Istituto Affari Internazionali

Oil Price Volatility and the Implications for European Foreign and Security Policy

by Nicolò Sartori

ABSTRACT

The volatility characterising oil prices in the last year and a half is likely to affect negatively the already compromised economies and socio-political patterns of MENA producing countries. The echo would resound directly in Europe, an important import destination and migrant recipient. Starting from a broad overview of the consequences of declining oil prices on the revenue-dependent economies of North Africa and the Middle East, this paper investigates the possible social and political implications in the medium-long term, highlighting the need for producing states to evaluate wisely policies able to prevent further turmoil in the area. A large part is dedicated to what the trend means for Europe, in order to shed light on the strong link between the regions and underline the importance of the EU playing an active role in mitigating the effects on both importing and exporting countries.

Middle East | North Africa | Oil | Prices | European Union | CFSP

keywords

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Introduction

Starting from its peak of June 2014, when oil arrived at 114 dollars per barrel, in the past year and a half the price has fallen by 70 percent, bottoming at 27 dollars per barrel in January 2016. Given the strategic importance of oil for both producing and consuming countries, the collapse of crude prices has strong economic, political and security implications at the national, regional and global levels. The Middle East and North Africa (MENA), where more than half of the world's oil reserves are located and which exports 43 percent of global crude output to the international market, is certainly one of the regions most affected by such a volatility.

Regional oil producers heavily depend on oil export revenues to sustain their public budgets, finance generous social and redistributive policies, and eventually ensure the stability of their political regimes. Starting from the 1970s, the majority of regional oil exporting countries have developed a peculiar model of State – defined by scholars as *rentier* State – that allows ruling elites to maintain huge public expenditure programs without resorting to taxation and without running into severe balance of payment or inflation problems.[1] In the past decades this model has been successfully used by governments to "buy off" citizens' acquiescence in political matters and to keep power in the hands of the ruling elites. Following the outbreak of the Arab Spring movements in 2011, the use of oil-derived financial resources has continued to play a central role in explaining (with the significant exception of Libya) the survival of these regimes.[2]

[1] Hossein Mahdavy, "Patterns and Problems of Economic Development in Rentier States: The Case of Iran", in M.A. Cook (Ed.), *Studies in the Economic History of the Middle East from the Rise of islam to the Present Day*, London and New York, Oxford University Press, 1970, p. 428-467.

[2] Kjetil Selvik and Bjørn Olav Utvik (eds.), *Oil States in the New Middle East. Uprisings and Stability*, London and New York, Routledge, 2016.

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The unprecedented reduction of oil-derived financial flows experienced in the last year and a half has the potential to modify these long-lasting patterns, prompting governments to undertake a forced revision of their public spending and fiscal mechanisms. It is an exceptional reform process that, however, risks to undermine the sustainability of the socio-economic policies that for decades have ensured a substantial degree of political stability and resilience to these regimes. New financial constraints, moreover, intertwine with these governments' responses to the manifold security challenges affecting the MENA area and might undermine their capacity to sustain their position in the long run. All this, in a region that is increasingly under pressure from the rise of the Islamic State and from the raging conflict between Sunni and Shia factions. Indeed, ongoing conflicts in producing countries such as Libya, Syria and Iraq threaten their capacity to export hydrocarbon resources to the EU, and in a long-term perspective limit the sustainability of their energy sectors due to lack of international investments in the region.

In the last few years, the basic grounds of the traditional EU policies towards the region have changed, while the long-standing strategic orientations of MENA governments can no longer be taken for granted. In this context, the mounting volatility of the southeastern flank of Europe confronts Member States with vital political and security challenges such as massive migrant and refugee flows and Islamic terrorism, as well as serious threats to the security of EU oil and gas supplies from the MENA area.

1. The economic impact of falling oil prices in producing countries

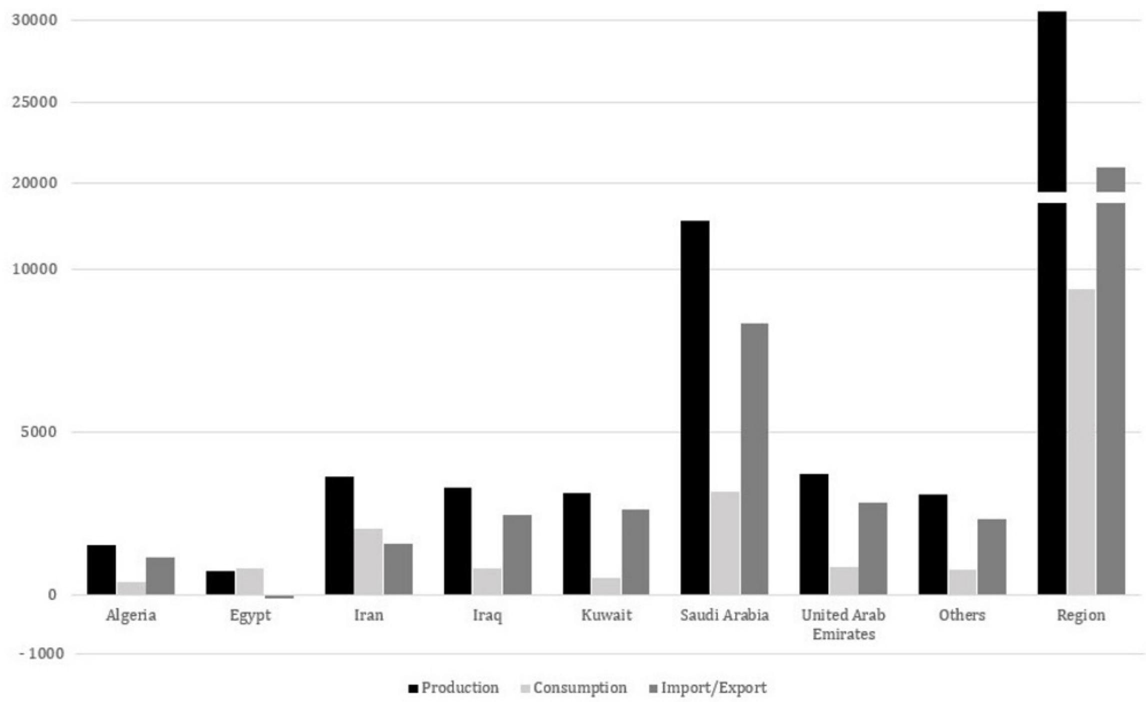
Although with different intensity on a case-by-case basis, oil revenues represent the cornerstone of the political and socio-economic architectures of oil producing and exporting countries of the Middle East and North Africa, a group that includes the members of the Gulf Cooperation Council (GCC),[3] as well as Algeria, Egypt, Iran, Iraq, Libya and Syria.[4] The region holds about 50 percent of the world's total oil reserves and produces roughly one-third of the global oil output, the majority of which is exported towards the East Asian and European markets.[5]

[3] The Gulf Cooperation Council (GCC) is composed of Saudi Arabia, Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates (UAE).

[4] Egypt, Iran and Syria represent extreme cases since, due to different factors, their financial reliance on oil and gas revenues has notably declined in the last few years. The case of Egypt is particularly relevant, as the country has been a net exporter of oil and gas until recently. In 2011 the country reverted to importing oil from the international markets, while in 2015 it abandoned its status of natural gas exporter. However, Egypt is expected to soon resume its gas exports, thanks to the gas discoveries in 2015 in the Zohr giant offshore field, in the Mediterranean Sea. As for Iranian revenues, these have been severely hit by the new international sanctions that targeted the country's nuclear programme. Finally Syria, where oil revenues have basically disappeared due to the almost complete halt of the national oil industry resulting from the presence of the Islamic State in the country's more productive provinces.

