UPES Centre for Continuing Education

A Report on

The Relationship Between economy, oil and politics in a developing country.

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Sign of Student Sign of Guide

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Further, I certify that the work is based on the investigation made, data collected and analysed by him and it has not been submitted in any other University or Institution for award of any degree. In my opinion it is fully adequate, in scope and utility, as a dissertation towards partial fulfilment for the award of degree of MBA.

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1.Introduction

Many oil-based countries failed to boost their economy development despite the long period of high oil prices going from 2002 to 2014. 12 years of inflated prices were marked by a more or less stagnated economy. While possessing large oil and shale gas resources for decades, many oil-based countries were and are still suffering from an economic collapse. This situation was long called the resource curse. The combination of oil price volatility, the pressure on agricultural and manufacturing sectors, the development of inequalities, and the disincentive effects of tax and weak institutions all result in a failure of policies and a growth collapse.

Since June 2014, oil markets have shown a significant fall in oil prices thus putting a lot of pressure on oil-dependent countries all over the world. Several reasons to this fall were identified by experts; among the main causes listed are: an oversupply faced to a declining demand (mainly the US dependence on oil), the technological innovations that decreased the liquid fuel consumption in engines, the nuclear deal in Iran, the high US dollar value, the shale revolution in the United States and the geopolitical tensions in the Middle East. The shale revolution influenced the global energy markets to the point that many countries that are solely dependent on the oil resource started then to be alarmed about the danger of this crisis. This paper highlights the strange situation in which many countries that are rich in natural resources are suffering from an economic vulnerability, internal conflicts and bad governance comparatively with the other countries lacking those same resources. This is called the resource curse, also called "the paradox of plenty" of oil-countries that have no clear vision of the post-oil.

With the current changes in the oil market, and the shale revolution in the US, many governments are catching up and the experts have shifted their attention to the role of institutions. The institutional component is now a lead to government development success.

2. Factors of the Resource Curse

The last 50 years show that the consequences of development, which is exclusively based on the export of petroleum, have tended to be negative. Among the apparent adverse effects are: an economic growth that is slower than expected, a weak economic diversification, bad indicators to the social well-being, corruption, high levels poverty and inequality, appalling environmental impacts at the local level, exceptionally poor governance and a rather high frequency of conflicts and wars. Countries exporting mining or petroleum products suffer from a surprisingly high level of poverty, inadequate health care, widespread malnutrition, a high infant mortality, low life expectancy and poor performance, especially compared to

countries dependent on agricultural exports. Given the financial income of rich countries from natural resources, the poor situation is very astonishing. Because of the extreme volatility of oil markets, exporting countries are often the victims of brutal declines in per capita income and huge growth collapses.

The surprisingly negative outcomes of countries dependent on both oil resources and mining are known as the "resource curse". Before studying what is the resource curse, however, it is useful to clarify what it is not. Resource curse does not mean that the abundance of natural resources is always or inevitably bad for economic growth or development. However, the resource curse does not refer to the mere possession of petroleum or other minerals but rather it refers to countries that rely too heavily on oil revenues. This dependence is generally measured by the extent to which oil exports dominate total exports in general, from 60% to 95% of the total.

Theories that try to justify the poor economic performances are very diverse and debatable, but there is a combination of factors resulting in the exporting oil countries to fall into the category of: political failure and growth collapse. The economists outlined the main characteristics that have a negative impact on growth in four main factors:

i. Oil Price Volatility

The international oil market is probably the most unstable in the world and politicians have difficulty managing sudden price fluctuations and the economic expansion that follow. The price volatility has a significant negative effect on budgetary discipline control of public finances, as well as public planning efforts. It is also accompanied by a negative impact on real investment, income distribution and poverty reduction. Latife Ghalayini (2011) suggested that usually oil price shocks will influence the economic performance in a number of ways which in itself influence the world economies especially when there is a limited oil purchase by oil importers. Indeed, the increase in oil price has an impact on both oil importers and oil exporters. Of course, extractive industries have found ways around access problems by several strategic methods going through insurance, corporate planning, and cost reduction analysis. Price fluctuation is a business risk that can be managed effectively with good planning. Similarly, price volatility is also a risk on government finances that can be bypassed with strategic planning. Except that volatility is not considered as a risk but as a curse.

