The Gulf's Renewed Oil Wealth: Getting it Right This Time?

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Two small news items juxtaposed on a single page of a Qatari newspaper illustrate the opportunities and challenges facing Middle Eastern states. One article details efforts to settle a series of strikes by expatriate labourers in Bahrain with an offer to raise salaries by $40 per month. The other reports on the record-setting price – $14 million – paid for a vanity licence plate at a charity auction in the United Arab Emirates.[1] The contrast reveals the paradox of the Persian Gulf in the twenty-first century. The legacy of record oil prices of the last seven years is spectacular wealth, but also persistent and intensified economic disparities and social stresses. In the boom of the 1970s and 1980s, Middle Eastern nations squandered much of their bounty on wasteful and inefficient investments. There are indications that, this time around, they are showing more prudence and judgement, but failure to get it right could threaten stability and security.

Since 2002, the price of a barrel of oil on the world market has increased from a low of $17.10 to a record $146 in July 2008. By October 2008 the price had fallen back to the $60–70 per barrel range as a result of the global economic crisis, but most indications are that the world is unlikely to return to an era of cheap oil. The Gulf states have reaped an incredible windfall from this rapid price escalation: at least $1.5 trillion between 2002 and 2006, representing a doubling over the previous five-year period.[2] The scope of this influx is expanding at a rapidly accelerating rate, with the Gulf Cooperation Council (GCC) expected to take in similarly astronomical sums in the next

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two years alone. The price spike that has made this possible is the product of a unique set of global economic circumstances: unlike previous oil booms, recent price escalation is not the product of a disruption in supply but of the seemingly insatiable demand of the rapidly developing Chinese, Indian and other Asian economies. As a result, despite new interest and investment in alternative-energy technologies, there is little reason to believe that these vast flows of wealth to the Persian Gulf will taper off in the near term.

For the region's boosters, oil windfalls have launched a new 'golden age' for the Gulf and the broader Middle East.[3] Regional real-estate and financial markets are booming; grandiose infrastructure projects are once again rising in the desert; and expatriate capital, institutions and executives are being lured to the glittering city-states of the Gulf. And the boom is fuelling far more than just more conspicuous consumption: the petro-states have embraced the lessons of previous eras and are using their increased resources to expand badly needed savings and investment, engage in serious programmes of economic reform, and repatriate more of their capital to the region. The net effect, from the perspective of many regional leaders and investors, is that a part of the world often perceived as mired in tradition and dangerously insulated from recent globalisation has begun embracing modernity. The old verities of Arab politics are quickly being supplanted by a competitive new technocracy.

Not everyone sees the oil boom as an unqualified boon for the region, however. In the eyes of many long-time observers, epic windfalls carry renewed risks for the future of the Middle East and US security, as high revenues only exacerbate long-standing economic distortions and socio-political stagnation. Critics rightly note the role of petroleum rents in facilitating the region's democratic deficit and relentless resort to violence, a system in which, as scholar Fouad Ajami has written, 'wealth comes to the rulers, they dispose of it, they distribute it to cronies, they punish and overwhelm their would-be challengers at home, and they use it to sustain adventures abroad way beyond the limits of their societies'.[4] Sceptics maintain that, far from integrating the Middle East in the broader global economy, the region's recent spending spree has been directed at white elephants designed to inflate investors' profits and rulers' vanity. Meanwhile, the central challenge facing the Middle East – harnessing the energy of its disproportionately young population – remains unmet as a result of an outmoded educational system, anaemic job-creation programmes and continuing reliance on expatriate labour. Moreover, the continued overreliance on oil revenues leaves the region particularly vulnerable to global economic shocks.

The truth lies somewhere between these two exaggerated scenarios, incorporating elements of both. The oil boom has neither saved nor doomed the Middle East, but rather opened new possibilities and heightened existing problems in a way that makes the coming decade a particularly critical one for the region. In recent years, Middle Eastern petro-states have exhibited generally sound judgement in managing the boom – a notably positive development, given the serious challenges these states have faced in navigating their own internal contradictions and the changing international environment during this period. However, alleviating and ultimately evading the traps associated with resource wealth will not come easily in a period of mounting revenues. It will require the active engagement of the United States and other outside powers.

