



Research Bulletin
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Low Oil Prices: Implications for the GCC Countries

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Overview

The global economic and financial crisis has undoubtedly spread its tentacles in every nook and cranny of the world in varying degrees. As the crisis moves from one phase to another, more and more countries and sectors are exposed to its vagaries. One such sector, which in recent years has been bubbling with effervescence is oil, but which is now precariously at the receiving end of the global economic meltdown. Oil prices have plummeted by more than 70% from the record peak level of \$147 a barrel in July 2008 to around \$40 a barrel in the first quarter of 2009, due to economic recession in the industrialised world and economic slowdown in emerging economies.

For the first time in six decades, the global economy is expected to contract by around 1% in 2009, according to the World Bank, and the volume of international trade is expected to shrink by 9% this year (World Trade Organisation). Such dramatic declines in global growth and trade would unleash unprecedented socio-economic challenges across global frontiers. In the case of oil dependent economies, crude oil prices are currently well below the threshold or break-even levels used in their budgets. This means that if oil prices continued to remain at their current levels or drift further downwards, it would impact adversely on the economies of many oil exporting countries, including those in the Gulf Cooperation Council (GCC) region.

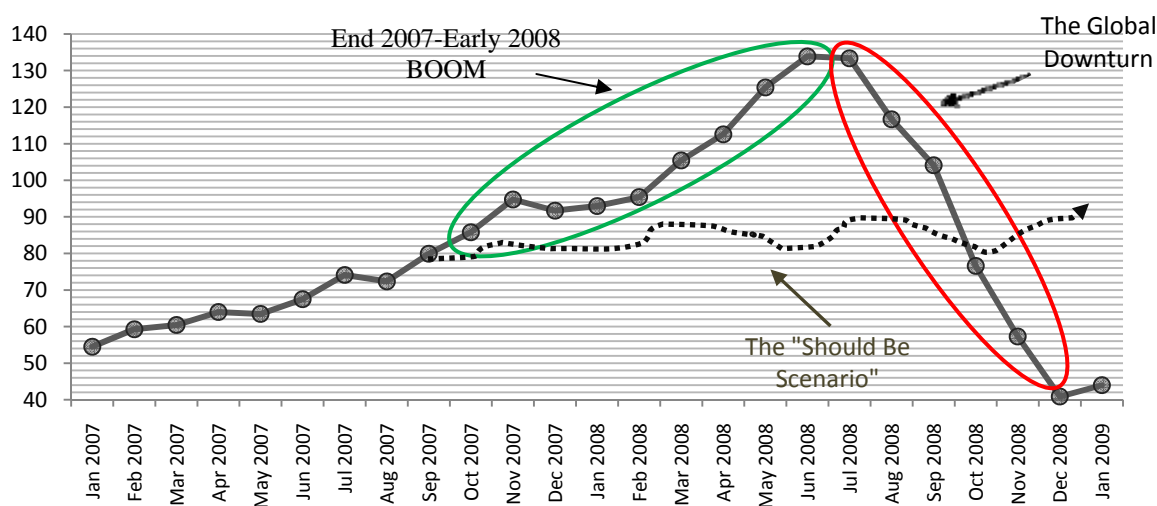
Low oil prices would also act as a disincentive to invest in the oil sector, and thereby jeopardise the stability of the industry in the future. Under investment in the oil industry would create supply-side constraints which would in turn lead to high oil prices when the global economy is back on track. Such boom-bust cycles would undermine meaningful efforts at formulation of credible and sustainable energy policy. What the oil industry wants is market stability that sustains a price that is low enough to stimulate demand and high enough to encourage new investments.

The key questions are: what are the trends and prospects of international oil prices? How do the current oil price dynamics differ from those in the past? What are the implications of low oil prices on the economies of the GCC countries? What policy measures should GCC countries take to mitigate the adverse effects of the deterioration in oil prices? This bulletin attempts to provide answers to these and other related questions.

Global Oil Prices: Trends, Determinants and Outlook

Less than a year ago, oil prices were in the ascendancy and were forecast to reach \$200 by the end of 2008 (Goldman Sachs)¹. Indeed, oil prices increased by 70% between January 2007 and January 2008, and then rose further by an additional 54% in the following 6 months to reach the pick of \$147/barrel in July (Figure 1).

Figure 1: Monthly Movements in Crude Oil Price (US\$ Per Barrel)



Source: EIA database, and Gulf One Estimates

A number of factors have contributed to the soaring oil prices in recent years. One such factor relates to market fundamentals where growth in world oil demand, fuelled largely by growth in world GDP. For three consecutive years, from 2005 to 2007, the world economy experienced a high GDP growth rate of 5% per annum. And in 2008, global GDP grew by a respectable 4% despite the global financial crisis which characterised the last quarter of the year. As is well known, the global economic growth was driven largely by substantial income growth in China and India, which in turn fuelled their appetite for oil consumption.

Oil prices during the so-called 'boom' period in Figure 1 were also driven by speculative factors and the deterioration in the value of the US dollar. According to the IMF, the constellation of dollar depreciation and falling short-term real interest rates has pushed up commodity prices, thereby enhancing the attractiveness of commodities as an alternative asset². It is therefore not surprising

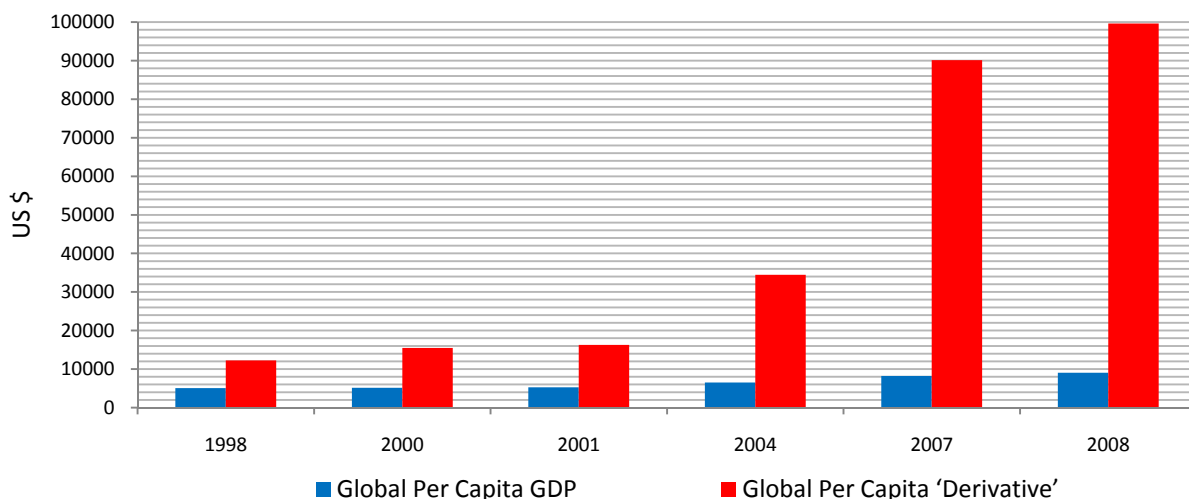
¹ The Financial Times (3 July 2008) reported that the number of financial bets on crude oil price reaching US\$200 a barrel before the end of the year quadrupled during the month of June, underlining the growing concern that oil prices would continue to rise throughout the year.

² See also the Financial Times (20 March 2008).

that speculative behaviour generated considerable controversy in 2008. On the one hand, oil exporting countries blamed speculative investors as the biggest culprits behind the oil price hikes. On the other hand, oil importing countries blamed oil producers for not supplying enough oil to the market.

The blame game was only interrupted by the onset of the US financial crisis following the demise of Lehman Brothers and the changing financial landscape in September 2008. The root causes of the US financial crisis are now well known³, but excessive leverage and derivative trade featured prominently as one of the explanations. As Figure 2 shows, global per capita derivative in 2008 outstripped global per capita GDP by a factor of 10, as opposed to a factor of less than 2 a decade ago. This trend highlights not only the rapidity with which derivative trade grew over the years but also the dangers of undertaking such colossal transactions without adequate underlying assets to back them.

