The Impact of Decline in Oil Prices on the Middle Eastern Countries

Dr. Shah Mehrabi
Professor of Economics
Montgomery College
Senior Economic Consultant and Member of the Supreme Council of the Central Bank of Afghanistan

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

It is my great pleasure to welcome you to our GASI 24th Annual Meetings and thank all of you for your participation and contributions. I am pleased to join my colleagues to update you on economic and financial developments in the Middle East.

I would like to take this opportunity, first, to thank Chung Roh for his tireless efforts in organizing this plenary session and to commend the program committee members who have assembled an excellent program.

There have been significant changes and challenges for the world economy in the last year and more specifically in the last few months. The changes are to a great extent the result of greater uncertainty and volatility that could pose risk for the world economy. One of the factors that could play an important role in the performance of Middle East countries and the world is the decline in oil prices. Oil plays an essential role throughout world politics and continues to be an important part of the economy of the Middle East as it has most of the world's supply of oil. It has "810 billion barrels in proven reserves (that is 50% of global market total) and 28 million barrel per day in production (40% of global total) and it accounts for about half of the 37.8 million barrel per day international crude oil market. Saudi Arabia produces nearly 10 million barrels a day, a third of OPEC total.

Over the past year however, oil prices have declined sharply, dropping by more than 50% from June 2014-January 2015 and then by 9% in February 2015. This decline has been due to both supply and demand factors. On the supply side, increase in oil production by both OPEC and non-OPEC countries is a contributing factor as well as the boom in Shale Oil Production in the U.S that 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.

Another supply factor is the increased oil production in Libya. Turmoil and internal strife has had very little impact on production. Libya sorted out disruptions much quicker than anticipated, producing 810,000 barrels per day. Iraq is also producing nearly 2 million barrel and its output has not been affected. Saudi Arabia has not reduced their production of oil either. They can withstand low oil prices as they have $900 billion in a reserve. Gulf Cooperation Countries (GCC); likewise continue their production at the current level.

There have also been demand factors that caused oil prices to decline. In countries like Europe, China and Russia, the demand for oil has decreased as a result of weak economic activity and switch from oil to other fuels and increased efficiency.

Another demand factor is the exchange rate appreciation of the US dollar. These both supply and demand factors have affected the countries in the Middle East differently depending on whether they are oil exporters or oil importers.

Oil exporting countries like Saudi Arabia, UAE, Iraq, Iran, Libya, Oman, Qatar, Bahrain and Kuwait have managed to keep their growth at the same level as that of 2014 (2.5%) despite the decline in oil revenue. IMF projection shows that oil exporting countries could grow at a rate of 3 1/2% assuming the security conditions will stabilize and oil production will continue and increase in the countries where turmoil currently prevails.

In addition to decline in oil prices, political instability and prolonged conflict in Libya, Iraq, Syria and Yemen are some of the other reasons for continued slow growth in low oil exporting countries.

The decline in oil prices will nevertheless have direct impact on their export earnings. The Gulf Cooperation Council (GCC) countries will collectively be harmed by the drop in oil prices as they rely heavily on oil exports, with over half of its GDP coming from oil and gas revenues. If prices do not increase soon, the government could see a loss of $215 billion in oil revenues. While the oil exporting countries are currently enjoying a surplus in their reserve accounts (Saudi Arabia has $900 billion in reserves), this could easily turn into a deficit if the decline in oil prices continue. (Based on IMF projection it could experience $22 billion deficit in 2015, 81/2% of GDP). The continuation of decline in oil prices and the slow pace of reforms could retard investment opportunities and significantly increase the unemployment rate.

A comprehensive lifting of sanctions on Iran once the final nuclear agreement has been reached could increase economic activity and accelerate growth in Iran. It has been estimated by the World Bank that Iran could achieve 5% growth in 2016. Oil revenue in Iran could be back up to the level it was before the sanctions were put in place by 2007. Iraq will also be affected due to increasing oil exports despite the lowered prices as well as political struggles as it deals with ISIS. However, it is projected that Iraq will grow at a rate of 1.3% in 2015 due to increased oil production. Non-oil activity is expected to remain flat because of deteriorating security situation and fiscal spending cuts. Algeria will grow at 2.6% in 2015, lower prices has affected the severity of the economy's fiscal conditions.

With the decline in oil prices, some countries in the Gulf Cooperation Council are changing the way the governments spend their money. Saudi Arabia seems like the best prepared country with a close to $900 billion dollars in reserves. Bahrain will be negatively affected. The United Arab Emirates has also been looking for new sources of revenue and is placing a tax on remittances. If the spending level continues at the same level in these exporting oil countries, it will increase their deficits. How much deficit will oil exporting countries can accumulate will depend on how much of a reserve they have. Oil exporting countries that have large reserves such as Saudi Arabia will be hurt least, while Libya and Yemen are the most vulnerable. Kuwait is also affected by the decline in oil prices as evidenced by the decline in their GDP as well as their stock market.

