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The Political Economy of Falling Oil Prices: Implications for Arab Gulf States and the U.S.

Vinod K. Aggarwal





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Executive Summary¹

- On November 27, 2014 at the Vienna OPEC meeting, the cartel members decided not to cut production, leading to a dramatic fall in the price Brent Crude oil to below \$70—lower than at any time since 2010. What motivated OPEC, pushed by Saudi Arabia, to refuse to production cuts?
- Disagreements over the price of oil in light of very different costs of production and political-economic conditions? A strategy to undercut U.S. shale producers by driving prices below their economic viability? Or a plot by the U.S. and Saudi Arabia to undermine the Russian economy, ISIS, and Iran?
- All of these ideas have been broached by commentators as possible motivations for the plunging prices of oil. Underlying these political arguments is an important secular trend in oil production—namely that shale oil, conservation, and alternative energy sources are decreasing reliance on OPEC oil, which accounts for about 40% of global daily production.
- The U.S. imported 50% of its crude oil in 2010, but that number is likely to fall to about 20% by 2015.²
- Although predicting oil prices is difficult in light of the multiplicity of political and economic factors that influence prices, it is likely that as Europe recovers, continued American, Chinese, and Indian economic growth will lead to a turn and increase in oil prices. At the same time, the shale oil boom is likely to continue, albeit after a shakeout of the more inefficient producers.

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¹ For research assistance and comments, I would like to thank Bora Park, Vanessa Cheuk, Sahil Gupta, and Katheryn Lee.

² <http://www.reuters.com/article/2014/09/12/us-oil-politics-idUSKBN0H71R920140912>

Policy Recommendations

Arab Gulf States:

- It appears that Saudi Arabia is willing to continue to play the role of oil “hegemon”—a role it repeatedly played as the swing producer since the mid-1970s. Yet this role is fraught with uncertainty and controlling volatile oil markets is not a simple task.
- While the cost of production including capital costs is well under \$10 a barrel for Saudi Arabia and a few others in the Middle East, the more important constraint oil producers face is a budgetary one, with almost all countries likely to face a budget deficit with current oil prices with a price range of \$65 a barrel for Qatar and \$140 for Iran.³
- Without budgetary restraint, OPEC producers will be increasingly weakened, forcing them to tap into their financial reserves to avoid facing political and economic turmoil. At this point, these countries need to exercise restraint and avoid excessive borrowing.

United States:

- If the U.S. Government stops efforts to conserve energy and promote alternative sources of energy, the U.S. will once again become reliant on OPEC oil, despite the current fall in oil prices.
- While subsidizing alternative energy is often problematic, some support to producers who are being whipsawed by volatile oil prices may be a reasonable response to producers’ strategies to undermine the viability of the shale oil sector.
- Although the interests of the U.S. and Saudi Arabia are aligned politically with respect to ISIS, Russia, and Iran in terms of lower oil prices, their interests are likely to diverge from an economic standpoint. Thus using the oil tool to further U.S. policy goals is unlikely to be successful.

I. Introduction

The oil market is once again experiencing significant turmoil. On November 27, 2014, OPEC cartel members decided not to cut production at their Vienna meeting, leading to a dramatic fall in the price of Brent Crude oil to below \$70—lower than at any time since 2010. Hardly new from a historical standpoint, dramatic changes in the price of oil since the 1973-4 oil shock have actually been the norm.

To this point, the ups and downs of the oil market have been primarily driven by economic conditions, conflicts in the Middle East, and OPEC strategy—the latter primarily driven by Saudi Arabia, which has attempted to exert a hegemonic role in the oil market by acting as a swing producer. With respect to the latter, this time is not much different: Saudi Arabia has once again

³ <http://online.wsj.com/articles/oil-price-slump-strains-budgets-of-some-opec-members-1412952367>

played a leadership role, this time refusing to countenance production cuts. But an important element in the oil market is clearly the new role of the U.S. as a major oil producer, driven by its success with fracking technology.

Although oil markets have always been the subject of political intrigue and strategy, analysts have focused on this latest OPEC action in the current political economic context with a great deal of speculation about the ultimate aim of its members. Are disagreements over the price of oil simply due to very different costs of production and differing budgetary constraints? Is the willingness of Saudi Arabia and its allies a concerted strategy to undercut U.S. shale producers by driving prices below their economic viability? Or is this latest action a collusive and individual effort by the U.S. and Saudi Arabia to undermine the Russian economy, pressure Iran and Venezuela, and ISIS?

Underlying these political arguments is an important secular trend in oil production—namely that shale oil, conservation, and alternative energy sources are decreasing reliance on OPEC oil, which accounts for about 40% of global daily production. The U.S. for example, imported 50% of its crude oil in 2010, but that number is likely to fall to about 20% by 2015.⁴

Because it is hard to ascertain the underlying motive or motives of the participants involved, the focus of this article instead centers on the implications of falling oil prices for key Arab Gulf states as well as the U.S., with an eye to understanding both the constraints these countries face as well as their likely strategic responses. Although Saudi Arabia appears to be in the driver's seat, particularly as the world's largest oil producer whose cost of production, including capital costs is well under \$10 a barrel (as well as a few others in the Middle East),⁵ the more important constraint oil producers face is a budgetary one.

Almost all countries are likely to face a budget deficit with current oil prices with a price range of \$65 a barrel for Qatar and \$140 for Iran.⁶ Without budgetary restraint, OPEC producers will be increasingly weakened, with a need to tap into their financial reserves to avoid facing political and economic turmoil. More broadly, falling oil prices, while benefitting American consumers and possibly making the job of central bankers who seek to avoid deflation more difficult, might undermine efforts on the part of the U.S. Government to foster energy conservation and promote alternative sources of energy. Without such a continued push, the U.S. will once again become reliant on OPEC oil, despite the current fall in oil prices.

This article first examines the changes in oil markets, both over the last few months and since the financial crisis. It then turns to consideration of the problems that key Arab Gulf oil players are likely to face, focusing on Saudi Arabia, the UAE, and Qatar, as well as more briefly on Kuwait and Bahrain. We then examine the implications of a price drop for the U.S. market and government strategy before concluding with some policy recommendations.

