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THE GCC: ENERGY, ECONOMY AND GEOPOLITICS IN 2017

In February 2017, the Center on Global Energy Policy at Columbia University SIPA convened a roundtable of energy and regional experts from academia, industry, finance and government to discuss the changes underway in oil markets and their implications for the countries that make up the Gulf Cooperation Council (GCC), as well as the other forces at work in their decision-making. Given its outsized importance within the GCC and to global energy markets, as well as the planned IPO of Saudi Aramco, there was a special focus on Saudi Arabia. This document provides a summary of the discussions of the roundtable, which was held under Chatham House Rule.

SHIFTING GEOPOLITICS IN THE MIDDLE EAST

One of the biggest questions now facing GCC nations is the approach that U.S. President Donald Trump will take to the region. Participants said Trump clearly intends to take a fundamentally different approach to US foreign policy than has been pursued over the past 50 years, and the role of the United States and the nature of the US alliances are in question. The new approach seems to take a more transactional and confrontational view of foreign policy than the ideological approach favored by recent administrations.

Despite the anti-Islamic rhetoric that Trump eschewed on the campaign trail, roundtable participants said there is a sense among some GCC leaders that relations with the United States could improve after the deterioration that occurred under the Obama administration for a number of reasons. The Arab Gulf states were very concerned about the Iran nuclear deal, especially Riyadh, which worried that this would lead to warmer ties between Washington and Tehran, at the expense of the Kingdom. Other concerns stem from feelings that the United States did not stand closely enough with the regimes

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of some of the GCC states during the Arab Spring when they were under pressure. There was also a sense that the Obama Administration did not really understand the threat posed by some of the groups that came to the fore during the Arab Spring, including the Muslim Brotherhood in Egypt, and that the United States did not have a deep enough understanding of some of the dynamics underway in the region. By the end of the Obama term, some attendees said that relations between Washington and Riyadh had dropped to their lowest point since 9/11.

As such, there is hope in some quarters that the Trump Administration's priorities of fighting ISIS and challenging Iran, as well as a more transactional approach to foreign relations in which human rights issues are less important – could lead to an improvement in relations between the United States and the GCC. Still it is not clear that the new Administration will completely ignore human rights issues, or that Trump will carry through on his threats and tear up or renegotiate the nuclear deal between the west and Iran. Renegotiation will be difficult unless it is paired with a credible threat of force, which some argued would run counter to the isolationist streak of the President. Some attendees noted that the possibility of establishing new non-nuclear sanctions against Tehran could draw concerns from US business that such sanctions would unfairly disadvantages them compared to companies from other countries, concerns to which Trump may be sympathetic.

With regard to the efforts to defeat ISIS, roundtable participants observed that Trump appears to see this as a military battle that can be resolved with force. Recent history of the United States in the Middle East suggests that a military victory that is not followed with governance and political reconciliation can lead to power vacuums that give rise to anti-US groups (such as ISIS itself). As such, the United States must recognize that economic, political and governance action must follow any military action, less it just lead to the emergence of another group like ISIS.

At the same time, it was stressed how difficult it is to predict the geopolitics of the Middle East given how fluid and dynamic the region is. It was stressed how the Bush Administration's decision to invade Iraq created major ripples of instability in the region. Attendees also discussed the evolving relations between Russia and the GCC, and whether the Saudis were seeking a more transactional relationship with Russia based on oil revenues – and despite the rising tensions between Iran and the Kingdom. While the lack of trust between Riyadh and Moscow remains, it was noted that if Russia actually complies with the deal with OPEC nations to remove oil from the market and boost prices, it could be seen as a confidence building measure. However, in the end, Russia cannot provide the GCC with what they want – security. The Saudis still need the United States for that, even if they are not particularly happy with this reality. It was also stressed how US and Russian national security interests are fundamentally at odds: Russia wants to split the US away from Europe and split up NATO. Moscow also supports Iran; Washington does not, a fact not lost on GCC capitals. Indeed, Russia's support for the Assad regime, helping to support it at a time when it was teetering was a serious problem for Riyadh. As Iran had previously provided aid to Assad, an alliance was struck between Tehran and Moscow related to Syria. Some attendees noted that Russia benefitted in cases where instability in the Gulf drove up oil prices.