ii. "Dutch Disease" or Failure to Compete

Oil-dependent countries often suffer from what is called the "Dutch disease", a phenomenon in which the oil industry causes a rise in the exchange rate of the local currency, which automatically makes other exports very uncompetitive. Indeed, oil exports become the centre of exports and blocks other export sectors, including agriculture and manufacturing. This may raise the difficulty in diversifying the economy, and it can also inflict a permanent

damage to the economy. In response, policymakers often adopt strict policies to support and protect the less competitive economic activities.

iii. Lack of Skill and Performance Quality

Another argument other than the recurring "curses" and "diseases," is about governments own performance and skills. If an institution is able to manage the whole investment mechanism, then it can stabilize expenditures, and sterilize any excess revenue inflows of foreign currency. Since 2014, a high and first priority emerged as the importance of saving money and regulating fiscal spending to adverse any negative effects from oil price fluctuation. Various countries have already developed fiscal austerity policies, and created stabilization funds and other similar measures in order to reduce budget spending and curb the welfare provision. In that sense, the resource curse is perceived as an institutional rather than an economic problem. Additionally, the oil-sector industry is an industry that requires skilled workers but usually the qualified labour is brought from abroad which deprives the exporting country from creating employment positions to their locals. Additionally, because the demand for petroleum education/training is low, this weakens further the exporting country.

iv. Problem of Taxes, Fiscal insecurity and Management of Revenue

In many countries, oil projects are often large-scale projects that are owned by foreign companies. Therefore, production linkages with any other sectors of the economy of these countries are low. In general, revenues from oil exploitation go directly to the government, either as royalties or rents paid by foreign oil companies, or as taxes and profits earned by public enterprises. This arrangement is not conducive to the establishment of separate tax systems of oil, which further exacerbates the dependence on oil.

3. Developing Countries Oil Challenge

The decline in oil prices since June 2014 has forced oil producing countries to adapt to a new economic and social reality, plunging several states into deep economic and social crises linked to the depreciation of the exchange rate of their currency in dollar, their low tax reserves, and the declining fiscal dependence on oil revenues. Since the beginning of 2015, the oil economies have entered an era of drastic reduction in their spending and are trying to contain the social discontent linked to the reduction of subsidies and other benefits. The most spectacular crisis is affecting Venezuela. Despite the historic May 2016 agreement between member and non-member countries of the Organization of the Petroleum Exporting Countries (OPEC) to restrict crude oil production (which was extended from May 25, 2017 to March 2018), the outlook remains uncertain today, particularly in the face of the rapid development of American shale oil.

Beyond these immediate challenges to return to the path of economic growth, these states must also deal in the longer term with the "carbon risk", a risk that would constrain the production of hydrocarbons in the coming decades with the progressive deployment of energy transition policies. According to the International Energy Agency (IEA), the global oil demand is expected to decrease by some 20 million barrels per day (bpd) between 2017 and 2040; a decrease of about 20% from the current consumption. Most international oil companies (IPCs) are trying to adapt to control this carbon risk by diversifying their activities and strengthening the resilience of their assets; but the national oil companies (CPNs) of hydrocarbon-producing countries, in which the State holds more than 50% of the shares, do not seem to have taken the same initiative, even though they are being hit hard by the new reality of the oil market.

Some are assimilated to cash accumulation funds and do not have any real operational capacity. In countries like Venezuela, the state relies on its National Petroleum Corporation (NPC) to promote a political and social agenda, beyond economic goals. Other NPCs can take charge of developing national infrastructures or setting up social programs. Some companies are (or have been) run by the Oil Ministers, such as the National Iranian Oil Company (NIOC) until 2001, Sonatrach (2001-2003) and Petroleos de Venezuela SA (PDVSA) from 2004 onwards. CPN have activities that are usually the prerogatives of the State, like Sonangol, which rather acts as a regulator of the activities of the ICC in Angola and produces only a small part of the gas and oil extracted in the country. State-owned companies in emerging hydrocarbon-importing countries, such as China National Petroleum Corporation (CNPC), China National Offshore Oil Corporation (CNOOC) and China Petroleum and Chemical Corporation (Sinopec), occupy a special place in this landscape , their main objective being to guarantee access to resources with a large international deployment and foreign direct investments which have risen sharply since the 2000s, while ensuring strong domestic production where they are in a dominant position.

The role of the main oil and gas companies is variable in each producing country. Although the strategy of the National governments since independence in 1962 has enabled Sonatrach to explore, produce, transport and create wealth by itself, it is running out of steam today after the oil price decline. While the role of NNPC is very different from that of Sonatrach because the organization's goal is more about managing the profit generated by private companies. The 2014 crisis may lead to reforms, but this would require a strong political will and a long process of reforms to enhance all transparency and efficiency.

