IJER © Serials Publications
13(2), 2016: 553-561
ISSN: 0972-9380

THE MACROECONOMIC IMPACT OF THE RECENT DECLINE IN OIL PRICES ON KUWAIT'S ECONOMY

Hassan Sharafuddin*

Abstract: *The oil sector in Kuwait accounts for about 95% of the governmental income of the country. The recent sharp decline in oil prices has threatened the future growth of the country's GDP growth and levels of investment. This paper investigates the macroeconomic impact of the declining oil prices on Kuwait's economy. This paper adopts a quantitative methodology to identify the impact of lower oil prices on economic activity in Kuwait using historic data going back to the mid-1990s to estimate the impact of current events.The study found that the correlation between oil prices and investment, oil prices and slower GDP growth, and oil prices and current levels of investment within the region has served to indicate not only the resolution to those questions but also has allowed insight into potential additional areas of study that will shed further insight into this matter.*

INTRODUCTION

In Kuwait, the oil sector accounts for approximately half of the GDP, makes up approximately 95% of revenues received from exports, and accounts for 95% of the governmental income of the country, indicating a high level of reliance on oil within the country (Index Mundi, 2014). Given the fact that the country does not have any control over fluctuating oil prices, as such a task falls to the responsibility of OPEC, the Organization of Petroleum Exporting Countries, this study seeks to explore the macroeconomic relationship that has emerged as a result of the decline in oil prices and how that decline has affected Kuwait (Hoium, 2015; OPEC, 2015). It is anticipated that it will be shown that the declines in oil prices have had a significant effect on both economic activity and price indexes within the region. While in some countries, lower oil prices are viewed as a positive for both household energy consumptions and the government, most of these countries are in the business of importing oil, not exporting it. Kuwait's economy relies heavily on the oil industry; therefore, a change in oil prices heavily affects the gross domestic product (GDP) along with other macroeconomic issues, such as the consumer price index, inflation, and even taxation. This is not the first time that decreased oil prices have had the potential to cause issues for Kuwait; however the last time that such an event occurred was in the late 1990s (Middle East Economic Digest, 1998).

PURPOSE OF THE STUDY

The purpose of the study is to further investigate the macroeconomic impact of the declining oil prices on Kuwait's economy currently being faced by the country in terms of its dependence on oil in light of changing economies allowing for an identification of the relationship between the price of oil and the investments in the region, focusing on the role of uncertainty regarding oil prices and whether or not this will slow the GDP growth of the country or if current investment will be depressed in the region. In addition, this study will work to identify the true effects of oil dependencies within the region, allowing for the determination of the true impact of declining oil process within the region. While the country has attempted to make certain plans into diversification and a reduced dependence on oil as a result of the economic reforms of the early 2000s, it is not yet clear as to how effective such methods have been, particularly in light of predictions that Kuwait would be able to move beyond the financial crisis of the late 2000s. (Ford, 2003; Middle East Economic Digest, 2010).

METHODOLOGY

Economic models are not offered as full and detailed representations of the underlying economic reality. This is due to the high uncertainty in markets trends resulted from the political changes in the Middle East. In other words, the economic model cannot define the cause and effects in regression trends of oil price market. Therefore, This paper will adopt a quantitative methodology to be used to identify the impact of lower oil prices on economic activity in Kuwait using historic data going back to the mid-1990s to estimate the impact of current events. The negative of the oil futures spread may be viewed as a potential indicator of the fluctuations in the price of crude oil as driven by precautionary demands. The empirical analysis of this indicator is expected to provide evidence of how a decline in the oil price affects the macroeconomic activities of the country in the future and how this decline in oil revenues leads to slower growth in the GDP.

