MENA and the Evolution of Oil Prices

Lili Mottaghi

Introduction: Since September 2014, world crude oil prices have fallen by more than half, setting a new low at $30 a barrel (Brent crude) in February 2016. Since then, prices rallied to $50 a barrel in May due to supply disruptions in Nigeria and Canada, and the seasonal increase in demand in the summer. The recent recovery did not hold because global stockpiles remain well above historical averages; Iran and Iraq are increasing production; and Russia and Saudi Arabia, among others, are producing at their highest levels since January 2016.

Even if the recovery is sustained, there is less chance that prices will revert to the triple digits observed during 2011-13 because of fundamental changes in the behavior of market players. In particular, with 4,200 idle oil wells (the backlog of unfracked wells) and a reaction time in ramping production up or down of about 4 to 6 months—compared with several years for conventional producers—the US shale oil industry may be the marginal producer. And Saudi Arabia appears to have relinquished its role as the swing producer who absorbs fluctuations in global demand and supply.

The Oil Markets New Normal: Clearly, the oil market has entered a new normal. This report seeks to understand the factors behind the new normal to discern the evolution of world oil prices in the future, and their implications for the economies of the Middle East and North Africa (MENA). We begin by trying to explain the oil price crash of 2014, noting that it was preceded by a significant increase in the size and frequency of volatility of oil prices. This volatility in turn contributed to the accumulation of oil inventories that many observers, including the U.S. Energy Information Administration (EIA), attribute to the decline in oil prices. Noting that, historically, oil price slumps have lasted longer than spikes, we suggest that the current situation may persist because of the changing behavior of market players, and the fact that overall oil demand is weak and not expected to rebound anytime soon.

Indeed, we find that the correlation between oil production and prices, which used to be positively-sloped, has turned negative: a decline in oil prices is met by an increase in production.

---

1 This Quick Note is derived from the MENA Quarterly Economic Brief, July 2016: Whither Oil Prices?. Washington, DC: World Bank. © World Bank.
2 Lili Mottaghi, Economist, Office the Chief Economist, The Middle East and North Africa Region (MNACE), the World Bank.
In the absence of a pickup in demand\(^3\), this situation can result in rising oil inventories going forward.

**Figure 1.** Correlation between Oil Prices and Production (May 1987 – January 2016)

Rebalancing the World Oil Market: Putting these findings together, we expect the world oil market to work through its current oversupply and rebalance in early 2020 at market-clearing prices that are close to the marginal cost of the last producer (US shale oil producers). Oil prices are likely to be in the range of $53 - $60 a barrel. Prices higher than the upper bound would encourage drilling rigs leading to another supply glut; prices below the lower bound would prevent them from entering the market. However, risks to the timing of market rebalancing remain high, stemming from an expectation of lower demand and continuation of the oil glut as the return of Iran, Libya and Iraq to the oil market could exacerbate the oversupply situation in the market, pushing prices further down. Other risks include the U.K.’s surprising vote to leave the European Union (EU) on June 23, 2016 (Brexit) which led to a 5 to 6 percent decline in spot and futures prices. While futures regained their losses in the aftermath of Brexit (on June 29th) as the market has been focusing on the oil glut – it may slow down our projections for pricing and the timing of market rebalancing.

To be sure, our analysis shows that oil prices will more likely settle close to $60 a barrel by 2020. There is a consensus in the US shale oil industry that at oil prices above $60 a barrel, the industry would pick up. In effect, that would put a ceiling on oil prices, because as soon as oil becomes expensive enough, there will be more drilling and more supply coming on the market.

The New Normal and MENA’s Oil Producers: The new normal for oil prices will prove difficult for MENA’s oil producers, as they are well below the prices needed to balance budgets. Break-even oil prices have increased substantially over time due to governments’ high spending during the boom years particularly after the 2011 Arab Spring where governments of both oil-exporting and importing countries increased subsidies and the public-sector wage bill. For example, Saudi Arabia introduced a welfare package worth of $93 billion. Oil importers such as Tunisia and Egypt, buoyed by remittances and aid from oil-exporting countries, also raised subsidies and civil-service wages.

Oil Wealth and MENA’s Old Social Contract: MENA countries are well known for their procyclical policies, especially their spending during oil booms, and this has shaped the trajectory of their economic growth. Historically, oil wealth has been used to support the existing social contract between the state and citizens, where the former provided fuel and food subsidies, free health and education, handouts and public sector jobs in return for muted citizen voice and limited accountability (Devarajan and Mottaghi, 2015). That contract is fraying. Governments throughout the region are taking measures long considered impossible such as imposing taxes, eliminating fuel subsidies and reducing public sector jobs and salaries. The sharp drop in oil prices in 2014 is changing this picture.

Almost every oil-exporting country is cutting subsidies to fuel, electricity, gas, and water (Devarajan and Mottaghi, 2016). Even oil importers such as Morocco, Egypt, and Jordan,

---

\(^3\) Preliminary estimates by the World Bank show that the recent vote in favor of the U.K.’s leaving the European Union is likely to slow global growth even further.
who started reforming subsidies in 2014, are shifting from a fixed domestic price of fuel to one that is tied to the world price. Many are cutting public spending and some, like Algeria, are freezing public-sector hiring. Morocco and several GCC countries have introduced energy-efficiency improvements, lowering carbon emissions. These reforms, if sustained, could enhance the efficiency of MENA economies going forward.

**An Emerging New Social Contract?** This time seems to be different. With low oil prices staying for a long period, governments in the region are not only taking austerity measures seriously, but they are introducing some bold measures that are expected to transform at least part of the old social contract. These reforms include reducing the bloated public sector wage bill, privatizing State Owned Enterprises (SOEs), and diversifying their fiscal revenues away from oil through increasing direct and indirect taxes. The group of GCC countries is preparing to introduce Value Added Taxes (VAT) for the first time.