A New Era in the Middle East

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In Greek mythology, Cassandra's curse was that she could foretell the future but wasn't believed. Middle Easterners who have been warning their countrymen that the oil age is ending have experienced some of that curse, but much less since oil markets tanked in March amidst a collapse in demand and a price war among the largest producers.

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While oil will remain important to the world economy for decades, its privileged geostrategic role is declining. The concept that oil is a scarce commodity to which access must be protected at all costs feels like it is starting to belong to another time. It seems as though we are headed towards a post-hydrocarbon future, and the coming change will shake the Middle East to its core. After the spring of 2020, it is no longer hard to imagine a world awash in surplus oil. What is hard to imagine is understanding how the oil age will end and how Middle Eastern societies will transition to the post-oil world. The coming year will give us a taste.

Not every country in the Middle East is an oil exporter, but oil runs through the economies of the entire region. The countries without oil generally export labor to the countries that have it, and oil-rich countries invest in the region's non-oil economies and subsidize their governments. Directly or indirectly, oil is the lifeblood of economies and of governments from Morocco to Iran.

When oil runs the world, money from oil sales helps run the Middle East. But what happens when oil demand plummets? The COVID shock shrunk global oil demand almost 30% in April, and traders wondered where they were going to store all of the oil. On April 27, deep in Oklahoma oil country, traders paid others $37/barrel to take oil off their hands.

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Twenty years after vigorous debates of whether the world had reached “peak oil” and economies would strain against limited supply, the opposite case has prevailed. Questions emerged, instead, whether the world had reached “peak demand.” The COVID-19 pandemic may be changing structural aspects of the global energy market. Workplaces may never be the same as they were before the pandemic, business travel may permanently decline, and car manufacturers are pouring billions into alternatives to the internal combustion engine. All suggest a sharp drop in demand for refined products.

However, hydrocarbons are not going away. Internal combustion-fueled cars and trucks will be on the road for decades, and jet planes will still ply the skies. Petrochemicals—not only textiles like nylon, polyester, and spandex, but also products such as plastics, solvents, and explosives—are all derived from hydrocarbons. The Middle East will be pumping oil and gas for decades.

The world’s integrated oil and gas majors, of which Saudi Aramco is the largest, are not waiting passively, either. They are investing heavily in alternative and lower carbon fuels and simultaneously driving down the cost of production.

Middle East producers have an advantage. Even when demand shrinks, the costs of production in the Middle East are among the lowest costs in the world. When the last barrel of oil is pumped from the ground, it is likely to be pumped in the Middle East. Yet, oil’s days as “black gold” are almost certainly behind it.

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A Lighter U.S. Military Footprint

The shift is increasingly visible in how the U.S. government looks at the Middle East. After almost two decades (and some would say four) of U.S.-led wars in the Middle East that have neither solved the region's domestic problems nor healed its international rifts, a bipartisan consensus has emerged that the United States must lighten the U.S. military footprint in the region. The military sees the counterterrorism mission, which became so central in the years after 9/11, as a Sisyphean task that skews U.S. forces, erodes readiness, and depletes equipment.

For U.S. allies and partners in the Middle East, any shift in the U.S. role is unsettling. For over a half-century or more, they have purchased U.S. weapons, and alongside them U.S. maintenance and training to use those weapons. They have built their militaries around the idea that the United States would be a security guarantor. Their security challenges, whether from regional rivals or domestic threats, have scarcely diminished. They see the U.S. beginning to leave before the job is done.

Some will seek to take matters into their own hands, as the Saudis and Emiratis have done in Yemen, and the Egyptians and Emiratis have done in Libya. The campaigns they have waged there have struggled to accomplish their political objectives (which, of course, U.S. efforts have struggled to do in Iraq and Afghanistan). Others will seek to engage with their adversaries, as many of the regional states have done with Iran in the last year, especially in the wake of unanswered Iranian attacks on regional energy assets in the summer of 2019. Many will seek other relationships to supplement, if not supplant, the dwindling U.S. interest.

China and Russia

China has a rising presence in the region. China's Middle East trade is exploding, and there are hundreds of thousands of Chinese workers in the Middle East, largely divided between professionals, traders, and construction workers. The Chinese government not only portrays itself as a reliable trading partner pointedly disinterested in domestic affairs, but also as a powerful model of guiding dramatic economic development without social unrest. Middle Eastern states, seeing China as both a rising global power, as well as a rising energy consumer—at a time when most countries' oil imports are declining—see opening to China not merely as an opportunity, but as an imperative. As the COVID crisis subsides, China will renew its Middle Eastern push.

