

Oil Prices and the Future of the Middle East

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Brief Analysis

Oil ministers from the Organization of Petroleum Exporting Countries (OPEC) are due to meet in Vienna, Austria on 23 March to agree formally on production cuts that will bolster the flagging price of oil. The current weak oil prices have benefited the industrialized economies of the world but have created economic and political strains in the producing countries. In the cases of Iran, Iraq, and Libya, this acts to Washington's advantage. However, U.S. allies among the conservative Arab states of the Persian Gulf, like Saudi Arabia and Kuwait, have also been negatively affected.

Prospects for the Oil Industry. As the Vienna meeting approaches, the price of oil and the prices of oil company stock have been increasing with reports of an agreement on production cuts. Although producing only 27 million barrels of the world's daily output of 75 million barrels, the 10 members of OPEC can still influence, though not control, prices. But the anticipated pact would be the third agreement to cut quotas within a year. The other two were widely broken, leading to surplus supplies and large stocks that have kept oil prices low. Everybody's favorite likely suspect to cheat on the new agreement is Venezuela, where the new government is under tremendous political strain.

The usual Middle East bad actors -- Iran, Iraq, and Libya -- are not likely to break the OPEC ranks. Having won the argument to allow it to calculate its production cutbacks from an artificially high level, Iran is unlikely to cheat by much more. Iraqi production is currently outside the quota system, but is unlikely to pose a problem to the new agreement. Although the United Nations has given Baghdad permission to export under the oil-for-food program much more than it now does, Iraq cannot expand production much further without extra technical assistance. Libyan production is also constrained, particularly by U.N. and U.S. sanctions against oilfield equipment.

Despite close diplomatic relations between Washington and the conservative Arab Gulf states, there is still a worrying gap between them concerning what is a reasonable price for oil. Addressing a small group of journalists and policymakers on a trip to the Middle East organized by The Washington Institute for Near East Policy last December, a Gulf oil minister confided that "nobody except consumers wants to see the price of oil as it is today." Contrastingly, newly-appointed U.S. energy secretary Bill Richardson said a few days earlier: "I think whatever we can do to build trust and stronger relations with [Saudi Arabia and Kuwait], so they don't artificially raise or lower oil prices, is in our interest." There are also different perceptions among the Western allies about prices: due to tax

increases this month in Great Britain, gasoline at the pump is now four times more expensive there than it is in the United States.

One way forward is for Gulf oil producers, whose oil and gas assets are almost completely state-owned, to allow foreign oil companies to gain equity participation, providing direct foreign investment and thus freeing government revenues for other purposes. Most Gulf states prefer a formula more complicated than such a simple trade-off. Iran has welcomed back companies prepared to accept a simple pay-back on money spent. Kuwait is trying to construct a formula acceptable to both foreign companies and its highly nationalistic and suspicious national assembly. Saudi Arabia is seeking ideas but is said to balk at foreign participation in the oil sector, preferring investments in its gas or power sectors. Iraq is offering agreements, and although companies are signing, they are doing little on the ground until sanctions are lifted. After all, there is a risk that Saddam Husayn or a successor regime may not honor the contracts once free of sanctions restraints.

Low Oil Income and Stability of Gulf Governments. Even though production costs may be as low as one dollar a barrel, oil priced at \$10 a barrel -- representing a profit of 900 per cent -- still creates difficulties for Gulf states like Saudi Arabia, Kuwait, Bahrain, and Oman. An unwritten social contract between the rulers and ruled implies that the absence of political participation is to be compensated by generous social benefits and subsidies. The Washington Institute group visiting Kuwait was told that the average Kuwaiti family has 7.5 domestic servants. Neighboring Saudi Arabia produces only half as much oil per capita, meaning that the government in Riyadh can ill afford to maintain a Gulf-style welfare state. It has had to begin to charge extra for a range of services, although prices are still below the real economic cost.

For the United States, the challenge is to allow a low oil price which may encourage oil states to restructure their economies, reduce some of the generous subsidies, and allow for foreign investment from U.S. and other foreign oil companies. But the price cannot be so low as to provoke political troubles locally. If Gulf oil income drops more quickly than the Gulf governments can adapt their economies, the result could be social and political disruption within U.S. Persian Gulf allies. If existing governments collapse, the oil market could be controlled by radical regimes which might drastically curtail supplies. Another troubling scenario would be if the low oil prices so infuriated the region's radicals that they decided to take drastic measures to curtail output. After all, Saddam Husayn decided to invade Kuwait when the falling price of oil cut sharply into his revenue.

Since the Persian Gulf states have two-thirds of the world's oil reserves and such cheap production costs, a theoretically logical way out of their predicament would be to increase production. Although the price would fall, they would secure an increased market share, squeezing out many higher cost producers in the United States, the North Sea, Latin America, Asia, and the Caspian region. The immediate result of such a step by Persian Gulf producers might be that the Gulf governments would have initially smaller revenues -- the lower prices per barrel could offset the higher volumes exported -- but, once customers were secured, production could be cut back and prices forced up again. At least, that is the theory. But many economists think that oil's days are numbered anyway. Only transportation is now dependent on oil products, and the large-scale production of fuel-cell automobiles may be only a decade or so away. Although such vehicles may initially use gasoline to generate electricity, eventually they will switch to hydrogen-based fuel cells.

Conclusion. U.S. allies in the Persian Gulf need to be persuaded to allow participation by international oil companies in their oil industries, both to ease investment problems and to secure a market for their crude (each oil refinery works best with a particular crude, so a buyer often develops special relationship with a specific supplier). Deepening the oil ties would help cement the Gulf's defense relationship with the West. Washington should also use its influence to promote economic restructuring and more democratic-style accountability, in order to prevent social pressures from getting out of hand and complaints from being channeled into Islamist directions. At the same time,

if OPEC is successful at raising oil prices moderately, that might be a price worth paying for greater Gulf stability.

Simon Henderson, a journalist with the Financial Times in London and former Washington Institute visiting fellow, is author of the forthcoming FT report, *The Middle East in 2002*.

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