GCC: Assessing the potential impact of lower oil prices

The OPEC reference price has declined sharply in recent weeks, reaching its lowest level since mid-2012. In this note, we outline some of the reasons for the decline in oil prices, even against a backdrop of increased regional geopolitical tension, we consider market expectations for the coming two years, and we discuss the potential macroeconomic implications of lower oil prices on the GCC countries.

Chart 1: OPEC reference oil price

Why have oil prices declined since July?

Increased supply
OPEC oil production increased by 810,000 bpd in Q3 2014, according to Bloomberg estimates. More than half of this net increase (480,000 bpd) came from Libya, which has managed to ramp up oil production despite increasing domestic political violence and uncertainty.

Sub-Saharan oil producers Angola and Nigeria also increased production substantially in the third quarter. GCC output was only marginally higher in Q3 2014, as increased production in Kuwait (+144,000 bpd) was largely offset by production cuts in Saudi Arabia (-150,000 bpd).

US crude oil production (Chart 2) has also increased since the end of June, reaching 8.88mn bpd in the week ending 3 October, according to the US Department of Energy – the highest level of output since March 1986.

Lower demand on weaker global growth
Weaker than expected economic growth in China and the Eurozone have weighed on demand for oil, and the IMF’s recent downgrade of global growth forecasts for 2014 and 2015 have contributed to the downward pressure on prices. Earlier this month, the International Energy Agency (IEA) also cut its forecast for global oil demand for this year and 2015.

Stronger USD
The strength of the USD has weighed on all commodities, and has also contributed to the recent decline in oil prices. To the extent that the ‘purchasing power’ of oil revenues has not declined as much as the headline drop in USD prices, oil exporters may take a more benign view of the recent price decline.
What is the outlook for oil prices?

Consensus forecasts show that analysts expect oil prices to remain under pressure. The Bloomberg median estimate is for the oil price (average of WTI and Brent) to decline to USD 101pb in 2015, from an estimated average of USD 103pb this year. The median estimate for 2016 is USD 99pb.

We note that at the start of 2014, the consensus forecast for oil prices was USD 100pb, which is broadly in line with what is expected for 2015. We also highlight that year-to-date, the OPEC reference price has averaged USD 104pb, broadly unchanged on 2013.

In its October World Economic Outlook, the IMF said that risks to oil prices were skewed to the upside, citing the high risk of supply disruptions and on-going geopolitical tensions. Given the uncertain and fluid political situation in Libya, supply is likely to remain volatile and the recent increase in production may not be sustained. Furthermore, while the conflict in Iraq has not yet affected oil supply there, the
situation can change unexpectedly. On the downside, the Fund notes that increased output from Iran (in the event that a comprehensive agreement on its nuclear program is reached by 24 November) is a risk, as is increased non-OPEC supply and weaker than expected global demand.

Implications for the GCC

Although most GCC economies have made progress on diversifying their economies away from oil production over the last decade, there has been less success in diversifying sources of revenue. Consequently, regional budget revenues are still quite vulnerable to sustained changes in oil prices. We have ranked the GCC countries in terms of the proportion of budget revenues derived from oil, based on IMF estimates and official budget data (Chart 4).

Only Qatar has reduced the proportion of budget revenue derived from oil since 2007. However, the decline in Qatar’s oil revenues as a share of total budget income is partly due to the strong growth in LNG revenues. Total hydrocarbon revenue accounts for 60% of budget revenue, broadly unchanged from 2007.

We make one additional caveat at this point: there is a lack of transparency on investment income from sovereign wealth funds, and in our view it is possible that annual investment income is higher than officially reflected in the budget, or estimated by the IMF. The actual share of oil revenues may therefore be lower than these numbers suggest. Nevertheless, it is clear that a sustained decline in oil prices would have a significant impact on regional budget revenues.

One way of measuring the sensitivity of regional budgets to oil prices is by looking at the break-even oil price for each country; that is, the oil price at which a country’s budget would be balanced. This takes into account not only the proportion of budget revenues that come from oil, but also the level of expenditure (which in most GCC countries has grown sharply over the last five years).

Our analysis suggests that Bahrain and Oman have the highest breakeven oil prices in the GCC, at USD 125pb and USD 121pb respectively (based on 2014 expenditure and oil production estimates). At the other end of the spectrum, Kuwait has the lowest break-even oil price at USD 61pb, which reflects the relatively low level of budget spending as it is the least diversified in terms of sources of budget revenues. Saudi Arabia’s breakeven oil price this year is around USD 100pb and we estimate...
the UAE’s at USD 78pb.

**Chart 5: Break-even oil prices**

![Chart showing break-even oil prices for different GCC states from 2008 to 2015.](source: Emirates NBD Research)

**Base case scenario – oil prices average USD 100 in 2015**

If oil prices are in line with consensus forecasts in 2015, then Kuwait and the UAE should still post budget surpluses (based on our forecast budget expenditure). However, Saudi Arabia would record its first budget deficit since 2009, as we estimate the break-even oil price for next year is around USD 103pb (assuming a 5% increase in expenditure on 2014, and average oil production of 9.7mn bpd).

Saudi Arabia would have no problems financing a budget deficit for several years, in our view, given its substantial levels of accumulated reserves and low levels of sovereign debt. However, there is little scope for the kingdom to boost expenditure from current levels and indeed, we expect spending growth to slow sharply in the coming years. With substantial requirements for further infrastructure development, we expect current spending (wages and salaries, subsidies and transfers etc) to be contained, with capital spending likely to benefit from any further increase in total expenditure.

We also expect Bahrain and Oman to finance budget shortfalls from savings and transfers from other GCC states.