Explaining high oil prices

Over the past year, as oil prices have doubled and eventually raced past the $100 per barrel milepost, the issue of energy costs has dominated news headlines and political debates across the globe. Together with the credit crunch sparked by the subprime-mortgage crisis, ever-escalating oil prices have been identified as one of the main precipitants of a vicious cycle that has brought the United States, and potentially the world, to the brink of a recession. Considerable evidence suggests that factors beyond the market fundamentals – such as the weak dollar, the frenzied activity of oil-futures markets, and ongoing instability in key suppliers such as Nigeria – have played a role in the price surge. Nonetheless, the underlying market conditions are also directly relevant, both in understanding the current revenue stream accruing to producers as well as anticipating near- and medium-term trends.

Rising prices have prompted massive development of additional resources. A $50 billion investment over the past five years by Saudi Arabia will bring the kingdom's production capacity from 9m barrels per day (b/d) to 12.5m b/d, while smaller additions are expected to come on line in the United Arab Emirates, Nigeria, Qatar, Libya and Angola, as well as in Russia, Azerbaijan, Kazakhstan, Brazil and Canada. However, many of the big prizes in terms of potential resource expansion remain off limits for the foreseeable future, largely because of domestic politics and security concerns in countries such as Iran, Iraq, Kuwait and Venezuela. In addition, the cost of developing new reservoirs is rising considerably as a result of spending on technology that provides access to previously unrecoverable reserves and a price environment that drives production of formerly marginal supplies.

The cost of developing new reservoirs is rising

Even with significant investment and increased conservation and innovation in alternative-energy technology, the world is facing increasing difficulty in keeping pace with the voracious global demand for energy. As India, China and other Asian countries grow at unprecedented rates, demand for oil has increased at an accelerating pace even as prices rise. Total worldwide demand grew by 10m b/d to 70m b/d between 1977 and 1995 – an 18-year interval. By 2003, a mere eight years later, demand had reached 80m b/d, and at current projections could exceed 90m b/d by 2010.[5] Two-thirds of future demand increases are expected to come from Asia, and most of this will have to be satisfied by those states that are members of the Organisation of Petroleum Exporting Countries (OPEC), as supplies from producing countries that are not members of OPEC are expected to plateau over the next five years.

To meet rising demand and cover natural declines in its own reservoirs, OPEC will have to produce at least 3m b/d more each year, a challenge that one oil analyst describes as 'an impossible task'.[6] Rising prices and the slowdown in the US economy might mitigate these pressures slightly, but given the exploding size of the Asian middle class and the short-term price inelasticity of demand for fuel, only a miraculous technological breakthrough or catastrophic changes in the Chinese and Indian economies would significantly alter the near-term demand picture. The burden – and rewards – of this new global environment for energy will fall particularly to the Middle

East's mature producers, thanks to the geological fluke that has made the Persian Gulf home to two-thirds of the world's proven oil reserves and approximately one-third of its natural gas. The International Energy Agency estimates that the primary sources for any new production sufficient to meet medium-term demand from a growing Asia will come from Saudi Arabia, Iran and Iraq.[7]

Opportunities for the Middle East

While the consequences of escalating oil prices have been profoundly problematic for many countries around the world, the Middle East's strategic position and natural-resource inheritance have meant that it has been uniquely positioned to benefit. Contrary to the 1973–85 oil boom, the region has used the recent price spike to reduce debt, stockpile savings and invest wisely while intensifying long-needed structural reforms. It is conceivable that if managed wisely and complemented by external pressures where needed, oil-fuelled reforms and the broader ripple effects of the boom may help secure a better future for the region.

The report card for the region's development in the aftermath of previous price spikes is notably dismal. One representative overview of the first two decades of Middle Eastern oil wealth catalogues 'the low returns to OPEC investments, useless white-elephant projects, resource waste and moral corruption', adding that the 'real pity' was that even after 20 years of massive resource wealth, most petro-states were 'still not on a secure path toward sustained growth and prosperity'.[8] At home, massive investment in physical and social infrastructure, economic development and diversification generated progress, but overall relatively poor returns: educational systems produced graduates unprepared for the job market, public sectors were bloated and inefficient, average growth rates were lower than in the pre-OPEC period, non-oil sectors were highly subsidised and unproductive, and the region's share of world trade declined. Externally, the region directed most of its oil investment toward the United States, thanks in part to the unique openness of the American economy, the shared security interests of the region's oil producers and Washington, and assiduous US government efforts to 'recoup the American dollars flowing toward oil-producing capitals'.[9]

