One way Pakistan may suffer

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EVEN if Pakistan had not been inducted into the United Nations Security Council on January 1, 2003, Washington's decision to go to war against Iraq would have had momentous consequences for the country. With membership in the Security Council, Pakistan's position on the issue — whether war was the best way of disarming Iraq — acquired even greater importance for the country's future.

The impact of the war in Iraq will be around for a long time. But before addressing ourselves to an analysis of this impact, let us look at the business of oil. The cliche that the world has shrunk from a vast globe to a mere village has some truth when we look at the economics of oil, the world's most precious commodity. The business of oil is complicated. A complex set of markets link the centres of production, the means of transporting the commodity and the centres of consumption. There are severe repercussions and they are felt around the world if any of the links in the oil chain are disrupted. Arbitrary events can cause disruptions.

The decision by the oil producing and exporting countries (Opec) to sharply increase the price of oil in 1973 and again in 1979 produced a world economic recession. It also ultimately led to the debt crisis experienced by

second Iraq war? Two, how long will this effect last? Three, how would it affect a country such as Pakistan, dependent as it is on imported oil to meet a significant part of its demand for energy? There is, of course, a fourth question. Given Pakistan's own situation, how could it relieve itself from the impact of a highly volatile oil market? We will answer this last question some time later in this space.

Pakistan will have to bear the burden of the cost of the war in Iraq for many years to come. The most immediate impact will be a sharp increase in the price of oil, a commodity on which Pakistan spends a significant proportion of its total import bill. A hike in the price of oil will also disrupt the global economy, slowing down the rate of growth to a point where the world may be plunged into a deep and prolonged recession. Even before the war started, the oil market tightened, sending the price soaring in February. In the trading week of February 24-28, crude oil

the consumption of fossil fuels with such sources of energy as nuclear and hydel. There is a strong opposition to the construction of hydroelectric dams in any part of the world.

These disruptions — war, political upheaval, environmentalists' opposition to other sources of energy — have the capacity to disrupt the business of oil. But what about demand in some of the major areas of consumption such as the United States? What are the prospects that the constraint on demand could relieve some pressure on the oil market so that a disruption in supply would not cause a great deal of harm to the global economy, in particular to the economies of oil-importing developing countries such as Pakistan?

While America, the largest consumer of oil, has done little to use the mechanism of price to curtail the demand for oil, technological advances made by it have helped reduce its dependence on conventional energy. The United States uses only about half as much oil per dollar of inflation-adjusted output as it did in the early 1970s. Ever since the last Gulf war in 1991, the economy's energy dependence has shrunk significantly. The implication of this is that a significant disruption in supply may not have a severe impact on price such as the one experienced, albeit briefly, in 1991.

While a prolonged conflict in the Middle East could severely affect supply, much of the world's oil moves in super-tankers sailing in the

Pakistan will feel the impact of a sustained price hike in oil in two ways — a much larger import bill and a slower growth in its exports. Both will impact the country's balance of payments and, consequently, begin to eat into the foreign exchange reserves built with loving care over the last couple of years. A hike in the price of oil could seriously affect economic growth.

the debt crisis experienced by many middle income countries — mostly in Latin America — causing economic stagnation that lasted for more than a decade.

Domestic politics and policies can also be disruptive. Nigeria, a major oil producer, offers a depressing case of a country where such a major endowment can be frittered away by selfish politicians bent upon benefiting themselves rather than their citizens. Such rapacious behaviour can produce a popular reaction against the rulers as has happened on many occasions in Nigeria. When political turbulence is extreme and persists over time as it has done in Nigeria and is now happening in Venezuela, its impact can be felt in the world's four corners.