**Alternative scenario – oil prices average USD 85pb in 2015**

If the average oil price is one standard deviation lower than the current median forecast, then we estimate Saudi Arabia’s budget deficit would widen to -6.0% of GDP, based on our current expenditure forecast for 2015. If Saudi Arabia adopted a more prudent fiscal stance and kept expenditure stable in nominal terms next year, then the budget deficit would be around -4% of GDP, assuming no secondary impact on GDP growth from lower government spending.

The UAE and Kuwait would still run budget surpluses in this scenario, based on our estimates of expenditure and oil production in 2015. The UAE’s budget would move into deficit if oil prices averaged less than USD 78pb next year, while Kuwait’s budget would move into deficit below USD 65pb.

We expect Oman’s budget spending to remain around OMR 13.5bn in 2015, close to

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1 The standard deviation of the OPEC reference oil price over the last five years is USD 14.3pb.
where it has been since 2012. If the OPEC reference price averaged USD 85pb next year, Oman's budget deficit would widen to nearly -5.0% of GDP, compared with -0.3% of GDP in the baseline case and from an estimated -0.7% of GDP in 2015. In Bahrain, the budget deficit would widen to around -9% of GDP under this scenario, compared with -6.4% of GDP in the baseline case and from an estimated -4.4% in 2014.

The double whammy
The above analysis assumes that production levels remain constant even as oil prices fall. However, the reality in the event of a sharp, sustained decline in oil production is likely to involve production cuts from the main GCC oil exporters in a bid to support prices.

In this situation, there would be a direct impact on GDP growth from lower oil production (the oil sector accounts for around 20% of Saudi Arabia's and Bahrain's GDP and around 33% of the UAE's economy). This first round impact of lower oil production on GDP could be compounded by lower government spending (as budgets are hit both by lower oil prices and export volumes), which could undermine growth in the non-oil sectors.

How worried should we be?
While these alternative scenarios are possible, we think they are unlikely in the short term. We have already discussed the uncertainty and risks around supply of oil from non-GCC oil exporters in the Middle East, and there are several other reasons why OPEC oil producers may be relatively sanguine about the sharp declines in oil prices in recent weeks. One is that the correction may be relatively short-lived; in June 2012 weak demand and increased oil supply saw oil fall by more than 25% to USD 88.7pb in the space of a month, but this was largely unwound the following month. The start of QE3 in September 2012 helped to support oil prices thereafter. While the monetary policy outlook in the US is now much different, the ECB could – and is indeed expected – to provide further stimulus and monetary easing as deflation concerns mount. Lower oil prices would also ultimately support global economic growth.

OPEC producers may also be willing to absorb lower prices in the short term to put pressure on US shale producers, which face much higher costs of production (estimates range between USD 50-100 pb compared with USD 4pb in Saudi Arabia). That the cost of producing US shale is so high helps to establish a floor for oil prices in that additional supply is unlikely to be added below the cost of production.

These factors go some way towards explaining why Saudi Arabia lowered its official selling price in early October, to maintain market share according to most observers, rather than scale back output further. We note that OPEC is set to meet on 27 November, and could still announce a lower ceiling for oil production at that meeting.

However, over the medium and long term, the issue of the vulnerability of regional budgets to lower oil prices is likely to become more relevant, particularly as analysts have predicted that supply and demand in the oil market are likely to be more balanced over the next decade than they have been over the last 10-20 years. Indeed, the median Bloomberg oil price forecast declines to USD 93.4 in 2018, a full USD 10 lower than average 2014. While accumulated savings provide substantial buffers to finance high levels of spending for several years, this is not a sustainable strategy. Structural reforms to diversify the revenue base and rationalization of budget expenditure will become increasingly important for GCC governments over the medium term, in our view.
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## Emirates NBD Research & Treasury Contact List

### Emirates NBD Head Office
12th Floor  
Baniyas Road, Deira  
P.O.Box 777  
Dubai

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Contact Information</th>
</tr>
</thead>
</table>
| Aazar Ali Khwaja      | Group Treasurer & EVP Global Markets & Treasury | +971 4 609 3000  
aazark@emiratesnbd.com |
| Tim Fox               | Head of Research & Chief Economist         | +971 4 230 7800  
timothyl@emiratesnbd.com |
| Khatija Haque         | Head of MENA Research                      | +971 4 230 7803  
khatijah@emiratesnbd.com |
| Jean Paul Pigat       | Economist                                  | +971 4 230 7807  
jeanp@emiratesnbd.com |
| Aditya Pugalia        | Analyst                                    | +971 4 230 7802  
adityap@emiratesnbd.com |
| Anita Yadav           | Head of Fixed Income Research              | +971 4 230 7630  
anitay@emiratesnbd.com |
| Athanasios Tsetsonis  | Sector Economist                           | +971 4 230 7629  
athanasiost@emiratesnbd.com |
| Abha Elmasri          | Economist                                  | +971 4 230 7630  
anitay@emiratesnbd.com |
| Lee Sims              | London Sales                               | +44 (0) 20 7838 2240  
simsi@emiratesnbd.com |
| Egyptian Sales        | Shahinaz Foda                              | +20 22 726 5050  
shahinaz.foda@bnpparibas.com |
| Supriyakumar Sakhalkar| Singapore Sales                            | +65 65785 627  
supriyakumars@emiratesnbd.com |
| Ibrahim Sowaidan      | Investor Relations                         | +971 4 609 4113  
ibrahims@emiratesnbd.com |
| Claire Andrea         | Investor Relations                         | +971 4 609 4143  
clairea@emiratesnbd.com |
| Patrick Clerk         | Investor Relations                         | +971 4 230 7805  
paticke@emiratesnbd.com |