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Oil puts Iran out of reach

By Gal Luft
Originally published August 16, 2005

WASHINGTON - Iran's decision to resume its uranium conversion activity in defiance of Europe and the United States raises the specter of sanctions imposed against Tehran by the U.N. Security Council.

Sanctions always have been a favorite punishment against the rogue state. But as the Iraqi case shows, they are easily breached and do little to bring about behavioral change. With no realistic military option, economic sanctions are always the fallback. In Iran's case, economic sanctions may be a double-edged sword. Before we tout them we must carefully assess whether they would be effective and who would be the prime casualty of such a policy.

No doubt, Iran is heavily dependent on petrodollars. Oil revenues constitute over 80 percent of its total export earnings and 50 percent of its gross domestic product. The country earned more than $40 billion from oil exports this year, an increase of 25 percent over last year. Denying revenues to Iran would no doubt hurt its economy and might even spark social discontent.

But the Iranians know that oil is their insurance policy and that the best way to forestall U.S. efforts in the United Nations is by getting into bed with energy hungry powers such as Japan and the two fastest growing energy consumers, China and India.

China and Iran entered into a $70 billion natural gas deal last year that Beijing views as critical to its continued economic expansion. China has already announced that it will block any effort to punish Iran in the Security Council.

Against U.S. advice, India seems to have decided to strengthen ties with Iran by embarking on a gas pipeline project that will create a strong economic bond between the two countries. Japan, which joined the Security Council this year, also has a stake in Iran.

Last year, a Japanese consortium signed a deal to develop the Azadegan oil field, Iran's biggest oil discovery in 30 years. Fully developed, Azadegan is expected to supply up to 6 percent of Japan's oil imports. With over a third of humanity becoming dependent on its energy, no wonder Tehran is unfazed by the prospect of economic sanctions.

Difficult as it may be to accept, Iran's influence on the world's economy makes it virtually untouchable.

It is the second largest oil producer of the Organization of Petroleum Exporting Countries after Saudi Arabia and holder of 10 percent of the world's proven oil reserves. It also has the world's second largest natural gas reserve after Russia.

The oil market suffers from unprecedented tightness. In recent years, the world's spare production capacity dwindled to historically low levels. Absent a mechanism of liquidity, and at a time when oil prices have already reached $66 a barrel, the world oil market cannot sustain any significant drop in supply. Removal of oil from the market immediately translates into a spike in prices.

Iran is fully aware of the power of oil. Its supreme leader Ayatollah Ali Khamenei, warned in 2002: "If the West did not receive oil, their factories would grind to a halt. This will shake the world!" His reference at the time was to suspension of oil exports because of the West's support of Israel.

Threatening Iran with sanctions may well force it to flex its muscles by cutting its oil production and driving oil prices to new highs in order to remind the world how harmful such a policy could be.

Should Iran choose to cut production, or should its biggest consumers agree to participate in sanctioning it, the impact of such action on the U.S. economy could be severe.

Iran currently exports roughly 2.5 million barrels a day. Recent studies and simulations have shown what could happen to the U.S. economy if such an amount of oil would be removed from the market over an extended period of time: gasoline prices could double, more than 1 million jobs could be lost and the current account deficit, a large portion of which is already caused by oil imports, could surpass $1 trillion.

If sanctions were enforced, there would also be long-term implications for the oil market. Iran's oil fields are declining by 8 percent to 13 percent a year, which amounts to 300,000 to 500,000 barrels a day, and are in urgent need of upgrading. Tehran is counting on billions of dollars of foreign investment to ramp up its production capacity. Economic sanctions will make it difficult for international companies to invest in new oil field development.

With global demand for oil projected to grow by 50 percent in the next two decades, any delay in development of new fields means less Iranian crude available to the global market when the world will need this oil most.

Most of the countries with which the United States and, increasingly, the rest of the free world are at odds are oil producers. If we ever want to have leverage on them, it behooves us to take a good hard look at our energy policy and lead the world toward reducing dependence on oil. The failure to do so increasingly will lead to such dead-end situations as just described.

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