

EFFECTS OF OIL PRICE PLUNGE ON THE MENA ECONOMIES



ORTADOĞU STRATEJİK ARAŞTIRMALAR MERKEZİ
CENTER FOR MIDDLE EASTERN STRATEGIC STUDIES

مركز الشرق الأوسط للدراسات الاستراتيجية



ORSAM

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ORSAM Report No: 194

December 2014

ISBN: 978-605-4615-94-0

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PREFACE

Oil has been one of the primary factors that determine the political developments in the Middle East for the last century. In 1973, the attempts of the oil producing regional countries to have a say in energy sector, which had started with the foundation of OPEC in the 1960s, produced a tangible result for the first time. However, the oil prices that started to increase with the 1973 oil crisis created serious problems for the world economy and, since then, OPEC has been associated with crises.

There is a bilateral relationship between the oil prices and the Middle Eastern economies. Since the region possesses most of the world oil reserves and more than % 30 of the world oil production, it has become a significant actor in determining the world oil prices. Nevertheless, the fact that oil producing Middle Eastern countries are heavily dependent on oil has made them susceptible to the instability stemming from the price changes. In this respect, there is a common expectation that the decrease in oil prices during the recent months will create serious consequences for the regional countries. This ORSAM report examines the trend in oil prices and crisis originating from the price changes within the historical context and elaborates on the impact of the 2014 price shock. We hope that this analysis, which contextualizes the price movements of high international significance, will be an important reference for those who are interested in the subject.

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EFFECTS OF OIL PRICE PLUNGE ON THE MENA ECONOMIES

INTRODUCTION

There was a rapid decrease in oil prices in the last four months and the price of the Brent oil per barrel fell below \$ 80 at the beginning of November for the first time in the last four years. It was decided during the Organization of Petroleum Exporting Countries (OPEC) meeting that took place in Vienna on 27 November that the oil supply could not be decreased. This decision led the price of oil (per barrel) to decrease to \$ 71. The price of oil (per barrel), which dropped to \$60 following the Mortgage Crisis of 2008, started to increase due to the rapid growth trend in the developing countries and the expectation of decline in the oil supply with the Arab Spring. The prices that had increased to \$ 160 were over\$ 100 for the last 4 years.

The changes in the oil prices are crucial for the world economy since oil has still been one of the primary sources of energy and is used in several sectors as raw material. It can be expected that gradually decreasing oil prices will have positive effects on inflation, mainly because it will decrease the cost of input in the oil-importing countries in the short-run. At the same time, it will also create a positive impact on the external trade balance and growth due to the fact that these countries will have to pay less in foreign exchange. In terms of the middle-run consequences, the demand shrinkage in the oil export-

ing countries may bring in negative effects since it will lead to a decrease in the exports of the countries trading with the oil exporting countries.

The decrease in prices is also a sign of bad times for the oil exporting countries. The continuation of the low prices carries high risks for the OPEC countries and the Middle Eastern economies which are heavily dependent on oil. The regional countries have confronted serious economic problems in the last four years because of the political instability in the Middle East and North Africa (MENA). The decrease in oil prices will lead to shrinkage in the economies of the region. This situation can cause an increase in political instability originating from the decrease in public expenditure and increase in unemployment.

The Reasons of Oil Price Decline

It is necessary to examine the factors that led to the decreasing trend which started in June of 2014, namely supply-side factors and demand-side factors. In terms of demand, the low growth rate in the global economy and the downgrading of future expectations are offered as the main reasons. The expectations that the low performance of the European economies in the last four years will continue and the expectations of a recession in the Japanese

economy in light of the growth data led to a decline in demand for oil, hence causing the fall in oil prices.

When it comes to the supply-side effects, newly discovered oil reserves and the increase in the oil production due to unconventional methods (especially in the US) is intensifying the pressure on the prices downwards. According to the International Energy Agency report, North America will no longer depend on foreign oil by the year 2020 and instead become an oil exporter. The expectation that there

will be an increase in the oil supply in a few years causes a decrease in prices.

