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## Middle East Economies and the Impact of Oil

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### SUMMARY

- Earlier this year, revolutions and civil war in the Middle East took the world by surprise, but the problems that motivated these revolutions had been apparent for many years: an inability of the countries of the Middle East to meet the economic aspirations of their people.
- Oil and gas production alone is insufficient to meet these aspirations because it employs very few people.
- Oil producing countries thus have two options: to use their oil wealth to buy off dissenters or to invest their oil wealth to diversify their economies and create jobs.
- So far, the countries of the Persian Gulf region have focused on buying off their people with gifts.
- However, these countries have much greater growth potential than the rest of the Middle East; if the countries of the Persian Gulf choose to embrace economic reform, they may be able to meet the economic aspirations of their people.
- By contrast, growth potential elsewhere in the Middle East is so limited that it seems unlikely these countries could ever deliver strong growth without fundamental changes, which may help to explain why the Arab Spring has been much more tumultuous outside of the Persian Gulf.

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### INTRODUCTION

Now that the immediate shock of the collapse of the Egyptian regime and Libya's descent into civil war has passed, it is time to stop and take stock of the more fundamental situation of how this volatile yet vital region will evolve in the future. Although the immediate causes of the current crisis are complex, including a surge in global oil prices and rapidly rising food prices, in the longer term the greatest economic challenge for the countries of the Middle East is to diversify away from petroleum in order to satisfy the broader economic aspirations of their people.

#### Resource Curse

Dependence on oil revenue for economic growth creates a number of serious problems for any economy. Oil and gas production employs relatively few people, yet it brings in

substantial revenues that often swamp any other economic activity. This leads to a number of serious problems. First, the reliance causes a shift in economic power from private enterprise, whose earnings have been overtaken by oil revenue, to the state, which receives the bulk of the oil revenue. This effect is particularly strong in countries, like those in the Middle East, that primarily have a state-controlled oil industry. This shifts incentives for ambitious people away from entrepreneurship and new wealth creation, to trying to capture a greater share of the wealth already being created. Second, the flow of oil wealth through the economy causes both currency appreciation and wage inflation, eroding the country's external competitiveness by making exports more expensive. In combination, these two problems can often lead to a fall in private sector employment and demands for the state to provide jobs at wages that reflect the perceived value of the country's oil revenue. In the long term, this can lead to a reorientation of the economy to focus on oil production, public sector employment and domestic services: an economic structure that will struggle to perform if oil revenue falls due to either price or geology. Collectively, these problems are often known as the resource curse, and they hinder the ability of oil producing countries to meet the economic aspirations of their populace.

The core of the problem becomes clear when we look at Saudi Arabia as an example. While the GDP per capita of the US has grown continuously since 1970, Saudi Arabia has been unable to achieve the highs it experienced during the 1970s. At a simplistic level, this can be explained by the fact that Saudi Arabia's population has grown by 342 percent since 1970—meaning more people have to share the oil revenue—while the US population has only grown by 50 percent. However, this simple comparison masks the real problem. GDP per capita in the US has grown because the productivity per worker has increased as technology and skills have improved. Saudi Arabia's oil revenue, however, has nothing to do with the size of its workforce. Broadly speaking, if the US population grows the US economy will grow with it, but if the Saudi population grows there will simply be more people trying to eat the same pie. Even though the combination of stable oil production and rising oil prices means that this pie has grown meaningfully over the last ten years, its growth has barely been able to keep pace with the rate of population growth.

#### Responses to the Resource Curse

This situation leaves Saudi Arabia with a conundrum: how can it meet the economic aspirations of a growing population when population increases do not translate into economic growth? There are two ways to try to solve this problem: one solution is easy, while one is effective. The easy option is to try to use oil wealth to buy off discontent. In essence, this means giving more pie to the people who complain the loudest and hoping that others will accept having a bit less. Of course, those who get less may not always accept this, so this approach requires being willing to use force to maintain order. The effective option is to grow your way out of the problem by using oil wealth and government policy to encourage the growth of competitive, non-oil industries. To push our pie analogy a bit further, this would be like trading some pie for cooking lessons in order to make a bigger pie in the future. This works in principle, but it means giving up some pie today, even though it may take a long time to learn how to cook well.