4. Research Focus and Objectives

To be able to answer the question about the link between oil endowment and development it is necessary to define 'development'. According to Sen (1999) development is another term for freedom – a proper wide definition that includes not only economic indicators but also

freedoms such as human and political rights, social opportunities, transparency and protective security, and this is when democracy should lead to development. For the sake of the limitation of words, this research will focus specifically on economic development through economic indicator such as growth, GDP, CPI, etc. Additionally, this paper considers the political and social development, which can be related and significant while assessing economic development.

The objective of my research is to show that dependency on oil revenues had hindered growth and economic development in the GCC. A government with sufficient income from natural resource rents has little incentive to invest in education, to broaden its institutions, to diversify its industries or to engage in various economic sectors because it does not need to live from other source of revenues, or taxes. (Verdier 2006)

Amongst the GCC, some countries have looked beyond their oil wealth and started investing in infrastructure and industries hence, they diversified their wealth and economic structure and escaped the oil curse while others and has failed in doing that and still relied thoroughly on their oil wealth. This is why I want to test which GCC countries succeeded and which one failed.

5. Outline and Research Plan

The first step in this essay is to discuss the notion of development process in the GCC countries in general through the literature review by comparing many scholars and literature where much has already been written taking place in chapter II. Section III examines my theory (the oil curse) and states the methodology that is going to be applied and the analytical tool that I am going to be building my data on. This paper will also reinforce some of Ross's work and discuss more his theory about the oil curse. In the 5th chapter of this essay, the discussion about my findings and my results will be led. Starting with the diversification plan in each of the country stated, this part is going to analyse and reassess their development plan in the past years. Moreover, this parts also looks at the statistical analysis and the regression using STATA where the data was collected and analysed to get the desired results. Finally, analysing all the results in the last part of the essay before jumping to a general conclusion, which will wrap up the oil curse theory and findings. Furthermore, a broader spectrum of research in this essay will be discussed. In short, this dissertation aims to provide clear answers to a number of challenges and look further to assessing the role of governments in the GCC countries, evaluating the occurrence of the oil curse and assessing the extent in which countries are affected by the curse. Moreover, this dissertation will question the likelihood of the diversification plan being translated into action, incorporating the diversification plan of each of Saudi Arabia, Oman and the UAE. In short it will assess the effect of the oil curse, and the extent these countries are escaping this curse.

6. Literature Review

The main objective of the literature review is to provide the different sources that are used to test the hypothesis, and that will answer the main question for this research: The relationship between oil, politics and economic change in developing countries.

Acemoglu and Robinson (2012) reveal in their book "Why Nations Fail", how some countries fail to achieve development and how others succeed, even within the same geographical boundaries. Acemoglu (2012) studies the motives behind countries that succeeds and the various factors that contribute to the failure of cothers. Acemolgu and Robinson indicated that the reason that keeps them immersed in underdevelopment, corruption and patronage. "Man-made political and economic institutions underlie economic success or the lack of it". In the context of this dissertation, this visualizes the case of the GCC, in countries like Saudi Arabia and Oman which fail while other like the UAE do not [1]. This statement also suggests that countries differ in their diversification process, governance and economic and political institution that have a big effect for the reason behind countries' success especially in Petro-states where the government, their allocation of resources, their way of ruling the country and their decision is very important while examining the nature of development in the country. Scholars has argued that a strong economy is always accompanied by strong institution and that is why some industrialized advance countries with abundance of resources like the UK Holland and Norway had not fail: because the discovery of the oil came at a time where democratic regimes were established, paralleled with good governance, empowered with the right technology, advancement and public accountability. While this is the case in the west, however, in the Arab states, especially in the GCC, democratic regimes, developed institution, availability of technology, public accountability, skilled workers, strong industries had not yet been shaped in the region and this is why these countries fail and fall under miner resource curse that later is going to be tested deeply. (Acemoglu, why nations fail). Karl(1997) argued that that large resource sector in itself is likely to produce poor institution of government although this has been challenged by Haber & Menaldo (2011), who proved statistically that resource abundance does not affect poor political outcome, but solving the larger question of orderly mis-use of resources encompasses fixing political systems and institutions which is beyond the scope of the paper.