Figure 2: World Per Capita Derivative and Per Capita GDP

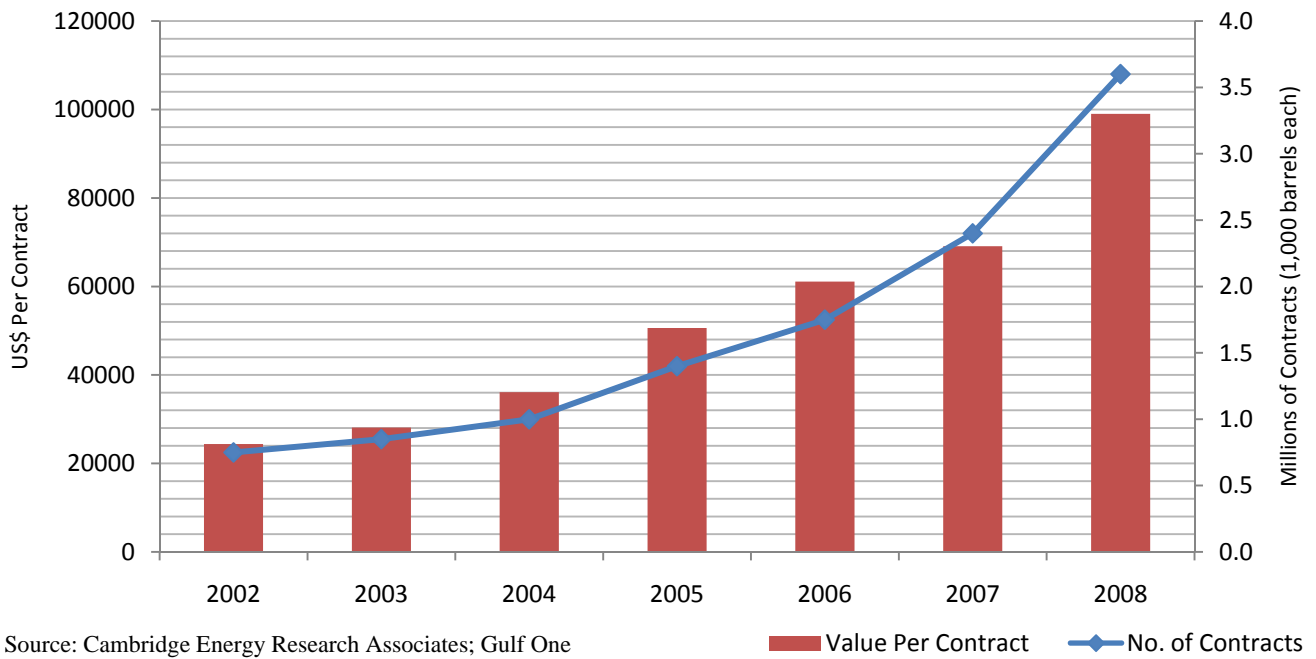


Source: BIS, IMF, World Bank

Available data on the New York Mercantile Exchange (NYMEX) crude oil derivative corroborates the rapidly increasing trend in global derivative trade. On average, the number of daily trading in crude oil futures and options on the NYMEX more than quadruple from less than 1 million contracts in 2002 to around 3.6 million contracts in 2008. Equally, the value of oil derivative trade jumped by four fold – from around US\$24,000 to nearly US\$100,000 per contract – during the same period (Figure 3). Clearly, this underlines the role of speculative behaviour in exacerbating the oil price bubbles of the past few years, which indirectly contributed to the global credit crunch by way of high costs of consumer and industrial goods.

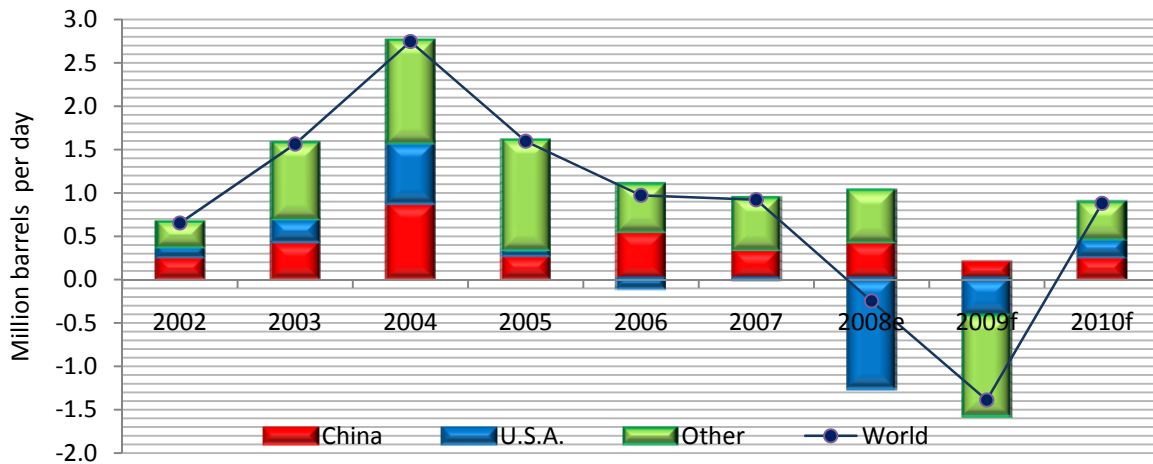
³ For a detailed explanation of the root causes of the US financial crisis which date back to the demise of the gold standard, see Gulf One Research Bulletin, 'Global Financial Crisis and its Impact on the GCC', vol.1, no.11, October 2008.

Figure 3: NYMEX Crude Oil Derivative Trade (Daily Trading Day Average)



As the global credit crunch rapidly spread to the real economy, it triggered economic recession in the US and other major advanced countries, which in turn weakened global demand, thereby driving down oil prices considerably. Since September 2008, actual oil price has been markedly lower than the hypothetical price represented by the dotted line in Figure 1. This is not surprising as oil consumption in major oil importing countries declined substantially. For instance, oil consumption in the US, the world's biggest oil consuming nation, declined by around 1.2 million barrels per day in 2008 and is expected to continue to decline throughout 2009 (Figure 4).

Figure 4: Changes in Oil Consumption, 2002-2010



Similarly, in 2008, oil demand in the world's second largest oil consuming nation, China, declined by 3.2% over the preceding year, and in India and South Korea, oil consumption fell by 17% and 6.5%, respectively, over the same period. The short-term global outlook for oil demand is also dire, as average annual world oil consumption is projected to decline by around 1.4 million barrels per day in 2009 before recovering marginally in 2010, as Figure 4 shows.

Thus, it is likely that the expected recovery in global demand next year would not be enough to lift oil prices to the \$75-\$90 per barrel which the oil cartel, OPEC (Organisation of Petroleum Exporting Countries), regards as the minimum level required for profitable investments in the oil industry. For instance, Merrill Lynch has projected that oil prices could slide further to as low as \$25 a barrel in 2009 if China's oil consumption decreases further⁴. Other forecasters are, however, more optimistic even as they predict crude oil prices in the range of \$40-\$53 per barrel, well below the OPEC benchmark⁵.

It is worth noting that the prospects of recovery in global oil demand and prices largely hinge on the speed with which the current global economic meltdown is nipped in the bud. This depends upon the effectiveness of the various economic stimulus packages and other 'corrective' measures being implemented around the globe⁶. That is why it is not just the weakening of current demand that is pushing oil prices down, but also concerns that the economic recession would last longer than expected and the prospects of slower growth in emerging economies, both of which serve to lower the probability of an early recovery in future oil demand.

