



Director of
Central
Intelligence

~~Secret~~



25X1

MASTER FILE COPY

DO NOT GIVE OUT
OR MARK ON

Implications of an Oil Price Decline

Special National Intelligence Estimate

~~Secret~~

SNIE 3-85
August 1985

Copy 426

Warning Notice
Intelligence Sources or Methods Involved
(WNINTEL)

NATIONAL SECURITY INFORMATION
Unauthorized Disclosure Subject to Criminal Sanctions

DISSEMINATION CONTROL ABBREVIATIONS

NOFORN-	Not Releasable to Foreign Nationals
NOCONTRACT-	Not Releasable to Contractors or Contractor/Consultants
PROPIN-	Caution—Proprietary Information Involved
NFIBONLY-	NFIB Departments Only
ORCON-	Dissemination and Extraction of Information Controlled by Originator
REL . . .-	This Information Has Been Authorized for Release to . . .
FGI-	Foreign Government Information



STAT

SECRET

25X1

SNIE 3-85

IMPLICATIONS OF AN OIL PRICE DECLINE

Information available as of 9 August 1985 was used in the preparation of this Estimate, which was approved by the National Foreign Intelligence Board on that date.

SECRET

SECRET

25X1

THIS ESTIMATE IS ISSUED BY THE DIRECTOR OF CENTRAL INTELLIGENCE.

THE NATIONAL FOREIGN INTELLIGENCE BOARD CONCURS.

The following intelligence organizations participated in the preparation of the Estimate:

The Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, and the intelligence organizations of the Departments of State, the Treasury, and Energy.

Also Participating:

The Assistant Chief of Staff for Intelligence, Department of the Army

The Director of Naval Intelligence, Department of the Navy

The Assistant Chief of Staff, Intelligence, Department of the Air Force

The Director of Intelligence, Headquarters, Marine Corps

SECRET

SECRET

25X1

CONTENTS

	<i>Page</i>
SCOPE NOTE	1
KEY JUDGMENTS	3
DISCUSSION	7
Market Trends and Uncertainties	7
Impacts and Reactions	7
Beneficial to Most Industrial Countries	7
Likely OECD Policy Responses	10
Exchange Rate Movements	10
Generally Positive Effects for Oil-Importing LDCs	12
Mixed Effects for OECD Oil/Gas Exporters	13
Clear Harm to LDC Oil Exporters	13
Difficult Choices for the Soviet Union	16
Ramifications for US Interests	17
West European Energy Security	18
Long-Run Oil Market Impacts	18

SECRET

25X1

SCOPE NOTE

Stagnant oil demand in non-Communist nations and rising non-OPEC supplies have created softness in the world oil market unmatched since the 1960s. Prices have already declined by about \$6 to \$7 per barrel since 1981, and continued pressures that could produce marked price declines seem likely for the next couple of years. The purpose of this Special National Intelligence Estimate is not to predict whether such declines will occur but to examine the effects of such declines, should they take place, on: (a) global economic performance, (b) international financial linkages, and (c) the political situations in some affected countries. In addition to quantifying the benefits of a decline, the Estimate looks at the midterm impact—that is, through about 1990—on US interests in the Middle East, Western Europe, Japan, and the less developed countries

25X1

SECRET

25X1

KEY JUDGMENTS

If oil prices fall markedly over the next few years—say to \$20 per barrel—most of the world, including the United States, will benefit substantially. However, certain oil exporters and other countries could suffer economic setbacks and political repercussions—in some cases sufficiently serious to affect US strategic interests adversely. [redacted]

25X1

On the positive side, most developed countries and oil-importing LDCs would receive substantial direct economic benefits and also would obtain added policy flexibility to enhance these benefits and deal with current economic problems:

- Overall growth in member countries of the Organization for Economic Cooperation and Development (OECD) would increase by about 0.3 percent per year over the rest of the decade, inflation would subside further, and unemployment in Western Europe would decline. Even Canada and the United Kingdom would be likely to benefit from a decline in oil prices, despite being net energy exporters.
- Although Western governments could accentuate the growth benefits from an oil price decline by adopting more stimulative economic policies, we believe most would simply let the benefits go directly to consumers. Japan and, perhaps, Italy might raise energy taxes to avoid increases in oil imports and reduce government deficits. [redacted]

25X1

As for the oil-importing LDCs, a reduction in oil prices to the \$20 per barrel range would reduce energy import costs and raise exports to the developed countries:

- Brazil and South Korea, for example, each would save more than \$5 billion in oil import payments between now and 1990, and could add roughly \$2 billion to their exports to the OECD over the same period.
- As with the developed countries, most oil-importing LDCs would pass on the full price reduction to their domestic economies, although some, including Brazil and the Philippines, might raise taxes on oil to reduce budget deficits and protect domestic energy investments. [redacted]


25X1

In contrast to the benefits of lower oil prices for most oil-importing LDCs, a few countries, dependent on aid or remittances from OPEC


SECRET




25X1

countries, are likely to be hurt as the OPEC countries cut their aid flows and employment levels in response to declining income. 


25X1

Lower prices would create serious problems for some oil exporters. In Mexico, Nigeria, and Egypt, lower oil prices would stall economic recovery, increase the potential for social unrest, and bring calls for higher levels of US aid or other types of assistance. In Iran and Iraq, the loss in revenues would increase the burden of continuing the war while trying to meet domestic needs. Libya, which uses its oil revenues to support terrorism and other activities inimical to US interests, also would be hit financially, but not enough to end its support of these activities. 


25X1

Those oil exporters with larger reserve bases and financial assets and smaller populations—notably Saudi Arabia, Kuwait, and UAE—would also suffer, but we believe they could ride out the stresses in the near term. Riyadh, in addition to drawing down its assets, has to date coped with lower oil revenues by putting development projects on hold, paying bills late, and reducing foreign aid. Kuwait and UAE have even managed to keep their current accounts in surplus. 

25X1

Even in these countries, however, stresses would be brought on by lower oil prices. In Saudi Arabia, foreign liquid assets—now under \$80 billion and declining by \$1-1.5 billion per month—are approaching psychologically and politically important thresholds. As a result, Riyadh is for the first time making serious efforts to cut expenditures in areas that will be felt by the typical Saudi. Lower oil prices would aggravate these problems. 

25X1

We believe that in the Soviet Union a fall in oil prices would have a net unfavorable impact in the near term. If oil prices fell to \$20 per barrel, hard currency earnings from oil exports would drop by \$10-12 billion over the rest of the decade, and natural gas earnings—given the link of Soviet gas prices with world oil prices—would slide sharply as well. Such declines would force Moscow to make difficult choices: selling off assets, increasing Western borrowing, shifting energy exports from Eastern to Western Europe, or reducing imports. On the basis of Moscow's past conservative financial policies and the already constrained levels of its East European energy sales, we believe a cut in hard currency imports would be necessary if oil prices fell dramatically. 

25X1

Although the United States would derive largely positive economic benefits from lower oil prices, we see four sets of possibly adverse political and strategic effects on US interests:

- If the economic problems created in oil-exporting countries, such as Mexico, Egypt, Nigeria, and the Persian Gulf states, were sufficiently great to cause political instability in those

SECRET

25X1

countries, the United States could be called on to react. These responses could range from the protection of US citizens and property against domestic unrest to attempts to moderate the effects on these countries and on the international financial system of the deteriorated debt situation of some of the countries.

