Declining Oil Prices And Beyond Oil: The Case Of Middle Eastern Countries

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Delivered at the Plenary Session-Budapest, Hungary
May 26-28, 2016

Chairman Roh, Distinguished Panelist Members, Colleagues, Participants, Ladies and Gentlemen,

Good Morning:

I regret that I could not be with you at this meeting in this beautiful city of Budapest. I trust you will have a productive meeting. I would like to thank Chairman Roh for his continuous dedications to this organization and in organizing this plenary session and for invitation to speak.

Let me state at the outset that my focus today will be on the Middle Eastern countries economy and how has the decline in oil prices has affected their economy and what lies beyond oil?

The Middle East is a region centered in Western Asia and Egypt. A total of 17 countries make up this region. The region stretches from Egypt in the west to Iran in the east. These countries could be further subdivided into Gulf and non-Gulf countries. The Middle Eastern countries were among the most poorly developed countries in the 1950s. Prior to the discovery of oil, Middle East was a poor region, forbidding ecologically and deprived economically, with very limited agricultural and pastoral economies and a small but locally important caravan trade. With discovery of large reserves of oil in the region, their utilization and further exportation of this so called black gold resulted in an economic turnaround of these countries in general; especially gulf kingdoms. Increasing global reliance on oil meant huge revenues for these small countries. According to current estimates, more than 80% of the world's proven oil reserves are located in and owned by the Organization of the Petroleum Exporting Countries (OPEC), with the bulk of OPEC oil reserves in the Middle East, amounting to around 66% of the OPEC total.

Major share of revenues in these oil rich countries like United Arab Emirates, Kuwait, Iran, Iraq, Abu Dhabi, Qatar, Saudi Arabia etc., ever since the early 20th century have been derived from oil exports and oil royalties. This has resulted in progressive growth of their GDP, wealth of their citizens, growth in government spending to make life of its citizens better and modernize their economies. From 2010 unit mid-2014, world oil prices had been fairly stable, at around $110 a barrel (Bowler). With production costs well below the world oil prices these countries were making huge profits which fueled their economies resulting in healthy GDP growth rate. A healthy economy also allowed the governments to provide abundant subsidies to its citizens in many forms. While some countries like Saudi Arabia, UAE, Qatar, Oman, Bahrain and Kuwait gained substantially from high oil prices, others such as Iraq, Iran and Egypt did not due to various domestic reasons.

As I argued in my last year presentation and stated the reasons for a decline in oil prices is complicated but it boils down to the fundamental economics of supply and demand. The astonishing fall in oil prices, from a peak of $115 per barrel in June 2014 to under $35 at the end of February 2016, has been one of the most important global macroeconomic developments of the past 20 months. Understanding the underlying causes of price drop is essential in interpreting their Macroeconomic effects on the society. Many analysts have argued that, the 1985-86 declines in oil prices was mainly supply-driven, while the drop in 2008-2009 was almost entirely due to a collapse in demand. The recent price decline appears to be mix of two.

On the supply side, increase in oil production in both OPEC and NON-OPEC countries is a contributing factor. Prices of OPEC's benchmark crude oil have fallen 50% since the organization decided against cutting oil production at a 2014 meeting in Vienna. Increased oil production in Libya, Iraq, Saudi Arabia and Gulf Cooperation Council countries have contributed to this decline in oil prices.

Another important factor is the boom in Shale oil production in the U.S. The domestic production of United States of America has nearly doubled over the last several years and it has grown by 4 million barrels per day since 2008. U.S. has become the world's largest oil producer, though it does not export crude oil, it imports much less, creating a lot of spare supply.

As a result of nuclear deal with Iran, more Iranian oil exports will further exacerbate this situation. Given that the global oversupply is increasing oil stock piles, crude futures declined in late September 2015. Not relating to the futures, the oil inventories have still risen more than expected. The Energy Information Administration (EIA) reported on September 30, 2015, that the U.S commercial crude oil inventories rose by 4.5 million barrels from the previous week. At almost 500 million barrels, U.S. oil inventories are at the highest level in at least the last 80 years, contributing to a decline in oil prices.

These have also been demand factors that caused oil prices to decline. In countries like China and Europe, the demand for oil has decreased as a result of weak economic activity and switch from fossil fuel to other fuels, increased efficiency, and depreciation of Asian currencies against dollar and cutting of energy subsidies.

The decline in oil prices in oil-driven economy, whether it is demand or supply driven, will affect their economy. The declining oil prices is affecting economies around the world and especially in the Middle East countries such as Saudi Arabia, United Arab Emirates, Oman, Qatar, Iraq and Iran since their economy is singularly dependent on export of oil. It is one of the most important commodities and any change in oil markets reverberates throughout the world.

Since mid-2014, the persistent decline in oil prices has resulted in slowing economic growth and steady decline in surpluses in Middle Eastern oil exporting countries mentioned above. The growth rate for oil exporters (Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Saudi Arabia, United Arab Emirates and Yemen) is projected to be at 2.9% (IMF estimate) for the year 2016 and 3.1 for the year 2017 from a low of 1.9% in 2015.

