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FORECASTS OF WORLD OIL MARKETS AND THE SAUDI ROLE*

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Saudis Predict Oil Boom

When the Saudis unveiled their Third Development Plan for 1980-85, in the spring of 1980, it was with supreme confidence: "The Kingdom is now one of the world's foremost financial powers, in addition to its role as the major oil exporter of the free world."

The Saudi assessment of their country's future was based on the projections of almost all oil analysts, including those of the oil companies, the banks, the International Energy Agency, the World Bank, U.S. Government agencies, and those of other countries, as well as a host of private consultants. A few examples of the "standard" forecasts made during the second oil shock (1979-81) or shortly thereafter, will suffice. In an article entitled "Oil and the Decline of the West," published by the prestigious journal *Foreign Affairs* (Summer 1980), a well-known and widely quoted American oil consultant concluded: "It now appears that world energy requirements could be met if OPEC production, after a decline in 1980 (as compared with 1979), would then increase again and reach about the 1979 level by 1985. . . the question arises whether the (oil) producing countries would really be prepared to continue to produce at a rate that would continuously generate surplus petrodollars . . . the terms imposed by producing countries for oil supplies include

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more and more political and other extraneous conditions, related, for instance, to the interest of the (Arab) producing countries in the Palestinian problem."

In other words, dependence on OPEC oil, especially from Saudi Arabia, would continue to increase, accompanied by further price rises, while the presumed inability of the small-population Middle Eastern oil exporters to spend the vast and growing flood of oil revenues would generate huge and continuous "petrodollar" surpluses.

A British analyst who had served as an adviser to the government of Saudi Arabia wrote the following in *International Affairs* (London, 1980): "With its existing financial resources, its projected income flows (from growing oil exports and rising prices) and its known physical reserves of oil, (Saudi Arabia) has an economic power base unique in world history . . . by its possession of a large portion (of the world's proved oil reserves) Saudi Arabia can literally buy any future that is commercially 'buyable'."

In a similar vein, two American oil analysts wrote in *Foreign Affairs* (1979): "Saudi Arabia is favored by a unique conjunction of huge (oil) reserves, extraordinary ease of exploitation (i.e., very low costs of production), and a population so tiny that domestic revenue needs have no practical effect on the level of oil production."

The U.S. Senate Committee on Energy and Natural Resources, having heard the views of various "experts," concluded (in 1980) that: "Even if all present plans to reduce oil consumption, increase indigenous (oil) production and accelerate the use of alternative fuels succeed, the industrialized countries will remain heavily dependent on imported oil from unreliable or insecure sources (i.e., the Middle East) for the rest of this century or well into the next . . . (which) will lead to higher prices, and greater political and military concessions in return for oil (from Saudi Arabia and other Arab oil-exporting countries) . . . Several producing countries (i.e., the small-population Arab oil exporters) are earning far more in oil revenues than they are able to spend on imports . . . Dependence on Persian Gulf oil means that the industrialized countries, at least for the next ten to fifteen years, can expect to live in a world of steady increases in (real) oil prices, lower economic growth, inflation and stagnant, or at least sluggish, growth in GNP."

Libraries are filled with a myriad of similar studies and thousands of books and articles in newspapers and journals which drew political and economic conclusions based on the "consensus" forecasts. It is by now abundantly clear that these forecasters committed gross errors, not only in terms of magnitude of change, but, far more important, in terms of direction of change. Instead of increased dependence on OPEC, and especially Middle East oil, there has been a very sharp diminution. OPEC production, which had reached 31.5 million barrels per day (mbd) in 1979, dropped to 17 mbd in 1985; Middle East output (the Arab members of OPEC plus Iran) was cut in half from 24.7 mbd to 12 mbd; and Saudi oil production went from about 10 mbd in 1979-81 to 3.5 mbd in 1985. Oil prices have been weakening almost steadily since 1981, and there has been a collapse since the end of 1985. Instead of rising "petrodollar" surpluses, most OPEC countries, particularly Saudi Arabia, are incurring large current account deficits in their balance of payments and are rapidly drawing down their financial reserves. Some have begun to incur foreign indebtedness. The change is most dramatic, especially since it occurred within such a short time. In 1980, the Saudi surplus in the balance of payments (the current account) was huge, $41.4 billion, dropping somehwat to $38.4 billion in 1981. Subsequently, there were growing deficits reaching $24.0 billion in 1984, not including foreign aid. At this time (March 1986), 1985 figures have not been published, but I estimate that the deficit approximated or exceeded that of 1984.

