Middle East Economy Watch

Ambitious reforms across the region will continue to define 2018 prospects

In this edition of Middle East Economy Watch we have stepped back to assess whether the region's major economies performed to expectations last year and to look forward at the outlook for 2018.

OPEC-led oil production cuts are a dominant theme in both years, however there is plenty else going on. Fiscal reforms are progressing, including the introduction of VAT in various Gulf states. However, there are also new efforts in some countries, notably Saudi Arabia, to ease back on fiscal consolidation to stimulate the private sector.

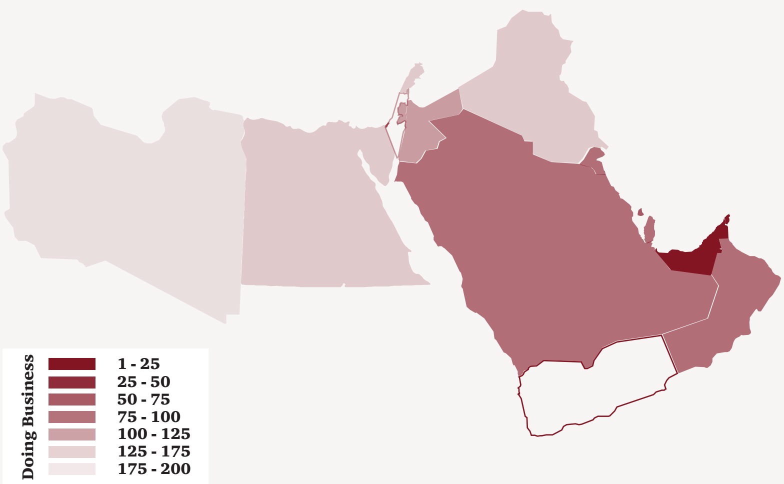
This is also a good time to take stock of the business environment in the region. (See below)
According to leading benchmarks, countries in the region range from among the best in the world (UAE) to nearly the worst (Libya). There is also substantial flux as some countries implement ambitious reform programmes to attract investment (Saudi Arabia) while others languish.

While such assessments are useful, the rankings still only tell a part of the story, and our discussions with clients often reveal opportunities and challenges in the region that can be obscured by only looking at the big picture.

Finally, our special feature takes a quick look into the complex issue of productivity, an area where we are planning to do more detailed research in 2018. Nobel prize winning economist Paul Krugman has said that productivity determines "almost everything" about an economy in the long run. Many countries in the region are beginning to wake up to the challenges they face in boosting productivity, which lags behind global peers and has been falling in more Middle Eastern countries than it has been improving in.

We wish you all a very productive 2018 and look forward to continuing discussing Middle Eastern economic issues with many of you through out the year.

Business Environment Rankings 2017



	Doing Business (out of 190)	GlobalCompetitiveness (out of 137)
UAE	21	17
Qatar	83	25
Bahrain	66	44
Saudi	92	30
Oman	71	62
Kuwait	96	52
Jordan	103	65
Pal. Terr.	114	-
Egypt	128	100
Lebanon	133	105
Iraq	168	-
Libya	185	-
Averages		
Regional	105	55
Non-GCC	138.5	90
GCC	71.5	38

Source: *World Bank Doing Business 2018, World Economic Forum Global Competitiveness Index 2017-18.*
Notes: *Due to occasional changes in methodology and data, the World Bank no longer compares rankings between years, as we do here.*

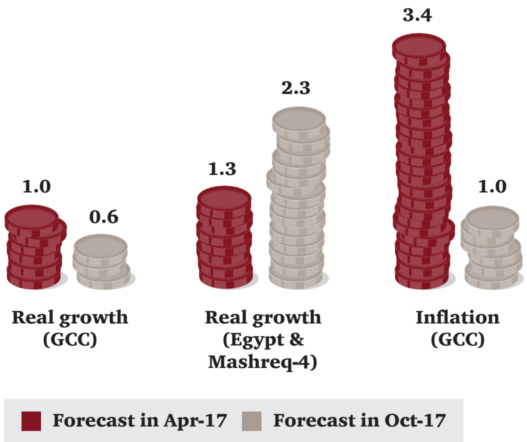
Economic update: 2017 review

A mixed year

In order to take stock of how the Middle East performed in 2017, at a time when only partial outturn data is available, it is helpful to look at how benchmark forecasts, such as the IMF's biannual World Economic Outlook, evolved during the year.

In some areas, the IMF latest forecasts, published in October, closely match the way things looked in April. However, there were a couple of unexpected developments both regionally and for individual economies.

Evolution of IMF forecasts for 2017



Source: *IMF WEO, PwC analysis*

One area which seems to have panned out as expected is the large fiscal deficits, which remained broadly unchanged in the IMF's two sets of forecasts. They average about 7% of GDP across the 12 countries we cover, and partial outturn data, in the few countries where it is available, largely fits with this. Saudi Arabia's preliminary outturn shows a deficit of 8.9% of GDP, suggesting that there was sizable spending in the final quarter, as data for the first three quarters had indicated a much lower deficit. For oil exporters, slightly higher oil prices in the second half of the year broadly offset the fiscal impact of an extension in output cuts.

Non-Oil growth beats expectations

The extension of cuts naturally dragged down GDP for oil producers, with the IMF's latest forecasts seeing just 0.6% annual growth for the GCC, although stronger non-oil sector performance in some countries partly offset this impact; One indicator of this is that purchasing manager indices (PMIs) in the UAE and Saudi Arabia were at, or close to, two-year highs in November.

