The Fluctuation in Oil Prices and its Effect on the GCC Economies [1]

I am pleased to be with you today and to be able to share some thoughts on an important and timely subject, the fluctuation in oil prices and its effect on the GCC countries. There are, in fact, many economic and social factors involved in this broad topic, and they can cover a wide range of possible effects, depending upon whether we visualize them as temporary, short-term or long-term, desirable or undesirable, and whether we consider that they require partial or comprehensive solutions. It has thus been necessary for me to limit the scope of my remarks, although I shall draw upon examples from the Kuwaiti economy to illustrate the general situation in the GCC.

In addition, it may be helpful for you to have a frame of reference during this discussion, so I shall quickly sketch in a brief historical background on the present fluctuations in oil prices before tracing their current and projected effects on the GCC Economies.

Internationally, we do not have an oil market which can respond steadily and adequately to the inevitable ups and downs of supply and demand, while maintaining a degree of price stability. From the point of view of the individual suppliers, price stability is necessary for effective domestic economic planning and policy. A number of reasons have been advanced to explain the current

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mismanaged international oil market, and among them there has been the "unnatural" increase in oil prices in 1979 and 1980, which had later to be adjusted downward. Others have included the decrease in the growth rate of the international economy and the consequent decrease in oil consumption in developed countries, and the search for alternative sources of energy, brought on by the relatively high price of oil. To these must be added the pronounced decrease in the OPEC price which has resulted from - among other things - a vast increase in non-OPEC oil production.

Against all these developments in the international oil market, OPEC maintained reasonable control over oil prices until 1984, when it had to lower its production ceiling to 16 million barrels/day. This new ceiling produced disagreement among OPEC members; they could not settle upon a quota system among themselves because each wanted its own "fair quota", and so the international oil market problem was extended to OPEC, with the member countries each trying to increase its quota by means of price cuts. The end result of this competition has been a weakening of control over the international oil market. Many diversified interests are now at play, and they influence the making of decisions which are hard to reconcile with fair production levels and the interests of OPEC. At the same time, the recent decline in the exchange rate of the US dollar has contributed to an additional reduction in the real price of oil and thus in the purchasing power of oil revenues.

The four factors determining GCC oil revenues in local currencies are production, export, prices and US dollar exchange rates. From the point of view of the GCC economies, these may be treated as exogenous variables, since their determination involves a great deal of uncertainty and different technical and political considerations. Fluctuations in oil revenues have been predictable, and therefore undue importance ought not to accrue to the mere existence of surpluses and shortages in revenues. Rather, attention should be centered on how best to allocate available revenues to current needs and future development objectives, and to finding socially, politically and economically acceptable strategies for handling the effects of reduced oil revenues. This is the real challenge facing GCC economies at present.

Let me now be more specific, and turn to an explanation of certain key economic indicators in the GCC countries during recent years, in order to clarify for you some possible effects of that drop on different aspects of their economies.

First is GDP growth: During the 1970's the GCC experienced an impressive increase in GDP at current prices in a relatively short span of time, from U.S.$ 53 billion in 1974 to a peak of U.S.$ 190 billion in 1980. In contrast, GDP started to decrease in the last few years, amounting to U.S.$ 188 billion in 1983. This says that the GCC economies have been passing through a period of adjusted growth, requiring new strategies for dealing with the imbalances that have resulted from the rapid growth of the seventies, and encouraging higher efficiency in the various sectors of their economies.

Second is oil revenues: They reached their peak in the GCC countries in 1981 at a value of U.S.$ 158 billion (U.S.$ 53 billion in 1974), and then started to decline, amounting to around U.S.$ 80 billion in 1983 and again in 1984. To be sure, public expenditure in the GCC during the seventies and early eighties produced positive, tangible achievements in the form of social services, capital formation, foreign reserves and basic infrastructure. However, this expanded public expanded to the management of financial resources, producing budget deficits which made rationalized allocations necessary.

A third factor is growth problems in the GCC economies: The GCC have attempted to deal with a variety of growth problems. For example, they have dealt extensively with population and labor force issues, low productivity problems, and efficiency measures for better use of available resources, both oil and non-oil, so as to diversify their production base. The continuing decrease in oil revenues has given an even greater urgency to the search for appropriate alternatives for the GCC economies.

Next we may consider the impact of the drop in oil revenues. As oil producing and exporting countries, the GCC must examine several aspects of the effects of the drop in oil revenues, bearing in mind that the extent and severity of these effects must vary from one economy to another, depending upon each country's economic maturity, the extent and duration of the decrease in its oil revenues, and its dependence upon its oil sector. Crude oil production, for example, varies substantially, having ranged in 1985 from 1237 million barrels for Saudi Arabia to 15 million barrels for Bahrain, which, like Oman (with a 1985 production level of 182 million barrels), is not a member of OPEC.

A Number of theoretical forecasts of oil revenues have been put forward for the remainder of this year and the near future, based upon possible price levels, OPEC and non-OPEC production levels, and the development of domestic energy programs in the developed countries. How realistic these forecasts may prove to be is not an issue which concerns us here. More importantly, we must face the possibility that the GCC economies may be unable to overcome the negative impact of falling revenues through government management alone. Since the limits of existing economic policies may not permit the GCC to manage its acclimatization without disturbing the process of social and economic development, new or adjusted policies must be introduced.