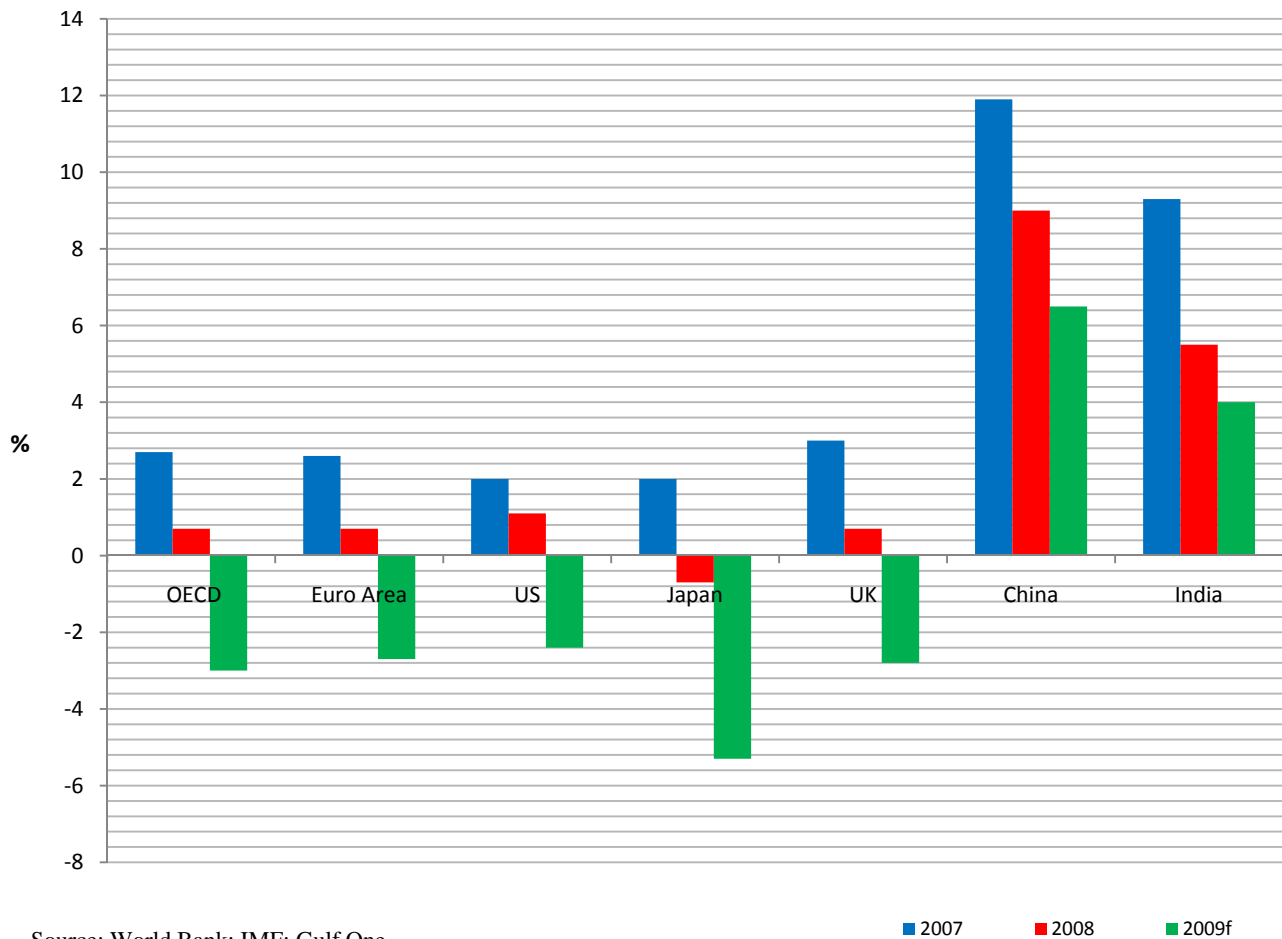
As is now common knowledge, many forecasting agencies, including the IMF and the World Bank, have been constantly revising down their economic growth forecasts for all countries. Latest forecasts show that, on average, the economies of the advanced countries would contract by 3% in 2009; those for the USA, Euro-zone, Japan and the UK would shrink by 2.4%, 2.7%, 5.3%, and 2.8% respectively (Figure 5). China and India, the two main drivers of global economic growth, are also expected to grow at much lower rates, which may not be enough to prevent the overall global economy from shrinking in 2009.

⁴ Sourced from Bloomberg.

⁵ These include forecasts by EIA (\$42 per barrel in 2009 and \$53 per barrel in 2010), Deutsche Bank (\$47.50 a barrel), and Sieminski (\$45, \$50, and \$40-\$45 per barrel in the first quarter, second quarter, the last half of 2009 respectively) (Reuters, 22 January 2009). The IMF, however, has projected oil prices of \$50 and \$60 per barrel in 2009 and 2010 respectively.

⁶ The forthcoming G20 summit, scheduled to take place in London (2 April 2009), is expected to provide a roadmap for overcoming the global economic crisis but the effectiveness of such a roadmap largely depends on whether or not member states would be able to bridge the gap in ideas on specific issues such as fiscal stimuli, protectionism, toxic assets, financial regulation and reform of the Breton Woods Institutions.

Figure 5: Growth Rates of Real GDP in Selected Regions & Countries (%)



Assessment of Current and Past Oil Price Cycles

The international oil market is obviously going through a rough ride at the moment, but the key questions are: what is a fair oil price? How different is the current oil price shock from the past cycles? Are there discernible differences in long-term trends between nominal and real oil prices? What are the implications of all this for policy? These questions are pertinent for a number of reasons. First, the root causes of oil price volatility may have varied over time but exogenous as well as policy-oriented shocks are nothing new to the international oil market. Second, oil prices are currently low in nominal terms, but how low are they in real terms, as it is the latter that is crucial for income terms of trade considerations? Third, what policy lessons can be learnt from past experiences in coping with adverse market conditions?

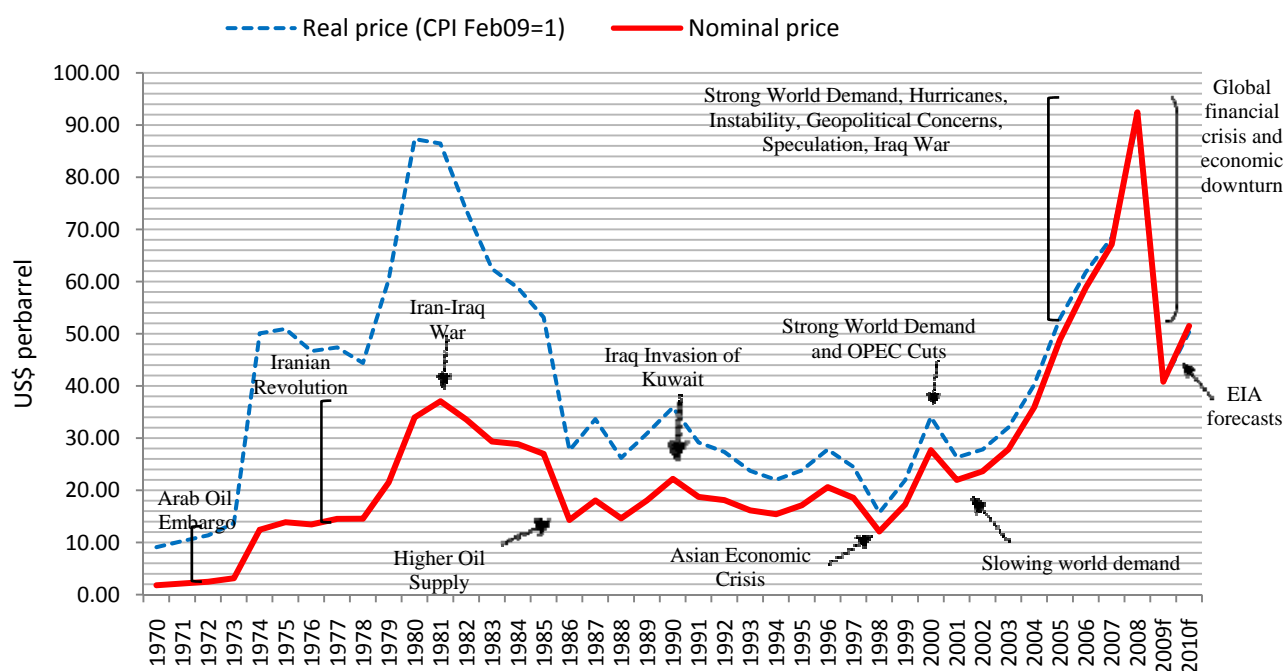
Figure 6 illustrates the historical trends in both nominal and real prices of crude oil and the underlying determinants for each episode. Broadly, there are 9 such episodes, consisting of five periods of oil price peaks (boom) and four trough periods. The five oil price peaks correspond to: the Arab oil embargo of 1973 following the Yom Kippur war; Iranian revolution which led to the ousting of Shah in 1979; Iran-Iraq war of early 1980s; Iraq's invasion of Kuwait in 1990; and strong global economic growth of the early 2000s. The four trough periods (low oil prices) are: OPEC's 'free-for-all' cut-throat competition of mid-1980s which led to oil glut; Asian financial crisis (late 1990s); global slowdown in the aftermath of September 11 attack in New York; and the current global financial crisis.

A number of interesting points are noteworthy from the trend. First, the currently low nominal oil prices are still higher than nominal prices during all previous oil price (boom and bust) cycles. But do they reflect what can be called a fair oil price range? This is debatable because theoretically a fair price can be equated to 'equilibrium' price which is determined by the forces of demand and supply. However, the distortions introduced into the international oil market by speculators in recent years appeared to have cast serious doubts on the relative importance of demand-supply imbalances. It is for this reason that oil exporting countries view a price range of \$60-\$75 per barrel as 'fair' enough to guarantee long-term stability in the energy sector. So far, oil prices are well below this perceived range.

