INTERNATIONAL ECONOMIC POLICY AND NATIONAL SECURITY

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I. THE PROBLEM

No element of national security is more visible today than the economic component of foreign policy and national security. In the 1980 election, the economic component was arguably the central issue. Thus, there is a substantial awareness of the range of economic problems facing the United States. That range includes differential economic growth rates of the West versus those of the Soviet Bloc, growth rates of the developing countries, a healthy international trade, access to fuel and nonfuel mineral resources, questions of sensitive technology transfer, and many other aspects. This article will focus on the oil crisis, one of the problems honestly deserving the use of that overworked term “crisis.” The oil crisis broadly affects many economic issues of importance for national security.

Specifically, this article will address three elements of the oil crisis and then discuss the nonfuel mineral area, focusing on what might be learned from the oil crisis in that area. First, it will address what the oil crisis problem is and is not. Second, it will focus on the particular national security elements of the oil crisis, including the specific components that are harmful to the national security of the United States and deserve particular attention. Third, this article will address what might be done to deal with those security components of the oil crisis and to develop what might be called a foreign policy for dealing with

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oil, as opposed to the general focus on domestic issues in responding to the oil crisis. Finally, it will focus on a parallel nonfuel mineral problem.

First, what is the nature of the oil crisis? What is the oil problem? To greatly oversimplify, the problem is that during the late 1960s and particularly the early 1970s, the United States and much of the rest of the world became hooked on cheap oil. Geologists discovered large oil fields, particularly in the Middle East, from which oil flowed out of the ground at 2000 pounds per square inch at a production cost of some fifty cents to a dollar per barrel.1 The world responded to these very large finds of cheap oil by becoming addicted to oil because it was the cheapest fuel around. A few years later several unhappy facts about that addiction became evident. First, at the projected rates of use of the cheap oil, production of cheap oil was going to begin to decrease sometime near the year 2000, even with all of the enhanced recovery techniques and a variety of more intensive exploration and development programs. That estimate continues to be supported by most of the experts on the issue, although it is always possible there will be happy surprises in the future. However, the problem is not one of running out of oil. Oil will be available from oil shale, coal, and many other sources. The question is one of cheap oil and a transition from a cheap oil past to an expensive oil future.

The second unhappy shock was that the nations of the area where the majority of these giant oil fields were located got together politically. The Organization of Petroleum Exporting Countries (OPEC) and the Organization of Arab Petroleum Exporting Countries (OAPEC) loosely coordinated the pricing and, to a lesser extent, production policies of the various countries. Unfortunately for the rest of the world, there was a concentration of export surplus of oil in the members of OPEC, particularly OAPEC in the Middle East. That led to a series of shocks as the cartel began to realize its political and economic power. There was a deliberate use of the oil weapon against the United States and the Netherlands at the time of the Yom Kippur War.2 The oil weapon was employed in an effort to prevent the United States and others from providing assistance to Israel.

In addition, coinciding with that first oil shock and partially as a result of the embargo and the shortage of world markets and partially as a result of OPEC pricing policies, the price of oil quadrupled. From 1974 until about 1979, there was a slight reduction in real terms in the price of oil just as there had been a reduction in real terms in the price of the oil prior to about 1973 as the addiction to cheap oil was developing. In 1979, the Iranian crisis led to the second oil shock: an increase in the price of oil that was about 125% in the first year and is still continuing. When all of the ramifications of the Iranian oil shock have passed through the system, the price of oil may go even higher. If increased Saudi production remains high, however, prices could be held down.

What is the impact on the world economy as the result of these oil shocks? The simple fact that cheap oil will become more scarce and production from these giant fields will decrease at least by the year 2000 means the price of oil must increase. In theory, the price should increase to the scarcity value of alternate sources of energy to deal with the basic supply problem.

During an oil price shock, the impact on inflation around the world is substantial. The figures used by the International Monetary Fund (IMF) show that in 1978 the industrialized nations had an inflation rate of approximately 7%. In 1979, one year later, the industrial nations had an inflation rate of approximately 14%. The IMF report attributed about 4.5 of those percentage points out of the additional seven to the direct effect of the oil price increase. When one looks at the indirect effects of the rising cost of money, the actual impact in inflationary terms was probably higher than 4.5%. Whatever it was, there was an enormous percentage jump in the inflation rate in the oil shock year.