In addition to the real economic developments, the effects of international political developments on the decline in oil prices has created a discussion lately. Especially, several scholars expressed that the tension created by the Russian foreign policies and the disputes caused by nuclear energy policies of Iran are related to the fall in oil prices.¹

OIL SHOCKS FROM PAST TO PRESENT AND MENA ECONOMIES

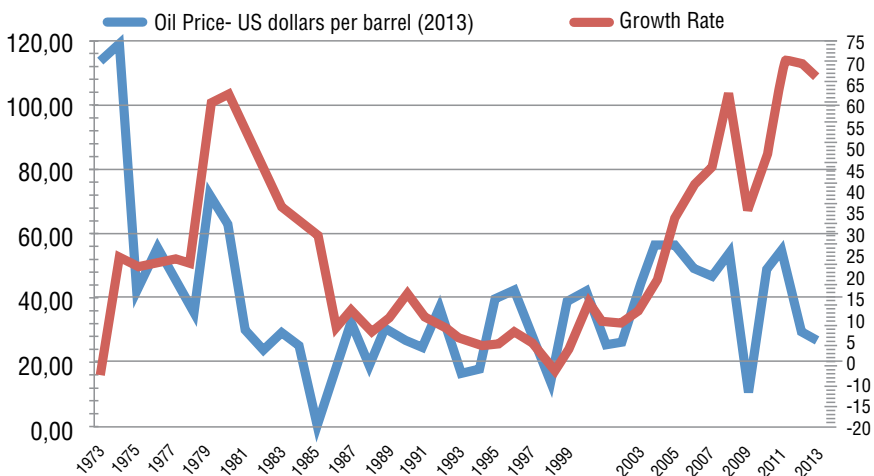
The change in the oil prices is not a new phenomenon. Oil prices, which had been relatively low and stable until the 1970s since the Second World War, rose three-fold due to the embargo by the OPEC countries following the 1973 Yom Kippur War. Oil prices were relatively stable during 1974-78, but they started to rise after the Iranian Revolution in 1979. The Iran-Iraq War in 1981 led oil prices to increase up to \$37. The rapid increases in oil price at the time led rapid yet unstable economic growth in the oil exporting countries and the increased oil incomes were transferred to global finance market as “petrodollars”.

During 1981-87, the oil price per barrel dropped to 8 dollars as a result of the increase in oil production in the non-OPEC countries and the technological developments. The oil prices experienced a slight increase after the Iraqi invasion of Ku-

wait in August 1990, but then featured a continuous declining trend in the 1990s. Following the 1997 Asian crisis, oil prices dropped to \$12. Nevertheless, they started to increase through the reduction in the oil supply by Russia and OPEC countries. When the oil prices declined in 2002, once again the policy of supply reduction was implemented. After 2002, oil prices rapidly rose due to the increase in demand as a result of the global economic growth. This increasing trend continued until the 2008 crisis.

The last increase trend beginning with 2009 stemmed from the quick recovery of the growth performance of the developing countries. The decline trend in oil prices that has been ongoing for the last four months stemmed from the expansion of the recession in Europe and the USA to the developing markets and supply-side effects.

Graph1. Trends of Oil Price Change and Economic Growth



Source: BP, 2014 - OPEC

Fluctuations in oil prices within the last forty years have brought instabilities in terms of economic performance, especially in the Middle Eastern countries where oil has so long been the only commodity of export and in some countries it still is (See Graph 1). On the one hand, the increase in oil prices is leading to an increase in income and acceleration in economic growth. On the other hand, the decline in prices causes the weakening of economic dynamism. In these countries, where economic diversity is low and oil is the most important source of income, the rising prices create a rise in expenditures due to the ease in financing. However, increasing income from foreign exchange causes Dutch Disease, which can be defined as the loss of competitiveness in the sectors other than oil by making the national currency stronger compared to that of other nations. This situation causes the economy to depend heavily on a single commodity and decrease in expenditures, raising the public deficit and instable growth with the declining prices.

