

What Can Stabilize the Middle East Region; Military Power or Soft Power

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Combatting COVID-19 has resulted in 2020 in a sharp reduction in economic activity and global demand for energy resources and the collapse of energy prices. The oil and gas markets have been affected most of all, with a simultaneous drop in demand and prices. This shock threatened Middle East two-fold: in the short term, a drastic shrinking of revenues from energy exports, and in the long term, the acceleration of energy transition and the redivision of energy markets. The only sustainable solution which could prevent Middle Eastern region from economic and social destabilization accompanied by military conflicts is to help it to diversify and decarbonize its industry.

Middle Eastern economies became much more vulnerable during the pandemic: COVID-19 caused a tremendous oil shock with oil prices and revenues of the oil producing countries collapsing in spring 2020, state expenditures in the region growing in order to face COVID-19 economic slowdown and social dissatisfaction. Oil industry, which is the backbone of all the major economies in the region, is experiencing probably its most painful demand-driven shock ever, members of OPEC+ coalition had to reduce dramatically their output and exports, while total global investment into oil and gas exploration and production fell by 34%, the lowest since 2004, according to International Energy Forum and the Boston Consulting Group¹. This is indeed a strong macroeconomic and social challenge for all the countries of the region, and many observers are concerned about the military stability of the region in this extraordinary situation with raising marginalization of the society.

This unpleasant current situation is aggravated by a more long-term (and, probably, even more painful) challenge of the energy transition. Basically, COVID-19 could be even regarded as an “energy transition test-drive”, illustrating potential impact of decarbonization and moving away from oil on the stability in the resource-rich countries. This process is characterized by oversupplied oil and gas (and coal) markets and expectations of stranded assets lead to “lower-for-longer” prices. Growing share of renewables limits the demand growth for fossil fuels, thus resulting in lower than expected export volumes for hydrocarbons. Creation of carbon border adjustment mechanisms, which is currently being prepared in the EU for introduction in 2022, might well be adopted in the future by the other countries and regions and could become a long-term source of instability for

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¹ <https://www.worldoil.com/news/2021/1/29/fossil-fuel-transition-expect-oil-price-spikes-as-capital-investment-declines?fbclid=IwAR3BH0YOegRpZCgoQGjqlqHW-u-HBjTzbdScMLuk8bfB9twrpi47Vab2zFU>

economies relying on fossil fuels. Moreover, banks and financial institutions are assessing climate risks and becoming more reluctant to provide financing for fossil fuel – many of them have stated already complete refusal to finance oil and gas related projects.

It is clear that the global energy transition towards a lower carbon system presents some real threats for the Middle East. Perhaps the most obvious is financial, with lower hydrocarbon rents meaning lower budget revenues and slower economic growth, with implications for government spending and the wealth of the population at large. This could have implications internationally, if reduced military spending of some of the countries in the region will clash with marginalized impoverished population in the other countries – in this case military conflicts might become inevitable. At the same time, at home these governments will also face huge risks of domestic conflicts and separatism, if the current political regimes are undermined by their ability to satisfy the welfare demands of its population.

Furthermore, these problems could be exacerbated by the fact that countries of the Middle East may have a weaker position in international financial markets as restrictions on the availability of capital for carbon-intensive industries may well be increased. In addition, even their non-energy exports may be impacted if carbon tax adjustments are made for imported goods in key markets. The combination of all these factors could weaken their global geopolitical position, which could be further undermined by increased use of renewables in countries where they were targeting their energy exports and which were to a certain extent guarantying stability in the region. For example, the U.S. and the countries in North East Asia could become less engaged with the Middle East as their energy needs increasingly focus on alternative sources with lower carbon intensity, and will no longer be interested in playing stabilizing role for the region nor with military, nor with Soft Power. This scenario seems to be very pessimistic for the region and, in the longer term, will definitely have negative consequences for the whole world.

However, despite the presence of these clear threats, there are also reasons for optimism thanks to huge potential of Middle East in solar, carbon capture and hydrogen. If green technology transfers and capital are available, these countries could become leaders in decarbonizing oil and gas, as well in solar generated electricity and heat. Saudi Arabia and several other countries of the region are already very closely studying potential for commercialization of CCUS, direct air capture, usage of CO₂ for enhanced oil recovery, blue hydrogen production, etc. and have even developed the whole concept of “Circular Carbon Economy”.² In addition to that, Middle East has huge solar power potential, and if improvements in technology could allow DC lines to be connected to major consumers in Europe and Asia, then Middle East could become a major exporter of green electricity or, alternatively, produce and export green hydrogen. The first projects of export-oriented green hydrogen production are already underway in Saudi Arabia.³

Transforming this potential into reality would require huge support from the international

² <https://www.aramco.com/en/making-a-difference/planet/the-circular-carbon-economy>

³ <https://www.greentechmedia.com/articles/read/us-firm-unveils-worlds-largest-green-hydrogen-project>

partners – but at the end of the day these efforts could be the most efficient “investment” in stabilizing the region and, simultaneously, facing the global climate challenge. The U.S., China, EU and Japan could use their soft power and perform as the key providers of financial and technological support for diversification and decarbonization of the Middle Eastern economies – for the mutual benefit. This would be the most optimistic “win-win” scenario.

But as long as oil is still representing the dominant source of revenues, it is also critically important to try to keep this market stable for the very period of transition – in this respect further cooperation and some sort of coordination between Middle East, Russia and the U.S. (three major oil producing countries) could be extremely valuable not only for the MENA countries, but also for all oil producing countries globally and for the whole global oil market stabilization. This need for producers’ coordination on the shrinking oil market became obvious (and supported by all the key global stakeholders, including G20) as a result of COVID-19 and March 2020 oil price collapse.

This critical situation forced producers to agree on compromises which were unthinkable previously. In April 2020, OPEC members and, for the first time ever, non-OPEC countries resolved to collectively decrease production: the former for two years, including by 8.2 million barrels per day in 2020, the latter (the USA, Canada, Brazil) by 5 million barrels per day, without strict obligations. The agreement helped to avoid the worst-case scenario but did not guarantee rapid market growth. The April agreements, like quarantine measures, does not treat the disease but will help mitigate its consequences over time. The agreed reduction in production was sufficient only to avoid overfilled storage facilities and negative prices, as long as all participants fully observe the agreement.

This April 2020 OPEC++ deal marked a new milestone in the global governance of the oil markets and the new role of this coalition – it was no longer blamed by the consumers as cartel, manipulating prices, but fully supported as the only reasonable instrument allowing to avoid complete collapse of the physical, and, more importantly, financial oil market. Up until 2021 only massive production cut and strict compliance with the quotas were providing an acceptable price level for the oil producers.

It is indeed an extraordinary deal without exit: if OPEC + (or any of its biggest participants) will just open the taps, the prices will get back to the situation of March 2020. So now oil producers have to learn, how to operate within this new framework, how to negotiate the quotas with the oil producers outside Middle East (first of all – with Russia, which is thus gaining new instruments of geopolitical influence in the Middle East) and how to remain profitable in the highly competitive market with declining demand. So this is another area, where soft power from the U.S. and Russia on the producer side and China, Japan, EU and India on the consumer side could actually affect the situation and allow to keep oil prices, which are so critical for the region, in an acceptable range.

This whole interplay between medium-term OPEC+ power game and long-term geopolitics of

energy transition makes the future of Middle East extremely unclear and unpredictable, but at the same time create some opportunities for a profound change in the region's social-economic model and, most likely, its political model as well.

Writer's Profile

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