Attendees discussed a range of US policies that could affect the GCC directly or indirectly through markets. US policies might impact global economic demand, it was noted, with one participant highlighting the so-called provision of public goods. Others said that it is not clear whether the Trump administration has the same commitment to maintain open, functioning energy markets that most recent administrations have had. If the US enacts tax cuts and simultaneously embarks on a major infrastructure spending bill, the deficit will expand and interest rates will likely rise, dampening demand growth in the GCC and other emerging markets. A related issue is the Trump Administration's emerging economic nationalism, and participants discussed the possibility of protectionist trade policies negatively impacting global growth.

GCC RESPONSES TO A CHANGING OIL MARKET

The outlook for global oil markets, which have seen prices plunge since mid-2014 thanks in part to rising US oil production and weaker demand from China, was also discussed at length, given the importance of oil price to the economies of the GCC. The discussion touched upon the late 2016 agreement between OPEC and non-OPEC producers like Russia to reduce output in a bid to balance the market and lift prices. Participants said that while there were signs that market conditions were improving, many stressed the process of rebalancing would likely continue through 2018. Others observed that the market had not experienced the kind of inventory draws that many market pundits anticipated. It was also suggested that even if the six-month agreement is not renewed, crude oil production policies in the GCC states are not likely to change dramatically -- production levels would likely remain consistent with Q4 2016 levels. In relation to the impact of market conditions to US oil production in 2017 and 2018, one attendee estimated that total US oil production will likely rebound to Q4 2014 levels, led by gains from the Permian Basin. Other participants said that even if markets are on the cusp of a sustained recovery, the quest for price stability will likely continue to be elusive, while still others forecast that oil markets are in for a period of sustained lower prices, referencing the fickle nature of financial markets and investment flows.

Some participants in fact questioned whether the recent OPEC/non-OPEC agreement to cut production will prove as historic as participants have made out. One noted that even with high levels of compliance among the 11 counties associated with the agreement, production cuts would be made from an elevated base, making the net effect less significant. Moreover, several other factors could blunt the impact of production cuts, including the possibility of Russian noncompliance, production cut exemptions for Libya and Nigeria, and whether even a modest price increase would push a reaction from US shale producers that would just nullify efforts to bring the market back into balance. Discussants generally agreed that oil markets were dealing with several new factors that fomented uncertainty, including shale oil elasticity, potentially weaker demand, and limited spare capacity.

Turning to the potential for GCC states to withstand a weaker oil price environment, discussants were divided. It was stressed that several GCC states had accumulated considerable foreign reserves cushions during periods of high oil prices that preceded the crash, however, there were huge difference between the various states. Kuwait, attendees said, has been rather resilient to lower oil prices and has continued investing in the oil sector. Qatar and the UAE were regarded as being in reasonably strong financial positions, while Bahrain, Oman, and Saudi Arabia were under increasing financial pressure. More generally, any drawdown of fiscal reserves could have negative implications for liquidity and loan growth, which could hurt efforts to diversify their economies.

Attendees also discussed the range of responses to low oil prices, including fiscal consolidation, subsidy reform, tax changes, and longer-term diversification of their economies. However, because oil revenues in many GCC states have sustained a long-term public largesse and wealth sharing system, it was noted that it will not be easy to change the social contract. Several challenges to improving fiscal discipline were highlighted, including: an overreliance on the state for job creation, corruption, and regional instability in places like Syria and Yemen that can add further strain to government budgets.

On the subject of Saudi Arabia specifically, one participant offered a bearish view on the state of the Kingdom's fiscal health, pointing out that it is running a $100 billion fiscal deficit with a fiscal breakeven oil price of roughly $85 per barrel and added that it is unlikely there will be a market determined equilibrium oil price anywhere close to that price range, straining the government's coffers. There was a wide divergence of views on the economy, however, with some attendees conveying a more optimistic outlook on the Saudi's ability to weather a low-price environment through its 2030 diversification plan.