[5] According to the BP *Statistical Review of World Energy*, in 2014 the region produced about 30

Figure 1 | Oil production, consumption, exports - MENA region, 2014 (thousand barrels per day)



Oil (and gas) trade represents the bulk of the exports of these countries.[6] In the case of Saudi Arabia, the world's leading oil exporter with almost 7 million barrels per day, international oil trade accounts for about 85 percent of the Kingdom's total export earnings. In other major exporting countries such as Kuwait and Iraq it amounts respectively to 95 percent and 98 percent, while North African producers such as Libya and Algeria depend on hydrocarbon trade for 95 percent and 97 percent of their total export revenues, respectively. In Iran and the United Arab Emirates, which have developed more diversified economic systems, oil income has a relatively lower – although still relevant – impact on the total international revenue flow (60 percent and 30 percent each).[7]

Producers not only heavily depend on oil exports as a main source of income, but they also tend to calibrate their public budgets to crude price expectations. This

million barrels per day (bbl/d), with a consumption of a bit less than 10 million bbl/d, and an export capacity of around 20 million bbl/d.

[6] Before the oil price collapse, energy revenues accounted for approximately 50 percent of gross domestic product, 75 percent of exports and 80 percent of total revenues of the GCC countries. See Tim Callen et al., "Economic Diversification in the GCC: Past, Present, and Future", in *IMF Staff Discussion Notes*, No. 14/12 (December 2014), https://www.imf.org/external/pubs/cat/longres.aspx?sk=42531.

[7] Information available on OPEC official website: http://www.opec.org/opec_web/en/about_us/25.htm.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

practice exposes them to the potential volatility of oil markets, as happened in the last year and a half. Since prior to June 2014 oil price projections were relatively stable at over 100 dollars per barrel, governments unsurprisingly placed their fiscal breakeven prices for 2015 well above the current 35 dollars: Saudi Arabia was just over 100 dollars per barrel, Iran around 120 dollars, Algeria at 130 dollars, while Libya was dangerously around 180 dollars. More cautious – but still far from current values – was the approach adopted by smaller GCC members such as the UAE, Kuwait and Qatar, which placed equilibrium prices at around 70 dollars a barrel. Since mid-2014, this policy has generated massive fiscal deficits across the region, forcing producers to tap into the huge financial reserves accumulated in the previous years and to propose (and possibly adopt) austerity plans encompassing the radical revision of their fiscal and socio-economic policies.

1.1 Financial and economic effects

The financial and economic impact across the Middle East and North Africa is outstanding.[8] The GCC group, for instance, which in the past decade registered impressive fiscal surpluses that averaged 12.4 percent of GDP, in 2015 ran aggregate deficits of 7.9 percent, with projections for 2016 at around 3.6 percent of GDP.[9] The situation in the region is heterogeneous: in Kuwait the budget declined by about 30 percent of GDP, by 22 percent in Algeria, by 15 percent in Saudi Arabia and by 12 percent in Iraq. The situation in Iran and the UAE is less dramatic, with the two countries running fiscal deficits of "only" 2.6 percent and 2.1 percent of GDP respectively. Singular is the case of Libya: severely damaged by the conjunction of oil price decline and the violent conflicts between militias on the ground, the country's fiscal deficit for 2015 is estimated to have reached more than 55 percent of GDP.[10]

The huge shortfalls in government revenues and the fiscal imbalances they generate have significant consequences on the economic results of these countries. Slowdown in growth rates, rise in unemployment, weaker balance of payments, and falling per-capita income and expenditure are in fact the main results of the rapid collapse of oil prices in the region. The six GCC countries, after a decade of sustained economic performance,[11] in 2015 registered a modest 3 percent growth, significantly slower compared to the 4.2 percent scored in 2014. The economic slowdown is expected to endure, as the International Monetary Fund

[8] Paul Cochrane, "GCC Starts Tightening Its Belt on Glimmers of Future Austerity", in *Middle East Eye*, 21 April 2015, http://www.middleeasteye.net/node/42194.

[9] Laura El-Katiri, "Oil's Fall Is a Challenge for Gulf Economies, but Also an Opportunity", in *Harvard Business Review Blog*, 7 March 2016, https://hbr.org/2016/03/oils-fall-is-a-challenge-for-gulf-economies-but-also-an-opportunity.

[10] World Bank, *The Economic Outlook for the Middle East and North Africa - October 2015*, 5 October 2015. http://goo.gl/QVl9WI.

[11] In the period between 2000 and 2011 the GCC economies grew on average at a rate of 5.8 percent.

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IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

(IMF) forecasts for the GCC project a drop in growth to 2.75 percent in 2016.[12] Saudi Arabia's economy is set to grow at 1.2 percent (the slowest pace for the Kingdom since 2002), Oman will grow at 0.5 percent, Bahrain at 1.8 percent and Kuwait at 1.9 percent. The UAE is expected to score a 2.6 percent growth rate in 2016, the weakest performance the country has experienced since 2010, while Qatar, the best performing country in the group,[13] will expand to 3.6 percent versus an initial estimate of 5.5 percent.[14]

Table 1 | Macro economic effects of falling oil prices

	Fiscal surplus/deficit on GDP (%)				Foreign currency reserves (Bn$)
	2013	2014	2015	2016	
Algeria	-1.5	-7	-16	-7	143
Egypt*	-13.8	-12.4	-8.9	-9.9	7
Iran*	-2.25	-1.25	-2.5	-2.6	125
Iraq	-6	-5.3	-18.4	-11.9	43
Kuwait*	11.7	-4.4	-10	-30	592
Saudi Arabia	6.5	-2,3	-16	-12.9	685

Source: Own compilation on IMF; Reuters; Sovereign Wealth Fund Institute (SWFI).
Note: *2013/14; 2014/15; 2015/16; 2016/17.

In North Africa, the economies of Algeria and Libya are heavily hit by the combination of decreasing oil revenues and enduring internal troubles. In Algeria, GDP growth rate has slowed down from 4.3 percent in 2014 to a projected 2.8 percent in 2015, due both to the weakness of the national oil and gas industry and deceleration in the non-hydrocarbon sector.[15] Libya's economy, more critically, is affected by the extreme violence between rival militias on the field and by the unresolved fragmentation at the political level: according to estimates, in 2015 the country's GDP has dropped by another 6 percent, and it is expected to grow by only 2 percent in 2016.[16] Finally Egypt, where the economic outlook remains variable: for 2016, the IMF predicts an economic growth of 3.3 percent of GDP, with a significant slowdown compared to the previous year (4 percent growth in 2015).

[12] "How Low Oil Prices Are Battering the MENA Region", in *Knowledge@Wharton*, 19 January 2016, http://knlg.net/1V626ZX.

[13] Differently from other countries in the region, Qatar is not a major oil exporter, while the majority of its international revenues come from the LNG sector. Although LNG supply contracts are often oil-indexed, and thus indirectly affected by the crude price decline, this specific condition (along with substantial growth in the non-oil and gas sector) contributes to explain the less dramatic economic performance of the country in the last year and a half.

