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Gulf Cooperation Council Strong Enough To Take The Pain Of Falling Oil Prices

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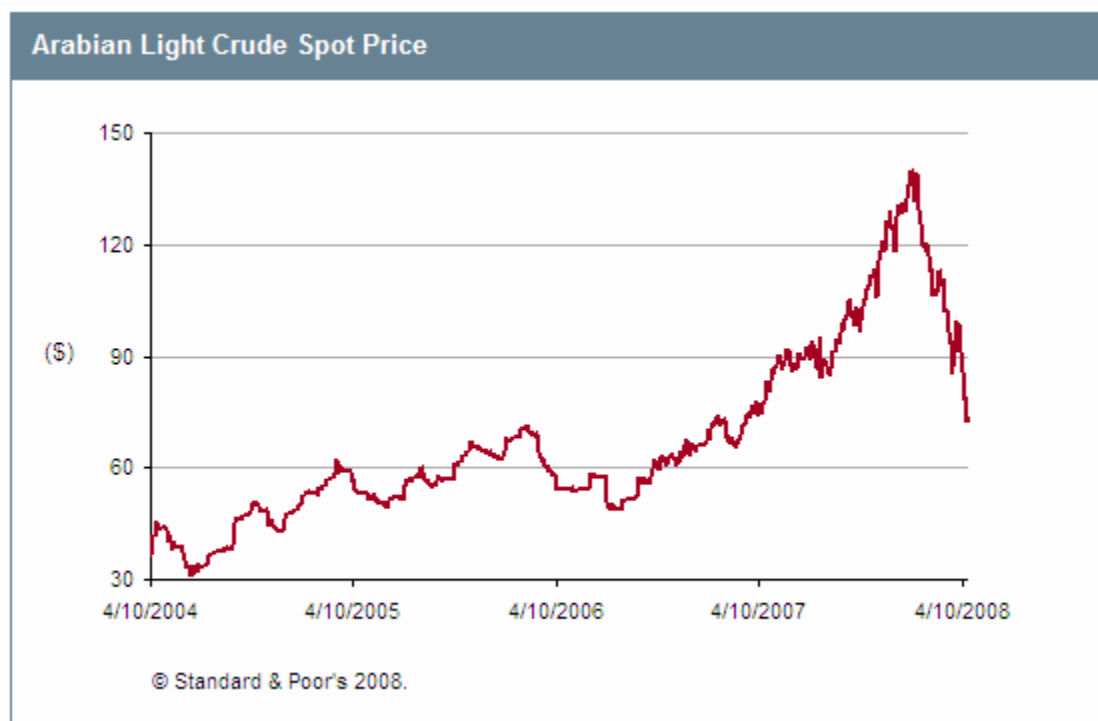
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Gulf Cooperation Council Strong Enough To Take The Pain Of Falling Oil Prices

In recent months, global oil prices have been falling precipitously, with the spot price for Arabian Light Crude almost halving between July 2008 and the present (see chart 1). The deteriorating outlook for the global economy and subsequent slowing demand for oil, combined with a strengthening of the U.S. dollar, are two of the main drivers behind the fall. While this decline in oil prices has led many of the world's oil-importing countries to breathe a sigh of relief, the impact on the world's oil exporters is clearly less benign. In this commentary Standard & Poor's Ratings Services considers what the credit implications are for the oil-exporting countries of the Gulf Cooperation Council (GCC), all of which are rated by Standard & Poor's. Employing a stress-test approach, we demonstrate just how vulnerable government revenues and external balances are to oil price fluctuations. At the same time, however, our analysis highlights the robustness of GCC government balance sheets in the face of severe negative oil price shocks.

Chart 1



A stress-test approach

We adopt a stress-test approach which, while admittedly limited by the need to make rigid assumptions and the inability to take into consideration second-round effects of an oil price decline, does nonetheless serve as a useful indicator of the resilience, or lack thereof, of key macroeconomic indicators to various oil price scenarios over a given forecast period.

Box 1 outlines the specific assumptions we have made with respect to key variables in the stress test. In a nutshell, the approach is to adjust government oil revenues and exports to the varying oil price assumptions, while keeping all other variables fairly constant. We then assess the extent to which changes in oil revenues would affect government finances and the external positions in the six rated GCC sovereigns.