Another noteworthy feature of the oil price trend is that, from peak to trough, nominal oil prices plummeted by over 70% while the magnitudes of the oil price fall under previous episodes were much lower. Even under the 'free-for-all' situation of 1986, oil prices fell by a maximum of 58%. Third, with the exception of the recent oil price shocks, real oil prices (inflation-adjusted) in all past cycles were higher than the corresponding nominal prices. However, the gap between real and nominal oil prices narrowed in recent years, due to the relatively high inflationary pressures, and given that the most recent consumer price index is used as a base year for the price deflator.

The policy responses of oil producing and exporting countries vary across oil price cycles, but they were asymmetrical between peak and trough periods. While output cuts during trough periods were deep, in times of peak oil prices output expansion was shallow presumably due to technical or other supply-side factors. Only Saudi Arabia, as a swing producer, has the capability to intervene at critical moments to either restrict or expand production to stabilise the international oil market. Even so, the overall impacts of oil supply responses are generally low due to the significant role of speculations in the international oil market.

Figure 6: Nominal and Real Prices of Crude Oil and Historical Episodes



Source: EIA database and Gulf One calculations

Implications of Low Oil Prices for the GCC Countries

The importance of oil in the GCC economies cannot be overemphasised. For instance, in Kuwait it accounted for around 95% of total exports and government revenues, and 54% of the GDP (Table 1). Bahrain is the only country in the region in which oil accounted for only a quarter of GDP, but even so oil accounts for more than three-quarters of the country's foreign exchange earnings and government revenues. Obviously, the continuing decline in international oil prices would adversely impact the GCC economies, but how big would the impact be? What measures should countries in the region take to mitigate the adverse consequences? The first question is addressed in this section while the second question is discussed in a later section of this bulletin.

Table 1: Contribution of Oil to Exports, Fiscal Revenues and GDP in GCC Countries, 2007

	Total Exports (%)	Fiscal Revenues (%)	GDP (%)
Bahrain	76	77	25
Kuwait	95	94	54
Oman	67	65	45
Qatar	58	65	62
Saudi Arabia	89	82	55
UAE	44	80	43

Source: GCC Central Banks; Gulf One Calculations

There are a number of channels through which the GCC economies would be affected by the slump in oil prices. These transmission channels include fiscal balance, current account position, terms of trade, and inflation. The combined effects of all these factors would impact the rate of growth of real GDP.

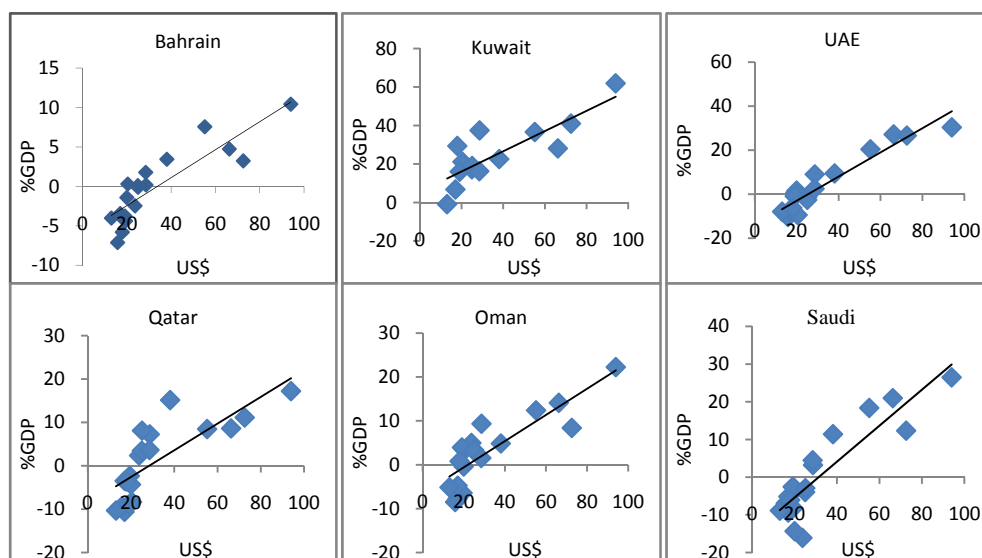
Effect on Fiscal Balances

The scatter plots of past oil prices and fiscal balances of the GCC countries show that there is a positive correlation between the two variables (Figure 7). This means that high oil prices tend to be associated with fiscal surpluses (incomes exceeding expenditures) and low oil prices are associated with either fiscal deficits or low budget surpluses. Since 2003 oil prices have increased dramatically and equally all GCC countries have experienced increasing fiscal surpluses, with 2008 witnessing the highest budget surpluses, as a percentage of GDP, due to the record high oil prices in the first half of the year (Table 2).

	2003	2004	2005	2006	2007	2008e	2009f
Bahrain	1.78	3.44	7.55	4.73	3.23	10.41	7.62
Kuwait	16.24	22.52	36.59	28.08	40.95	61.88	55.41
Oman	1.52	4.83	12.38	14.10	8.38	22.25	21.21
Qatar	3.63	15.14	8.44	8.59	11.10	17.20	18.77
Saudi Arabia	4.47	11.41	18.38	20.99	12.34	26.50	19.22
UAE	2.50	9.48	20.44	27.20	26.67	30.42	28.33

Source: Institute of International Finance

Figures 7: Oil Price (US\$ pb) and Fiscal Balances (% of GDP) in GCC Countries, 1990-2008



Source: IMF; Gulf One

Judging by the positive correlation between oil prices and fiscal balances, there is no doubt that low oil prices would lead to deterioration in fiscal balances of all GCC countries. The nature and extent of the fiscal deterioration in each country would, however, depend on a number of factors including the break-even level of oil price each country has used in its budgets. As oil prices increased over the years, the break-even prices used in the budgets of GCC countries also increased accordingly, and in some cases astronomically. On average, break-even prices in the GCC countries increased by over 80% between 2006 and 2009. In Kuwait, for instance, break-even price nearly tripled from \$17 a barrel in 2006 to \$48 per barrel in 2009. Even so, Kuwait's oil price threshold is still one of the lowest in the GCC, along with Qatar and the UAE (Table 3). In contrast, Bahrain and Oman have the highest break-even prices of \$72 and \$76 per barrel respectively. They, along with Saudi Arabia (with \$54 per barrel), have relatively high oil price thresholds, and are therefore likely to record fiscal deficits this year provided oil prices remain at their present levels.

	Break Even Oil Prices		
	2006	2008	2009
Bahrain	40	75	72
Kuwait	17	33	48
Oman	40	77	76
Qatar	30	24	38
Saudi Arabia	30	49	54
UAE	25	23	35

Source: Institute of International Finance; <http://www.enbc.com>; <http://seekingalpha.com>

Based on these break-even points, what would be the extent and magnitude of the impact of the low oil prices on the fiscal positions of the GCC countries in 2009? Table 4 shows the estimated fiscal balances for all the countries in the region, assuming four crude oil prices and using oil price thresholds provided by the Institute of International Finance (IIF). As can be seen from the table, for

the first time since 2002, the region is expected to record unfavourable fiscal positions across most countries depending upon what price scenario prevails. For instance, if oil prices drift to \$35 a barrel, only the UAE is likely to maintain a balanced budget, but as prices increase towards \$55 a barrel all countries in the region would experience sizeable fiscal surpluses except Bahrain and Oman.