In contrast, early indications offer some reason for optimism that sounder judgement and more sober planning for optimising the rewards of recent price escalation may yet prevail in the Middle East. Governments are exhibiting greater prudence by saving more and paying down debts; Saudi Arabia and Kuwait managed to reduce their external debt by more than half by 2005, from 97% of GDP to 41% and from 32% to 17% respectively.[10] During the first few years of the recent price escalation, the Saudis and other governments continued to base their budgets around revenue expectations of $25 per barrel, only shifting upward well after that price band had become quaintly obsolete. Between 2002 and 2005, Middle East oil producers spent on average one-third of their windfall revenues, compared with spending rates of 75% during previous oil booms.

Massive budget and current-account surpluses are providing unprecedented liquidity in financial markets, in turn boosting investment and growth. The oil boom has corresponded to an overall expansion of employment opportunities in the region, and a decline in regional unemployment rates from 15% in 2000 to 12.7% in 2005.[11] Many of the larger states appear to have placed a premium on projects with real potential to accommodate the region's fast-growing labour market. Saudi Arabia has invested $200bn in new 'economic cities' intended not just to compete with traditional hubs like Dubai and Bahrain but to generate large-scale employment, as the 2,000 planned factories and 800,000 planned jobs of King Abdullah Economic City and the 1.3m projected jobs for an agribusiness city in Hail suggest.[12] The GCC states have approximately $1tr in infrastructure investments already in the pipeline, or as much as double that amount if all the announced projects are actually launched.[13] Much of this investment in power generation, water desalination, education and housing is desperately needed to support rapidly growing populations and to compensate for a legacy of domestic underinvestment as compared with other middle-income economies, such as Brazil, Russia, India and China.[14]

The region is becoming far more globalised, with foreign direct investment (FDI) in the Middle East expanding by more than 200% between 2001 and 2006 – a tenfold increase in the region's proportion of global FDI.[15] Multinationals are racing to gain a foothold in this fast-growing region;

for instance, in 2008 NASDAQ acquired a one-third stake in the Dubai International Financial Exchange. At the same time, Gulf-held foreign assets have more than doubled since 2003, with estimates ranging from $1.8tr to $2.4tr,[16] and the region's portfolios are much more diversified than ever before, with a greater focus on other Gulf states as well as Asia. These changes reflect a variety of factors. First and foremost, the evolving international market for capital means that in seeking to invest their windfalls, oil producers have far more options today than they did during OPEC's original heyday. Moreover, turmoil in the region's relationship with Washington has slightly dampened Arab enthusiasm about US investments, whereas markets closer to home offer the comfort factor of cultural and linguistic commonalities along with real opportunities for growth.

Whatever their rationale, the consequence of these investment patterns is that the impact of the oil boom extends beyond the oil-rich states to other Middle Eastern countries. Intra-Arab investment tripled between 2000 and 2005, and at least 11% of Gulf foreign investment since 2002 has remained within the region, particularly North Africa.[17] 'Gulf investors are going very big on North Africa,' one hedge-fund manager told a reporter recently.[18] The numbers may still be paltry relative to the overall flow of revenues gushing into the Gulf, but for the recipients, the newfound regional interest can have a decisive impact, particularly for economies still transitioning away from the heavy hand of state control. The United Arab Emirates invested $3bn during 2007 in Egypt alone – a country whose stock market now draws 30% of its investors from the Gulf – and has made commitments to Morocco in the range of one-third of the country's GDP. Overall, Gulf investments in the Arab world could reach $750bn by 2020, which would represent a quadrupling compared to the past five years.[19]

Having examined the fast-rising Gulf interest in local financial products, where private regional investors now park at least one-quarter of their portfolios (as opposed to 15% in 2002), one consulting firm has suggested that this investment is creating 'a virtuous development cycle' that can strengthen and mature local capital markets.[20] One can reasonably extend this conclusion to the broader economic vitality of the region, since the multiplicity of alternatives available to the Gulf will minimise their tolerance for any business opportunities seen to suffer from a poor investment climate. Growing interest in intra-regional investment also holds out the prospect of not simply facilitating further privatisation and economic liberalisation across the region, but also mitigating at least some of its festering conflicts. Although the wealthy Middle Eastern states are rightly criticised for their stingy support to the Palestinians,[21] Gulf wealth has played a significant role in rebuilding Lebanon after its civil war and helping to stabilise the government and the economy in the aftermath of the 2006 conflict with Israel and ensuing internal crises.