The Transmission Mechanisms of Oil Price Changes to Economy

Changes in oil prices directly affect the economic performance in the Middle East where a heavy dependence on oil prevails. Several studies have tested the relation between the oil prices in regional countries and their economic performance. Almost all of the studies have concluded that the increase in oil prices led to the accelera-

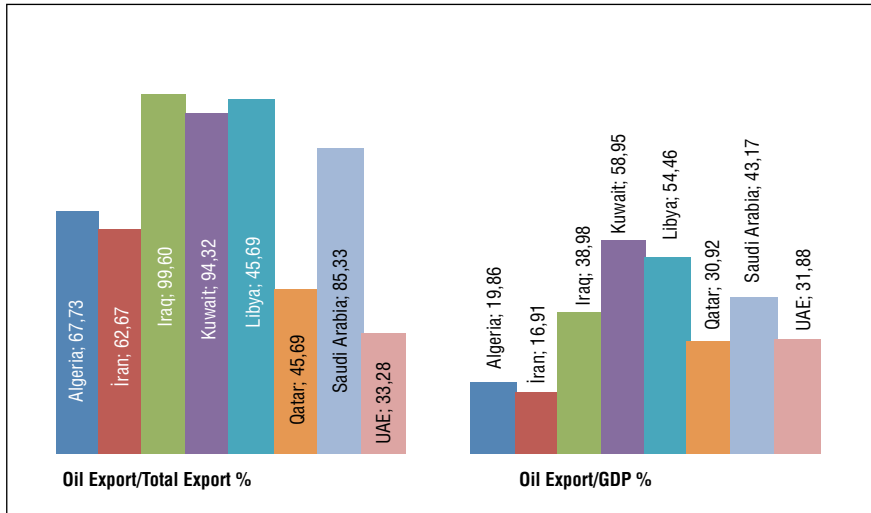
tion of the economic growth in the Middle Eastern oil exporting countries.²The effects of the oil prices occur via three mechanisms, namely current accounts, public expenditures and foreign exchange rate (Berumentet al., 2010).

First and foremost, changes in oil prices induce welfare transfer from the oil importer to oil exporter. The increase in oil prices causes the accumulation of current accounts surplus in the oil exporting countries, whereas the decline in oil prices adversely affects the current accounts.

Graph 2 displays the share of oil in total export and GDP in the Middle East. There is a high oil dependency in external trade in all countries except Qatar and United Arab Emirates (UAE). Since the share of the export of natural gas is increasing in Qatar and UAE, the share of oil is decreasing. That the UAE has a high re-export ratio is another reason reduces the share of oil.

In addition, the share of oil in GDP is quite high. Oil is important in terms of total goods and services especially in Kuwait, Libya, Iran and Saudi Arabia. In this context, the increase in oil prices causes transfer of welfare to these nations from oil importing ones and thus accelerates economic growth while the decrease in oil prices has an adverse impact. When the price movements in the last forty years are considered (See Graph 1), this relationship can be seen more clearly.

Graph 2. Share of Oil in Exports and GDP



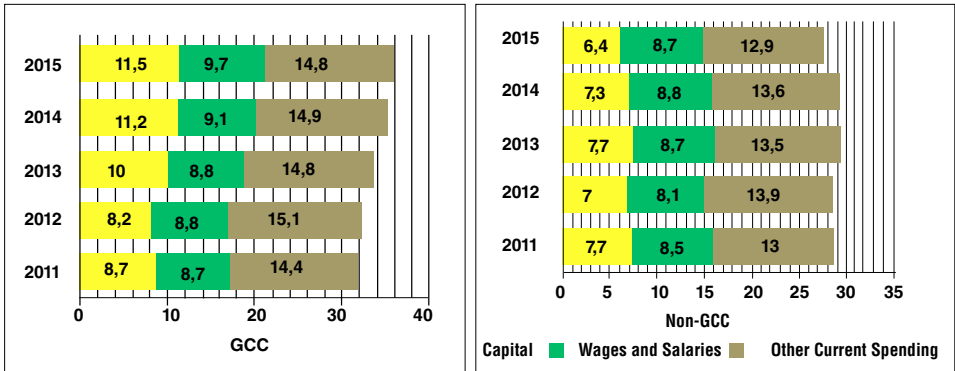
Source: IMF, 2014

The second mechanism is the impact of the changing prices on the public revenues. Oil has still been the engine of economic growth in oil exporting countries³ and the transmission mechanism is the governmental expenditures (Hamdi-Sbia, 2013). According to the research by Hussain et al. (2008), there is a strong correlation between GDP growth and the oil prices in these countries because of the increase in the public expenditures as a result of the rising prices.