Box 1: Key Assumptions For Stress Tests

1. **Oil prices** for our base-case scenario are as follows:

2008	2009	2010	2011	2012	2013	2014	2015
\$108	\$79	\$82	\$95	\$105	\$115	\$127	\$139

2. **Oil production** for all countries throughout forecast period assumed to remain at 2007 levels.

3. **Government non-oil revenues** throughout forecast period assumed to remain at 2007 levels.

4. **Government expenditures** in the forecast period assumed to grow at the average annual rate of growth recorded between 2004-2007.

5. **Gross government debt** throughout forecast period assumed to remain at 2007 levels (governments do not take on more debt).

6. **Government assets** throughout the forecast period adjusted upwards (downwards) for government budget surpluses (deficits) – the value of assets does not reflect global market conditions (such as equity markets, real estate, and other vehicles in which assets are invested).

7. **Non-oil exports and imports** grow at 20% per year in the forecast period

8. **Non-oil GDP** in the forecast period assumed to grow at the averaged annual rate of growth recorded between 2004-2007

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The base case

The base case scenario is modeled around our current assumptions regarding the evolution of oil prices through to 2015. As shown in Box 1, we expect average oil prices to fall to \$79/barrel in 2009, from an average of \$108/barrel in 2008, before once again rising modestly from 2010 onwards.

The evolution of key variables for the six GCC countries under this base case scenario is summarized in charts 2–5. It is important to stress that these are not Standard & Poor's forecasts, which differ from the presented figures inasmuch as they are not subject to the rigid assumptions summarized in Box 1.