- A drop in oil prices could further the continuing shift in the Middle Eastern power balance away from moderate states that use oil money as a lever of power, particularly Saudi Arabia.
- In the area of West European energy security, unless substantial progress is achieved in the development of indigenous resources over the next few years, the Soviet-supplied proportion of West European gas consumption could rise sharply, perhaps to about one-third of the total by 2000. We believe there is a possibility that lower oil prices would push the outcome in this direction. Because of the high cost of developing new West European gas, including taxes, development of indigenous gas is at best a risky proposition. If natural gas prices fall with those of oil, then a drop in oil prices could well eliminate many incentives for further development. In time, Moscow could take advantage of the opportunity presented by a decline in West European gas development by taking only a few extra steps of its own. All of the primary Soviet–West European pipeline will be in place by late 1986; all that would be necessary would be building the Trans-Czech pipeline, a task that could be done in eight months.
- Finally, a drop in oil prices, without compensatory policy adjustments, could stimulate consumption and reduce exploration, development, and maintenance of capacity, thereby increasing dependence on Persian Gulf supplies and raising the potential for an oil supply shortfall and a runup in oil prices. We believe, however, that, given present capacity excesses, this problem is unlikely to occur in this decade.

25X1

While we believe even a sharp fall in prices—in contrast to the more gradual slide we feel is more likely—would be favorable for most of the world economy, there would be some added risks. There would be some risk that banks with heavy energy or LDC loan exposure would fail and there would be the potential for political backlash in LDC oil exporters as sudden income declines forced rapid reductions in living standards. Because of its precarious economic situation and proximity to the United States, we are most concerned about the effects on Mexico.

25X1

SECRET

25X1

DISCUSSION

Market Trends and Uncertainties

1. Since early 1981, when the average official oil price of the Organization of Petroleum Exporting Countries (OPEC) reached almost \$35 a barrel, surplus productive capacity has caused steady downward pressure on official prices. Several factors have played a role in this reversal of the trends of the previous decade (see figure 1):

- Conservation, set in train by the first oil price shock of the mid-1970s and accelerated by the 1979-81 increases, continued to reduce the energy intensity—the ratio of energy use to economic activity—of the world economy. Between 1980 and 1983 the amount of energy used per unit of real GNP in the member countries of the Organization for Economic Cooperation and Development (OECD) declined by almost 10 percent.
- Substitution of other forms of energy further reduced the demand for oil. The 1980-83 period brought a reduction in oil's share of non-Communist primary energy production from 50 percent to 47 percent.
- Widespread economic recession also reduced oil demand; between 1980 and 1983, world real output rose only 4 percent, according to the World Bank.
- Additional supplies of oil, stimulated by the price rises of the 1970s, continued to expand. Despite falling demand, the quantity of oil supplied by non-OPEC countries, including net Communist exports, rose from 21.5 million b/d in 1980 to 24.7 million b/d in 1983.
- The strength of the US dollar kept European prices, measured in nominal national currencies, from falling and further reduced the quantity of oil demanded.

These factors combined to put severe downward pressures on global oil prices and forced OPEC to lower its benchmark price in 1983, in 1984, and again in 1985. As a result, the average official OPEC price now stands at about \$27 a barrel—\$8 a barrel below the 1981 peak.

2. Despite the drop in world oil prices, the oil market remains in considerable surplus. Even with the rebound in global economic activity, oil demand has remained stagnant, with non-Communist oil consumption no higher now than it was in 1982 despite the lower prices and an 8-percent gain in world GNP. Continued increases in non-OPEC supplies also have contributed to oversupply in the market. As a result, oil prices are again softening, and most observers believe that, without a major disruption, the excess capacity will exist for several years.

25X1

3. This SNIE examines the economic effects of an assumed drop in oil prices to \$20 per barrel (see figure 2). The \$20 price was chosen because:

- It is large enough to have a major impact on the world economy; a drop to \$25, while more likely, would have less effect.
- It is the price most often mentioned in discussing where oil prices could go in the next two years.
- It has some precedent in that OPEC, under pressure from Saudi Arabia, cut nominal prices in 1983 by more than \$4 a barrel; a fall to \$20 a barrel would be a cut of about the same magnitude.

25X1

Impacts and Reactions

4. An orderly decline in the price of oil to the \$20 per barrel range—that is, a drop that occurred in discrete increments over the next two to three years—would of itself affect the world economy in a number of ways. At the same time it would create opportunities for governments to offset or magnify these effects.

25X1

Beneficial to Most Industrial Countries

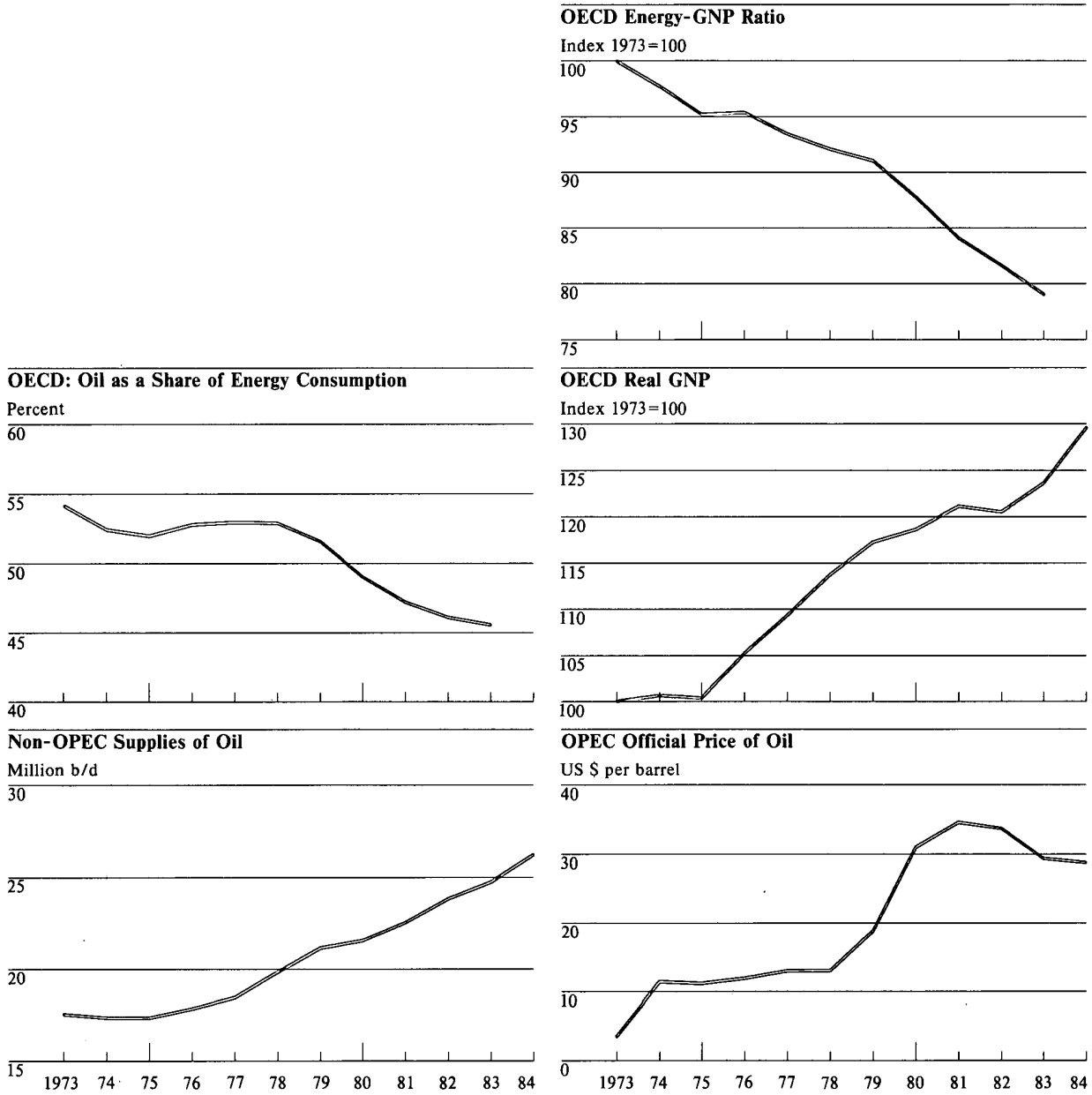
5. Most OECD countries would receive economic benefits from such an oil price cut. A sustained, orderly drop in world oil prices to \$20 a barrel would increase overall OECD real GNP by a total of 1.5 to 2 percent by the late 1980s, adding about 0.3 percentage point to annual growth rates over the rest of the decade, and creating some 1 million jobs (see table 2).