Also, in this book, acemoglu and robinson stated: "Countries differ in their economic success because of their different institutions – the rules influencing how the economy works and the incentives that motivate people. Crucial is private property rights – which needs to be backed by the state.... In South Korea, people know that they will be rewarded for their efforts, in North Korea, there is no incentive to innovate and invest because the state will expropriate the benefits of any such initiatives." Linking it back to this dissertation topic we see that the state has failed to implement good education system in the Arab region of the GCC and

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people always rely to work for the government which might not require such know-how and innovation and for the government where in other terms get their wages every month which translated into other words , their gift from oil. A job in the public sector is almost guaranteed for every citizen of the GCC, in Kuwait for example, 91% of the Kuwaiti nationals work for the public sector, while in the private sector, it is 98% occupied by non-Kuwaiti's (Segal,202). Because of the low education system and the low motivation of the citizens, there are no such incentives for the people to innovate and when innovation is low, economic success remain stagnant.

What lagged in the analysis of Robyn& Acemoglu is the fact that they disregarded geography as being an important factor affecting growth. Early cultures relied heavily on agriculture, and that is how they started development, industries and machinery also prospered in other areas because they had water, they a crucial element of life that GCC countries do not have. Whilst in the case of GCC, geography turned to be really bad on development, the dry lands of the GCC which is almost 90% deserted, challenged the availability water, which is very limited. Dry conditions did not help agriculture to grow, that was a big challenge to build a nation from scratch, this barrier for development wasn't taken into consideration when analysing countries development. The case of Saudi Arabia, and neighbouring countries proves that these countries did not have the same advantage to grow as Europe or the US.

Moreover, in an ambitious study that includes 135 countries between 1950 and 1990, Adam prezwoski observed and studied sharply the fundamental relationship between both democracy and development and the direction of this correlation (causal relationship) and finds that, while political institutions do matter, regime type as such has no significant influence on states economic growth and national income. Linking it back to my dissertation topic, regime type does matter, the authoritarian regimes and leadership in the GCC countries do hinder growth by taking large part of the wealth, by not giving every citizen his/her fair share of oil revenue, and more. And when growth is hindered, economic performance decreases and therefore national income will be lower.

7. Data and Methodology

A case study is conducted that is focusing on three countries. Those 3 countries: Oman, UAE and Saudi have been chosen due to the similar attributes in geographical location, culture, authoritarian governance and influence of Islam, and because of the available of data for these countries. This study will rely on academic research, thorough analysis and data gathering. The Data has been extracted from policy papers issued from the World Bank, International monetary fund (IMF), National Bureau of Statistics (NBS), Sovereign Wealth Fund Institute (SWFI), Transparency International and the Economic and Social Commission for Western Asia (ESCWA) in addition to governmental reports and scholars' works.

8. Result Analysis

In short, those results prove that oil has a negative effect on growth and the higher the production of oil by the above countries; the more they suffer from the curse.

The results show that that oil production can be damaging and harmful for the economic growth and development. However, oil reserves do not seem harmful for these countries since they tend to stabilize the economy.

The regression results conclude that UAE tend to be the least affected from the curse, as their oil production does not correlate negatively with the GDP/growth per capita thus does not hinder development. Therefore, the above outcomes reveal that the UAE has escaped the oil curse. On the other hand, the obtained results from the regression on the Omani GDP per capita growth, population growth and lagged real oil production indicate that Oman is affected the most between the three observed countries. The Omani economic development is shown to be the slowest and weakest. Finally, Saudi Arabia's results are vague due to the contradicting results in the regression, hence those results cannot conclude whether Saudi Arabia falls in the oil curse or not.

Due to the vagueness in some of the results of the regressions in this section sections, more structural data such as secondary source analysis (development and diversification plan) and statistical/ graphical analysis are going to be looked at in this dissertation. Those methods in the matter of this study, will give a more precise results on the position of each country's level of diversification, economic growth, degree of development. Thus, deducting their involvement vis-à-vis of the oil curse.

9. Conclusion

When a government discovers oil reserves on its country's soil, it is normal that it starts to think strategically about how to manage the fiscal regime and implement a new system to earn high revenues. Every oil resourced country needs to have a policy that improves the gains. These gains are supposed to be shared with the society in many ways. However, the existence of a strategy or a policy does not mean this approach is forcibly successful because there are many factors that may influence the value of oil. The increase or decrease of oil prices, the fiscal system, the number of injection and production wells, the government corrupted system or unskilled professionals, and more importantly the government institutional system. Even a mineral-exporting country is capable to develop its economy if its institutional component is robust. Indeed, there is no economic development when boosted by a deficient institution, and vice versa. However, the high level of institutional development alone is not sufficient for a robust strategy.