Price Increases Influence Oil Consumption

In my earlier, more detailed studies of Middle East oil (1980 to 1982), I concluded that fundamental structural changes were taking place in energy markets, particularly in oil markets, but the focus of my studies was the assumption by most analysts that the Saudis and other small-population oil exporters had limited revenue "needs". In 1981 I concluded that economic forces point towards "downward pressure on real and possibly even nominal oil prices, (and that) if the major oil price increases have not killed the goose that lays the golden eggs (for the oil exporters), they have at least inflicted some serious wounds. It will not be surprising if the

importance of Middle East oil continues to diminish."

In my study, completed in March 1982 (a few months after the last increase in Saudi oil prices), I concluded that: "1. The real price of oil is likely to decline over a long period. 2. The current account surpluses of Saudi Arabia and of other major oil exporters will probably diminish rapidly . . . Given the trends in the oil markets and in Saudi imports, it will not be long before the Saudis have to begin utilizing their accumulated foreign assets to cover current account deficits. 3. For the Saudis and other major oil exporters, adjusting to lower real incomes and expenditures . . . will probably create serious internal social and political problems. 4. For other Middle Eastern countries which have benefited from the oil boom . . . foreign aid, jobs for their nationals and remittances . . . a curtailment of spending by the oil countries could have serious consequences . . . The progressive dethroning of Middle East oil has the most profound implications, political and strategic, as well as economic."

In 1984, a U.S. consulting firm specializing in energy studies attempted to explain why their own forecasts and those of the overwhelming majority had been consistently erroneous. They noted that "since modern, long-term oil forecasting began in the early 1970s, consensus has been the norm, and (that) in each case the consensus proved incorrect" – an understatement, to say the least. They quote an unnamed Canadian oil specialist who rather cynically remarked that "Oil price forecasters make a flock of sheep look like independent thinkers." The authors of the study estimated that "in 1980-81 alone, on the order of half a trillion dollars ($500 billion) was invested around the world on the assumption that oil prices would continue to rise (in real terms) throughout the rest of this century . . . A significant part (of the investments) will add up to one of the most expensive business errors ever." Of greater current interest is their new "consensus" forecast of future oil markets and prices, based on interviews with 125 oil forecasters in 1984. They concluded that (real) oil prices would be falling for the next several years, followed by rising real oil prices in the 1990s. One of the assumptions is that "OPEC and Saudi Arabia, in particular, are politically and economically able to continue to play the 'swing' role." What is particularly noteworthy is that they again make the crucial assumption that Saudi revenue needs will not induce them to raise production. In order for the Saudis – and other major Middle Eastern oil exporters – to play the swing role, they must be able to curb expenditures (and imports) very sharply, and/or be able and willing to further deplete their dwindling foreign assets and/or incur large foreign debts. My own thesis remains that the Saudi regime's space to maneuver in terms of expenditure cutbacks is very limited. I also postulate that the Saudi economy will continue to be overwhelmingly dependent on oil revenues. In other words, their attempts at economic diversification will not yield any significant fruits in the foreseeable future, and that the regime will have little choice but to raise oil exports in order to satisfy its revenue needs.

Saudi Leadership Blunders

It is clear that the Saudi leadership made a number of very serious blunders during the past decade. They accepted the projections of the oil analysts at face value, forecasting almost ever-rising real oil prices and a growing demand for Saudi oil. With their possession of one fourth of the world's known oil reserves, there was no apparent reason for financial concern. They appeared to believe that they could spend lavishly and that their financial reserves would, nonetheless, continue to grow. During most periods since the early 1970s, the Saudis were relatively moderate with respect to oil pricing because their huge reserves dictated a long-term view, unlike some other members of OPEC with relatively small oil reserves. However, there were crucial periods, especially in 1978 and the first half of 1979, when they welcomed and even stimulated a sharp increase in prices in order to extricate themselves from budgetary and balance of payments deficits and declining financial reserves. In 1984, the Saudi oil minister admitted candidly that "in 1979/80 we made a mistake. We raised prices without regard for actual demand." An American oil analyst argues that "The Saudis blundered by allowing the price to rise in 1979-81 . . . and then blundered a second time by trying to defend the high price. Had the Saudis not done this, many investments in nuclear plants, gas

pipelines, expensive oil exploration projects and other long-term commitments would not have been made."