25X1

SECRET

25X1

Figure 1
Oil Market Trends



308443-85

25X1

SECRET

25X1

6. Lower oil prices would improve OECD growth in several ways:

- A gradual drop to \$20 a barrel would leave a cumulative \$270 billion in the hands of OECD

consumers and businesses between now and 1990. Present spending patterns indicate that most of this would be spent on OECD-produced goods and services.

A Price Decline Scenario

Given the current level of surplus production capacity in OPEC and the financial problems in many OPEC countries, a number of factors could cause oil prices to decline substantially over the next couple of years. OECD growth, already expected to slow, could drop more than expected and, in combination with continuing substitution and conservation trends, could reduce oil demand. A second potential source of a drop in oil prices could be more rapid increases in the quantity of oil supplied by non-OPEC producers. Oil price declines also could stem from a further breakdown in OPEC production discipline. Saudi Arabia, for example, could make good its threats to increase production in the face of widespread cheating on quotas; the increase in production planned by Iraq could also trigger price declines [redacted]

Should oil prices fall, there is the matter of how far and how fast. From the standpoint of how far, world oil prices presently are well above levels required to cover competitive long- and short-run costs, even in very expensive fields, where total costs are no more than \$15 to \$20 a barrel and operating costs are \$10 per barrel or less. We believe, however, it is unlikely that oil prices would fall to this range. OPEC members recognize that a "price war" would be financially disastrous; thus we believe a price this low to be unlikely. [redacted]

Should those OPEC members with large reserve-to-production ratios, such as Saudi Arabia and Kuwait, decide to cut prices in a measured way in order to protect their long-term interests, several factors argue against a cut below the \$20 per barrel range:

- The Saudis previously have been extremely cautious in cutting prices—and have done so only while simultaneously reducing production in order to defend the new price level. At present, however, Saudi Arabia is producing at under 3 million b/d, severely limiting its ability to cut production further. We believe the Saudis would attempt to gain agreement within the organization for a consolidated approach, and because almost all other OPEC members oppose further reductions in nominal oil prices, such a cut would probably be relatively moderate.
- A price drop of this size could add marginally to price stability because some analysts argue that at

\$22 to \$25 per barrel, some high-cost secondary and tertiary oil production—in the United States, for example—could become uneconomic. [redacted]

All in all, it is our view that further \$1 to \$2 per year declines in oil prices over the next year or two are likely. According to some industry estimates, even with OECD growth of 3 percent, non-Communist oil demand is expected to increase only 0.5 to 1.0 percent a year through 1990 (see table 1). Meanwhile, non-OPEC supplies will continue to rise, at least for the next year or two. With OPEC countries already producing well below capacity, it seems likely they will find it difficult to prevent further declines in prices. [redacted]

A sudden, large fall in oil prices cannot be ruled out. A major recession in the OECD countries akin to that which occurred in 1982-83 would cause demand for oil to decline below the already stagnant baseline by an additional 1-2 million b/d. This outcome could force OPEC to cut production further in order to avoid a large surplus of oil. If OPEC discipline broke down, spot prices would fall and OPEC would eventually be forced to cut official prices. This scenario could play out in a matter of months. [redacted]

Another possible cause of suddenly lower oil prices would be an end to the Iran-Iraq war, with Iraq and Iran rapidly boosting oil production and aggressively marketing the increment. Our estimates indicate that within six months after the end of hostilities, the two countries combined would have the physical capability to place an additional 1-2 million b/d on the market. As with the OECD recession scenario, we do not believe Saudi Arabia would be willing to offset this increase in supply and a sharp price drop could occur. [redacted]

Table 1
Projected Oil Market Trends, 1986-90

Change in non-Communist real GNP (percent)	15
Change in non-Communist energy demand (percent)	5
Change in non-Communist oil demand (million b/d)	2
Change in non-OPEC supply (million b/d)	1

[redacted]

SECRET



25X1

- The favorable impact on inflation—which we estimate at about a half percentage point a year for the entire OECD—would further increase real purchasing power, as declines in wage rate increases lagged the falloff in inflation.
- Lower inflation rates also would help reduce nominal interest rates, increase investment, and add an additional increment to growth.

would respond to lower oil prices by adopting more expansionary policies, despite the need to reduce unemployment.

25X1

Set against these favorable impacts would be lowered purchases by oil-exporting countries. We are not sure how great these cuts would be, but, given the difficult financial position of most oil exporters, import cuts could be almost as great as revenue declines. This offset, however, would by no means undo the favorable impacts on growth.¹

9. The Japanese Government is considering action to keep retail oil prices from falling. US Embassy reporting indicates Tokyo thinks the current softness in oil prices will last only a few years, and producers will regain control of the oil market by the late 1980s. Consequently, if the market continues to weaken this year, Tokyo probably would raise oil taxes to maintain current retail prices and avoid an increase in oil dependence. Moreover, this would help Prime Minister Nakasone reduce the government deficit—still an important goal for the government.

25X1

25X1

7. Among the larger OECD countries, the United States, Japan, and Canada would receive the largest benefits to growth from a drop in oil prices to \$20 per barrel. Canada, while losing from lower oil revenues, would receive more-than-offsetting benefits from the impact of lower oil prices on the US economy and improved prospects for Canada's nonoil sectors. Japan would receive the largest improvement in its current account—a rise of some \$35 billion. The United States' current account balance would improve at first, but eventually higher imports fueled by higher GNP would lead to a worsening balance. The major West European countries—which are more dependent on exports to OPEC—would gain less than the United States and Japan, but would still register improved growth. Turkey and Greece would benefit less than other OECD countries because their exports depend especially heavily on sales to the Middle East.

10. Italy has yet to formulate a policy to deal with a drop in oil prices. Initially, Rome would probably raise oil taxes in order to help limit a growing budget deficit—now around 15 percent of GDP—but concern with high unemployment, which averaged 10 percent last year, would limit the extent of an oil tax increase. The Christian Democratic Party probably would recommend a tax increase, with the funds used to maintain employment through public works projects. Some of the smaller coalition partners, however, would probably prefer a more market-oriented approach. As a result, the final policy will probably be a compromise solution, including some tax increases.

25X1

Likely OECD Policy Responses

8. Because the increased strength of the dollar has largely offset the decline in the price of oil since early 1983 in national currency terms for OECD economies other than the United States, we believe most governments—with the possible exceptions of those in Japan, Italy, and France among the major countries—would welcome the opportunity to pass on to consumers a decline in the price of oil. We believe, however, that because of continuing problems with inflation and budget deficits, few, if any, OECD governments

11. West Germany's market-oriented government probably would allow domestic oil prices to decline as the market price of oil goes down; the potential reaction in France, on the other hand, is less clear. A passthrough of lower oil prices would be appealing as the Socialist Party tries to improve its prospects in next year's National Assembly elections. On the other hand, the French Government has promised additional income tax cuts for 1986 and, if the price of oil falls, compensating increases in domestic oil taxes might be a convenient way to make up the revenue shortfall. Almost all other OECD governments would let domestic oil prices go down in line with a world oil price decline. Those with major deficit problems—Greece, Portugal, and Iceland—probably would consider raising oil taxes, however.