	Break-Even Prices (\$bp)	Oil Exports (mn bpd)	Fiscal Balances (US\$ bn)			
			Scenario 1	Scenario 2	Scenario 3	Scenario 4
Bahrain	72	0.045	-0.61	-0.5	-0.4	-0.3
Kuwait	48	2.33	-11.19	-2.6	1.7	6.0
Oman	76	0.81	-12.7	-9.2	-7.7	-6.2
Qatar	38	0.785	-0.9	2.0	3.4	4.9
Saudi Arabia	54	7.7	-53.4	-25.3	-1.1	2.8
UAE	35	2.54	0.0	9.3	13.9	18.5

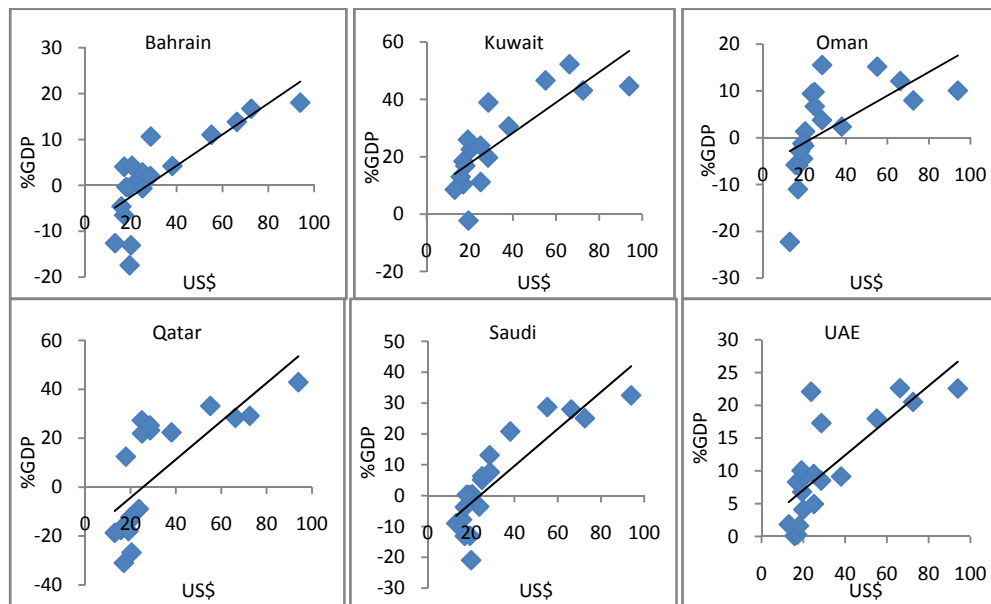
Note: Scenarios 1, 2, 3, and 4 are based on oil prices of \$35, \$45, \$50, and \$55 a barrel respectively
Source: GCC Central Banks, EIA, Zawya, AMEINFO, and Gulf One estimates

Effect on Balance of Payments (BOP)

By accounting for a substantial proportion of total exports (over 90% in Kuwait and Saudi Arabia and at least 75% in Bahrain), oil is a major contributor to the current account component of the BOP of the GCC countries. It is therefore not surprising that, over the long haul, oil prices are positively correlated with current account balances of the GCC countries (Figure 8).

In fact, over the past six years, these countries have consistently recorded successive current account surpluses. In 2008, in particular, the unprecedented surge in oil prices boosted the current account positions of all countries in the region. In that year, the estimated current account surpluses in the GCC region averaged 28% of regional GDP, albeit with considerable cross-country variation ranging from 10% in Oman to 45% in Kuwait (Table 5).

Figures 8: Scatter Plots of Oil Price (US\$ pb) and Current Account Balances (% of GDP) in GCC Countries, 1990-2008



Source: IMF¹ WEO database

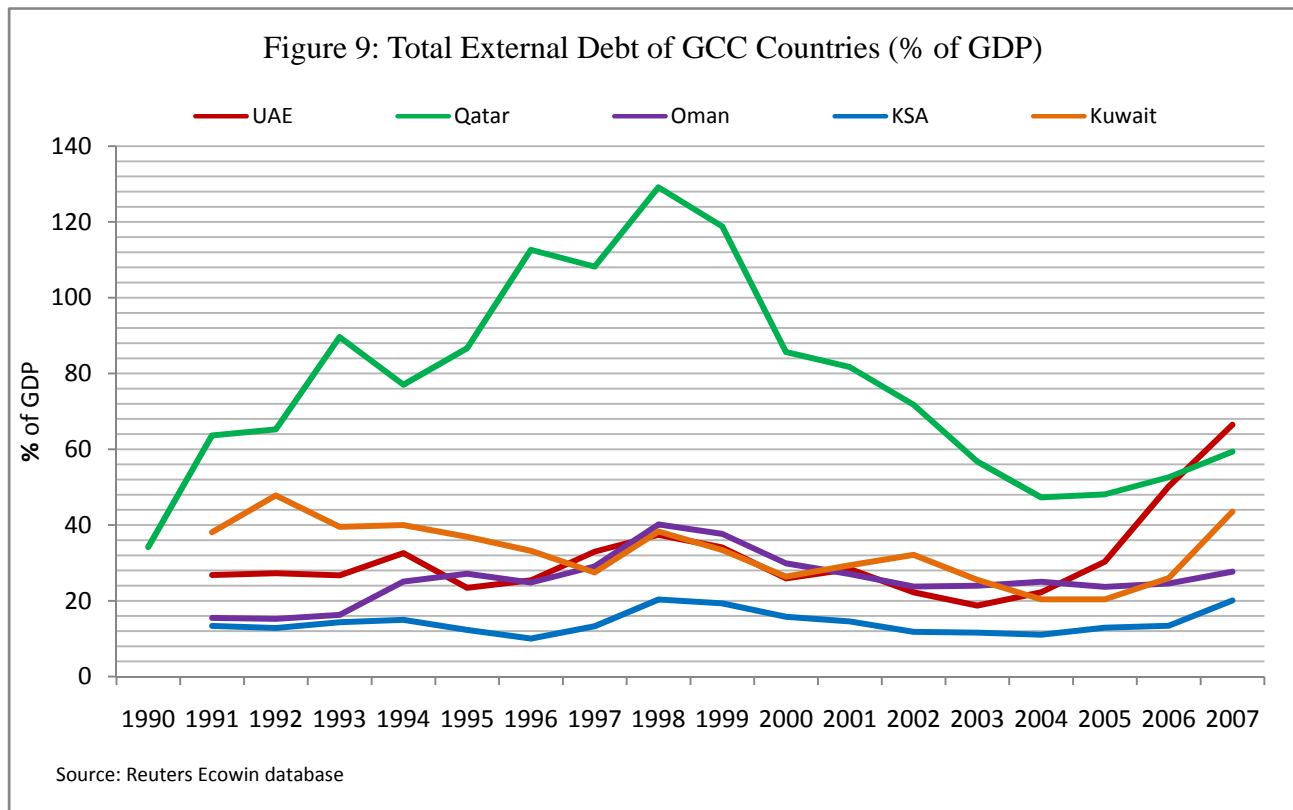
Although oil prices are currently plunging markedly, GCC countries are still expected to register current account surpluses in 2009 but at much lower levels than in the preceding year. Oman would be the hardest hit with a 44% decline in current account surplus, followed by Saudi Arabia where current account surplus this year would be 27% lower than in 2008. Overall, current account surplus in the GCC region is likely to plummet by 19% due to the unfavourable international oil prices (Table 5).

Table 5: Current Account Balance of GCC Countries (Percentage of GDP)								% Change (2008- 2009)
	2003	2004	2005	2006	2007	2008e	2009f	
Bahrain	2.0	4.2	11.0	13.8	16.7	18.0	15.0	-16.7
Kuwait	19.7	30.6	46.6	52.2	43.1	44.6	39.3	-12.0
Oman	3.8	2.4	15.2	12.1	8.0	10.1	5.6	-44.3
Qatar	25.3	22.4	33.2	28.4	29.2	42.9	35.6	-17.1
Saudi Arabia	13.1	20.8	28.7	27.9	25.1	32.5	23.8	-26.8
UAE	8.5	9.1	18.0	22.6	20.5	22.6	18.8	-16.6
GCC	12.1	14.9	25.4	26.2	23.8	28.4	23.0	-19.1

