Draftings In

Volume 2
Number 4 *Draftings in Economics: Major Themes*

Article 8

1987

The Role of Oil in Kuwait's Economy

Steve Anderson
University of Northern Iowa

The Role of Oil in Kuwait's Economy

by Steve Anderson

After an Anglo-Persian geologist by the name of P.T. Cox produced the first evidence of oil in 1931, Kuwait would never be the same again. The whole structure of Kuwait, economically and politically, changed dramatically. Kuwait developed from a poor Middle Eastern country to one of the richest countries in the world. The population went from poor pearl divers and fishermen to some of the most powerful oil barons in the world. This paper will show the transformation of a poverty stricken country into a petroleum giant.

Background

Kuwait was founded in the 18th century by migrating herders. In 1899, Great Britain assumed control of Kuwait's foreign affairs and, following an outbreak of war with the Ottomans in 1914, established a protectorate over Kuwait. In 1961, Kuwait received its independence and, in 1963, was admitted to the United Nations. Kuwait is located on the coast of the Persian Gulf, which is in the heart of the Middle East petroleum basin. The total population of Kuwait, as of the 1985 census, was 1,709,857; the population per square mile was approximately 231 people (Hall 1983, p. 179). The dominant language is Arabic, and the dominant religion is Sunni Muslim.

Kuwait's climate and landscape create ideal conditions for the extraction of petroleum. The landscape is generally flat, broken by occasional low hills. Elevations range from sea level to 1000 feet above sea level (Winstone 1972, p. 12). Generally, the landscape consists of desert and desert basins called "playas." The climate is semitropical tempered by the warm waters of the Persian Gulf.

In the pre-oil era, the fishing economy of Kuwait provided the most important occupation for the working class. The daily surplus of fish was dried, salted and transported to the interior but never developed into a regular export industry. At its peak in 1963, pearl industry exports reached $714,286 (Al-Sabah 1980, p. 16). The industry, however, was organized around a system of debt. Advances were given out and then became liabilities against the crew, thus insuring subsistence level wages and no turnover in labor. The conditions were similar to those experienced by the sharecroppers of the southern United States during the 1930s depression.

In the 1950s and 1960s the shipping industry was fruitful for Kuwait because of its central location in the Persian Gulf. Kuwait was also the main ship builder in the Persian Gulf in the 1950s, producing an average of 50 to 60 ships annually (Al-Sabah 1980, p. 23). The villages supplied all the vegetables needed, but Kuwait imported all of its grain and other agricultural needs. Thus, despite the absence of unemployment in the pre-oil era, the people of Kuwait were poor.

Kuwait's Post-Oil Economy

In the post-oil era Kuwait's economy became dualistic, consisting of the oil sector and the non-oil sector. From 1963 to 1968, the annual growth rate of GNP was a relatively high 8.8 percent (Al-Sabah 1980, p. 81). Most of the growth was attributed to the rapid development of the oil industry and the influx of immigrants. The 8.8 percent rise in GNP was thought to be very large at that time, but in the period 1968 to 1976, it was overshadowed by a booming 12 percent annual growth rate (Al-Sabah 1980, p. 81). The 12 percent annual growth rate was attributed to increasing posted prices in the crude oil and liquified petroleum gas industries. The growth rate increased government expenditures and private economic activity greatly. The GNP growth rates for the years since the 1960s were always proportional to rates of oil exports, oil prices, and government expenditures.

A study of income distribution in Kuwait is almost impossible because no financial or monetary records exist. People of Kuwait pay neither personal income tax nor taxes on capital gains. Import duties are low, and imported goods are sometimes underreported in order to reduce import duties. The only companies which pay taxes are the oil companies, and they are mostly nationalized.

In 1959, the United Nations attempted to measure the GNP of Kuwait. The GNP was measured at over $105 million or about $3,000 per capita (Al-Sabah 1980, p. 83). A second measurement attempt was made in 1963, and the GNP was $132 million or about $2,960 per capita (Al-Sabah 1980, p. 83). These estimates of GNP excluded retained profits and foreign exchange expenditure of the foreign oil companies. The decline in per capita income between 1959 and 1963 was attributed to the massive influx of people into the country which, in effect, reduced the oil revenues per capita from $1,600 in 1959 to $1,400 in 1963. From 1970 to 1977, GNP rose consistently, due to the increase in oil and gas prices, to the extent that increases in population had no effect on the level of GNP per capita. In 1977 the GNP was in excess of $1.15 billion or $14,000 per capita (Al-Sabah 1980, p. 84). In the years since 1977, the GNP per capita has fallen because of falling oil and gas prices. The standard of living has been affected only slightly, however, due to the massive cash reserves Kuwait has accumulated.