25X1

25X1

¹ The quantitative estimates of the OECD impacts of a drop in oil prices are based on CIA's Model of the world economy. In utilizing this model, the effects of a drop in oil prices were calculated



Exchange Rate Movements

12. The distribution of the impacts would be affected if the lower prices caused adjustment of exchange rates, particularly of the dollar in relation to other currencies. During the first major oil price rise in 1974-75, the dollar was somewhat favored by the

25X1

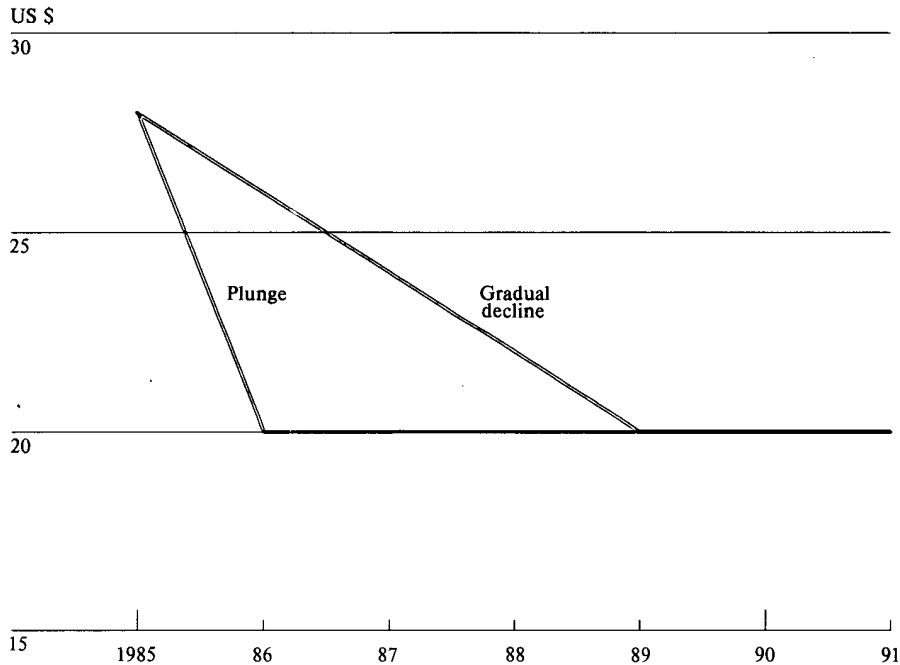
25X1

25X1

SECRET

25X1

Figure 2
Declining Oil Prices: Alternative Scenarios



25X1

306448-85

Table 2
OECD: Estimated Impacts of Gradual Declines
in Oil Prices, 1986-90

	Impacts on Average Annual Real Growth (percentage points)	Impacts on Average Annual Inflation (percentage points)	Total Impact on Unemployment Rate (percentage points)	Cumulative Impact on Current Account Balances (billion US \$)
Total OECD	0.3	-0.7	-0.5	82.3
United States	0.4	-0.6	-0.5	-12.0
Japan	0.4	-0.5	-0.1	35.0
Western Europe	0.1	-0.8	0.1	45.4
West Germany	0.1	-0.4	0.0	0.8
France	0.2	-0.4	0.0	5.3
United Kingdom	0.1	-0.3	-0.1	0.6
Italy	0.2	-0.9	-0.2	0.6
Canada	0.7	-0.3	-1.2	10.7
Other OECD countries	-0.2	-0.9	0.3	3.2

25X1

SECRET

25X1

perception that the United States would be less harmed than Japan or Europe by oil price rises. By the same reasoning, a fall in oil prices could supply downward pressure on the dollar if Japan and Europe (excluding the United Kingdom) were perceived to enjoy disproportionate gains from an oil price decline. If such an outcome did occur, the benefits of lower dollar oil prices to Western Europe and Japan would be followed by a further drop in their national currency oil prices. Over the long run, the lower dollar would provide an additional benefit to the United States in the form of enhanced trade competitiveness relative to Europe and Japan. It should be noted, however, that the downward movement in oil prices over the past several months has been interpreted in the market as favorable to the dollar. []

Generally Positive Effects for Oil-Importing LDCs

13. Oil-importing LDCs also would benefit from falling oil prices; those with debt problems and large oil imports would receive the greatest benefit. Brazil and South Korea, because they are large oil importers, would receive the greatest direct benefit; a drop in oil prices to \$20 a barrel would mean each would realize import savings exceeding \$5 billion in the 1986-90 period at current consumption levels (see table 3). The Philippines would achieve savings of \$2 billion. []

14. So-called second-order effects also would benefit oil-importing LDCs. In particular, the greater growth in OECD countries generated by oil price drops would lead to greater demand for imports,

including those from LDCs, although LDCs that sell substantial amounts of goods to oil-exporting countries—notably Pakistan, Jordan, India, and Sudan—would find markets in these countries diminishing following an oil price decline. The diverse composition of LDC exports makes it difficult to assess which countries would benefit most from OECD growth, but export-oriented countries, such as South Korea and Brazil, would be in the best position to benefit from increased demand from the OECD. []

15. If these price declines result in lower interest rates, oil-importing LDCs would derive even more benefit. Each 1-point decline in rates saves oil-importing LDCs \$2 billion annually. LDC oil importers with large debts—including Brazil, Argentina, and the Philippines—would receive the largest impact from this second-order effect. []

16. The LDC governments, like those in OECD countries, would also face policy decisions:

- Lower oil prices would allow governments to raise revenues relatively painlessly by imposing new energy taxes or tariffs. Domestic oil product prices would be maintained, thus not disturbing investment projects and energy consumption patterns that depend on an oil price of roughly \$30 per barrel. Governments especially in need of funds, such as Brazil, could find this tax policy attractive.
- Alternatively, some countries could choose simply to pass the full oil price reduction on to their

Table 3
Key LDC Oil Importers:
Estimated Impact of Gradual Decline in Oil Prices, 1986-90

Billion US \$

	Direct Impact of Reduced Oil Import Payments Total Savings ^a	Indirect Impact on Exports Total Additions ^b	Indirect Impact on Interest Payments Total Savings ^c
Brazil	7.3	2.0	4.5
India	4.0	0.7	NEGL
Philippines	2.3	0.5	1.3
South Korea	5.3	2.0	2.0
Taiwan	3.6	2.5	0.3

^a Based on oil import volumes for 1984.

^b Assumes a 1:1 relationship between changes in OECD real GNP and LDC exports.

^c Assumes that, as a result of low oil prices, floating rate interest charges paid by LDCs average 1 percentage point lower.

25X1

25X1

25X1

25X1

25X1

SECRET

25X1

domestic economies, allowing greater imports of other goods. At the same time, the oil price decline would also encourage a greater volume of oil imports, especially after an adjustment period of several years.