Source: IMF; Gulf One Estimates

National Debt, Inflation and Income Terms of Trade Effects

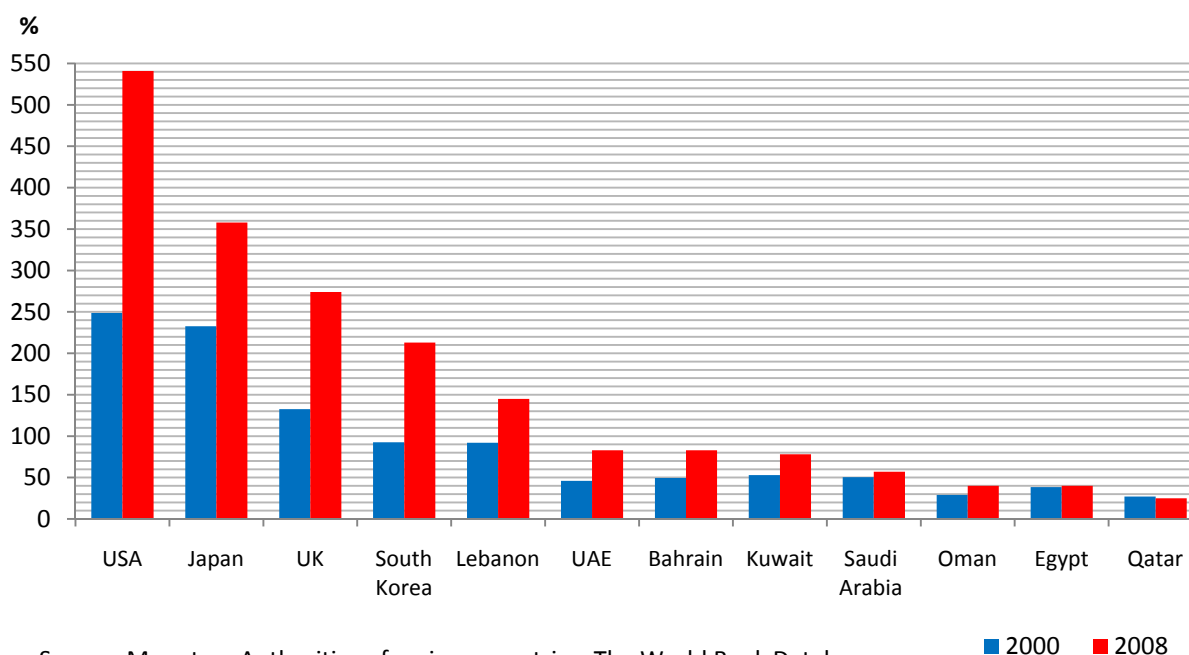
Past oil windfalls have undoubtedly shielded the GCC countries from amassing external debt and their national debt figures have been relatively low. For a very long period of time, with the exception of Qatar, external debt in all GCC countries has been less very low (below 40% of GDP). Even in the case of Qatar, there has been a remarkable decline in external debt burden from over 120% of GDP in late 1990s to less than 60% of GDP in 2007, well below the international debt sustainability standard (Figure 9).



Similarly, all Gulf countries have relatively low national leverage intensity in the world as illustrated by the national debt profile. As Figure 10 shows, national (both public and private) debt to GDP ratio in the GCC region is a fraction of that in the US from where the current global financial crisis originated. Although the national debt is relatively low in the GCC countries, it has increased rapidly over the recent past, so much so that it eroded a significant part of the income terms of trade generated by high oil prices.

In Saudi Arabia, for instance, up until the early 1990s, the income terms of trade (wealth effects of oil prices) have exceeded total claims of banks (credit to public and private sectors). Since then, however, real incomes from successive oil price hikes were grossly inadequate to service the country's national debt, except during the latest oil price boom, late 2007-2008 (Figure 11), as income terms of trade exceeded total claims of the banking sector in 2008 except in the fourth quarter of the year when oil prices dropped quite considerably.

Figure 10: National Debt as Percentage of GDP



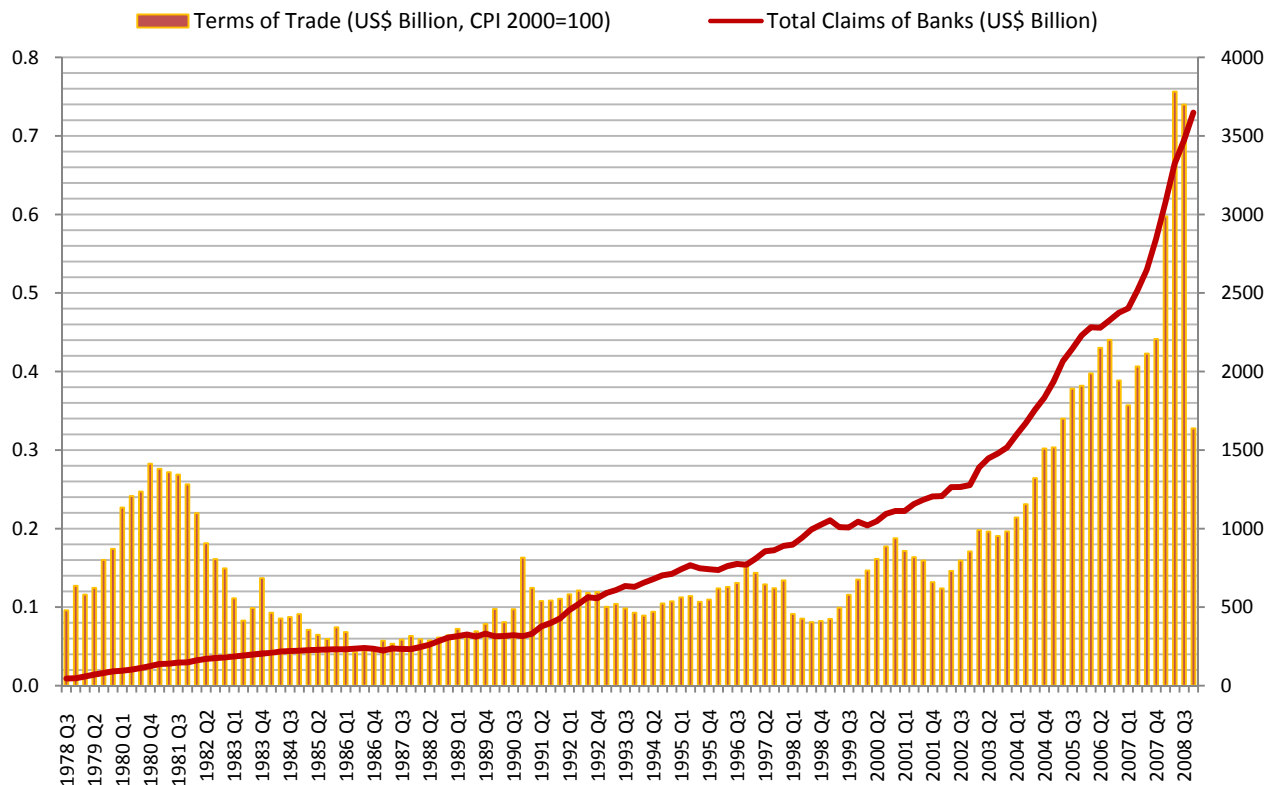
Source: Monetary Authorities of various countries, The World Bank Database

The main lesson from Saudi Arabia's experience is that the dwindling oil prices would have adverse effects on real oil incomes across GCC countries, and thereby exacerbate national debt situations. Given the apparently low diversification level of the GCC economies, the non-oil sector is too feeble to offset the supposedly temporary deterioration in oil incomes across the region. The consolation, however, is that inflation in the region and in the rest of the world has eased significantly, and it is likely to remain low throughout 2009, and this would help to minimise the scale of the income terms of trade deterioration.

In effect, the rates of inflation, which reached double digits in most GCC countries in 2008, have now declined to single digits⁷. For instance, inflation in Saudi Arabia declined from 11% in July 2008 to 6.9% in February 2009, and in Oman it declined to 9% in January 2009, down from 12% in December 2008 (Reuters). Even in the inflation-prone countries of Qatar and the UAE, inflation rate has dropped substantially and is expected to reach single digit by the end of 2009. Whether or not the expected decline in global inflation would minimise the magnitude of net wealth erosion in the GCC depends on the relative changes in nominal oil incomes and prices.

⁷ Bahrain and Kuwait are the only GCC countries that did not experience double-digit inflation in 2008, and they currently have relatively low inflation rates in the region.