For the moment, Saudi Arabia appears to be leaning towards the seemingly easy solution of buying off the population. Since the beginning of the Arab Spring, the Saudi King has given roughly \$125 billion of "gifts" to the country (~\$5000 per person), ranging from direct subsidies to investments in education. The cost of these "gifts" helps to explain why analysts now estimate the Saudi Arabia's breakeven price (i.e. the price at which oil revenue covers the cost of oil extraction and government spending) has risen from \$75 per barrel last year to \$90 per barrel this year. While some of these investments may contribute marginally to economic diversification, this is clearly not the primary goal. The approach throughout the rest of the Gulf is similar. Kuwait's King gave a gift of \$3,619 per person, ostensibly to

celebrate the 50<sup>th</sup> anniversary of Kuwait's independence from Britain, and the Gulf Cooperation Council (GCC) as a whole has pledged \$20 billion in aid to Oman and Bahrain, its poorer members. And, just in case the extra pie is not enough, Saudi Arabia and the UAE have also provided active military and police support to the Bahraini regime.

Ironically, continued civil war in Libya, combined with the threat of instability elsewhere, has pushed up oil prices, making it easier for the Gulf countries to maintain this strategy. If Saudi Arabia were to spread the cost of these gifts over the next four years, it would imply an additional \$10 premium on each barrel of oil exported by Saudi Arabia. However, oil prices have risen by more than \$20 per barrel since the beginning of the year, opening the possibility that the Gulf monarchies could use these additional windfalls to subsidize their populations further. Assuming that prices remain roughly \$20 per barrel higher than they otherwise would have been for the rest of the year, Saudi Arabia will receive an additional \$51.8 billion in revenue, with similar, though proportionately smaller, windfalls elsewhere in the region.

In the long term, however, because of the mismatch between oil revenue and demographics, reliance on oil alone may not enable the countries of the Gulf to meet their economic goals. According to the US Census Bureau, Saudi Arabia's population will grow by 30 percent by 2030. This means that in order to maintain the current level of GDP per capita, Saudi Arabia will need to either increase its oil exports by a third or see real oil prices continue at roughly their current levels. While the former may be technically possible, it should be noted that Saudi net exports have never regained their 1980 peak of 9.7 million barrels per day. Looking at a regional level, the GCC's population as a whole will grow slightly faster than Saudi Arabia's, with 34 percent growth by 2030. While oil revenues might be squeezed to maintain current levels of GDP per capita across the region, they are unlikely to deliver substantially rising standards of living. By contrast, given historical trends, US GDP per capita is likely to rise by roughly 30 percent over the period.

### Long-term Solutions?

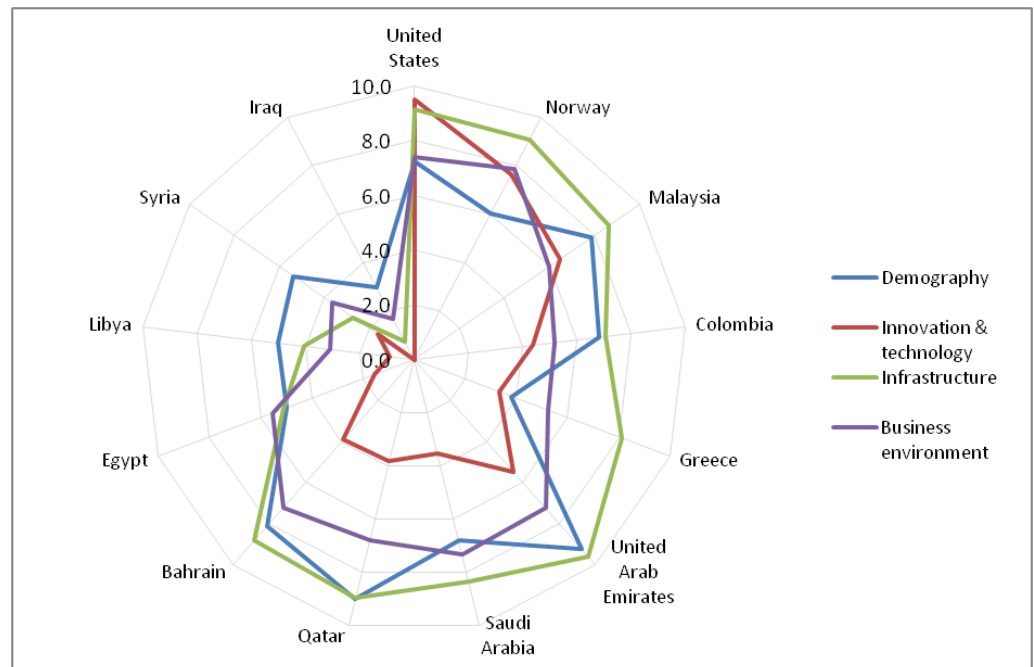
In order for the Middle East to avoid falling further behind the advanced economies, it will need to diversify beyond oil. This means developing profitable businesses outside of the energy sector that will contribute to both economic growth and employment. While there are many examples of countries that have done this successfully, perhaps most notably Malaysia and Norway, one notable example lies closer to home: Texas. Texas used its oil wealth to invest in higher education and infrastructure while using low taxes and an uncomplicated approach to business regulation to encourage new businesses to grow. Some of these new businesses were in totally new sectors, like IT, while others were still in oil and gas, but higher up the value chain. Long after Texas's oil is completely depleted, Houston will still be a global center for offshore engineering, just as Austin will still be a center for technology.