China, which has far less domestic energy than the United States, seems lashed to the Middle East for longer than the United States. That unsettles U.S. allies in Asia, such as Japan and South Korea, which share China's reliance on Middle Eastern energy in the near and medium term and fear U.S. abandonment in the region—paradoxically, intended to allow the U.S. to rebalance toward Asia. To further its interests, China's regional weapons sales (especially drones) are increasing. In addition, many U.S. government officials believe growing Chinese electronics sales give China a back door to widespread surveillance.

Russia is also extending its footprint, although more slowly. While some of Russia's advance is through straightforward weapons sales, Russia also looks for opportunities to invest economically and militarily in distressed nations at a discount. Russia has used a surprisingly low-cost intervention in Syria to lock in long-term military basing rights. Russia has been exploring closer ties with Egypt, for example, agreeing to finance and build a nuclear plant on the Mediterranean coast, in addition to selling advanced jet fighters. Unlike China, Russia is not an economic powerhouse—its GDP is lower than Canada's—and its regional ambitions are more limited. A rising Russian regional profile, however, will serve as a reminder that the United States has retreated from its own dominance of the region.

The sudden drop in global oil demand, combined with a sense of imminent U.S. abandonment, highlights the third leg of regional challenge: the need to create high-quality jobs. The Middle East has been demographically young for decades, and governments have traditionally hired large numbers of young people. This has been true not only in oil-rich countries, where government employment was often considered a right of citizenship and a part of the social contract. It has also been true in poorer countries such as Egypt and Jordan, where public sector jobs have been a key form of patronage. Youth unemployment has been rising for years in the Middle East, running close to 30% in rich and poor countries alike.

It often takes years for young men, and increasingly young women, to find their first jobs.

Middle East

Youth unemployment

+30%

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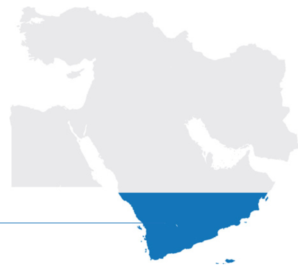

Regional governments have been counting on an enlarging private sector to pick up the slack. National programs, from Jordan's "Vision 2025" to Saudi Arabia's "Vision 2030" to Kuwait's "Vision 2035" to Abu Dhabi's "Ghadan 21," seek to boost private business activity and entrepreneurship, ultimately changing governments' roles from patrons to partners. The plans were ambitious before the 2020 drop in global oil demand, and the shifting economic context makes them both more necessary and harder at the same time.

All countries embarking on such plans have had to grapple with the enormity of the tasks ahead. They start with improving primary, secondary, and university education; include improving the regulatory and legal environment; and necessarily require an adjustment in societal attitudes toward work. In oil-rich societies, the tasks require a transition from relying on low-cost, high-productivity foreign labor, replacing it with high-cost, low-productivity local labor.

These tasks encompass the work of decades, but the collapse in global oil demand is making clear that time is limited. Rapid transitions might threaten domestic stability, and governments have shown an instinct to revert to subsidies when they sense unrest. Yet, the old pattern of relying on subsidies forestalls the forthcoming economic transition and threatens greater instability when it actually occurs.

A Variety of Approaches

What we are likely to see then is a variety of approaches to the change looming on the horizon. Some countries, such as Saudi Arabia, are advertising their commitment to vigorous change and ambitious megaprojects that aim to change mindsets. The leadership is betting that the country's wealth and its access to capital markets will allow it to power through the transition, carried along by young peoples' embrace of change.

Other countries, such as Kuwait, are taking a more cautious role. While the government made headlines in mid-2020 when it called for the eventual departure of half of the country's expatriate workforce, it generally has been slow implementing economic change. Kuwait's parliament, a U.S.-imposed legacy of the country's 1991 liberation from Iraq and the most independent parliament in the Gulf, has been aggressively protecting constituents' benefits from governmental reform efforts.

Iraq is in a genuinely difficult position, reliant on oil revenues but with a massively higher population than most of its Gulf neighbors and without their accumulated resources. Iraq's transition to a resilient and diversified economy will be especially fraught.

Egypt is projected to have the region's only growing economy in 2020, boosted by more than $2.75 billion in IMF loans and a $5 billion standby arrangement, on top of $7 billion in Eurobond offerings in the last 12 months. With long-term yields over 8%, some investors worry that too little of the money flowing into Egypt is creating jobs, and the country will fall into a debt trap. The government argues, correctly, that short-term financing is necessary to blunt the effects of decreased tourism, remittances, and Suez Canal tolls, all due to COVID-19.

While most projections suggest a broad-based recovery in the Middle East in 2021, populations and their leaders cannot un-see what they witnessed in 2020. Certainties that had been accepted for generations are now uncertain. At the same time, the threat of a world with more than enough oil is more real than it has ever been. How quickly that future comes, and how well countries adapt, remains unclear. There is no question, though, that it is coming, and 2020 was only a taste.

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