As a result of the higher inflation rates, the other side of the equation will show deceleration in growth rates. The result is the classic combination of stagflation that has been so puzzling. There is a deceleration in growth because as interest rates are

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driven up, real investment and real growth decline. Interest rates are driven up in part because the rate of return on investment now has to be higher than the inflation rate. The rate of return must at least match the inflation rate. In addition, central banks, in order to deal with inflation, have to adopt policies seeking to restrain the growth of the money supply. A restraint would lead to higher interest rates, which lead to deceleration of growth. This is coupled with a global impact which leads to decreased trade, at least among traditional trading partners. To some extent, however, new trade exists with OPEC members rich in petro-dollars. The decrease in growth leads to lessened productivity, which in turn increases the inflation rate. Thus, after each oil shock there has been a vicious cycle in the economies of the developed nations leading to stagflation.

In the developing world, the mechanism is very much the same, except the impact is greater. The nonoil developing nations of the world, the NOPEC nations, obtain two-thirds of their commercial energy from Middle East oil. By comparison, the United States imports 45% at the present time, and the Europeans are still at or below the rate of the average developing (NOPEC) country.6

Thus, the economy of a typical NOPEC developing nation is more adversely affected by oil shocks than even the industrial West. The problem is exacerbated because the downturn in the developed world economy has a direct effect in decreasing exports, on which the developing countries rely to a greater degree. Every 1% decrease in developed nation GNP per year results in about a 1-1¼% reduction in the exports of developing countries, about a $2 billion reduction in their exports.7

Developing countries must borrow to meet their oil debt, and therefore, are running increasingly more serious deficits. When they go to the capital market to borrow money, they find the interest rates are much higher. In addition, they discover real rates of investment are decreasing in the world as a result of the same problem, which otherwise could be a positive adjustment factor. Developing countries discover real rates of aid and development


7. Interview with Fred Rosi of the Energy Policy Center, University of Virginia.
assistance, as aid grants and in other forms, are also decreasing because of the problems developed nations are experiencing.

The impact of the first oil shock on some developing countries and the increase in their oil bills can best be understood by comparing the rate of growth of their real gross national product from 1972 to 1978 to their debt service cost. Brazil had a GNP growth in that period of 55% and a debt service growth of 600%; Chile had 8% in GNP and 1100% in debt service; Panama had 15% in GNP and 1100% in debt service, Singapore had 60% in GNP, 900% in debt service; Egypt had 25% in GNP and 350% in debt service. In turn, this leads to another effect of the oil crisis: instability of financial markets as a result of the enormous transfers of wealth.

This pattern resulted in a very large surplus generated in the OPEC developing countries with the largest export surplus of oil. There was a reduction in the surplus after the first oil shock because there was an increasing appetite for goods and services on the part of the OPEC nations.

In the second oil shock, there was a surplus in OPEC nations of approximately $110 billion in 1980, twenty times larger than the surplus in 1978 before the second oil shock. A wealth transfer of that magnitude is too large to be recycled by increasing demand for goods and services in OPEC developing nations. Indeed, following the Iran problems, OPEC nations are becoming much more sensitive to the impact of huge infusions of wealth and social programs and the potential social instability. As a result, even if the surpluses could be recycled, the OPEC nations are not as enthusiastic about such trade imbalances.

The prospects for capital recycling, i.e. investment, are not bright, at least in the short run. Rather than being invested in productive areas, the funds tend to be placed in gold or dollar denominated instruments, a third of which are in francs, yen, marks, or other currency. This money is deposited for a short-term, for the most part in commercial banks, but must be lent for the medium range or long-term to the developing countries to meet their oil bills. Since it is not sound banking practice to borrow short-term and lend long-term, there is an inherent instability in the international banking process which further exacerbates instability in financial markets.