PROGRESS REPORT ON ECONOMIC REFORMS: FROM VISION TO EXECUTION

Implementation of reforms, whether those entail gradually increasing taxes on business or reducing energy subsidies, will be challenging. With their economies often almost exclusively dependent on state spending, GCC countries face a conundrum: austerity measures will, on the one hand, help them balance their budgets by cutting spending, but also, on the other hand, undermine their budgets by weakening demand and hurting the domestic private economy. One attendee suggested that the leadership in the KSA does not fully grasp the scale of the contraction that will occur if it implements all the austerity measures outlined so far, highlighting that the size of the private sector is tightly correlated with state spending. Despite this, another participant conveyed an optimistic view on the resilience of the Saudi population and its ability to withstand the pain associated with austerity measures, noting that they did not expect any major organized opposition or social instability. Given the high levels of youth unemployment in the region, there was a shared view on the importance of education and technology. As such, diversification efforts in the GCC region will at least partly depend on reforms that improve the quality of education and opportunities for young people.

Overall, panelists agreed that Kuwait has been a bright spot in the region, emphasizing its comparatively robust balance sheet, improving levels of transparency in the financial sector, and greater accountability among Kuwait's publicly traded companies. The long-term outlook appeared more difficult, however, with some less sanguine on the nation's long-term ability to create jobs and reduce its dependence on oil revenue. One participant noted that Kuwait faces complications from the regional instability impacting other GCC states. It was also noted that lower oil prices have amplified the need for reform, and that social appeasement policies are easier to manage in an environment where there is less geopolitical tension. Some participants expressed the difficulty among policy makers to build consensus that short-term reform is needed in Kuwait. Another panelist made an important distinction about Kuwait vis a vis Saudi Arabia, pointing out that Kuwait's parliamentary system will make it harder for Kuwait to take the kind of decisive action that the KSA has over the past year.

More broadly, attendees expressed doubt on whether a distinct GCC model for economic reform is emerging, indicating that the particulars of financial and economic diversification will look different among GCC states. One participant argued that the UAE and Qatar are likely to be solvent for the foreseeable future, and went on to suggest that the expatriate-driven economic development of Dubai cannot easily be extrapolated as a growth model for the rest of Arab World. Overall, participants generally agreed that GCC states deserve a score of 2 out of 5 in reform execution, demonstrating a degree of skepticism based on the fact that embedded patronage systems across the region will be a major obstacle to sustainable reform programs.

REINVENTING NATIONAL OIL COMPANIES

Participants discussed some of the main differences among the regional national oil companies (NOCs), generally agreeing that governance structure is the factor that most differentiates the major NOCs. Specifically, attendees noted that the nature of the relationship between the oil company and the national government is the most important determinant of the scope and pace of reform. One participant noted that a prerequisite for success is the ability to reinvent the oil company itself, though there was a good degree of division among attendees on how much the NOCs of the GCC could actually reinvent themselves and what this process specifically entails. The focus on diversification thus far has been on integrating down the value chain, building out more refining and petrochemical capacity. Panelists raised doubts on whether or not increasing investment in the downstream segment of the business actually constitutes diversification or is just an extension of normal business activity. Attendees noted that financial transformation is one objective behind Saudi Aramco's IPO, but stressed that the real challenge will lie in broader economic plans and whether reform measures can meaningfully create new jobs. Kuwait, for example, has seen relative success in its diversification efforts, though panelists cautioned that financial diversification alone does not necessarily lead to a more vibrant private sector.

Other views on the Saudi Aramco IPO were offered. One participant emphasized that the IPO is intended to enhance transparency and governance in the oil sector, another suggested the IPO is more about raising revenue for diversification efforts. Yet another offered it is a reflection of Saudi Arabia's desire to double down and reinforce its competitive advantage in the oil sector, focusing on expanding petrochemical capacity.

On the subject of expanding investments in refining and petrochemical capacity, most attendees agreed this would be an important measure in the low oil price environment. Kuwait's strategy can be instructive to the KSA, as Kuwait is planning to spend $120 billion over the next five years on new downstream projects, including a large-scale petrochemical complex and a clean fuel project. On the question of reinventing the oil company in Kuwait's context, one participant noted that part of the broader diversification strategy is to emphasize growth in all segments of value chain. Additionally, Kuwait intends to pursue greater coordination with the private sector, gradually shifting more power to the private sector and less to the government.

Understanding the impact of the oil price collapse and the major changes underway in the oil market on GCC countries will require deeper analysis on a range of overlapping dynamics, and as such will be the focus of several forthcoming research streams from the Center on Global Energy Policy.

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