Gulf wealth has played a significant role in rebuilding Lebanon

Growing relationships with Asia have reinforced a new Eastern orientation to regional economic interests. This reflects a natural extension of the energy flows from the region: two-thirds of Gulf oil exports go to East or South Asia, and the region relies on the Gulf for at least as much of its oil supplies. Eleven percent of Gulf foreign investment since 2002 has been in Asia, and that proportion is expected to double by 2020.[22] Middle Eastern investors (not including private-equity firms) bought $20–30bn in Asian assets in 2007, and trade between the two regions doubled between 2000 and 2005, with a tripling of exports from China, India and Pakistan to the Persian Gulf. The changing vector of the region's economic interests raises a host of diverse issues and concerns for US policy, but at a basic level this trend speaks to an unprecedented interdependence and global integration that will enhance regional stability in the long term.

Beyond their spending patterns, regional governments are also undertaking real reforms, including the Saudi accession to the World Trade Organisation, a new legal framework for corporate activities in the United Arab Emirates, and a sustained effort to liberalise the Egyptian economy, which has boosted foreign direct investment from $300m in 2003–04 to $6bn in 2005–06. Even in Iran's disastrously mismanaged economy, high oil prices have both forced and enabled an unprecedented effort to address the long-standing distortion of state-subsidised gasoline through both rationing and substitution programmes. A healthy competition for investment dollars and diversification has begun to emerge, pitting the pioneering Dubai model against rivals in Abu Dhabi, Doha, Bahrain and elsewhere in the region. There is a much keener focus on the overall climate for investment – what one Saudi official describes as the 'soft infrastructure to help the business environment prosper' – that will help generate innovation and raise standards.[23] All this means growth in economies that actually contracted at the end of the first major oil boom. One investment firm has suggested that the Gulf market could expand to rival advanced economies such as France by 2050.[24]

Developments outside the region have also positively shaped the context for social and political freedoms in the Gulf. As the Indian economy has liberalised and recorded record growth rates in recent years – itself an important factor in the current oil-price equation – domestic demand for labour has intensified significantly. The new competition for human capital in India has helped generate higher standards and expectations from one of the most important labour sources for the Gulf. To some extent this has been expressed by implicit declines in labour supply; an Indian businessman told an Arab business website last year that 'where you could have 10 laborers in the past, maybe you will only have five. Contractors will need to ensure their long-term sustainability by offering them a career path, good wages and living conditions.'[25] The Indian government in 2007 set a minimum wage for overseas unskilled labourers, a move that was mirrored by the Philippines and Bangladesh.[26] These moves are small but crucial steps in helping to improve the living standards and legal protections for the region's expatriate workers, its most vital as well as most vulnerable population.

Wealth is also generating much-needed investment in human capital. The Gulf states have launched massive new educational initiatives, building more than a dozen new campuses of American universities and opening art galleries, media centres and an array of cultural institutions at an investment of more than $20bn a year.[27] Governments have made it clear that they are prepared to import the very best of Western education and culture – and in most cases have agreed to adhere to the rigorous standards and cultural norms of the home institutions, such as co-ed facilities and US accreditation requirements. The scope of these educational undertakings, coupled with a new focus on promoting entrepreneurship,[28] can help address one of the most important underlying risk factors for the regional environment, the demographic time bomb.

Threats to regional energy security

It would be tempting to view the latest avalanche of revenues and investment in the Middle East as an antidote to its manifold internal and external challenges. However, more than any other region of the world, the Middle East has long stood as a testament to the limitations of wealth in generating good governance and sustainable growth. Amidst the benefits of the current boom lies considerable reason to fear that the new global energy balance – in which demand is likely to maintain high prices for the near to medium term – will only exacerbate the region's existing tendencies toward extremism, corruption, unrest and intra-state violence. Under such a scenario, the perverse consequence of the new oil boom could be a Middle East that is far wealthier but even more unstable than it is today, with disturbing implications for the rest of the world's increasing reliance on Gulf oil and gas.

