

Middle East Economy Watch

2017 shows signs of improvement, but less than anticipated due to the oil market

Following a positive response to our first Middle East Economy Watch report, we are pleased to announce that we will continue it as a quarterly publication.

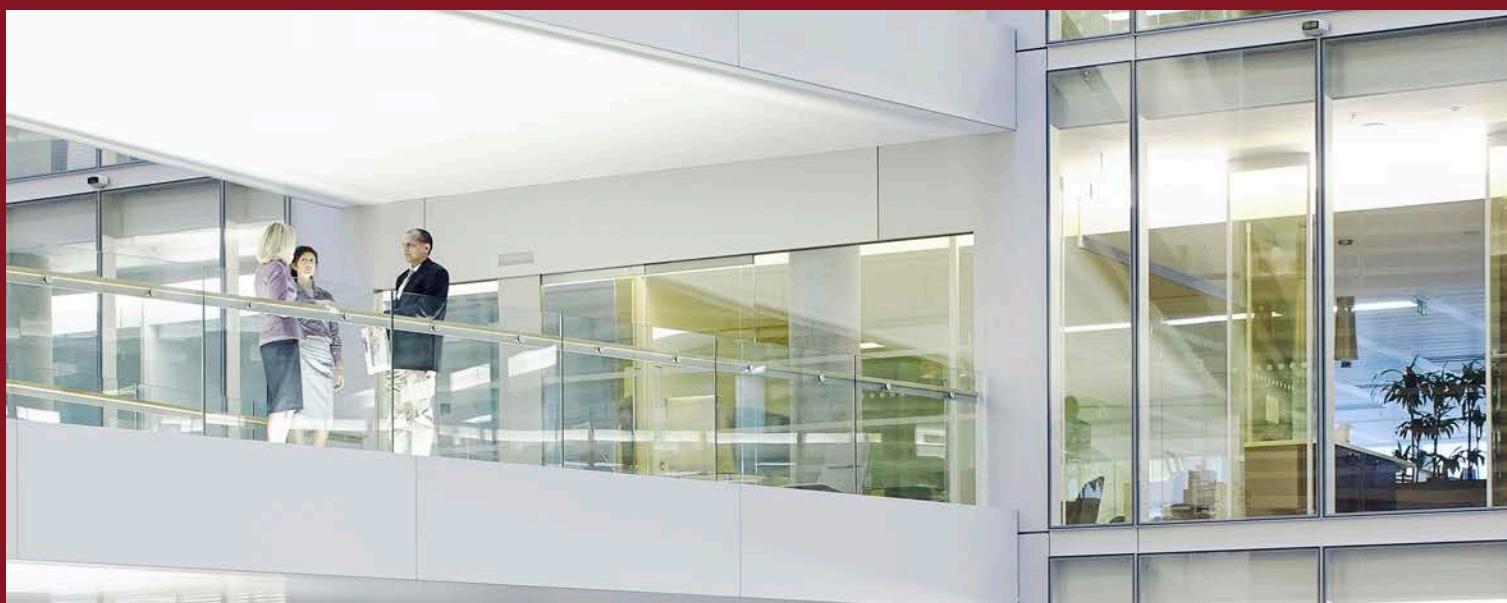
There were high hopes that 2017 would be a turning point for oil exporting nations, as OPEC-led production cuts rebalanced the market. However, the results so far have been weaker than anticipated, limiting the gains in fiscal revenue and in turn restricting government expenditure capacity. This has been compounded by the decision in June to extend the producer action to March 2018, and a decision could be taken in November to continue it to June 2018 or even further.

In the meantime, political risk continues to weigh on the regional economy.

The Qatar political crisis and economic situation has created challenges for firms that operate across the GCC. Early data suggests that, while the situation is having a negative impact on some parts of Qatar's economy it remains manageable for the authorities. However, if the dispute intensifies or continues for a prolonged period then the economic impact could become more severe.

Notwithstanding these challenges, some economies in the region do appear to be turning the corner with momentum building in the UAE, where the PMI hit a two-and-a-half-year high in August, Saudi Arabia also seeing positive sentiment in its non-oil sector. Oman is benefiting from its new role as the primary transshipment hub for Qatar. Meanwhile, Egypt delivered a much stronger than expected Q2 growth of 4.9% and burgeoning central bank reserves could be a lead indicator of higher foreign investment.