The second element of the oil crisis is national security. What are the national problems faced by the United States and
the West as a result of the oil shocks? First, there has to be a realization of vulnerability of the West to an OPEC or an OAPEC oil embargo. The first embargo occurred in 1973 at a time of less dependence by the United States on foreign oil. The United States imported about 37% of its supply at that time.\textsuperscript{8} By 1980, the United States imported about 45% of its supply.\textsuperscript{9} In addition, there is now a great deal more downstream control by OPEC and OAPEC nations than there was at the time of the first oil embargo. Although the first oil embargo was a very short embargo, the potential for enormous disruption of the world economy is still possible because of the vulnerability of most of the world to a deliberate use of the oil weapon.

Second, the oil crisis has had an enormous differential economic impact on the West and the East. The Soviet Union remains the number one oil producer in the world. It is, at least today, basically independent in its own production although there is speculation that the Soviet Union will enter world oil markets. Regardless, when the Soviet Union enters oil markets its percentage of imports will be far less than the imports of the West and the non-OPEC developing countries.

Consequently, the effects of large transfers of wealth and stagflation have been felt predominantly in the West as opposed to the Soviet Union. Indeed, one can argue there has even been an increase in wealth transfer to the Soviet Union from the East European satellites as a result of the oil crisis. The Soviet Union has sold oil at slightly under world market prices to the East European satellite nations. Thus, similar to the transfer taking place from the West to OPEC, there is also a transfer taking place from East European countries to the Soviet Union. The result can be seen in the economic problems of the East European countries. The 1980-81 Polish crisis resulted in part from an economic malaise precipitated by this overall set of events.

Has that differential impact on the East and the West had any impact on the defense budget? The answer has to be yes. It was not in coincidence that the decade of the 1970s was the decade in which the Soviet Union outspent the United States by

\textsuperscript{8} Cline, World Power Assessment 156.
\textsuperscript{9} American Petroleum Institute, Two Energy Futures: A National Choice for the 80s 28 (1980).
more than $100 billion on national defense.\textsuperscript{10} This level coincided with the highest levels of taxation in history in the West, particularly in the United States, and a lower percentage of GNP devoted to defense than at any time since World War II. To give an example of the economic impact in relation to defense budgets in the United States, the increase in oil cost in 1979 for every man, woman, and child in the United States was approximately $400 per year.\textsuperscript{11} That is approximately four-fifths of the equivalent per capita cost of the defense budget of the United States each year. In short, the increased impact in 1979 alone was approximately four-fifths, on a continuing yearly basis, of the entire United States defense budget. That kind of trend cannot continue—unless the Soviets begin to feel the same constraints—without serious problems in providing the kind of national defense that is necessary.

When faced with the enormous transfer of payments to OPEC, there are several choices available. Nations and individuals may elect to accept a lower standard of living. This is not likely to work. Another alternative is to increase the money supply from public or private borrowing, with the cost being inflation and higher budgets. A third choice is to decrease real expenditures that are not highly visible. It is not easy to see there is a decrease in the defense budget when it is held roughly constant and not permitted to grow or is allowed to grow at very low rates compared with other segments of the federal budget. In short, the differential economic impact has a substantial and continuing national security component.

A third national security problem is increased tensions between allies as the struggle to pay oil bills heats up. The developed nations, trying to meet their oil deficits, seek to expand their basic exports. They adopt protectionist measures, reacting to expansive exports from others or internal pressures to reverse the deficit. Perhaps there is also pressure for dumping. All of this results in increased tension between the United States and Japan and between the United States and its European allies.


\textsuperscript{11} Interview with Dr. Fred Singer of the Energy Policy Center, University of Virginia.
Fourth, there are strains on the allies caused by different efforts to solve the oil crisis. Some of the European allies have sought to accommodate OAPEC political concerns. Some European allies, who are more dependent on OAPEC than the United States, have adopted the simplistic policy that the way to assure a steady supply of oil is to please OAPEC. One accommodation by these countries has been the adoption of a more liberal position with respect to the Palestinian Liberation Organization. This policy tends to exacerbate tensions between the United States and its allies.

Fifth, the European allies in need of oil may increasingly be drawn toward the Soviet orbit and thus accelerate political accommodation with the Soviet Union in return for access to oil. It is possible that the recent press release (probably exaggerated) as to Soviet oil supplies may be related to an understanding that the Soviet Union, as a great oil power, could accelerate the process of West European accommodation and might also aid in relations with East European members of the Soviet Bloc.