The reason for this prospective paradox is the well-documented linkage between resource wealth, growth and autocracy. This is a function of the very mixed economic and political implications of resource wealth. Oil exploration and development is a highly capital-intensive industry that tends to create export enclaves without sufficient employment or related industrialisation to promote balanced or sustainable development. States dependent on resource revenues are subject to intense fiscal volatility and wage and balance-of-payments distortions, and resource wealth is associated with lower rates of economic growth and development.[29]

In the political realm, a disproportionate reliance on external rents distorts the political process by divorcing the state from any meaningful social accountability, reinforcing instruments of repression, giving rise to corruption, and eroding checks and balances. The state's primary role vis-à-vis society becomes a distributive one, and the result is a corrosion of formal institutions and the reinforcement of patronage.[30] Beyond the internal distortions, academic studies have demonstrated that oil-rich states tend to be more likely to engage in conflict, spending more on security and maintaining larger armies than non-oil-dependent countries.[31]

There are no simple solutions to the problematic consequences of resource revenues. Democracy is certainly not the answer, insofar as democracy is typically introduced via the mechanism of competitive elections. Resource rents facilitate the typically pre-existing patterns of patronage politics and erode the checks and balances, such as an open press, that might constrain patronage. As a result, resource-rich governments fail to create the kind of public infrastructure that is needed for the development of competitive politics – or, for that matter, for economic growth. Scholars Paul Collier and Anke Hoeffler have demonstrated that 'in those developing societies where the state has most command over resources, the democratic process has been least effective at controlling them for the public good'.[32]

According to Stanford University political scientist Larry Diamond, none of the 23 countries that currently derive at least 60% of their export revenues from petroleum qualify as democracies, and 'all of the oil-rich countries of the world remained under or returned to authoritarian rule after 1974 and the third wave of democratization'.[33] This trend applies to all of the Middle East's major oil producers, and indeed extends more broadly across the region, where only Israel has been designated 'free' by Freedom House, with Bahrain, Lebanon and Yemen categorised as 'partly free'.[34] The region's proclivity for armed conflict is all too well established, from the succession of wars between Iraq, its neighbours and several global coalitions, to the protracted failure of peacemaking between Palestinians and Israelis, to the persistence of terrorist violence against peoples and states from North Africa to Yemen.

Given this background, forecasts of potentially negative fallout from the region's renewed influx of revenues have obvious resonance. Recent years have brought more open elections and representative institutions to a number of Middle Eastern states, but considerable evidence suggests that these advances have not fundamentally altered the authoritarian bargain that has long prevailed there, particularly in the oil-rich states.[35] The improving economic fortunes of the region will likely facilitate this bargain's perpetuation, since, as Thomas Friedman has opined in the *New York*

Times, 'as the price of oil goes up, the pace of freedom goes down'.[36] This logic appears to be borne out by the experience of countries such as Iran: when oil prices dipped as low as $10 per barrel during the late 1990s, the country's president championed a 'dialogue of civilizations'; more recently, with oil prices careening to record highs, his successor spews anti-Israel invective and oversees a new era of internal repression and international provocation.

While political reform carries its own substantial risks, the relative dearth of meaningful steps toward greater accountability and popular participation in the Middle East creates significant uncertainties for the region's future – particularly in those states, such as Egypt and Saudi Arabia, that are poised to undergo rare changes in leadership in the near term. Managing those transitions may be rocky, and the surfeit of oil revenues may only complicate the process by facilitating corruption, entrenching privileged networks of power, and reducing incentives for good governance and the rule of law, all of which would rebound negatively for economic development. Rather than generating the 'virtuous cycle' predicted by some commentators, a future of enduring high oil revenues in the Middle East could generate the worst possible outcome for the region and for global interests in regional energy security by propping up undemocratic and predatory regimes, temporarily sustained by oil windfalls but inherently precarious. Setting aside the particularist ideology of Iran's Islamic Republic, the ascendance of Mahmoud Ahmadinejad and his brand of radical populism and economic malpractice may be a harbinger of the region's future.

