Low Oil Prices:

Implications for the Gulf Monarchies

Jul 24, 1998

Brief Analysis

The oil price downturn began in late 1996, but the very sharp fall started in mid-1997 and has persisted to the present. The average price of oil in 1997 was approximately $1.50 less per barrel than in 1996, and the average for 1998 may be as much as $3.00 to $4.00 a barrel lower. Because of the lower price, the 1998 oil revenues of the principal Gulf exporters will about $22 billion less than in 1997, which is a drop of one-third.

There are five reasons which led to the decline in oil prices since mid-1997. In ascending order of importance, they are:

- Last year's El Niño winter was warmer then average in all the major industrial countries. Thus, less oil was used. This is a short-term immediate effect since over a number of years, warm winters tend to be balanced by cold winters.

- Iraq increased its oil production and exports by about a million barrels a day, from 600,000 barrels a day to 1.6 million barrels. As permitted by UN resolutions, Iraq will continue to raise output, but the limited export infrastructure will constrain the 1998 increase to less than .5 million barrels a day.

- OPEC made an ill-timed decision in November 1997 to raise production quotas by 2 million barrels a day. This increase in output came just at the moment when demand was weakening. The various rounds of reductions in OPEC quotas, combined with reductions by other states, has effectively rolled back this production increase.

- The Asian financial crisis has had a sharp effect on oil demand. For the past 5 years the Asian demand was driving the oil market, leading to an increase in world demand about 2 percent to 2.5 percent. The projected Asian demand growth for 1998 is about zero. It is possible that Asian demand will not return to the previous growth path for some time.

- Structural change in the oil industry itself is the longest lasting factor. The world is awash in oil and gas, thanks to technologies which allow drilling deeper cheaper and increase the chances wells will find oil. The oil industry has lowered costs dramatically and is operating more efficiently. World oil reserves have effectively been multiplied by technology that makes new reserves accessible at a price that is attractive.

In general, the oil industry is profitable at $10 a barrel or less, while oil is selling at $16 to $18 a barrel. This is not a long run viable proposition. Prices are likely to come down over the longer term. Furthermore, technological developments make oil more accessible in parts of the world other than the Middle East, which means that a sharp increase in demand for Middle East oil is unlikely for at least the next few years.

Impact on Gulf Governments. The Saudi situation is a good example of the problems facing the Gulf countries. The Saudi population is growing 3.5 percent per year, with there now being 18 million Saudis. Meanwhile, the gross domestic product (GDP) is flat, so GDP per person is falling -- it was down to $8,000 in 1998, which is half the Israeli level. Large numbers of young men are unemployed; more important, they are unemployable, because they lack the skills needed in modern economies.

Given the nature of the oil market, there are no short-term fixes to this problem. Fundamental economic reform is required, and the policy changes need to be made soon. Currently, some reform is being tried in Qatar, Kuwait and Oman. By contrast, Iran has the biggest problems of all and is not doing much about them. President Khatami's economic program, to the extent it is visible, does not have the right medicine.

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Currently, four problems plague the Gulf states. They are:

- Economic problems , such as low per capita income and declining prices.
- A crisis in leadership, as the current generation of leaders grows older.
- Demographic issues, with a rapidly growing population.
- Internal opposition groups, mostly of an Islamist orientation.

A number of ways to explain this situation have been offered. The most credible is the "state-building approach." That is, the Gulf states were transformed from tribal confederacy into organized, modern states over a short period of time. During this time, they underwent phases in direct response to particular challenges:

- The first phase was the formal establishment of states after the dissolution of the Ottoman Empire, when borders were delineated and governments established. A social contract that developed gave the appearance of a modern monarchical state while, underneath, old tribal structures remained intact.
- The second phase was in the 1960s, in response to the challenge of oil revenue. At this time, many Gulf states had trouble adjusting to their newfound wealth. The social contract of this time could be called "the rentier state" or "Faisal's order," named after Saudi King Faisal, who developed and perfected the system. In "Faisal's order," the government took it upon itself to provide all services to the population in return for its loyalty (or at least acquiescence).
- The current phase is marked by the demise of "Faisal's order." No longer are governments able to provide cradle-to-grave support, including employment, to their populations. This is especially true for Saudi Arabia. Despite the difficulties, most people in the Gulf countries want to reform the "rentier state" in order to maintain it. There is no real push for structural economic or political change. But people do want leadership accountability. That will be difficult. In some states, the ailing leadership resembles the Soviet Union of 1975-85 (Brezhnev, Andropov, Chernienko), where dysfunctional leadership itself led to the fundamental change.

This Special Policy Forum Report was prepared by Alisa Mandel.

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