December 2020

Middle East Economy Watch

Recovery begins but long-term challenges remain

In the months since our last Economy Watch in June, the Middle East region is on the path to economic recovery as lockdowns have eased and activity has begun to recover.

The severity of the crisis at its most intense point has also become more apparent as data has become available, including second-quarter GDP for some countries.

COVID-19 infection rates are now flat and falling across most of the Gulf, although renewed spikes are still possible. Even if that happens, better systems are now in place to both manage the pandemic and ensure the economy continues to operate. The recent vaccine news from Pfizer / BioNTech, Moderna and AstraZeneca / University of Oxford is very positive for the region.

There are trials underway in the Gulf for several other vaccines, and some countries have already granted emergency use approval (with Dubai's ruler among those to be vaccinated). In the coming months, the region is likely to be at the forefront of the global vaccination drive, just as it has implemented some of the most extensive testing regimes.

Nonetheless, significant challenges remain. The fiscal impact of the crisis has required heavy borrowing and debt levels are rising, and credit ratings falling, across the region.

The vaccine breakthrough should permit a stronger rebound than had previously been forecast by the IMF and others, although some of the key sectors for the region, such as tourism and aviation, will still face a relatively slow recovery. The critical hydrocarbons sector, having suffered a severe blow from COVID-19, is now also facing up to the threat posed by the clean energy transition.

Policy innovation will be needed to create new opportunities and chart a path forward. There are already signs of such innovative thinking, ranging from Dubai's offer of residency for remote workers to efforts to develop blockchain technology.

In challenging times, we are here to help our clients understand the lasting impacts of COVID-19 on their business and how they can repair, rethink and reconfigure their future strategic plans.

pwc

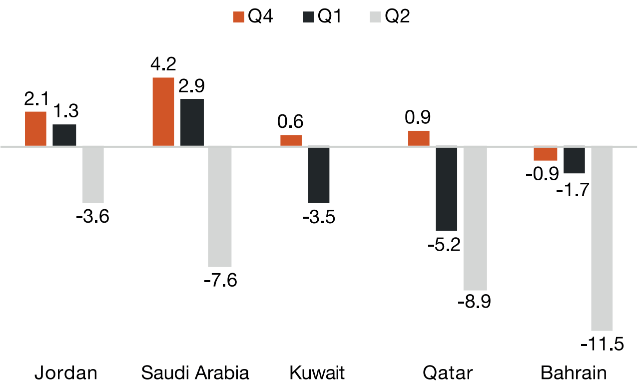
Economic activity picks up in Q3 as restrictions ease

A challenging Q2

The impact of COVID-19 lockdowns, on top of a procyclical squeeze on government spending and reductions in oil production (for OPEC+ members) was most intense in Q2 (April to June), with pain visible across the Middle East.

At the time of writing, several major economies such as Egypt and UAE have not yet reported Q2 GDP. The picture from those who have done so is understandably challenging, with most countries suffering their deepest contractions on record. The non-oil declines ranged from a surprisingly mild -3.6% for Jordan to -11.5% for Bahrain (its overall GDP contraction was a bit milder at -8.9% because higher gas output more than offset crude oil cuts).

Non-oil GDP growth (% y/y)



Source: National statistical agencies

The pain was broad-based and spanned most sectors. Sectors that were most directly susceptible to the lockdown saw the most extreme impacts. Hotels suffered a staggering -79% y/y contraction in Q2 in Bahrain, the only country that disaggregates the sector. Similarly, transport shrank by -40% in Qatar. The impact on the retail sector varied from just -5% in Jordan to -30% in Qatar. Manufacturing declined across the region, due to both reduced demand and difficulties operating under lockdown restrictions, led by a -12% y/y contraction in Saudi Arabia. However, construction was not as seriously affected as might have been expected, only seeing a -5% contraction in Saudi Arabia, the biggest decline in the region. Government spending on megaprojects appeared to support the sector and work on outdoor sites was not inhibited too much by COVID-19 prevention rules.