Graph 3 shows public economy as a share of total GDP. Public sector's share in the total GDP is over %30 in oil exporting countries. The high share of public expenditures in economy and the dependency of public revenues on oil destabilizes the economic performance.

The variety as well as the amount of public expenditures is important in terms of their economic results. There is a difference between Gulf countries and other regional countries in terms of the variety of public expenditures. The share of capital expenditures is increasing in the Gulf countries whereas they are decreasing in other countries. While current expenditures and personnel expenditures lead to actual increases in economy, the capital expenditures are intended to improve the potential of long-term economic growth. In this respect, Gulf countries aim to increase economic diversity and decrease dependency on oil through capital expenditures. This aim can only be materialized via increasing non-oil investments.

Graph 3. Government Spending (Percentage of GDP)



Source: IMF, 2014

The third mechanism occurs via the foreign exchange rate. The increase in oil prices raises the value of national currency and decreases the competitiveness in the sectors other than oil. This situation, which leads to a decrease in economic diversity, is known as “Dutch Disease” or

“the curse of natural resources.” The effect of transmission from oil price changes to foreign exchange rates is closely related with the exchange rate regime implemented in the country. Therefore, the effects of transmission can vary according to the exchange rate regime.

2014 PRICE SHOCK AND ITS EFFECTS

When examined within the specific context of the countries in the MENA region, the economic effects of the recent declining oil prices will be different in oil exporting countries and oil importing countries. Oil importing countries⁴ are expected to be positively affected from the falling oil prices, in terms of current accounts and inflation. However, the previous research demonstrated that the regional countries which are not oil exporters are also affected from the price shocks (Berument et al., 2010). It can be said that since the declining oil prices causes shrinkage in demand for the oil exporting countries, the economies exporting to these countries may be adversely affected. Syria with its devastated economy as well as Jordan and Lebanon that are flooded with refugees are extremely negatively affected because of the present civil war in the region. It is also possible that there may be a decrease in revenues of Egypt and Tunisia which acquire workers' remittances from oil ex-

porting countries. The situation in these countries may get worse due to the economic cost of the transition period, high public deficit and the current accounts deficit. Table 1 displays the economic data for the oil exporting countries. Accordingly, it is seen that the economic growth has slowed down and current accounts deficit and budget deficit has increased after 2010.

The Gulf countries are the main source of financing external deficit of the oil importing countries in the Middle East. The financing is in the form of workers' remittances in Yemen and Egypt. It can also be in the form of direct investment, infrastructural investment and budget financing support. Therefore, declining oil prices will lead to diminishing of workers' remittances and direct financing support due to the decrease in revenues in oil exporting countries. This process carries high risks for the countries in transition.

Table 1. Selected Macroeconomic Indicators of Oil Exporting Middle Eastern Countries

	2000- 2010	2011	2012	2013	2014*
Real GDP Growth	5,10	1,80	2,00	2,60	3,70
CurrentAccountsBalance/ GDP	-1,90	-5,10	-7,50	-4,70	-5,90
Budget Balance/GDP	-5,50	-7,40	-8,70	-10,50	-9,30
Inflation	6,20	8,60	8,10	10,10	10,80

**Projection, Source, IMF, 2014*

As far as the oil exporting countries are concerned, in case of a persistent decline in oil prices, economic recession seems to be unavoidable in these countries. There is a slowdown in the growth trend in these countries after 2012. Thus, the continuation of the current decline in oil prices may result in economic shrinkage.

