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MENA QUARTERLY ECONOMIC BRIEF: PLUNGING OIL PRICES

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Introduction: In the three months since most observers, including the World Bank, issued their last forecasts, the Middle East and North Africa (MENA) Region has changed substantially. Political tensions have eased somewhat with presidential and legislative elections completed in a few countries. Egypt's cabinet approved the electoral constituencies' law, the last step before calling for the House of Representatives elections, the final milestone in the political roadmap initiated in July 2013. Presidential elections were held in Tunisia, with Beji Caid Essebsi sworn in as the new president in December. Iran's nuclear talks with the P5+1 were extended for 6 months — while bilateral talks continue —with the aim of reaching a deal in July 2015. In Iraq, the government and the Kurdish region reached an agreement in December resolving a longstanding dispute over the budget and distribution of oil revenues. Meanwhile, Lebanon, Yemen and Libya still struggle to maintain a functional government. The global economy is estimated to have expanded by 2.6 percent (q/q annualized rate), better than the second quarter of 2014, but unchanged from the slow pace seen in 2012 and 2013.

But the most important development is that international oil prices have literally collapsed, reaching a level below \$50 per barrel (Brent crude) in early January, a drop of more than 50 percent since peaking in mid-June 2014.

The Impact of Falling Oil Prices – A quick summary: Oil prices halved in the fourth quarter of 2014 and in a month into 2015, they have fallen by another 9 percent. Brent crude oil dropped below \$50 a barrel in early January 2015 for the first time since May 2009. Though they recovered slightly afterwards, there are indications that prices will not go back up anytime soon. The sharpness of the decline in oil prices is almost unprecedented-- second only to the 2008 collapse when prices fell from \$148 to \$40 per barrel. Three reasons have been suggested for the oil prices collapse. From the supply side an increase in US shale oil production and a shift in OPEC's policy from price targeting to maintaining market share; and on the demand side weaker than expected global demand due to sluggish global growth. Unlike the 2008 oil price crash which was demand-driven, supply-side factors have been playing a dominant role in the current oil market.

Overall the decline in oil prices has already reduced inflation globally and could stimulate a global recovery. The World Bank estimates that a sustained 30 percent oil price decline, if resulting from a supply glut, could increase global GDP by around 0.5

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percentage points in the medium term. To be sure, the overall growth impact depends on several other factors that vary widely across regions and particular countries. In the developing world, the impact will vary greatly between oil exporters and importers. Plunging oil prices are expected to have serious adverse consequences for oil producers' fiscal and external accounts, particularly those who rely heavily on oil export receipts such as Russia and Venezuela.

The positive impact of lower prices on oil importers will take more time to materialize and remains uncertain. The gains could be spread over a large number of countries but are likely to be modest on average, depending on the share of oil imports in GDP and overall level of confidence in the economy. In economies such as the Euro Area that are already struggling to stabilize deflationary expectations, declining oil prices could deepen existing concerns.

This issue of the MENA Quarterly Economic Brief focused on the implications of low oil prices for eight developing countries, the MENA-8 (oil importers: Egypt, Tunisia, Lebanon and Jordan and oil exporters: Iran, Iraq, Yemen and Libya) and the economies of the GCC (Gulf Cooperation Council), who play a major role in providing funds in the form of aid, investment, tourism revenues and remittances to the rest of the countries of the region. We make the following assumptions about the future price of oil: (i) The price will average $65 - Brent per barrel (p/b) in 2015; (ii) a higher price $78 – Brent p/b will be used for comparison analysis. As with other economic variables, there is uncertainty associated with the future price of oil, which adds to the error involved in projections. We assume no change in the quantity of oil imported or exported (in 2014) and calculate the impact as the effect of the change in price. These projections are based on statistical information available through early January 2015.

Oil Prices and the GCC and MENA-8: Plunging oil prices will have significant consequences for both oil exporters and importers in the MENA region. Low oil prices are expected to benefit fiscal and external accounts for those countries that are heavily reliant on oil imports. These countries will see improvements in their current account through lower import bills; and fiscal account as the cost of fuel subsidies (some of which are as high as 10 percent of GDP) declines. Oil importers that are expected to gain include Jordan, Tunisia, Lebanon and Egypt, whose trade balances could improve by up to 2 percent of GDP (Table 1).