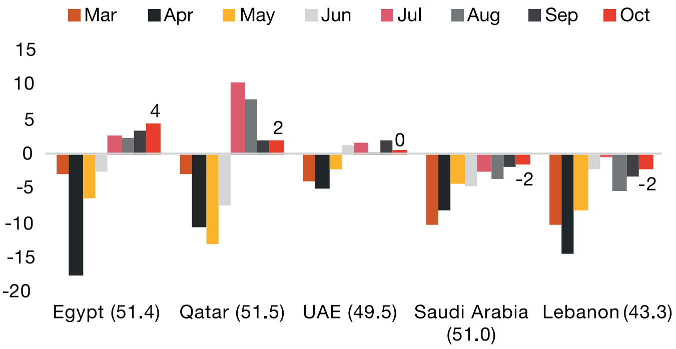
Leading indicators show signs of recovery

The purchasing managers indices across the region, which are among the best leading indicators for trends in non-oil GDP, were all firmly in contractionary territory (below 50-points) throughout Q2, mirroring the GDP data. However, since July all except Lebanon have been showing expansion in most months.

Each country entered the COVID-19 crisis with different initial conditions. For example, in January, Saudi Arabia's PMI was 10-points higher than Lebanon. Therefore, in trying to distinguish the impact of COVID-19 and the speed of recovery from other factors it's helpful to look at relative changes. These show that although Egypt had the second-lowest PMI in the region in September, it achieved the biggest increase relative to its January level (up 4 points). Although the UAE was only up 2 points in September, it also suffered the least volatility this year, seeing only a 5-point decline at its lowest point in April. It is notable that Saudi Arabia's PMI remains the furthest below its January level. Although it has returned to expansion, it lacks the net fiscal stimulus that was driving very strong non-oil growth in 2019 and is instead suffering additional drag from the tripling of VAT in July, which may prove to have been a wise fiscal move long-term, but does dampen consumption in the near-term.

Purchasing Managers Indices

(change from Feb in points; latest absolute reading shown at bottom)



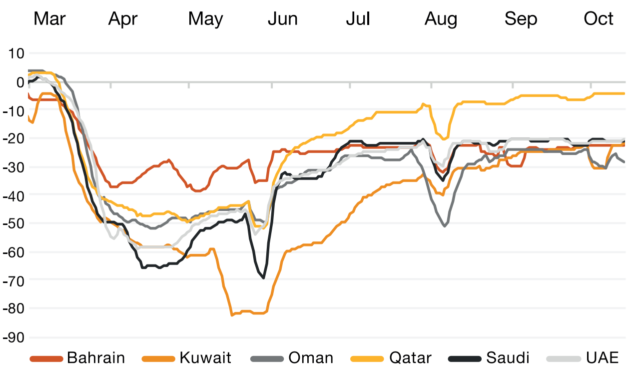
Source: IHS Markit, PwC Analysis

Moving again

One helpful new source of information in the context of the COVID-19 crisis is aggregate mobility data from mobile phone GPS locations. Google uses this data to show the frequency of visits to different locations. We have created an index for the GCC based on the 7-day average of visits to shops and workplaces.

The mobility data suggests that the lockdown in Q2 was least intense in Bahrain and most intense in Kuwait, mirroring Oxford University's COVID-19 stringency index which tracks lockdown policies. (N.B. The dips in May and August correspond to the two Eids.) By November, most countries were showing a marked recovery in mobility, although still about a 20%-25% below the baseline. This doesn't mean that economic activity is down by a proportionate amount because the uptake of home working and online shopping in the region has partly delinked economic activity from mobility. This may explain why the UAE, which has eased its lockdown stringency the most, isn't showing higher mobility. Bahrain's point of sales data for September, another useful leading indicator, shows sales were up by 6% y/y, the first annual increase since the onset of the crisis, even though mobility data shows that visits to shops remained down by a quarter.

Mobility Index (% change from baseline)



Source: Google Mobility Index, PwC Analysis; baseline 3 Jan- 6 Feb

The PMI, mobility and point of sales data, along with more anecdotal accounts of activity, suggest that strong rebounds will show up in Q3 GDP data. Saudi Arabia has published a Q3 flash GDP estimate showing 1.2% q/q growth which probably equates to about 5% non-oil growth (taking into account oil product cuts), regaining less than half the ground lost in Q2 when non-oil contracted by -13% q/q. Some sectors, like manufacturing and trade, will have likely recovered more strongly than tourism, for example. Hotels occupancy levels remain very low and most countries only began reopening to foreign tourists in Q4, and even then with significant limitations and limited uptake.
Government stimulus spending, including support for private-sector salaries and tax deferrals, has been extended for longer than initially planned, but it has been steadily tapered and loan service deferrals, financed by central bank lending, are currently set to largely expire at the end of 2020. This will have introduced constraints to recovery in Q4 and beyond.

