

IMPLICATIONS OF THE FALL IN OIL PRICES

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The international price of crude oil increased 2.5 fold between 2001 and 2006. This was largely due to rising demand, although speculative trading also played a role. Between July 2006 and January 2007, the price fell by 26%, also as a result of demand factors. If the current price - about \$54 a barrel - holds during 2007, then it will be about 11% lower than the 2006 average. Assuming no major changes in the quantities produced by Middle Eastern and other major producers, then oil revenues will fall by a similar amount. What will this mean for the Middle East? It is worthwhile looking at two producers - Saudi Arabia and Iran - in order to understand the possible effects.

The rise in oil prices has transformed Saudi Arabia's finances: in 2001, its oil export revenues amounted to \$60 billion; by 2006 they had more than tripled, to over \$200 billion. In 2001, the Kingdom's budget had a deficit of \$7 billion, in 2006 there was a surplus of \$70 billion. This huge turnaround, due entirely to the increase in oil revenues, has enabled the government to reduce its internal debt (and thus the interest that it pays) and generate reserves for future use. The balance of payments was also transformed: in 2001, there was a current account surplus of \$9 billion; by 2006 it had

grown to over \$100 billion. Saudi Arabia is therefore no longer short of funds for investments in infrastructure and the oil sector; it does not need still higher oil prices in order to overcome its chronic unemployment problems. Rather, it needs price stability and this can only be maintained if it can sell its oil. Overly high prices pose a threat because they encourage production elsewhere, the use of other energy sources, including the development of new technologies, and energy conservation. All these factors reduce the demand for oil, whatever the source, thus threatening Saudi Arabia's long term interests. In recent months there have been reports that Saudi Arabia has played a moderating role, preventing OPEC production quota cuts designed to push prices back up. The five other members of the Gulf Cooperation Council also benefited from the rise in oil prices until mid-2006 and most of them will not face problems coping with the subsequent fall in prices.

However, the same is not true for Iran. Its population numbers about 70 million persons, more than three times that of Saudi Arabia, while its average income per capita is hardly higher than it was at the time of the Islamic Revolution twenty-eight years ago. To be sure, Iran's economy, like Saudi Arabia's, is heavily reliant



on oil, accounting for 75% of government revenues and 85% of exports. But Iran cannot compensate for falling prices by increasing exports, since domestic demand is high and production capacity cannot be increased. The development of the oil sector has been significantly hurt by US sanctions and Iranian government policies, which together have discouraged foreign investment. In 2006, Iran produced 3.8-3.9 million barrels of oil a day, 300,000 barrels (8%) less than in 2005 and nearly 40% less than in 1974.

The prospects for 2007 depend, of course, on pricing and production levels. While the scenario posited here is speculative it is not unrealistic. Production could fall again in 2007 as the US sanctions regime is being tightened and Iran faces increasing difficulty maintaining its oilfields. Assuming that local demand accounts for the same proportion of production, exports may also fall by eight percent. Added to this is the assumption of an 11% price drop between 2006 and 2007. The combined effect would be a revenue fall of about 20%. This means that estimated Iranian oil export revenues of \$55 billion in the financial year to April 2007 could fall by \$11 billion, to \$44 billion in 2007/08. As the government has become ever more reliant on oil, owing to the overextension of public spending under President Ahmadinejad, the projected fall in revenue would prove to be a major blow. There is evidence that more and more people in Iran are aware of the possible implications.

Given its limited ability to export, Iran has an interest in very high oil prices. Saudi Arabia, by contrast, wants to avoid excessively high prices. The price rise in recent years was largely due to increasing demand, but OPEC also contributed to the hike by periodically limiting production. The fall in prices in the second half of 2006 was also due to demand factors: changes in oil stocks and a mild winter in the US contributed to lower consumption of oil. Saudi policy, or the

perception of Saudi oil policy, has therefore reinforced the effects of the slowdown in demand growth. The onset of cold weather in the US in early February pushed up prices but they remain about 20% lower than their July 2006 peak.

The fall in oil prices is also to Saudi Arabia's advantage in its strategic rivalry with Iran. It has huge financial reserves that Iran lacks and can thus cope with lower revenues, while Iran will face socio-economic distress as a result. The two countries buy influence in the region and the oil price fall will reduce (but not eliminate) Iran's abilities much more than Saudi Arabia's. In addition, Iran's ally, Syria, is also an oil exporter. The volume of its exports has fallen in recent years and is forecast to continue declining. High oil prices have disguised the effects of the decline in volume, but the fall in prices will reveal Syria's plight more sharply.

The decline in the price of oil will benefit all oil-importing states, including those in the Middle East. Morocco, Tunisia and Jordan, as well as Turkey and Israel, will now feel some relief, after years of steadily rising prices. The fall will therefore give a modest boost to world trade, with further beneficial effects on the world economy. The danger of falling prices is that they will discourage oil and energy conservation, especially in the US, where taxes on fuel are low and domestic prices move with international ones more closely than in countries such as Israel and the EU, where fuel taxes are heavier. Without conservation and major investment in alternative energy sources, the international economy will remain reliant on Middle East oil for many years to come.