⁴ <http://www.reuters.com/article/2014/09/12/us-oil-politics-idUSKBN0H71R920140912>

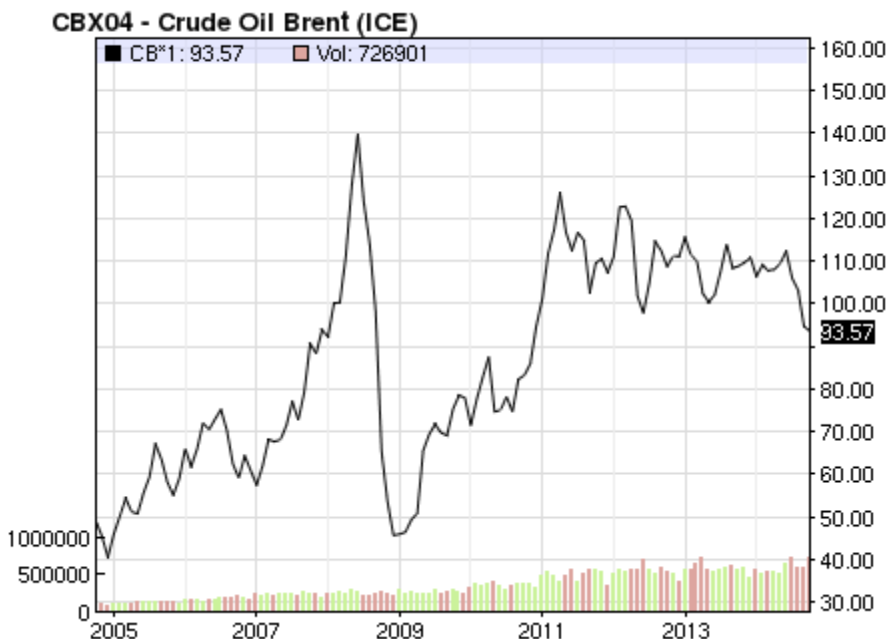
⁵ <http://www.reuters.com/article/2009/07/28/oil-cost-factbox-idUSLS12407420090728>. See also, <http://www.businessinsider.com/oil-price-december-11-2014-12>.

⁶ <http://online.wsj.com/articles/oil-price-slump-strains-budgets-of-some-opec-members-1412952367>

II. Volatile Oil Prices: The Financial Crisis and the Changing Oil Market

Oil prices have fluctuated dramatically, particularly over the last 6 years, driven in part by the financial crisis of 2008 and its aftermath, changes in conservation, and the rise of both alternative energy sources and oil fracking technology (see Figure 1).

Figure 1: Crude Oil Prices, 2005-2104



Source: <http://www.vox.com/2014/10/2/6892781/how-the-oil-and-gas-boom-is-changing-america>, based on NADAQ data.

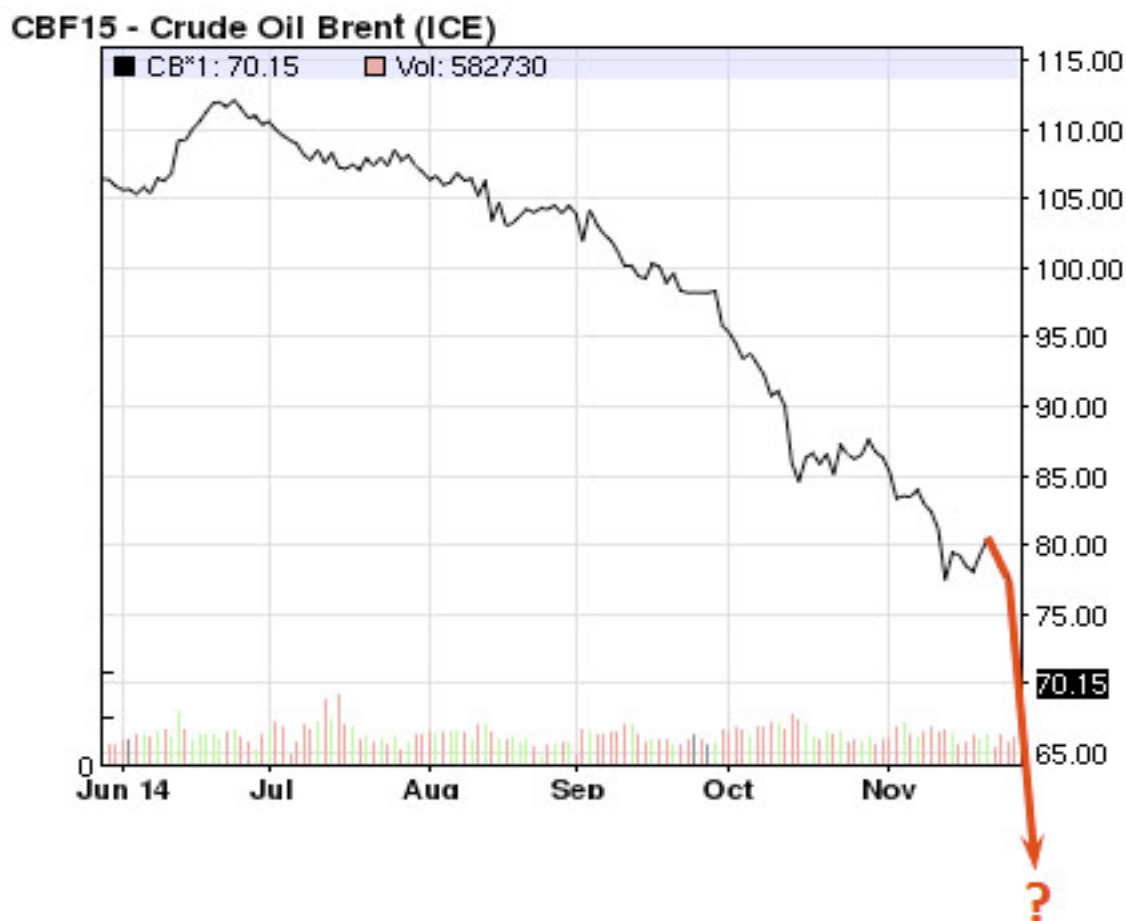
As this figure shows, the booming global economy in the 2000s, particularly with rapid rates of growth in China and India, led to rapid escalation in oil prices, peaking in early 2008, and then plunging dramatically by 2009. Since then, with economic recovery in the U.S. in particular, oil prices began a sustained increase.