So far, the region has largely avoided the kind of COVID-19 second wave that has emerged in Europe, thanks to large scale testing, widespread use of tracking apps and other measures. However, were a new wave to emerge then there could be renewed lockdowns, with a commensurate impact on the recovery.

The outlook remains challenging and debt levels are rising

The economic recovery from COVID-19 will be just as challenging as the health response, and even more drawn out. Both will depend on the delivery, uptake and efficacies of vaccines, such as those being trailed in UAE and Saudi Arabia. The IMF anticipates that it will take 2 years for the GCC economies to recover to pre-COVID-19 levels, but some sectors like tourism could take longer.

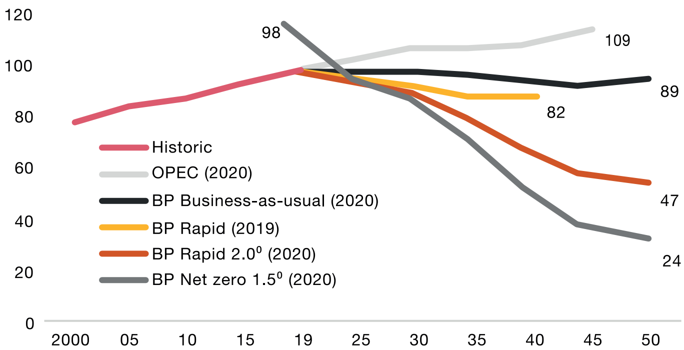
Peak oil?

One sector that may be permanently changed is hydrocarbons. The COVID-19 crisis has caused a historic shock to oil demand, which is forecast to decline about -9% y/y on average over 2020. There will likely be a prolonged impact in the transport sector owing to reduced aviation and increased home-working. It is possible that 2019 may have been the year of peak oil demand, or close to it.

The problem is that the COVID-19 crisis came just as the transition to low carbon technologies was beginning to build pace. The momentum could pick up further given the recent Democratic victory and return the US to the Paris Climate Agreement. There is also a growing sense that the forceful actions taken to respond to COVID-19 provide a precedent for stronger global action on the much more serious threat of climate change. This all means that the outlook for oil demand is likely to be challenging.

BP's annual energy outlook in September, the first major long-term forecasting report published post-COVID-19, saw a gradual decline in demand even in its business-as-usual scenario. It also considers two more extreme energy transition scenarios that seek to limit the global temperature rise to 2.0⁰C or 1.5⁰C, which require oil demand to fall by half and three quarters, respectively, by 2050. Even OPEC's latest forecast only sees a modest rise in oil demand, far slower than in recent years and in its previous outlooks.

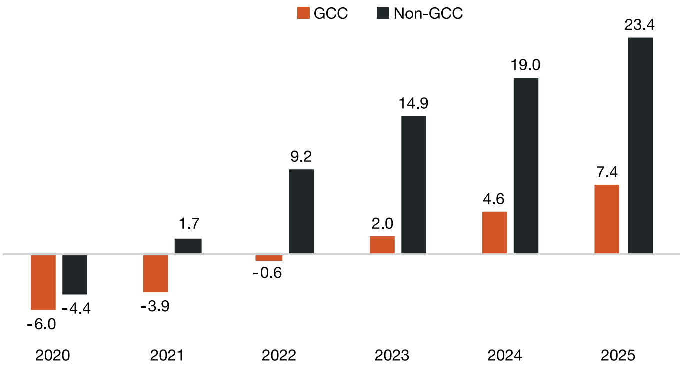
BP oil demand scenarios (m b/d)



