SURVEY OF ARAB AFFAIRS
A periodic supplement to Jerusalem Letter/Viewpoints

SAA:33 28 Av 5753 / 15 August 1993

ACCELERATING OPEC'S DEMISE: THE ECONOMIC CONSEQUENCES OF THE PERSIAN GULF WAR

Eliyahu Kanovsky

A Decade of Budget Deficits in Saudi Arabia / Kuwait Recovers from the War / Over-Expansion of Production Capacity / The Restrained Demand for Oil / The Coming Oil Glut / Egypt's Troubled Economy / Fueling the Growth of Muslim Extremism

The presumed power of Saudi Arabia with its massive oil reserves — about one-fourth of the world's total — is based upon the experience of the West with the oil shocks of the 1970s and early 1980s. To put matters into perspective, however, Russian output of natural gas — in terms of energy equivalent — is greater than Saudi and United Arab Emirates oil production combined. Moreover, Russia alone possesses about 40 percent of the world's natural gas reserves, and its potential oil reserves are also vast.

History tells us that power stemming from ownership of natural resources is a myth and that their possession certainly does not guarantee economic success. In fact, the fastest growing economies in recent decades have been mainly in East Asia, a region poor in natural resources. By and large, their unusual success is attributable to the adoption and implementation of appropriate economic policies.

In sharp contrast, most Middle Eastern countries have pursued economic policies which were harmful to long-term economic growth, and to the creation of productive jobs and improved living standards for the majority of the population. Since the mid-1980s these countries have been reaping the bitter fruits of their destructive policies. In many respects their problems are similar to those encountered by the ex-communist countries of the former Soviet Union and Eastern Europe.

There are, of course, important differences between the oil-rich Middle Eastern countries, such as Saudi Arabia, and others with much smaller or no oil resources, and with larger populations.

Jerusalem Center for Public Affairs, Daniel J. Elazar, Editor and Publisher; Zvi R. Marom, Executive Editor; Mordechai Abir and Raphael Israeli, Contributing Editors. 13 Tel-Hai St., Jerusalem, 92107, Israel; Tel. 02-619281, Fax 972-2-619112. © Copyright. All rights reserved. ISSN: 0334-4096.
The opinions expressed herein do not necessarily reflect those of the Jerusalem Center for Public Affairs.

A Decade of Budget Deficits in Saudi Arabia

One crucial fact about Saudi Arabia, often overlooked, is that in every year since 1983 Saudi Arabia has incurred large deficits both in its budget and in its balance of payments (the current account). The Persian Gulf War accelerated this trend. Of course this calculation deals only with the state treasury and central bank, not the fabulous private wealth of the monarch, thousands of princes and some other very wealthy Saudis. The cumulative budget deficits between 1983 and 1992 were about $135 billion and the cumulative current account deficits during the same period were about $125 billion. In 1991 alone the current account deficit was an unprecedented $26 billion. Not that oil export revenues were paltry; they totaled over $300 billion in 1983-1992.

Between 1983 and 1988 the deficits were covered by drawing down the large financial reserves accumulated during the heyday of the oil shocks. Toward the end of the 1980s the Saudis became increasingly concerned about their rapidly depleting financial reserves and began to borrow, mainly internally. Since the Persian Gulf War they have also taken substantial external loans. Despite the loans, Saudi central bank foreign assets fell from a peak of $128 billion in 1982 to $54 billion in the third quarter of 1991 (the latest available official data). Unofficial current estimates put them at $20-30 billion, after excluding loans of dubious value such as those to Iraq. Foreign companies working for the government have been suffering from lengthy delays in payment.

In the past three years, 1990-92, Saudi oil export revenues were almost double those of the immediate pre-Persian Gulf War years, but they were far from sufficient. The Saudi monarchy is under increasing pressure to provide more and more goods and services to the public at low or nominal cost. The unexpected royal announcement in March 1992 which decreed still larger subsidies both for consumers and producers was designed to mollify public opinion. There are clear indications of growing discontent with the regime, fueled, in part, by lavish spending by the royal princes and other wealthy Saudis, while the incomes of most Saudis are stagnant or declining. Schools are overcrowded and hospital facilities are inadequate. In the past Saudi university graduates were given jobs in the bureaucracy, whether they were needed or not. In more recent years budgetary stringency has created some unemployment among Saudi youth.