BACKGROUND

The fluctuation of oil prices has always played a role in macroeconomics, dramatically affecting all players in the field, both importers and exporters alike. Kuwait first started drilling for oil in the 1930s and started exporting oil in the mid-1940s (OPEC, 2015). The 1970s saw the price per barrel of oil fairly low, with the price of oil coming in at less than $5 per barrel though the price of oil rose steadily, until its peak in the high $30s per barrel in 1981 (EIA, 2000). From this point, however, the price of oil continued to deteriorate until the 1990s. As a result of the invasion of Kuwait by Iraq, the crude oil price collapsed followed almost immediately by the dissolution of the USSR, a fact that likewise worked to play a role in lowering the price per barrel of oil (EIA, 2000). This created a tricky environment, for at this same time, many of the energy companies in the US were either shutting their doors or merging with one another, while the amount of gas consumed continued to rise; such events worked to ensure that oil prices did not drop as much as they could have, though clean air amendments and pressure regulations likewise worked to affect the industry adversely as a larger amount of refining was needed (EIA, 2002).

Between 2007 and 2009, Kuwait was likewise affected by the global economic crisis, which in turn worked to depress crude oil prices, though the country was said to have plentiful reserves and the necessary cash to be able to push through this most recent economic crisis (Middle East Economic Digest, 2010). In spite of such high hopes, and in spite of the fact that as of 2014 the country had crude oil reserves of approximately 102 billion barrels, over 6% of global crude oil reserves, a country can only work to counteract adverse oil prices for so long (Index Mundi, 2014). The GDP however, indicates that though the country did take a dip in its GDP in 2010, in spite of record low oil prices, the GDP has continued to rise (Trading Economics, 2016).

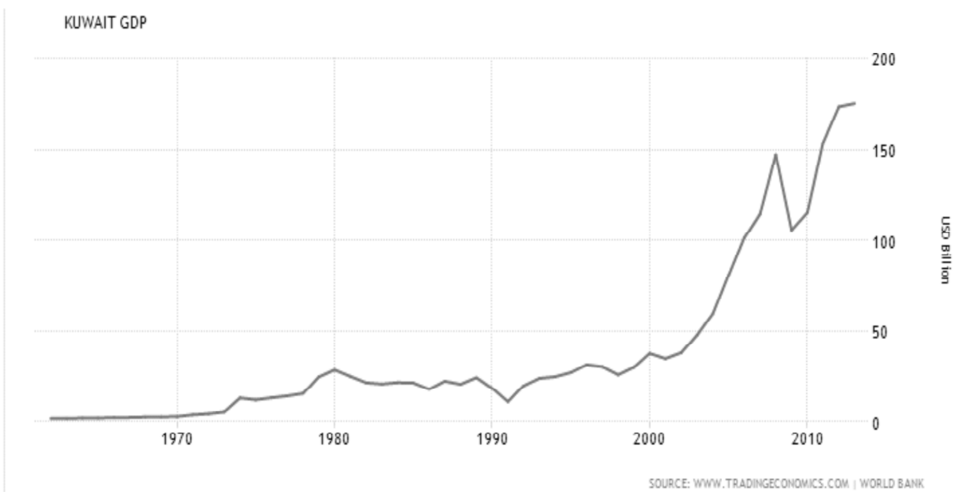

Figure 2: Kuwait GDP 1969-2016

Source: (Trading Economics, 2016)

KUWAIT TODAY

In 2014, aware that oil prices were still lower than desired, the country was confident that in spite of the lowest oil prices in four years that the country's plans for economic reform would not be affected and that output plans or rates of production for crude oil within the country would not be changed (Reuters, 2014). In fact, in spite of these four-year lows, the chief executive of the Kuwait Oil Company indicated that the company was on track to continue with the long-term plans of the company and the country to increase its overall production capacities (Reuters, 2014). The comments of the CEO were viewed as indicative of the fact that OPEC would most likely not decrease the output when it would meet in November of that year, in spite of the fact that $83 dollars per barrel was the lowest price seen in recent memory (Reuters, 2014).