One impact felt by Qatar has been a weakening of its currency offshore, indeed most GCC currencies are facing some negative sentiment. This comes at a time when there is growing interest in the suitability of the GCC currency pegs more generally in the lower for longer oil price environment. In this edition, we explore the currency debate but we still expect the pegs to remain in place for the medium term, while oil and gas remain the dominant exports. If and when any of the Gulf economies diversify substantially, then different currency regimes may eventually become more suitable.



Economic update: 2017 growth and fiscal positions weaker than hoped

Oil prices below expectations

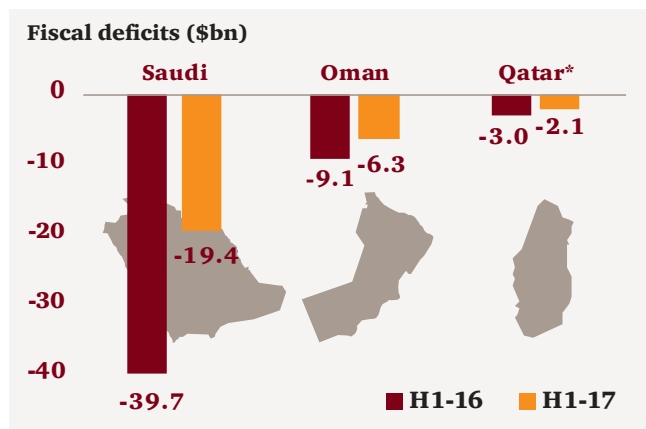
2016 was an extremely tough year for oil exporting states in the Middle East, as discussed in our last Economy Watch report. There was widespread hope that, by contrast, 2017 would mark a turning point in the oil market and in the performance of the region's economy.

Although 2017 has certainly seen an improvement, it has not been as substantial as was expected. At the start of the year, forward markets expected Brent crude to average \$58/barrel. In reality, it only averaged \$52 in the first 8 months and, although there has been a rally in September, bringing prices above \$57 for the first time in two years, this is not expected to be sustained. Average oil prices in 2017 will be an improvement on the low of \$45 seen in 2016, and above budget assumptions in some countries, but well below what the actual expectations were. Inadequate compliance with cuts, at least until August, (see chart of the quarter), plus revivals in production in Libya, Nigeria and US shale combined to avert a major supply squeeze.

In addition, the failure of oil exporters to rebalance the market in the first half of the year led them to agree to a 9-month extension of the production cuts until March 2018, further harming fiscal revenues. There is talk of a further extension, of between 3-9 months, which has driven the recent oil price rally, but would erode revenue even more.

Deficits fall, but not fast enough

Three of the GCC states publish intra-year fiscal data, including Saudi Arabia, which began doing this in 2017 as part of a new trend towards transparency. The preliminary fiscal data is often substantially revised, but it shows that in Oman and Qatar deficits are only down by about a third compared with the low point in the first part of 2016.



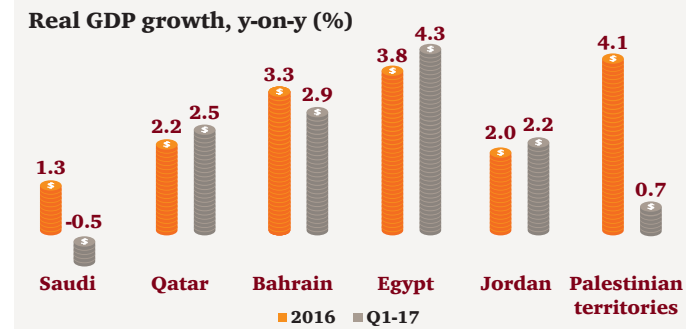
Sources: National sources

Notes: *Q1 not H1

The Saudi data seems to show more improvement, cutting the deficit in the first half of the year by more than 50% y/y. However, the government pledged in late June to repay various public sector benefits and bonuses that had been suspended in October-April, which could push up expenditure in the second half. This suggests that deficits could be larger than anticipated for the year as a whole, likely prompting additional borrowing (such as Saudi's \$8bn worth of domestic sukuk, issued in July and August). Oman's deficit eased by a third in the first half of 2017, but was still nearly 9% of GDP. Oman's fiscal accounting tends to frontload the deficit, but it is still likely to be substantially higher than the IMF's April forecast of 10% of GDP for the full-year.