Possibly the most serious error made by the Saudi leadership was in escalating expenditures on massive infrastructural projects, huge subsidies, a bloated bureaucracy, a mammoth military buildup and a large-scale diversification program in industry and agriculture, which proved wasteful in many cases. Had the Saudis been more restrained in their spending program, especially in 1979-82, their situation today might be different. Their financial needs might have been smaller, and their accumulation of foreign assets and investment income would have been higher, covering a major share of more modest public expenditures. The influx of foreign labor would also have been smaller. In a 1985 interview, the planning minister revealed that "when we were launching our infrastuctural development, we were told (by some unnamed advisers) that we would be best advised to put our money in financial institutions (in the West) and live on its earnings." Many in Saudi Arabia no doubt regret that this advice was not heeded.

Another major error was noted by the *Financial Times* in mid-1985, when Saudi output was reduced to about 2.5 mbd, one fourth of its peak production in 1979-81. "By allowing its production to fall to such a low level, the Kingdom has made a tactical error from which it will have great difficulty recovering." Subsequently, when the Saudis recognized that they could no longer afford to continue with their role as "swing" producer, they offered discounts in order to raise their share of the oil market. But other exporters, OPEC and non-OPEC alike, would not readily give up their shares of the market, and the consequence was a collapse in oil prices. These mistakes cannot be undone. All the king's horses and all the king's men will not put the Saudi economy together again.

What do these developments imply for the future? For the regime in Saudi Arabia, the outlook is grim. The authorities face unenviable and dangerous choices. If they implement more drastic cutbacks in spending, the recession would intensify, and the expectations of Saudi nationals for "soft jobs" and higher living standards would be thwarted. The citizenry would have to accept far lower living standards. Blatant inequalities between the life-styles of the princes and others who have amassed great wealth and those of the Saudi population at large can only add fuel to social discontent. If the regime implements the relatively mild expenditure cutbacks indicated in the 1985-1990 Plan, it will not be long before their financial reserves approach exhaustion. Government borrowing can postpone the inevitable, but cannot circumvent it. If the authorities attempt to enhance revenues by exporting more oil – as they have been doing since the fall of 1985 – the struggle for market shares would intensify and add to downward pressure on oil prices.

Fiscal deficits are soon translated into balance of payments deficits. The industrialization program holds little promise of making up for more than a tiny fraction of the decline in oil export revenues. Moreover, the rapid depletion of financial reserves and lower interest rates will continue to erode investment income. The agricultural program is, for the most part, a drain on the dwindling resources available to the economy. In short, barring unforseen radical internal or external events, Saudi Arabia's economic future is bleak.

Consequences of the Oil Crash for Other Countries

There are important variations, but, by and large, the sharp downturn in oil markets since 1981 has affected all of the other Middle Eastern oil-exporting countries. The Libyan economy is in worse shape than the others in this group. In the United Arab Emirates, the internal struggle between the have-nots – the five poorer emirates in the federation – and the two very rich members, Abu Dhabi and Dubai, may well be aggravated. As long as oil revenues were rising, the rich emirates could allocate part of the increment to aid the poor members; with shrinking revenues, continuing such actions implies accepting cutbacks in the rich emirates. Oman's ambitious development plans will have to be curtailed rather sharply.

Kuwait is in a category by itself in many ways. It was relatively prudent in its spending, and it financial per capita reserves are far larger than those of its neighbors. But, it is also suffering from the recession which pervades the whole Gulf region, and the pressures on the treasury to save weak or collapsing companies (and individuals) are

intense. Moreover, it is probably more susceptible than its neighbors to "requests" from Iraq for so-called loans. Business failures, terrorist incidents, and the fear that the hostilities between its powerful neighbors, Iran and Iraq, will spread to their country, have undermined business confidence and induced a flight of private capital.

Though Egypt is not a major oil exporter by Middle Eastern standards, the oil boom accounted for a strong boost in its export revenues. Egypt also gained from rising Suez Canal dues — due in large measure to the oil boom in the Persian Gulf countries. Arab tourism and private Arab investment were additional sources of gain. But by far the single most important source of foreign currency earnings were the remittances sent home by Egyptians working in the Arab oil states. The reversal of these trends is causing very severe economic problems.

There are important differences, but Syria's economy has, in many ways, also become oil-dependent during the past decade through large-scale financial aid from the rich Arab states and remittances from hundreds of thousands of Syrians working in those countries. The recession in Syria since 1982 is, in many respects, due to reverses in the oil market.

