Prospects for Middle East Economies: Where is the region headed?

Richard Boxshall, PwC Middle East Director, talks to Forbes Middle East about the prospects for Middle East economies.

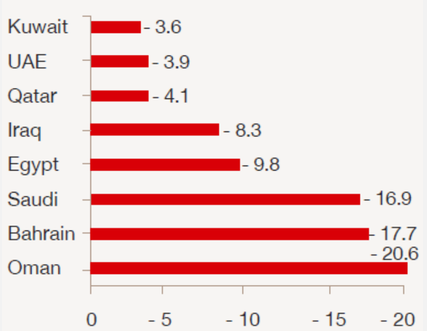
The Middle East is going through a period of tremendous change, with oil prices - still well below break-even levels - remaining the dominant theme driving the region's economic prospects. Governments have had to become more agile as they face up to large fiscal deficits and are forced to look at alternative sources of deficit financing, privatisation initiatives and the anticipated introduction of the VAT in the GCC. Reflecting on the past year and the first quarter of 2017, what do the economic realities tell us about where the region is headed next?

2016 was probably the low point for oil exporters, as Brent crude averaged just $44/barrel - the weakest in nearly two decades, in inflation adjusted terms. The price has since edged up, supported by the historic collaboration by OPEC and non-OPEC exporters, providing some respite to economies in the region, but low oil prices are here to stay.

This caused large fiscal **deficits across the board** for oil producing countries, including those that have previously posted many years of surpluses.

This resulted in the GCC collectively seeing a deficit of around 11.1% of GDP, ranging from an estimated 3.6% for Kuwait to a burdensome 20.6% for Oman *(Fig 1)*.

Fig 1: Fiscal balances in 2016 (% GDP)



Source: National statistical agencies, IMF

Most countries pushed through aggressive **fiscal reforms** in response to a third year of lower oil prices. Energy subsidies were cut across the board, even eventually in Kuwait, despite parliamentary opposition, which served to nudge up inflation (to a GCC average of 2.8%). There were also major cuts in expenditure, notably in Saudi Arabia, which dampened the non-oil sector and saw real GDP growth decline to about 1.8% in the region.

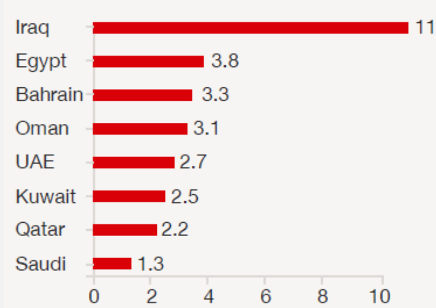
Although tax reforms were discussed in a number of countries, including controversial measures such as remittance taxes on expatriates, there were few new measures actually implemented during 2016.

There were some easy to implement measures, such as increasing fees for government services, but introducing new classes of tax is both politically and technically difficult, and Gulf finance ministries are already stretched in preparations for the launch of VAT in 2018.

Some countries opened the pumps in 2016 to **maximise oil revenue** while others suffered from maintenance outages, notable in Qatar where the giant Pearl gas-to-liquids plant faced technical problems in Q4 contributing to an annual decline in its oil sector GDP.

Outside the GCC, prior investments caused Iraq's production to rocket so much that its overall GDP grew by about 11%, according to the IMF's latest estimate, despite a further non-oil contraction resulting from the war with so-called Islamic State and austerity. This was possible because most of Iraq's facilities are well removed from conflict zones, unlike in Libya, where civil war periodically inhibited oil exports and contributed to a fourth consecutive year of contraction *(Fig 2)*.

Fig 2: Real GDP growth in 2016 (%)



Source: National statistical agencies, IMF

Meanwhile, oil importing countries, such as Egypt and Jordan, received an immediate benefit from low oil prices, reducing their current account deficits and inflation. Although low prices helped ease subsidy costs in places, sizeable structural fiscal deficits remain in some countries, particularly Egypt.

The low oil price environment is also having some negative indirect impacts on the importing countries because of their deep links with the GCC through remittances and exports, as well as aid and investment flows.

Separately, domestic challenges had a significant impact in these countries, ranging from the sharp depreciation in the Egyptian pound, after its depegging in November, to weaker fiscal support from donors to Palestine.

As the wealthier oil exporters accept the reality that oil prices are here to stay, Gulf governments have now started looking for new means of financing to fund vast infrastructure investment programmes. This will continue to be a focus in 2017 and beyond as even if prices improve slightly (around $50-60 is widely viewed as a likely level during the next few years), most countries will still be facing fiscal deficits.

Governments have tapped into several international financing sources, such as looking into the international bond markets, asset sales (whether securities held by sovereign wealth funds or the part-privatisation of state-owned companies), and developing PPPs.

The flurry of activity in debt markets, privatisation and PPPs has only just got started and should generate interesting business opportunities in the next few years and help to partially rebalance the roles of the state and private sector in the GCC.

Despite these seemingly challenging times, the growth potential in the region is undeniable, especially in markets like Egypt and Saudi Arabia, which we've identified in our latest Economic bulletin and earlier, in our World in 2050 report as "pockets of opportunities" - smaller economies with bright prospects.

Our projections show that by 2040 Saudi Arabia is expected to grow larger than three major developed economies – Canada, Spain and Australia – and Egypt will also surpass two of them by 2050. The rise of these two countries is a result of both higher population growth and rising per capita incomes.

The expansion of the global economy over the next generation is expected to see average incomes rise in most countries, both because of inflation and also in real terms.

However, the rates of increase are not expected to be uniform. We see Saudi's GDP/capita increasing by more than 4-fold, moving it ahead of both Spain and Canada, and several other developed economies.

Although Egypt will still remain a middle-income country in 2050, its growth rate is expected to be one of the highest among major economies, with GDP/capita rising by over 6-fold during this period.

Of course, our projections represent the *potential* growth of these economies conditioned on the assumption of broadly growth-friendly policies being pursued.

They help to understanding the rough trajectory of these economies and helps to inform business decisions, particularly long-term investments. But it remains incumbent upon the governments in the region to follow through with the necessary fiscal and economic adjustments to realise this potential.

For the full report on PwC's Middle East Economy Watch, visit: https://www.pwc.com/m1/en/publications/middle-east-economy-watch.html

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