In order to begin to see whether the countries of the Middle East will be able to follow a similar path, we need to look at the extent to which they have in place the foundations to change their model in order to diversify away from reliance on oil. Western commentators often see the Middle East, and particularly the Gulf, as a relatively homogenous economic area. While the Middle Eastern oil producers face many of the same basic problems, which will hinder their ability to meet the economic aspirations of their people, there is also significant differentiation between these countries. In order to understand these differences and what they may mean for the region, we have used an economic tool, Quantitative Country Assessment,<sup>1</sup> that enables us to conduct detailed comparisons by scoring countries from 1-10 on a range of different factors that determine economic strength and

<sup>1</sup> Quantitative Country Assessment is a product of John Howell and Co Ltd.

vulnerability. For this analysis, we have chosen to use only the factors relating to the ability of an economy to change its growth model: Demography (including education levels), Innovation and Technology, and Infrastructure and Business Environment (primarily business regulation). We have included for comparison by GCC member (UAE, Saudi Arabia, Qatar and Bahrain), other Middle Eastern oil productions (Egypt, Libya, Syria and Iraq) and successful non-Middle Eastern oil producers as comparators (the US, Norway, Malaysia and Colombia).

The analysis shows clear differentiation between the three groups. As we can see from the spider diagram below, the GCC countries have invested in infrastructure, education (which is driving the high demography scores), and improving their regulation. In these areas, they are more like the non-Middle Eastern comparators than the other Middle Eastern countries. However, with the exception of the UAE, all of the Middle Eastern countries lag significantly in innovation and technology. The percentage of the workforce employed in knowledge intensive sectors is only slightly higher in Saudi Arabia than it is in Sri Lanka, whose GDP per capita is only 14% of that of Saudi Arabia. Nonetheless, compared to the non-GCC Middle Eastern countries, Saudi Arabia is a model of innovation.



Broadly speaking, what this seems to suggest is that the GCC countries are using their oil revenue to buy infrastructure and education, but that is not flowing through into technology. In this way, they look something like Greece and Portugal, which are driving Europe's debt crisis. Greece and Portugal used windfall revenues, in their case EU structural adjustment funds, to build world class infrastructure, but they failed to make the more fundamental changes in economic incentives and regulation necessary to produce innovative firms to use that infrastructure. The GCC countries essentially face the same problem: while the foundations of an advanced economy are there, societal incentives will need to shift before the Middle East become a hub of innovation producing new companies and new economic growth outside of energy production.

However, the GCC countries are much stronger, even in innovation, than the rest of the

Middle East, which may help to explain why the Arab Spring has taken a much more tumultuous course outside of the GCC. Despite its challenges, there is a real possibility for future economic reform and growth in the GCC. By contrast, Libya, with poor infrastructure, burdensome regulation and practically no innovation to speak of, offers no real hope without a complete break with the past.

The interruption of Libya's oil exports has created a short-term energy security problem; however, the fundamental drivers of the current unrest point to a much more substantial long-term problem. If the countries of the Middle East, and especially the GCC, do not begin to make fundamental changes to encourage diversification, they will continue to struggle to meet the economic aspirations of their people. This will both put upward pressure on oil prices and lead to future discontent, as their levels of GDP per capita continue to fall further and further behind those of the developed economies.

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