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Iran's Plunging Oil Prices: The Challenge for the Gulf Oil Economies

Yoel Guzansky and Nizan Feldman

The decline in oil prices from $115 per barrel in June 2014 to less than $60 per barrel in March 2015 (Crude Oil Brent) was caused in part by the refusal of the Organization of Petroleum Exporting Countries (OPEC) to lower production. One explanation for the willingness of the Gulf states to suffer a steep decline in their short term revenues is their desire to moderate the effect of the energy revolution led by the US, which accelerated its oil production rate by about 50 percent since 2008 as a result of substantial technological improvements.

The enormous foreign currency reserves accumulated by the Gulf states in recent years enable these states to cope with lower oil prices. Yet while measures taken to slow the pace of investment and development in the American energy industry are likely to blunt the need of the Gulf states to institute dramatic domestic changes, including in the structure of their economies, in the medium term the plunge in oil prices is liable to affect the extensive subsidies that the Gulf states provide to their citizens.

Over the past 50 years, oil profits have turned the fishing villages on the Arabian side of the Gulf into some of the wealthiest places in the world. On average, over 40 percent of GDP in the Gulf states and over 80 percent of government revenues come from profits on the sale of oil and natural gas. These revenues enable the governments to provide substantial subsidies to their citizens: welfare and services in these countries, known as "rentier states," are either free or subsidized. The degree of support for citizens, who pay no taxes – but who have no political rights to speak of, either – varies, depends on each country's revenues. Bahrain, which relies on revenue from a Saudi Arabian oil field, and Oman, not a member of OPEC and with moderate oil exports, grant their citizens less than what the wealthier countries – Saudi Arabia, United Arab Emirates, Qatar, and Kuwait – grant their citizens. Still, the amounts involved in all these cases are substantial.

Since the upheaval began in the Middle East, the substantial foreign currency reserves that accumulated with the high oil prices over the past decade have enabled the six monarchies to provide their citizens with large amounts of cash and thereby ease social and political tensions. The regional unrest has taught the Gulf monarchies an important

lesson – a steep rise in energy prices is tantamount to political suicide. At the same time, plunging oil prices make it difficult for the regimes to meet the budget targets they have set and to maintain their subsidies policy.

If oil prices do not resume their upward path, a reduction in subsidies is only a matter of time, given the increase in local consumption, the desire of the Gulf states to use more oil for exports, and the steep drop in the revenues from the sale of oil over the past year. The price of oil necessary to maintain a balanced budget in these countries has risen steadily with the increase in their financial obligations. The International Monetary Fund (IMF) estimates that Gulf state economies are likely to lose $300 billion in oil revenues in 2015, amounting to about 21 percent of their GDP, due to lower oil prices in the markets. The drop in revenues from oil exports is expected to cut their current account surplus to 1.6 percent of GDP, compared with 16 percent of GDP in 2014. After many years in which oil prices enabled the Gulf states to enjoy large budget surpluses, the projected fall in revenues is expected to cause an average budget deficit of more than 6 percent of GDP in the Gulf states in the coming fiscal year.

This trend prompts the question of how the Gulf states will act to prevent the decline into chronic budget deficits following the gradual erosion of their balances that will result if oil prices remain low and government spending is not reduced. The question of where to cut spending involves questions of economic efficiency and, no less important, poses a significant social and political challenge to the Gulf governments.

The byproducts of the subsidies policy include low productivity, transportation problems, unemployment, and heavy air pollution (the World Bank estimates that eliminating the subsidies will reduce the emission of pollutants by 15 percent). It is therefore no wonder that the international economic institutions have long encouraged the Gulf states to halt their subsidies. Yet while a cut in subsidies will win the Gulf governments kudos from the IMF and perhaps also from the credit rating agencies, it is liable to encounter strong political protest on the part of the residents.

The Gulf states spend up to approximately 11 percent of their GDP on subsidies for the energy sector, amounting to about $160 billion a year (a gallon of gasoline costs $0.45 in Saudi Arabia, less than a bottle of water). Domestic consumption in Saudi Arabia, for example, is projected to grow from 3 to 8 million barrels of oil per day by 2030. More and more resources, therefore, will be needed to supply the growing demand, and thus if no substantial change is made in its subsidies policy, the kingdom will eventually become an importer of oil.

In the Gulf itself, Kuwait, Oman, and the United Arab Emirates have begun to consider various measures for cutting subsidies, and here Kuwait has taken the lead by raising its domestic prices for several types of fuel, including diesel fuel. This is a particularly

heated argument in Kuwait, because the country is relatively liberal politically and its parliament has relatively extensive authority. In Oman, where political stability is in jeopardy owing to the illness of Sultan Qaboos, the possibility of diversifying sources of revenue through measures such as an increase in indirect taxes levied on foreigners and privatization of companies is under consideration. In Bahrain, which has the most diversified economy in the Persian Gulf, political instability complicates the challenge of addressing the roots of the problem. Support from their wealthier neighbors for the other two Gulf states, which was forthcoming when the upheaval in the Middle East began, is expected. In any case, anxiety about public protest and criticism from the opposition following a cut in subsidies, as occurred in Jordan and Iran, has slowed implementation of the measures in this direction.

In addition to the direct effect on the economies in the Gulf states themselves, the decline in oil prices affects other Arab economies that receive support from the Gulf states. This support consists of investments, grants, and loans awarded by the Persian Gulf royal houses to the Egyptian and Jordanian economies, for example, and revenues from visits by tourists from the Gulf and money sent by citizens of the other countries working in the Gulf. Note that developing markets outside the Persian Gulf, including markets in Egypt, Morocco, Tunisia, and Sudan, have already begun in recent months to lower the fuel, water, and electricity subsidies granted to their citizens.

Despite progress in several Gulf states in diversifying their economies, the dependence on oil profits among Gulf principalities remains almost absolute, and their political stability is directly linked to the high standard of living enjoyed by their citizens. The public atmosphere emerging in the Gulf states since the unrest in the Arab world began exposed the dissatisfaction of the local population with the growing unemployment and the existing poverty that have been concealed from the public. The decline in oil prices, therefore, only highlighted how necessary it was for these countries to take far reaching measures to safeguard their future when oil exports will not enable them to cover government spending. This is particularly true at a time when the existing political order in the Arab world no longer appears unshakable. Even if the risks for the oil economies in the Gulf are not dramatic in the short term, the dependence on oil profits poses a real challenge to the stability of the monarchial regimes in the Gulf in the long term.

The political difficulty involved in reining in their subsidies policy is likely to encourage the Gulf states to cut government spending by reducing government investment, some of which is channeled to the non-oil sectors. Although this policy is likely to reduce political pressure in the short term, in the long term it will create an additional obstacle in the ability of the Gulf states to cope with a situation in which oil prices remain low. If the governments nevertheless decide to introduce substantial changes in their subsidies policy, they will have to find a way to direct some of the resource made available thereby

to underprivileged sectors and groups in order to take the sting out of any possible popular protest.