The aftermath of the war has also seen a large growth in military expenditures. The Saudis have placed huge orders for advanced and expensive military equipment both from the U.S. and the U.K. The continuing deficits must be covered by loans and, as a consequence, debt service has risen rapidly in recent years. Despite the diversification of the economy — a prime goal of Saudi planners — the economy is now even more dependent on oil revenues than in the past, a situation that is likely to continue for the foreseeable future.

Back in the mid-1970s, then-Saudi Oil Minister Sheik Yamani asserted that Saudi oil revenues resulting from the export of one million barrels a day (MBD) were adequate for Saudi needs. A few years later he stated that Saudi needs could be satisfied by exports of 3 MBD. At that time the price of oil was about $10-12 per barrel. He claimed that Saudi output of about 8 MBD at that time was far above his country's financial needs. It was, he stated, a political favor to the West, and in particular to the U.S., from whom due political compensation was expected. The reference was to U.S. adoption of a pro-Arab position in the Arab-Israeli conflict.

How things have changed. The Saudis are currently pumping over 8 MBD at a price of about $17-18 per barrel and are incurring substantial deficits. The U.S. need not prod them into expanding their oil exports. Nor does the U.S. have to urge the Saudis to restrain large price increases. The Saudis, chastened by the bitter experience of the 1980s, know that high oil prices will soon boomerang. They have learned that high oil prices are soon followed by even greater investments by the advanced industrial countries designed to improve energy efficiency and conservation, to accelerate fuel-switching away from oil, and to increase exploration for oil and gas worldwide. The only recourse for the Saudis is to increase the volume of oil exports — though they well know that this may lower prices. They and other oil exporters hope and pray that depressed production in Iraq (as a result of UN sanctions) and Russia (as a result of internal turmoil and political anarchy) will continue to bolster prices and allow the Saudis to retain the much larger share of the oil market they have captured since the Persian Gulf War and since the sharp decline in Soviet oil exports. The Saudis are investing very large sums in order

to increase oil production and export capacity to over 10 MBD. The expansion is financed, in part, by external loans. The Saudis are not likely to leave these facilities underutilized for long. They simply cannot afford to.

Kuwait Recovers from the War

Prior to the Gulf War Kuwait's foreign assets were continuing to accumulate, rising, according to some estimates, to as much as $100 billion, double those of Saudi Arabia, although Kuwait's population is only about one-tenth as large. Income from foreign investments financed about one-half of budgetary expenditures. In other words, Kuwait was becoming less and less dependent on oil revenues.

The Gulf War has completely reversed this situation. About two-thirds of its foreign assets were wiped out as a result of the costs of the war and its aftermath, according to some estimates; others believe that foreign assets have declined even further. For the first time in decades Kuwait had a current account deficit in 1990, followed by more deficits in 1991 and 1992. The cumulative deficits in 1990-92 were about $40 billion. The sharp decline in foreign assets was also due to Kuwaiti investment losses in Spain. Like Saudi Arabia, Kuwait has sought and received large loans from abroad since the war. The costs of reconstruction, debt servicing, and increased military spending, as well as sharply reduced investment income, mean that Kuwait has become far more dependent on oil revenues since the war. Even before the war Kuwait was not known for its strict adherence to OPEC quotas; it is far less likely to restrain output in the future.

Over-Expansion of Production Capacity

In addition to Saudi Arabia and Kuwait, numerous oil producers, large and small, both in the Middle East and elsewhere, are in the process of expanding production capacity. Iran's economy continues to suffer from the twin blows of the 1979 revolution and the costly eight-year war with Iraq which ended in 1988. It benefited from the temporary spurt in oil prices which followed the Iraqi invasion of Kuwait, but its enormous needs for reconstruction and rapid economic development for its large and rapidly growing population can only be met by much larger oil revenues. Its non-oil exports have been growing but are minuscule in terms of its foreign exchange needs. It is particularly noteworthy that since 1988 its external debt has grown exponentially, from $6 billion to $30 billion in 1992. For the first time since the 1979 revolution Iran is in arrears in the repayment of foreign loans. It is rapidly expanding oil production and export capacity in the hope that higher oil revenues will finance large-scale importation of machinery and raw materials sorely needed for economic development and to improve living standards, as well as for the repayment of debts.