In March of 2015,concerns finally started to arise. Oil prices continued to fall, reaching around $22 per barrel by the first two weeks of 2016. Though Kuwait still insisted that OPEC would not cut production, and though OPEC stated that it had no plans to cut production, as market share must be maintained, it was clear that the country was starting to feel the pressure (MacDonald, 2015; Reuters, 2015). Kuwait and the International Monetary Fund (IMF) started exploring the different ways in which the country could work to expedite its plan of diversification, allowing the country to ride out the low oil prices (Ford, 2003; Tully, 2015). Reports from the country indicate that the decreased oil process caused the GDP to shrink in 2014 as a result of a 1.7% contraction in prices associated with oil-generated funds (AFP, 2015). This resulted in a decrease in the Kuwait budget by 60% at the end of the last year, as indicated by the emir (Associated Press, 2015). In spite of such issues, within the 2015 year, the non-oil GDP was able to grow by 2.1% indicating that the measures being taken by the country were working, albeit slowly (Middle East Online, 2015). Further budgetary cuts were called for at the end of October by emir Sheikh Sabah Al Ahmad Al Jaber Al Sabah (Vela, 2015).

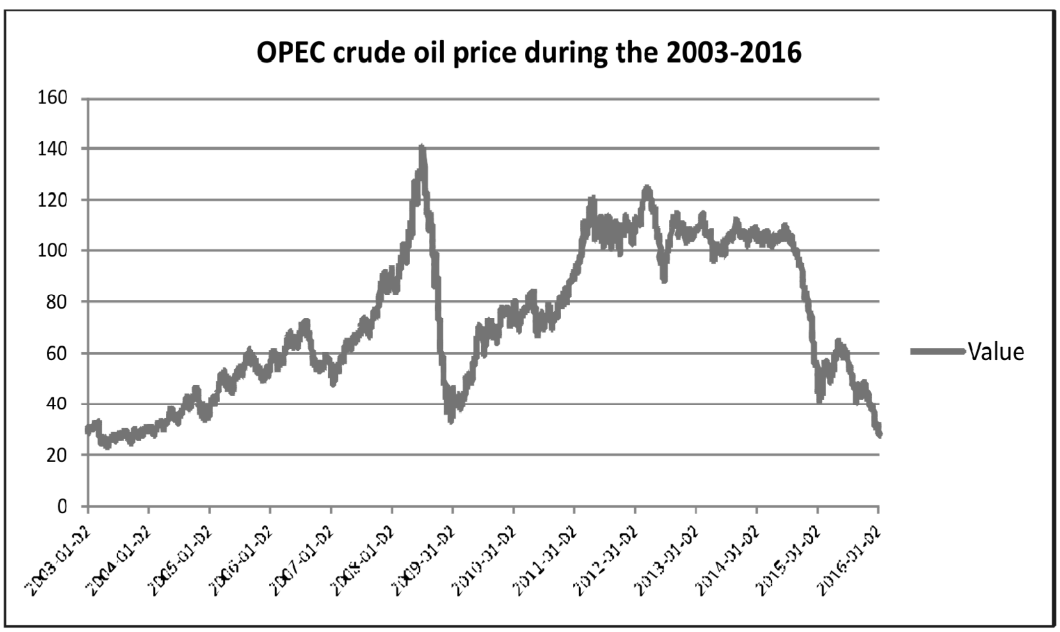

Figure 1: OPEC crude oil prices 2003 – 2016

(Source: https://www.quandl.com/data/OPEC/ORB-OPEC-Crude-Oil-Price)

ANALYSIS

Though the current price of crude oil has fallen since 2012, and though the prices of oil have not stabilized as of yet, there are certain factors that must be taken into consideration (Institute of Banking Studies, 2015). First is the fact that the country has the largest crude oil reserves in the world (Index Mundi, 2014). Second, the country has a high level of surplus cash funds and all reports indicate that the amount of surplus that the country has in reserve is enough to see it through these difficult times, while still aiding in the restructuring necessary to reduce overall oil dependencies (Middle East Economic Digest, 2010). Although the country needs oil prices to reach $78 per barrel in order to balance its budget (see Figure 5, below), the country is and will be able to continue operating at a deficit for many years (Bowler, 2015).

