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Petrostates in a changing world

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Oil remains one of the world's most important commodities, and petrostates like Saudi Arabia or Russia are major players in global markets and institutions thanks to their oil wealth.

Yet their governments are also heavily dependent on the revenues from oil and gas production, creating negative domestic market distortions and political problems. Recent dramatic changes in the global oil market compound these problems, as new extraction technologies shift production away from OPEC and other traditional producers, and raise the worrying possibility of domestic instability in petrostates.

The changing landscape of oil production will ultimately have major impacts on how these states interact with the global economy in the future.

Petrostates abroad

"Petrostate" is a useful shorthand term, but for many scholars who study the political and economic issues surrounding oil production, it is not the presence of an oil or gas extraction industry that defines a petrostate, but the extent to which a state is dependent on oil rents.

This separates states like Saudi Arabia or Nigeria, where the government relies on oil wealth for revenue, from states like Norway, Canada or the U.S, which are major oil producers but have well-diversified economies and broad tax bases. Though for much of the last 50 years, the world's biggest oil producers have also been petrostates – i.e., Russia or members of OPEC - this is no longer the case. The world's five biggest oil producers last year might surprise you: the United States, Saudi Arabia, Russia, China and Canada.

In contrast, the five top revenue dependent petrostates are more stereotypical: Kuwait, the Republic of the Congo, Equatorial Guinea, Libya and Saudi Arabia. Oil revenues can be lucrative for such states.

In Kuwait, for example, oil and natural gas rents in one year (2012) equaled 184 percent of government spending. Oil and gas revenues also enrich elites within these states, with Russian oligarchs and Saudi royals numbering among the world's richest individuals.

Petrostates influence world markets thanks to their disproportionate wealth. Notable in this category are the Gulf States, for whom petrodollar "recycling" has long been a way of life, with oil sale proceeds turned around, saved, invested or used to purchase imports of manufactured goods.

This has seriously impacted global markets in the past. In fact, massive petrostate bank deposits following the 1970s oil crises are widely believed to have driven the 1980s debt crisis. Since 2000, however, investment has become a popular way for petrostates to handle their cash surpluses, with petrodollars increasingly funneled into western financial markets. In 2008, for example, the countries of the Gulf Cooperation Council - all petrostates - invested about half of their oil revenues in such assets.

The scale of these investments increases with rising oil prices; Kuwait, for example, saw its foreign reserves grow tenfold from 2000 to 2008 alone.

The mushrooming of Sovereign Wealth Funds since 2000 has been the result. In 2015, global SWFs totaled $7.1 trillion, of which $4.29 trillion were oil and gas funds. SWFs are relatively small but influential players in global financial markets: $7.1 trillion globally compares to around $15 trillion in pension funds, for example.

These SWFs come in several forms, including savings funds, owned by states like Norway, which seek to create a nest egg for the day when resources are depleted, and stabilization funds, where states seek to invest surplus income and create a hedge against future drops in oil price. In both cases, SWFs seek to guard the Achilles heel of the petrostate: its reliance on a volatile commodity.

Despite the amount of money involved, we understand little about petrostate investment patterns. SWFs are extremely opaque, especially those controlled by non-democracies.

In Kuwait, for example, the law actually prohibits SWFs from revealing their assets. But there are a few key facts we know. Petrostate SWFs do seem to be conservative in their investments, a trait which could actually prove a stabilizing force for global financial markets.

Some states, like Russia, operate multiple funds for different purposes: the Russian Reserve Fund is large - designed to act as an oil price stabilization tool - and invests in low yield, low-risk securities, while the National Welfare Fund invests in riskier, higher return instruments. The SWFs of the GCC states seem to be more profit oriented in their investments than those of states like Nigeria. Yet the opacity of SWFs has led to suspicion whenever they invest in key infrastructure in the United States or Europe, as well as to concerns that they could potentially influence market conditions in strategic sectors.

In addition to their economic influence, petrostates can derive political and military influence from their wealth. Wealth can be used as a tool of foreign policy, building up militaries easily, buying advanced weapons and hiring external contractors. In the case of Gulf allies like Saudi Arabia or the United Arab Emirates, the weapons and contractors are American; for less friendly states, the weapons often come from Russia and China. Money itself can provide diplomatic clout.

In the last decade, tiny Qatar has become increasingly involved in mediation of conflicts throughout the Middle East and Africa by offering financial inducements to combatants. Some petrostate governments even use their wealth to meddle in the affairs of neighbors and enemies,

such as the involvement of the Gulf States and Iran in the Syrian civil war.

Distortions in the rentier state

Though wealthy and internationally influential, petrostates often suffer serious domestic problems as a result of resource production, a phenomenon described by scholars as the "resource curse."