Chart 2

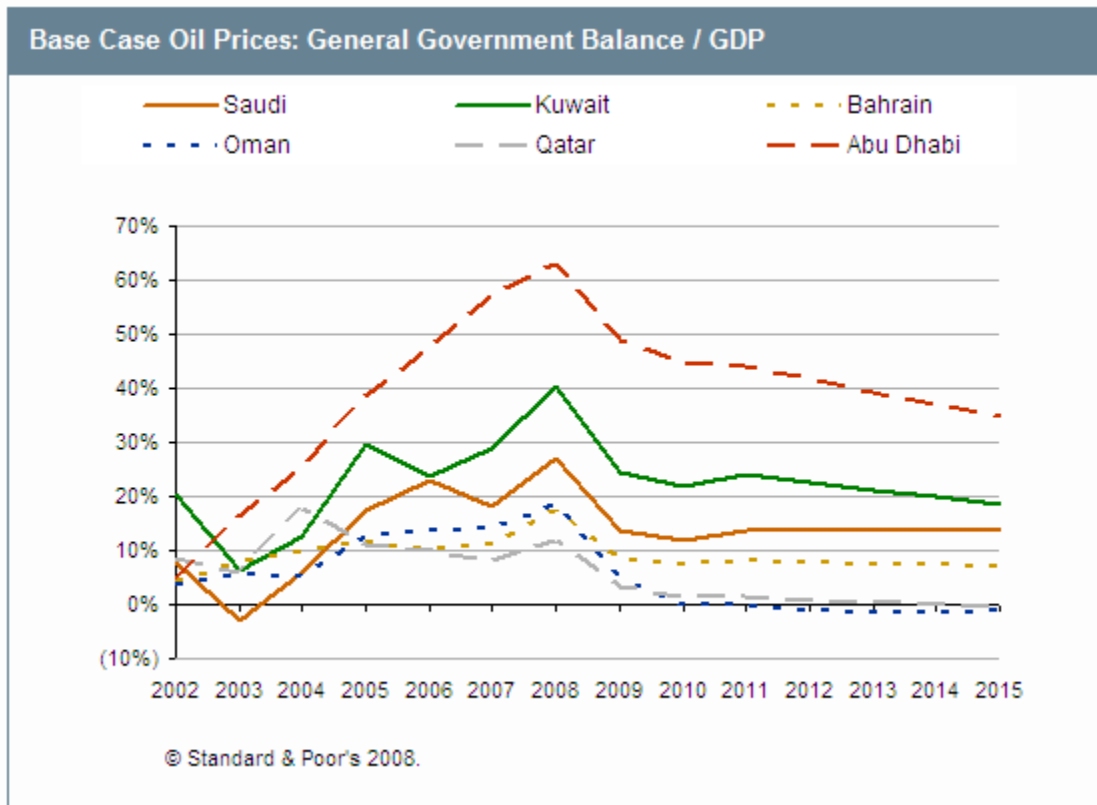


Chart 3

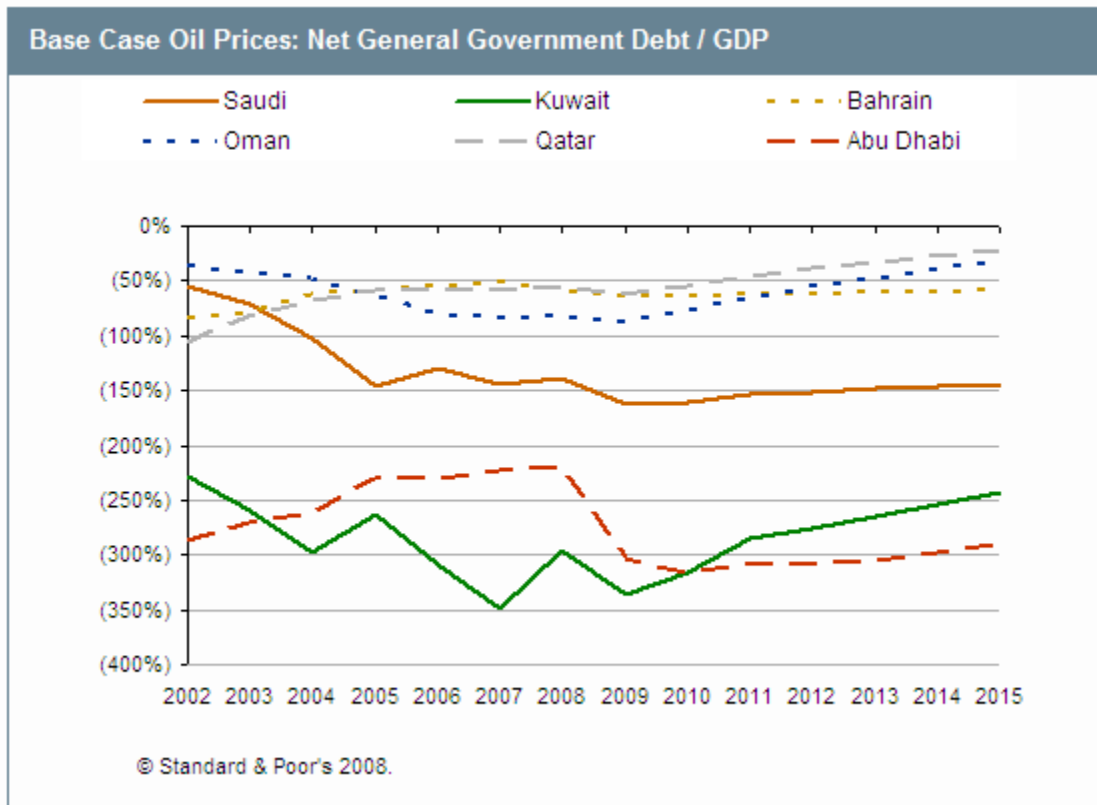