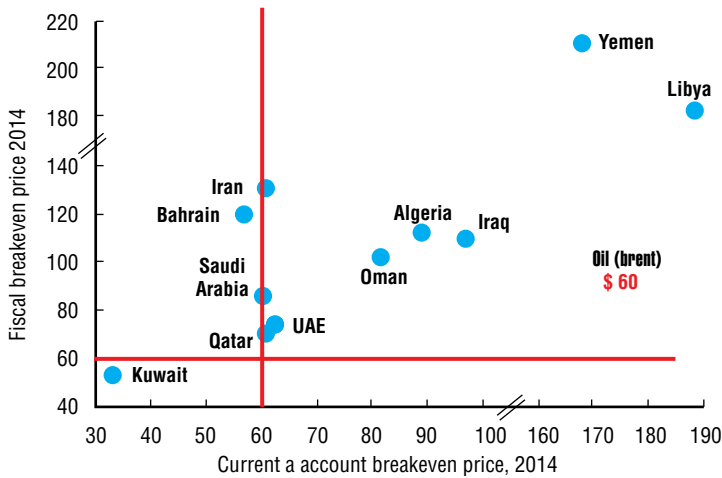
The slowdown of growth and the diminishing of oil revenues will decrease public revenues; hence the pressure on public budget balance will increase. The governments have increased personnel and current spending in order to prevent social uprisings after 2011. In addition, the current terrorist threat has increased the security expenditures lately in the region. The growing public expenditures result in the increasing public debt and causes inflationist pressures. Furthermore, the already heavy weight of public sector in economy is increasing. Bearing in mind these problems, oil price shocks are supposed to increase economic constraints in these countries.

Graph 3 shows the break-even prices in budget and current accounts deficit in terms of oil price in the Middle Eastern oil exporting countries. The oil prices required to sustain public budget balance is denoted in the vertical axis, whereas oil prices required to maintain current accounts balance is depicted in the horizon-

tal axis. The budget and current accounts of the countries are displayed in the graph when the price of Brent oil per barrel is taken as \$ 60 . At this price level, it is fair to say that Yemen, Libya, Algeria, Oman, UAE and Iraq will confront not only current accounts deficit, but also public deficit. The negative effects originating from declining oil prices will become chronic in the countries facing twin deficits since their GDPs are heavily dependent on oil. In addition to the transition process in Yemen and Libya and the war in Iraq, the slowdown created by the oil prices will exacerbate the economic problems in these countries. With the oil prices falling below \$ 60, S. Arabia, Qatar and Iran will have to deal with not only budget deficit, but also current accounts deficit.

There will not be a problem of current accounts deficit in Iran, Bahrain, Qatar and Saudi Arabia given this level of oil price. However, they seem to be lacking the capacity to cope with the increasing public expenditures. Thus, it can be said that these countries are to face budget deficit. The high budget deficit has become chronic especially in Iran with declining oil prices. On the other hand, there will not be any problems regarding budget balance and current accounts balance in Kuwait as long as oil prices remain above \$ 50.

Graph 4. Break-even Oil Price, (US Dollars, Per barrel)¹



Source: IMF, 2014, (Oil price was updated by autor).

¹ 2013 break-even price for Yemen

In oil exporting countries, economy is heavily dependent on the public expenditures which gains momentum with the oil prices. For this reason, rising oil prices result in an increasing public expenditures

in these countries. In this case, employment and per capita income are accelerating. In case of declining prices, there is an adverse impact.

Table 2. Selected Macroeconomic Indicators in the Oil Exporting Countries

	GDP Growth (% Annual)			Budget Balance/GDP			Current Account Balance/GDP		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Algeria	2.8	3.3	2.7	-1.2	-4.1	-1.8	9.9	6	0.4
Bahrain	2.1	3.4	4.9	-1.5	-3.2	-4.4	11.2	7.3	12
Iran	2.7	-5.6	-1.7	-1.4	-2	-2.2	11	6.6	8.1
Iraq	10.2	10.3	4.2	4.7	4.1	-5.9	12	6.7	0
Kuwait	6.3	6.2	0.8	33.3	33.4	28.7	41.8	43.2	38.8
Libya	-62.1	104.5	-9.4	-9	25.9	-1.3	9.1	35.4	-2.8
Oman	4.5	5	5.1	9.1	4.5	5.8	15.3	11.6	9.7
Qatar	13	6.2	6.1	6.6	9.6	11.3	30.3	32.4	29.2
Saudi Arabia	8.6	5.8	3.8	12	14.6	8.3	23.7	22.4	17.4
UAE	3.9	4.4	4.8	4.1	8.5	7.1	14.6	17.3	14.9
Yemen	-12.7	2.4	4.4	-4.5	-6.4	-7.1	-4	-1.3	-2.7

