



The Gulf States and Oil Prices

by Giacomo Luciani

Lower prices will not necessarily result in greater instability

It is common these days to read that Gulf states have got their oil production policy completely wrong. The simplistic argument maintains that, because they are the largest oil exporters and have the most to lose out of low prices, their November 2014 decision not to reduce production and exports was a notable mistake. Because domestic stability of the Gulf regimes is said to be based on an immutable bargain with their people, whereby acquiescence to patrimonial monarchies' monopoly on power is exchanged for income and material benefits, political instability is to be expected if oil prices do not recover fast.

It is probably correct to say that the Gulf's major exporters (Saudi Arabia, Abu Dhabi, and Kuwait) did not expect prices to fall as low as they have, nor that they could remain low for quite some time; yet

this is not a valid enough argument to dismiss the policy as a mistake.

Maintaining high prices would have supported continuing production increases from other countries—some within OPEC (the Organization of the Petroleum Exporting Countries), some outside, including American shale oil producers. A cutback in Gulf production would have supported prices for a few months, then new cuts would have been necessary until such low production levels were reached that the policy would perforce be abandoned. This is, so to say, an old movie: we saw it already in the first half of the 1980s.

It is important to recognize that prices came down because they were too high and supply systematically exceeded demand. Furthermore, prices will remain low until the market reaches equilibrium and the huge stocks that have been accumulated since 2011 can be liquidated. This will take time—some hope that we will reach this point towards the end of 2017. Thereafter, prices may recover somewhat, but they will not climb back to \$100 a barrel or above.

Massive rainy day funds

There are multiple reasons why low oil prices, per se, are not likely to cause political instability in the Gulf states. Gulf countries have accumulated large financial reserves, have essentially no debt, have quite a flexible structure of expenditure that allows for large incremental cuts, and own large real assets which can be divested. The financial room for maneuver that Gulf governments enjoy relative to any other government in the world is significant.

Other producers are suffering far more than the Gulf countries. They all must cut back on expenditure and/or (as many have done) allow their currencies to depreciate in order to reduce the budget deficit (oil revenue is in dollars, expenditure in the national currency), thus shifting the pain of adjustment to all earners of incomes in

national currency.

In contrast, the purchasing power of salaries paid in national Gulf currencies is protected by the dollar peg—indeed, it may increase due to other currencies losing value relative to the dollar. We may see governments losing legitimacy and facing political turmoil, but the Gulf governments will not be first on the list.

High oil prices = instability

That said, what is even more important to understand is that high oil prices, far from being an element of stabilization in domestic and regional Middle East politics, have been a key determinant of rapidly growing instability throughout the region. Since 2004, the Middle East progressively precipitated into a regional civil war, engulfing all countries and all political forces. The war is actively fought in four countries (Iraq, Syria, Yemen and Libya) but in fact all countries are involved, and all will be affected by the eventual outcome.

Since the turn of the century, political instability and high oil prices have fed each other in an explosive vicious cycle. There is a close connection between regime change in Iraq and the onset of the oil price cycle that began in 2004. In the run-up to the allied intervention in Iraq, the expectation was that the demise of the Saddam regime would open the country to international oil companies' investment, and oil production would rapidly increase. In contrast, it soon became apparent that the outcome was entirely different, and oil prices started increasing gradually. The upward trend found little immediate resistance. The market, influenced primarily by the peak oil narrative, became convinced that prices could grow much higher, and eventually a bubble was created. The financial crisis led to a collapse in prices in the latter part of 2008—but this proved temporary. Prices recovered quite rapidly and kept climbing until 2011. The outbreak of the Arab Spring supported the fear that oil supplies from the Middle East might be seriously disrupted, although this was in fact not the case.

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It is clear that the period of very high prices led to greater regional instability rather than the opposite. It enhanced the income gap between the major oil exporters and the rest of the region, as well as income concentration within each country. In the major oil exporting countries, governments again relied on old and ineffective redistribution policies, which further benefitted the haves without offering significant improvement in the lot of the have-nots. Low prices for energy products have regressive impact on income distribution. Infrastructure expenditure benefits local contractors; increased spending leads to higher prices for housing, benefitting real estate investors and damaging the poorer nationals for whom cheap housing is not provided; even the very generous schemes to support nationals studying abroad only accrue to a minority, while the majority of adolescents get only mediocre education and are not ready for gainful employment. Youth unemployment climbed, as nationals were squeezed out of the market by excessively low wages paid to unqualified expatriates from South Asian countries (the bottom wages showed no significant tendency to increase, notwithstanding the spending boom, because the supply of expatriates is essentially infinite).

In the non-rentier states, the development model of Dubai and the other Gulf countries became hegemonic: political elites nurtured cronies whose role was to attract investment from the Gulf, offering opportunities to invest in real estate, high-level tourism, and financial speculation. The economies of the non-rentier countries experienced satisfactory growth in the 2000-2010 decade, but the quality of increased investment and value added did not allow for trickle-down to occur.

Looking forward

The Arab Spring and its regional dimension cannot be easily explained unless we take into account the dynamics of income distribution at the regional level, not just within each country in the region. Although national statistics tell us that income distribution did not appreciably worsen, the extreme concentration of income and wealth in the hands of the top one percent of the distribution is underestimated. Furthermore, income inequality is extremely large if considered at the regional level. It is the perception of such growing inequality, further fuelled by the growing role of regional media, and the constant image of Dubai-style success that they project, that ignited the resentment and revolt against the incumbent authoritarian regimes.

Now that the tide of oil prices has turned, will tensions decrease? Unfortunately, history cannot be run in reverse, omelets cannot be turned back to eggs. The reduced financial means may possibly encourage a speedier resolution of the regional civil war, but political stabilization will require creating a regional economic order that promises opportunities for all and allows for reducing economic disparities.

In the meantime, and for as long as direct involvement in hostilities will be minimized, the citizens of the Gulf will certainly appreciate the benefit of relative security and stability, in contrast to the chaos and destruction in neighboring countries. I expect that the vast majority will accept a reduction in material benefits received from the state in line with reduced oil revenue. At the same time, Gulf governments must learn how to make better use of the available revenue and get more political bang for each buck of oil money: there is ample potential for succeeding in this respect.

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