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The Effects of Rising Oil and Food Prices on the Middle East

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Over the last 12 months, the international price of oil doubled, while in the twelve month period ending on March 1, 2008, the price of food, measured by the UN Food and Agriculture Organization's composite index, rose by 50%. These developments have had major and differential effects on the economies of the Middle East, including changes in economic growth rates and a serious acceleration of inflation.

Oil prices and revenues

Middle East oil and gas exporters are expected to earn \$830 billion in 2008, an increase of over \$300 billion (or almost 60%) on 2007. This is due to the rise in the price of oil rather than increases in production. As a result, the six member states of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates - are awash with funds. In contrast to the situation after the price rises of 1973 and 1979-80, they have been using the huge surpluses more carefully, and as their own banking systems have become more mature, a larger share of funds has been retained in the region. Despite this, they have also become major players on the international scene, acquiring foreign assets and partly helping to finance the enormous US balance of payments deficit. At the end of 2006, according to the Institute for International Finance, the GCC states possessed identified foreign reserves of \$434 billion and unidentified reserves of \$283 billion, a total of \$717 billion. The estimates for 2007 and forecasts for 2008 suggest that Middle East oil producers will have balance of payments current account surpluses of almost \$300 billion and \$420 billion, respectively. The GCC states alone had a surplus of \$227 billion in 2007 and is forecast to have a surplus of \$332 billion in 2008. This implies that by the end of 2008 GCC total foreign reserves could reach \$1.3 trillion.

Food Prices

The rise in oil prices has affected the balance of payments of oil-importing countries, of which there are a number in the region. In addition, the indirect effect of higher oil prices has been to push up the cost of transport, irrigation and fertilizers. As a result the price of food has risen. The very sharp increases in the prices of many basic foodstuffs on international markets are also the result of rising demand, problems in supply and the diversion of food crops to the production of bio-fuels. The IMF has estimated that diversion to bio-fuels was the cause of half of the rise in food prices in 2006-2007. Other estimates suggest that the effect was even stronger. This was, therefore, another consequence of rising oil prices. In addition there had been speculation in commodity markets, which were used as partial alternatives for investors when the real estate bubble burst in mid-2007. The fall in the exchange rate of the dollar is both a cause and consequence of these developments. There were poor harvests in major producing countries partly due to extreme weather events. In addition, the imposition of export restrictions in some countries led to hoarding and panic buying, pushing prices up further. The Middle East, which is the most arid region in the world, imports half of its food. Net food imports account for between 5% and 10% of total imports; the most important product being wheat. The region is therefore very exposed to the current global food crisis.

The rising cost of food has had drastic effects on the poor and even on sections of the middle class. For the over thirty million Egyptians who live on less than \$2 a day, the rise in the cost of food - almost 25% in the year to January 2008 - has generated a major crisis that has already resulted in riots. The government responded by increasing subsidies and even by ordering the army to bake bread for the population as a whole. Morocco also experienced riots as a result of rising food costs. The volume of Moroccan wheat imports rose because of a bad harvest in 2007 that, coupled with the rise in prices, has magnified the crisis. Although the 2008 grain harvest is expected to be more than double that of 2007, it is still smaller than the average of the past ten years.

The impact of rising food prices has even been felt in the oil-rich Gulf states. The inflation rate in Saudi Arabia was estimated at 2% a year in April 2007, but a year later it had reached 10%. In Qatar, the acceleration was less dramatic but the rates were higher: 14% and 15%, respectively. In Iran, a country with a history of rapid inflationary spurts, the rate has accelerated from 16% a year ago to about 24%; the increase in food prices has been much faster. Throughout the region, governments have increased public sector wages in an attempt to compensate for the rise in prices. Given that the public sector is one of the largest employers in the region, this is significant in buying loyalty and preventing economic hardship from being translated into political discontent.

Some countries are both large oil producers and have large populations. The best example is Iran, which has a population of over 70 million and has the third largest oil export revenues in OPEC. The government has used oil revenues to subsidize basic commodities such as wheat, but remains dependent on imports for this strategic product. Iran has a large balance of payments current account surplus that will exceed \$35 billion a year in 2007-2008. Iraq is also a major oil producer, despite the problems it has experienced in restoring its oil production. There too, the government uses oil revenues to buy food and supply it - at heavily subsidized prices - to the population. It is forecast to have a balance of payments surplus of \$6.5-\$7 billion in 2007-2008. The largest oil producer in the world, Saudi Arabia, now has a population of over 20 million, much of which is exposed to higher costs. The Saudi government has increased subsidies to restrain inflation. Like other Gulf states, it has increased the salaries of civil servants to compensate them for rising prices, something that discourages attempts to move nationals from the public to the private sector. Since 2003, Saudi Arabia's foreign reserves are estimated to have increased by \$500 billion.

Developments outside the GCC reveal the serious problems that agriculture faces in much of the region. Not only does the Middle East face chronic water shortages, but in most countries water is misused on a large scale. It is under-priced or supplied without cost to agriculture, thereby encouraging the production of strategically important crops, such as wheat, which are not suited to an arid environment and is therefore both economically and ecologically damaging. Furthermore, increasing consumption of meat in the region has led to more animal feeds being produced, at the expense of food for people. This is also inefficient from a water-use perspective. Overall, agriculture has been neglected in terms of investment in infrastructure, training and marketing.

The economic situation in the Middle East is ironic: oil-rich countries are now experiencing huge increases in income. These now exceed the high levels of the mid-1970s and early 1980s in real terms and in 2008 may even exceed them in per capita terms. At the same time, non-oil producers and small oil producers in the region are facing soaring import costs for oil as well as food, with serious macro-economic and distributional consequences. The sensitivity of these economies to the rise in food prices reflects the failures of their development strategies over many years.

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