[14] Alaa Shahine and Vivian Nereim, "IMF, HSBC See Saudi Growth at 14-Year Low on Oil Prices Fall", in *Bloomberg*, 19 January 2016, http://bloom.bg/1Rxmghn.

[15] World Bank, *Algeria: Overview*, updated 31 March 2016, http://www.worldbank.org/en/country/algeria/overview.

[16] IMF, *Arab Countries in Transition: Economic Outlook and Key Challenges*, 8 October 2015, https://www.imf.org/external/pp/longres.aspx?id=4989.

Foreign reserves have considerably reduced, while the country is increasingly dependent on foreign aid. Despite lower oil prices, the fiscal deficit is growing compared to 2015, while domestic public debt remains high. The potential income from exploitation of the newly discovered Zohr gas field could however contribute to altering the picture in the next few years.[17]

1.2 Socio-economic policies

These circumstances are forcing the governments of oil producing countries to adopt urgent measures to address the current fiscal imbalances, and to implement mid-term policies aimed at reducing their dependence on hydrocarbon revenues and at strengthening the process of diversification of their national economies. These reforms would necessarily transform the fiscal and social model that has so far guaranteed welfare services and subsidies to the population in exchange for its exclusion from national political processes. The first countermoves have not been slow in coming. In order to address huge budgetary disproportions, governments across the region are introducing radical fiscal austerity programmes to cut public spending, while discussing possible privatisation plans and tax system reforms to make public budgets more sustainable and resilient to oil price shocks.[18]

At the end of 2015 the Saudi ruling elite announced a 14 percent cut in public budget, putting a cap to the generous bonuses on salaries granted to public workers just one year before as a tool to boost citizens' purchasing power and expand the national economy. In addition to this, the Saudi reform package would consider the opportunity to launch an extensive privatisation process: along with privatising national airports, municipalities, hospitals and the education system, the plan would include also a portion of Saudi Aramco shares and/or some downstream subsidiaries of the national oil giant. In Kuwait, as well, the government is committed to the rationalisation of its fiscal policy: after Sheikh Sabah's request to the Cabinet and Parliament to review public expenditure last October, the country's Ministry of Finance announced a 1.6 percent spending reduction in the fiscal year beginning in April. In the plan of the Kuwaiti authorities, the massive spending review could be accompanied by the progressive introduction of income, corporate and sales taxes on local firms to compensate for lost oil revenues.[19]

In Iraq, the main cuts would apply to civil servants' salaries (by far the largest spending voice in the Iraqi budget), which have been reduced by 3 percent starting from 2016. Also funding for the national healthcare system, which since the 1970s has offered free and reliable healthcare service to Iraqi citizens,

[17] IMF, *World Economic Outlook April 2016 : Too Slow for Too Long*, 12 April 2016, p. 44, http://www.imf.org/external/pubs/ft/weo/2016/01/index.htm.

[18] In this context, for instance, the GCC plans to introduce a region-wide value-added tax of 5 percent, possibly by 2018, which would contribute about 1 percent of GDP in fiscal revenues.

[19] Ahmed Feteha and Nour Al Ali, "Kuwait Plans to Cut Spending Next Year as Oil Revenue Plummets", in *Bloomberg*, 28 January 2016, http://bloom.bg/1Sl7zwA.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

is expected to shrink significantly. While the initiatives to impose new excise and consumption taxes have still to be verified, the government is concretely planning to issue international and domestic bonds valued at 7 billion dollars (5 and 2 billion respectively) to reduce the excessive deficit, projected to amount to 20.1 billion dollars in 2016. Another example of budgetary consolidation policies is Algeria, where the government has introduced an unspecified 9 percent cut in its budget for 2016. This move, however, is balanced by the decision to ring-fence public spending in sectors such as housing, healthcare and education: this move would cost roughly 60 billion dollars a year, as part of the regime's plan to increase subsidies by 7.5 percent to ensure social stability.[20] While the compatibility between these two diverging fiscal measures is still to be evaluated, the finance package adopted by the government includes the increase of VAT on consumer goods and services and the raising of taxes on imported products, as well as the allocation of local-currency debt, with an interest rate of 5 percent, for its financing needs.

Box 1 | The state of reform processes across the region

Algeria: 9 percent cut in 2016 budget; increase of VAT on consumer goods and services; raised taxes on imported products; allocation of local-currency debt. Spending on subsidies expected to increase.
Egypt: Overall reform of subsidies on natural gas, transport and residential users.
Iran: Overall reform of domestic fuel prices and gas prices to households and commercial consumers; introduction of new petroleum contracts to attract foreign investments.
Iraq: Cuts to civil servant salaries; reduction of public healthcare spending; emission of international and domestic bonds worth 7 billion dollars; proposed new excise and consumption taxes; introduction of new contractual formulas to attract oil investments from abroad.
Kuwait: 1.6 percent cut in 2016 government spending; progressive introduction of income, corporate and sales taxes on local firms; reform of national oil industry through selling loss-making assets and facilities, evaluates the opportunity to issue bonds to sustain 100 billion dollars of planned investment planned a gradual reduction of energy subsidies.
Saudi Arabia: 14 percent cut in 2016 budget; reduction of bonuses on public salaries; reforms to phase out energy subsidies; privatisation of national assets, companies and services; rationalisation and consolidation of national oil industry.
Bahrain, Oman, and Qatar: Measures to progressively reduce the cost of subsidies.

[20] "Algeria: The Curse of Falling Oil Prices", in *Al Jazeera*, 28 November 2015, http://fw.to/6RGTtcO.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

1.3 Energy sector policies

While representing the main source of income for oil producing countries, the energy sector – in particular due to extensive energy subsidies – is also among the largest cost components in their public budgets.[21] In the short term, energy subsidies heavily impact the financial and economic performances of these countries – including net-importers such as Egypt.[22] In the mid to long term, these energy pricing policies have an important effect on oil production and export activities, and hence on future revenue stream. For these reasons, the revision of their current energy subsidies systems is one of the key measures to be considered by governments to cope with the financial effects of the collapse of oil prices.

The five-year austerity plan launched by the Saudi regime at the end of 2015 goes in just this direction. The government decision to reduce the financial weight of subsidies – which, in 2014, amounted to 107 billion dollars, roughly 13 percent of the country's GDP – and to progressively align national prices of fuel and electricity (as well as water) to market values, immediately produced its first effects: ethane price increased by 133 percent, diesel transport by 79 percent, and natural gas and low-grade gasoline by 67 percent each. Similarly, other members of the GCC such as Bahrain, Oman and Qatar are introducing measures to progressively reduce the cost of subsidies, in order to encourage a more efficient use of both financial and energy resources. While in the fiscal budget for 2016, Oman's expenditure in subsidies is expected to drop by 64 percent thanks to measures already in place, in Bahrain and Qatar gas prices at the pump rose by up to 60 percent and 30 percent respectively at the beginning of the year.

In Iraq, national authorities plan to progressively phase out subsidies on fuels and on power generation, with the objective of saving at least 14 billion dollars per year, a move that is already under scrutiny also in Algeria, although in both cases the effective implementation of such potentially socially destabilising measures could be postponed by the governments for political stability reasons.