We believe most LDC governments, given the already severe retrenchment of their economies, would opt to use the savings from lower oil prices in a stimulative manner, either by passing the lower oil prices on to their private sectors or by restoring government programs recently cut. [redacted]

17. Some oil-importing LDCs would be hit with significant negative effects from lower oil prices. Non-Arab African countries probably would receive less aid from Saudi Arabia and other Persian Gulf states. Saudi aid to moderate regional regimes—such as Morocco, Jordan, and Pakistan—is likely to continue, although possibly in slightly reduced amounts and more of it in the form of free oil. Also, countries that have supplied workers to the Persian Gulf region would see a drop in worker remittance receipts and a return home of workers, in most cases, to already surplus labor markets. Oil importers likely to be hit hardest by this effect include Pakistan and the Philippines. [redacted]

Mixed Effects for OECD Oil/Gas Exporters

18. We believe that for the United Kingdom a decline in oil prices will produce a net benefit, but it will also have unwelcome short-term effects on government oil revenues and perhaps create pressure on the pound, particularly vis-a-vis other European currencies. As oil prices fell between 1981 and 1984, for example, British Government oil-generated revenues barely increased and the pound's trade-weighted value declined by some 20 percent. Higher losses in the energy industries could eventually be offset by gains in other sectors of the economy, particularly in the nonoil export sector, where the cheaper pound would make goods and services more attractive. London, which has recently taken action to remove government involvement in pricing by abolishing the British National Oil Company, probably would pass any decline in world oil prices on to consumers. [redacted]

19. In the event lower prices did push the pound sharply downward, Prime Minister Margaret Thatcher probably would act quickly to avoid a repeat of the pound crisis that occurred earlier this year. London could raise interest rates—as it did in January—but this would be costly for the Thatcher government, both economically and politically; indeed, the government recently has encouraged rates to fall following

signs of a weakening in economic growth. New interest rate hikes would cut growth and further increase unemployment—one of the UK's major economic problems. Given the domestic constraints on shoring up the pound, Thatcher might ask for coordinated intervention in the foreign exchange market to support the pound temporarily, but probably would get little response. [redacted]

20. In Canada, Ottawa recently announced that it would stop regulating domestic oil prices and would henceforth allow market forces to set prices. In addition, the new Conservative government eliminated several major federal taxes on energy. We believe the government, given this policy stance, would resist pressure from either private-sector energy firms or the governments of the oil-producing provinces to take action, unless prices fall well below \$20 a barrel. [redacted]

21. Among the OECD countries, Norway would be the biggest loser from an oil price decline because oil and gas now account for about one-third of exports and provide almost one-fifth of government revenue. Moreover, should oil prices decline to \$20 a barrel, Norway would lose the opportunity to develop the high cost offshore gas in the Troll field. The Netherlands' trade balance would benefit from falling oil prices, as lower oil import costs would offset smaller declines in the earnings of gas exports. On the other hand, the falling gas prices would reduce government revenues and frustrate government attempts to reduce the budget deficit. [redacted]

Clear Harm to LDC Oil Exporters

22. While lower oil prices would impact negatively on all LDC oil exporters, those with high per capita incomes, including Saudi Arabia, Kuwait, and UAE, are in the best position to handle a decline. While oil earnings make up most of the foreign exchange earnings of these countries, each has significant levels of foreign assets to draw on to continue spending at current levels:

- Saudi Arabia has official liquid foreign assets of about \$80 billion, equivalent to two years of imports, giving it time to make adjustments by continuing to draw down assets. [redacted]
- Kuwait and UAE are in even stronger positions. High foreign investment income and reductions in imports and spending have allowed these countries to continue to increase foreign assets, albeit at a slower rate. [redacted]

23. Despite its strong asset bases, a decline in oil prices would force Saudi Arabia to make some diffi-

SECRET

25X1

cult choices. Officials in Riyadh have to date coped with lower oil revenues by putting some major development projects on hold, delaying payments, and reducing foreign aid, in addition to drawing down assets (see table 4). Most of the impact has fallen on foreign construction firms and workers. []

24. Reductions in liquid official foreign assets, however, are now approaching psychologically and politically important levels and further cuts may be more difficult. To stem the asset drawdown, Riyadh has formulated a balanced budget for the current fiscal year. Even though this goal will not be achieved, Saudi officials are, for the first time, making serious efforts to cut expenditures in areas that will be felt by the typical Saudi. For example, overtime payments to civil servants are to be severely restricted, and those who live in government-provided housing will now have to pay rent. []

25. Saudi Arabia, however, does have options that are unavailable to most other oil exporters. It has sufficient excess capacity that, should Riyadh choose to give up its attempts to uphold OPEC price stability, it could sell significantly more oil. Although this would accelerate the oil price slide, by capturing larger market shares, Saudi Arabia could probably increase its revenues. []

26. An economic decline caused by reduced oil prices will erode further the monarchy's popular

Table 4
Saudi Arabia:
Reactions to Soft Oil Market, 1982-84

	1981	1984	1984 vs. 1981	
			Absolute Change	Percent Change
Price of its oil (\$ per barrel)	31.58	26.91	-4.67	-14.8
Oil exports (million b/d)	9.5	3.9	-5.6	-58.9
Export earnings (billion US \$)	109.9	39.5	-70.4	-64.1
Import expenditures (billion US \$)	34.0	35.0	1.0	2.9
Grant aid (billion US \$)	5.7	2.0	-3.7	-64.9
Current account balance (billion US \$)	49.7	-14.1	-63.8	NC ^a
Official liquid assets (billion US \$)	127	92	-35	-27.6

^a Not calculated.

Continued Downward Pressure: The Implications for OPEC's Survival

Although a breakup of OPEC would almost inevitably bring about lower oil prices, it is less apparent that lower oil prices would necessarily bring about the dissolution of OPEC. The true test of OPEC's market power has been its ability to limit the fall in the oil prices over the last four years—Saudi Light, the official benchmark crude, dropped only \$6 per barrel, or 18 percent, from its peak in 1982—despite enormous downward pressure from energy conservation, fuel substitution, and economic recession. The cost to the organization, however, has been significant, in that current OPEC output is now under half the 31-million-b/d production level attained in 1979. The resulting drop in sales and revenue has forced members to explore new marketing strategies, many of which are at odds with OPEC's price and production guidelines, although in past times of crisis individual members generally have acted collectively to defend the official price structure. []

The value of continued membership in OPEC is now being seriously questioned by some members. OPEC members realize that even concerted action in coming months will not alter the gloomy demand outlook for its oil over the next two to three years. Production discipline is no longer viewed as a short-term sacrifice guaranteeing a brighter future, but as a long-term headache with no relief in sight. With OPEC providing neither effective leadership to halt the slide in prices nor innovative solutions to its problems, the organization's utility to its members is decreasing, and each successive price drop will further loosen the bonds that hold the members together. []

In our view, Saudi Arabia is key to OPEC's future. While all OPEC countries could undertake unilateral actions, and a number already have, none except the Saudis have the excess capacity to drop prices so dramatically as to render OPEC completely ineffective as an organization. While we believe Riyadh would be reluctant to cause OPEC's demise, the pressure of holding it together is beginning to tell. At OPEC's last meeting in July, Riyadh informed the other members that if they continued their efforts to raise revenues by boosting production above their agreed quotas then Saudi Arabia would do the same. How willing the Saudis are to follow through is uncertain, but continued lack of discipline among other OPEC members at the expense of the Saudis raises the probability of unilateral Saudi action. []

support but is not sufficient, by itself, to pose a near-term threat to the continued rule of the Saudi royal family. Most politically significant segments of Saudi society have direct and close ties to the royal family and will maintain a vested interest in the current

SECRET

25X1

regime. If public dissatisfaction with the government's handling of the economy became worrisome, King Fahd almost certainly would identify scapegoats. He would probably begin to blame publicly the private sector for not undertaking its proper role in economic development. Fahd also probably would try to exploit the situation to make changes in his favor in the Council of Ministers, possibly replacing key technocrats. []