Other OPEC members currently expanding capacity — mainly in order to cope with budgetary and balance of payments deficits — include Nigeria, Libya, the United Arab Emirates, and Venezuela. Iraq is in a separate category. Since August 1990 UN sanctions have effectively blocked almost all oil exports. The UN apparently allows Iraqi oil shipments to Jordan for the latter's domestic needs, but there are also reports of smuggling through Turkey and Iran. Nonetheless, it is hard to believe that Iraqi oil exports amount to more than 100-200,000 barrels per day, as compared with over 2.5 MBD before the war. Toward the end of 1992 the Iraqi oil minister stated that production capacity had been restored to 2 MBD and that within a few months following the removal of sanctions output would reach its prewar level of 3.2 MBD. He also stated that Iraq's goal was to reach a capacity of 6 MBD by 1995-96. While there is no way of knowing when the UN sanctions will be removed, we do know that, according to Western oil men, Iraq's potential oil reserves are vast, second only to those of Saudi Arabia in the Middle East, and that following the destruction during eight years of war with Iran (1980-88), and the carnage wrought during the recent war, to which one must add the cumulative impact of UN sanctions, Iraq surely has a powerful incentive to exploit its oil resources as rapidly and as fully as possible. It has ignored OPEC quotas in the past and is more likely to do so in the future.

By 1992 OPEC's share of world oil production had fallen to 39 percent as compared with over 50 percent in the mid-1970s. The deterioration within the Soviet Union during its last years and the political anarchy since its breakup have sharply reduced production in the area included in the former Soviet Union from a peak of 12.5 MBD in 1987-88 to 9.0 MBD in 1992 (8.0 MBD from the Russian Republic). Western oil men are flocking to these republics in

the hope that they can profit from what is believed to be the area's huge oil and gas potential. A recent one billion dollar loan from the World Bank to the Russian Republic to finance the purchase of machinery and spare parts should increase oil production. An agreement between Chevron and Khazakhstan signed in April 1993 calls for the development of the Tengiz field, believed to have double the reserves of Prudhoe Bay in Alaska.

Other non-OPEC producers are also in the process of expanding capacity, including the U.K. and Norway (North Sea oil), Oman, Ecuador, Colombia, Argentina, Brazil, Vietnam, a number of African countries and others. Exploration for oil and gas is continuing worldwide and new technology has considerably improved the success rate. New technology has also increased the quantity of oil recovered from older fields. In the U.S. oil production resumed its long-term downtrend in 1992, but the rate of decline appears to have moderated. A study sponsored jointly by the U.S. Department of Energy and the University of Texas concluded that U.S. potential recoverable oil reserves are far larger than previously estimated.

Non-OPEC production as a whole, excluding the U.S. and the former Soviet Union, has been climbing steadily, reaching almost 20 MBD in 1989 — twice its 1977 level — and climbed by another 2 MBD between 1989 and 1992. This oil comes from a wide variety of larger and smaller producers, none of whom have oil fields nearly as prolific as those in the Middle East, but the cumulative impact of many smaller and medium-sized fields is no less significant. Those who have predicted declining non-OPEC production, and hence enhanced OPEC power to raise or maintain oil prices, should revise their forecasts.

The Restrained Demand for Oil

While there are powerful forces increasing the supply of oil, both from OPEC and non-OPEC countries, there are, concurrently, other forces restraining the growth in demand. Possibly of greatest importance is the growing strength of the worldwide movement for a cleaner environment which has given additional stimulus to improved energy efficiency and more fuel switching, especially in favor of natural gas which is environmentally cleaner than petroleum. Moreover, while oil reserves are heavily concentrated in the Middle East, natural gas reserves are widely diffused geographically. Both oil reserves and natural gas reserves have grown since the 1970s but natural gas reserves have increased far more rapidly.