The last six months have seen a sharp change in oil prices (see Figure 2). While shale gas and oil are important, more significant than this steady secular trend in U.S. oil production increasing global competition for market share has been the relative increase in output from political volatility of Libya and Iraq despite ongoing political instability. On the supply side, for example, Libyan oil production has recently increased to over 800,000 barrels per day, over eight times its output earlier this year. Iraq has also been able to increase its oil production. Together with weak economic growth in Europe and Asia, demand has also fallen.

Still, the U.S. market remains a very important one, both on the supply and demand side. Since 2008, there has been 70 percent increase in United States oil production, cutting imports from OPEC producers in half.⁷

⁷ http://www.nytimes.com/2014/10/16/world/middleeast/as-oil-prices-plummet-saudi-arabia-faces-a-test-of-strategy.html?_r=0

Figure 2: Oil Prices, June 2014 to the present



Source: <http://www.motherjones.com/kevin-drum/2014/11/chart-day-oil-prices-are-plunging-thanks-opec>

Moreover, as Figure 3 shows, there has been a secular increase in U.S. crude oil production.⁸ As a result of the growth in U.S. output of energy, imports from OPEC countries have fallen dramatically from over 10 million barrels a day in 2007 to around 7 million barrels per day in 2014.⁹ At the same time, U.S. gasoline consumption has actually fallen from a peak of around 9.3 mb/d in 2007 to 8.7 mb/d in 2013.¹⁰ This fall in U.S. imports has meant that Middle Eastern energy producers have been forced to turn China, which has continued to rely on energy imports to fuel its growing economy.¹¹ Other oil producers have pursued a similar strategy, with Venezuela, for example, rely-

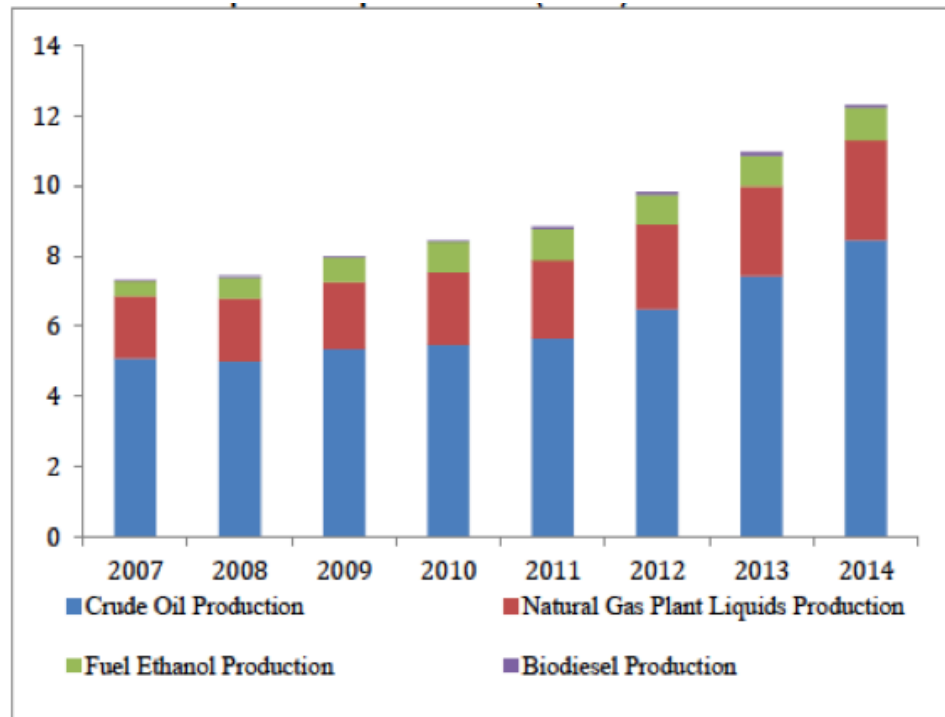
⁸ <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/10/WPM-54.pdf>

⁹ Ibid.

¹⁰ Ibid.

¹¹ <http://blogs.reuters.com/ian-bremmer/2014/11/11/oil-price-plummet-wont-help-u-s-with-iran-or-russia/>

Figure 3: US Crude Oil and Liquid Fuel Production (mb/d)



Source: EIA; Estimate for 2014.

ing on loans from China for future oil exports and Russia recently agreeing to a 30-year, \$400 billion gas deal with China in May 2014.¹²

III. Responding to the Falling Price of Oil: OPEC and the Arab Gulf States

The response of OPEC countries to falling oil prices has varied dramatically, with Venezuela’s calls in October for an emergency OPEC meeting to press for price hikes failing to gain traction as a result of opposition by Saudi Arabia and Kuwait.¹³ Iran has also been concerned about falling oil prices and some members have called for OPEC to undertake efforts to boost prices—an effort that clearly failed at the OPEC meeting on November 27.¹⁴ OPEC’s Secretary General, Abdullah al-Badri said at the annual Oil & Money conference on October 29th that, “OPEC’s oil production is unlikely to change much in 2015 and there is no need to panic at the crude price drop.”¹⁵ He went on to say that production of “shale would be curbed if oil remained at \$85 a barrel while the OPEC enjoys lower costs and will see higher demand for its crude in the longer term.”¹⁶

¹² <http://blogs.reuters.com/ian-bremmer/2014/11/11/oil-price-plummet-wont-help-u-s-with-iran-or-russia/>

¹³ <http://www.businessweek.com/articles/2014-10-23/oil-saudi-arabias-risky-price-play>