But the collapse in the price of oil also has important implications in terms of direct investments in the region's hydrocarbon industry. According to both OPEC and IEA, in fact, the price decline has led to significant reduction in capital investment in the oil and gas sector at the global level: a 20 percent decline in 2015, based on the Agency's estimates, a tendency that is expected to continue throughout 2016.[23] Due also to the political and economic uncertainties surrounding the region,

[21] Laura El-Katiri and Bassam Fattouh, "A Brief Political Economy of Energy Subsidies in the Middle East and North Africa", in *OIES Papers*, No. MEP 11 (February 2015), https://www.oxfordenergy.org/publications/a-brief-political-economy-of-energy-subsidies-in-the-middle-east-and-north-africa.

[22] Egypt is the fourth largest oil producer and the second gas producer on the African continent, but since 2015 the whole domestic hydrocarbon output is currently absorbed by a rising internal demand.

[23] International Energy Agency (IEA), *World Energy Outlook 2015*, November 2015.

the decline in international investments also affects the MENA countries, where the national energy authorities and stakeholders are exploring new solutions to counteract these alarming trends.[24]

Iraq is a case in point. The country, expected to become the largest contributor to future OPEC production growth, is currently struggling to attract the cash inflows necessary to maintain the projected output levels for the years to come. Due to the combination of declining oil price, security concerns on the ground and administrative issues among different federal entities, the national oil industry is facing a significant squeeze on international investments. While the situation is particularly critical in the Kurdistan region, where major operators like Genel Energy are heavily cutting their capital expenditure,[25] the oil-rich southern province also looks somewhat vulnerable to investment cuts. The State-run South Oil Company (SOC) has recently proposed new contractual formulas to major international players such PetroChina and ExxonMobil, trying to attract their investments to foster the expansion of smaller oilfields located in the southern part of the country (Luhais, Nassiriya, Tuba, Nahr Bin Umar and Artawi), the development of which is slowed down by the current price conditions.

Besides Iraq, other regional actors – including Saudi Arabia, Kuwait, Algeria and Iran, as well as Egypt – are seeking opportunities to attract investments in order to further increase their production and expand their market share despite the current oil glut. In order to cope with dropping international investments, the oil giant Saudi Aramco has announced a process aimed at prioritising projects, controlling costs, re-examining existing contracts and seeking cost-containment opportunities in future contracts for goods and services.[26] In parallel with these rationalisation efforts, the company has confirmed investments commitments, to be fostered by listing a number of Saudi Aramco shares – including part of the company's exploration and production assets – on the local and international financial markets. Similarly, the State-run Kuwait Petroleum Corporation (KPC), while planning to sell loss-making assets and facilities, is evaluating the opportunity to issue bonds to sustain 100 billion dollars of planned investment foreseen by the company to boost oil production over the next five years.[27] Also Algeria's oil company Sonatrach, currently involved in a programme of restructuring aimed at reducing costs and enhancing effectiveness (i.e., through the reduction of gas reinjections for oil recovery, a practice that currently diminishes by about 50 percent the amount of gas available for internal demand and exports), is developing

[24] Carole Nakhele, "Low Oil Prices Today May Not Mean Low Investment Tomorrow", in *Geopolitical Intelligence Service*, 22 January 2016, http://ceip.org/292WDo7.

[25] Anthony McAuley, "Iraqi Oil Companies Starved for Investment", in *The National*, 21 January 2016, http://www.thenational.ae/business/energy/iraqi-oil-companies-starved-for-investment.

[26] Reem Shamseddine and Dmitry Zhdannikov, "Saudi Aramco Chief Says Maintaining Oil and Gas Investment", in *Reuters*, 25 January 2016, http://reut.rs/1QnUb90.

[27] Wael Mahdi, "Kuwait May Issue Bonds Amid $100 Billion Oil-Investment Push", in *Bloomberg*, 26 January 2016, http://bloom.bg/1UodLmC.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

a plan to expand future crude production.[28] After the partial failure of the 2014 bidding round determined by the country's burdensome business environment, Algerian authorities seem keen to adapt their bidding parameters and regulatory procedures in order to attract international companies and investments to develop huge – conventional and unconventional – oil and gas reserves.[29]

Egypt's changing energy status (since 2015 the country has become a natural gas net importer) has encouraged the government to begin an ambitious reform that foresees a 30 percent cut in energy subsidies, which in the past equalled the combined expenditure on health and education. This reform effort would go in parallel with a renewed activism in the hydrocarbon upstream sector that, thanks to the discovery of the giant Zohr field in August 2015, will allow Egypt to stop importing natural gas starting from 2017/2018. The development of the resources located in the field is a priority for the Egyptian government, as it would contribute to both boosting the country's economic development and stabilising the political situation in the country. In addition, the establishment of deeper energy cooperation between Egypt and its neighbouring East Med countries (Cyprus and Israel first and foremost) and the development of an integrated Eastern Mediterranean gas hub, would result in a more stable regional geopolitical framework and in improved security of supply for the EU, which would benefit from new gas volumes from the region.

2. The effects of low oil price in a destabilised region

The socio-economic imbalances in most of the Middle Eastern and North African oil producers -resulting from a number of structural factors and accelerated by the crude price decline- have the potential to foster popular discontent, especially among young people, and to put under pressure the internal stability of the regimes in place. At the same time, the effects of collapsing oil price and external revenues can contribute to precipitating the geopolitical and security situation in a region severely destabilised by sectarian rivalries and by enduring conflicts in Libya, Syria, Iraq and Yemen.

2.1 Internal political effects

The poor economic performance recorder in the last year and a half is mainly the result of the rapid collapse of oil prices in the region. The policies planned and/or implemented by governments to rebalance the fiscal and economic disparities generated by the dependence on oil revenues, risk – at least in the short term –

[28] Lamine Chickhi, "Algeria's Sonatrach Looks to Restructure in Face of Oil Crisis", in *Reuters Africa*, 16 October 2015, http://af.reuters.com/article/algeriaNews/idAFL8N12G1QY20151016.

[29] Salah Slimani, "Algeria to Boost 2016 Oil Output, Offer Rights Amid Global Glut", in *Bloomberg*, 17 December 2015. http://bloom.bg/1k48rYP.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

having deep implications for the domestic stability of some of these countries. Indeed, austerity programmes aimed at cutting public spending, introducing new taxes and privatising services would have a direct impact on citizens' daily lives.

The phase-out of energy subsidies is a case in point. Removing subsidies would not only mean higher cost of living for the population, but also indirect costs for national non-oil industries, expected to pay higher prices for the energy they consume. In the short term, with regional economies challenged by falling oil prices, the loss of industrial competitiveness caused by higher non-subsidized energy prices might generate dangerous vicious circles and contribute to further deteriorating the political and socio-economic environment.

This situation may lead MENA countries to three different scenarios:

- First, the break-up of the rentier social pact that has immunised these countries from popular protests during the past decades, producing diffuse popular disaffection.
- Second, precipitation of the economic conditions, igniting popular protests difficult to handle due also to the scarcity of financial resources available.
- Third, financial, economic and political unsustainability, leading to risks of State failure.

Box 2 | Political effects of falling oil price

Algeria: Risk of instability due to State fragility and risk of State failure.
Bahrain: Risk of instability due to worsening economic conditions and population hostility.
Egypt: Risk of instability due to worsening economic conditions and population hostility.
Iraq: Risk of instability due to State fragility and risk of State failure.
Kuwait: Risk of instability due to the break-up of rentier socio-political pact.
Oman: Risk of instability due to the break-up of rentier socio-political pact.
Saudi Arabia: Risk of instability due to the break-up of rentier socio-political pact.

