June 2020

Middle East Economy Watch

Reopening begins, but COVID-19 economic shockwaves persist

Given the high level of uncertainty and volatility over the past few months, we have been somewhat hesitant in publishing an Economy Watch report because of the risk that it could become outdated, and hence misleading, very rapidly. However, as we are now moving past the immediate crisis into a recovery phase, and are armed with some initial impact data, now seems like a good time to provide our clients with some thoughts to help in making sense of what might look like a confusing economic outlook.

This report starts by assessing the evidence available so far of the economic impact of the crisis, including data for some indicators in April, which is likely to have been the low point of the regional recession to date.

However, there were hopeful signs in late May that the levels of active infections were flat or falling in many countries.

We then look at the policy responses by governments, which include a mixture of liquidity support, stimulus measures to protect jobs and struggling firms, but also consolidation measures to adjust to new fiscal constraints.

Overall the net policy stances vary from significant consolidation (Oman and Saudi Arabia) to moderate stimulus (Bahrain and UAE).

Finally, we look at the outlook for the next two years which will be shaped more than ever by global trends, including epidemiological ones and their impact on the oil market.

This report gives a high-level overview, but of course the experiences of the crisis vary significantly in each country and economic sector.

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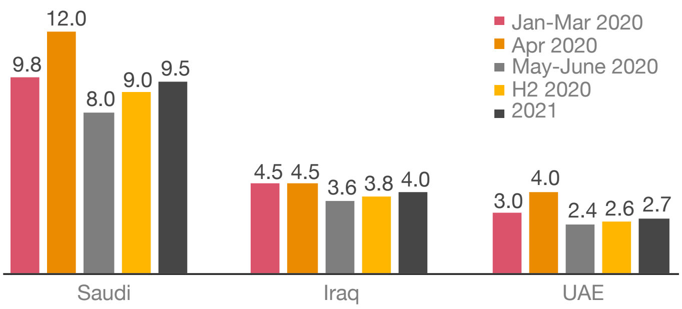
Weaker oil and COVID-19 lockdowns had pushed down 2020 forecasts

Oil collapse

The recognition of the scale of COVID-19 as a global pandemic came just days after OPEC+ failed to agree on extending product cuts that had been in place since 2017. The combination of factors pushed oil prices down to their lowest in decades, with Brent crude futures touching a low of $16/barrel, a quarter their pre-crisis level.

The OPEC+ countries managed to come together in April and agree to a new and much more extensive round of cuts, in an effort to rebalance the market. The new cuts committed countries to a 23% cut in output for May and June 2020 relative to an October 2018 baseline (also used in the previous two rounds of cuts), the cuts will ease to 18% for the second half of 2020 and then 14% throughout 2021. The scale and duration of the agreement is unprecedented. However, it has not been enough to compensate for the short-term demand shock from lockdowns and so Saudi Arabia has voluntarily reduced its production by a further 1m b/d for June (to 7.5m, more than a third below its peak output of 12m in April) and some other Gulf states have also made further cuts.

Oil production, actual and planned (m barrels/day)

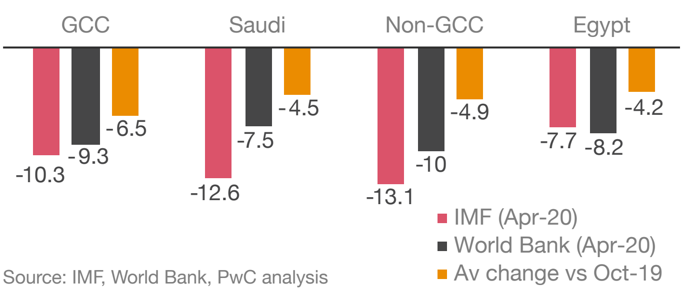


Source: Bloomberg for Jan-Apr, PwC analysis of OPEC+ deal

Even with the OPEC+ deal, the oil price outlook remains weak, with the most recent Reuters poll of economists forecasting an average price of just $36/barrel this year, down from $64 in 2019 and only slowly rising to $59 by 2024. Prior to the crisis, most Middle East states were running deficits even with oil at $64, some of them very sizable, and so the new environment is extremely challenging.