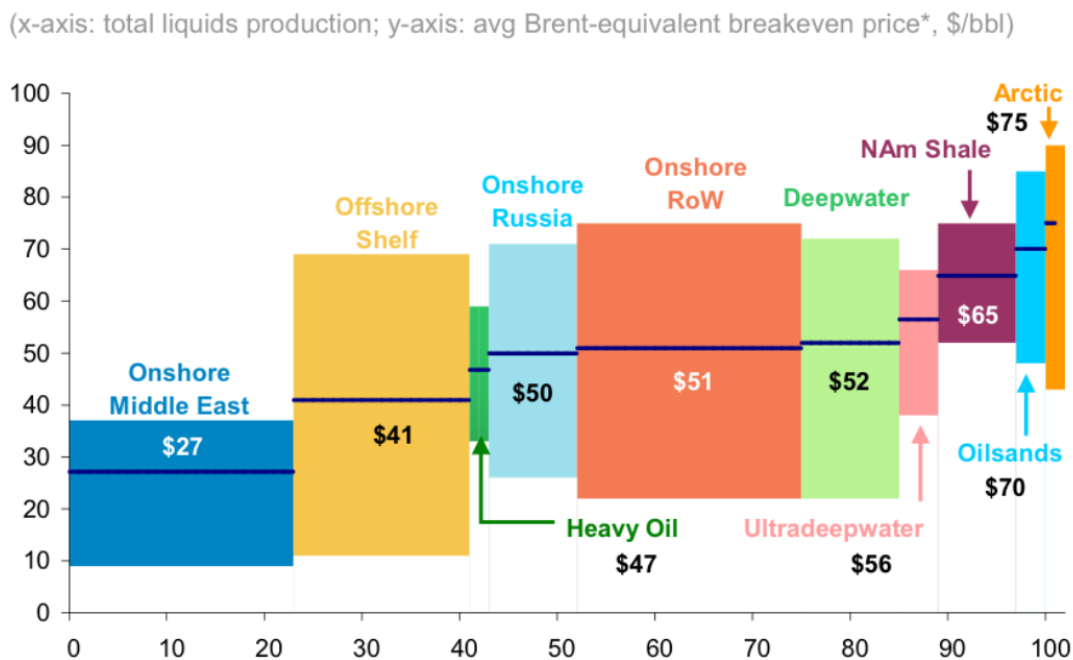
¹⁴ <http://english.alarabiya.net/en/business/economy/2014/10/07/Iran-says-no-plan-for-OPEC-emergency-meeting-on-price-fall.html>

¹⁵ <http://www.reuters.com/article/2014/10/29/us-opec-oil-idUSKBN0II0XD20141029>

¹⁶ <http://www.reuters.com/article/2014/10/29/us-opec-oil-idUSKBN0II0XD20141029>

The key to understanding the differential pressure on OPEC members and Gulf Countries is tied both to their production costs as well as their budgetary constraints. In terms of production costs, Figure 4 illustrates the range.¹⁷

Figure 4: Oil Production Costs



Source: Rystad Energy, Morgan Stanley Commodity Research estimates

This figure demonstrates the sharply different production costs associated of oil. As a first step, then, understanding the break-even point for oil production can give us a first cut into the differential interests of OPEC members and other producers. It also speaks to the claim that at least some OPEC members might be trying to drive shale oil producers and other higher cost producers of both oil (and other energy) out of the market.

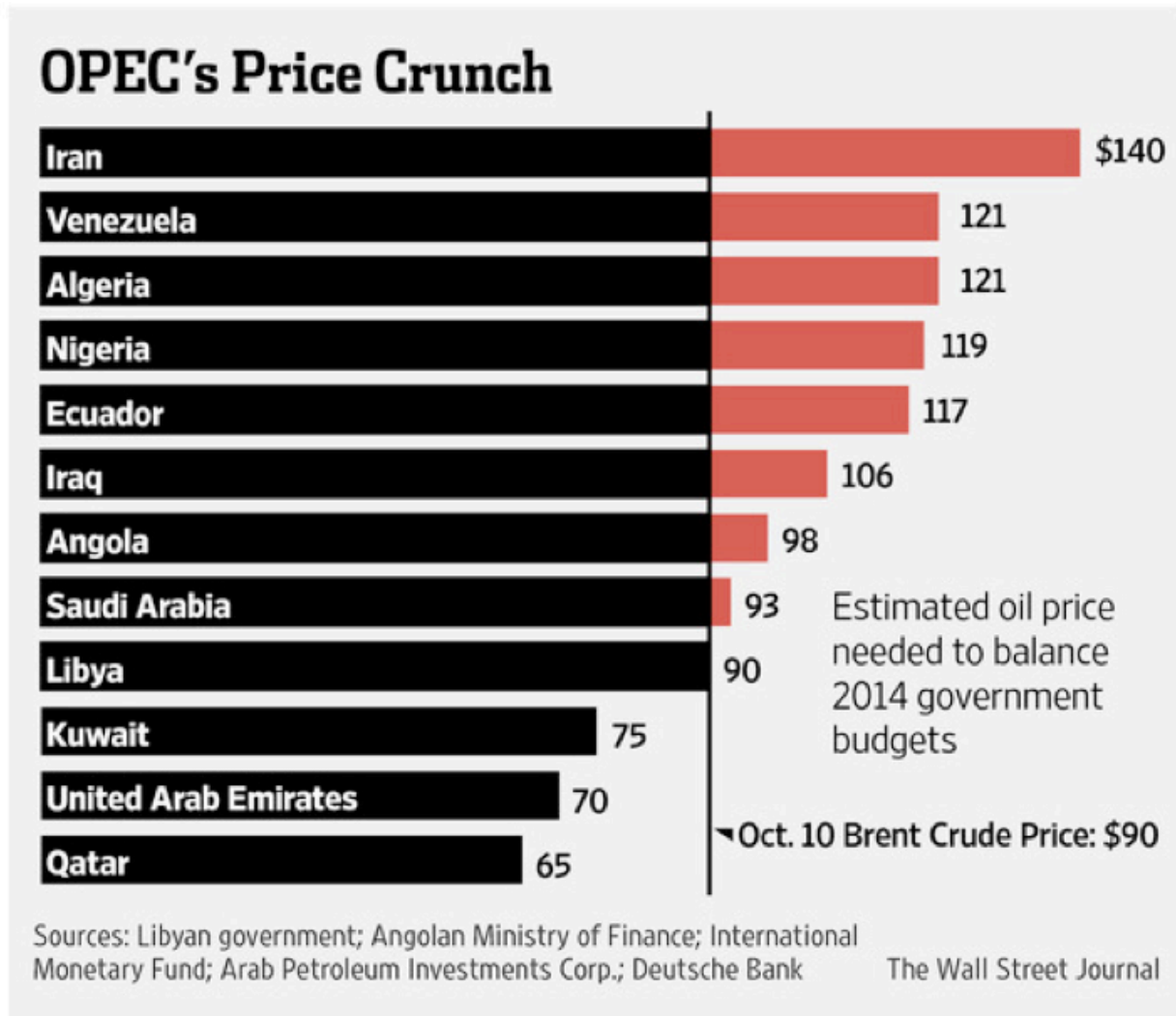
Yet a more important factor than simple oil production costs may well be the differential budgetary constraints that countries face. While there are debates about actual numbers, Figure 5 clearly illustrates the sharp differences on this score.¹⁸