The revenue lost as a result of decline in oil prices in the past year and the first five months of this year amounted to $530 billion. The deficit for many oil exporting countries with the exception of Gulf Cooperation Council (GCC) and Algeria is expected to average 7 3/4% of GDP in 2016, while for GCC and Algeria it is expected to be 12 3/4% of GDP (IMF projection). If we were to take into consideration the impact of stronger U.S. dollars to the existing trend of lower prices, the outcome is even more dramatic. For example, most OPEC producers will suffer because they have fixed exchange rates-i.e. their currencies appreciates together with the USD. These countries, like Saudi Arabia, will not only get less dollar revenues- because of lower oil prices- they also have to translate them into less domestic currency when they plan their domestic expenditure. Saudi Arabia ran its first budget deficit since 2009. Their budget deficit is to reach 13.5% of GDP this year. It faced a budget deficit because it required an oil price greater than $100 per barrel to balance its budget. With a cost per barrel of $9.9 dollars, the country is still making a profit from selling oil, but it is not generating enough money to accomplish its budget requirement.

An analysis of economies of these countries revealed different break even oil prices for different countries. Iran needs $140 oil price to break even. Saudi Arabia needs a price just over $90, Qatar over $77 and the UAE around $70. Therefore, as long as Brent crude prices remained above $70 per barrel, most Gulf countries did have no trouble funding their fiscal expansion. However, as soon as the oil prices dropped below $70 per barrel, which happened around September 2014 the economies of these countries, have seriously suffered.

Countries like Bahrain and Oman cannot increase their oil production but extremely low oil prices affect their economy the most. Both Bahrain and Oman under the present oil prices levels are looking at negative GDP growth and mounting budget deficits of around 8% of GDP. Kuwait on the other hand has already announced a 17.7% cut in expenditure to overcome the losses due to low oil prices. Saudi Arabia and UAE are tapping into their financial reserves to cover the losses due to low oil prices; these two countries have also the advantage of lowest break even oil prices at around $70.

Away from the Gulf, the Middle East oil exporters who are most vulnerable to declining oil prices are Algeria, Iran, Iraq and Libya. None of a these countries possess deep fiscal buffers, hence their economies will suffer. In Algeria, the fiscal balance as a percentage of GDP has been negative since 2009. This is also case for Iran since 2011. Libya’s fiscal deficit is estimated to be the largest in the Middle East this year, and Iraq, and Iraq is expected to have a second deficit in a row.

What should the policy response of oil exporting countries be to low oils prices?

Oil exporting countries need to diversify their economy and move away from reliance on oil as the main source of revenue. They need to promote a diverse set of economic and industrial activity to raise revenue and sustain it for the long term. Saudi Arabia has already embarked on diversification strategy and their diversification efforts are focusing on power generation, telecommunications, natural gas exploration and petrochemical sectors. Overall, the plan aims to make the Arab world's largest economy dependent on investment, rather than oil. In addition, Mr. Naimi, Oil Minister of Saudi Arabia, unveiled plans to cut government spending, is including energy subsidies for consumers. The country raised domestic fuel prices. Automobile fuel now cost $0.24 a liter compared to $0.16 a liter before. In recent years, Saudi Arabia has relied on oil revenue for about 90% of its budget.

Saudi Arabia is encouraging the growth of the private sector in order to diversify its economy and to employ more Saudi nationals. Prince Mohammad bin Salman, the Saudi ruler's 30 year old son, confirmed that the country would sell about 5% of Aramco which is estimated to be the world's most valuable company. This company is valued at $2 trillion dollars. Prince Muhammad would like to promote private sector in other areas as well, even to provide education and health through private sector. The government also intends to sell valuable land to developers, mining, and other minerals and expand tourism.

The most critical challenge facing oil exporting and importing countries are to create jobs for a rapidly rising population in the private sectors. Further steps need to be taken in order to improve the functioning of financial markets and increase trade in order to bring about an improvement in economic growth. Gulf Cooperation Council Countries (GCC) has decided to introduce a Value added Tax (VAT) in 2018. They have also increased their efforts to diversify their economy and have begun to cut spending in several areas. In his 2015 address, the Qatari Emir advised Qataris that "the government can no longer provide for everything." In December 2015, Oman's cabinet approved a set of belt-tightening measures that include public sector spending cuts and subsidy reforms. In the long run, the main challenges will be increasing the participation of GCC nationals in the private sector, away from government employment.

For oil importing countries, the impact of declining oil prices is much smaller. Oil is not big part of their economy. Oil importers growth rate improved and increased from 3% in 2011-2014 to 3 3/4 % in 2015. It is projected that it will remain at 3 3/4% in 2016 based on IMF projection. Lower oil prices along with progress from recent reforms have supported and contributed to recovery. Lower prices coupled with reduction in subsidy in energy sector resulted in lower deficit. Government deficit have been reduced from a high of 9 1/2 % in 2013 to about 6 1/2% of GDP in 2016. However, the security condition in the region and adverse spillover from regional conflict combined with low remittances, trade and financial assistance from oil exporting countries, i.e. GCC will affect the future growth. The slight recovery has not resulted in improvement in employment situation as unemployment is still over 10%. The turmoil of the five years since the Arab uprising has resulted in 15% loss of potential GDP for the region.