27. Other LDC oil-exporters are in a much weaker position to weather a price decline (see table 5). A price decline would be a major blow to Mexico's efforts to promote economic recovery after a period of economic decline and would complicate the government's political problems. A decline in oil prices to \$20 per barrel would deprive Mexico of some \$3-4 billion in foreign exchange earnings, more than offsetting the favorable effects of faster US growth and any interest rate declines that might follow oil price drops. Mexico City would attempt to stave off the most severe consequences of an annual \$2 a barrel fall in oil prices by drawing down foreign exchange reserves, seeking new debt rescheduling, and devaluing the currency more rapidly. Even with such measures, however, the economy would stagnate, and unemployment and underemployment would rise []

28. Under these circumstances, we believe Mexico City would be likely to turn once again to the United

States for financial assistance, including emergency loans and credits for basic imports. Additionally, Mexico would increase efforts to gain unilateral trade concessions for Mexican goods. At the same time, US leverage with Mexico over issues important to Washington would increase, although Mexico City would resist any domestic appearance of being a lackey to US interests. In particular, the government would continue to emphasize statist policies rather than turn to the private sector []

29. Egypt is another area of potential policy concern. The country's economic difficulties are already being exacerbated by lower oil prices. Moreover, while Cairo has been able to obtain credits easily in the past, some bankers are expressing concern about Egypt's financial situation. Additional oil price drops would compound these difficulties—oil income accounts for 60 percent of goods exports and over 20 percent of goods and services exports. []

30. Lower oil prices would adversely affect Egypt in several ways:

- They would directly lower export earnings.
- They would reduce remittances and cause Egyptian workers in the Persian Gulf countries and Libya to return home in large numbers; the 1 million Egyptian workers in the Gulf area presently remit more than \$2 billion annually through official channels.

- They could interrupt Egyptian oil exploration efforts, reducing present inflows of capital and hindering future growth of oil production []

31. President Mubarak would undoubtedly try to insulate Egyptian citizens from the adverse fallout of Egypt's more precarious international economic position. Despite progress, incomes—at about \$700 per person—remain low, the population is growing rapidly, and most of the urban population is concentrated in Cairo and Alexandria. To mitigate or delay the impact of lower oil prices, Mubarak almost certainly would turn to Washington with requests for even more assistance. He already is using his financial difficulties as leverage to try to obtain better terms on loans and forgiveness for Egypt's Foreign Military Sales debt to the United States. []

32. While of less importance to US interests, other oil-exporting debtor LDCs would also be adversely affected and require US attention. Lower oil prices will pose particularly difficult economic and political problems for whatever government rules in Nigeria, which depends on oil sales for 96 percent of its export earnings. General Buhari's regime has been

Table 5
LDC Oil Exporters:
Dependence on Oil and Foreign
Reserve Position in 1984

	Oil Exports as Share of Exports (percent)	Ratios of Reserves to Imports (months)
Algeria	70	2
Egypt	60	1
Indonesia	57	7
Iran	98	2
Iraq	97	1
Kuwait	82	107 ^a
Libya	97	6
Mexico	64	9
Nigeria	96	1
Saudi Arabia	98	41 ^a
UAE	87	75 ^a
Venezuela	91	14

^a Includes all foreign official assets.

[]

SECRET

unable to fulfill promises made upon seizing power in late 1983 to improve living standards and end the worst economic recession since the 1967-70 civil war. Lagos now faces even greater challenges because of its refusal to accept a politically risky agreement with the International Monetary Fund and its inability to sell sufficient oil to cover rising debt service payments that will consume at least 45 percent of Lagos's estimated \$10 billion oil earnings for 1985. These debt obligations—which peak in 1987—will remain high throughout the decade, and declining oil revenues would force Lagos to cut back even further on imports and to fall behind on debt payments without rescheduling or recourse to the IMF. In this event, perceptions of mismanagement and of worsening economic conditions will increase chances for a coup by disadvantaged ethnic groups or more radical officers that could set off regional violence or an anti-Western backlash.

33. We expect that, despite ample foreign reserves of almost \$13 billion, lower oil prices would give Venezuela some difficulties; in particular, we believe Caracas would experience greater difficulty in finalizing its rescheduling agreement and obtaining new money from creditors. Venezuela has not borrowed externally in two years, while private investment has stagnated. Caracas needs new investment funds to stimulate the economy out of an austerity-induced recession. Venezuela would probably react with a combination of continued austerity and a reserves drawdown. The administration of President Jaime Lusinchi, however, will likely keep unrest under control by balancing mild stimulus with price and wage controls. Because of a sound underlying financial position and a strong government, Indonesia should be able to cope with a loss in revenue. Even there, however, the loss of an accumulated \$2.5-3 billion in export revenue by 1988 from a slide in oil prices to \$20 a barrel would force the government to take strong action to bring the current account deficit down to levels that could be financed.

34. Sliding oil prices would impose considerable economic cost on Iran and Iraq. They derive most of their foreign earnings from oil sales and, because of the cost of their war, both are in precarious economic shape, both domestically and internationally. Baghdad probably hopes to increase exports by 500,000 b/d when its new pipeline through Saudi Arabia opens later this year and will continue to push for new outlets outside the Gulf. However, Baghdad has already promised to repay some of its commercial creditors with funds generated from the added sales. For its part, Tehran probably would try to use some of its

present excess capacity to recapture some of the lost revenue.

35. The United States could potentially derive benefit from the impact of lower oil prices on oil exporters, such as Libya, that use oil earnings for arms purchases, to fund terrorism, and for other activities inimical to US interests. Libya—whose international reserves have fallen by \$10 billion in the last three years—would be seriously harmed by lower oil prices; a drop in price to \$20 a barrel would reduce Tripoli's annual revenues by over \$2 billion. We believe Tripoli would react primarily by cutting back imports. On the other hand, Qadhafi would not reduce its support of terrorist groups and anti-American governments. Recent examples of Libyan aid to anti-American governments in Nicaragua and Ethiopia suggest that even tighter financial conditions would not cause Qadhafi to forgo these activities.

Difficult Choices for the Soviet Union

36. A gradual slide in oil prices probably will pose more problems than opportunities for the Soviet Union in the near to medium term, given the importance of Moscow's energy exports as a source of hard currency (see table 6). Directly, the sliding prices will reduce oil revenues by an average of some \$2-3 billion annually for the 1986-90 period. Moreover, because their natural gas prices are tied to world oil prices, revenues from this source would also fall by just under \$1 billion annually.

37. In a world of declining oil prices, Moscow would face difficult choices with regard to hard currency expenditures, use of oil in its own economy, and provision of oil to Eastern Europe, but would have time to make nondisruptive adjustments. Moscow could respond to a drop in energy prices initially by cutting less essential imports, stepping up its borrowing, and increasing gold sales.

