic production or reducing consumption, it would pay $56 million per day extra for its imports. This amounts to $20.5 billion per year.

Now $20.5 billion is not small change. But put the figure into perspective. It is less than 1/2 of 1% of America's $5 trillion GNP. A loss of 1/2 of 1% of GNP is surely not what Henry Kissinger had in mind when he referred to an "economic crisis."

At the gasoline pump, the cost would show up as an added 17 cents per gallon on top of the old price of about $1.09 -- a total of about $1.26, less than motorists are paying now. Total cost per American per year of the price hike would be less than $80.

Consider, by contrast, the costs of war. Sending troops to the Gulf has not been cheap. The U.S. spent an estimated $2 billion extra in the first two weeks of the operation. Staying there a year, or fighting, would probably cost much more than $20.5 billion in added spending. Nor is this spending the only cost of intervening, as the plight of the hostages makes clear.

Remember also that the U.S. embargo of Kuwait and Iraq ensures that less oil will be produced. As a result, oil prices will stay high, which is presumably one of the outcomes the administration wanted to prevent.

The $20.5 billion tax that Saddam can levy on the American economy is only a short-run cost. The longer he restricts oil production, the less annual damage he can inflict. At the higher price of oil, other oil producers will produce more, as is already happening. Moreover, according to energy economists Arlon Tussing and Sam Van Vactor, at $25 per barrel, many substitutes
for oil become economically feasible. The bottom line: Whatever other justifications there may be for war with Saddam, cheap oil isn't one of them.

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