There are a wide range of scenarios for the overall fiscal outturns, which depend on a combination of the hit to oil revenue, the policy changes discussed on the previous page, and the impact of the crisis on non-oil revenue. Benchmark forecasts from the IMF and World Bank see the aggregate deficit for the GCC more than doubling to around 10% of GDP. These forecasts were made in early April, just before the renewed OPEC+ cuts and so if it doesn't provide a sufficient boost in prices to offset the reduced output then they might underestimate the total hit to oil revenue. The evolution of the epidemic and the fiscal response since then may also differ from the Fund and Bank's expectations. However, more recent forecasts from other sources, such as rating agencies, see a broadly similar net fiscal impact.

F2020 fiscal deficit forecasts (% of GDP)

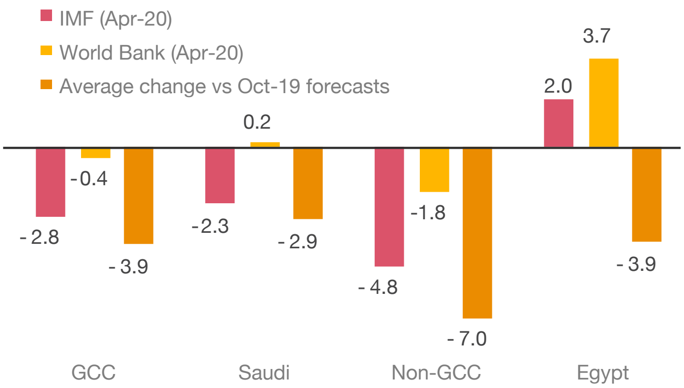


Source: IMF, World Bank, PwC analysis

Both multilaterals also forecast smaller increases in deficits for the rest of the Middle East, which is less tuned to oil but which entered the crisis with a weaker fiscal position than the GCC. (The full IMF forecasts by country are shown in the data table on the final page.)

When it comes to GDP, there are larger differences between the IMFand World Bank forecasts, which see the GCC contracting by -2.8% and -0.4% respectively in 2020. However, there were similar differences in their previous round of forecasts in October and both see a similar magnitude of impact from the crisis. Most of the weaker growth in their forecasts comes from the lockdown impact on the non-oil sector (given that the forecasts pre-date the OPEC+ cuts). The IMF's forecasts see a -4.3% contraction in the non-oil sector, nearly 8 percentage points below its pre-crisis forecast of 3.6% growth. This is comparable to its forecasts of the COVID-shock on Advanced Economies. If the OPEC+ cuts are fully applied then GCC oil production will be about 9% less than it was in 2019, which could knock about a further 4 percentage points off total real GDP, on top of the IMF/World Bank forecasts.

Real GDP growth forecasts for 2020 (% change)



Source: IMF, World Bank, PwC analysis

Looking ahead to 2021, there should be a significant rebound in non-oil sectors, as lockdowns end and demand recovers, although oil production will only be slightly higher y/y. The biggest uncertainty for 2021 is the oil price. The consensus forecast of $46 would be an improvement but still far below achievable fiscal breakeven levels for most countries. However, a wide range of prices are currently easily conceivable and leading economies forecast a range of $40-60. The lower case is easily conceivable if the OPEC+ deal breaks down or there is a second wave of infections and lockdowns, while the higher case is also plausible if an effective coronavirus vaccine leads to a V-shaped recovery in global oil demand.

Although the oil market has always been volatile, it is unusual to see such a wide range in forecasts. This uncertainty makes planning very difficult for both governments and for companies that are heavily driven by government spending. It also impacts the non-oil exports in the region, such as Jordan and Lebanon, whose economies are heavily influenced by trade, tourism and remittances from the Gulf. Hopefully by the time of our next Economic Watch report there will be greater clarity on the outlook.

COVID-19 lockdowns squeeze economic activity

Different starting points

Economies across the region entered the crisis in widely varying states of economic health. Egypt's GDP grew by 5.6% in 2019, the most in a decade, and its consumer confidence index in Q1 2020, as measured in Nielsen's global survey shortly before the crisis struck, was at the highest since 2012 (99 points). Saudi Arabia was also in a robust place with its non-oil private sector growing by 5.2% y/y in Q4 2019, the most in six years, and its consumer confidence at a record high of 121. By contrast, Qatar experienced its first contraction in a generation in 2019, albeit by only -0.2%, as major infrastructure projects were completed and hydrocarbon production declined. Meanwhile, Dubai was facing headwinds from oversupply in its real estate sector and Lebanon was already in the midst of its most severe economic crisis since the civil war.

