

Covid-19, Oil and Stability in the Middle East

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This short article is based upon two assertions: The Middle East is already unstable. The Covid-19 pandemic will aggravated that instability.

Three factors explain the existing instability. First, the causes of the Arab Uprisings, which began in Tunisia at the start of 2011, have not been addressed. Thus there remains popular frustration with incompetence and corruption on the part of governments and general unmet aspirations. Second, there has been a general failure to diversify their economies away from dependence on oil. This is largely because the ruling elites in many countries have stifled the private sector because of a lack of property rights and a tendency to grab all the best deals for themselves. Thus the post-2014 oil price collapse and the consequent collapse in government oil revenues meant they were unable to buy-off popular unrest arising from growing unemployment amongst a rapidly growing young population. Around one third of the population in the region is aged between 15 and 29. Finally, for the last two hundred years at least the region has suffered from interference by outside powers. This created competing ‘client states’ leading inevitably to conflict between these states.

The current ‘energy transition’ has already aggravated this instability. An ‘energy transition’ is when an economy switches from one main source of energy to another. The current transition is away from hydrocarbon molecules to electrons. It was triggered initially by concerns over carbon emissions and climate change but more recently this has been reinforced by concerns over urban air quality. As with earlier transitions, once the triggers have been pulled, reinforcing factors come into play usually related to technical change altering relative energy prices. This time, these revolved around the falling costs of renewables and the development of electric vehicles. The speed of this transition was being seriously underestimated by the ‘energy establishment’ i.e. the IEA, OPEC, the large international oil companies (IOCs) and many others. This was because of vested interests, a degree of intellectual inertia and a tendency for forecasters to cluster together for safety. Their arguments have tended to revolve around a view that ‘energy transitions are slow’. While it is true that some have indeed been slow, in more recent times, the speed has been very much faster especially when governments are involved. Thus the French experience from coal and oil to nuclear took only ten years while the UK switch from coal to renewables took only around 8 years. This ‘energy transition’ has already aggravated regional instability as the slowing of growth in oil demand has led to competition for oil market share with growing conflict between Saudi Arabia

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and Iran, fuelled by the US.

Into this unstable mixture we can now examine the impact of the COVID-19 pandemic. There has been much discussion in the media about the fact the pandemic has led to a lock-down in many countries, leading to “oil demand destruction” and a collapse in oil prices. However, such claims are misleading and confuse demand destruction with demand deferment. The level of oil demand is determined as the result of the consumer taking a three-stage decision. Oil demand is a derived demand. Consumers do not want gasoline or jet fuel. They want the energy services – the light, heat or work – they provide. To get these services, the oil must be consumed in an oil-using appliance – a car, a jet plane etc. Thus the first decision by the consumer is whether to buy the oil-using appliance? The second decision is what type of appliance, related in some case to which fuel to use, assuming there is a technical choice between different fuels. Another choice is whether to buy an energy efficient or energy inefficient appliance. The choice will be determined by the costs of saving on fuel over the life of the appliance versus the difference in purchase price. Efficient appliances tend to cost more. The final decision by the consumer is the capacity utilization of the appliance once bought.

Collectively these three decisions determine how much oil is demanded. Once the first two decisions have been taken, the appliance stock is fixed. Thus in the short-term, oil demand destruction can only occur if the appliance is destroyed and/or replaced by a more efficient appliance or an appliance using another fuel. Once oil demand has been destroyed it cannot return unless a new oil-using appliance is created. However, the consumer has the choice to underutilize the capacity of the appliance. In that case, oil demand is deferred until the capacity use is increased if it ever will be. Thus the fall in oil demand as a result of the COVID-19 pandemic is not per se demand destruction. It is only demand deferment. Whether it will return when the pandemic ends, depends upon what else happens to the appliance stock and how it is utilized, i.e. consumer behaviour. It only becomes demand destruction if the behaviour to reduce capacity utilization of the appliance becomes irreversible and the appliance is scrapped. Any such behaviour can of course be determined by government policy. An important question is whether the changes in behaviour as a result of the pandemic is a blip or a permanent discontinuity.

The global lock-down has severely impacted GDP as a result of recession. Therefore, so far, most of the fall in oil demand has been deferred demand, which implies that it could come back. Estimates of how much oil demand has fallen so far this year vary and the data are very unreliable. The longer the lock-down continues the greater the damage will be in terms of firms going out of business and supply chains being disrupted. There is already a second wave of infections in many countries. If the economic damage continues to grow, oil demand will begin to suffer from demand destruction as the appliance stock shrinks. Also, after some point, as government budget deficits rise, it may be increasingly financially difficult for many governments to mount any sort of effective stimulus package to protect jobs and maintain aggregate demand in the economy so far

experienced in many countries.

Whatever the nature of the fall in oil demand, it is indisputable that oil revenues for the oil producing countries have fallen dramatically, greatly aggravating the ability of the governments to buy-off the domestic unrest and consequent political instability that has already been present in the Middle East since 2014.

An important uncertainty created by the pandemic in this context is whether it will speed or slow the energy transition. Some have argued that the pandemic and its aftermath will divert political attention away from climate change thereby slowing the transition. This will be reinforced because lower oil prices may slow the move away from oil and the economic recession may well slow spending on EVs and solar panels. All this might be reinforced if growing conflict between China and the West reduces the chances of agreements linked into COP26 in 2021. However, these arguments have several flaws. Much of the lower crude prices will not be passed onto consumers in full as sellers of oil products try to protect their margins and consumer governments try to capture some of the fall by increasing sales taxes on oil products. Also, the pandemic has actually emphasised the need for governments to intervene even more to correct market failures, which will encourage further regulatory moves towards a lower carbon economy.

By contrast, some have argued the energy transition will be speeded up as a result of the pandemic. As a result of the economic recession many are now expecting oil demand to peak sooner rather than later. This is very much driven by reductions in demand for travel following changes to working patterns. Transport accounts for 60 percent of liquid fuels demand. The pandemic has also raised concerns about self-sufficiency and import dependence in value chains that will constrain international trade. Renewables remove much concern over import dependence. Also, renewables can be small scale and decentralized allowing governments to address issues of fuel poverty without recourse to very expensive grids for electricity or gas.

If the transition is faster than many expect this will lead to lower oil demand post the pandemic. This will aggravate instability in the Middle East as falling revenues cause rising unemployment. Such instability will be greatly aggravated as producers compete for a declining market share. There is however one slight ray of hope on the horizon. As oil becomes less important, it is likely that the importance of the Middle East in the geopolitics of global energy will diminish. Thus there will be much less incentive for others to interfere in the region. As outlined at the start of this short piece, this could reduce what has been a major cause of instability in the region. However, before this happens, and it will take at least a decade if not longer before this might happen, the region faces the serious prospect of an increasing number of failed states as the governments are unable to keep the lid on a bubbling cauldron.

Writer's Profile

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Professor Stevens was educated as an economist and as a specialist on the Middle East at Cambridge and SOAS; 1973-1979 teaching at the American University of Beirut in Lebanon; 1979-93 at the University of Surrey. Between 1993 and 2008, he was Professor of Petroleum Policy and Economics at the University of Dundee, Scotland, a chair created by BP. He is an expert in the international petroleum industry, economic development in the Gulf and energy economics.