Growth outlook stabilises

Growth in Q1 was mixed, with results in Saudi and the Palestinian territories lower than expected, but a steady performance elsewhere. However, more positive data is coming through from the forward looking indicators (e.g. August PMIs for Saudi Arabia and UAE) and the non-oil sector in these economies is also growing strongly. These signs suggest that stronger non-oil economic growth could return in 2018, so long as oil prices maintain or exceed current price levels, although an extension of production cuts would limit overall growth.



Sources: National sources

Reaffirming the currency pegs

Since the mid-1980s, the Gulf currencies have all been pegged at fixed rates to the US dollar, with the exception of Kuwait, whose dinar is pegged to a currency basket, which is not published but is understood to be dominated by the dollar. These currency regimes have survived some extreme circumstances including a decade of weak oil prices in the 1990s, when there were concerns about forced devaluation. Conversely, they were also maintained during a period of dollar weakness in 2007-8, when the GCC debated changing the currency regimes as a means to dampen imported inflation, driving up 1-year forwards rates (which are also affected by interest rate differentials with the US) by 2%-4% above the pegs, as markets speculated on upward revaluations (see graph below). The pressures observed in the current market remain within the bounds these economies withstood during 2007-8. Nevertheless, the current environment of low oil prices has prompted fresh interest in the economic suitability of the pegs.

Oman and Bahrain have particular vulnerabilities

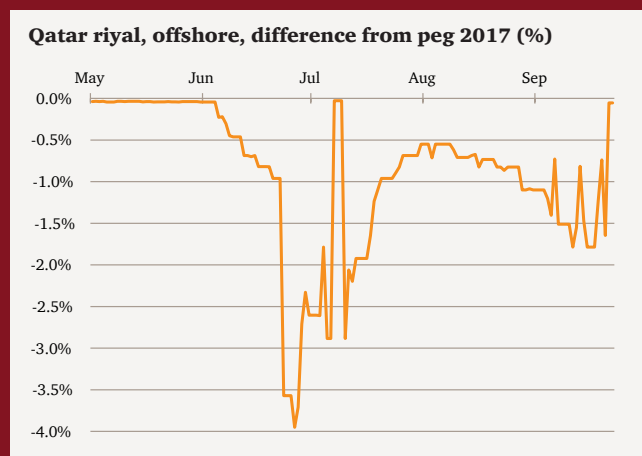
The Omani rial and Bahraini dinar have usually been seen as the most vulnerable currencies, given those countries' structural fiscal and current account deficits and dwindling foreign exchange reserves. However, Oman has sovereign wealth fund assets that it could repatriate to defend the peg if needed. Bahrain's reserves are much weaker, but it is widely assumed that Saudi Arabia would step in with financing if Bahrain's peg was threatened, because of their close relationship.

Twice in the last year, Bahrain's foreign reserves have touched US\$1.7bn, the lowest since 2005 and less than one month of import cover (the IMF recommends at least three months cover). On both occasions, they were replenished by bond issues, but these are getting more expensive as its credit rating weakens (Moody's rates it at just B1, down seven notches since 2011 and four notches below investment grade).

A four-month lag in the publication of foreign reserve data means it is possible, given recent trends of depletion, that they could be once again nearing a critical level that could reopen the question on devaluation.

Qatar's peg has been tested

Meanwhile, the Qatar situation has shown that even the strongest economies can face pressure on their currencies at times of political tension. At one point, the offshore exchange rate depreciated to 3.78 Qatari riyal to the dollar on June 26th, 4% below the official peg rate of 3.64 (which has continued to be honoured by domestic banks). This was the biggest deviation by a Gulf currency since the Omani peg was devalued in 1986. The pressure on the riyal eased in July, as fears of depegging receded, but began to emerge again in August (with some volatility) as expectations grew of a prolonged situation. A 30% decline in the central bank's foreign reserves in June (the latest available) adds to pressure on the currency, although the authorities have indicated that the foreign assets of the Qatar Investment Authority, estimated at over US\$300bn, will be drawn on as needed.