These distortions primarily impact less developed states by preventing further economic and political development, a nuance that explains why Norway - often an anecdotal case against the resource curse - has not experienced the same negative consequences as many other petrostates. Historically, petrostates suffered from the "Dutch disease," inflationary pressures created by the large influx of foreign rents, which made manufacturing and exports unprofitable. Such extreme outcomes are rarer today, but private employment (and investment) in most petrostates is still heavily concentrated in the extraction sector.

Generally, petrostate economies are weak. It is almost always cheaper to import manufactured goods than produce them domestically, and governments have little interest in economic development, since resource rents substitute for broad taxation. Diversification is difficult, as it is tough to attract non-hydrocarbon related foreign investment.

Only a few petrostates have successfully diversified and these either had limited reliance on oil rents (i.e., Malaysia), or unique mitigating factors (i.e., Mexico's membership of NAFTA). A successful modern diversification of a petrostate can be found in Dubai, yet even here it is worth noting that success was not built on manufacturing or trade, but rather on the leveraging of a convenient location to develop a transportation, tourism and finance hub. Such a combination is unlikely to be successful in other locations. Other GCC states have attempted to diversify their economies in recent years with limited success.

In most petrostates, governments don't even try to diversify. Instead, they dominate the economy though state-owned oil companies, using high public sector employment and generous social spending to quiet popular discontent. Such social spending is not cheap, and the volatility of oil can lead petrostates into boom-bust cycles of spending and debt. Venezuela has repeatedly experienced such cycles through its century of oil production.

Though the growth of Sovereign Wealth Funds seeks to remediate this problem, even states with substantial SWFs will experience problems in the event of a prolonged drop in the price of oil. Russia's reserves (including SWFs), for example, have dropped by 26 percent in the last year alone - from $499 billion to $369 billion - due to low prices and U.S.-EU sanctions.

Dependence on oil rents in petrostates also has political consequences. Scholars have shown that petrostates often have weak state institutions, and are less likely to democratize. With no taxation, governments are less responsive to their populations, and leaders can use oil funds to keep the population happy, or to fund repression. Consider Russia, for example, where Vladimir Putin occupies the central role in an elite patronage system driven by oil rents.

The volatility of oil prices also means that petrostates are more likely to experience political instability during periods of low oil prices, as governments are forced to cut back on social spending.

Petrostates and the global oil glut

The landscape of global oil production has changed dramatically in the last decade, with big consequences for petrostates. New technologies such as hydraulic fracturing ("fracking") and improved offshore and arctic drilling technologies permit oil to be extracted in places once thought impossible.

This has shifted the balance of power in global oil production away from traditional producers like OPEC. The technological revolution will likely create some new petrostates, in particular in Africa where new offshore drilling is likely.

But it is also increasing production in well-developed states like the United States, where many of the economic and political distortions common to petrostates are not likely to occur.

The emergence of new suppliers - combined with declining demand - has created a global oil glut, dropping the price of a barrel of oil from $110 to $45 in just a year. While such a drop would normally be met by OPEC production cuts, new suppliers have to some extent robbed the cartel of its price-setting power. Faced with a choice between oil price and market share, OPEC opted to maintain production levels, hoping to put small American fracking companies out of business through sustained low oil prices.

This decision was primarily made by Saudi Arabia, which has reserves to see it through several years of lower prices, but has been largely unsuccessful, as fracking wells proved resilient at far lower prices than previously thought.

Low oil prices pose a major problem for petrostates whose budgets are premised on high oil prices. Even Saudi Arabia - in possession of over $700 billion in reserves - recently issued its first sovereign bonds since 2007 in an attempt to slow the depletion of reserves.

Yet for other petrostates, the falling price of oil is more acute, creating major budgetary constraints. Even conservative petrostates mostly mistakenly set budgets based on estimated oil prices of greater than $80 a barrel. This has required many states to revise budgets and reduce superfluous spending. Iran rewrote its budget for 2015, while Russia initiated mandatory budget cuts of 10 percent to every non-military government ministry in January, with further cuts rumored.

For petrostates with limited reserves, the price crash could be economically and politically catastrophic: Venezuela has been an economic basket-case for years thanks to poor economic management, but has been unable to sustain spending as oil plunged to half of its expected budgetary revenue of $117 per barrel. Moody's cut Venezuela's debt rating earlier this year, and the country is sliding towards default, with food shortages and growing popular unrest.

Though Venezuela is an extreme case, unrest may follow in other petrostates if oil prices remain low for an extended period. In short, political risk will increase in petrostates so long as oil prices remain low.

Conclusion

Petrostates are a unique phenomenon, riddled with economic and political distortions created by the modern world's hunger for oil and gas. Though their wealth gives them substantial clout in Western financial markets, their economies remain underdeveloped, state-centric, undiversified and vulnerable to price shocks. The changing pattern of global oil and gas production, and the resulting fall in oil prices will impact these states in the long-term.

Petrostates can expect several lean years, and will need to slash budgets and seek to diversify, a difficult task for any oil-dependent economy. Only time will tell if they are successful.

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