

Hammerin' Hank

How the Treasury secretary can help in a showdown with Iran.

by Marc Sumerlin

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AS WALL STREET veteran Hank Paulson settles into his new job as Treasury secretary, the conventional wisdom is that he can't accomplish much in the waning years of President Bush's second term. Paulson fiercely resists such assertions, and there is reason to believe he is right. But the arena in which he is most likely to shine is one the conventional wisdom has mostly ignored: crisis management with Iran.

Paulson is taking over Treasury at a momentous time. This month, the debate over Iran's nuclear program will turn to sanctions--an area where his experience will prove an immense asset. The best nonmilitary hope for turning back Tehran's decision to become a nuclear power is aggressive financial sanctions targeting Iranian leaders. Such sanctions would naturally be led by the Treasury Department, building on its expertise in suppressing money laundering and financial support for terrorism. It would be a significant achievement if Paulson were able to gain international agreement on sanctions and the cooperation needed to enforce them. At the G-7 finance ministers' meeting in Singapore this month, he will have an excellent setting to make the case.

So far, Iranian leaders have suffered little for their nuclear ambition--in fact they have gained as oil prices have risen. But if they were to suffer severe and personal financial losses, it might affect their calculus. Securing financial sanctions is no easy task. European cooperation is needed to get at Iranian bank accounts, and European political leaders face resistance from business leaders who prefer cozy relations. An even more aggressive sanctions strategy would turn the oil weapon on its head and restrict gasoline exports *to* Iran, on which they are surprisingly dependent. This, however, would require cooperation from both Europe and India, and is even higher up on the ladder of diplomatic difficulty.

Even with punitive personal sanctions, Iran's leaders, fueled by a dangerous mixture of hate and religion, may not be deterred. A broader containment strategy may ultimately involve targeted strikes on Iran's key nuclear facilities. It is true that many foreign policy experts argue that taking on Iran militarily is highly unlikely. But given that Iran's leaders are pursuing a nuclear weapon and that President Bush is committed to preventing them from acquiring one, it is impossible to say military action will not be

taken.

Should such a conflict happen, Paulson, again, would be in the spotlight. His role would be to ensure that someone who is sensitive to markets has a strong voice at the table. Oil prices would undoubtedly surge with any military action. But, if handled well, the administration would give oil traders a reason to take profits as early as possible. Buy stocks on the cannons, goes the old market saying--but the inverse should be true for oil.

The most important policy would be to announce without delay a coordinated release of strategic petroleum stocks led by Energy Secretary Samuel Bodman and International Energy Agency executive director Claude Mandil. Global government-controlled petroleum of IEA member countries could offset about 20 months of Iranian oil exports--a figure that should not only make Tehran nervous, but could also allow for an over-release, providing more oil to markets than was taken off-line. A coordinated oil release would shift supply from religious fanatics to known allies and demonstrate that oil vulnerability can be a two-way street. During the Persian Gulf war, a release of the Strategic Petroleum Reserve was announced on the same day that the war began. The price of oil fell by one-third over the next six weeks, as the military action proved successful. After Hurricane Katrina, the administration waited five days to announce a coordinated release of strategic oil--a period too long for traders experiencing pain with every tick.

Parrying Iran's oil dagger will require substantial preparation beyond a release of the strategic petroleum stocks. If Iran were to mine the Strait of Hormuz, for example, the administration would ideally provide markets with immediate information about the status and progress of mine-clearing ships. Markets would react positively to such information even if mine-clearing (or similar activity) were to take time. Silence, on the other hand, would increase uncertainty and push oil prices even higher.

Another challenge would be the risk of hostile action by Venezuela's Hugo Chávez, a committed ally of the Iranian regime. Eleven refineries in the United States use significant amounts of Venezuelan crude, and these refineries are tuned to run most efficiently with Venezuela's heavy oil. (In an additional complication, four of these refineries are also owned by Venezuela.) Should Chávez cut off shipments, it could take more than 30 days for a similar type of crude to arrive from the Middle East.

The administration will thus need to make sure that alternative supplies of the same type of oil are available from the strategic reserve or elsewhere on short notice. The administration should also have plans to facilitate the purchase of any oil on the high seas that does not have a final port of destination--which at times is a significant amount.

It is impossible to calculate the "Iran premium" in the current price of oil, but it is not unreasonable to suppose that a durable political or military solution to the dispute could drop today's price by as much as \$10 per barrel. Rational traders fear shorting oil in a

world where large amounts of supply can go off-line while they sleep. The largest worry, of course, is with Iran, which not only exports 2.7 million barrels a day but also sits on a strategic position at the Strait of Hormuz, where one-fifth of the world's oil supply passes under its gaze each day.

A \$10 drop in the price of oil over the course of a year would add about \$75 billion in income to U.S. consumers and take about \$30 billion from U.S. oil producers. This \$45 billion net improvement to U.S. income would directly improve our trade deficit since oil imports would cost less. The effect on economic growth could be even larger than this calculation alone suggests. The change in the price of oil would shift from being a drag on growth to a supporter of growth, providing a net swing that could add a one-half percent or more to the next year's growth rate. More important, a fall in oil prices would help ease inflation concerns, allowing the markets and the Federal Reserve to take a longer-term perspective on the recent increase in inflation.

In short, successfully handling the economic and financial aspects of a potential Iran crisis may be the best opportunity for Paulson to simultaneously and immediately make a contribution to raising growth, lowering inflation, and reducing global imbalances. Even better, reducing inflation and trimming our external deficit is the best way to strengthen the currency that will soon bear his name. A well-prepared policy response that reveals the weakness of Iran's oil card would offer benefits that far outweigh the economic impact of a sizable but brief spike in the price of oil.

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