The economies of oil exporters could be hurt, as oil accounts for more than half their budget revenues and exports earnings (in Yemen and Libya, oil constitutes more than 90 percent of total exports). Fiscal spending has been on the rise in these countries and they will likely run larger budget deficits or their surpluses would shrink substantially. Their external

Table 1. At a glance: Changes in oil trade and fiscal balances

	Change in oil trade balance (US$ mln)	Change in oil trade balance (% GDP)	Change in fiscal balance (US$ mln)	Change in fiscal balance (% GDP)
Bahrain	-29	-0.1	-2,602	-7.7
Kuwait	-30,051	-16.2	-40,050	-21.9
Oman	-12,235	-14.9	-12,868	-15.2
Qatar	-8,741	-4.1	-19,193	-8.9
Saudi Arabia	-63,082	-8.2	-103,114	-15.1
United Arab Emirates	-39,440	-9.6	-41,655	-10.0
Iran	-17,739	-4.4	-8,648	-1.9
Iraq	-34,894	-14.1	-34,504	-14.9
Libya	-8,599	-14.7	-15,427	-26.9
Yemen	-2,628	-6.1	-1,970	-4.7
Egypt	1,504	0.5	…	…
Tunisia	292	0.6	935	2.0
Jordan	997	2.2	…	…

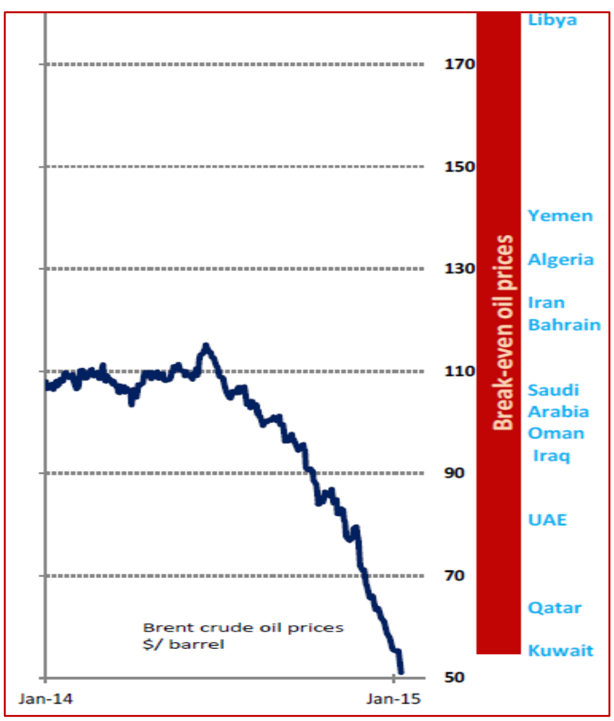
Source: World Bank staff estimates .The assumptions of $65 Brent crude oil and no

accounts would also deteriorate, eventually putting pressure on their currencies.

In this context, the oil exporters of MENA-8 (Iran, Iraq, Libya and Yemen) have been eyeing an oil price below $60 p/b in next year's fiscal budget (and in some instances $40 p/b), which is much higher than the current (or futures) oil price and also much lower than their fiscal breakeven oil prices - prices at which the government's budget is balanced (Figure 1). If the current situation persists, let alone if oil prices drop further, it would be difficult for these governments to maintain their fiscal stance. Yemen and Libya are among the most vulnerable oil producers, with oil accounting for roughly 95 per cent of export earnings and budget revenues. Iran, Iraq, and Libya could experience a worsening of the oil trade balance (net oil exports) in excess of 10 percent of GDP in 2015 (Table 1).

The GCC oil exporters are in a much better position to cushion the impact of falling oil prices, due to their ample reserves. Some of these countries have already started to take policy actions, however. The new budget in Saudi Arabia is expecting only a modest increase (0.5 percent) in spending compared to the 28 percent increase over spending in the previous year, including a big shift in composition away from capital and in favor of current spending.