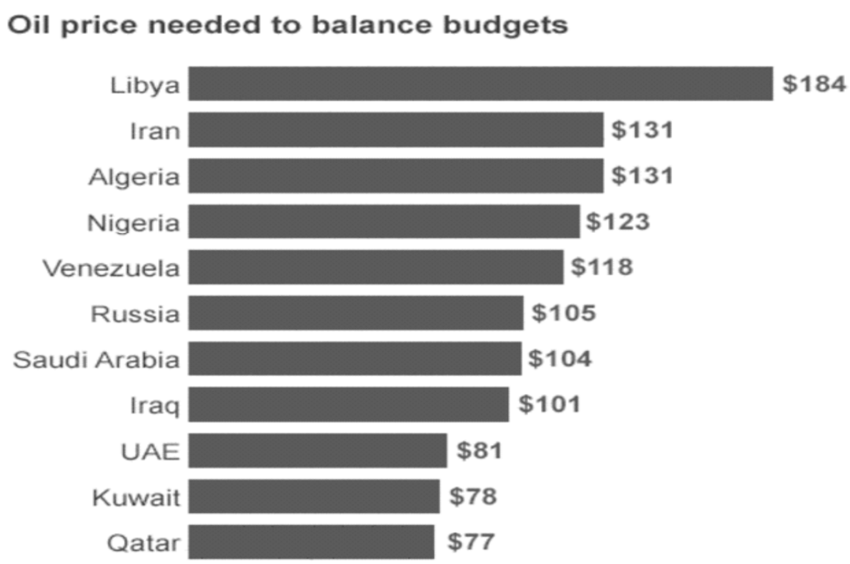

Figure 5: Oil Prices Necessary to Balance the Budget

Source: (Bowler, 2015)

What this means is that government expenditures for not only the 2014-2015 year remained largely unaffected, but that the government expenditures for the 2015-2016 year are expected to remain largely unaffected as well (Institute of Banking Studies, 2015). The country is taking proactive steps to ensure that it will be able to sustain, such as the consideration of additional taxes, however these measures are not immediately necessary and serve as a means of allowing the country to sustain its current state of economic reform (AFP, 2015; Ford, 2003). According to the Institute of Banking Studies, even assuming that the government were to spend "KD 21 billion in 2015/16 (an increase of 4.5 percent over our 2014/15 forecast) and the Brent oil price to average $60 per barrel, we estimate GDP would be KD 38.8 billion (a decline of 15 percent from our 2014/15 forecast), and that the government would run a small and entirely manageable fiscal deficit of 2.6 percent of the GDP" (Institute of Banking Studies, 2015, p. 3). Furthermore, results of the analysis conducted by the Institute of Banking Studies (2015) indicates that if any decrease is found in investment, it is not as a result of oil prices, but instead stems from fluctuations in the real estate market and the current levels of non-performing loans in correlation to the gross loans. The Institute of Banking Studies (2015) indicates that, at this time, such matters are more volatile and have a higher level of effect on the current market in Kuwait than the declines in oil prices. It should be noted, however, that there is a likelihood that the decline in real estate prices may have to do with the decline in oil prices, though no such correlation has been directly made as of yet.

DISCUSSION, CONCLUSION, AND RECOMMENDATIONS FOR FUTURE RESEARCH

It is hypothesized that, while there is no current immediate correlation between the relationship between the price of oil and the level of investments occurring within the region, and though studies show that current uncertainties stem from matters unrelated directly to the current decreases in oil pricing, as evidenced by the Institute of Banking Studies (2015), that there are still indirect channels of affect that have an influential role in the amount of investments occurring within the region. This serves to indicate that though decline in the oil price has affected the macroeconomic activities within the region to a certain degree, the primary means of affect has been a shift away from dependencies on the production and exportation of crude oil and a shift toward alternative means of income generation, which, while slower, work to ensure that the country has more than enough resources to be able to easily weather this particular storm, affecting a positive change within the country, one that has been planned for more than a decade (Ford, 2003). This latest drop in the price per barrel of crude oil serves as a means through which the country will be empowered to make the changes that it has desired, a particularly beneficial concept in today's world, where a gradual shift to other alternative fuel sources has been occurring for the past five to ten years.

