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Persian Gulf States: Unequal Burden of Low Oil Prices

The decline of oil prices this year is taking a far greater toll on Iran and Iraq than on other Persian Gulf producers and, consequently, is leading to growing tensions in the region. Iran and Iraq, heavily dependent on oil, want higher prices to finance current spending as well as reconstruction needs. Saudi Arabia has joined Iran and Iraq in increasing pressure on Kuwait and the UAE to trim their production. In light of this pressure, we believe that the OPEC producers will agree on a new production accord at the 25 July ministerial in Geneva. Nevertheless, the continued differences in actual and perceived revenue needs among the Persian Gulf oil-producing states dim prospects for production restraint over the longer term to support higher prices.

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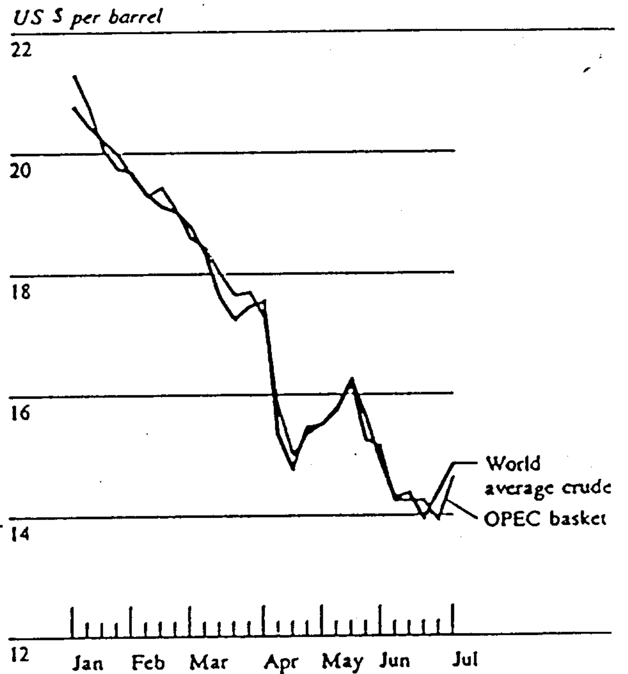
Crude Oil Prices, 1990



Heavily Dependent on Oil

Despite massive investment in nonoil infrastructure over the past 20 years, most of the region's economies continue to be dependent on oil revenues and have been hard hit by declining prices this year. Average world oil prices tumbled from $20 per barrel in January to about $14 per barrel during the first week of July largely because of excess oil production by Persian Gulf states. Oil revenues for the first six months of 1990 already lag behind budget projections for the Persian Gulf states by as much as 9 percent.

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Iran and Iraq Hurt the Most

The weak oil market conditions of the late 1980s and economic toll of the Iran-Iraq war has already sapped government coffers of these two producers. Iran probably is suffering the most from low oil prices. Iranian President Rafsanjani's ambitious 1990-95 reconstruction plan assumes average annual oil revenues of $16.2 billion, but earnings this year will reach only $11 billion barring a strong price rebound. The $5-per-barrel drop in prices for Iranian crude since January costs Tehran up to $345 million each month. Iran is unable to offset falling prices by increasing export volume because it is already producing near its 3.1 million b/d production capacity. Tehran also faces substantial unsold inventories of crude, which is working to further depress prices.

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reporting indicates that Iranian oil stocks had grown to at least 50 million barrels in June and led Tehran to offer some buyers oil at $12 per barrel. We project Iran will face a current account deficit this year of around $2 billion that will severely impede its reconstruction efforts.

Tehran publicly has played down the burden of the oil price drop. A few Iranian newspaper articles have criticized OPEC overproduction and Iran's oil minister recently traveled to the UAE, Algeria, and Libya to discuss oil market conditions. Nonetheless, Tehran's reaction overall has been uncharacteristically restrained.

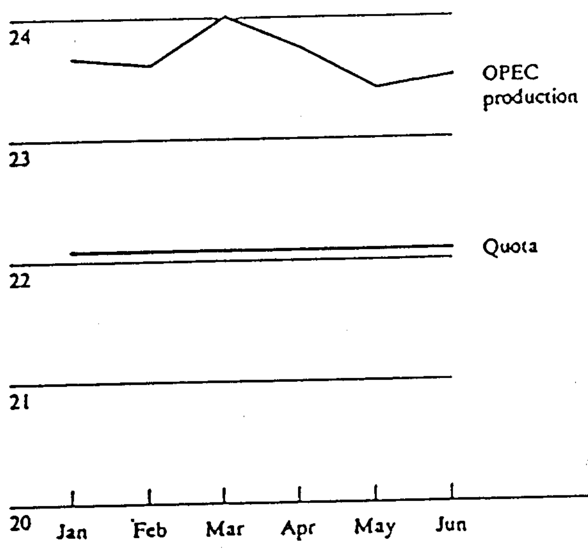
The decline in oil prices is also hampering Iraq's postwar economic recovery and is worsening its liquidity problems. The price decline has already cost Iraq at least $1.0 billion in lost revenues this year. Like Iran, Baghdad is operating near its maximum sustainable capacity of 3.3 million b/d and cannot offset declining oil prices with additional production.