As this figure shows, the Gulf Arab producers and Libya are in considerably better shape than Iran, Latin American countries, and African states. To explore the differential impact and policy responses, we now turn to a few specific country cases, beginning with Saudi Arabia.

¹⁷ See <http://www.businessinsider.com/crude-oil-cost-of-production-2014-5>.

¹⁸ <http://online.wsj.com/articles/oil-price-slump-strains-budgets-of-some-opec-members-1412952367>

Figure 5: OPEC Members' Budgetary Constrains and the Price of Oil



Saudi Arabia

Saudi Arabia, as the leader of the OPEC, has carefully calibrated oil prices since the first oil crisis in the 1970s by shifting its oil production from time to time. Saudi Arabia has viewed price stability as important in maintaining a stable global economy, and has used its spare production capacity to moderate volatility in oil markets since the first oil crisis of the early 1970s.¹⁹ And in the 1980s, we have already seen how Saudi Arabia had orchestrated a strategy to control its market share and drive the US out of the market.

The Saudi effort to manage oil prices and prevent either an excessively rapid rise or dramatic fall has a long history. Despite OPEC efforts after the debt crisis of the early 1980s that led to a recession, downward pressure on prices continued through the 1980s. Saudi cut its oil production from its peak of 10 million barrels per day to 2.3 million barrels a day by August 1985.²⁰ In late 1985, Saudi

¹⁹ <http://fas.org/sgp/crs/mideast/RL33533.pdf>

²⁰ http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm

Arabia finally decided to use the stick rather than the carrot and increased production dramatically. The price continued to fall to the point it became unprofitable for the US producers to drill.²¹ Gradually, U.S. crude oil imports increased from 3.2 million barrels per day in 1985 to 9.1 million barrels per day in 2000.²² The OPEC share of U.S. oil imports increased from 41% in 1985 to 51% in 2000.²³

We now see the similar Saudi maneuvering to deal with the increased US oil production. The Saudis made their views known on November 27, 2014 at the OPEC meeting, when they pushed and succeeded in maintaining output at the same level, thus driving down oil prices. Although the Saudi Government derives 85 percent of its revenue from oil exports, it remains in a strong fiscal position.²⁴ As Bruce Jones at the Brookings Institution put it, "The kingdom has sterling credit and about \$735 billion in financial reserves, so it's better positioned to withstand a prolonged downturn than its rivals."²⁵ By contrast, Iran, whose exports are under sanction, needs oil at \$140 according to Figure 5 above and \$153.40 a barrel according to the IMF.²⁶

The Saudi effort to delicately manage oil prices is a difficult task, however, and the view that has been expressed by many that this is a cynical effort to undercut shale oil producers in the U.S., thus potentially creating political problems. Already, some have criticized this effort; Congress may begin to take a more aggressive stance toward Saudi Arabia. From the Saudi perspective, the fact that its actions create problems for the Russian economy, Iran, and the Assad regime that is backed by Russia may be seen as sparing it from sharper criticism.²⁷

UAE

As with Saudi Arabia, its relatively less stringent budget constraints than other OPEC members means that the UAE is in no rush to reduce its oil production to raise oil prices.²⁸ The UAE energy minister recently commented on the falling oil prices, "Yes we are concerned but we are not panicking."²⁹

To respond to the slow global economic recovery and low demand, the UAE has already cut government spending. According to Harald Finger, the head of the IMF's mission to the UAE (from late October to early November of this year),³⁰ the UAE has been reducing government spending to balance its budget.³¹ In addition, according to Finger, the Abu Dhabi government is also reviewing cuts in its generous welfare program, particularly its subsidies for electricity and water.³² The IMF estimates that Abu Dhabi currently spends about 20% of its budget on subsidies and transfers.³³

²¹ http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm

²² http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm

²³ http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm

²⁴ <http://www.businessweek.com/articles/2014-10-23/oil-saudi-arabias-risky-price-play>

²⁵ <http://www.businessweek.com/articles/2014-10-23/oil-saudi-arabias-risky-price-play>

²⁶ <http://www.businessweek.com/articles/2014-10-23/oil-saudi-arabias-risky-price-play>

²⁷ <http://www.asiaenergysecurity.com/newsdetail.aspx?pid=1752>; <http://www.theglobeandmail.com/report-on-business/industry-news/energy-and-resources/opec-sees-lower-2015-demand-for-its-oil-saudi-output-still-high/article21553889/>; <http://www.brookings.edu/blogs/planetpolicy/posts/2014/10/17-world-oil-demand-ebinger>

²⁸ <http://www.reuters.com/article/2014/09/23/us-emirates-oil-minister-idUSKCN0HIOVB20140923>

²⁹ <http://www.reuters.com/article/2014/11/04/us-opec-emirates-idUSKBN0IO0FB20141104>

³⁰ <http://www.imf.org/external/np/sec/pr/2014/pr14498.htm>

³¹ <http://www.bloomberg.com/news/2014-11-05/imf-sees-u-a-e-s-diverse-economy-weathering-the-oil-price-slump.html>

³² <http://gulfbusiness.com/2014/11/abu-dhabi-considers-reforming-electricity-water-subsidies-imf-official/#.VGQMmSldXyB>

³³ <http://gulfbusiness.com/2014/11/abu-dhabi-considers-reforming-electricity-water-subsidies-imf-official/#.VGQMmSldXyB>

The IMF has already warned the UAE to cut its energy subsidies to “help mitigate risks of fluctuating oil prices and allow Dubai to cut its debt.”³⁴ The UAE had increased social spending in the aftermath of the Arab Spring³⁵ and the decline in oil price could justify cuts in its subsidies.³⁶

At the same time, the UAE is in an enviable financial situation, with a large sovereign wealth fund. While Saudi Arabia has foreign-exchange reserves of \$753 billion in July 2014, the Abu Dhabi Investment Authority sovereign wealth fund had \$773 billion in 2013, approximately 190% of its GDP.³⁷ So, even with a budget deficit, the government could draw from this massive reserve for its government expenditure.

