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Envisioning the Future

Iranian and Saudi Perspectives on the Post-Oil Economy

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Introduction

Recent changes in the global energy landscape have had a strong impact on the economies of energy exporting countries, with Iran and Saudi Arabia being no exception. Sinking oil prices pose major challenges for national economies in the Gulf region, where almost all national budgets rely on the revenues from the energy industry and the export of natural resources like oil and gas to finance their investments and social programs.

While not long ago 'peak oil' – the hypothetical point at which global oil production reaches its maximum rate after which production will gradually decline – was the major scenario for analyzing the challenges

Executive Summary

Falling oil and gas prices and shrinking demand across global energy markets pose enormous challenges for energy exporting countries like Iran and Saudi Arabia and lead to decreasing revenues from this sector. Despite differences in the structures of their respective national economies, both countries share common challenges in adapting to this new situation. High youth unemployment rates, an underrepresentation of women in the workforce, a public sector unable to absorb the high numbers of university graduates as well as environmental degradation and pollution, all constitute major problems for both countries and their economies. But, while solving many of these issues would ideally demand bilateral cooperation, a political climate of mutual mistrust and enmity currently inhibits such a process.

CARPO and the EastWest Institute initiated a meeting of experts from Saudi Arabia and Iran as part of their 'Iran-Saudi Track 2 Initiative'. The stated aim was to shed light on the challenges and opportunities a 'post-oil' era might bring as well as to explore potential areas for cooperation between both countries. While participants agreed on the necessity of cooperation for creating strong and less oil-dependent economies, from which both countries as well as the whole region would benefit, their assessments varied on where this could begin.

ahead for the oil dependent economies of the Gulf, today it is rather the notion of ‘peak demand’ on global energy markets that is leading the discourse. A global slowdown in demand due to alternatives to hydrocarbons, coupled with slower growth rates in key importing countries, may affect exporting countries to no lesser degree however. Thus Saudi Arabia and Iran face the necessity of adapting their economies to this new situation and both have developed strategies and visions to diversify their economies and make them fit for a post-oil era.

Besides differences in the characters of their respective national economies, Saudi Arabia and Iran face common challenges. Both have to deal, for example, with high youth unemployment, an underrepresentation of women in the labor force and a public sector that cannot absorb the high numbers of university graduates. Besides this, environmental degradation and pollution constitute major problems for both countries and their economies, creating rising costs and increased risks.

While many of these challenges call for mutual cooperation and learning, a situation of regional rivalry and enmity between Saudi Arabia and Iran have hampered any process of rapprochement. A political climate of mutual mistrust coupled with a lack of knowledge of the other country’s decision-making processes further complicates economic cooperation. Against this background, CARPO and the EastWest Institute (EWI) brought together policy experts and economists in a confidential setting to shed light on the challenges and opportunities this new era may bring, as well as to explore potential areas of

collaboration between Iran and Saudi Arabia. This meeting, which included participants from Iran and Saudi Arabia as well as experts from Europe, was part of CARPO and EWI’s ‘Iran-Saudi Track 2 Initiative’ and took place in fall 2016. The first part of the meeting dealt with the current status quo of the respective economies in Iran and Saudi Arabia and focused on current trends as well as prospects for growth, investment, employment and international trade. A second part was dedicated to the social and political implications of a post-oil economy and explored the future of bilateral economic relations between both countries.

Iran and Saudi Arabia and the changing parameters of global energy markets

During the last two years we have witnessed some dramatic and potentially irreversible changes in the global energy landscape, which have already had a strong impact on the energy exporters, in particular Iran and Saudi Arabia. As energy prices sank globally following the crash in crude price in the second half of 2015, the energy industry was severely hit in energy producing and energy consuming countries alike. The political and social impact of cheap oil is particularly visible in the Gulf region, where virtually all of the countries are dependent on oil to finance investments and social programs – albeit to varying degrees.

Participants of the meeting agreed that today’s situation is different, however, from usual business dynamics whereby an (energy)

market swings from a seller's to a buyer's market. Prices might rise again, but the rules of the game and market dynamics are not the same – a fact which both buyers and sellers are aware of. In fact, 'peak oil' theory is no longer a dominant energy discourse – there is plenty of energy available in the form of unconventional hydrocarbons and offshore oil and gas, and a deficit in the foreseeable future seems therefore to be out of question. Such reserves might be expensive to develop but they are abundant and sufficient to cover the global energy demand for at least the next 50 years. Unconventional oil and gas reserves set a natural price ceiling – if the oil price rises, energy companies are able to quickly launch production of shale and offshore hydrocarbons and consequently increase the offer of oil and gas, which then restabilizes the prices.