Sixth, the destabilization of the economies of the developing world countries has made many of them more subject to external influence. Whether it is due to the increase in OAPEC oil power, or perceived Soviet strength, or simply disintegration in the domestic fabric, this permits external intervention. As a rough measure of some of the problems, the non-OAPEC developing countries went from a $36 billion trade deficit in 1979 to a $68 billion trade deficit in 1980.

Seventh, there is a destabilization of the surplus oil producers of the Middle East, caused in part by the rapid transfers of wealth in terms of rapid modernization and social development. A period of rapid social change, rather than being the panacea against revolution, is frequently a platform for revolution and internal unrest.

Eighth, the West faces an external threat from some OPEC nations as the power of oil is realized and its importance to the West and the East becomes greater through the years. There has been an increase in the political and economic power of the OPEC and OAPEC nations particularly, some of which provide aid to radical anti-Western causes including, in the case of Libya, the financing of terrorism.

Finally, there is a destabilization of the international monetary system that lessens the efficiency and the operation of
the interlinked global economies of the West. This threatens disruption in the event there should be massive withdrawals of short-term deposits.

In sum, the oil crisis has weakened the West vis-à-vis the Soviet Bloc. At the same time, the oil crisis tends to increase the level of political risk and uncertainty and exacerbate general political problems throughout the world.

II. Meeting the Problem

What, if anything, can be done in the West to try to ameliorate some of these difficulties? Unfortunately, there has not been a conceptualization that the problem has a major foreign policy component. The energy crisis has focused attention on debates of conservation versus alternate energy sources, or whether price controls should be removed and additional taxes should be added. For some strange reason, despite the fact gas lines tend to occur after some unpleasant foreign event has taken place, Americans have not realized the foreign policy component of the problem. The United States cannot deal with the oil crisis purely by domestic national energy policy, regardless of how effective that national energy policy may be.

The American Petroleum Institute published a booklet in 1980 on alternate energy futures. The most optimistic projection is that the demand for imported oil over the next ten years will go down from a rate of six million barrels per day to four million barrels per day in the United States. Under alternate energy futures, the rate of consumption will increase while the price is also increasing, thereby accelerating real wealth transfers. For at least the next decade, the United States will continue to have an addiction to foreign oil. Therefore, whatever is done domestically is unlikely to solve the problem—although obviously it would be of great importance and certainly the starting point of any effective dealing with the impact of the oil crisis on foreign policy.

What then should be the foreign policy for oil? First, the United States must have an adequate strategic petroleum reserve. It is a national disgrace that despite the ominous warning of the 1973 oil embargo and the institution of Project In-

dependence, there was only a two week supply in the United States strategic petroleum reserve at the end of 1980. This was considerably less than the supply in most of the major industrialized nations of the West. The answer to the problem of tight supplies is to fill the strategic petroleum reserve when there is a glut of petroleum on the market. The United States went through such a period from 1975 through 1978. It was dissembling at its worst when the Carter Administration attributed the lack of a strategic petroleum reserve to accommodation of the requests of United States allies to refrain from filling the reserve during the Iranian oil shock. The United States sought to take advantage of the slight oil surplus at the end of 1980 by filling the strategic petroleum reserve. The fact the United States does not have a meaningful strategic petroleum reserve is one of the major failings of United States policy. Although it is a failure that a number of administrations can share, it was particularly true of the Carter Administration.

Second, a foreign policy for oil should include intensification of domestic efforts and cooperation with allies as to import targets. At the Tokyo economic summit, there was for the first time a meaningful agreement among the principal consuming nations of the West that they should try to hold their imports of oil down to 1977-1978 levels. This policy was sharpened at the meeting of ministers of the energy agency. This is the kind of effort that is essential in the West—an effort which includes simultaneously developing national programs to reduce importation of oil and agreeing with other major developed nations that they must do the same.

Third, it would be sound policy to encourage the rule of law in oil dealings and investment dealings in general. The practice which has evolved during the oil price shock is one of blatantly tearing up oil contracts and throwing them out. It is very difficult to have stability in the marketplace when after entering into an oil contract, the foreign producer simply says, "Well, let's tear it up. We can draw up another one. The price has gone up." In that setting it is essential that a major element of the United States foreign policy in the oil crisis should be to seek to restore the integrity of the rule of law in oil pricing agreements. In addition, there is the general question of encouraging a climate for investment around the world. There is a great paradox in the OPEC nations tearing up oil price contracts and
then having difficulty finding investments for their petro-dollars because of the unstable economic conditions created by oil prices.