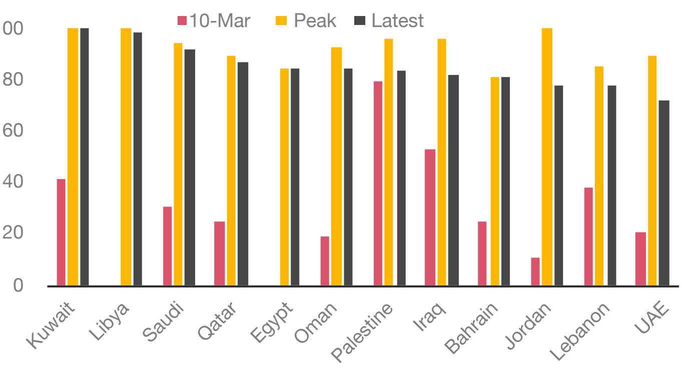
Implementing lockdowns

Despite the different starting points, the immediate economic impacts were similar in type across most of the region as lockdowns to prevent the spread of the virus impacted firstly the travel and tourism sectors and then, as they tightened, the rest of the non-oil economy. Meanwhile, although oil production (largely unaffected by lockdowns) surged briefly in March-April, after the previous round of OPEC+ cuts broke down, this did little to alleviate a decline in revenue due to an historic crash in oil prices.

Although broad approaches to the virus have largely coincided, there have been timing differences in the imposition and then easing of lockdowns that will likely have had a differential impact on economic indicators month-by-month. The Gulf states were among the first to respond globally to COVID-19 given their potential exposure from hub airports and expat populations, cancelling flights to China in early February. Similar restrictions were added to other destinations as a global spread began to emerge. The nearby outbreak in Iran further heightened concerns and resulted in Iraq and Kuwait being early movers to implement broader closure measures. The Saudi decision to suspend Umrah pilgrimages was a significant moment in the global response, coming nearly two weeks before the WHO declared a global pandemic on 11 March. By contrast, Egypt was the slowest mover in the region, implementing no measures prior to the WHO declaration.

By late March, however, there were widespread lockdown measures in place across the region, with many Middle Eastern countries implementing among the most stringent policies internationally, including not only curfews but, in some cases, mandatory facemasks and contract-tracking apps. At their peak, all states in the region scored at least 81/100 on the Stringency Index compiled by Oxford University's Blavatnik School of Government (by contrast the US peaked at only 71).

Lockdown stringency (max=100, ordered by latest data)



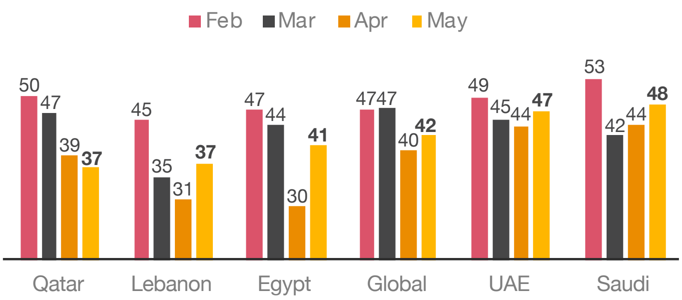
Source: Oxford University, "latest" varies from 16-30 May.

Leading indicators show serious impact

Given the region's relatively slow economic release schedule, Q1 data for major indicators such as GDP and the balance of payments will not be available until the end of June or later and by the time the full Q2 impact is known the recovery may already be well underway. However, some leading indicators gave an indication of the extent of the impact.

Monthly purchasing managers index (PMI) series, which have some correlation with non-oil GDP trends, are available for five Middle East states and show declines to record lows during the crisis. All, bar Saudi Arabia, were already experiencing periods of contraction pre-crisis, with PMI's below the 50-point breakeven level in February. The Middle East states saw declines of 11-17 points, well ahead of the (still substantial) 7-point decline in the global PMI. The latest readings, based on survey data in May, show a partial rebound in all states except Qatar and a much stronger performance from Saudi Arabia and UAE than the other three. The differences may relate to the timing lockdowns/reopenings and the survey collection itself. The unusual situation could be distorting some of the reading, for example longer delivery times, which are usually a positive indicator, are due to the lockdown rather than rising demand. Still, the picture in the Middle East broadly tracks the earlier experience in China, where a solid rebound in the PMI and other indicators followed lockdown easing.