Looking back at the history of the region, there are relevant examples of the destabilising effects of the combination between oil price decline and bad economic performance on the fate of the regimes in power. Algeria, for instance, experienced massive social protests at the end of the 1980s, determined by the economic effects of the 1986 oil shock, during which the crude price fell from 30 dollars to about 10 dollars a barrel, back to the level of 1974. The social unrest that followed the deterioration of the economic conditions resulted in a set of political reforms culminating in the introduction of a multiparty system and democratic elections. The course of reform ended with the victory of the Islamic Salvation Front (FIS) in the first round, a military coup that blocked the electoral process,

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

and a decade of brutal civil war between Islamic militant groups and the Algerian army during the 1990s. As well, the financial stringency, economic weakness and political instability experienced by Iraq after the fall of oil prices at the end of the 1980s is considered one of the variables to explain[30] the aggressiveness of Saddam Hussain's regime, climaxing with the invasion of Kuwait.

More recently, the events of the so-called Arab Spring have shown how deep the impact of the combination between political and economic factors on the stability and sustainability of North African and Middle Eastern regimes can be.[31] Although not directly associated with the decline of oil price, economic parameters such as poverty conditions, income inequality, wealth disparities, rising inflation, growing unemployment (particularly among youth), dissatisfaction with the quality of life and poor public services contribute to explaining popular mobilisation and discontent across the region. In the past, the availability of huge financial resources allowed the governments with highest oil revenues – with the relevant exception of Libya – to react more effectively against the challenges posed by the wave of uprisings spreading to their countries. In particular, the political turmoil that erupted between 2010 and 2011 persuaded political leaders of the need to spend larger shares of their oil-derived wealth on buying social peace in the region. The extensive domestic social spending planned by GCC countries in the aftermath of the uprisings, amounting to 150 billion dollars or 12.8 percent of the bloc's aggregate GDP for 2011, is the clearest example of this strategy.[32] Nowadays, in face of potential popular mobilisation triggered by poor socio-economic performances – possibly coupled with requests for greater political participation, sectarian rivalries and radicalisation trends across the region – the collapse of oil price offers reduces the financial tools to continue with old policies aimed at buying social peace.

Although it has to be noted that, after a year and half of low oil prices and worsening economic outlook, the region has not yet experienced major outbreaks of popular protest, the experience of the Arab Spring still suggests that the trends in place in the region could seriously affect the stability and sustainability of these countries. In countries where the political conditions are more precarious, like Algeria and Iraq, the fiscal and social reforms launched by the regimes have already triggered resentment among the population.

In Iraq, where the necessity to act is made extremely urgent by the combination of oil price decline and domestic vicissitudes (i.e., fight against the Islamic State, refugees' flows), the initiatives promoted by the government are facing growing

[30] F. Gregory Gause III, "Sultans of Swing? The Geopolitics of Falling Oil Prices", in *Brookings Doha Center Policy Briefings*, April 2015, p. 6, http://brook.gs/28Z07VC.

[31] Political factors include repression, nepotism, corruption, political accountability and sectarian rivalries, and help to explain the eruption of protests across the Arab world.

[32] Elizabeth Broomhall, "Arab Spring Has Cost Gulf Arab States $150bn", in *Arabian Business*, 8 September 2011, http://www.arabianbusiness.com/arab-spring-has-cost-gulf-arab-states-150bn-419429.html.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

opposition at the popular level, but also from institutional actors such as the Parliament. In fact, rising cost of living and decreasing public services for citizens (i.e., electricity cuts, suspension of water supplies, healthcare system reshaping) not accompanied by serious efforts to address corruption and nepotism in governmental bodies, have triggered popular protests in different cities across the country. In the current unstable environment where sectarian conflicts are on the rise, the plan to cut salaries and pensions to about 8 million Iraqi citizens who fully depend on public support as their source of livelihood is considered a strong trigger for the outburst of civil disobedience in the country.

The situation is worsening also in Algeria, where the combination of economic slowdown, rising cost of living and reduced public benefits triggered by declining oil revenues could further increase disaffection vis-à-vis the Bouteflika regime. For various reasons, popular discontent among the population is high, as witnessed by the head-to-head confrontation between the government and anti-shale local activists, escalated in 2015 during the prolonged protests in the southern part of the country, where Sonatrach was carrying out unconventional drilling tests aimed at exploiting the large shale reserves located in the Algerian subsoil.[33] For a country threatened externally by the events in Libya and Mali, mounting social and economic discontent combined with strong uncertainty over the fate of the regime open the door to protracted political instability possibly matched by the risk of domestic radicalisation, violence and terrorism.

In Egypt, the attempt of President Al-Sisi to limit popular disaffection by devoting the country's scarce public resources to the lowest classes and the seven million people on the State's payroll did not prevent the eruption of popular protests aimed at the regime during the fifth anniversary of the revolution. The situation in the country remains tense: on one hand the repressive practices adopted by the government against those who dissent, and on the other the worsening economic conditions hitting also the upper classes of Egyptian society, may actually threaten the stability of Al-Sisi's rule.

More timid, but still relevant, are the popular complaints aroused in Kuwait and Bahrain in response to the reform measures proposed by the respective governments to cope with collapsing oil prices. At the beginning of 2016, the regime's decision to lift subsidies on diesel, kerosene and aviation fuel resulted in a public outcry in Kuwait, with the national Parliament, considered the most independent and assertive assembly of the GCC bloc, being particularly critical towards the government's cuts in social spending. Recently, Kuwaiti oil workers went on strike, protesting against the spending review measures applied by the government to their salaries: this situation led the country's oil production to fall by almost two-thirds, stabilising at the 1 million bbl/d level due to foreign workers

[33] According to the US Energy Information Administration (EIA), Algeria is the third country in the world in terms of shale reserve, behind China and Argentina. See EIA, *World Shale Resource Assessments*, updated 24 September 2015, https://www.eia.gov/analysis/studies/worldshalegas.

remaining operational at the oil fields.[34] Output has not yet recovered full capacity, reaching about 1.5 million bbl/d to date.[35] Similarly in Bahrain, where political stability was challenged in 2011 by the eruption of Sunni-Shia tensions followed by the military intervention of the GCC, the government decision to cut spending on subsidies fuelled discontent from different parties, also at the institutional level.[36] The socio-economic effects of these measures, added to the ruling elite's failure to find a political solution to the enduring sectarian divisions, could deteriorate the solidity of the Sunni Al-Khalifa dynasty, already confronted by the Shia majority.

2.2 Regional political effects

The limited financial leverage of governments, coupled with the lack of political will, significantly hinder their capacity to address vital security challenges posed by armed militias, Islamist terrorist groups and sectarian clashes. In Iraq, for instance, the expensive fight against the Islamic State group – which controls areas in the northwest of the country – and the management of internally displaced people and refugees from Syria are increasingly constrained by the financial pressure derived by the oil price decline. Along with the financial and military assistance ensured by the US and the international community,[37] in fact, oil revenues are fundamental to sustain the government's fight against the Caliphate and to run defence activities in general, which account for roughly 20 percent of the country's overall budget. The picture is particularly critical in the Iraqi Kurdistan region where, due to shrinking oil-generated financial transfers from Baghdad, Peshmerga fighters lack sufficient money to sustain the military efforts against the IS and are pushing the US-led coalition to provide further financial support directly to Kurdish authorities.[38]

Also in Libya, the drop in revenues caused by the combination of collapsed production/exports and declining oil price is impacting on the capacity to respond to mounting security threats. The country has been weakened by the longstanding confrontation between the two parliaments in Tripoli and Tobruk and by the continuous clashes among rival factions and groups on the field. Indeed, the growth of terrorist attacks and sabotages against critical energy infrastructures in the country – perpetrated by different groups affiliated with the IS as well as by ethnic minorities like Berbers and Toubous – is having an impact on vital assets

[34] Devika Krishna Kumar, "Oil Rises as Kuwaiti Strike Cuts Output for Third Day", in *Reuters*, 20 April 2016, http://reut.rs/26bINFK.