Sources: Bloomberg

Diversification might suit different currency regimes

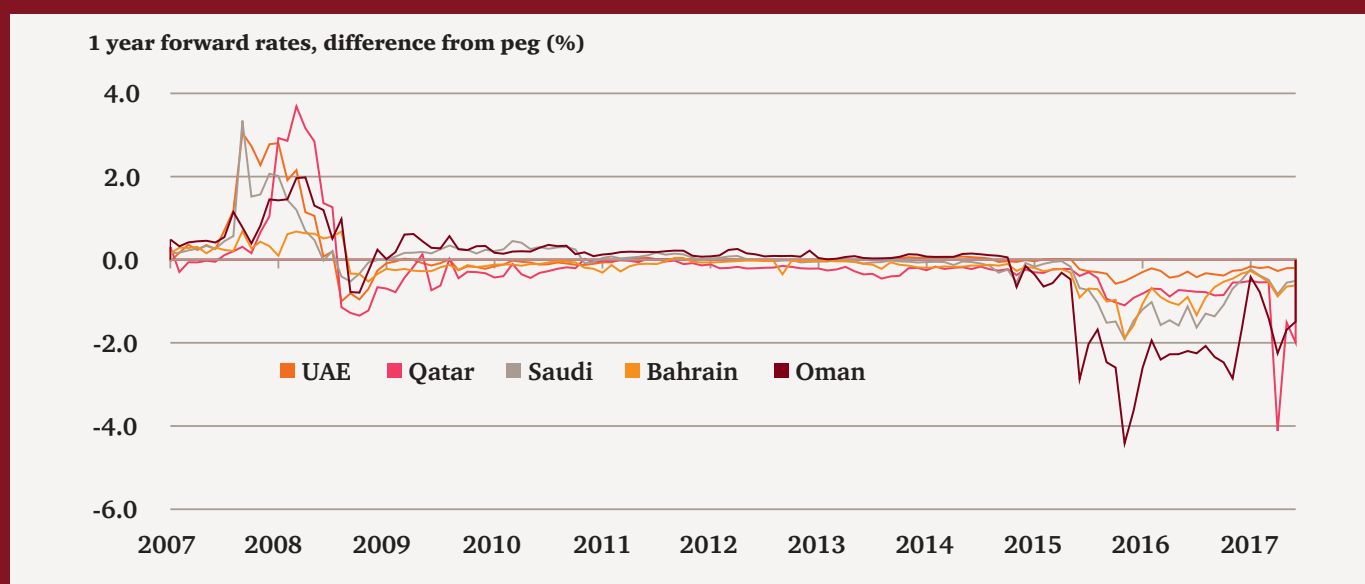
While external pressure remains within comfortable boundaries, it is also up for debate whether they remain economically suitable. A number of Gulf economists have long argued that a change to the peg regimes might be appropriate at some point.

Currency baskets, like Kuwait's, could provide greater price stability, while freely floated currencies would give Gulf states greater freedom to set interest rates. Currently, the pegs compel central banks (including Kuwait's) to broadly match US interest rates, even if business cycles are not aligned, as is currently the case, and so the rates don't necessarily suit the Gulf's economic needs.

However, the strong consensus remains that, so long as the region's economy is dominated by oil and other commodities traded in dollars, the advantages of retaining the pegs outweigh the downsides.

Devaluations, either one-off moves or free-float regimes, would not do much to boost competitiveness in most Gulf countries. This is because of current paucity of non-commodity exports, except in a few cases—for example Dubai's tourism sector. Even then, high import costs and demands for higher salaries, from both nationals and expatriates, could offset much of the competitiveness gains and fiscal benefits that are the goals of planned devaluations in other countries. Russia, for example, has seen a significant fiscal benefit from currency devaluation, partly offsetting the domestic impact of lower oil export earnings, however Gulf countries would not be able to achieve a similar result because of their heavy dependence on imported labour, goods and services.

A change in the pegs is only likely to make good economic sense if and when oil plays a much smaller role in Gulf economies as a result of successful diversification efforts. For most countries, this remains a fairly distant goal, although the possibility of permanently low oil prices is engendering a new seriousness in diversification efforts.