There must be a return of the rule of law, whether by better agreement on substance about the maintenance of integrity of investment agreements or new pragmatic arrangements in terms of insurance guarantees. Whatever is done must encourage the flow of petro-dollars into productive investment. Some developing countries have been against these kinds of guarantees. From an economic standpoint there is a strong case to be made that developing countries are the principal beneficiaries of increased investment flows. It may be one way they can adjust to paying their oil bills. A change in ideology is sorely needed.

Fourth, the United States should make every effort to separate foreign policy for oil and the oil crisis from the Arab-Israeli conflict. This may seem impossible since there is no issue more sensitive to the OAPEC oil producers. This is not to suggest that nothing be done about the Arab-Israeli conflict. It is more essential than ever to try to resolve the conflict because of the oil dimension. There is, however, a myth that if the OAPEC nations are accommodated on the Arab-Israeli dispute, the oil crisis will go away. It may ease, but there is no reason to believe that it will go away. Efforts to accommodate OPEC nations through political moves are particularly troubling. This would only encourage the use of the oil weapon. It is critically important for the West to be united to try to resist linkages to the Arab-Israeli conflict. This will be difficult in the face of pressure from the OAPEC nations who will be seeking to expand that linkage.

Fifth, the United States should seek to raise the cost of political embargoes in basic commodities in world trade. One possibility is to argue by analogy to neutrality laws and the laws of war. Use of the oil weapon has such an impact on civilian populations and on nations not involved in particular hostilities that it should be outlawed, given the current dependence and addiction of the world on oil. Whether this is pursued in the United Nations or elsewhere, one would not view prospects for immediate success as high. It is, however, a concept that should be more fully developed.

In order to achieve this, it would probably be necessary for the United States to forego any use of the food weapon. Grain embargoes, as much as the Soviet Union may have deserved one
in the case of Afghanistan, must not be used in the future. The pattern and the demonstrated effect of embargoes in basic commodities at the least is an additional cost of the use of those weapons on the part of the United States. The United States may be more vulnerable to the use of the oil weapon than the Soviets are to the use of the grain weapon. This is a factor which must be taken into account in a decision to use the embargo weapon.

Sixth, the United States should increase exports of American coal and the technology to use it in environmentally safe ways. That is taking place, although there is still a huge backlog in shipping. One problem is port congestion. Although there are many issues which must be resolved, it is in the interest of the United States to greatly increase the export of coal.

Seventh, the United States needs to develop a sharpened Carter doctrine for enhanced Middle East security which is fully coordinated with its allies and considers American capabilities and those of the nations the United States seeks to protect. This doctrine must be particularly sensitive to the fact there are as many real internal threats as there are external threats. How does the law of intervention in developing a modern law of nonintervention apply to a serious internal threat in Saudi Arabia? What is a coordinated allied and Saudi response in dealing with some of those contingencies ahead of time? Developing these issues more fully is far more important than the rather sketchy Carter doctrine which was correct as a first step.

Eighth, the United States needs to enhance its naval power for protection of the so-called “sea lines of communication” (the SLOCs), the ability to have naval power projection, and capability of a true rapid deployment force (RDF). That will not come about simply by setting up a new command structure and calling it a rapid deployment force. The United States has let itself come to the point of shockingly poor capability in terms of true RDF capabilities. The trend in naval power, unless reversed, is also very troubling. Although the movement of oil and resources is riskiest in the shipping nations rather than on the sea lines of communication, it would be irresponsible of the United States to reach a point where it could not defend these sea lines of communication.

There is one last point on dealing with the oil crisis and it is
the most important point. There is only a small chance of being able to achieve it, but it is worth an effort since the effort itself could have some useful by-products. It would be an effort at a producer-consumer accord in oil. A page could be taken from developing country ideology, where commodity stabilization agreements are the most important economic items on the agenda, and apply it to oil.