In the period 1965-71, the value of expenditures in the oil sector greatly outweighed the value of expenditures in the non-oil sector. The oil sector held 63.4 percent of the GDP in the period 1965-6 and it increased its position to 70 percent in the period 1970-1 due to the increase in oil and gas prices (Al-Sabah 1980, p. 84). These figures disclose the dualistic nature of the economy and make it obvious that Kuwait depends on the export of crude oil. The bulk of the non-oil sector lies in public administration and wholesale and retail trade. These sectors, however, are linked closely with the oil sector. The true non-oil sectors are the industrial, and the finance, insurance, and real estate sectors.

The industrial sector of the economy made a larger contribution to GDP during 1966-7 than during previous years, even though the domestic market was small and other non-oil national resources were scarce (Al-Sabah 1980, p. 85). The number of industrial establishments increased from 995 in 1965 to 1,549 in 1974. Proportionally the number of industrial workers rose from 10,155 in 1965 to 16,733 in 1974 (Al-Sabah 1980, p. 85). The value of industrial production increased from $10 million in 1965 to over $35 million in 1974, and the value added rose from $500,000 to almost $13 million (Al-Sabah 1980, p. 86). Although non-oil industries have been trying to thrive in Kuwait since the early sixties, it must be realized that the country has become just a finishing plant for consumer goods. This processing depends on imported capital, materials, and intermediate goods. Kuwait's paint industry, for example, is wholly import-based. The only process that takes place in Kuwait is the mixing of the paint. Kuwait's metal, building, and food and beverage industries are almost wholly imported. A large volume of domestic furniture is produced in Kuwait, but again all the materials are imported. Kuwaiti factories only put the parts together. In truth, Kuwait's industrial sector, excluding the oil industry, is hardly a goods producing sector but rather a series of importing agencies.

Kuwait's finance, insurance and real estate sector contributed 0.8 percent to GDP in 1955-6, and the contribution rose to 5 percent in 1976 (Al-Sabah 1980, p. 87). This was due to the influx of new companies and banks. The assets of commercial banks increased from over $135 million in 1973 to $1.80 billion in 1977 (Al-Sabah 1980, p. 87). The commercial banks were mainly concerned with trade and import financing, while the financial services companies were concerned mostly with personal loans for real estate purchases and speculation. Before 1965 there were no real estate or insurance companies in Kuwait, but by 1977 there were over 40 such companies whose assets were almost $115 million (Al-Sabah 1980, p. 88). It is notable that the most successful entrepreneurs in Kuwait have been working in two sub-sectors: (1) industry and (2) finance, insurance and real estate.

Another aspect of Kuwait's dualism lies in the manpower sector of the economy. In 1959 more than 75 percent of the labor force consisted of non-Kuwaitis, who earned higher wages and salaries than the Kuwaiti workers. Since that time, in the oil sector of the economy, their wages and salaries have remained higher than those of the Kuwaitis. This is due to the fact that American and European technicians who are employed in the oil sector ususally have higher salaries because of their expertise. In the non-oil sectors, foreigners have not done as well. As of 1974, the average annual income for the entire non-Kuwaiti labor force was $618 whereas the average annual income for Kuwaiti workers was $1496 (Al-Sabah 1980, p. 93). In the fishing industry, for example, in 1974, average earnings were $237 a year for non-Kuwaitis and $1,658 a year for Kuwaitis (Al-Sabah 1980, p. 93). In the food manufacturing sector, the non-Kuwaiti annual average income was $282 while the Kuwaiti annual average income was $1070 (Al-Sabah 1980, p. 93). The effect of the oil boom has been to raise the standard of living of Kuwaitis at the expense of low-wage immigrants in the non-oil sector.

Surpluses and Gaps

In Kuwait there are three main surpluses and gaps. The first gap, between government revenue and government expenditure, has resulted in a surplus almost every year. The highest domestic surplus in post-oil Kuwait was $563 million (net of public expenditure) in 1976 (Al-Sabah 1980, p. 95). This resulted from rising oil prices and the government takeover of the Kuwait Oil Company. The second gap is the international trade balance, where there is always a surplus in the balance of payments. Kuwait's balance of payments has been consistently in surplus since 1960. The 1977 surplus of over $74 million was realized because of the increase in foreign reserves, created by previous foreign investments. The balance of payment surpluses has come from the enormous revenue generated by the oil industry, proving once again that Kuwait lives and dies by the oil well.