Results do indicate that the fluctuating oil prices have had an effect on a macroeconomic scale, whichhas in turn caused the country to shift its focus away from oil production and exportation as its primary source of GDP; these changes have not drastically adversely affected the country (AFP, 2015; Ford, 2003). Results further indicate that while the GDP does increase at a slower rate due to the decline in oil revenues, results indicate that the GDP is still continuing to increase, showing that the situation has not been entirely adverse for the country (Trading Economics, 2016). The country has shown remarkable growth in spite of the hit taken to its primary source of income, indicating that the country's transition from an oil dependent nation is well on its way (Ford, 2003). However, it will still take time for the country to work to even out the differences between the current reliance on oil, its budget, and its boost toward a GDP driven by non-oil production (Middle East Online, 2015). As a result, it is anticipated that though the country may either stay within its budget or operate at a small deficit during this transitory period, the oil industry is not what is currently affecting further macroeconomic development (Institute of Banking Studies, 2015).

To this end, it is recommended that additional research be conducted to further investigate this matter. It was hypothesized, following the dissemination of information by the Institute of Banking Studies (2015) that though the decline in oil prices is not the primary causal factor when it comes to the level of investment in the economy, it may be a secondary factor. In order to investigate this matter, certain steps are recommended. It is first recommended that research be conducted to determine the specific differences between the non-performing loans and gross loans within the country, allowing for a determination on the effects of such loan fluctuations. It is further recommended that it be determined as to whether the decrease in the real estate market is because of outside factors, such as a lack of total recovery following the global economic crisis of the late 2000s, or whether the decrease in the real estate market is as a result of individuals whose funds are tied up in the oil market right now not having anything additional that they are willing to invest in real estate, or because of some other reason. Once this information is determined, a true identification of which factor plays the largest role in the current level of investment, the loan percentages or the real estate market, can be determined. Following the completion of this research, it will then be possible to identify whether or not the fluctuations in oil prices are a secondary cause of the current issues present within the region. While such issues are not currently a large issue, though still cause for concern and careful planning, this does not make it any less relevant in the identification of such information. Furthermore, the identification of such information will work to further serve the purpose of this study, in terms of the identification of levels of causality between the price of oil and investment.

The brief exploration of this topic of interest has worked to ensure that the basic questions regarding the correlation between oil prices and investment, oil prices and slower GDP growth, and oil prices and current levels of investment within the region has served to indicate not only the resolution to those questions but also has allowed insight into potential additional areas of study that will shed further insight into this matter. It should likewise be noted that Kuwait is not the only country that has been affected by declining oil prices; while those that are primarily importers of oil are benefitting from the situation, other countries, like Kuwait, whose primary consideration is the exportation of the same, are not doing as well as Kuwait is. Dubai experienced a large issue in the late 1990s, as it did not have the capital reserves that Kuwait currently has available (Ford, 2003). Russia is experiencing a high level of issue as a result of the decline in oil prices, and Nigeria is likewise experiencing a high level of issue (Bowler, 2015). While these are by no means the only countries that are adversely affected as a result of decreased oil prices, they are some of those that are affected the most severely as a result. To this end, exploration and identification of underlying causalities that may be detrimental on a macroeconomic scale can work to assist not only this country, but also other countries who are experiencing similar issues, with varying degrees of severity.

References

AFP (Associated Free Press), (2015), *Kuwait economy shrinks on falling oil prices*. [online] Yahoo News. Available at: *http://news.yahoo.com/kuwait-economy-shrinks-falling-oil-prices-170106024.html* [Accessed 8 Jan. 2016].

Associated Press, (2015), *Kuwait budget down 60 percent on low oil prices, emir says*. [online] Fuel Fix. Available at: *http://fuelfix.com/blog/2015/10/27/kuwait-budget-down-60-percent-on-low-oil-prices-emir-says/#34482101=0* [Accessed 8 Jan. 2016].

Bowler, T. (2015), *Falling oil prices: Who are the winners and losers?*. [online] BBC News. Available at: *http://www.bbc.com/news/business-29643612* [Accessed 8 Jan. 2016].

'Dubai boom has a lesson for Kuwait' 2010, *MEED: Middle East Economic Digest*, 54, 34, p. 7, International Security & Counter Terrorism Reference Center, EBSCO*host*, viewed 8 January 2016.

EIA, (2000), *Critical Petroleum-Related Events and U.S. Refiner Acquisition Cost, 1970-2000*. [image] Available at: *http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petrochrohotgraph.htm* [Accessed 8 Jan. 2016].