Source: BP Energy Outlook, PwC analysis

The historically deep OPEC+ production cuts, presently set at -18% below the October 2018 baseline, have managed to revive prices somewhat. Back in April, some major forecasters were envisaging an annual average as low as $30, whereas the reality is now looking more like $45, albeit still a painful cut from $64 in 2019. However, the recovery from here is expected to be slow, with few forecasters seeing much above $55 over the medium term.
On the positive side, oil producers in the Middle East, and particularly in the Gulf, have among the lowest dollar and carbon costs of production and so should be able to find a market even in a world of declining oil demand. It is even possible that prices might rise later in the decade if the current underinvestment in new capacity causes supply to decline even more quickly than demand. Still, for now oil producers are facing a twin challenge. The OPEC+ cuts combined with pressure on the non-oil sector from both COVID-19 directly and from fiscal consolidation, as governments grapple with lower oil revenues, puts particular pressure on the GCC economy. The IMF's latest forecasts see the GCC's aggregate real GDP only returning to 2019 levels in 2023, and by 2025 it will only be 7.4% above 2019. By contrast, the non-GCC countries, particularly Egypt, are expected to recover more quickly, recovering to above 2019 levels next year and then expanding by nearly a quarter by 2025.

Real GDP relative to 2019 base (% change)



Source: IMF WEO, PwC analysis; excludes Lebanon because IMF does note forecast it beyond 2020

This economic rebalancing also applies to nominal GDP, with the non-GCC countries increasing their share to about 33% of the region by 2025, up from 29% in 2019.

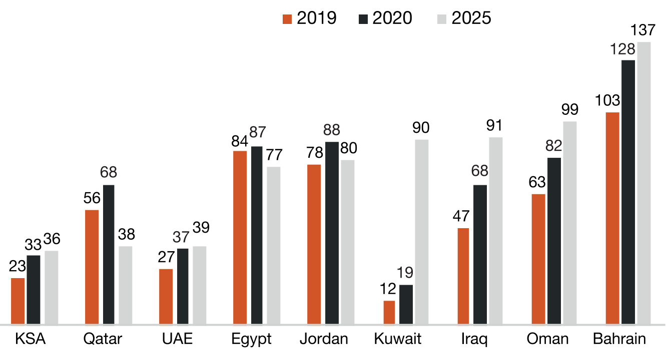
Rising debt

One of the lasting impacts of the crisis will be on sovereign balance sheets. The IMF expects regional debt (excluding Lebanon, which went into default in April) to increase by 64% by 2025 to $1.5trn.

The most dramatic increase will be in Kuwait, going from just 12% of GDP in 2019 to 91% in 2025. However, in order to do this, it first needs to issue a debt law, which needs to come soon otherwise the Minister of Finance has warned that the government could run out of liquid cash to pay salaries by year-end (its vast foreign assets, over four times its GDP, are locked away in the Future Generations Fund, which requires parliamentary approval to access).

Other countries will see more modest increases as they press ahead with fiscal consolidation or draw on their sovereign assets. Saudi Arabia is expected to do both, planning to spend down much of the government's deposits with SAMA while aiming to bring the budget to balance by 2023 through tripling VAT and other measures.

Debt (% GDP)



Source: IMF WEO, PwC analysis

Despite the real challenges, the post-COVID-19 world could present opportunities for the region. Efforts to reduce the need for human interaction to fight COVID-19 could point the way to operating Gulf states with fewer low-paid migrants in the services sector, helping the countries achieve long standing aspirations to rebalance demographics. At the same time, they could attract a new cadre of highly skilled and wealthier migrants. Dubai's initiatives to offer residency to remote workers and retirees are an example of one such opportunity – there are likely to be many other novel policies under consideration.

