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The Challenge of the Oil Market to the Gulf States

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The Gulf states (Saudi Arabia, Kuwait, the United Arab Emirates, Oman, Bahrain, and Qatar) continue to face much volatility in the global oil market. In recent years, the price of a barrel of OPEC oil (the OPEC basket price) has declined from an average of $106 in 2013 to $96 in 2014, $50 in 2015, and $41 in 2016. The price in 2017 has averaged $51 thus far ($47 in May 8, 2017). In other words, the Gulf states' oil revenues are still less than half of what they were several years ago. In order to deal with the state of the oil market, the Gulf states are adopting economic measures that are posing difficult political challenges to their regimes.

Following the steep decline in their revenues, combined with pressures from various oil producers, the Gulf states, headed by Saudi Arabia, the most important player in OPEC, have had to accept – according to the agreement signed in late 2016 - cuts in their oil production in the first half of 2017. Out of a 1.2 million barrel cut in the OPEC daily oil production quota, Saudi Arabia, which has a population of 28 million (approximately 30 percent of whom are foreign nationals), has been assigned a cut of 500,000 barrels a day, and has been forced to accept Iran's refusal to cut its own production. The agreement led to a substantial rise in oil prices, compared with the low point reached in 2016, but prices are still relatively low. At this stage, the Gulf states seek to boost the price of oil to $60 a barrel to help balance their budgets, but there is a great deal of uncertainty about the future price of oil. The drop in oil prices is likely to resume under circumstances of distrust between the oil producers, increased production by countries not committed to the agreement (headed by the US, whose output is rising), and lower than expected global oil demand. According to an April 2017 OPEC bulletin, the projected global oil demand for 2017 is a daily average of 96.3 million barrels of oil, compared with 95.1 million barrels in 2016; in other words, only a moderate increase in demand.

The upcoming OPEC meeting in May 25, 2017 is set to decide whether to extend the agreement on production cuts. On May 8, 2017, the Saudi oil minister said that he is "confident the agreement will be extended into the second half of the year and possibly beyond." Other parties to the agreement like Russia have an interest to see the agreement extended – otherwise there's likely to be a sharp drop in oil prices.

The steep fall in oil revenues in recent years has caused large budget deficits in the Gulf states. The planned Saudi budget deficit for 2017 is $53 billion (7.7 percent of GDP). This is significantly lower than the heavy deficits in the two preceding years, but it still requires continued financing in the form of withdrawals from foreign currency reserves or loans. Over the past two years, following withdrawals from its reserves, Saudi Arabia's foreign currency reserves fell from $725 billion in late 2014 to an estimated $550 billion in late 2016, i.e., by $175 billion. The kingdom is raising money by issuing bonds: $17.5 billion was raised in October 2016 and $9 billion in April 2017.

The depletion of foreign currency reserves and uncertainty about future oil prices have forced the Gulf states to adopt restraint in economic policy, including streamlining and cost-cutting measures. Cuts in subsidies have already led to higher prices for fuel, electricity, gas, and water. As part of the economizing measures, various government agencies were instructed to cut their spending on new projects and return unused budget allocations to the Ministry of Finance.

Further plans include introducing a 5 percent VAT in the GCC bloc starting in 2018. Drugs and basic food products will be exempt from VAT, but this measure will clearly be interpreted as a change in attitude by the royal houses towards their citizens, who have become accustomed to a tax-free environment.

The economic reforms in the Gulf states also extend to the labor market, which is based primarily on foreign workers. In recent years, Saudi Arabia has been expelling foreign workers en masse who do not have professional expertise needed for the state's economic development, and is providing incentives for the employment of local workers. Many of its young citizens now completing their education, however, lack appropriate qualifications for working in the private sector, and their salary demands are higher than those of foreign workers. The result is that the public sector employs 90 percent of Saudi citizens, and 90 percent of the private sector is manned by foreign workers.

The 2017 Saudi budget states that through its fiscal policy and streamlining measures, the kingdom aims at a balanced budget by 2020. It appears, however, that this target depends mainly on oil prices in the coming years. Note that despite the budgetary constraints, Saudi Arabia is still not cutting military spending, in view of the military challenges that it faces. In 2016, military spending amounted to $55 billion (8.6 percent of GDP), compared with a planned $48 billion. Approximately $51 billion in military spending is planned for 2017.

In view of the great volatility of oil prices over past decades, the Gulf states seek increasingly to escape their profound dependence on oil revenues – through streamlining, diversification of revenue sources, and adoption of the principles of a modern economy. This idea underlies the ambitious Vision 2030 multi-year plan announced by Saudi Arabia in 2016. The first year of this program is 2017. In order to finance the plan, preparations are already underway to issue 5 percent of the shares in the Saudi national oil company Aramco.

The main difficulty in converting the oil-based Gulf economies to diversity is that political stability in these countries is directly related to the high standard of living of their citizens, which is supported by oil money. The question of where to make budget cuts is therefore as much political as it is economic, and is regarded as one of the main challenges facing the Gulf governments. For example, the increase in gasoline prices in Bahrain and Oman caused by the reduction of the subsidy caused protest demonstrations, albeit on a limited scale, thereby highlighting the risk that will be incurred by a more extensive measure.

Another challenge in carrying out reforms involves adjustment to the rules of a modern economy, in particular the entrepreneurship essential for the development of a private business sector, transparency, inclusion of women in the labor market, and so on. Entrepreneurial culture, however, is undeveloped in the Gulf states, because their citizens have become used to the state providing their living and almost all of their needs. They regard free services and regular income from the state as a basic right possessed by virtue of being loyal citizens of the monarchy. A large scale breach of this right is therefore liable to affect their feeling of loyalty to the monarchy.

The royal houses are aware of these risks, and have behaved cautiously up until now, so that despite the economic pressures, no significant expression of social unrest has surfaced. At the same time, it is unclear how citizens in the Gulf states will receive the coming measures, such as the introduction of VAT. Developments in the oil market in various directions are likely to pose a dilemma for the regimes: continuation of the current level of prices, and certainly any decline in them, will make it difficult for the monarchies to pay for the many years of reforms planned. On the other hand, a sharp increase in oil prices is likely to aggravate public pressure to abandon the reforms, including the processes needed to reduce dependence on the oil market. It is also likely to encourage a rapid rise in global oil production and accelerate the transition to oil substitutes, a development that will cause further fluctuations in oil prices and revenues. It is therefore probable that the Gulf states prefer a moderate increase in oil prices.

In conclusion, Gulf rulers assume that the high level of oil prices that prevailed in 2011-2014 will not recur in the coming years, and are preparing for a continuation of the current situation in the oil market. This preparation focuses on adjustment processes, including spending cuts and VAT for citizens in order to reduce as much as possible the rate of withdrawals from the countries' foreign currency reserves and accumulation of debt, and to approach a balanced budget. On the one hand, there is a clear effort to carry out structural changes in the monarchies' revenue sources in order to reduce future dependence on oil market fluctuations. On the economic challenge side, the processes of adjustment and reform also pose a difficult political challenge, because their success requires a change in the terms of the "social contract" between the citizens and the monarchies, which has hitherto guaranteed citizens a high level of welfare without effort in exchange for preservation of the existing political order. As they begin to cut deeper, the economic processes therefore incur risks for internal stability in the Gulf states. These risks are liable to increase when internal political pressure and external subversion from Iran and its satellites escalate. Furthermore, the economic situation in the Gulf states is liable to have consequences for the regimes in other Middle East countries that receive direct or indirect economic support from the Gulf states (primarily through employment of workers), including Egypt and Jordan.