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Saudi Arabia and the Gulf States Amidst Falling Oil Prices and Regional Upheavals

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The drop in oil prices of 55 percent over the past year stems from a classic supply and demand imbalance. While demand grew at moderate rates because of slow economic growth or economic stagnation in many parts of the world, supply grew at a much faster rate. More specifically, supply in the United States has grown and OPEC output – which includes the large Arab oil producers, Iran, and other nations – has exceeded demand.

In August 2015 the OPEC basket price averaged about $45 a barrel, compared to $100 a barrel at the same time last year. According to the OPEC newsletter of August 11, 2015, in order to satisfy the global demand for oil and liquid gas – a total of 92.7 million barrels per day (bpd) – the organization's members had to produce only 29.2 million barrels bpd (given that the supply of oil outside of OPEC is 57.5 million bpd and the production of liquid gas by OPEC is 6 million bpd). However, in practice, oil production by OPEC members in July was 32.5 million bpd, i.e., a 12 percent production surplus.

The imminent return of Iranian oil to the market is already affecting expectations. Iran would like to see an OPEC summit in the immediate future; this is true also of Venezuela and Algeria, which have both called for an urgent gathering of OPEC leaders to discuss the free-fall of prices. Russia, not an OPEC member, is also interested in reducing output as it is itself a large oil producer suffering from economic difficulties. For now, Saudi Arabia and the Gulf states, whose economies are still in much better shape, do not favor cutting production.

In the longer term, as long as the prices drop, demand will rise, and pumping in more oil wells around the world will decrease because of economic considerations, at which point prices will rise again. In other words, the oil market will suffer fluctuations, with the unknowns being the depth and duration of the slump. In the previous low point, which occurred in mid-February 2009, prices fell to $34 a barrel, compared to the high of $140 a barrel in June 2008.

The Saudi Strategy

Saudi Arabia and the Gulf states sit on one third of the world's proven oil reserves. Their refusal to cut back on oil production, even if the low prices translate into a sharp decrease in their revenues, can be explained by three factors.

First, their objective is to maximize their income from their oil reserves in the long term. They are therefore prepared for current low prices in order to curb the feasibility of developing alternatives to their reserves. For example, they are interested in curbing the rate of production in the United States, which since 2008 has risen by some 50 percent, thanks to technological advances and the exploitation of shale. The long term Saudi vision – which is far from realization – is to convert the oil reserves into industrial production capabilities that will free it from its dependence on oil. The Gulf principalities are interested in yield-bearing investments, especially abroad, that in future generations will support them in the style to which they have become accustomed.

Another more concrete explanation for the current situation is that the Gulf states are trying to protect their market share. Sadad al-Husseini, the former vice president of exploration and development at Aramco, the Saudi national oil company, explained in August 2015 that even if the Gulf states had curtailed their production late last year, "a flood of new oil supplies from the United States, Canada, the deep offshore and other basins would have continued to undermine the oil markets, and prices would have collapsed to where they are now in any case." Furthermore, Saudi Arabia has no faith in OPEC members and believes that even if an agreement to cut back production were reached, the members would not honor it.

A third explanation involves Saudi Arabia and the Gulf States using oil as a weapon against Iran. At least so believes the regime in Tehran.

Domestic Constraints

The low oil prices seem to match the strategy of Saudi Arabia and the principalities to maximize their oil reserves in the long run and hamper the reconstruction of the Iranian economy. But an ongoing drop in prices conflicts with their strategy for domestic survival, which requires a high level of wealth even in the short term, because their populations do not take kindly to reduced welfare.

More than 80 percent of government revenues in these countries stem from the sale of oil, oil products, and gas, and this income enables the regimes to provide their populations with a high standard of welfare. In other words, oil revenues translate into highly subsidized services and products. For example, the cost of one liter of oil in Saudi Arabia is 16 cents – less than the price of a bottle of water. The regimes are also the largest employers and the source of salary increases and bonuses, none of which is taxed. On the other hand, citizens have no political rights, and the society-state contract is bound by the notion that the ruler takes care of his subjects while they agree to non-interference in government. Hence the close correlation between oil revenues and regime stability. The drop in oil prices will make it difficult for these states to maintain the development momentum and the high standard of living. This has been especially important since the Arab Spring, because of the infusion of cash required to quell social-political tensions. At present, almost all the Gulf states have budgetary deficits eating away at their reserves.

Saudi Arabia is expected to end the year with a deficit of $150 billion, the largest in its history. The nation has already started cutting project budgets and even military acquisitions. So far, the government has allocated some $10 billion a month from its foreign currency reserves to finance its expenses. According to the World Monetary Fund, the kingdom’s foreign currency reserves dropped from $724 billion in late 2014 to $660 billion in June 2015. The reserves are still large, but this loss and the uncertainty over the duration of the current slump require a policy of expenditure cutting, a policy with risks of its own.

The IMF is urging a policy of cutting subsidies and generating income, via taxation if necessary. However, in early 2015, when Kuwait tried to cut the diesel subsidy, public outrage caused the kingdom to reverse its decision. That incident demonstrated to the regimes the risk involved in such a move. They will therefore likely take very small steps and prefer long term cuts (development) to cuts in current expenditures. The less wealthy monarchies, such as Bahrain and Oman, are particularly at risk.

The Regional Effects of the Phenomenon

To Iran, this policy of the Gulf states amounts to economic warfare; in December 2014, President Rouhani described the falling oil prices as a “conspiracy,” and added, “Iran and the people of the region will not forget this treason and will respond to it.” The tensions between the sides may worsen if Iran ends up exporting more following the repealed sanctions but doesn’t see its revenues grow because of the low price level. (After the sanctions against Iran are lifted, the Gulf states might remain alone in the economic war on Iran.)

The situation in the Gulf affects Egypt, Jordan, the Palestinian Authority, Syria, and Lebanon, all of which are experiencing severe economic difficulties. They are sustained by the money from their workers in the Gulf, investments and trade with the Gulf states and, in some cases, outright aid. Egypt received $39 billion in the 2013-2014 fiscal year: some $20 billion from workers in the Gulf and some $19 billion in aid from Saudi Arabia and the Gulf states. The financial aid for the 2014-2015 fiscal year was set at $12 billion, at a time when Egypt’s own foreign currency reserves stand at only $20 billion.

The singular aspect of the current slump in the oil market is its occurrence at the height of the Middle East upheavals. This convergence of factors is problematic for the Gulf monarchies, and even more so for the nations economically connected to them. The high oil prices and foreign currency reserves from the outbreak of the unrest until 2014 helped the regimes in the Gulf maintain their citizens' high standard of living. The big challenge now is to navigate this slump in peace and quiet. Given the uncertainty over its duration, their current strategy consists of a controlled use of monetary reserves and budget cuts so as to minimize the damage to the standard of living and the risk of public discontent. However, sentiments are difficult to control, especially given the presence of subversive elements. Consequently, the risk to the stability of the regimes in the Gulf and the region is on the rise.