The prospects for such a scenario are reinforced by the demographic realities that complicate the region's internal challenges. Even with a new flood of cash, it is not clear that any Middle Eastern state beyond the tiniest Persian Gulf emirates can sustain the social contract that has underpinned the long-standing bargain between the region's rulers and ruled. Two-thirds of Middle Easterners are under the age of 30, which represents a historic opportunity for growth in the context of the region's expanding economies; alternatively, this disproportionately young population could trigger what one expert has described as 'double jeopardy: the economic and social exclusion of youth drains growth and creates social strife'.[37]

To successfully marshal these human resources, states will have to embrace forward-leaning policies and programmes to create 80m new, productive jobs by 2020, nearly all in the private sector, as well as implement the sort of comprehensive educational expansion and reforms necessary to produce a trained and competitive work force. Today, youth unemployment and underemployment is rampant. Within the Gulf states alone, the challenge is to create 280,000 jobs per year to absorb new entrants to the labour markets – or 4m new jobs by 2020 in a regional economy that currently employs only 4.8m local citizens.[38]

The boom has generated new private-sector growth, but capacity remains far below what is required to meet the skyrocketing needs of most societies. And despite episodic political crises, and the countervailing economic shocks of the oil-price decline in the late 1990s and the current boom, the region's overall reliance on a primarily low-skilled, low-cost expatriate labour has remained steady over the past decade at approximately 40%. Ambitious nationalisation programmes, including changes in the sponsorship system of some Gulf countries and a recent Saudi publicity campaign riffing on the labour minister's brief stint at a fast-food restaurant, have had only a limited impact. As a result, impressive job-creation targets remain largely aspirational, and the prerequisite structural changes – in particular, the massive expansion and empowerment of the private sector – are still in their infancy. If these employment targets are not achieved, the spectre of a youth bulge characterised by idleness and frustration looms on the horizon for the Gulf.

Reliance on expat labour has remained steady

Compounding the political issues at stake for the region are real economic pressures that could exacerbate the task of maintaining stability at home. The scope of windfall spending could overwhelm some economies, and population pressures and the associated infrastructure demands pose a little-discussed but very real set of hazards. Already the region is suffering from widespread inflation – still modest by world standards but deeply worrisome in the context of local history – that has been sparked by massive spending, rising global food prices, and the local currency's peg to a weak dollar. Over the past year alone, construction costs in the Gulf have risen by a shocking 30%.[39] Food prices are a major component of the challenge, and Egypt, Jordan, Yemen and the United Arab Emirates have each experienced food riots in recent months. Housing and real estate are the other dimension of the inflation problem; rents in Dubai rose by 30% in 2006 and another 17% in 2007. Government efforts to address inflation by raising public-sector salaries, building strategic food stocks and enhancing domestic price subsidies have provided short-term relief for some beneficiaries, but ultimately will simply exacerbate the problem. Expatriate workers are particularly vulnerable, as inflation stings both their own pocketbooks as well as the dollar-denominated remittances they send back home. As a consequence, labour activism over pay and working conditions is on the rise around the region, and recent riots by expatriate labourers in Kuwait and the United Arab Emirates have spooked both those governments and their neighbours.

The root of the inflation problem is twofold – the fact that most Gulf currencies are pegged to a steadily depreciating dollar is a cause, as is massive spending that tends to be highly import-dependent. The dollar peg, which effectively forces the region's central banks to cut interest rates when they should be raising them, presents a particularly knotty set of dilemmas. Any revaluation would cut both ways, alleviating domestic political and economic pressures, while slashing the value of the GCC's trillions of dollars in offshore assets and causing friction with Washington.[40] Addressing the spending question is similarly fraught: deferring or scaling back the Gulf's approximately $1tr in infrastructure investments might mitigate the inflationary spiral, but would leave the region's growing population even more vulnerable to power and water shortages. For all the justifiable criticism of the region's affinity for mega-projects, the efforts under way to modernise and expand the region's inadequate infrastructure represent a necessary response to a potential source of instability. Already, efforts to meet the challenge of supplying the youth bulge's basic needs – including power, water, health care, education and transportation – are hampered by problematic shortages of both qualified contractors and concerns about credit availability and banking capacity.[41]

Beyond these pressures, other dimensions of the region's approach to capitalising on the oil boom should cast doubts on expectations that the current price environment will inevitably facilitate a new era of peace and prosperity. After decades of discussion, efforts to advance meaningful economic integration in the Gulf are still moving at a snail's pace, and as a result the region is missing real opportunities to optimise its resources, particularly in developing much-needed power-generation infrastructure. Gulf efforts to move their economies away from wholesale reliance on petroleum exports appear disturbingly redundant, raising concerns about overcapacity in aluminium, petrochemicals and real-estate ventures.[42] Also, the launch dates on several showpiece projects have been moved ahead precipitously – in the case of the King Abdullah Economic City in Saudi Arabia, a decade earlier than originally planned – which raises concerns about excessive haste.[43]

