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Sustainable Economic Cooperation between Korea and the Middle East in Times of Lower Oil Prices

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Introduction

A global oil price decline since the second half of 2014 has negatively impacted the economies of GCC countries, which heavily depend on the oil and gas sector. GCC countries are facing an economic recession due to worsening financial situations, lack of liquidity and falling investment. The sharp drop in oil revenues brought about by lower oil prices also caused governments' fiscal distress. While oil export revenues sharply decreased, the oil production of GCC countries expanded continuously as they sought to make up for reduced government revenue by boosting petroleum exports. The share of the oil sector as a proportion of GDP in these countries remains high, which means they have a weak economy that is vulnerable to volatile oil prices. A sustainable economic cooperation framework between Korea and the Middle East is proposed, after a review of the impacts of and policy responses to lower oil prices.

The Impact of Lower Oil Prices on GCC Countries

1. Trade and Government Revenue

The oil export revenues of four major GCC countries — Saudi Arabia, the United Arab Emirates (UAE), Kuwait, Qatar — dropped by 46% in 2015 compared to the previous year. This led to a decline in trade surpluses and undermined current account balances, resulting in a slowdown of economic growth in these countries. The current account balance as a percentage of GDP for Saudi Arabia has also suffered a deficit for the first time since 1998.

Although there would be differences by country, the decline in the government income of GCC countries, which rely heavily on the hydrocarbons sector, has stood out. The fiscal balance also showed a significant decline, as government spending has not changed much despite drastic reductions in government revenues. GCC countries have promoted expansionary policies for economic growth with national development plans, and government spending increased after the so-called "Arab Spring," the revolutionary wave of pro-democracy demanding reform

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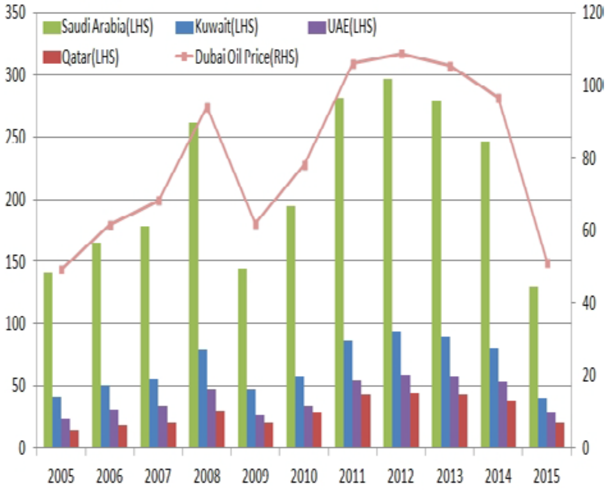
across the Middle East. Against this backdrop, the fiscal balance of each country plummeted dramatically, and Saudi Arabia and the UAE's financial deficits recorded 15.9% and 2.1% of GDP, respectively.

Figure 1. Net Oil Export Revenues of GCC Countries and Oil Prices

Unit: USD billion, $/b



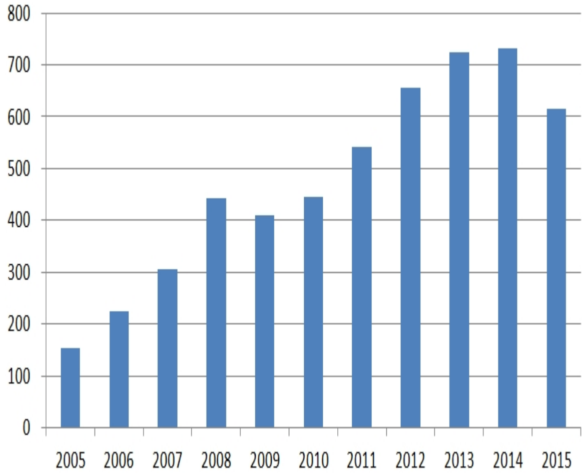
Source: EIA, OPEC Revenues Fact Sheet (accessed June 20, 2016).

2. Investment and Finance

Moreover, these countries are faced with a liquidity crunch, due to decreased government revenues and spending levels that have barely shifted. This led GCC countries to use accumulated foreign exchange reserves, mainly spent to maintain the current dollar-pegged currency system, and sovereign wealth funds. Saudi Arabia in particular, which is under more pressure from local currency devaluation compared to other GCC countries, displayed a significant fall in foreign exchange reserves.

Figure 2. Saudi Arabia's Foreign Exchange Reserves

Unit: USD billion



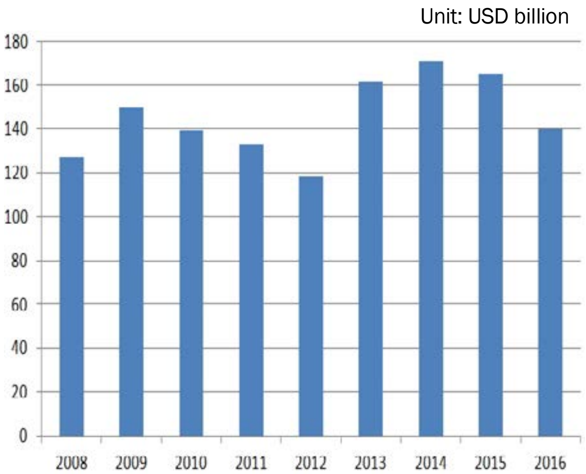
Note: Gold is excluded.

Source: IMF, Data, International Financial Statistics, Data Tables (accessed October 27, 2016).

Meanwhile, GCC countries promote economic diversification and reform policies that reduce government spending in response to implications of lower oil prices. They also prioritize projects focusing on social infrastructure, including education and public services, which results in a lower number of project contracts awarded in the GCC region. This trend is linked to the poor performance of Korean construction companies in the GCC construction market.