Source: IMF, 2014

In line with the declining oil revenues, growing budget deficits and imbalance in the current accounts have the potential to negatively affect the economic performance. Regarding the data in Table 2, this process will lead to increasing recession and unemployment. At the same time, it is probable that the growing need for borrowing from foreign markets will bring in increasing vulnerability and increasing cost of borrowing in these countries. The present transition period in the Middle East, political uncertainties and the terrorist threat have decreased the credibility of these countries in the eyes of the foreign investors. In case the decline in oil prices remains persistent, there is the risk that the problems in these countries will become more chronic. This is not only a problem of oil exporting countries, but also a problem of other regional countries that acquire financial assistance and workers' remittances from these nations.

However, it is necessary to examine the effects of oil price changes in the short-run and the middle-run. Research has shown that the middle-run effects will be much more severe than the short-run effects (Ftitiet al., 2014) due to the price stability funds of these countries (See Table 3). In this sense, although the short-run effects

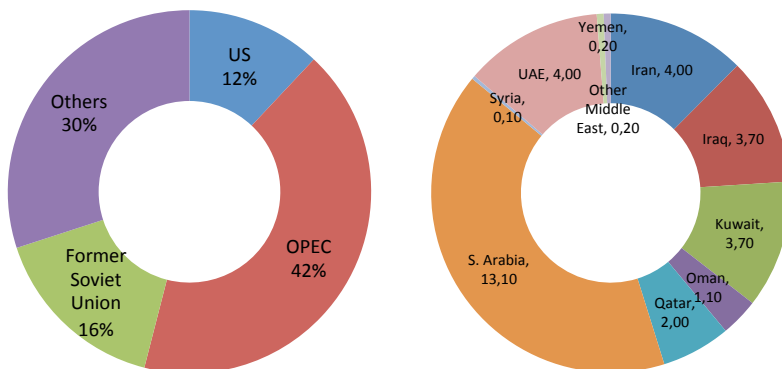
may not be notable, economic shrinkage will be a matter in the middle-run because of the changes in oil prices.

Coping with Low Oil Price

It is possible to minimize the effects of oil price changes in two ways. The first way is to change the amount of supply in order to prevent declining oil prices. OPEC, composed of 12 oil exporting countries, is producing % 42 of the world oil. % 77 of this production is made up by the countries in the MENA. Therefore, the increase in production of these countries causes declining oil prices whereas the decrease in oil production leads to rising prices. OPEC countries prevented the decline in oil prices by decreasing oil production in 1998 and 2002.

It was expected that the OPEC countries would decrease daily oil production in order to rule out the negative effects of the declining oil prices. However, any decision about decreasing oil production did not come out from the meeting that took place on 27 November in Vienna. Since there will not be a great increase in the worldwide demand for oil in 2015, it is possible to conclude that the decline in oil prices will continue in the coming days.

Graph 5. The Share of OPEC and Middle Eastern Countries in World Oil Production (2013)



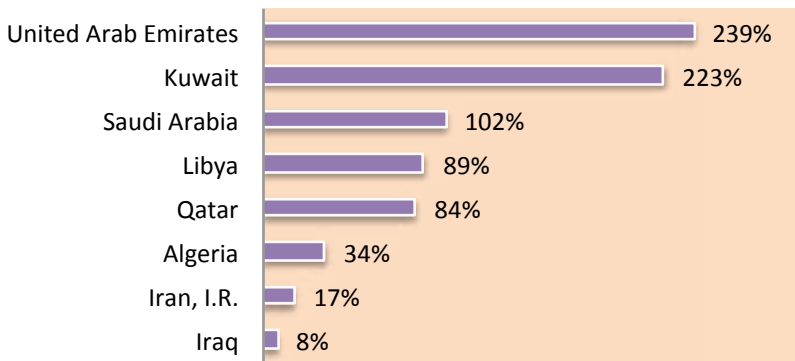
Source: BP Energy Statistics

The second way for increasing savings when the prices are high and minimize the effects of declining prices is to create stability funds. All of the Middle Eastern countries except for Yemen have such funds (Table 2). This type of funds can

prevent the decreasing of economic activities at the times of declining prices. Nevertheless, research has shown that such funds in the oil exporting countries are not effective in the long-run and cannot stop economic slowdown.⁵

Graph 6. The Ratio of Sovereign Wealth Funds to GDP in MENA

Sovereign Wealth Fund/GDP



Source: Calculated by the author from the data by OPEC 2014 and SWFI 2014.