Unlike peak production then, 'peak demand' is a real challenge for the oil and gas exporting countries. A strong U.S. dollar as well as technological progress in renewables and non-conventional/deep offshore hydrocarbons puts a continuous downwards pressure on oil prices. Furthermore, renewable technologies have also shown remarkable progress in recent years and the costs of wind and solar energy have dramatically lowered. In the case of a strong rise in oil prices, solar and wind technologies may not only halt this growth but also conquer a sizable part of a market share occupied until now by oil. There is even a high probability that global energy demand will level off in the coming decades, primarily due to environmental concerns. Commitments made at the COP21

in Paris in December 2015 do not allow for a massive expansion of fossil fuels on a global scale, a fact that will clearly have strong impact on the energy strategies of both Saudi Arabia and Iran.

Changing market dynamics also play a role in the peak demand scenario. Lower economic growth rates in key importing countries like China and India have reduced the global demand for energy and there is a clear link between feeble economic growth in China and the oversupply in global energy markets that culminated in the collapse of oil prices in 2014-2015. In fact, already by then supply had far outstripped demand. In 2015 global oil consumption grew by 1.9 million barrels/day (b/d) or 1.9% Year-on-Year (YoY) growth. Most of this growth originated from China (+6.3%, YoY or +770,000 b/d) and India (+8.1%, or 310,000 b/d), but during that same period oil production grew even more rapidly than consumption for a second consecutive year, increasing by 2.8 million b/d or 3.2%, the strongest growth since 2004.¹

The uncertain fate of the global economy as well as U.S. internal energy dynamics could further complicate this picture. The prospect that under President Donald Trump the U.S. will introduce an effective 20 percent tax on imports including oil would drastically reduce U.S. oil imports and further increase its supply in international markets. This will most probably result in further 'price wars' for the market share between the key producers as well as a decrease in revenues for oil-exporting countries like Iran and Saudi

¹ BP (2016): Statistical Review of World Energy, June 2016, London, p 3. Available at <http://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html> (12.04.2017).

Arabia. These developments would not necessarily lead to bankruptcy but could spell the beginning of the end of the welfare state in the oil-rich countries.

In fact, key oil exporters are already under financial pressure and need to adjust their public spending. In Saudi Arabia the budget deficit reached a record of 98 billion USD in 2015.² Although it shrank to 79 billion USD in 2016, it remains at a high level and the cumulative budget deficit of the Kingdom is expected to reach up to 380 billion USD by 2020.³ Moreover, the Kingdom's central bank reserves dropped from 732 billion USD in December 2014 to 555 billion USD in September 2016.⁴ Although these resources can still sustain the Saudi economy in the short term, they are unsustainable in the long term.

Despite the fact that Iran's budget is less dependent on oil revenues, the budget deficit remains an important economic challenge for the Islamic Republic. According to the Central Bank of Iran, the country's budget deficit for the first three quarters of the previous fiscal year (March 20 – December 20, 2016) amounted to 7 billion USD.⁵

Inflation remains an important issue for both countries. According to data from the International Monetary Fund (IMF), in December 2016 consumer prices in Iran rose by 7.4 per cent year-on-year.⁶ The situation was more optimistic in Saudi Arabia where inflation went down to zero (and even to negative figures) in the beginning of 2017. However, according to the Saudi Arabian Monetary Authority, inflation remained at over 4% in the first half of 2016.⁷

Iran and Saudi Arabia: Bound together by common challenges?

Both countries are aware of the challenges presented by global economic trends as well as domestic developments. The need to adapt to these circumstances was expressed by many participants from both sides during the meeting.

Both countries have recently developed new plans and visions to make their countries fit for the future: In April 2016 Saudi Arabia announced its 'Vision 2030' and already in 2005 Iran published its '20 year Vision' ending 2025.⁸

2 Nereim, Vivian / Carey, Glen (28.12.2015): Saudi 2015 Budget Deficit Is \$98 Billion as Revenue Drops, in: Bloomberg. Available at <https://www.bloomberg.com/news/articles/2015-12-28/saudi-2015-budget-deficit-is-98-billion-as-revenue-drops> (12.04.2017); and data provided by the Dialogue's participants.