What strategy should oil exporting countries employ in light of decline in oil prices? Some countries with large reserves can draw down on their reserves to continue their spending at the same level as before. Others with fewer reserves should reduce their spending and re-structure their subsidies. They need to also diversity and move away from reliance on oil as the main source of revenue.

For oil importing countries, the impact of declining oil prices is much smaller. Oil is not a big part of their economy. Oil importers will likely see their growth rate to increase from 3% in 2014 to 4% in 2015 based on the projections made by the World Bank and IMF. Overall, the oil importing countries stand to gain from this price decline. Egypt consumption of oil has been increasing by an average of 3% per year. The drop in oil prices means that Egypt can spend more of its savings on other goods in order to meet growing demand. It can also result in lower inflation.

One negative side effect will be a decline in remittances from Egyptians working in Gulf countries as well as decline in tourism. Other countries could be the beneficiaries of decline in oil prices include Lebanon, Turkey, Jordan and Afghanistan. In Lebanon, the price drop will decrease government spending on electricity. The lower prices will also help decrease Lebanon's trade deficit as oil import constitute significant part of it. Turkey will also benefit as they will enjoy lower inflation and improve their account balance if prices continue to remain low. Jordan will also be the beneficiary of lower prices as the inflation will also decline. Afghanistan's import bill for oil and gas amounts to $1.5 billion annually and the overall impact of declining oil prices on the economy is likely to be positive as Afghanistan being a landlocked country imports most of its commodities by land and from Pakistan and transportation cost are significant. Lower transportation costs will benefit the poor through lower food prices and reduce the costs for local producers who mostly import their goods from Pakistan by land. This decline in prices will also increase the purchasing power of consumers.

On the other hand, a sharp and prolonged decline in oil and other commodity prices could negatively impact the incentives for investment in extracting other natural resources. Falling oil prices could result in declining agricultural product prices. This decline in commodity prices would benefit the majority of those people who are living in poverty. While there could be potential fiscal gains from declining oil prices from other oil importing countries through the subsidy channel, this however does not apply to Afghanistan as she does not subsidize fuel.

The benefit from lower prices in Morocco and Tunisia is offset by the fact that their exports to the European countries is declining and their exporting earning have suffered. Decline in oil prices and an increase in public investment in Jordan is expected to result is an increase in growth rate of more than 3% in 2015. In Lebanon, lower prices have resulted in increased economic activity and it is expected that economy will grow at 2.5% in 2015.

Overall, most oil importing countries have used the savings from lower oil prices to reduce their public debt and increase their international reserve and spending on education, health and infrastructure development. The main effect of declining oil prices is on the riskiest and most vulnerable people. They include western oil companies because of high cost of deep drilling in Arctic and American Frackers who have borrowed heavily with the expectations of higher oil prices. Other countries that will have difficulty to pay for their external and internal programer as a result of lower prices of oil are Russia and Iran.

Conclusion:

The decline in oil prices had negative impact on oil exporting countries but positive impact on oil importing countries. One of the positive impact from lower prices of oil has been decline in inflation in both importers and exporter of oil, assuming this decline in prices is passed on to the consumers which could in turn increase their consumption of commodities due to lowered prices. This could help increase growth of the economies of exporting and importing countries. Lower prices of oil could place pressure on agriculture, which could reduce food prices.

These countries should also use the gains from lower prices of oil to reduce their public debt, increase their international reserves, and their spending on education, health and infrastructure development. It should be mentioned here that there are still significant risks and security problems in the region. While Jordan, Egypt, Libya and Yemen are still adversely affected by security challenges, violence and uncertainty in Syria could spill over to Iraq, Lebanon and Jordan. Other risks that are external to the region also point to downward trend. A weaken recovery in Europe could reduce export, capital flows, tourism and remittances. If the decline in oil prices continues, it could adversely affect the oil exporting countries fiscal accounts.

How long will this price drop lasts? It depends on whether OPEC decides to lower production to offset other countries increase in production. It will also depend on the marginal cost of shale oil. The decline in oil prices resembles the 1986 oil drop which lasted for 15 years. Could this drop continue for that long? Based on historical observation, new technology could not stop it. As we stated, Middle Eastern economies are largely reliant on price of oil. Higher oil prices have strengthened their economies, while lower oil prices adversely affect their financial well-being. Different countries have different tolerance to world oil prices depending on diversification of their economy. Nevertheless, lower than break even oil prices have negative impact on the economy of these countries. Countries like Iran, Iraq, Libya, and Algeria have suffered the most, while UAE, Saudi Arabia, Kuwait and Qatar have had least impact in their economy.