How major centres of consumption price oil through taxes or subsidies also affects the oil business. The most telling example of this is the approach adopted by the United States which has kept the price of gasoline — the most important by-product of oil — at a level that encourages careless consumption. At the petrol pump, US consumers pay about one-half of the price paid by the Europeans and the Japanese. Although, as we will discuss below, the US has been able to reduce its dependence on oil over time, the pressure on the price of this precious commodity would have been much less had the American government chosen to tax the consumers somewhat more aggressively.

However, nothing is more disruptive in the business of oil than a major war, particularly when it is waged in and around the major areas of production such as the Middle East. That happened in January 1991 when America attacked Iraq in order to get it to vacate its occupation of Kuwait. That has happened again and there is a great probability that this new American enterprise in the Middle East will result in a sharp increase in the price of oil.

There is a four-fold purpose behind this article. We will ask and then attempt to answer three questions. One, what is the likely impact on the business of oil of the

price reached the feared level of $40 per barrel.

The oil market is different this time compared to the first Gulf War in 1991. Prices rose to more than $41 a barrel by October 1990 as America began to assemble its troops to attack Iraq. But in January 1991, they fell to $18 a barrel, wiping out the entire war-induced gain. This happened since a number of large oil producers were able to tap their surplus capacity to compensate for the loss of exports from Kuwait and Iraq. The US also released large quantities of oil from its strategic reserves and pumped more oil from the fields in Alaska.

The disruption caused by the new war may last for a long time. This is for several reasons, the most important of which is the tight inventory situation in the world. A dozen years ago, the world was awash with oil. Although the UN imposed an embargo on the export of oil from Kuwait and Iraq, removing more than seven per cent of global oil supplies, large oil producers were able to quickly close the gap. This time most major production centres have been pumping almost all they can produce. This was done to compensate for the fall in production in Venezuela which removed as much as four per cent from total supplies.

It appears, therefore, that the spare capacity that was available in 1990-91 is no longer available if a sudden loss of supply is caused by the present war. In July 1990, before the Iraqis invaded Kuwait, Opec's spare capacity was 5.2 million barrels a day. According to some estimates, Opec now has only 1.1 million barrels to tap to compensate for any shortfall.

There are other circumstances that might affect the business of oil. An important development in the major consuming areas is the growing strength of the "green movement" — environmentalists who are gaining political clout in many industrial countries. The environmental movement in the United States is strong enough to stop the construction of new nuclear plants. Environmentalists will not allow replacing

super tankers sailing in the troubled waters of the Middle East. A disruption in their movement could happen for any number of reasons — war and a terrorist attack being two of them. Fearing that something like that could happen, Saudi Arabia took the precaution of loading its large fleet of tankers with oil in the days before the new war began. These tankers were positioned near the areas of major consumption such as the United States, Japan and Southeast Asia.

While the Saudis have opted for "floating buffers," there are other strategic reserves available around the world that could be tapped in case of a severe disruption in supplies. The largest of these is in the United States. The US Strategic Petroleum Reserves (SPR) holds about 559 million barrels of oil, equivalent to about thirty days of the combined current output of the five largest oil producers of the Middle East — Saudi Arabia, Iran, Iraq, UAE and Kuwait. Other countries also have reserves. Fairly significant quantities are available in Japan, Korea, Canada and Germany.

Several serious and well informed analysts believe that a surge in energy prices for whatever reason will have a serious impact on the world economy. According to one, "They have the weight of history on their side. Since the first Arab embargo in 1973, nearly every oil [price hike] in the US has been followed by a recession." According to Stephen S. Roach, Morgan Stanley's chief economist: "Inasmuch as America has yet to withstand an oil shock without tumbling back into recession, I am hard pressed to believe that this will be the sole exception."

Pakistan will feel the impact of a sustained price hike in oil in two ways — a much larger import bill and a slower growth in its exports. Both will impact the country's balance of payments and, consequently, begin to eat into the foreign exchange reserves built with loving care over the last couple of years. Notwithstanding all the other costs Pakistan will have to bear as a result of the 2003 Iraq war, a hike in the price of oil could seriously affect economic growth.