Though Jordan has very little oil, it was greatly affected by the oil boom in the neighboring countries, also benefiting from large-scale financial aid, remittances from its nationals working in the oil countries which were equivalent to between one-fourth and one-third of its GNP, transit trade and ready markets for its own exports. The recent sharp cutback in financial aid and the return of many of its nationals have been major factors in causing a recession and in increasing problems of unemployment.

Other countries with large numbers of nationals working in the Gulf states are being affected by the end of the oil boom, particularly North and South Yemen. There are, of course, important variations, but the radical change from an oil boom to an oil crash has had a strongly adverse impact both on the oil-exporters and the poorer countries in the region. These developments may well have destabilizing effects in various countries in the region. The political and strategic ramifications of these developments may well be as momentous as was the decade of rising Arab oil power.

Impact on the Middle East Arms Race

One beneficial effect for the Middle East of the end of the oil boom may well be a deescalation in the regional arms race. The Saudi military budget for 1985/86 includes a cutback from $19.6 to $17.6 billion. Though still very high by international, or even Middle Eastern, standards, the direction of change is important. Moreover, arms imports of a number of other countries including Syria, Jordan and others were financed, in large measure, by Saudi Arabia, Kuwait, and, in earlier years, by Libya and some other rich oil states. This was in addition to announced economic aid. One can assume that the growing financial problems of Saudi Arabia and others will significantly reduce their ability, and willingness, to make such allocations. This conclusion assumes that extra-regional powers, both Communist and Western, will not increase their financial aid for military purchases.

Diminishing Importance of Middle East Oil

I have elaborated earlier on my view that oil prices will remain depressed in the foreseeable future. It also bears mentioning that the importance of Middle East oil has been diminishing, steadily and sharply. Only a few short years ago it was widely believed that if the Saudis reduced production by a few million barrels per day, calamity would not be far behind. American and other political leaders were beseeching the Saudis not to reduce production. And yet, Saudi output dropped sharply from some 10 mbd in 1979 to 3.5 mbd in 1985, and the oil glut persisted and intensified. For the Arab members of OPEC, as a whole, the decline was from 21.6 mbd in 1979 to 9.7 mbd in 1985, and there was much spare capacity in other countries as well. The Saudi (and Arab) share of world oil markets will probably rise in 1986, not as a consequence of increased demand, but because of their revenue needs and a more intense struggle for market shares.

It was also not so many years ago when the Persian Gulf, especially the Strait of Hormuz, was viewed as the industrialized West's lifeline; hence, the establishment of the U.S. Rapid Deployment Force to deal with possible emergencies in that volatile part of the globe. This is no longer the case for two reasons:

1. The overall decline in oil exports from Iran and the Arab countries in that region as

alternative oil sources have emerged. In 1975, 17.5 mbd were exported through the Strait of Hormuz;this dropped to 6.5 mbd in 1985, and a further decline appears imminent.

2. A number of pipelines have been built which avoid transit through the Gulf. Saudi Arabia completed an internal east-west pipeline with a capacity of 1.85 mbd, currently being expanded to 3 mbd. Most of the existing capacity has not been utilized; its construction is to insure exports in case of closure of the Strait of Hormuz. Iraq completed a pipeline (with a capacity of one half mbd) connecting with the Saudi pipeline. It is also planning a parallel line of its own through Saudi Arabia to the Red Sea with a capacity of 1.6 mbd. Iraq recently expanded the capacity of its pipeline through Turkey from 650 thousand barrels per day to one mbd and is also laying down a parallel pipeline with a throughput of one half mbd.

Upon the completion of the new Saudi and Iraqi pipelines in 1987-88 total capacity would be about 6 mbd, even without taking into account the dormant lines from Iraq through Syria (capacity 1.4 mbd), and Tapline, from Saudi Arabia to Syria and Lebanon (capacity one half mbd). In short, just as the two oil shocks set into motion forces which greatly reduced the importance of Middle East oil, the Iran-Iraq war induced actions which made world oil markets immune to major shocks arising from a possible closure of the Persian Gulf.

Other than those countries in the Middle East (and some outside) which have become overly dependent on oil, the world should welcome oil's tumble from its exalted position as a "special" commodity. Lower prices should stimulate economic growth and reduce inflation and interest rates – a reversal from the trends of the 1970s and early 1980s. The oil crash may well exacerbate the forces of instability in a number of Middle Eastern countries, but the impact these countries would have on oil markets would be minimal and ephemeral.

Providence has ways of vitiating prophecies of global gloom and doom, but wise economic policies also help.

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