Chart 4

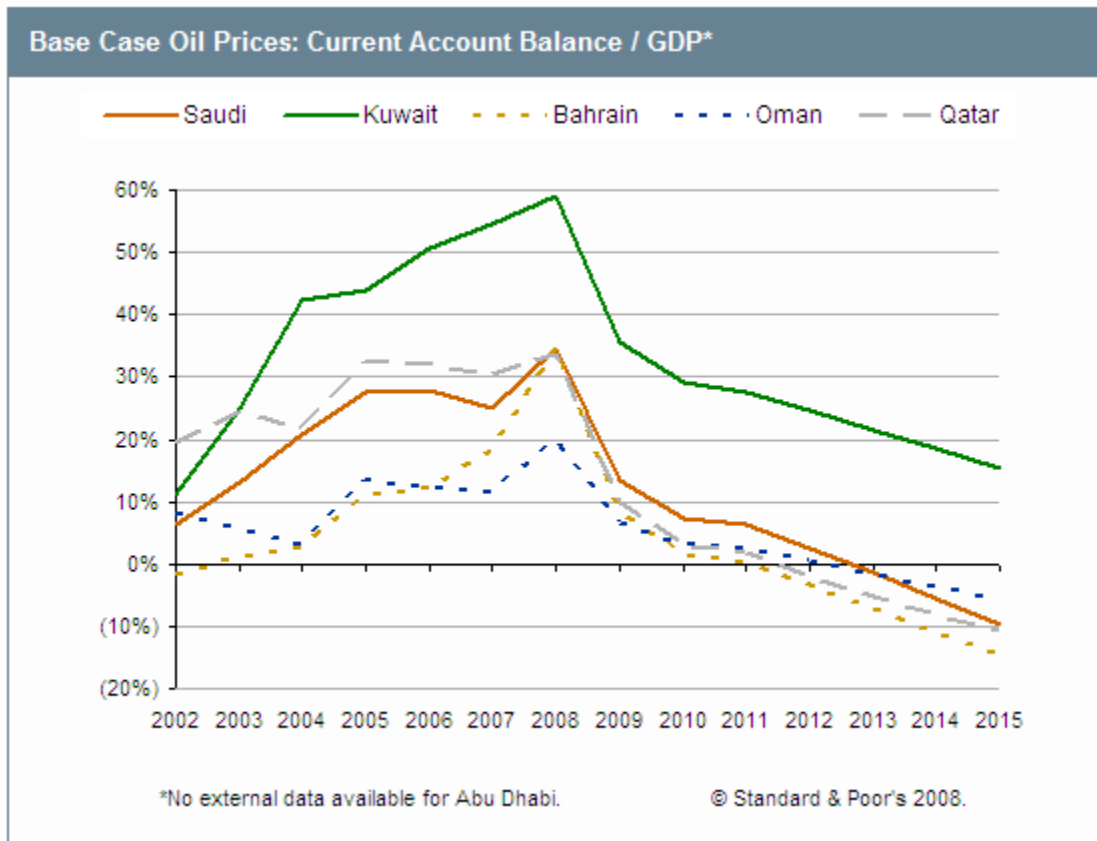
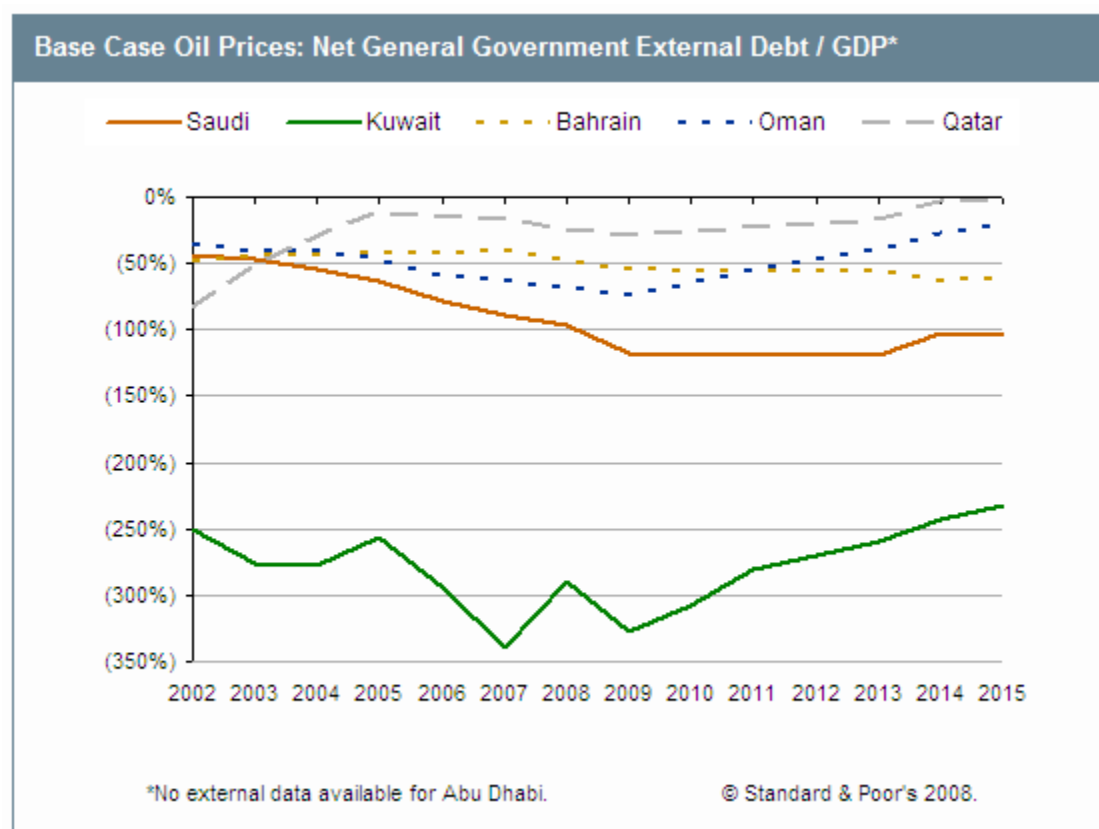