3 Ali, Jasmin (08.04.2017): Saudi Arabia's outreach programme will aid economy, in: Gulf News. Available at <http://gulfnews.com/business/analysis/saudi-arabia-s-outreach-programme-will-aid-economy-1.2007666> (12.04.2017).

4 Al Arabiya English (14.11.2016): Saudi comfortable with foreign reserves level: Central Bank, in Al Arabiya English. Available at <http://english.alarabiya.net/en/business/economy/2016/11/14/Saudi-Arabia-central-bank-predicts-1-8-percent-GDP-growth-this-year-above-IMF.html> (12.04.2017).

5 Financial Tribune (19.02.2017): Iran's Budget Deficit: \$7b in 9 Months, in: Financial Tribune. Available at <https://financialtribune.com/articles/economy-domestic-economy/59874/iran-s-budget-deficit-7b-in-9-months> (12.04.2017).

6 International Monetary Fund (2017): Islamic Republic of Iran and the IMF, Washington DC. Available at <https://www.imf.org/external/country/IRN/> (12.04.2017).

7 Saudi Arabian Monetary Authority (2017): Inflation Rate, Riyadh. Available at <http://www.sama.gov.sa/en-US/Indices/Pages/InflationRate.aspx> (12.04.2017).

8 In the following referred to as 'Vision 2025'.

Both countries' initiatives aim at reforming their respective economies to make them less oil-dependent and more sustainable, to help diversify their economies, attract foreign investment, and decrease vulnerability to external shocks as well as guarantee a high standard of living for their citizens.

Criticisms were voiced, however, that beyond the declaration of new programs and visions very little has changed on the ground for many decades. A completely new mindset is necessary, as one expert from Saudi Arabia pointed out, but the political will is still missing and all too often it is the same strategists that planned the oil-based economy who are now in charge of planning for the post-oil era, he continued.

Key challenges for Iran as well as Saudi Arabia arise in the fields of general economic structures, demographic developments and the impact of energy waste and environmental problems.

General economic structures and the need for reform

Saudi Arabia and Iran's economies offer great potential in many regards, not least for foreign investors. A growing and young population constitutes a huge market and both countries' natural resources and geographical location remain attractive. On the other hand, a volatile political context and a risky and sometimes unwelcoming business environment deter foreign investors, along with a strong state sector. High levels of corruption and non-transparent business regulations also contribute to economic unpredictability.

Given the changing patterns of global energy markets there is a need for diversifying both economies to decrease their oil-dependency. While the Iranian economy already has a higher degree of diversification, Saudi Arabia is in urgent need of broadening its economic basis.

Experts from both Iran and Saudi Arabia saw privatization as a major step towards reforming their economies. They frequently made positive reference to the Structural Adjustment Programs (SAPs) of the 1990s when the IMF demanded structural reforms of many developing countries' economies. A major difference though, participants stressed, is that reform programs like 'Vision 2030' and 'Vision 2025' are not external programs but rather initiated by the countries themselves. However, past mistakes need to be avoided so that privatization does not further increase inequality, corruption and the rise of monopolies. Transparency and accountability are key to such reforms, and one Saudi expert cited the listing of ARAMCO, the Saudi Arabian national petroleum and natural gas company, as a good example of such reform – disclosure obligations at international stock exchanges require transparency. Beyond such disclosure to investors there furthermore remains the need for improving communication with citizens. As another Saudi participant pointed out, it is about rethinking state-society relations in general. New models of taxation could be another way forward, although this remains difficult given the current structures. It would require a great deal of political will and courage to fundamentally reform these structures. Saudi participants expressed optimism regarding 'Vision 2030', but it remains to be seen what portion of this initiative

really materializes and whether its agenda has broad support or is rather the project of a single person. A Saudi participant emphasized that economic changes never take place in a political vacuum, the socio-political context remains of utmost importance.