Other initiatives, such as massive education projects under way in the Gulf, may have unintended consequences that are far more adverse than their enlightened backers intend, by drawing much-needed talent and expertise away from the traditional centres of learning in the Arab world. In other words, investments in educational infrastructure in the Gulf may only exacerbate and change the geographical vector of the region's long-standing brain drain, a problem that has already stripped the Arab world of one-quarter of its engineers and half its doctors over the past 30 years.[44]

Inflation, emerging bottlenecks, hyper-development, lack of coordination, and unrealistic goals and timelines – all these maladies and distortions conjure comparisons with the overheated development schemes launched by Iran's monarchy in the years preceding the 1979 Islamic Revolution, and spark unease about the prospect of future radical regime change in the region.[45] Moreover, as the latest economic crisis, sustained high prices and increasing investment in alternative technology cut demand for oil and gas, the region may yet again face the whiplash effect of declining government revenues but perpetually high public expectations.

For obvious reasons, the region's internal political and economic challenges are directly relevant to the broader global economy and American security interests. Threats to infrastructure and transportation corridors are very real. Serious and sustained domestic unrest in any of the key Gulf oil and gas producers could disrupt export capabilities, as occurred in the aftermath of Iran's revolution. Even more ominously, internal destabilisation could provoke terrorist attacks on oil-export facilities and transportation routes; over the past several years, Saudi authorities have thwarted several such planned strikes by militants associated with al-Qaeda. Unprecedented oil revenues also generate renewed prospects for intra-state frictions, as empowered autocrats such as Iran's Ahmadinejad perceive themselves as invincible and the unlucky resource-poor are left embittered and potentially emboldened in the manner of Saddam Hussein.

The road ahead

Ultimately, neither the region's boosters nor the naysayers have it completely right. The risks posed by the soaring price of oil are compelling and critical. However, they need not be foreordained. The traumatic experience of prior oil-price crashes in 1985–86 and 1997–98 – when OPEC revenues dropped by more than three-quarters and one-third respectively[46] – coupled with the pressure exerted by a young, globalised and demanding population, has generated a determination among regional leaders to avoid another lost opportunity. 'We want to learn from the mistakes of the '70s,' one Saudi official acknowledged.[47] With this hindsight and the judiciousness demonstrated in the early stewardship of the current boom, there is some reason to believe that the past need not repeat itself.

Still, it would be dangerous and irresponsible to rely on regional leaders' hard-earned prudence, their willingness to engage in modest top-down reforms, and the buoying effect of economic growth to ensure a durable pathway to a more secure and prosperous Middle East. Contemporary regional history and politics offer little evidence that prosperity alone begets peace and stability, or even that economic reform can generate political systems and cultures that are conducive to long-term stability.[48] Iran's cataclysmic revolution unfolded in the context of rapid economic growth made possible by an unprecedented oil-revenue bonanza, while more recent developments in Tunisia and Egypt underscore the capacity of authoritarian states to liberalise their economies without yielding an inch of political control.

The obvious conclusion to be drawn from this mixed assessment is that the region and the world must work cooperatively to ensure that the opportunities presented by the oil boom are maximised and that the windfalls pay broader dividends. This will not be an easy task. Most of the world is struggling to cope with the short-term economic pain caused by soaring oil prices and the need to shift the energy balance through conservation and the development of alternative sources and technologies. Focusing on the dilemmas of the boom's apparent 'winners' will, understandably, fall lower on the priority list. In addition, the challenge is complicated by the extent to which the changing environment for energy reduces the leverage of foreign governments. For Washington, oil windfalls – and the likelihood of their indefinite perpetuation – legitimately intensify the imperative of assisting the Middle East in navigating a path toward sustainable prosperity and meaningful political reform. Yet the United States' ability to pressure and persuade the region is inevitably constrained by the dependence of both the American and world economies on the very commodity that is responsible for the Middle East's rising fortunes.