Table 6 *Billion US \$*
Soviet Union:
Importance of Energy Exports

	1970	1975	1980	1984
Hard currency exports	2.8	9.8	27.8	31.6
Oil	0.4	3.4	12.3	15.8
Gas	NEGL	0.2	2.7	3.9
Other	2.4	6.2	12.8	11.9
Hard currency imports	3.0	14.6	26.1	27.2
Hard currency trade balance	-0.2	-4.8	1.7	4.4

SECRET

SECRET

25X1

38. The financial adjustments could be taken immediately. The Kremlin has used these tools before to overcome short-term hard currency payment problems and is in a good position to apply them now:

- It enjoys a highly favorable credit rating among Western lenders who are willing to make loans available at relatively low rates of interest.
- Its net hard currency debt totals only about \$10 billion, with a gross debt of \$20.5 billion offset by about \$10 billion in hard currency asset holdings.
- Soviet gold reserves are now valued at around \$28 billion.
- The debt service ratio has long been a favorable 17 percent. []

39. Moscow would probably view any significant decline in its foreign asset holdings as unacceptable, however. Because these assets serve Moscow in a variety of economic and political ways, it would probably dispose of them only as a last resort. During past periods of heavy hard currency borrowing, the Soviets have tried to leave their foreign asset holdings intact as much as possible and would be likely to do the same at this time. []

40. The Kremlin also probably would not let its hard currency debt grow rapidly. Moscow has been very cautious in its financial dealings with the West, carefully keeping its own debt under control. It has been critical of the rapid growth of the hard currency debt of some of its partners in the Council for Mutual Economic Assistance, asserting that they have become vulnerable to Western pressures and influence. As the perceived duration of the loss of earnings from a fall in energy prices lengthened, however, Moscow would need to reassess its conservative financial policies. The Soviets would most likely increase their long-term hard currency borrowing, being careful not to let the debt service ratio rise to an economically and politically unacceptable level. []

41. In addition, Moscow would increasingly have to rely on adjustments in its hard currency imports to compensate, although significant reductions in any one area would be limited. Given Soviet emphasis on the food program and consumer welfare in general and the ever-present possibility for poor grain crops, we believe that Moscow would be very reluctant to curtail greatly imports of agricultural commodities such as grain and meat. The Soviets would also hesitate to cut imports of industrial materials such as metals, raw materials, and chemicals very much, as these are

needed to reduce key bottlenecks in the Soviet economy. Imports of machinery and equipment, turnkey plants, and high-technology items—which receive high priority under the new 12th Five Year Plan (1986-90) and part of the push to modernize and revitalize the Soviet economy—also would not be cut drastically. In all cases, Moscow would ensure that needed import cuts did not impact on military requirements. []

25X1

42. The Soviets would have limited success in compensating for losses in hard currency earnings due to lower energy prices by increasing oil or gas exports. Energy exports would be constrained by several factors:

- Soviet oil production is likely to remain stagnant or decline into the 1990s.
- Substantial quantities of oil could not be quickly diverted from Eastern Europe without causing possibly serious economic damage there.
- Evidence does suggest that the Soviets are trying to conserve oil and substitute gas for oil, but these changes require time and are not likely to do more than stabilize domestic consumption over the short term. []

25X1

25X1

43. The Soviets would also suffer in the global arms market, which is a substantial source of hard currency for Moscow. With oil prices depressed, its main arms customers—Iraq, Syria, Libya, and Algeria—would be financially strapped and less able to pay in hard currency. Indeed, they might well find it necessary to curtail their arms import programs; Iraq and Libya already have to pay for past purchases in oil rather than hard currency. []

25X1

44. Although the Soviets could step up gold sales, the gold market is now weaker than it has been in past years and, should the price of oil fall, would probably become weaker still. Soviet efforts to compensate for hard currency losses by selling gold could depress the price further. For these reasons, we believe that the Soviets would be reluctant to compensate for a large share of these losses through gold sales unless the only alternatives involved a sharp rise in the debt service ratio or a large reduction in foreign asset holdings. []

25X1

25X1

Ramifications for US Interests

45. While OECD and US economic interests are best served by competitive oil prices, the current situation of artificially high prices serves some strategic interests. It creates private-sector opportunities and incentives to develop relatively high-cost gas in Western Europe; these resources could limit expansion of

SECRET

Soviet gas sales in that market. Also, high prices limit reliance on Persian Gulf exports by promoting conservation, non-OPEC energy exploration and development and further gains in energy productivity. []

Additional Disruptions of a Sharp Plunge in Prices

A drop in oil prices, however it occurs, will increase the purchasing power of those economic units that are net purchasers of oil or oil-based products. In this sense, the same potential gains exist for a rapid as for a gradual decline; moreover, the benefits would come sooner. Nonetheless, a sudden drop would create selective disruptions that could offset some of these positive economic effects for many key sectors of the world economy:

- One potential problem area in a rapid price decline would be in industrial-country oil and other energy industries. Should prices decline rapidly, say to \$20 a barrel by the end of this year, we believe this decline could sharply and adversely affect the energy industry. However, the overall impact on oil-importing economies would be favorable on balance because of the benefits of lower prices on nonenergy sectors.
- Similarly, in the event of a sharp decline in oil prices, we would be concerned about international financial problems stemming from the impact of lower oil prices on banks with large proportions of energy-related loans in their portfolios. Banks with extensive exposure in oil-producing LDCs also could be adversely affected as these countries' overall foreign exchange earnings fall. []

Finally, and most important, we are concerned about the implications for political stability in a number of countries of a sudden plunge in oil prices. A sudden plunge in prices would create problems not present in a gradual decline, chiefly by forcing all the negative effects into a single year and eliminating the ability to adjust gradually. Such an outcome would exacerbate policy dilemmas in a number of countries, notably Mexico, Egypt, Nigeria, Iran, and Iraq. []

One of our greatest concerns would be for the impact on and reactions of Mexico. There, where a gradual decline in oil prices would cause the economy to stagnate for the next few years, an immediate drop in oil prices would plunge their economy into severe recession. [] model of Mexico, for example, suggests a decline in oil prices of \$2 a year for 1985-88, even accompanied by government action to offset some of the most severe results, would reduce growth to an average of 1 percent or so a year. On the other hand a sudden drop to \$20 a barrel without significant government policy response would bring Mexico's real growth to a complete halt for several years, with some years of actual recession. []

West European Energy Security

46. For years the Soviet Union has emphasized energy exports to the West—chiefly Western Europe—as a means of obtaining hard currency. Historically, oil has been the major earner, but, with the completion of the Soviet-West European pipeline, natural gas will become increasingly important. Indeed, unless substantial progress is achieved in the development of indigenous resources over the next few years, Soviet inroads into West European gas consumption could rise to as high as one-third of supplies by 2000 (see table 7). We believe there is a good possibility lower oil prices will push the outcome in this direction. Because of the high cost of developing West European gas—inclusive of taxes—development of indigenous gas would become less attractive. If natural gas prices fall with those of oil—historically they have moved together—then a drop in oil prices could well postpone further development. []

47. Moreover, Moscow could take advantage of the opportunity presented by a decline in West European gas development with only a few steps of its own, chiefly building a transit pipeline through Czechoslovakia, a task that would take only eight months. We believe the Kremlin would be willing to take these steps and would be able to increase its gas sales to Western Europe. []

Long-Run Oil Market Impacts

48. The other area in which lower oil prices might create longer run problems is by spurring demand, reducing supply, and tightening the market. In turn, susceptibility to rising prices and supply disruptions and renewed dependence on OPEC would occur sooner than if prices remained at present levels. Some analysts believe there is the possibility that dramatical-

Table 7
Soviet-West European Gasline:
Potential Impacts

	1984	1990 ^a	2000 ^a
Total Continental European gas consumption (<i>billion cubic meters</i>)	167	190	220
Supplied by Soviet Union (<i>billion cubic meters</i>)	30	50	70
Soviet share of total (<i>percent</i>)	18	26	32

^a Projected

[]

SECRET

25X1

ly lower oil prices would spur consumption in the next few years and lead to a tight market in this decade. There are several reasons, however, to believe this will not be the case:

- One key factor is the momentum of the responses to the last two price hikes. We believe that, even if oil prices fall, consumers and businesses will not undo past conservation measures. Consumers, for example, seem unlikely to return fully to large cars and uninsulated homes, even with lower oil prices. At the same time, there is continuing momentum to back out residual fuel oil in stationary applications. Business may switch to some extent back to oil if its price declines lead those of other energy sources, but will be likely to preserve dual capabilities, retaining the ability to reduce demand if supply grows tight.
- Implementation of new technologies probably also will minimize any upturn in oil demand. Many of the newer technologies coming on line, for example bio processes, are energy saving. Their implementation, moreover, is not entirely dependent on oil prices, and we believe many new technologies will be put in place even at lower oil prices.
- A final factor that is by no means unimportant is the change in population and lifestyles. In the OECD countries, for example, population growth in general and adult population growth in particular will be less rapid over the rest of the century. Moreover, the trends toward compactness—in cars, houses, and appliances—also will hold down increases in energy demand.