Iraq increasingly is venting its frustration at Kuwait and the UAE The government-controlled press has accused Kuwait and the UAE of deliberately overproducing to limit Iraqi revenues.

Less Financial Pain for the Peninsula States

Large financial reserves and considerable spare petroleum-production capacity allow Saudi Arabia greater flexibility in dealing with current soft oil prices. These reserves and the 600,000 b/d increase in Riyadh's OPEC quota to 5.4 million b/d this year probably will compensate for lower prices and yield oil export receipts close to the

OPEC Crude Oil Production, 1990



1989 level of $24 billion. Moreover, Saudi excess capacity of nearly 3 million b/d also gives Riyadh the ability to offset declining prices by further boosting production.

Kuwait and the UAE are blunting the effect of lower oil prices by producing at levels significantly above their OPEC quotas. Kuwait and the UAE have exceeded in recent months their OPEC quotas by about 300,000 b/d and 1 million b/d, respectively, but last week agreed to trim their production. In addition to continued high oil revenues, both continue to earn significant income from their foreign investments—enabling them to enjoy large current account surpluses,

oil production averages about 1.8-2.0 million b/d this year for both countries and prices average near $17 per barrel, oil export receipts are likely to remain near 1989 levels.

Near-Term Agreement But Long-Run Problems

Growing pressure being exerted by Iran, Iraq, and Saudi Arabia for production restraint will likely result in the OPEC members agreeing to a new production accord at the upcoming ministerial. As in the past, none of the producers wants to be held responsible for a collapse in prices. Nonetheless, we believe producers with excess capacity also have incentive to resume overproduction down the line. The press reports, for example, that several OPEC members have stated that they will increase their production when, "... it meets their national interest."

Both Kuwait and Abu Dhabi will argue that production above their quotas is warranted by pressing financial needs. The government does not include sizable investment earnings in the national accounts that would produce a substantial budget surplus. Abu Dhabi, which finances virtually all of the UAE budget, claims the right to produce close to the 1.5 million b/d level because of the similarity of its petroleum reserves and production capacity with those of Kuwait. The total UAE quota is 1.1 million b/d. Dubayy has not felt bound by OPEC rulings and produces at maximum capacity of 400,000 b/d, leaving Abu Dhabi with a share far short of its needs.

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Production constraints in Iran and Iraq sharply limit their options for dealing with low prices. In Iran the clerical regime has responded in the past to falling oil revenues by slashing civilian imports, but this option has become less viable after many years of austerity. Per capita imports in 1989 were already down by 50 percent compared with 1980 levels. We believe Tehran will have to increase imports just to keep up with the basic needs of its rapidly growing population—every seven months Iran adds another million people.

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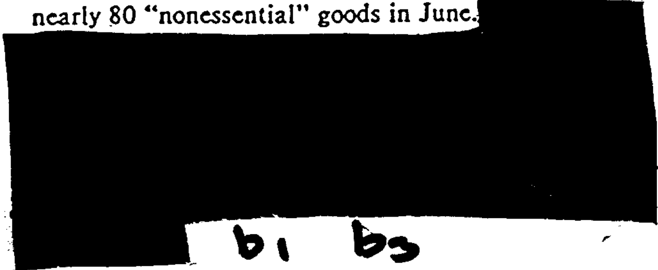
Iraq has begun cutbacks in imports to offset the fall in oil revenues. Press reporting indicate revenue problems caused Iraq to ban the import of nearly 80 "nonessential" goods in June.



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Recipe for Rising Tensions

In light of the prospect for a resumption in overproduction, financial shortfalls resulting from low oil prices will pose difficult challenges for Iran and Iraq. In Iran, where public tolerance of austerity is waning, lower revenues and continuing shortages could result in renewed public demonstrations against the clerical regime. Similarly, Iraq faces further postponement of important reconstruction and development projects and politically unpopular import cutbacks as long as oil receipts remain low.

The uneven burden of the oil price decline also is likely to raise regional tensions in the Persian Gulf if OPEC is unable to restrain output to prop up prices in the months ahead. Iran and Iraq will probably continue to put political pressure on overproducers to help boost prices and enable Tehran and Baghdad to avoid imposing further domestic austerity at a time of popular discontent over economic conditions. Saddam Husayn, in a recent speech, threatened that if words do not resolve overproduction and price problems, Iraq will take effective action to rectify the situation. Recognizing the potential to become embroiled in regional disputes, King Fahd has warned publicly that Saudi Arabia will not reassume the role of a swing producer in OPEC. And, according to press reports, the Saudis will boost oil production, if necessary, to maintain its share of nearly 24 percent of OPEC production and persuade recalcitrant cartel members to toe the line as it did in 1986 and 1988.

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