Purchasing Managers Indices (below 50=contraction)



Source: IHS Markit

There are several indicators of consumer demand available for April in some countries. Bahrain, for example, reported a -24% m/m decline (by value) in point of sales transactions and cheque clearing in the UAE fell by -42% m/m. Other negative signals include a -24% m/m decline in building permits in Qatar and a -1.0% m/m drop in expat employment in Oman, the only country in the region that publishes monthly labour data. Wherever data on flights, visitor numbers and hotel occupancies are available, they show record lows in April. The overall picture suggests that economies in the region contracted substantially in Q1 which has continued in Q2. Trends in these monthly indicators will help signal how solid a recovery comes in Q3 and beyond.

Two other sources of high-frequency data that will be useful in assessing the recovery are consumer prices and corporate earnings, and these also provide some sectoral insights. Most countries in the region suffered deflation in April, due to the collapse in consumption, with the sharpest declines often seen in areas such as recreation and transportation. However, some impact from the crisis was already visible in Q1 corporate earnings, although lockdowns were only in place for the latter part of that period, particularly as firms made provisions for expected losses.

PwC's latest CFO Pulse Survey,in early May, showed that two-thirds of firms expect that it will take at least three months before a return to business as usual and Middle East firms expect to see a larger negative impact on profits this year. 40% of Middle Eastern firms expect to see at least a 25% decline in profits, compared to only a quarter of firms globally. Also more Middle Eastern firms expect to cut staff – 40% compared with 29% globally. However, a relative improvement in the global and regional epidemiological outlook during May is likely to be reflected in slightly stronger results in the next survey.

Fiscal responses vary from sharp consolidation to modest net stimulus

Preventing a credit crunch

Within a week of the WHO declaration of a pandemic, and the imposition of severe lockdown measures, most states had announced policy measures to offset the impact of the crisis. The first measures came from central banks, as they worked to ensure liquidity and mitigate the risk of a credit crisis developing.

Those countries with pegged currencies were anyway compelled to cut policy interest rates, mirroring moves by the US Federal Reserves and others also made similar moves, including a 300bp cut by Egypt. In addition, central banks announced a raft of stimulus measures focused on facilitating bank lending and easing the burden of loan payments for companies facing a temporary cash crunch, particularly SMEs.

One of the largest of these was the UAE's Target Economic Support Scheme, which initially allocated $27bn in liquidity through zero-interest loans to banks and cuts in capital reserve requirements, while Saudi Arabia offered $13bn of funding to support banks in deferring loan payments and Jordan provided $0.8bn in liquidity by reducing the deposit reserve ratio from 7% to 5%. It is difficult to judge how effective these measures have been. The fact that interbank lending rates have generally fallen back, after an initial spike in March, is one indicator that the monetary response has been somewhat successful. However, it is less clear how accessible new lending is to help businesses impacted by the crisis.

Businesses have, though, received some relief from government cashflow management measures. These range from a commitment by the Saudi government to expedite the payment of $13bn in arrears, to the extension of payment deadlines for taxes. Kuwait, for example, has given firms a six-month extension for the payment of corporate social security contributions. Many states have also permitted the postponement of other payments due to the state, such as loans. These kinds of policy measures will have an impact on government cash flows and on quarterly fiscal outturns, but in theory should balance out for fiscal year as a whole, unless further extensions are granted.

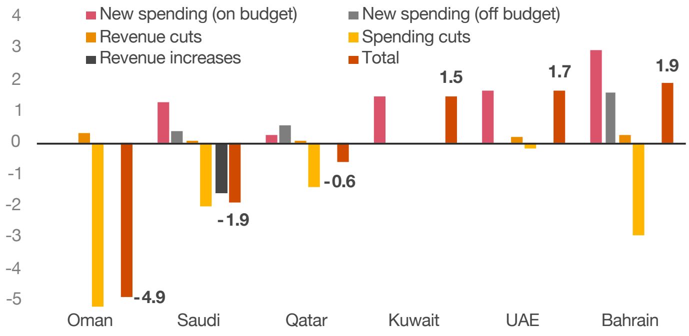
Fiscal responses vary widely and are hard to quantify

Alongside the monetary announcements and cashflow measures, governments have rolled out a wide range of fiscal policies, including both stimulus to bolster the economy but also consolidation measures in response to sharp declines in revenue. Often, but not always, these policies are announced with an estimate of their magnitude. However, it is difficult to access the net effect of all these policies because multiple measures can be bundled up into a single announcement, there is considerable potential for double counting.