Figure 11: Terms of Trade Effects and Bank Claims in Saudi Arabia



Source: SAMA; IMF; Gulf One Calculations

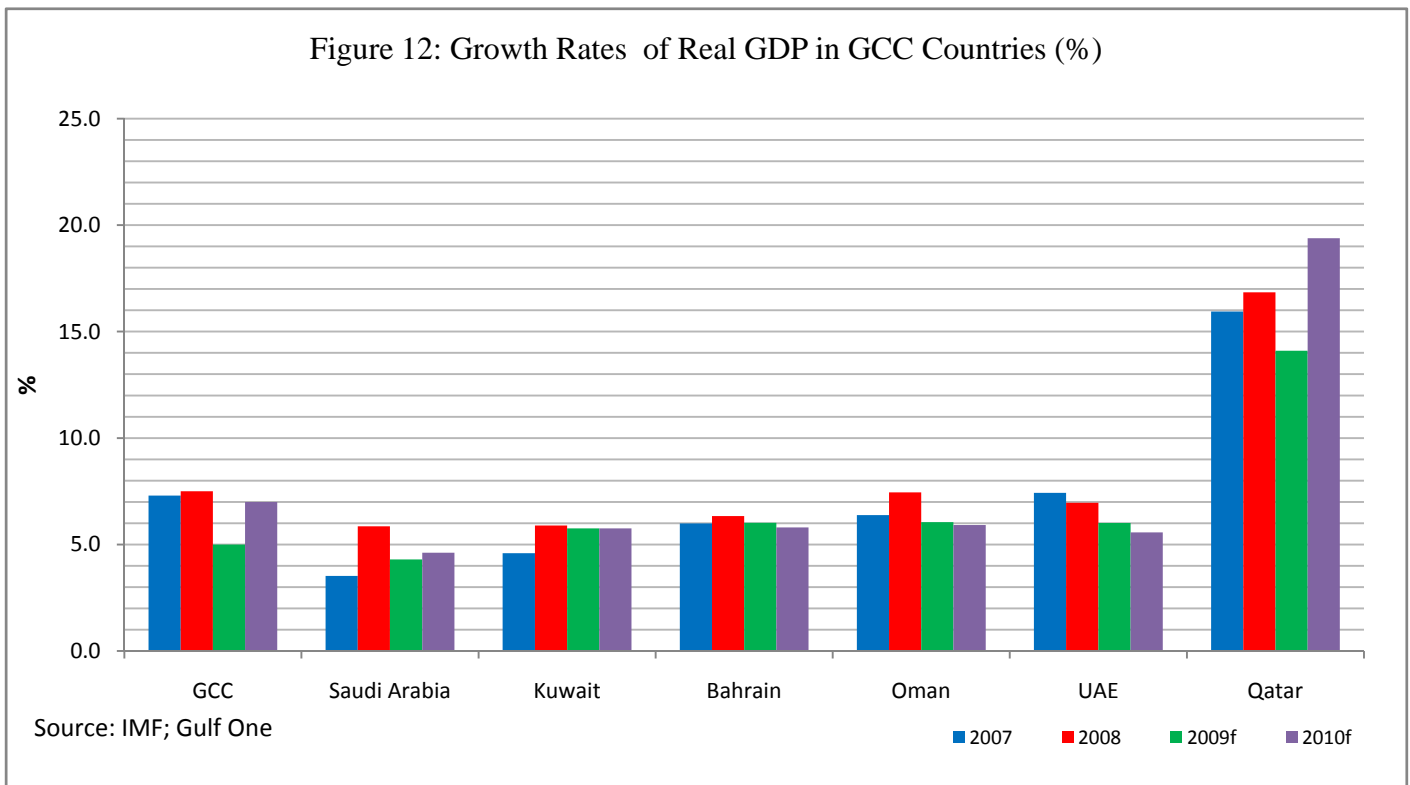
Effect on Economic Growth

For the past six years, the GCC countries have experienced unprecedented economic growth, with real GDP growth rate averaging around 7%. Economic growth has been sustained by both domestic and external factors. The external factors included higher income terms of trade, supported by high hydrocarbon prices during the first half of the year, with oil price reaching a record peak of US\$147 a barrel in July 2008. Although oil prices plummeted sharply in the last quarter of 2008, following the onset of the global financial crisis, it did little to dent the economic boom that gathered tremendous momentum during the year. Economic growth in the GCC in recent years was also boosted internally by prudent economic policies and improved business climate which have helped to promote macroeconomic stability, enhance private sector investment, and boost economic activities and income.

The deterioration in the international oil market, occasioned by the deepening and broadening of the global economic and financial crisis, would undermine economic growth prospects for 2009. As the crisis moves from one phase to another, more and more countries and sectors are exposed to its vagaries. Business confidence in the region is currently low, and private sector activity is in a state

of lull⁸ as banks are reluctant to lend and investors are playing a ‘wait-and-see’ game. These along with the adverse effects of oil price slump on fiscal and current account positions would combine to slow down the rate of economic expansion in the region. Already, there are reports that a number of projects worth billions of dollars have been either put on hold or cancelled, but governments in the region have vowed to execute all planned projects⁹. Even so, economic growth in the region in 2009, at 5%, is forecast to be lower than it was in 2008¹⁰. Economic growth is, however, expected to bounce back to around 7% in 2010 when the global economic recovery is anticipated to occur. The economic growth prospects in individual GCC countries mirror the regional picture albeit with considerable variation across countries, with Qatar remaining as the fastest growing country in the region (Figure 12).

Figure 12: Growth Rates of Real GDP in GCC Countries (%)



⁸ For instance, a recent business survey conducted by SABB in Saudi Arabia shows that the majority of businesses are expecting lower revenues and slower growth in 2009. In fact, the SABB Business Confidence Index declined from a peak of 106.2 in Q1 of 2008 to 89.2 in Q1, 2009 (SABB Report, February 2009).

⁹ The UAE appears to be the hardest hit, particularly due to the impact of the global financial crisis on the construction and real estate sectors in the country, especially in Dubai. For example, according to MEED, the total value of projects on hold in the UAE has increased over the past five months to US\$335bn. Similarly, the total value of projects under way has fallen to “\$254bn, as projects that were active are shelved by their developers” (MEED, 13 March 2009).

¹⁰ It is noteworthy, however, that the nominal dollar value of the GDP at current prices is expected to decline from around \$1.04 trillion in 2008 to around \$924 billion this year (Global Investment House). For instance MEED estimates that nominal GDP would contract by 20% in 2009 if oil prices average \$60, but if it averages \$40 in 2009, the GDP of the GCC “would fall by at least one third” (MEED Dec29). But inflation-adjusted GDP (real GDP) is expected to grow albeit at lower rates than in the preceding year.

Policy Issues

The collapse in oil prices poses serious policy challenges for GCC countries, both internally and externally. On the external front, the challenges relate to collaboration and coordination within the Organisation for Petroleum Exporting Countries (OPEC) as well as non-OPEC producers to influence crude oil prices. It also relates to the role GCC countries could play in the current international efforts to overcome the global economic and financial downturn quickly in order to stimulate global demand. Internally, the challenges involve policy measures GCC countries should pursue individually and collectively to cushion the adverse effects of the oil price fall.

Policy Options at the International Level

As far OPEC is concerned, the organisation has already cut its oil production by 4.2 million barrels per day since September 2008. As is the case with any cartel, the difficulty with OPEC's output reduction strategy relates to 'chiselling and cheating' due to differences in revenue requirements among member countries. As a result, some members of the cartel, desperate for financial resources to execute their development programs, would undermine collective decisions by failing to comply with agreed production cuts, and thereby render the strategy impotent. It is therefore not surprising that even in its latest attempts to prop up oil prices by restricting output, some OPEC member countries are not abiding by cartel's decision while others are even producing more output¹¹. Of course, some countries within the OPEC, including Saudi Arabia, have cut production by more than their agreed reduction quotas, and yet oil price continued to fall.

It should, however, be stressed that the ineffectiveness of OPEC's output reduction strategy in propping up oil prices is partly to do with the magnitude of the production cut, which represents only 14% of total production. This contrasts sharply with the massive production cuts that took place during previous periods of low oil prices. For instance, in 1986 when oil prices fell by 58%, OPEC reduced oil supply by 20%. A similar policy intervention was also effected in 1998 when oil prices dipped by nearly 50%. But in the current situation, when oil prices have fallen by 70% over the past 8 months, output was curtailed by only 14%!

A number of factors might have informed OPEC's current parsimonious output reduction policy. Firstly, the root causes of the current international oil market deterioration are different from the past. Under the present situation of the twin evils of liquidity crunch and economic recession, forcing up oil prices too quickly can undermine current efforts to revive the global economy. Secondly, the Group of Twenty richest countries (G20), which includes Saudi Arabia, is tasked with the responsibility of fashioning global policy responses to the current financial and economic crisis. The overlapping membership of G20 and OPEC for Saudi Arabia should be seen as complementary rather than contradictory. It is in this context that the OPEC, in its latest communiqué, has unequivocally stated that in as much as it considers \$60-\$75 per barrel as a threshold point for new

¹¹ According to data from Reuters (13 February 2009), Algeria and Nigeria are producing 2,000 and 30,000 barrels per day, respectively, more than their agreed quotas. Both countries have relatively large populations and poorer than their Gulf counterparts.

investments in the energy sector, it would not undertake further production cuts until the global economy is back on track¹².