[35] This situation add to the ongoing dispute between Kuwait and Saudi Arabia over the exploitation of the jointly operated Wafra oil field located in the partitioned zone. The activities at the field have almost completely halted since mid-2015, reducing by a total of about 250,000 barrels of oil per day the output of the two countries.

[36] "Bahrain MPs Blast Fuel Price Hike in Heated Session", in *Reuters*, 12 January 2016, http://reut.rs/1Q2ejzn.

[37] Michael R. Gordon and Julie Hirschfeld Davis, "In Shift, U.S. Will Send 450 Advisers to Help Iraq Fight ISIS", in *The New York Times*, 10 June 2015, http://nyti.ms/1Gy0Xb0.

[38] Julian Pecquet, "Slump in Oil Prices Wallops Anti-IS Coalition", in *Al Monitor*, 12 January 2016, http://almon.co/2kvc.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8 © 2016 IAI

for hydrocarbon production, transmission and distribution. The most important energy facilities attacked by the militias include the huge oil terminals of Ras Lanuf, Es Sider and Zuetina, but also oil fields in the Sirte region such as Sarir and more generally pipeline networks transporting crude across the country. In this situation, the unity government formed in February 2016 seems almost ineffective in confronting the IS group, increasingly active internally against Libyan energy infrastructure, but also across the borders with Tunisia and Algeria. The North African country is *de facto* becoming a safe haven for Libyan and foreign terrorists, criminals and violent groups, with negative spinoffs at the regional level and across the Mediterranean Sea.

As an example, in 2013 an Islamist cell linked to the former military commander of Al-Qaeda in the Islamic Maghreb (AQIM), Mokhtar Belmokhtar, claimed the assault on the Is Amenas gas field in Algeria, during which 39 foreign hostages were killed. More recently, AQIM carried out a rocket attack on a gas plant in the southern Algerian desert near the town of In Salah.[39] While the assault, directed at a joint BP-Statoil facility, left the gas plant unharmed without injuries and casualties, the episode reveals how regional instability and the porosity of the Algerian borders with Libya, Tunisia and Mali may endanger the normal activities of the country's energy sector, already put under pressure by the lack of international financial inflows. Similarly, Egypt's energy infrastructure is threatened by the growth of radical anti-government forces in the northern Sinai region, where IS affiliates target not only local security/police forces – more than 700 casualties have been recorded since 2013 – but also critical assets such as the gas pipeline connecting Egypt to Jordan, attacked the last of several times in January 2016.[40] The group's action in Egypt is not limited to the Sinai Peninsula but extends also to the western part of the country, in proximity of the 1,200-kilometer Egyptian-Libyan border. Since the terrain is almost entirely open desert and virtually impossible to secure by Egypt's military forces, increasing presence in the area offers considerable strategic depth to IS, doubling the security challenges facing the Al-Sisi government.

In addition to this factor, shrinking budgets and diminishing financial capacity might induce oil producers to revise their foreign policy initiatives that have so far been aimed – although with mixed results – at promoting greater stability in the region. Traditionally, regional oil producers – particularly Saudi Arabia, Qatar and the UAE – have given assistance to neighbours in crisis. Starting from the 2011 upheavals, oil-rich GCC regimes provided political, financial and military support to regional partners, largely aimed at stabilising matters economically and preventing political radicalisation.[41] Aid policies have been used (with varying

[39] Terje Solsvik and Patrick Markey, "Militants Fire Rockets at Algerian BP/Statoil Gas Plant, No Casualties", in *Reuters*, 16 March 2016, http://reut.rs/1Ulzgro.

[40] In the last few years, the pipeline has been attacked various times, as in November 2014, and January, March and June 2015.

[41] The 12.5 billion dollar pledge made by Saudi Arabia, Kuwait, the United Arab Emirates and Oman in Sharm el-Sheikh at the beginning of 2015 – when the effects of the drop in oil price were not as acute as they are today – to stimulate the Egyptian economy is just the most recent example of

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

degrees of success) to suppress popular revolts in Bahrain, to stabilise Egypt's political environment, to influence the struggle among factions in Libya and to avoid setbacks for the new Tunisian government.

So far, despite the collapsed oil price, assistance policy guidelines have not experienced major revisions. However, financial concerns might contribute to influencing the range of these initiatives. Gulf assistance to Egypt is a case in point, as financial contribution passed from 12.5 billion dollars granted at the beginning of 2015 to 3 billion dollar loans agreed in January 2016. The new financial support package, in particular, is mainly aimed at encouraging the Al-Sisi regime to develop the Sinai Peninsula, financing Egypt's oil purchases and buying Saudi exports and products. From this perspective, to what degree future financial assistance and economic cooperation from major oil producers to the rest of the region will be impacted by oil prices, is still difficult to predict. In any case, it is reasonable to imagine that oil-rich regimes will face tough strategic dilemmas when deciding whether to prioritise domestic needs or to spend on external assistance. Governments are expected to become more picky and cautious when tapping into constrained domestic reserves for regional cooperation objectives, but it is hard to believe that financial flows will be turned off entirely. In any case, oil producers' capacity to promote regional stability could be substantially constrained by enduring budgetary restrictions caused by low oil price.

3. The MENA region in trouble: Implications for the EU

The geographical proximity of North Africa and the Middle East openly exposes the EU to the events occurring in the region. In the last few years, the long-standing political order in the MENA region has given way to an array of overlapping, often contradictory dynamics, which led the complex relationship between the EU and its southern neighbours to hit rock bottom. Europe's incapacity to intercept and understand political, social and economic factors that led to the eruption of the Arab Spring protests in 2011, along with its inability to propose and promote concrete recipes to back the hopes for a peaceful transition from authoritarianism to democracy of (at least part of) the region's population, created a profound gap between the EU and its southern neighbourhood.

Therefore, today the EU finds itself at a crossroads in its MENA policy. The progressive distancing from both the elites and the population of the MENA region has made it increasingly difficult for the EU to address the shifting regional dynamics, to address the root causes of resentment and to cope with emerging macro-trends such as radicalisation, violent extremism, human migrations, regionalisation of conflicts and international terrorism.[42] In this fragile environment, the local and

these policies.

[42] Richard Youngs, *Europe in the New Middle East. Opportunity or Exclusion?*, Oxford, Oxford University Press, 2014.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

regional destabilising effects of the fall of the price of oil contribute to increase the magnitude of these threats to the security of the European bloc.