In 1991 the U.S. was 90 percent self-sufficient in natural gas, with almost all of the balance imported from Canada. Russia, with its huge gas reserves, Norway, Holland, and Algeria are competing strongly for the rapidly growing gas market in Europe. Expressing OPEC's concern, its secretary-general recently stated that "The handwriting is on the wall. Gas will continue to replace oil." Understandably, OPEC has come out strongly in opposition to the proposed carbon tax in the European Common Market, and against President Clinton's proposed energy tax, which would tax oil more heavily.

The Coming Oil Glut

The drive to increase oil exports while demand growth is restrained spells lower prices, at least when measured in constant (inflation-corrected) dollars. While there have been price fluctuations arising from weather, accidents, wars, etc., the overall trend in oil prices in the past decade has been downward and this should continue to be the underlying trend, subject to fluctuations. For oil importers including the U.S., the world's largest oil importer, lower prices spell good news in terms of less inflation, more rapid economic growth, and an improved balance of payments.

On the other hand, for a number of Middle Eastern countries in particular, which became addicted to high spending during the 1970s and early 1980s, this spells trouble ahead. Like all governments which are faced with the necessity to sharply reduce spending, the results can be politically and socially disruptive, possibly even destabilizing. Despite the Saudi regime's advocacy of strict adherence to Islamic codes, there has been a growth in fundamentalist criticism of the regime. In the past Riyadh could utilize its presumed oil and financial power to buy influence internationally, and to ensure stability internally. This power will be eroded by its large deficits and weakened financial position, and by increased competition from other exporters of oil and gas.

Egypt's Troubled Economy

During the first half of the 1960s Egypt adopted economic and social policies broadly referred to as Arab socialism. This set the stage for the serious

and often severe economic problems facing the country since that time. During the period of the oil boom in the 1970s and the first half of the 1980s, many of the problems were masked by the direct and indirect effects of the oil boom. Since Egypt had become a net oil exporter in the mid-1970s it benefited greatly from the far higher oil prices. But the main benefit was from the jobs available to millions of Egyptians in the booming Gulf states. These workers sent home many billions of dollars which raised their families' living standards. This safety valve for Egypt's surplus labor was sharply curtailed by the end of the oil boom in the mid-1980s. Egypt's economy became once again heavily dependent on its inefficient agriculture stifled by government controls, and on industry, largely state-owned and grossly inefficient. Since the mid-1980s, economic growth per capita has approximated zero and unemployment has risen to dangerous levels. As a result of its support for the U.S.-led coalition against Iraq, Egypt was very handsomely rewarded, delaying the day of reckoning for a few years. Some reforms were implemented, but the authorities have been reluctant to go ahead with a privatization program that would streamline the state manufacturing enterprises and dismiss millions of unproductive workers today on government payrolls. The economic malaise, large-scale unemployment among the youth, and widespread corruption have made the younger generation fertile ground for the ideology of Muslim extremism which advocates the violent overthrow of the government. Armed clashes between extremists and the security forces have become an almost daily occurrence. Tourism, possibly the brightest spot in Egypt's economy, has been affected, harming a sector that alone employs about one million people.

Fueling the Growth of Muslim Extremism

The growing financial problems faced by Saudi Arabia and other major oil exporters imply that there is little hope for any significant aid from the oil-rich states to the poorer Arab countries. Nor is there much prospect of additional jobs in the oil states for the growing number of unemployed in the poorer Arab states. Another oil boom in the 1990s is not in the cards. In a number of Middle Eastern countries, as in Egypt, the rapid growth of Muslim extremism in the past five or ten years is due to a variety of factors, but there is little doubt that this movement has been immeasurably strengthened by growing unemployment, declining living standards, widespread corruption, and a yawning income gap between the few rich — often enriched by corrupt practices — and the many poor. The younger people, especially, despair of any change on the part of existing regimes and seek out new ideologies. These extremist groups go under different names in different countries — Hamas, Hizbollah, Islamic Jihad and others, but common to all of them is the drive to overthrow the existing regimes, the stringent imposition of Islamic law, a strong anti-Western bias with the U.S. viewed as the "Great Satan," and an ideology which advocates the complete destruction of Israel. The pattern, with variations, was set by the Islamic Revolution in Iran in 1979.