Data and projections: October 2020

	GDP share (2020)		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q2-20*	2020p	2021p	Sep-20*	2020p	2021p	2020p	2021p
Middle East	**100%**	**100%**	**-**	**-5.7**	**3.2**	**3.2**	**3.0**	**3.3**	**-7.1**	**-10.7**
GCC	**60.2%**	**68.6%**	**-**	**-6.0**	**2.2**	**1.9**	**1.3**	**2.8**	-6.2	**-9.2**
Saudi Arabia	33.2%	33.6%	-7.0	-5.4	3.1	5.7	3.6	3.7	-10.6	-6.0
UAE	13.4%	17.5%	-0.8*	-6.6	1.3	-2.4	-1.5	1.5	-9.9	-5.1
Qatar	5.3%	7.3%	-6.1	-4.5	2.5	-3.0	-2.2	1.8	3.0	3.3
Kuwait	4.2%	5.4%	-1.0*	-8.1	0.6	2.0	1.0	2.3	-8.5	-10.7
Oman	2.7%	3.1%	-	-10.0	-0.5	-1.2	1.0	3.4	-18.7	-16.8
Bahrain	1.5%	1.7%	-8.9	-4.9	2.3	-1.5	0.0	2.8	**-13.1**	-9.2
Non-GCC	**39.8%**	**31.4%**	**-**	**-5.0**	**5.3**	**6.0**	**6.7**	**4.4**	**-14.0**	**-10.4**
Egypt	26.7%	17.9%	5.0*	3.5	2.8	3.7	5.7	6.2	-7.5	-8.1
Iraq	8.2%	8.8%	-	-12.1	2.5	0.0	0.8	1.0	-17.5	-13.1
Jordan	2.1%	2.1%	-3.6	-5.0	3.4	0.1	-0.3	1.4	-9.1	-7.4
Lebanon	1.6%	0.9%	-	-25.0	n/a	131.0	85.5	n/a	-16.5	n/a
Libya	0.7%	1.1%	-	-66.7	76.0	1.3	22.3	15.1	-102.9	-43.2
Palest. Terr.	0.5%	0.7%	-3.4*	-12.0	8.2	-1.5	-1.2	0.3	-11.0	-8.6

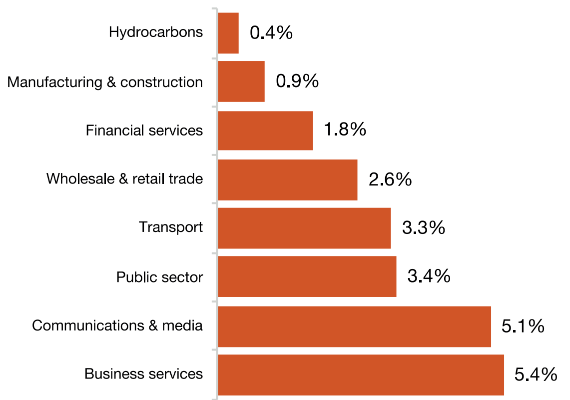
Sources: PwC analysis, National statistical authorities, IMF (WEO, Oct 2020) and Bloomberg consensus forecasts *GDP: Q1 for those stared; Inflation: Aug: Iraq; Apr: Libya
Notes: The Middle East region is defined here based on PwC's business coverage (which excludes non-Arab countries, Syria and Yemen).

Chart of the quarter

One of the promising new technologies is blockchain, which has implications for improving the efficiency of business well beyond its origin in the world of cryptocurrency. PwC has recently undertaken a global analysis of the potential economic impact of blockchain which concluded that it will reach an adoption tipping point by 2025 and by 2030 could boost global GDP by as much as $1.7 trillion, a net figure incorporating value created—particularly in the areas of provenance, payments and credentials—but also businesses made obsolete. In the process it could create 40 million new jobs.

Several Gulf countries have taken steps to encourage blockchain development and the efficiency gains it offers are well suited to Gulf economies. The UAE has been a leader in this and was one of the 12 sample countries included in the PwC global analysis. This showed that the UAE could see about a 1% GDP boost from blockchain, with particular benefits for trade and public administration.

UAE sectoral GDP gains from blockchain by 2030



Source: PwC; FCSA

Contact details

Hani Ashkar
Middle East Senior Partner
E: hani.ashkar@pwc.com

Stephen Anderson
Middle East Clients & Markets Leader
E: stephen.x.anderson@pwc.com

Richard Boxshall
Middle East Senior Economist
E: boxshall.richard@pwc.com

We partner with our region's governments and businesses, to help solve the region's most important problems and build trust in our society. We are investing in the very best talent, over 6,000 people, providing an unparalleled range of expert capabilities from Strategy, through Advisory and Consulting to Tax and Assurance Services, underpinned by the standout digital platform in the region.