EIA, (2002), *PETROLEUM CHRONOLOGY OF EVENTS 1970 - 2000*. [online] Available at: *http://www.eia.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm* [Accessed 8 Jan. 2016].

Ford, N. (2003), 'Who needs economic reform?',*Middle East*, 336, pp. 50-51, Academic Search Premier, EBSCO*host*, viewed 8 January 2016.

Hoium, T. (2015), *Why OPEC Might Be Prepared to Raise Oil Prices*. [online] DailyFinance.com. Available at: *http://www.dailyfinance.com/2015/03/11/why-opec-might-raise-oil-prices/* [Accessed 8 Jan. 2016].

Index Mundi, (2014), *Kuwait Economy Profile 2014*. [online] Available at: *http://www.indexmundi.com/kuwait/economy_profile.html* [Accessed 8 Jan. 2016].

Index Mundi, (2015), *Kuwait Inflation rate (consumer prices) - Economy*. [online] Available at: *http://www.indexmundi.com/kuwait/inflation_rate_%28consumer_prices%29.html* [Accessed 8 Jan. 2016].

Institute of Banking Studies, (2015), *What is the Impact of Lower Oil Prices in Kuwait and on the Kuwaiti Economy*. [online] Institute of Banking Studies, pp.1-20. Available at: *http://www.kibs.edu.kw/upload/The_Impact_of_Lower_Oil_Prices_in_Kuwait__English_KIBS_1402.pdf* [Accessed 8 Jan. 2016].

KAMCO Research, (2011), *Kuwait Economic & Oil Outlook*. [online] Available at: *http://www.kamconline.net/NewsDetails.aspx?newsId=43920&language=en* [Accessed 8 Jan. 2016].

MacDonald, F. (2015), *Kuwait Says OPEC Has No Choice But to Keep Oil Production Target*. [online] Bloomberg Business. Available at: *http://www.bloomberg.com/news/articles/2015-03-19/kuwait-says-opec-has-no-choice-but-to-keep-oil-production-target* [Accessed 8 Jan. 2016].

Middle East Online, (2015), *Falling oil prices take their toll on Kuwait economy*. [online] Available at: *http://www.middle-east-online.com/english/?id=73842* [Accessed 8 Jan. 2016].

'Oil price slide piles on the pressure' (1998), *MEED: Middle East Economic Digest*, 42, 9, p. 12, Business Source Complete, EBSCO*host*, viewed 8 January 2016.

OPEC, (2015), *Kuwait Facts and Figures*. [online] Available at: *http://www.opec.org/opec_web/en/about_us/165.htm* [Accessed 8 Jan. 2016].

Reuters, (2014), *Kuwait says no impact on output or plans from oil price drop*. [online] English.alarabiya.net. Available at: *http://english.alarabiya.net/en/business/energy/2014/10/16/Kuwait-says-no-impact-on-output-or-plans-from-oil-price-drop.html* [Accessed 8 Jan. 2016].

Reuters, (2015), *US crude settles down 70 cents, at $43.96 a barrel*. [online] CNBC. Available at: *http://www.cnbc.com/2015/03/18/oil-falls-to-55-as-kuwait-comments-refocus-on-oversupply.html* [Accessed 8 Jan. 2016].

Trading Economics, (2016), *Kuwait GDP | 1969-2016*. [online] Available at: *http://www.tradingeconomics.com/kuwait/gdp* [Accessed 8 Jan. 2016].

Tully, A. (2015), *Low Oil Prices Force Kuwait To Consider Unpopular Taxes*. [online] OilPrice.com. Available at: http://oilprice.com/Latest-Energy-News/World-News/Low-Oil-Prices-Force-Kuwait-To-Consider-Unpopular-Taxes.html [Accessed 8 Jan. 2016].

Vela, J. (2015), *Kuwaiti emir calls for spending cuts over low oil prices*. [online] The National. Available at: *http://www.thenational.ae/world/middle-east/kuwaiti-emir-calls-for-spending-cuts-over-low-oil-prices* [Accessed 8 Jan. 2016].