Demographic challenges

Demographic factors play an important role in a potential post-oil era in both countries. Between 2010 and 2015 population growth in Iran reached an average of 1.27 percent, while the population of Saudi Arabia grew on average by 2.32 percent. In Iran the population of under-25s represents about 40 percent of the total population, while in Saudi Arabia this share has reached almost 45 percent.⁹ Youth unemployment in Iran increased to 30.2 percent in the third quarter of 2016 while it averaged 25.54 percent between 2011 and 2016.¹⁰ According to World Bank data, youth unemployment in Saudi Arabia reached 29.4 percent in 2014.¹¹

Thus the creation of jobs is of utmost importance in both countries. Furthermore in Iran and Saudi Arabia the lack of inclusion of women in the labor market is a big problem. Although more women graduate from university than men (Saudi Arabia 55%, Iran 52%) they are underrepresented in the work force. Since the state sector is no longer capable of absorbing young people it was agreed in the discussions that the private

sector must take the lead. Especially Iranian participants held that the middle classes play a major role in creating new jobs. To lessen oil-dependency the service sector has to be further strengthened. Many saw a knowledge-based economy as the solution to this challenge. There was a critical discussion about the extent to which this sector can live up to such expectations. While many saw the potential of economies based on the production, distribution and use of knowledge and information to create new jobs and include women in the work force, critics voiced skepticism about the actual numbers of new jobs that would thus be created as well as to whether only elites would benefit from it. However, positive examples of knowledge transfer to the private sector were given, e.g. the creation of so called incubation centers at Iranian universities and the rise of start-ups in the field of information technologies.

Inefficient energy use and environmental problems as economic challenges

Besides the structures of national economies and demographic factors, energy waste and environmental challenges are problems that plague economies in Saudi Arabia and Iran as well as the whole region. A lack of awareness of these issues accompanied by high levels of energy inefficiency lead to unsustainable economies and considerable economic damage.

⁹ United Nations, Department of Economic and Social Affairs, Population Division (2015): World Population Prospects: The 2015 Revision, New York, custom data acquired via website. Available at <https://esa.un.org/unpd/wpp/DataQuery/> (12.04.2017).

¹⁰ Trading Economics (2017): Iran Youth Unemployment Rate, New York. Available at <http://www.tradingeconomics.com/iran/youth-unemployment-rate> (12.04.2017).

¹¹ World Bank (2016): Unemployment, youth total (% of total labor force ages 15-24), Washington DC. Available at <http://data.worldbank.org/indicator/SL.UEM.1524.ZS> (12.04.2017).

Energy efficiency and saving measures are therefore important for the sustainable development of both countries. Experts from both countries agreed that two sets of measures should be implemented: a behavioral change and a set of technical measures allowing for the more rational use of energy. Subsidies should be reduced or reviewed and the excessive use of energy penalized (for example via taxation of large motor vehicles, electricity and gasoline). These measures should be accompanied by public awareness raising initiatives on energy efficiency. Especially with regard to cross-border phenomena like pollution, dust storms and maritime degradation, there is a dire need for effective new programs and cooperation between countries of the region.

Avenues for economic cooperation: Preconditions and options

Throughout the discussions on changing global economic parameters and domestic socio-economic challenges, both sides expressed the need for more cooperation. It was established that the region has to move towards win-win-thinking instead of mutually exclusive rivalry, to create strong and less oil-dependent economies from which both countries as well as the whole region would benefit. Furthermore, environmental challenges such as pollution, dust storms and maritime degradation are trans-border phenomena that require joint efforts to combat.

A political climate that is driven by mutual distrust and enmity has so far not allowed

for the establishment of sustainable initiatives, however. It was lamented that politics always overshadows economic and other issues. Both sides continue to see each other as monolithic blocks without the potential for cooperation at various levels. A psychology of insecurity deters rational policy debate in the region and the situation is further complicated by mutual blaming and a lack of political will to move forward. The only solution would be to put political disagreements aside and concentrate on economics and specific infrastructure and energy projects. While the experts generally agreed that business between both countries would thrive without political interference, assessments on how realistic this is given the current situation varied to a large extent.