For example, one of the most substantive announcements came on 11 May when Saudi Arabia announced multiple fiscal consolidation policies including a tripling of VAT, an end to cost of living adjustment benefits and spending cuts, all of which were estimated to total to around SR100bn ($27bn). We estimate that the higher VAT might raise about SR40bn more revenue this year (and much more in 2021 as consumption rebounds and it is applied throughout the year) and the cost of living should save about SR10bn, which implies that the spending cuts would total about SR50bn. However, it is unclear if this repeats the SR50bn in cuts announced back in March (we assume it does). Moreover, the Minister of Finance has also indicated that announced cuts will broadly offset new spending, including on healthcare.

There are similar challenges in assessing the package of fiscal measures announced in other Middle Eastern states, particularly when off-budget measures, such as financing salaries of furloughed workers from social security funds, are included, not to mention possible spending by sovereign wealth funds. Looking just at GCC, we estimate that the sum of fiscal measures announced so far may range from as much as a 1.9% of GDP stimulus for Bahrain in 2020, which has announce a wide range of policies in both directions, to a -4.9% of GDP consolidation in Oman, where the main move has been a -10% spending cut, rolled out in two phases. There is considerable uncertainty in these estimates, perhaps by about +/- 1% of GDP, and of course further measures are likely to be announced as the crisis evolves. However, these figures, shown in the graph below, give a sense of the wide differences in fiscal responses across the Gulf in both magnitude and type.

Fiscal stimulus (+) or consolidation (-) (% GDP)



Source: PwC estimates based on government announcements

These fiscal moves will inevitably have an impact on economic growth, on top of the direct demand shock from the virus and lockdown. It is notable that the largest net consolidation comes from Oman, the most fiscally constrained state. Saudi Arabia's apparent decision to consolidate (on top of spending cuts already planned in the 2020 budget), despite its reserve buffers and relatively low debt, is particularly notable. Although Bahrain has less fiscal space, expectations of further GCC support may underlie its apparent decision to apply a net stimulus.

Bonds and bailouts

The impact of the fiscal policy responses, which would be substantial in normal times, are modest relative to the hit to revenue resulting from much lower oil prices and production (see the outlook discussion on the next page). As a result, all of the Gulf states, along with others in the Middle East region, will have large deficits to finance for several years.

Several countries have got ahead of the financing challenge through early issuance. Qatar, Saudi Arabia and Abu Dhabi have together issued $27bn in eurobonds since the start of the crisis and even Bahrain managed to issue $2bn and Oman raised over $0.5bn in local debt. The Saudi Ministry of Finance has indicated that its borrowing could reach $58bn for 2020 as a whole, more than twice its original plan.

Another major source of financing for the region are sovereign wealth funds. Some of these funds were developed for rainy days like this, but few states have clear mechanisms to determine how to draw down on them. Saudi Arabia is the clearest cut as it has already been part-financing deficits from its reserves with SAMA for several years and even included a three-year schedule for this in its 2020 budget. Kuwait, which has foreign assets equal to over five times its GDP, more than any other country, faces a unique challenge because most of those funds are locked away in its Reserve Fund for Future Generations, which it can't access without approval from a reluctant parliament. The parliament has also not authorised new borrowing, forcing the government to draw down on its rapidly diminishing State General Reserve Fund. Oman is also likely drawing on its similarly named fund, and on several smaller ones, as its pre-crisis plan to largely finance its deficit through debt issuance and sales of stakes in state-owned enterprises now looks unlikely to work.

Iraq is also seeking GCC support, although an alternative, or complementary approach, for them both could be to go to the IMF. Several other Middle East states such as Jordan and Egypt, have already done this and have been allocated $0.4bn and $2.8bn, respectively, from funds fast tracked in response to the crisis. Any support from donors inside and outside the regional will likely be conditional on restrained fiscal policies.