Figure 1: Break-even oil prices:



Source: World Bank and IMF

On a positive note, falling oil prices will reduce imported inflation in both oil exporters and importers and, depending on the magnitude of the pass-through effects on domestic inflation, could benefit the poor. The slight increase in consumption from lower prices would also contribute to an uptick in growth.

Low oil prices are expected to slow growth in remittances outflows from GCC countries to the rest of the region, mainly Egypt, Yemen and Jordan. The World Bank estimates that while remittances are expected to grow at positive rates, there may be a small deceleration in the growth rates but it will not turn negative. Aid flows from GCC to the rest of MENA may also decline as a result of low oil prices. Historically, bilateral aid has followed oil prices. Although in recent times, aid has been allocated on political considerations, there may be reasons to think that this pattern will not recur in the current slump.

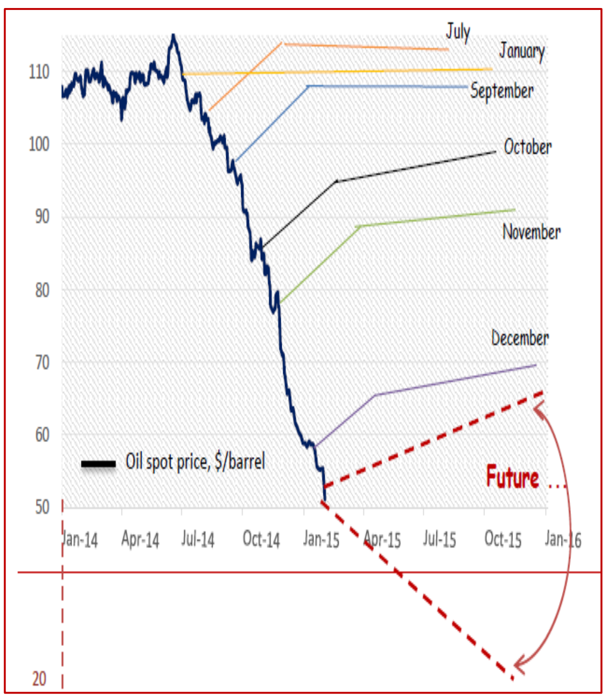
Future Prospects for Oil Prices: The International Energy Administration (IEA) estimates that low oil prices will carry over into 2015. Unlike the 2008 crash, where futures markets stayed optimistic about a recovery in oil prices, there are no indications of such a response in the futures market at this time. Data from IEC futures show that the price of oil for delivery in August is about $56 a barrel. However, as with other economic indicators, predicting the oil market is not straightforward, as the experience of 2014 shows (Figure 2). Several unknown factors such as supply, demand, geopolitics, and the global monetary and regulatory environment could shift prices in different directions.

There is some speculation that the average price of about $65 p/b could stay through 2015, as the market will tend to self-correct over the long run, most likely through US shale companies' cutting their production. The production costs of many shale companies are in the range of $70 p/b and a sustained drop in oil prices below this threshold could lead many of them to shut down or trim investment in oil fields. This would slow down production and stop oil prices from falling further. Some producers have already started to slash the number of drilling rigs in early 2015. About 50 rigs are planned to be idle up over the next month, a reduction in shale drilling activity by 20 percent.

However, some of the smaller companies are simply consolidating with the parent company, so production may not be affected any time soon.

The low price scenario is that oil prices could drop as low as $20 p/b in the short term, as the global economy and particularly the Euro area are not expected to turn the corner soon, and China (a major oil consumer) is entering a less oil-intensive stage of development. Furthermore, with a nuclear deal and removal of oil sanctions, an additional 1 million barrels per day of Iranian oil exports, combined with an increase in Iraqi and Libyan oil exports (in the case of easing geopolitical risks) could push oil prices further down.

Figure 2: Oil price forecasts in 2014 (Brent crude)



Source: The Economist and other International forecasters.

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