Aside from Lebanon, the Arab Middle East enjoyed a relatively high degree of political stability in the 1970s and 1980s. The assassination of Sadat in 1981 was followed by the smooth succession of Mubarak. Yet this relative political stability may not continue into the 1990s and beyond. The possibility that Muslim extremists will succeed in overthrowing the regime in a number of key Middle Eastern countries cannot be dismissed. Deteriorating economies strengthen their chances of achieving their goals.

In international relations it is assumed that a new government will recognize treaty obligations negotiated by the previous government. No such assumption can be made with regard to the extremist Muslim organizations which state, categorically, that they will not be obligated by the international agreements made by the present "traitorous" leaders, in particular with regard to recognizing Israel's right to exist and to live in peace. All the parties involved in the current Arab-Israeli peace negotiations would be well advised to take these new factors into account.

* * *

Eliyahu Kanovsky is Professor of Economics, and Senior Researcher at the Center for Strategic Studies, at Bar-Ilan University in Ramat Gan, and is Ludwig Jesselson Visiting Professor of Economics at Yeshiva University in New York. He is the author of *The Economic Consequences of the Persian Gulf War: Accelerating OPEC's Demise* (1992). This report is based on a recent presentation at the Washington Institute for Near East Policy.

★ ★ ★ THE JERUSALEM CENTER PROUDLY ANNOUNCES ★ ★ ★
THE PUBLICATION OF

Major Knesset Debates, 1948–1981 *(6 volumes)*

Edited by Netanel Lorch

Follow the history of contemporary Israel through the living words of its founders. In six volumes totalling 2,516 pages, the major debates held in the Israeli Knesset and in the legislative bodies immediately preceding it — the People's Council and the Provisional Council of State — are presented for the first time in English.

All the major events in Israel's history and the people who participated in their shaping are found here. The subject matter has been chosen for its long-term relevance and includes political questions, fundamental constitutional issues, and problems concerning the relationship between the Jewish diaspora and the State of Israel.

Dr. Lorch has written a short introduction relating to the circumstances under which each debate took place, as well as an introduction to each Knesset outlining its composition, and a general introduction to the Israeli Knesset, its history, structure, procedure, and the manner of its election. A glossary of political parties and personalities is also included.

> "The debates of the Knesset have never been made available to the non-Hebrew reader. Dr. Lorch's work fills that vacuum. Endowed with personal experience and scholarly attributes he has prepared a representative selection of debates, culled from over 100,000 pages...maintaining throughout a high level of both readability and scholarship. His book should be regarded as indispensable to anyone who wishes to understand the currents of thought and action which have agitated the political life of Israel and the surrounding world." — *Abba Eban*

Contents: Vol. 1 — The Knesset: Israel's Parliament, People's Council and Provisional Council of State (1948–1949); Vol. 2 — Constituent Assembly/First Knesset (1949–1951); Vol. 3 — Second Knesset (1951–1955), Third Knesset (1955–1959); Vol. 4 — Fourth Knesset (1959–1961), Fifth Knesset (1961–1965), Sixth Knesset (1965–1969); Vol. 5 — Seventh Knesset (1969–1973), Eighth Knesset (1974–1977); Vol. 6 — Ninth Knesset (1977–1981), Glossary of Political Parties and Personalities, Index.

Co-published with University Press of America, December 1992.

Netanel Lorch, one of Israel's most prominent military historians, served as Secretary General of the Knesset from 1972 to 1983, following a distinguished career in both the Israel Defense Forces and the diplomatic corps. He is a former President of the International Association of Secretaries General of Parliaments.

• A complete JCPA Publications Catalogue is available upon request, offering an extensive selection of the literature of Jewish public affairs.