At the same time, the approach of other global actors towards the region is evolving, with relevant implications for the priorities (and the challenges) of the EU in the area. The US, possibly due also to its shale bonanza and quasi-independence from Middle Eastern oil, is revising its foreign policy and presence in the MENA area, calling European partners to shoulder their responsibilities in dealing with political and security challenges emerging from the region.[43] The US retreat is balanced by the growing presence of Russia and China in the Arab world. The Russian strategic role for the stability of the area is proved by its direct involvement in the Syrian crisis, as well as by its expanding military ties with Egypt. Chinese presence, on the other hand, is not only motivated by energy factors – i.e., Beijing is the foremost customer for Saudi oil and the largest foreign investor in Iraq – but it is also justified by more general industrial, trade and financial interests in the region (i.e., in Algeria, Egypt and Iran).[44]

3.1 Foreign policy and security implications

The Arab Spring and the subsequent violent developments have triggered major refugee crises in and from the neighbourhood of the EU, prompting the largest migrant wave to Europe since the Second World War. According to the International Organisation for Migration (IOM), in 2015 alone over a million irregular migrants and refugees arrived in Europe. The large majority of them arrived via the Central Mediterranean and Eastern Mediterranean routes, with the emergence of Libya and Syria as a collecting point for African and Middle Eastern migrants.[45] A portion of the migrants amassed at the EU borders are refugees or asylum-seeker escaping from the Syrian and Iraqi conflicts, while others are economic migrants in search of improved living opportunities in Europe.[46]

In this context, in addition to the ongoing conflicts in the region, the political and socio-economic effects resulting from the fall of the price of oil and the decline of energy revenues may have a negative impact on the migration patterns already in

[43] Jeffrey Goldberg, "The Obama Doctrine", in *The Atlantic*, April 2016, http://www.theatlantic.com/magazine/archive/2016/04/the-obama-doctrine/471525.

[44] Ted C. Liu, "China's Economic Engagement in the Middle East and North Africa", in *FRIDE Policy Briefs*, No. 173 (January 2014), http://fride.org/publication/1173/.

[45] The central Mediterranean route from Libya, for instance, provides direct access to the heart of the Schengen area: once they have gained entry to Italy, refugees are likely only to encounter border patrols that may delay but seldom prevent their onward movement. The eastern Mediterranean route up through Turkey to Greece has the advantage of being largely land-based, meaning that those taking it can avoid seasonal holdups caused by adverse weather conditions.

[46] According to the UNHCR, Syria, Afghanistan and Iraq account for almost the totality of migrants arriving in the EU through the Eastern route. The situation is different for the central route, through which a more heterogeneous mix of nationalities (i.e., Nigerian, Eritrean, Somali, Bangladeshi, Gambian, Senegalese) arrive in the EU.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

place. Worsening living conditions, rising unemployment, economic disparities and exacerbation of violence potentially expanding in the region could induce other citizens to flee their homes in North Africa and the Middle East, contributing to increased migratory fluxes towards Europe. Iraq, where the number of citizens seeking refuge in other countries is rising considerably, is a case in point. The loss in international oil revenues is significantly reducing the capacity of the government both to stabilise the country and to ensure the socio-economic well-being of the population, producing rising numbers of internal refugees and migrants. In addition to this, the lack of control by the government over large parts of the country's territory increases the possibility for Iraq to become a transit country for human trafficking and other international illegal activities.[47] On a different note, the labour trends in the GCC – where many foreign workers coming from net-outward-migration countries, such as Egypt, are losing their jobs due to the economic downturn and nationalistic labour policies – risk to enlarge the mass of economic migrants coming from the MENA region towards the EU.[48]

Growing radicalisation in the region couples also with emerging terrorism threats. Indeed, an increasingly unstable North Africa and Middle East is becoming the foundry for terrorist groups and factions, mainly acting at the local and regional level in a context of political power struggle. These groups are increasingly attracting and interconnected with newly radicalised subjects based on Europe's soil, as demonstrated by the recent terrorist attacks in Paris and Brussels claimed by the Islamic State. While the perpetrators of these attacks were native Europeans, the growth of terrorism in the MENA region and its increasing appeal to young European Muslims is raising growing concerns for the security of the EU and its citizens.[49]

Although North African and Middle Eastern terrorists present themselves as primarily religiously motivated, their radicalisation results from the complex combination of different factors including anti-Western ideology, political dissatisfaction, social exclusion, poverty and unemployment, all elements that have spread across the MENA region in the last years. The inability of the region's regimes to offer political accountability and socio-economic opportunities to large shares of the population – youth in particular – along with the manipulation of religious precepts and sectarian rivalries, are helping to fuel terrorism. In this already destabilised context, the socio-economic outcomes of the fall of the crude price and the tremendous decline of energy revenues in many oil-exporting countries could act as an accelerator of these trends, possibly contributing to deepening religious radicalisation and swelling the ranks of the thousands of

[47] Imran Khan, "The Iraq War: The Root of Europe's Refugee Crisis", in *Al Jazeera Blog*, 9 September 2015, http://aje.io/rzm7.

[48] The GCC countries' dependence on foreign workers ranges from a relatively low 28 percent of the population in Oman, to a remarkable 85 percent in Qatar and the United Arab Emirates.

[49] Marco Funk and Roderick Parkes, "Refugees versus Terrorists", in *ISS EU Alerts*, No. 6/2016 (January 2016), http://www.iss.europa.eu/publications/detail/article/refugees-versus-terrorists.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

criminals, fighters and aspirant terrorists.

3.2 Energy security implications

In addition to traditional security challenges, the political and socio-economic effects generated by the collapse of oil prices can have a set of implications for the security of energy supplies to the EU, and in particular for some Member States significantly reliant on North African and Middle East oil and gas exports.

In the short term, the combination of possible deterioration of security conditions, demographic growth and decreasing investments to replace ageing oil and gas fields, could affect the capacity of MENA countries to maintain the current levels of production and export, but also threaten the stability of the transit of hydrocarbons through the region. As mentioned above, oil and gas facilities are among the favourite targets of terrorists and militias fighting on the field, whether they aim at undermining the government, advancing political requests and demanding recognition of their rights, or just gaining control of energy assets as platforms for garnering revenues and funds necessary to sustain military/terrorist initiatives. Today Libya (and to a lesser extent Syria, given its more limited impact on European energy supplies) is the most relevant example of these worsening security conditions. Before 2011 the country's oil production was around 1.6 million barrels per day, ensuring 10 percent of total EU imports, while today, due to the ongoing conflict, exports have collapsed to 2.5 percent of the EU's total foreign supplies. While the situation in the gas sector is not as critical, the worsening conditions and the inability of the government to react could also have an impact on natural gas flows to Europe. In Iraq, as well, the situation is rapidly deteriorating, particularly in the northern provinces where the IS is currently stronger. Should the financial difficulties of the government open the path to terrorists in the south of the country, where the largest oil fields are located, the security of the 280,000 barrels per day imported by the EU (7 percent of total imports) would be questionable. In the short term, also Algeria may become a hot-spot, with consequences for the energy security of Europe, to which it ensures 5 percent of the total oil imports and 13 percent of its gas external supplies. The recent attack at the joint BP-Norwegian Statoil gas treatment plant located in Krechba, claimed by the IS, is the result of the growing terrorist threat in the North African country – a threat that the Bouteflika government could have difficulties in effectively countering. In Egypt the circumstances are particularly alarming in the Sinai province, traversed by the Arab Gas Pipeline linking the country to Jordan (and then Syria and Lebanon), a situation that may affect the future capacity of Egypt to supply its eastern neighbours. Less critical, at least theoretically, are security conditions in the new gas production sites, whose offshore status would logically decrease their vulnerability against IS militias and other violent groups.