Yet another external policy measure, which might have a medium- to long-term dimension, relates to continuous dialogue between oil producers and consumers. The aim is to find common grounds on the most effective mechanisms for agreement “on a broad target range for oil prices – say, between \$50 and \$75 a barrel – backed by a strategic stock holding to be augmented or deployed when prices diverged from the range. To support such an agreement, trading would be limited to those with a direct physical interest in the market”¹³. Indeed, oil is an essential ingredient to the functioning of most modern economies and requires a set of rules within which producers can invest with confidence, but the challenge of developing an institutional structure within which dialogue can take place is enormous and requires transparent honesty between producers and consumers alike.

Policy Options at the Country Level

Despite low oil prices and dwindling revenues in recent months the economic fundamentals of the GCC countries are strong. As stated earlier, past oil price booms enabled countries in the region to save substantial amounts of the windfall. Conservative estimates put the total assets owned by the region’s sovereign wealth funds (SWFs) at over \$1.2 trillion and in 2008 alone the region accumulated around \$300 billion. These, along with ‘healthy’ fiscal and current account positions, high economic growth and relatively low inflation, can be powerful stabilising factors. Thus, there are a number of policy options available at the disposal of GCC countries to cushion the adverse effects of the current oil prices and to fortify their economies against exogenous shocks in the long run.

In the short run, countries in the region should utilise the huge savings accumulated over the past few years to beef up economic activities in the region. Governments in the region should “reprioritise investments to focus on creation of competitive advantage platforms, realign SWF investment objectives to support local economies, and proactively drive the creation of regional champions and global challengers” (*Business News* 24/7, 04 February 2009).

There is also a need for fiscal policy stimulus packages to enhance domestic demand through job creation and income growth. Kuwait has recently introduced a fiscal stimulus package, but other countries in the region would have to do the same for two reasons. First, this would complement as well as incentivise private sector activities in the region. Second, with the exception of Kuwait, all countries in the region maintain dollar-pegged exchange rate regimes. But such a policy compels monetary authorities in the GCC to monitor and mimic the monetary policy stance of the USA, particularly interest rate policy. Interest rate in the US is now at near zero levels and it is no longer an option for the Federal Reserve. However, recently, the US Federal Reserve has turned to ‘quantitative easing’ as an instrument of monetary policy, which would consequently influence money supply and the value of the dollar. To maintain the dollar-pegged parity, the GCC countries would require some kind of a corresponding monetary policy intervention, but to introduce quantitative easing in the GCC without appropriate countervailing fiscal policy measure would be counterproductive. Hence the importance of fiscal stimulus packages in the GCC countries.

¹² OPEC’s communiqué dated 15 March 2009.

¹³ Financial Times, 15 December 2008.

Yet another short-term measure revolves around direct support to the private sector in this extraordinary time of crisis. As the banking sector does not have the appetite for restarting large-scale lending, countries in the region could use financial buffers and other public investment funds to support the private sector. This would help to maintain or even increase private sector activities, which would otherwise have been crowded out through increased public investment programmes.

In the medium to long run, however, there must be real movements and paradigm shifts in the GCC governments' diversification and investment strategies to channel the negative influences into significant sustainable economic results. In other words, the GCC countries must see the current global economic and financial crisis as a silver lining to reform and diversify their economies as well as to initiate strategic mechanisms for acquiring appropriate technology and knowledge needed to accelerate the industrial development of the region. On paper, diversification remains the corner stone of national development plans of every country in the region, but on the ground it remains a mirage due to implementation challenges.

Overcoming these challenges would require bolder and more decisive measures on the part of the GCC governments. One such measure is to reduce the region's reliance on upstream activities, and to intensify efforts at robust development of downstream products. Selling crude oil alone without a parallel strategy for the acquisition of appropriate technology and know-how for the fabrication of petroleum products is a recipe for future economic disaster. Often oil exporting countries, including those in the GCC region, sell crude oil but import 'refined' oil and petroleum products due to lack of know-how to produce the latter despite the fact that value added products are generally more expensive than raw materials! Governments in the region should therefore be more ambitious in their strategic thinking and should act fast to stop the age long policy of selling crude and buying products.

Historically, global terms of trade movements have always favoured exporters of manufactured (finished) products rather than exporters of raw materials/commodities. Similarly, international markets for raw materials and commodities are more volatile than the international markets for manufactured products. GCC governments should therefore take drastic measures to acquire appropriate technological capabilities to produce differentiated products, particularly those products whose production relies heavily on abundant raw materials and feed stocks the region has revealed comparative advantage. Without such a proactive intervention by governments, all talks about diversification would continue to remain a theoretical proposition, and the region would continue to be at the mercy of the international oil markets, which are now widely known to be driven largely by activities of unregulated speculators.

A related strategy involves taking advantage of the current global financial crisis to engage in meaningful strategic alliances with knowledge-based international companies that can expedite the development of relevant industries in the GCC region. This could complement the traditional tradable sector and thereby lead to more effective and efficient utilisation of hydrocarbon revenues. As the cliché goes, 'cash is king in times of crisis', so countries in the region should deploy their past savings, including the SWFs and reserves, to attract prospective international companies, through carefully crafted strategic alliances involving local firms, to establish relevant industries. Where the social rates of return from such collaborative ventures exceed the private rates of return, governments should not hesitate to provide seed funding to private investments. Such direct government interventions were at the heart of the success stories of the East Asian Tigers, many of whom have now achieved the status of 'industrialised' countries. The global economy is facing extraordinary crisis and the world would look sympathetically at some of the unconventional

measures, which would otherwise have been frowned upon at crisis-free periods¹⁴. The GCC countries should not allow this golden opportunity to slip! If managed and nurtured properly, such a strategy can add tremendous value to the long term development objectives of the region, and thereby create millions of jobs, build human capital, boost income and sustain economic growth.

Finally, governments in the region should not relent in their liberalisation and economic reform policies to provide conducive environment for private sector participation. More and better economic reforms and privatization should be pursued vigorously to unlock the potential of the private sector as an engine of economic growth and development in the region. Innovative financing mechanisms, especially public-private partnerships, should be deployed to prevent the potential crowding out of private investments under the current difficult economic climate.

Conclusion

Since the onset of the global financial crisis at the end of the third quarter of last year, oil prices have deteriorated rapidly and sharply, and they now stand at less than one-third of their record high levels of \$147 a barrel in July 2008. The current low crude oil prices are well below the threshold or break-even levels used for budgetary purposes in many oil exporting countries, including those in the GCC region. If oil prices continued to remain at their current levels or drift further downwards during 2009, as most forecasts have predicted, it would pose serious challenges for the GCC economies in terms of fiscal and current account imbalances, difficulties associated with executing capital projects, and low growth. The repercussions of low oil prices would not be limited only to the GCC and other oil exporting countries, but it would also reverberate across the globe as they would hamper new investments in the oil sector, and thereby jeopardise the stability of the global energy industry. Under-investment in the oil sector would create supply-side constraints which would drive up oil prices when the world fully recovers from the current economic and financial woes. Looking backwards, such bubble and bust cycles in oil prices have not served the interests of both oil exporting and importing countries well, and are unlikely to do so in the future. What the world wants is market stability that sustains a 'fair' oil price that is low enough to stimulate demand and high enough to encourage new investments.

The GCC countries are, however, in a better position to cushion the adverse effects of the low oil prices than the rest of the world due to the relatively large savings and financial buffers built from past oil price booms. To mitigate these adverse effects, governments in the region should adopt a two-pronged approach. In the short term, efforts must be made to deploy existing savings, including the SWFs, to beef up economic activities and domestic demand given that private consumption and investments in the region are gradually declining. Efforts should also be taken quickly to provide temporary support to the private sector to offset the fall in lending from the financial sector. In parallel, long term strategies for the diversification of the regional economies must be put in place, including accelerated efforts to acquire appropriate technological and know-how for the production of high value added products. The private sector should be at the forefront of this paradigm shift and

¹⁴ For instance, the issue of government subsidy, which is now in vogue everywhere including in the advanced countries, would have attracted a huge outcry from several quarters but for the current global economic and financial crisis. Some of the cases of protectionism currently imbued in the fiscal stimulus packages of many countries in the world would have also attracted litigations at the WTO at normal times.

should be fully supported by governments through accelerated economic reforms and increased seed funding to private investments. Increased diversification will undoubtedly shield countries in the region from unpalatable consequences of future exogenous shocks and would increase the longevity of hydrocarbon resources and enhance the efficient utilisation of these resources.

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