Overall, most oil importing countries, have used their savings from lower oil prices to reduce their public debt and increase their international reserve and spending on education, health and infrastructure development.

Both exporters and importers should take advantage of lower oil prices to reform fuel subsidies and consider increasing prices/taxes where appropriate. According to the World Bank, fuel subsidies are highly regressive. As much as 60 or even 80% of what governments in the Middle East and North Africa spend is to subsidies energy. Subsidization of energy benefits the richest 20% of population, with the poor receiving less than 10% of these public funds.

How long will this period of low prices last?

Two years ago, Saudi Arabia led the OPEC on a new course of pumping more oil in the facing of declining prices. That was a historical departure for OPEC that produces a third of world's oil and had historically used its muscle to keep supply scarce enough to support desirable prices. With American production flooding the market, the Saudis no longer believed that a production cut would be effective. Oil prices have fallen by more than half ever since that November 2014 decision.

OPEC failed to reach any agreement to restrain production earlier this month, leaving members to continue pumping crude at near record levels into an already oversupplied market. The group abandoned its production ceiling of 30 million barrels a day, which it had breached routinely, Saudi Arabia, along with Iraq, led the pumping frenzy. Saudi Arabia pumped 10.130 million barrels a day in November of 2015, down from record levels over the summer but up from 9.584 million barrel in November of 2014, according to OPEC.

The Saudi lead policy is meant to cause a period of low prices that drives out producers throughout to need high prices, such as the U.S. Eventually, analysts have said, supplies should recede, increasing OPEC's share of the market and eventually causing prices to rebound. The strategy has taken longer to work than some OPEC officials initially thought. American production has proved resilient, remaining above the historically high 9 million barrels a day. Saudi Arabia and Arab allies in the Persian Gulf such as Kuwait and the United Arab Emirates won't cut unless other producers such as Iran, Iraq and Russia join them, Gulf officials have said.

Saudi Arabia, the main driver, and the largest oil producer of the OPEC group, is determined to keep oil production high despite the fact that prices are expected to plummet to record low levels. Iran has declared that it will increase oil production by 500,000 barrels per day once currently imposed sanctions are lifted. Oil revenues for OPEC member countries have already declined by almost half a trillion dollars in the recent past. Any further increase in oil production by OPEC member countries will further bring down oil prices, which are expected to hit a level as low as $20 per barrel.

It is expected that OPEC will continue this strategy of oversupply, with the primary aim to maintain its dominant mart share. This scenario will have varying impacts on different nations as well as on businesses.

In the short run, all oil exporting countries including Saudi Arabia are affected by the low oil prices. But Saudi Arabia benefits in the long run with estimated currency reserves of about $700 billion, allowing it to bear current low oil prices for a few more years. Some OPEC members such as Venezuela have called for drastic action that includes a 5% OPEC production cut to calm the market.

OPEC members and Russia reached a tentative agreement on February 16, 2016, their first in 15 years, to cap oil output. Oil prices have recovered from the 12 year low it reached in January. While a production freeze alone is seen as inadequate to tackle the oil surplus, Saudi Arabia's description of the deal as "the beginning of a process" spurred speculation that more concrete steps may be taken. Welcomed by most OPEC members, the pact struck between Saudi Arabia, Russia, Venezuela and Qatar also received some support from other producers. Azerbaijan is prepared to join the agreement and its production is already projected to decline this year.

Still, the initiative will have little impact on the global surplus without the cooperation of Iran, which is unlikely to participate. Poised to restore as much as one million barrels of daily exports previously blocked by sanctions, Iran has dismissed the proposal as "ridiculous".

Based on the above analysis, it will be correct to argue that the new low prices could remain low for some time. U.S. shale production has been on the rise and the demand growth in China continues its slow path and these conditions could persist for years.

Conclusion:

Middle Eastern countries have the largest combined reserves of crude oil in the world and their decision will affect the whole oil industry. The economies are largely reliant on price of oil. Higher prices have strengthened their economy, while low oil prices adversely affect their financial wellbeing. The decline in oil prices had negative impact on oil exporting countries but positive impact on oil importing countries. One of the positive impacts from lower prices of oil has been decline in inflation in both importers and exporters of oil. ON the negative side, oil exporting countries are faced with another year of decline in oil export revenues and need to introduce and implement reforms that centers on diversification of their economy away from oil, private sector development and creation of jobs in this sector along with training and education.

Oil importing countries should use the gains from lower prices of oil to reduce their public debt, increase their international revenue and increase their spending on education, health and infrastructure development. Oil importers should devise strategies to deal with security challenges and adjust to the challenges of spillovers from the oil exporting countries.