The UAE also has the most diversified economy among the Gulf Cooperation Council (GCC) countries.³⁸ While Abu Dhabi has the largest hydrocarbon endowment, the other six emirates have other significant sources of revenue such as services in Dubai and manufacturing in Sharjah and Ras Al Khaimah.³⁹ Ernest & Young estimates that the UAE’s GDP in the non-oil sector will increase by 5.9% in 2014, compared to only 1.8% in the oil sector.⁴⁰ With Dubai hosting the World Expo in 2020, investment in the non-oil sector is likely to increase even faster.⁴¹ This has led the IMF to conclude that “[the UAE] will not need to make any big adjustment in response to the drop in oil prices, which is expected to have only a marginal impact on economic growth next year.”⁴²

Qatar

Qatar has responded to falling oil prices by cutting oil exports and shifting to processing naphtha and other higher value added products.⁴³ It has also offered flexible contracts to Asia, where it sells 80% of its LNG.⁴⁴ The Qatar government is also considering rescheduling the target dates of some of its infrastructure projects (worth US\$660 billion), related to the 2030 National Vision development plan.⁴⁵ Still, it is pushing to complete the infrastructure projects for the World Cup in 2022.⁴⁶

Similar to Saudi Arabia and the UAE, Qatar is in a good financial position, and in fact is best situated among all OPEC members (see Figure 5) to cope with falling oil prices. For one, it has vast fiscal reserves to absorb the oil crisis.⁴⁷ According to the IMF, its sovereign wealth fund, the Qatar Investment Authority, is worth US\$175bn.⁴⁸ Most importantly, Qatar’s economy depends heavily on

³⁴ <http://www.bloomberg.com/news/2013-07-30/imf-advises-u-a-e-to-cut-energy-subsidies-as-gdp-growth-slows.html>

³⁵ <http://gulfbusiness.com/2014/11/abu-dhabi-considers-reforming-electricity-water-subsidies-imf-official/#.VGQMmSldXyB>

³⁶ <http://country.eiu.com/article.aspx?articleid=2012366385&Country=United%20Arab%20Emirates&topic=Economy>

³⁷ <https://gfs.eiu.com/Article.aspx?articleType=wif&articleId=2609>

³⁸ <http://www.arabianoilandgas.com/article-12587-how-will-the-shale-boom-affect-the-uae/1/print/>

³⁹ http://www.khaleejtimes.com/biz/inside.asp?xfile=/data/uaebusiness/2014/july/uaebusiness_july9.xml§ion=uaebusiness

⁴⁰ <http://www.ey.com/EM/en/Newsroom/News-releases/EY-future-growth-in-the-UAE-and-Qatar-lies-in-economic-diversification>

⁴¹ <http://www.ey.com/EM/en/Newsroom/News-releases/EY-future-growth-in-the-UAE-and-Qatar-lies-in-economic-diversification>

⁴² <http://gulfbusiness.com/2014/11/abu-dhabi-considers-reforming-electricity-water-subsidies-imf-official/#.VGQMmSldXyB>

⁴³ <http://www.bloomberg.com/news/2014-11-06/qatar-shifts-export-strategy-as-u-s-light-oil-competes.html>

⁴⁴ <http://country.eiu.com/article.aspx?articleid=1752441959&Country=Qatar&topic=Economy>

⁴⁵ <http://country.eiu.com/article.aspx?articleid=1752441959&Country=Qatar&topic=Economy>

⁴⁶ <http://country.eiu.com/article.aspx?articleid=1752441959&Country=Qatar&topic=Economy>

⁴⁷ <http://country.eiu.com/article.aspx?articleid=42421388&Country=Qatar&topic=Economy&subtopic=Forecast&subsubtopic=Fiscal+policy+outlook&u=1&pid=2002456984&oid=2002456984&uid=1>

⁴⁸ <http://country.eiu.com/article.aspx?articleid=1752441959&Country=Qatar&topic=Economy>

revenue generated by gas exports, not oil exports.⁴⁹ In a session of the country's advisory body, the Shura Council, on November 11, 2014, Qatar's emir emphasized that its economy "will not be affected" by the decline in oil price.⁵⁰ The government even plans to increase spending by 3.7% to about US\$60 billion in 2014/15.⁵¹

Kuwait

Kuwait also relies on oil export, which accounts for 60% of its GDP and 94% of export revenues.⁵² Still, with a low breakeven point from a budgetary standpoint, Kuwait remains in good financial shape. Nonetheless, Kuwaiti Finance Minister, Anas al-Saleh, on October 19, 2014 argued that that Gulf states need to reform spending as oil price slips. Specifically, Saleh called for the "reform of imbalances in public finances," to "diversify away from oil and decrease dependence on oil revenue."⁵³

It is unclear as to how far Kuwait will proceed with budget reforms. However, recently signs have emerged that officials are using "the oil price drop to justify reforms," as Kuwait tripled the prices of Kerosene and Diesel from 19 cents to 57 cents in October 2014.⁵⁴ Kuwait, in its drive for cutting its welfare program, has been studying the impact of hikes in electricity and water costs.⁵⁵ The head of Kuwait's Parliament's budget committee, Adnan Abdulsamad, claimed in November 2014 that if oil prices continue at the current level, "the budget surplus would shrink to just \$3.1 billion from \$45 billion" in 2013⁵⁶