Chart 5



In the base-case scenario, public finances remain solid for all six GCC countries, with fiscal balances all remaining in positive territory (with the exception of small deficits in Oman and Qatar), and all governments maintaining a comfortable net asset position. On the external side, the import growth assumption will drive most countries' current accounts into deficit, but the external asset positions will remain substantial.

A further 50% drop in oil prices

We ran a number of scenarios with varying degrees of oil price drops over different time horizons. Here we present what we consider a reasonable worst-case scenario, namely that oil prices drop a further 50%, to just under \$40/barrel, and remain at that depressed level for the entire forecast period. Charts 6-9 summarize the results.

Chart 6

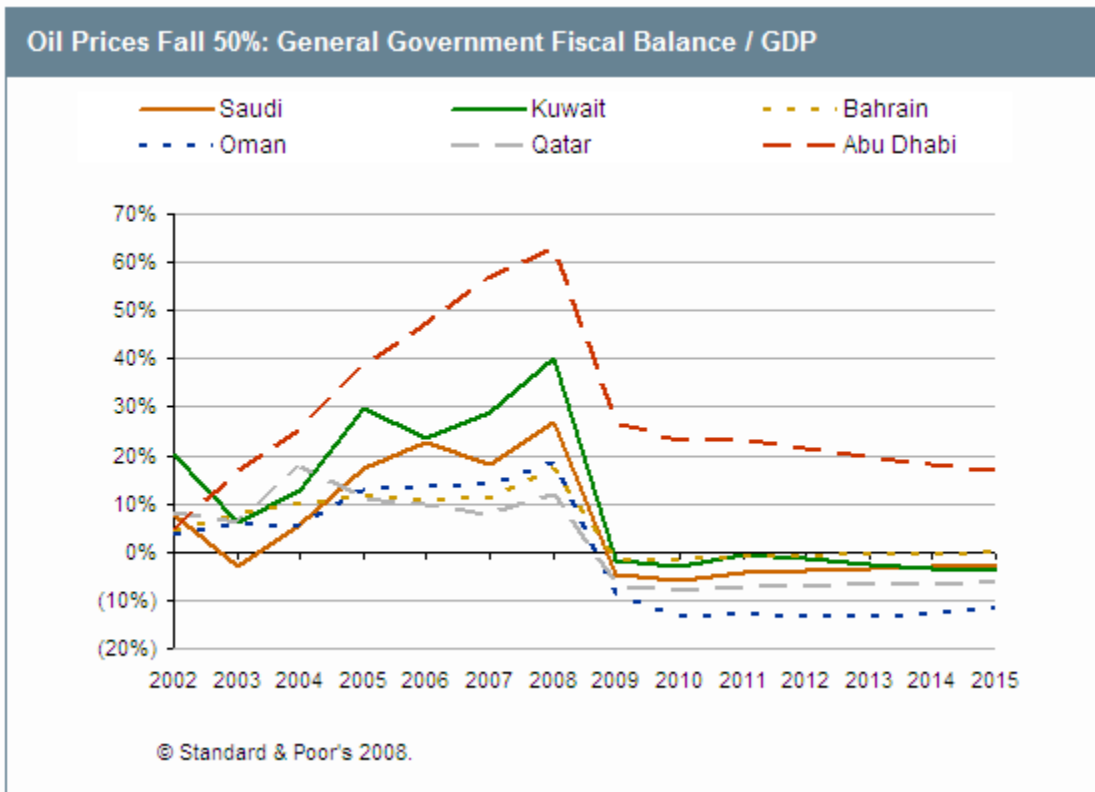


Chart 7

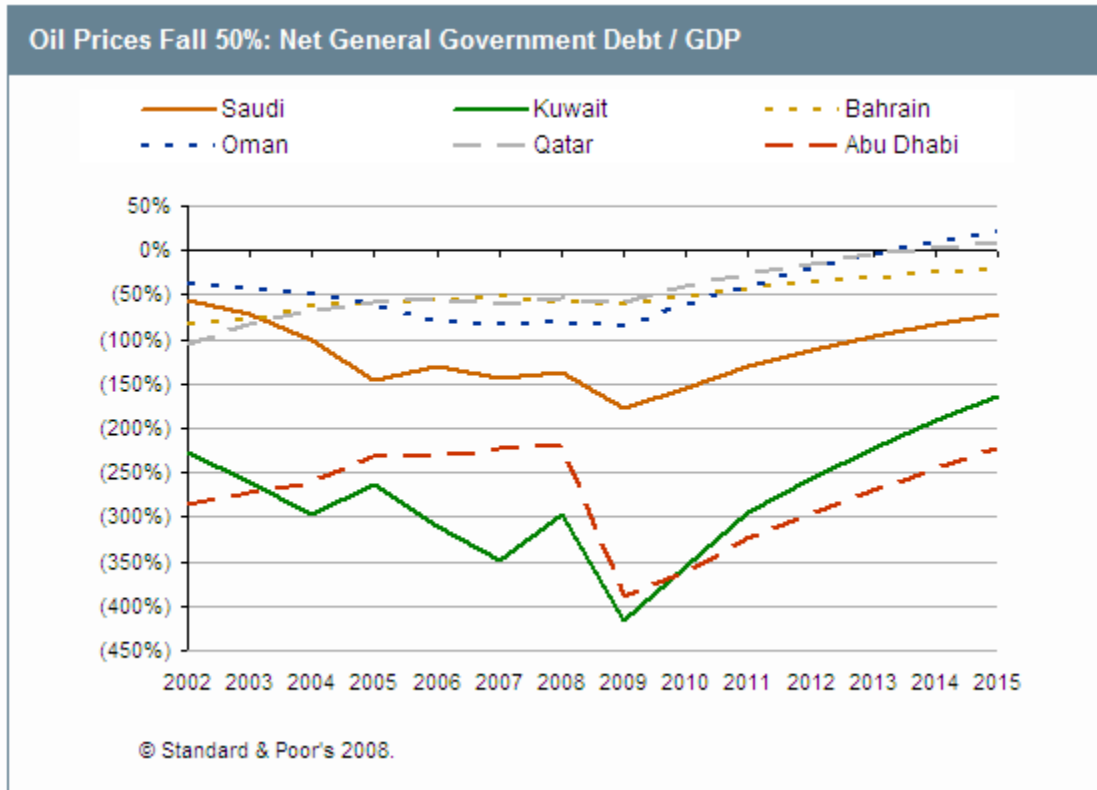


Chart 8

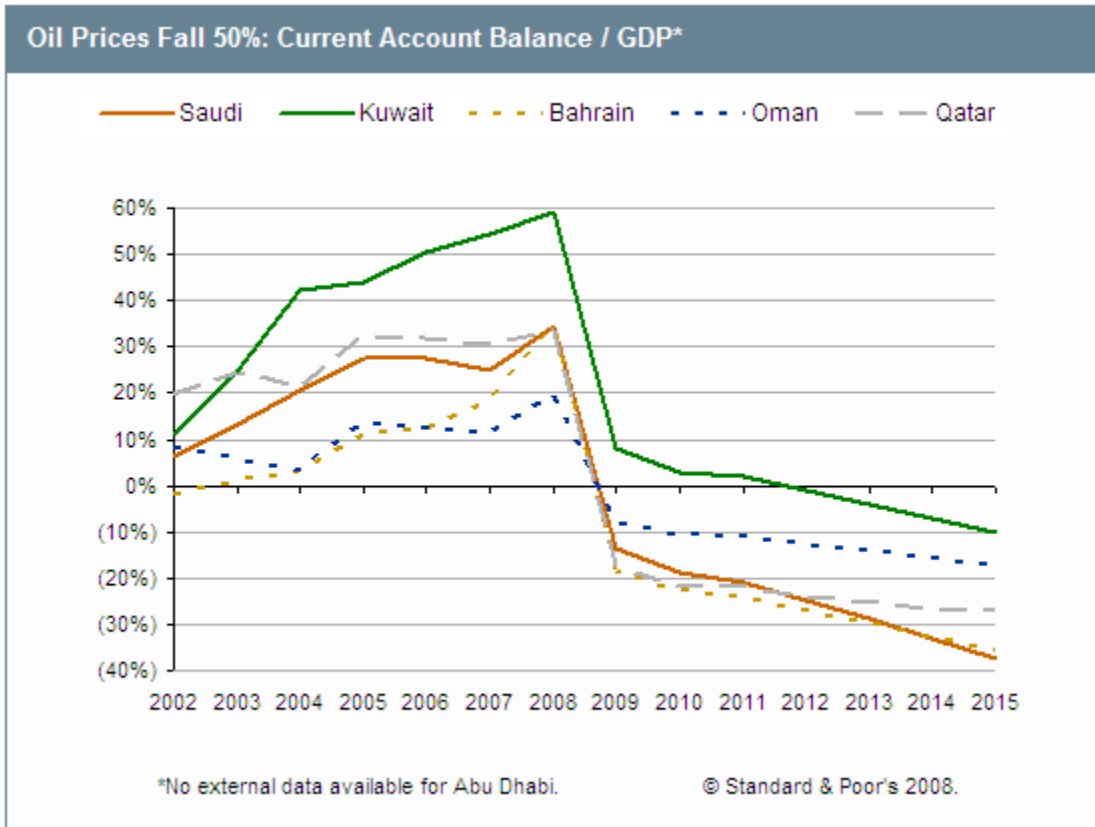
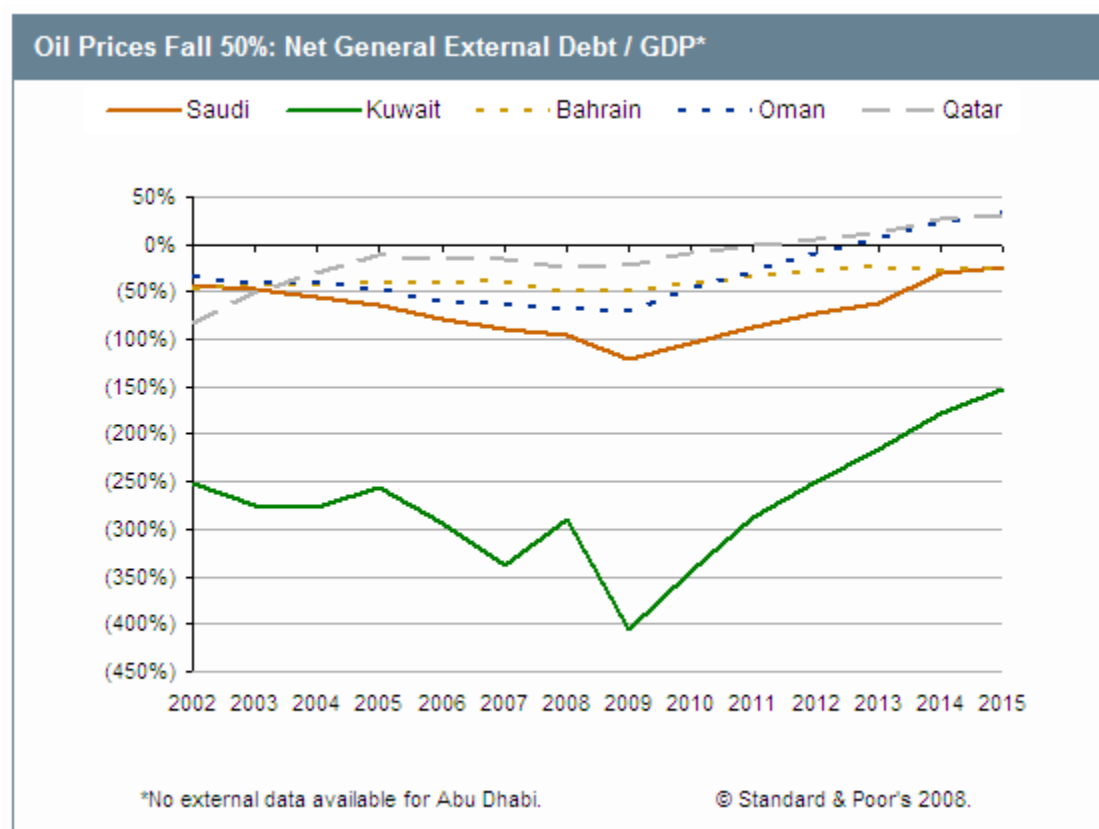