In a long-term perspective, the current low level of oil prices contributes to slowing the pace of international investments in exploration and production in a region already hit by enduring security threats. As announced by IEA, low oil price

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

conditions have slashed upstream investments by more than 20 percent, impacting on the typical investment cycle for the oil industry. These extraordinary conditions risk severely affecting the region's capacity to achieve its production targets for the future, to the detriment of both domestic energy security and the stability of oil export commitments to international consumers, including the EU, which imports 25 percent of its crude supply and 20 percent of its external gas supplies from North Africa and the Middle East. While the situation is already critical in countries such as Algeria, Libya and Iraq, the combination of "geopolitical uncertainty, the unattractiveness of the investment framework and companies cutting spending" represents a concrete threat to regional production growth over the next few years, as well as for the sustainability of the whole global energy sector.[50]

4. Falling oil price: An opportunity to re-engage the MENA region?

The last few years have shown that many of the basic grounds for traditional EU policies in the MENA region have changed. The balance of power among regional players and sectarian factions has shifted, while the presence and role of global actors in the area is significantly evolving. In parallel, the current fiscal and economic conditions require (at least some of) the regional governments to radically review the political and socio-economic architectures that have kept them in power in the last decades. In this new strategic context, the acceleration of some regional trends induced by the collapse of crude prices and the fall of oil-derived international revenues, coupled with ongoing security challenges like Islamist terrorism and migration flows, necessitates decisive strategic thinking and action on the part of the EU towards the MENA.

Like the oil market itself, Middle Eastern and North African oil producing governments are at a crossroads, as they face the strategic question of how much and how quickly global markets will move from fossil fuels towards renewable energy sources. Some of them have demonstrated a readiness to address the huge energy challenges their countries are facing, introducing innovative (though possibly destabilising) measures to reshape their current energy models. Particularly in the GCC, some regimes seem to have acknowledged that they have an interest in being ahead of the game in planning for future demand reductions in their key markets, embarking on an economic path that includes alternative sources of energy.[51]

[50] Fatih Birol cited in Anthony McAuley, "Incoming IEA Head Says Middle East Oil Investment Climate Must Improve to Avoid Crisis", in *The National*, 6 May 2015, http://www.thenational.ae/business/energy/incoming-iea-head-says-middle-east-oil-investment-climate-must-improve-to-avoid-crisis.

[51] Laura El Katiri, "A Quiet Revolution: Renewable Energy in the GCC Economies", in *National Council on US-Arab Relations Analyses & Assessments*, 5 April 2016, http://wp.me/p761Ki-3c.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

In this situation, an active EU energy diplomacy towards the region might stimulate broader positive foreign policy spin-offs. As highlighted above, in fact, during the last few years' energy factors have been a potent amplifier of many of the regional political and socio-economic problems. Although addressing energy-related factors would not be sufficient to neutralise the destabilisation potential of the region, if supported by a holistic (political, economic) action, the EU energy initiatives might trigger positive developments locally.

Such an evolving context offers the opportunity to the EU to review its energy action towards the region, with the potential to develop an ambitious strategy in terms of objectives but one that is extremely pragmatic in terms of means to achieve them.

4.1 An EU concept for support to Energy and Climate Sector Reform?

Starting from the release of the European Security Strategy (ESS), the EU has established the Support to Security Sector Reform (SSR) in partner countries as one of the core areas for its external action. The key objective of SSR is to "contribute to an accountable, effective and efficient security system,"[52] a process that could be translated also to the reform of the energy and climate sector (Energy and Climate Sector Reform, ECSR), and applied in particular to the MENA countries, which are experiencing an unprecedented phase of (r)evolution of their energy models.

There is in fact the concrete need to reinvent both the architecture and the functioning of the Middle East and North Africa energy sectors, which have proven to be barely sustainable, particularly due to new global challenges such as shale production and expanding decarbonisation policies. These evolving conditions force the EU and its regional partners also to renovate the fundamentals of their energy relationships, no longer based exclusively on the importer-exporter nexus. From a methodological point of view, past experiences have shown that while the EU has necessarily to adopt a broad regional strategic view to define its cooperation priorities, the fragmentation and heterogeneity of the MENA region (also in terms of energy performances) require EU institutions to develop and implement also *ad hoc* bilateral initiatives to engage their regional partners.

The ECSR process, which would be undertaken granting respect for local ownership and in full coherence with other areas of EU external objectives, would be expected to support governance and reform of the energy sector as a key element to ensure socio-economic stability, and to contribute to sustainable State-building and development in the MENA countries. Through a comprehensive energy approach, the ECSR would address a set of different tasks/activities, on which European and

[52] Council of the European Union, *EU Concept for ESDP Support to Security Sector Reform (SSR)*, 13 October 2005, p. 4, http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2012566%202005%20 REV%204.

IAI WORKING PAPERS 16 | 15 - JUNE 2016 ISSN 2280-4331 | ISBN 978-88-98650-95-8

local stakeholders are expected to work jointly:

- phasing-out of energy subsidies;
- revision of the energy market and regulatory framework, necessary to attract new international investors to ensure stable/increasing production and revenues, but also to avoid waste and mismanagement of energy resources;
- implementation of progressive privatisation schemes;
- design of new electricity and gas markets;
- introduction of renewables and smartisation of energy consumption for industrial and private consumers;
- integration of technological systems/applications and valorisation of local value chains.

In order to be reliable and effective, the ECSR must be based on a comprehensive approach resulting from a sound "grand strategy" towards the region, and supported by strong EU political involvement. The ECSR should not be conceived exclusively as a technical and operational assistance process, but as the result of an overall endeavour expected to transform the whole governance sphere of a country's energy model.

To achieve these ambitious objectives, the ECSR actions – developed in the framework of the EU Energy Diplomacy Action Plan presented jointly by the High Representative and the Commission in July 2015 – should be performed at different levels, involving a broad set of institutional and non-institutional actors and combining top-down and bottom-up approaches and practices:

- Political/strategic level: between EU and MENA national institutions and political authorities, in order to define strategic views and roadmaps of energy cooperation.
  > The "political dialogue on energy matters" launched by the European Commission and Algerian counterparts is an example.
- Regulatory level: between European agencies (ACER and MedReg) with national regulatory counterparties in the MENA, in order to establish rules and framework guidelines for the energy sectors.
  > The contribution of MedReg to the reform of Egypt's gas sector is an example. In this perspective, the MedReg scheme could be expanded to enclose other MENA countries, or replicated in the region.
- Operational and business level: between European industrial stakeholders and associations (i.e., ENTSO-G and ENTSO-E) and MENA national companies, in order to define best practices and strengthen the capacity of business to act efficiently in the market.

The ECSR process should include all these actors, overviewing and coordinating their roles, responsibilities and actions and working together to manage and operate the energy sector in a manner consistent with rigorous principles of good governance, in order to ensure sustainable socio-economic development, sound industrial growth and eventually greater political stability to the benefit of the population.

On the European side, the European External Action Service (EEAS) would be in charge of managing the ECSR and coordinating the efforts and the different contributions of the various European actors and stakeholders. In order to play this role effectively, the EEAS should:

- strengthen policy and programming dialogue;
- ensure coordinated planning;
- develop tools for planning and implementation;
- expand the expertise and pool of experts for field missions and programmes;
- strengthen cooperation with international partners.

This endeavour could be performed in cooperation with the activity of the EU-Med Energy Platforms, launched by the European Commission in the framework of the Energy Union initiative and potentially extendable to other Middle Eastern partners interested in strengthening an overall process of energy cooperation and reform.

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