What would such an agreement contain? First, it would seek to stabilize markets and prices in international trade in oil. For instance, an agreement could be reached that the price of oil would go up on a regular quarterly basis at a rate that is perhaps 2% above the rate of inflation and would be indexed to the rate of inflation. That would at least help prevent the wild oil shocks and the instability in oil markets which is not necessary even if the price of oil rises to the scarcity value. In addition such an agreement should deal with the rule of law point and try to restore the integrity of pricing contracts in oil markets.

The agreement should, in addition, deal with recycling petrodollars. How can a new framework of investment guarantees be created that will halt the increasing instability of commercial banks in the West which take the risk of making loans to NOPEC developing countries to meet their oil bills using petrodollar deposits? How can the United States encourage direct productive investment with those petro-dollars? It would seem that is something in which the Saudis would have a significant interest.

Finally, such an agreement should include a mechanism to deal with the debt crisis escalating in developing countries. This would be the major provision in the agreement for developing countries. Although the same provisions would aid the developed world, it would also aid the developing countries because of the interface in the economic impact.

Without going into the specifics of the procedure the United States should use, a producer-consumer accord needs to have the United Nations' endorsement to provide a platform that does not isolate OPEC nations with the developed West. On the other hand, the accord needs to avoid the impossible linkages currently being put forth in global economic negotiations. These linkages are formulas for ten to twenty years of negotiations and are unlikely to result in the resolution of the oil crisis in any timely
fashion. Some method is needed of getting global endorsement in a way that the OPEC moderates can go along with the developed nations of the West, and at the same time avoid some of the worst negotiating linkages and procedures of the full United Nations system.

The last point is a postscript on nonfuel minerals. There is some good news to report before going back to some bad news. Part of the good news is the nonfuel mineral problem is not of the magnitude of the fuel mineral problem. There are a number of reasons for that. None of the nonfuel minerals come up to the percentage of the value of world trade that oil does, which now exceeds 15% of total world trade. It is easier in most cases to have an effective stockpile strategy. With few exceptions, there is not the same degree of cartel potential since there is less concentration of producer export surplus. The Southern Africa region with its variety of minerals—chromium, platinum group minerals, cobalt and others—may be one exception. However, the partial bad news presents a significant problem. From 1973 to 1978, the importation of nonfuel minerals by the United States increased the balance of payment deficit by $2 billion to its 1980 level of $8 billion. The United States is heavily dependent upon a few of those that are concentrated in the Southern Africa region, a region of high political instability. The United States imports 92% of its chromium for example, a high degree of concentration. The platinum group has 80% importation by the United States, also a high degree of concentration.

What can be done to begin to meet some of the nonfuel minerals problem? First, the United States should completely review its stockpile program. A genuine stockpile program is necessary to protect the United States not only in a strategic mode in a shooting war, but in an economic mode.

Second, the United States needs to pay more attention to long-range negotiations regarding the common heritage of mankind in the deep seabed and in space and in the unique issue of Antarctica. With the possible exception of deep seabed mining, these negotiations will not result in immediate protec-

13. Interview with Dr. Fred Singer of the Energy Policy Center, University of Virginia.
tion. However, if the United States can secure a substantial supply of minerals such as cobalt and manganese—minerals for which it now must depend almost entirely on imports—then the United States certainly should insist on assured access to deep seabed production. A troubling issue is whether, in the current agreement, there is assured access for the United States to minerals of the deep seabed. Space and Antarctica present similar problems, as well as others not the least of which is the arms control issue in the context of Antarctica.

Lawyers must focus on the rule of law in this area. It may well be time for recognition that there is a struggle for law in the world. One of the components of that struggle for law is the kind of law to govern investment regimes. Stable investment is in the interest of every nation in the world. The United States should take a more vigorous leadership position in trying to encourage a greater return to the rule of law in investment stability and expectation.

In conclusion, what should be obvious at this point is that the United States must have a foreign policy for oil as well as for nonfuel minerals. It is one of the more serious national security crises facing not only the United States, but the West as a whole. The United States has not had an effective foreign policy for oil—partly because of a failure to conceptualize that it needs one, and partly because of the enormous difficulties of having one. It is time to get on with a policy and I am hopeful that the Reagan Administration will add a foreign policy component in this area, as well as a more vigorous domestic component, in meeting United States oil needs.