Table 3. Sovereign Wealth Funds of Oil Exporting Middle Eastern Countries

Country	Fund	Assets \$ billion	Beginning year	Resource
UAE	Abu Dhabi Investment Authority	\$773	1976	Oil
Saudi Arabia	SAMA Foreign Holdings	\$757.2	n/a	Oil
Kuwait	Kuwait Investment Authority	\$410	1953	Oil
Qatar	Qatar Investment Authority	\$170	2005	Oil –Gas
UAE	Abu Dhabi Investment Council	\$90	2007	Oil
Algeria	Revenue Regulation Fund	\$77.2	2000	Oil –Gas
UAE	Investment Corporation of Dubai	\$70	2006	Oil
UAE	International Petroleum Investment Company	\$65.3	1984	Oil
Libya	Libyan Investment Authority	\$66	2006	Oil
Iran	National Development Fund of Iran	\$62	2011	Oil –Gas
UAE	Mubadala Development Company	\$60.9	2002	Oil
Brunei	Brunei Investment Agency	\$40	1983	Oil
Iraq	Development Fund for Iraq	\$18	2003	Oil
UAE	Emirates Investment Authority	\$15	2007	Petrol

Source: SWFI

CONCLUSION

Oil prices have been an important parameter for the Middle Eastern economies especially in the 1970s. Declining oil prices has led to economic shrinkage whereas rise in oil prices has caused rapid increase in economic growth. This has been a significant factor affecting economic performance not only for the Middle Eastern oil exporting countries, but also other countries in the region. In response to the declining prices in the last few months, the decision of OPEC countries not to decrease oil supply is a sign of the continuation of this period. Furthermore, the pressure on the economic growth and budget deficits is likely to increase in the regional countries which are tackling with political instability and security constraints.

The worsening of the impact of declining oil prices in the Gulf countries which enjoy political stability can be prevented only for the short-run, owing to their Price Stability Funds. However, the funds will

lose their effectiveness in case of the long duration of the decline in oil prices.

The most effective way to deal with oil shocks is to increase economic diversity and rule out dependence on a single commodity. In fact, the economic diversity in the oil exporting Middle Eastern countries is very low. Lately, Gulf countries have strived to increase economic diversity through “Mega Projects,” but the dependence on oil and natural gas is still high in these countries. It is fair to say that Gulf countries have the chance to reduce the declining prices by their funds in the short-run. For this reason, the effects of declining prices may be felt in a longer term in these countries. However, the process may get worse due to the decreasing public expenditures resulting from declining prices in countries like Yemen, Iraq and Libya which have to deal with political instability and the terror threat and are heavily dependent on oil at the same time.

ENDNOTES

- 1 For the examples in this subject, see Lyuba Lyulko, "Obama wants Saudi Arabia to destroy Russian economy", http://english.pravda.ru/world/asia/03-04-2014/127254-saudi_arabia_russia_obama-0/ and Thomas Friedman, "A Pump War?", http://www.nytimes.com/2014/10/15/opinion/thomas-friedman-a-pump-war.html?_r=1
- 2 For more, see Yardıncıoğlu-Gülmez (2013), Berumentet al. (2010), Elmive Cahadi (2011), Emamive Adibpour (2012).
- 3 Oil exporting countries: Saudi Arabia, Iran, Iraq, UAE, Bahrain, Oman, Yemen, Qatar, Algeria, Libya, and Kuwait.
- 4 Oil importing countries: Egypt, Jordan, Lebanon, Syria, Tunisia, and Sudan.
- 5 See Asik (2013) and Sugawara (2014).

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