Bahrain

Bahrain is the smallest oil producer in the Persian Gulf, producing 48,000 barrels per day of crude oil in 2013 and is not a member of the OPEC.⁵⁷ Petroleum is Bahrain's most important export, accounting for 87% of government revenues and 19% of GDP in 2012.⁵⁸ However, it has one of the highest break-even prices in the region at \$136 per barrel according to a Deutsche Bank report.⁵⁹ Bahrain does not have the extensive reserves of Saudi Arabia or other OPEC nations, and S&P reports "Oman and Bahrain were the most vulnerable to any drop in oil prices."⁶⁰

Even when oil prices were over \$100 a barrel, Bahrain posted fiscal deficit (4.3% of GDP) and external debt (44% of its GDP) in 2013.⁶¹ In June 2014, it was reported that Bahrain's budget deficit stood at \$1.1 billion.⁶² Moody's downgraded Bahrain's government credit rating to Baa2 in September 2013.⁶³

⁴⁹ <http://english.alarabiya.net/en/business/economy/2014/11/11/Qatar-s-economy-not-affected-by-lower-oil-prices-emir.html>

⁵⁰ <http://english.alarabiya.net/en/business/economy/2014/11/11/Qatar-s-economy-not-affected-by-lower-oil-prices-emir.html>

⁵¹ <http://english.alarabiya.net/en/business/economy/2014/11/11/Qatar-s-economy-not-affected-by-lower-oil-prices-emir.html>

⁵² <http://www.eia.gov/countries/cab.cfm?fips=ku>

⁵³ <http://www.reuters.com/article/2014/10/25/us-kuwait-finmin-idUSKCN01E0AH20141025>

⁵⁴ <http://www.albawaba.com/business/theres-not-going-back-kuwait-quietly-triples-deisel-and-kerosene-prices-613611>

⁵⁵ <http://www.albawaba.com/business/theres-not-going-back-kuwait-quietly-triples-deisel-and-kerosene-prices-613611>

⁵⁶ <http://www.arabtimesonline.com/NewsDetails/tabid/96/smld/414/ArticleID/210754/refTab/36/t/Spending-cuts-eyed-as-oil-price-plunges/Default.aspx>

⁵⁷ <http://www.eia.gov/countries/country-data.cfm?fips=ba>

⁵⁸ <https://www.cia.gov/library/publications/the-world-factbook/geos/ba.html>

⁵⁹ <http://www.businessinsider.in/These-6-Countries-Will-Be-Screwed-If-Oil-Prices-Keep-Falling/articleshow/44852254.cms>

⁶⁰ <http://www.albawaba.com/business/gcc-economies-oil-prices-620507>

⁶¹ <http://www.imf.org/external/np/sec/pr/2014/pr14289.htm>

⁶² <http://www.arabianbusiness.com/bahrain-s-budget-deficit-nearly-doubles--1-1bn-552534.html#.VGU1vnF860>

From a political standpoint, with Shias in the majority in Bahrain and also dominating Bahrain's oilfields, the growth of ISIS and tensions between Shias and Sunnis is potentially hazardous.⁶⁴ Similarly in Saudi Arabia, Shias also dominate the oilfields.⁶⁵ As the looming threat of ISIS grows within the region, a Shia-Sunni fall out could threaten the oil economy of Bahrain.⁶⁶

IV. Falling Oil Prices: The U.S. Economy and Security Implications

The impact of the oil price decline on the U.S. is mixed. From a macroeconomic perspective, despite the shale oil boom, the U.S. remains one of the large net importers of oil.⁶⁷ Estimates by Moody's suggest that a one-cent decline in oil leads to \$1.2 billion in savings for U.S. consumers.⁶⁸ At the same time, the fall in oil prices and strengthening dollar have made the Federal Reserve's job more complex. With a current inflation target of 2%, it now has to take into account these factors as it considers when it should begin raising interest rates.

In terms of the impact on U.S. shale oil production, the story is more complex (see Figure 6).⁶⁹ With shale accounting for 55 percent of U.S. production,⁷⁰ falling oil prices may render the US production unprofitable because a considerable amount of shale oil has high extraction costs.⁷¹ For example, reports suggest that shale oil production in North Dakota and Texas is only viable at a minimum price of \$70 to \$80 a barrel.⁷² In early November, the IEA predicted that the decline in oil prices could "cut investment in US shale oil by 10 percent" in 2015.⁷³ The industry is relatively fragmented and the cost of production varies considerably, so it is hard to predict with certainty, which firms will remain viable and which will not.

With respect to security implications, the U.S. and Saudi Arabia have a shared interest in having the lower prices of oil damage the Russian economy. To this point, the ruble has continuously been falling and as Sergei Guriev, a former advisor to the Russian government notes, "should oil prices stay at their near-record lows of around \$82 a barrel, Russia, which is basing its economic forecasts on a much higher oil price, would face a serious problem."⁷⁴ As he goes on to note, the Russian budget has been based on a forecast of "\$100 per barrel oil for the next three years."⁷⁵ Oil is particularly

⁶³ <https://en-maktoob.news.yahoo.com/weakened-govt-finances-constrain-bahrains-credit-profile-moodys-073446173--business.html>

⁶⁴ <http://firstbiz.firstpost.com/economy/falling-oil-prices-will-aid-isis-growth-also-boost-anti-india-terror-107567.html>

⁶⁵ <http://firstbiz.firstpost.com/economy/falling-oil-prices-will-aid-isis-growth-also-boost-anti-india-terror-107567.html>

⁶⁶ <http://firstbiz.firstpost.com/economy/falling-oil-prices-will-aid-isis-growth-also-boost-anti-india-terror-107567.html>

⁶⁷ <http://www.asiaenergysecurity.com/newsdetail.aspx?pid=1752>

⁶⁸ Source needed

⁶⁹ <http://www.businessinsider.com/citi-breakeven-oil-production-prices-2014-11>

⁷⁰ <http://www.businessweek.com/articles/2014-10-23/oil-saudi-arabias-risky-price-play>

⁷¹ <http://www.bloomberg.com/news/2014-10-16/don-t-mess-with-saudis-in-oil-bear-market-global-shakeout.html>