In this regard, attracting FDI will likely become more important for these oil-producing countries, which are suffering from worsening fiscal conditions and liquidity problems. After FDI inflows into GCC countries fell sharply in 2011, the amount has yet to bounce back, what with political instability in the region and lower oil prices. Under these circumstances, it is expected that GCC countries will make continuous efforts to improve the investment system for expanding FDI in the region.

Figure 3. Contract Awards in the GCC



Note: Figure for 2016 is a projection.
Source: Deloitte (2015), p. 6; Deloitte (2016), p. 10.

Policy Responses of GCC Countries for Offsetting the Negative Effects of Lower Oil Prices

GCC countries are carrying out several policies, as they face slowing economic growth, deepening budget deficits, diminishing foreign investment and shrinking construction project markets due to lower oil prices.

1. Reinforcement of Economic Diversification Strategies

To solve the slowing economic growth problem, GCC governments are setting forth plans or strengthening the implementation of existing development plans. For instance, the Saudi government announced the Saudi Vision 2030 in April 2016. In June, in a follow-up to the plan, the government published the National Transformation Program, which includes the specific implementation goals of ministries. The UAE is seeking to reform the public sector and develop strategic industries through the 'Abu Dhabi Plan' and 'Dubai Industrial Strategy 2030'. Kuwait and Qatar are strengthening the implementation of infrastructure development plans. GCC governments are fostering diverse strategic industries in the course of pursuing economic diversification, and also underlining the development and investment of renewable energy. The governments also established supporting policies to promote small and medium-sized enterprises, as a key task for economic diversification.

Table 1. Major Economic Development Plans of GCC Countries

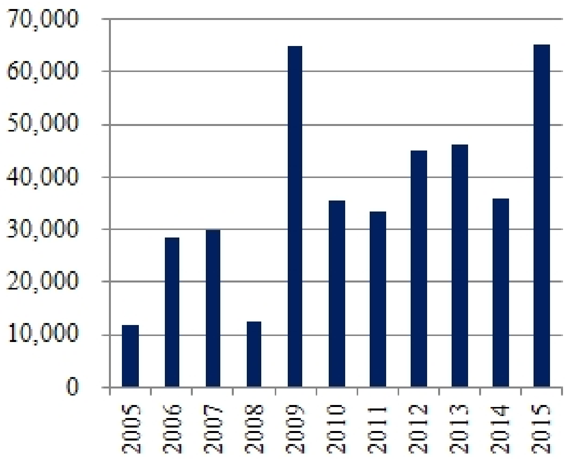
Country	Plans
Saudi Arabia	- Saudi Vision 2030 - National Transformation Program
UAE	- The Abu Dhabi Plan - Dubai Industrial Strategy 2030
Qatar	- Qatar National Vision 2030 - Qatar National Development Strategy 2011-2016
Kuwait	- New Kuwait 2035 - Five-Year Development plan 2015/16-2019/20

2. Regaining Fiscal Sustainability

To regain budgetary soundness, GCC governments are undertaking policies related to energy subsidies, tax systems, sovereign bonds, government loans and government-owned enterprises. The governments are cutting various subsidies, including for petroleum, natural gas, electricity and water charges in times of low oil prices. They are also considering the introduction of value-added tax, corporate tax and income tax. In particular, it is expected that GCC governments will push ahead with system reforms focusing on the introduction of VAT, which will be able to minimize the decline in foreign direct investment and taxation resistance. GCC governments are changing their financing strategy from utilizing foreign reserves or sovereign wealth funds to increasing sovereign bonds and government loans, so as to solve budget deficits. The privatization and restructuring of government-owned enterprises are considered as means of GCC governments' cost reduction, which are being activated after the announcement of the IPO plan for Saudi Aramco.

Figure 4. GCC Bonds and Sukuk Market New Issuance

Unit: USD Million



Source: Othman, Rasha A., Aliya Sattar Faisal (2016), p. 5.

3. Improvement in the Business Climate

To improve the investment climate and revitalize construction project markets, GCC governments are reforming investment law and introducing public-private partnership (PPP) regulations. The reformation of the investment law is focusing on the reduction of minimum capital requirements and abolishment of foreign ownership limitations. Through the introduction of PPPs, the GCC governments expect heightened efficiency and increased investment resources from private and foreigner participation in infrastructure development projects. They are also planning the structural reform of sovereign wealth funds, to foster strategic industries and supply liquidity. In line with the policy changes of GCC countries, it is necessary for the Korean government to come up with economic cooperation strategies and to help Korean companies enter GCC markets.

Sustainable Cooperation Framework between Korea and the Middle East

The economic difficulties that GCC countries are faced with due to lower oil prices are causing significant concern for their dwindling economic cooperation with Korea. In response, a new cooperation framework is required to strengthen bilateral ties for shared growth. Four fields of cooperation can be identified, as follows. First, industrial cooperation should be reinforced to expand economic diversification and job creation in GCC countries. This will help lower the region's dependence on the oil and gas sector. Second, energy security is one of the most significant rationales for bilateral cooperation between Korea and the Middle East, since Korea imports more than 60% of the oil it uses from GCC countries. Energy cooperation, however, should not be confined to energy trade. It should be broadened into the fields of renewable energy development and energy efficiency technology, focusing on reliable energy supply and demand. Third, investment cooperation should be strengthened to facilitate joint investment in the region, including joint ventures. For this, bilateral investment summits should be activated to explore and share information on investment opportunities in the region. Fourth, institutional cooperation between governments is needed to share experiences and know-how obtained in the process of Korea's institutional reforms in the fields of tax, subsidies, privatization and FDI. Civil servant exchange programs will also contribute to deepening mutual understanding in the bilateral economic partnership. KIEP