Thus, to a considerable degree, disagreement reigned on how cooperation can be initiated at all. Some experts, especially on the Saudi side, maintained that political problems have to be resolved first. Without solving the bigger issues between both countries economic relations remain more or less impossible. Such cooperation can be initiated during peace times to avoid another conflict, but cannot begin in an ongoing conflict, as one Saudi participant put it bluntly. Other participants from both sides saw the potential in bottom-up approaches, however. Pragmatic small steps and collaboration on concrete issues of common interest like counter-terrorism, development or environmental issues should lay the foundation of rapprochement and build trust between both sides. Economic cooperation was thus seen as a bridge and a trust building measure to start from. A

look beyond the Iranian-Saudi case might be helpful in this regard. In recent years, trans-border energy cooperation in various conflict environments has helped to secure a vibrant energy trade and has also reduced tensions. This was for example the case in the Barents Sea region, the South Caucasus and the Kurdistan Regional Government (KRG)-Turkey relationship.

Further track-2-initiatives and other forums should accompany such steps to improve mutual perceptions. In the discussions a general lack of knowledge of the respective other was diagnosed and thus an urgent need was identified to learn more about the other's perceptions, policies and decision-making processes. Participants from both sides expressed interest in the other's approaches like 'Vision 2030' or 'Vision 2025'. Given the shared challenges, further exchanges between experts can contribute to mutual learning and in the long term potentially result in a breaking down of enemy images and notions of threat.

Furthermore, participants stated that approaches should reach beyond the bilateral level to include the regional level. Forums for multilateral exchanges and their institutionalization could contribute to mitigating conflicts and preventing escalation. Third-party support and mediation was welcomed in the creation of such forums as well as in the generation of political will for reform and cooperation between Saudi Arabia and Iran.

Key Insights and Recommendations

- **Changing patterns of global energy markets force Saudi Arabia and Iran to reform their national economies.** To deal with the challenges of globally sinking oil and gas demands economic diversification is necessary. Furthermore, national economies need to adapt to a post-oil era by increasing accountability and transparency, thus creating more open communication with their citizens.
- **Economic relations between Saudi Arabia and Iran suffer from politicization and a security-fixated mentality.** To move from zero-sum thinking to a win-win-situation, political interference in the economic sphere should be limited. Iran and Saudi Arabia should decouple strategic issues from tactical ones, tune down security mentality and focus instead on trans-border economic, environmental, infrastructure, and energy dialogue.
- **Assessments of the potentials of economic cooperation and general rapprochement in the current situation vary to a large degree.** Top-down approaches calling for the solution of political issues first contradict bottom-up approaches, which demand small and pragmatic steps as a starting point. Nevertheless, such small-scale cooperation should still be promoted and common ground established through joint work on issues like environmental challenges and renewable technologies.

- **Relations between Iran and Saudi Arabia are characterized by mutual mistrust and an utter lack of knowledge about the other.** To move beyond negative perceptions and learn more about the other's economic approaches, policies and decision-making processes, exchanges at various levels are necessary. Both countries should compare their economic visions to foster mutual learning and find avenues of cooperation.
- **Approaches to cooperation should go beyond the bilateral level to include the regional context.** The European Union as well as its member states should encourage economic cooperation and facilitate exchanges through track-2-initiatives and mediation. Furthermore, regional approaches and the institutionalization of exchanges should be promoted.

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About CARPO

CARPO was founded in 2014 by Germany-based academics trained in the fields of Near and Middle Eastern Studies, Political Science and Social Anthropology. Its work is situated at the nexus of research, consultancy and exchange with a focus on implementing projects in close cooperation and partnership with stakeholders in the Orient. The researchers in CARPO's network believe that a prosperous and peaceful future for the region can best be achieved through inclusive policy making and economic investment that engages the creative and resourceful potential of all relevant actors. Therefore, CARPO opens enduring channels for interactive knowledge transfer between academics, citizens, entrepreneurs, and policy-makers.

About EastWest Institute

The EastWest Institute (EWI) is an independent NGO focused on conflict resolution. EWI has a 35-year track record of convening power, trust building and back channel diplomacy to develop sustainable solutions for today's major political, economic and security issues around the world. Recognized as an "honest broker," EWI's success is predicated on providing a platform where political, military and business leaders find common ground and solutions to international conflicts. EWI's Middle East and North Africa Program provides a platform for dialogue between regional rivals and engages major stakeholders in an attempt to find common ground in tackling root causes behind the rise of ISIS. Headquartered in New York City, EWI has offices in Brussels, Moscow, San Francisco and Washington D.C.

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