The changing energy environment reduces foreign governments' leverage

These contradictions were on full display during President Bush's final tour of the region in May 2008. In Egypt, before an array of Arab political and business leaders, Bush issued a stirring appeal for reform and democracy, declaring that 'too often in the Middle East, politics has consisted of one leader in power and the opposition in jail. The time has come for nations across the Middle East to abandon these practices, and treat their people with dignity and the respect they deserve.'[49] The strength of the president's rhetoric was powerfully undercut by an entreaty he had issued more quietly during an earlier stop on his trip: a request to Saudi leaders to expand oil production in order to lower the spiralling price of gasoline. The fact that neither presidential request was likely to succeed only underscores the faltering of American influence and the depth of the challenge the world faces.

The next US administration will have to move beyond such soaring oratory about democracy and the feel-good programming that accompanied the much vaunted 'Freedom Agenda' to work with the region and individual leaders on the specific opportunities and threats that stem from the hyperwealth generated by the current oil boom. One potentially useful step would entail reviving and upgrading a formal channel for dialogue and cooperation between Washington and the Middle East on economic issues, such as the US–GCC Economic Dialogue, which was devolved to the Commerce Department before finally being abandoned in 2001. The particular challenges of the oil boom warrant the involvement of senior officials on both sides, along the lines of the strategic dialogue with China that has been led by the US deputy secretary of state and the treasury secretary. This level of participation ensures that the channel transcends the standard focus on trade promotion, highlights the urgency of shared interests in seeing the region steward its oil revenues wisely, and helps ensure real buy-in from the relevant agencies on both sides. This dialogue should incorporate working groups comprised of representatives of each side, tasked to address specific priority issues on an ongoing basis. The resumption of the dialogue in some higher-profile format would also assuage some of the umbrage within the Gulf – and particularly in Riyadh – about the Bush administration's appropriate and astute decision to pursue bilateral rather than multilateral free-trade agreements with the Gulf states.

Several important economic issues appear ripe for greater engagement between the Middle East, Washington and other weighty international actors, including China, Japan, the European Union and Russia. One relates to mutual concerns about the increasing prominence of Gulf-based sovereign wealth funds in investing abroad; both the European move toward voluntary codes and the principles developed in recent discussions between the US Treasury and Gulf leaders suggest the utility of a broader effort to develop standards and mutual understanding as a means of avoiding politicisation of this issue by either side.

Another topic worthy of focus is the direction and composition of regional foreign-assistance programmes. Historically, Washington is prone to the temptations of 'tin-cupping' – turning to oil-rich states on a case-by-case basis to fund development and reconstruction projects that have either political (Iraq, Afghanistan) or humanitarian (disaster-relief) priority for the US administration. This is an inefficient and unstructured approach that serves no party's ultimate interests, and the likely continuation of the large revenue streams to the Gulf means a more systematic effort to identify areas of priority and potential cooperation is warranted.

Thirdly, the United States, together with the international financial institutions, should initiate a much more intensive effort to help facilitate greater regional economic integration. Short-term political obstacles have hindered long-standing interest in developing a regional power grid for the Gulf countries, a situation that could lead to future electricity shortages in some countries as well as considerable unnecessary financial costs. American diplomacy and, as necessary, incentives should be deployed to ensure that the long-term interest in projects like this, and those that would create similar linkages for water and transportation, is satisfied both within the Gulf and across the Middle East more broadly.

Finally, Washington and other major consuming nations should elevate the dialogue with the major oil producers in the Middle East about transparency in the petroleum sector. Combined with efforts to strengthen the capacity of indigenous institutions such as the media and parliaments, access to information about oil and gas revenues and spending is the most low-cost, high-returns tool available for promoting good governance and accountability. A voluntary code known as the Extractive Industries Transparency Initiative (EITI) has generated widespread interest and buy-in from non-governmental organisations, governments and companies, but has largely failed to penetrate the Middle East, with the recent exception of Iraq. Given the political sensitivities surrounding oil, the tendency toward secrecy is understandable, but ultimately detrimental to both the market and the political evolution of the region. No external actor can force the Middle East to embrace transparency, but the world could do more to impress upon the region the valuable role of the EITI and other efforts to enhance fiscal accountability.

Of course, summitry is not the equivalent of actual solutions, and the real objective of both regional leaders and the new US administration should be the promotion of good governance and enlightened management of the oil bounties accruing to the Middle East.

Effectively, this will entail a comprehensive transformation of long-standing patterns of behaviour by both public and private actors in the region. Washington can and should help the Middle East navigate between the perils and possibilities of the new era for energy and oil revenues, but ultimately the region and its people will determine its fate.

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