An important point to keep in mind is that the oil producing and exporting countries could benefit from the drop in oil prices up to a certain limit, let us say from U.S.$ 20 to not less than U.S.$ 15 per barrel. At these price levels demand for oil would increase and the supply from countries outside OPEC would decrease, since their profit would be reduced. Also, a drop to this level would call for better management and effective allocation of oil revenues.

The short-term effect of decreased oil revenues on the GCC economies would take the form of budget deficits, decreased government spending and rationalized spending policies, a drop in imports and a certain reduction in employment opportunities for expatriates.

Long-term economic policies would involve the structure of non-oil GDP, the dominance of the services sector, a growing volume of public subsidies, increasing domestic energy consumption, slow growth in productivity and the persistent dependence of economic growth on an influx of foreign workers.

To be more specific, the main, direct, short-term effects of lower oil prices on oil producing and exporting economies such as the GCC will be a reduction in government revenues (budgets) and the current account balance. The extent of these effects on different aspects of the local economy would vary, depending upon where the particular economy would fall in one of the following three groups:

1- A group of economies where the government budget is not greatly affected by the oil price cut because the fall in oil revenues is offset by the ability of the economy to draw upon income from the substantial financial resources accumulated during the boom years. Further, these economies have finished providing infrastructure and main public facilities.

2- Although the economies in this group depend heavily on oil revenues to finance their development programs, they are in a relatively satisfactory position to accommodate a possible diminution of economic activities as a result of a drop in oil revenues. This accommodation would be made possible through a two-track policy, namely a decrease in government spending in certain fields where projects can be cancelled or postponed since most infrastructure and public facilities have been completed, and the finding of additional non-oil sources of public revenues, such as through borrowing, levying taxes or fees, and, to a lesser degree, the use of a part of foreign reserves. One would in fact expect that the consequences of an oil price drop on these economies would be gradual and not really serious, with government expenditures buoyed against the decline in oil income by the reduced public spending and an increase in non-oil public revenues.

3- The economies in this group would be affected substantially, since the reduction in oil income would seriously hinder government investment programs, in the absence of an ability to borrow or tax. These economies would have to undertake practical and perhaps drastic measures in order to select where the reduction in government spending should be.

In summary four emerging conclusion need to be pointed out for emphasis:

1- That the main effects on the oil producing and exporting economies of lower oil prices will be different not just among the three groups of economies mentioned earlier, but also within each group.

2- That the effect of the slowdown in economic activity in any economy of the three groups would be felt more by foreign work forces than by the citizenry. Kuwait, for example , had 1.016 million expatriates in 1985, 59.9% of her total population of 1.7 million.

3- That the GCC economies fall basically into the second group of economies. Using the Kuwaiti economy as a specific illustration of certain effects of the oil price cuts, the most noticeable effect has been in Kuwait's oil revenues, which were KD 2456 million in 1985, a reduction of KD 216 million or 8.1% from the previous year. Kuwait's budget for the fiscal year 1985/86 shows a deficit of KD 657.1 million, to be financed from the general reserves, compared with the budget surpluses of the recent past, which peaked at KD 3187.8 million in 1979/80. By the following year, 1980/81, a 25.4% drop in oil revenues had brought the budget surplus down to KD 988 million. In the face of these developments, Kuwait is exerting greater effort toward rational and programmed public spending, as well as the search for additional non-oil sources of public revenues, to decrease the heavy reliance of the state budget on oil revenues.

4- That the exchange rate systems play a major role in affecting the value of oil revenues in local currencies, and they thus deserve attention. Because of the importance of the US dollar in the GCC states' foreign currency receipts (which stem mainly from oil), as well as their government incomes, these states determine their exchange rate policies on the basis of the dollar, either because they are tied to it with varying degrees of flexibility. The GCC states have not used identical external benchmarks for their exchange rates; one currency is tied to the dollar (the Omani riyal), four to the SDR (the Saudi riyal, the Qatari riyal, the U.A.E dirham, and the Bahraini dinar), and another to a specific, confidential basket of currencies (the Kuwaiti dinar). Since the strategy of monetary policy in Kuwait is to maintain a stable KD exchange rate against major foreign currencies, it was decided to tie the KD exchange rate to a basket of the currencies of Kuwait's major trading partners, beginning 18 March 1975. This options proved to be useful in maintaining an overall relative stability and strength for the Kuwaiti dinar, which in turn served to reduce the severity of possible fluctuations in oil revenues, which could result from either a drop in oil prices or changes in the US dollar exchange rate (the dollar being used to determine the price of oil), or both.

In conclusion, the real challenge posed by the oil price cuts is in the difficult area of the balance between non-oil income and the claims of expenditure on this income. In the absence of any system of public debt instruments, taxation, or adequate pricing of public services, private consumption and investment must continue to exhaust a sizeable portion of non-oil GDP. Effective adjustments in the direction of a greater balance would ensure a more permanent and reproducible income base, gradually replacing exclusive reliance on oil revenues.