Data and projections: June 2020

	GDP share 2019		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q4-19	2019	2020p	Apr-20*	2019	2020p	2019	2020p
Middle East	100%	100%	-	1.6	-3.4	1.0	1.2	1.7	-2.8	-11.1
GCC	60.1%	70.7%	-	0.7	-2.8	-0.1	-1.0	0.2	-2.0	-10.3
Saudi Arabia	31.8%	33.8%	-0.3	0.3	-2.3	1.3	-1.2	0.9	-4.5	-12.6
UAE	12.4%	17.6%	-	1.7	-3.5	-1.9	-1.9	-1.0	-0.8	-11.1
Qatar	6.0%	8.3%	-0.6	-0.2	-4.3	-3.1	-0.6	-1.2	4.1	5.3
Kuwait	5.2%	6.0%	-1.1	0.7	-1.1	1.9	1.1	0.5	4.8	-11.3
Oman	3.4%	3.3%	-	0.5	-2.8	-1.0	0.1	1.0	-7.0	-16.9
Bahrain	1.3%	1.7%	-0.4	1.8	-3.6	-3.6	1.0	2.6	-10.6	-15.7
Non-GCC	39.9%	29.3%	-	3.8	-4.8	3.9	6.6	5.5	-4.6	-13.1
Egypt	23.3%	13.1%	5.6	5.6	2.0	5.9	13.9	5.9	-7.4	-7.7
Iraq	11.8%	9.7%	-	3.9	-4.7	1.1	-0.2	0.8	-0.8	-22.3
Jordan	1.6%	1.9%	2.1	2.0	-3.7	0.5	0.3	0.2	-6.1	-6.7
Lebanon	1.4%	2.5%	-	-6.5	-12.0	10.0	2.9	17.0	-10.7	-15.3
Libya	1.4%	1.4%	-	9.9	-58.7	0.9	4.6	22.3	8.8	-7.2
Palestinian Terr.	0.4%	0.6%	-1.8	-1.6	0.5	-0.6	0.5	0.9	-7.5	-7.9

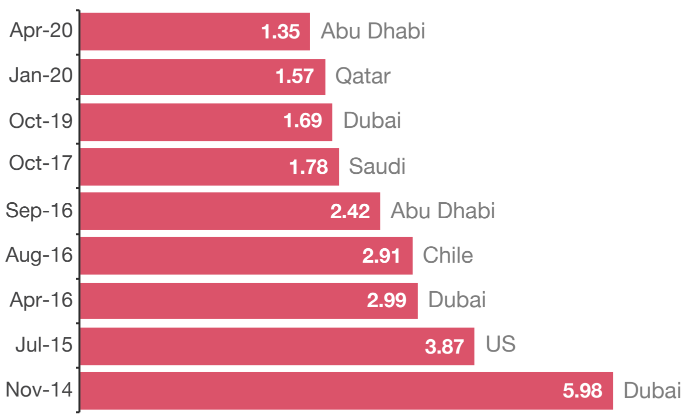
Sources: PwC analysis, National statistical authorities, IMF (WEO, April 2020) *Older inflation series: Mar (, Kuwait), Feb: (Iraq), Jan: (Lebanon), Dec (Libya).
Notes: The Middle East region is defined here based on PwC's business coverage (which excludes non-Arab countries, Syria and Yemen).

Chart of the quarter

The Gulf states may be best known for hydrocarbons, but over the past six years they have repeatedly set new record low prices for solar power. Dubai took the lead for the first time in 2014 when it secured an unsubsidised levelized energy cost (LEC) of 5.99 US cents / kwh for the 200MW second phase of the Mohammed bin Rashid Al Maktoum Solar Park. Since then Gulf states have held the record for all but a few months, tendering successively larger plants. The latest was a huge 1.5GW plant in Abu Dhabi for just 1.35c/kwh, less than a quarter the cost Dubai paid in 2014.

The Gulf has ideal conditions for solar power and the drive to expand capacity is driven by purely commercial considerations as it is now cheaper than burning oil and, in some cases, than developing gas reserves. Although some of the most grandiose schemes, such as a Softbank proposal to install 200GW capacity in Saudi Arabia and export electricity, have not materialised, the rate of solar (and some wind) installations continues to grow. This will enable the Gulf to export a larger share of its hydrocarbon production, which is particularly valuable when total production is constrained by OPEC+ quotas.

Lowest priced solar tenders (US cents /kwh)



Source: Industry reports

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