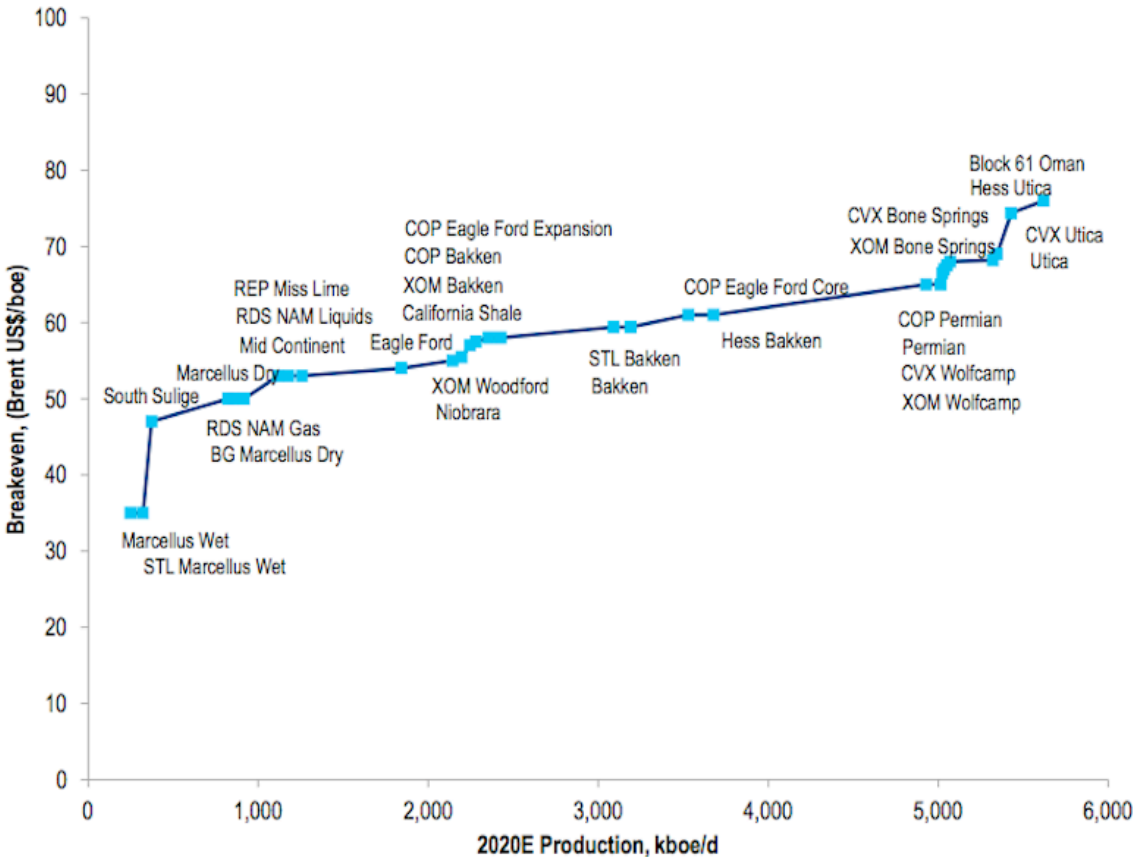
⁷² <http://wallstreetonparade.com/2014/10/saudi-arabia-goes-rogue-risking-oil-price-war/>

⁷³ <http://www.cnbc.com/id/102175914#>

⁷⁴ http://finance.yahoo.com/news/why-oil-price-serious-problem-094405418.html;_ylt=AwrSyCMj4mNUIkgAmwvQtDMD

⁷⁵ http://finance.yahoo.com/news/why-oil-price-serious-problem-094405418.html;_ylt=AwrSyCMj4mNUIkgAmwvQtDMD

Figure 6: Breakeven Costs for Shale Oil Producers



Source: Based on work by Ed Morse, Citibank.

important to the Russian economy because in 2013, it accounted for more than two-thirds of its total exports.⁷⁶

Iran also faces trouble, with a very high budgetary breakeven point (see Figure 5) of about \$140 a barrel. Some argue that declining oil revenue could make the Iranians more willing to make concessions in its nuclear talks.⁷⁷

ISIS also has become increasingly dependent on captured oil prices for revenue. One estimate is that oil provides it with on average \$2.5 million a day.⁷⁸ With these sales coming from the black market, falling oil prices could undermine its revenue stream.

⁷⁶ http://finance.yahoo.com/news/why-oil-price-serious-problem-094405418.html;_ylt=AwrSyCMj4mNUIkgAmvwQtDMD

⁷⁷ <http://www.asiaenergysecurity.com/newsdetail.aspx?pid=1752>

⁷⁸ <http://www.newsweek.com/isis-islamic-state-bajji-iraq-syria-oil-283524>

V. Conclusion

As oil prices continue to remain volatile, global markets and politics are increasingly in flux. In rich industrial countries, despite the likely overall macroeconomic benefit of cheaper crude, uncertainty about the price of energy in the near and medium term has actually had a negative effect on stock markets. And from a political standpoint, as countries such as Russia, Iran, and Venezuela face the specter of growing budget deficits, the prospect of political instability has also grown. Similarly, in oil rich exporters in the Arab Gulf states, concern has grown as to just how low oil prices might go and the extent to which spending cuts might be necessary.

As this article has argued, the cost of producing oil is less important for OPEC members than their budgetary situation. In the short run, these countries can clearly cope, but if oil prices remain low, both shale oil and alternative energy producers in different countries will face serious financial challenges. Managing the oil market, as Saudi Arabia has tried to do, both in pushing up and in pushing down the price of oil, is a complex and uncertain business.

Although predicting oil prices is difficult in light of the multiplicity of political and economic factors that influence prices, it is likely that as Europe recovers, continued American, Chinese, and Indian economic growth will lead to a turn and increase in oil prices. At the same time, the shale oil boom is likely to continue, albeit after a shakeout of the more inefficient producers.

In terms of policy choices, OPEC countries must begin to exercise more significant budgetary restraint. The danger of high oil prices is the creation of a temptation to borrow, which Mexico among others in the late 1970s did with dire consequences in the 1980s as they went into default.

From a U.S. perspective, whipsawing oil prices undermines the ability of private actors to engage in sustained R&D as well as continued investment in alternative energy sources. As noted, this may well be Saudi Arabia's intent. Yet at the end of the day, more stable oil prices are likely to be in everyone's interest.