Sources: Bloomberg

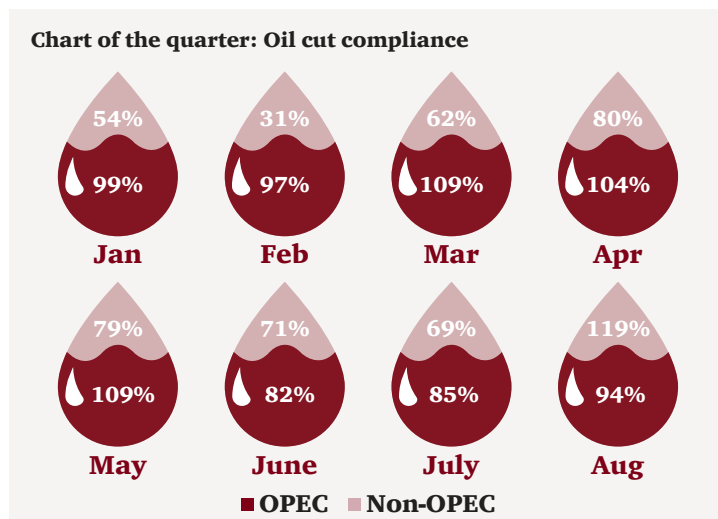
Data and projections: September 2017

	GDP share 2016		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	2016	Q1 - 17	2017p	2016	Jul - 17	2017p	2016	2017p
Middle East	100%	100%	3.1	-	1.9	4.5	5.8	6.7	- 11.4	- 7.3
GCC	62.0%	68.3%	2.2	-	0.8	2.8	0.4	2.7	- 11.6	- 6.8
Saudi	32.8%	31.8%	1.3	- 0.5	- 0.2	3.5	- 0.3	2.7	- 17.3	- 9.1
UAE	12.5%	18.5%	3.0	-	1.8	1.6	1.2	2.7	- 3.9	- 2.1
Qatar	6.2%	7.8%	2.2	2.5	2.3	3.0	0.2	2.4	- 9.0	- 4.6
Kuwait	5.7%	5.5%	3.5	-	0.4	3.2	1.3	3.3	- 3.6	- 8.6
Oman	3.5%	3.1%	3.1	-	1.0	1.1	0.7	2.0	- 17.4	- 11.4
Bahrain	1.3%	1.6%	3.3	2.9	2.8	2.3	1.4	1.8	- 17.7	- 12.5
Non-GCC	38.0%	31.7%	5.0	-	4.2	8.1	17.6	15.4	- 10.7	- 8.2
Egypt	21.2%	16.5%	3.8	4.3	3.5	13.8	33.0	24.4	- 9.8	- 10.0
Iraq	12.1%	8.3%	11.0	-	- 3.1	0.4	-	2.0	- 7.2	- 4.2
Jordan	1.6%	1.9%	2.0	2.2	2.4	14.2	1.8	3.3	- 3.2	- 3.0
Lebanon	1.6%	2.6%	2.0	-	2.0	- 0.5	3.1	2.6	- 7.7	- 8.8
Libya	1.0%	1.7%	- 4.4	-	53.7	- 0.8	-	32.8	- 53.4	- 16.4
Palestinian territories	0.4%	0.7%	4.1	0.7	3.5	- 0.2	-0.9	1.3	- 5.6	- 7.6

Sources: PwC analysis, National statistical authorities, Consensus forecasts from Bloomberg, IMF (mission reports and the World Economic Outlook). The Middle East region is defined here based on PwC's business coverage. It excludes two conflict affected countries (Syria and Yemen), typically defined as being part of the Middle East, and also non-Arab countries. Only 6 countries publish quarterly GDP data.

Chart of the quarter

Compliance with the oil production cuts agreed in late-2016, totaling 1.7m b/d, has been mixed. OPEC compliance was high in Jan-May, because of additional cuts by Saudi Arabia and despite overproduction by Iraq and UAE. Compliance by both OPEC and non-OPEC lagged in June-July, both recovered sharply in August after the lagards recommitted to meeting their targets at a meeting in Abu Dhabi, despite disagreements over data.



Sources: OPEC, IEA, Bloomberg
All data updated as of close, 22 September 2017

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