The last gap is between savings and investment, where a high percentage of GNP is saved, and half of the amount is invested domestically (Al-Sabah 1980, p. 94). National saving had increased by 1.82 percent per year until 1971 when saving began to increase by leaps and bounds (Al-Sabah 1980, p. 99). National saving increased from $63 million in 1970-71 to over $8 billion in 1975-6 (Al-Sabah 1980, p. 99). This massive jump can be attributed to the increase of oil and liquid gas prices. At the end of 1976, national saving represented 61.2 percent of the GDP, one of the highest percentages in the world (Al-Sabah 1980, p. 99). The rate of increase in the purchase of invisible foreign assets was even more dramatic than the increase in national investment in that same period. National investment increased from $50 million in 1970-1 to almost $553 million in 1975-6 (Al-Sabah 1980, p. 99).

Kuwait's Role in OPEC

Kuwait, though a small country compared to other members of the Organization of Petroleum Exporting Countries (OPEC), is a mighty producer. Kuwait uses a higher percentage of its flared gas than any other member of OPEC. Kuwait also refines more oil, percentage-wise, than any other Gulf state (Rouhani 1971, p. 71). Kuwait's economic policies, however, are not clearly defined, and there seems to be a lack of central planning geared to a well-defined objective. Furthermore, Kuwait is not in full control of its oil resources. The Ministry of Oil, the Kuwait Oil Company (KOC), the Kuwait National Petroleum Company (KNIC), and Petrochemical Industries Company (KNPC) comprise the oil sector of Kuwait. The Kuwaiti government owns 60 percent of the shares of stock and the other 40 percent is owned by Kuwaiti nationals (Al-Sabah 1980, p. 37).

The KOC, the Arabian Oil Company, and the American Independent Oil Company are the three foreign oil companies operating in Kuwait. KOC, the principle producing company in Kuwait, is owned equally by British Petroleum and Gulf Oil. Arabian Oil Company (AOC) is owned principally by Japanese firms; however, 20 percent of the company's shares are owned by the Kuwaiti government (Al-Sabah 1980, p. 42). The AOC operates solely off shore in the neutral zone shared by Saudi Arabia and Kuwait. The American Independent Oil Company (Aminoil) is owned solely by American firms. In 1973 Kuwait was in fourth place in the production of oil, producing 3.01 million barrels per day for an annual revenue of $203 million (Al-Sabah 1980, p. 53).

Since 1973 the price of a barrel of oil has plummeted, and OPEC has had to establish production quotas. Kuwait's major strategy in OPEC has been to get a better market share, while Saudi Arabia has been trying to play peacemaker between Libya, Kuwait and the rest of the OPEC countries. The Saudis have been willing to give Kuwait part of their production quota in hopes of keeping OPEC together. The Saudis believe a strong OPEC will restore profits.

Conclusion

Kuwait started out as a poor country whose main national income derived from pearl diving and fishing. Since the pre-oil era, many changes have taken place. Black gold, oil, was found and plenty of it! Since the oil strike, billions of dollars have been made in revenues, and the standard of living, for Kuwaitis at least, has skyrocketed. Per capita GNP has soared, and Kuwait's cash reserves have become enormous. However, all good things must come to an end. In 1980 there was a crash of oil prices, and Kuwait's reserves started to dwindle. The oil crash of 1980 taught Kuwait a lesson that goes like this, "Don't put all your eggs in one basket." Kuwait was so dualistic that it lived and died by the oil well. When oil prices were high, the economy was in good shape; when crude prices fell, the opposite became true. Kuwait should learn the basic principle of finance that one must diversify to spread the risk.

REFERENCES

Al-Otaiba, Mana Saeed. *O.P.E.C. and the Petroleum Industry.* New York: John Wiley and Sons, 1975.

Al-Sabah, Y.S.F. *The Oil Economy of Kuwait.* London: George Allen and Unwin Ltd., 1972.

Rouhani, Fuad. *A History of O.P.E.C.* New York: Praeger Publishers, 1971.

Winstone, H.V.F. and Freeth, Zahra. *Kuwait: Prospect and Reality.* London: George Allen and Unwin Ltd., 1972.