Chart 9



Under the rigid assumptions of this alternative scenario, which do not allow for any policy response or secondary effects to falling oil prices, government finances gradually deteriorate to the point where all oil-producing GCC countries, with the exception of Abu Dhabi, run large fiscal deficits, as high as 17% of GDP in the case of Oman. In reality, of course, government expenditure is likely to be curbed in light of lower oil prices, and we don't expect that such deficits will occur. However, even if they do, the impact of such a severe oil price shock on government debt positions, as measured by net debt to GDP, is fairly benign. Indeed, most GCC countries would remain in a net asset position, with Abu Dhabi's net assets remaining at 200% of GDP, similar to levels seen today. Oman and Qatar, in the worst-case scenario, will post net debt positions as the severity of government deficits forces them to borrow. That said, at 36% and 18% of GDP, respectively, even under the rigid assumptions of this stress test, debt levels will remain broadly in line with the median net debt level recorded for 'A' rated sovereigns in 2007 of 20% of GDP.

A similar story is seen on the external side. The assumption of continued rapid import growth means that current accounts dip sharply into deficit positions, as high as around 55% of GDP for Saudi Arabia. Once again, in reality we would expect domestic demand and imports to adjust to lower oil prices, and we don't expect the deterioration in current account balances to be so severe. But even if they were, with the exception of Oman and Qatar, GCC oil-producing governments would remain in a positive net external asset position.

Two key lessons

As in most scenario analyses, the above hypothetical situation is a highly stylized representation of what may occur within the rigid assumptions we set out at the outset. One must therefore resist the temptation to draw too many detailed conclusions. That said, in the current context it is a useful exercise that helps draw out two key lessons about the impact of oil prices on GCC countries.

Lesson 1: Oil matters.

The GCC countries remain highly dependent on oil production for both government revenues and exports. On average, oil and gas receipts represented 74% of GCC government revenues in 2007, and 66% of total exports. Fluctuations in oil prices are therefore bound to have a significant effect on government finances and balance of payments positions.

Lesson 2: Balance sheet strength provides a substantial buffer.

Over the past six years, a combination of soaring oil prices and relative fiscal restraint has meant that large surpluses have accrued to GCC oil-exporting governments. These have been saved in Sovereign Wealth Funds (SWFs) and other investment vehicles, mainly off shore (see article titled "How Sovereign Wealth Funds Are Underpinning Gulf States' Credit Quality," published June 5, 2008). As a result, sizeable net asset positions have built up such that even dire oil price shocks, while having a very negative effect on immediate fiscal and external balances, do not jeopardize the governments' balance sheet strength. Put simply, the savings of most GCC governments are such that they are in a position to absorb the oil price falls without resorting to borrowing, if they so choose, for a significant period of time.

Revenue Diversification Would Increase Resilience To Oil Shocks

The precipitous fall in global oil prices witnessed since mid-2008 raises questions regarding the impact on the creditworthiness of oil exporting countries whose revenues are largely dependent on oil receipts. As this report has shown, GCC countries' finances are sensitive to oil-price movements, but their balance sheets are likely to remain robust in the face of severe negative oil price shocks.

This exercise thus highlights the key underpinning to our sovereign credit ratings in the region, namely the balance sheet strength of GCC governments. Years of soaring oil prices and comparative fiscal restraint have resulted in substantial asset cushions to protect finances from fluctuations in oil prices. That said, the need to diversify government finances and exports away from hydrocarbons remains a challenge for all GCC countries, and one which remains on the top of policy agendas throughout the region.

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