The Impact of Low Oil Prices on the Gulf

by Paul Stevens

Economic uncertainty dominates region amid oil price plummet

Since June 2014, oil prices have fallen by some 60 percent, and currently Brent is priced around $45 per barrel. Historically this is not a "low" price. Between 1986 and 2004, Brent averaged $33 per barrel in real terms. It is only in relation to prices over the last 10 years that they might be seen as low. Between 2011 and 2014, oil prices averaged $112 per barrel. Today however, lower prices are having a significant impact on the Gulf oil producers and indeed in the wider Middle East and North African (MENA) region both economically and politically. The explanation for the price collapse is simple economics.

Following the Arab uprisings that began at the start of 2011, the Arab oil producers needed higher revenues to manage political discontent. This needed higher prices, which they were able to secure in large part because Saudi Arabia quietly resumed its "swing role" in the oil market. Thus it manipulated production to achieve a price target of around $100 per barrel. However, such high prices produce market feedback loops. These led to lower demand for oil and increased supply. Supply greatly exceeded demand and oil inventories grew to record levels. By the summer of 2014, this led to weakening oil prices. In September 2014, Saudi Arabia refused to continue its swing role and reduce production, and prices collapsed.

On the domestic side

The immediate impact has been to create serious macroeconomic consequences as oil revenues fell dramatically. Some of the Gulf Cooperation Council (GCC) countries had room for maneuver given existing financial reserves. For example, Saudi Arabia in September 2014 had reserves amounting to $745 billion. To put this in perspective, their official budget deficit at the start of the fiscal year 2015 was $45 billion and the actual outcome was a deficit of $98 billion. Similarly, Kuwait, Abu Dhabi and Qatar also had a significant financial cushion. However, other MENA producers had no such reserves and were forced to face serious budget deficits.

Estimates made in the summer of 2014 by APICORP suggest that the weighted average oil price to meet the budget needs of OPEC averaged $102 per barrel. At the current oil price of some $45 per barrel, every OPEC producer will be forced either to borrow or reduce expenditure. Already, many producers are trying to cut expenditure and improve the efficiency of spending. A good example is Saudi Arabia's recent set of economic reforms, officially designed to reduce oil dependence. How-

ever, such economic reforms will not be easy and in many countries may produce a political backlash domestically as subsidies are removed and public sector employment opportunities are reduced. Again, Saudi Arabia provides a good example with recently increased water and electricity charges causing some unrest leading to the dismissal of the Water and Electricity minister.

On the international side

Another immediate impact of lower oil prices concerns geopolitics and a deterioration of relations between Saudi Arabia and Iran. Iran, coming out of a sanctions regime following the JCPOA agreement on their nuclear program is determined to restore their crude exports to pre-sanctions levels and beyond. This directly conflicts with Saudi Arabia's determination not to cede market share. It was this determination that caused Saudi Arabia to cease its swing role and protect market share. This was linked into a general perception of "Shia encirclement" within the Kingdom in 2015 with Assad in Syria appearing to secure his position, Iran developing a détente with the United States, and the growing Houthi involvement in Yemen. This sense of threat, real or otherwise, encouraged the new regime of King Salman, fronted by his son Mohammad, to adopt a more aggressive foreign policy.

One consequence has been that attempts to accommodate Iran's return to the oil market (that initially appeared acceptable) are no longer an option. The agreement at the Doha meeting on 17 April 2016 between OPEC and Non-OPEC to cap production but exclude Iran from such restrictions (which had been agreed weeks before the actual meeting) was suddenly no longer acceptable to Saudi Arabia. On the morning of the actual meeting it was announced that without Iranian compliance there could be no deal.

This could be dangerous politically for MENA.

> The immediate impact has been to create serious macroeconomic consequences as oil revenues fell dramatically.

Iran is already deeply frustrated by what it sees (with some justification) as the US reneging on the nuclear deal. Thus there are threats of heavy fines by the US Office of Foreign Assets Control on banks operating in the USA (which covers virtually all major banks, American or otherwise) and continued sanctions for dealing with the IRGC that could be involved in almost any Iranian business operation. With the US presidential election looming, rhetoric against Iran by both candidates will stretch the patience of the reformist elements in Tehran. If Iran's frustration is not assuaged, might they jump before they are pushed and abrogate the JCPOA nuclear deal? Given their ability to cause significant mischief in the region, this could well prove dangerous. It is necessary to go back to 1918—the end of World War I and the collapse of the Ottoman Empire—to find a period of similar uncertainty in the region compared to today.

Professor Paul Stevens is a Distinguished Fellow of Energy, Environment and Resources at Chatham House, the Royal Institute of International Affairs in London.