The continued efforts at conservation should also be aided by the knowledge that, in the past, current trends and consensus forecasts have frequently been poor predictors of long-run price trends.

49. There is more uncertainty on the supply side, however. On the one hand, we believe that \$20 a barrel oil prices will not significantly affect non-OPEC production between now and 1990, even though the weak oil market has slowed exploration in other areas of the non-Communist world. After more than 20 years of annual increases in capital and exploration spending by the oil industry, expenditures outside North America declined about 10 percent in 1983 compared to 1982 levels. Preliminary data indicate that this trend has continued into early 1985. Nonetheless, our analysis suggest that production through 1990 can rely on already discovered fields and on development projects under way. Consequently, we feel sig-

Growth in Oil Demand: An Alternative View and Its Implications

In large part, the optimistic conclusion that lower oil prices would not generate a tight oil market later in this decade is based on the assumption embodied in the paper that, with no change in prices, conservation of/substitution for oil will continue at close to the pace of the past few years. Specifically, the baseline projection of the oil market through 1990 assumes the oil intensity drops at about 2.5 percent a year; since 1980, the non-Communist world's use of oil for each unit of real production has fallen at more than 5 percent a year. In this event, non-Communist oil demand will be barely 1 million b/d higher in 1990 than it is at present. Even with no growth in non-OPEC supplies, OPEC output would remain several million barrels per day below capacity.

An alternative view is that the recent decline in real oil and energy prices at the consumer level will reverse, or at least bring to an end, the declines in the oil intensity of the world economy. Certainly, energy prices paid by consumers and businesses, particularly in the OECD, have fallen since the decline in oil prices got under way. Since 1982, we estimate final consumer energy prices for the OECD as a whole have fallen an average of 6 percent in real terms.

To examine the ramifications of this alternative view we utilized the energy sector of CIA's Linked Policy Impact Model, which allows an explicit examination of the impact of lowered oil prices. According to the results of that model, there is a possibility that the declines in real energy prices that have occurred since 1982 and that probably will occur even with constant oil prices will produce much less of a decline in oil intensity. Specifically, the model suggests that with constant nominal oil prices, non-Communist oil intensity likely will end its decline, and oil consumption will expand at about the rate of real GNP growth, as it did when real oil prices were falling in the 1960s. Moreover, further declines in oil price will produce an even greater upturn in oil demand.

Should this outcome prove correct, oil market tightness within the next 10 years would be much more likely to occur substantially earlier. The model results indicate that, if lower oil and energy prices do have a strong impact on the use of oil in non-Communist economies, then demand for OPEC oil could well strain OPEC available capacities before 1990. In contrast, continued reduction in oil use would postpone the timing of market tightness into the 1990s, if it occurred at all.

nificant reductions in non-OPEC production before the early 1990s are unlikely, even with \$20 per barrel oil prices.

SECRET

25X1

50. On the other hand, OPEC's decision as to what it views as optimum available capacity could be crucial to whether lower oil prices create a tight market. Over the past several years, OPEC capacity has eroded by some 5 million b/d, as a result of the Iranian Revolution, the Iran-Iraq war, financial constraints on maintenance, and decisions that available capacity exceeds needs for the foreseeable future (see figure 3). If OPEC continues to allow capacity to erode, then by 1990 rises in demand could reduce surplus capacity to perilously low levels. If, however, as OPEC production picks up over the next several years, OPEC countries hold production capacities near

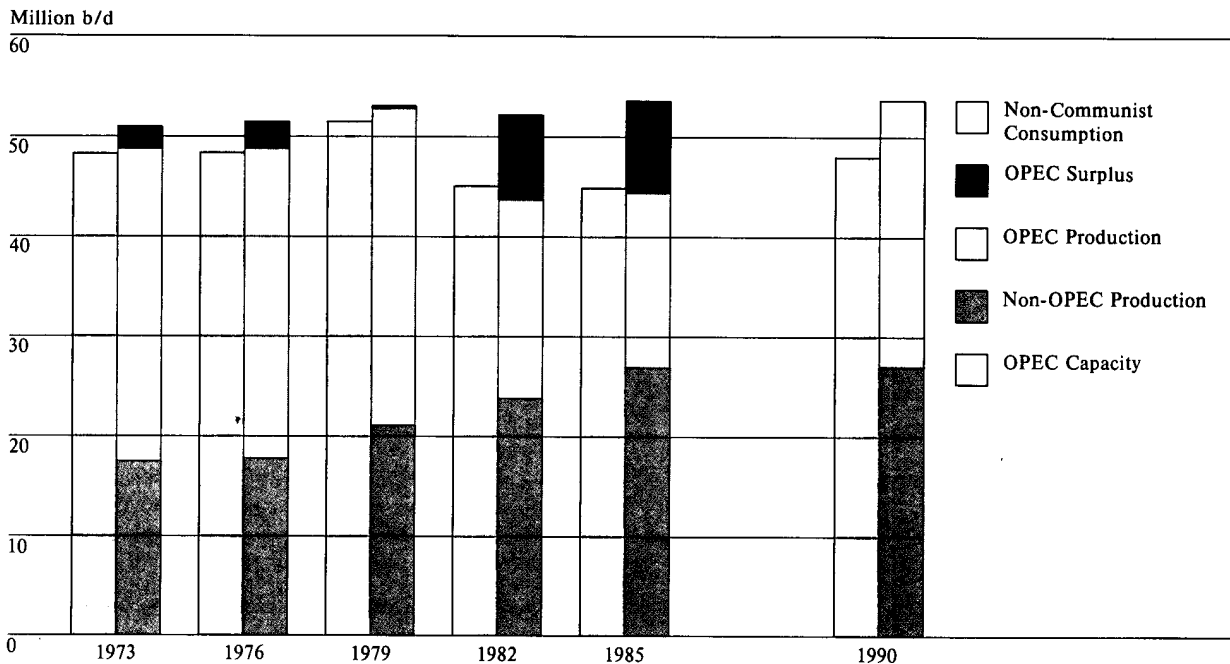
present levels, then the oil market should remain in substantial surplus into the 1990s.

25X1

51. Although the present combination of excess oil supplies and weak oil demand provides considerable protection against supply disruptions in the near term, the dependence of the industrialized countries on oil from the Persian Gulf could increase by the early 1990s because of rises in consumption and lower oil production induced by lower prices. If this scenario comes to pass, the West will again be vulnerable to supply cutoffs and renewed upward pressure on oil prices despite the success of policies to conserve energy, diversify away from oil, and build strategic oil stockpiles.

25X1

Figure 3
Non-Communist Oil Market: Supply and Demand



306449 8-85

25X1

Secret