Meanwhile, some non-GCC countries are beating growth expectations. Egypt's economy is beating expectations, including a very strong 4.9% y/y growth in Q2. These results contributed to an increase in the aggregate forecast to 2.3% from 1.3% growth for the group including Egypt and our 4 Mashreq countries (for clarity, we've excluded Libya, where the dramatic recovery in oil production should have increased its GDP by over a 50% in 2017).

Inflation muted in Gulf

In the Gulf countries, the most notable surprise is that inflation has been much weaker than had been expected. The IMF cut its forecast from 3.4% to 1.0% and the GGC's actual inflation in October was just 0.7% y/y. Cuts in subsidies made in 2016 seem to have only had a one-off impact and deflation in some countries in certain key price categories, such as rents, has more than offset the impact of more expensive fuel in countries like UAE where it is now benchmarked to crude prices. Outside the Gulf, inflation was higher, particularly in Egypt where it reached 31% y/y in October.

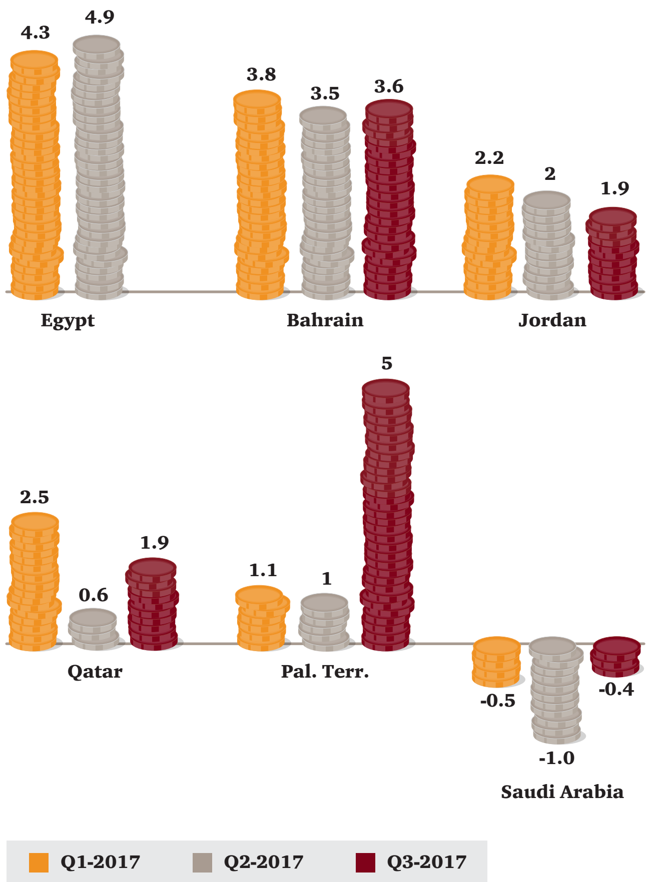
Bahrain leads the GCC

Bahrain delivered a consistently strong performance through the first three quarters of 2017, leading the GCC, among the countries that report on a quarterly basis, with 3.6% y/y growth in Jan-Sep, driven by the key sectors: finance and hospitality.

Saudi Arabia, however, has entered a recession in 2017, with three quarters of contraction, averaging -0.7%, as the non-oil sector remained hamstrung by austerity. Qatar's growth rebounded in Q3, after slowing at the start of the political crisis, because of strong gas output (given little maintenance downtime) but also strong non-oil performance, despite some signs of disruption in sectors such as accommodation and transportation.

The Palestinian Territories posted an unusually strong Q3, up 5%, driven by a 19% jump in the domestic trade sector.

Quarterly real GDP (% change y/y)



Source: *National statistics agencies*

Outlook for 2018: Oil cuts extended but austerity eases in places

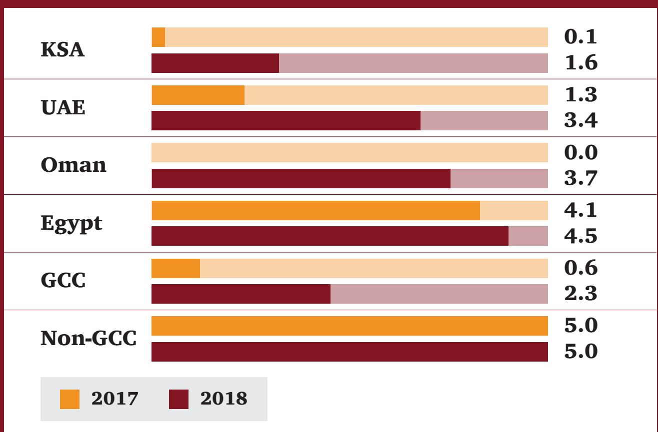
Oil cuts extended through 2018

Once again, the dominant economic driver for the year will be oil producer action, after OPEC decided in November to extend cuts by up to nine more months, until the end of 2018. In addition, Libya, which did not participate in 2017, will cap its production at current levels.

The big question is whether rising US shale production, in response to higher prices, will negate the impact of oil exporter cuts on inventory levels. As a sop to Russia, which is more sceptical about the extension than OPEC, there is a provision for a review in June, to assess progress towards reducing inventories. However, the current market view is that this will not result in a policy change.

The extensions mean that some published forecasts in 2018 for oil exporters could be overstating growth.

Real GDP growth forecasts (%)



Source: *IMF WEO Oct-17*

Austerity eases

Saudi Arabia had been aiming to balance its budget by 2020. However, following IMF warnings about the negative impact on the private sector of such a sharp adjustment, it is now delaying this balancing target. A cash transfer programme has just launched to compensate Saudi nationals for cuts in subsidies, which should help maintain their discretionary spending levels, although the recent introduction of VAT will have a somewhat negative impact on this.

In addition, a package of $19bn in stimulus measures for the private sector was launched in December. This includes concessional loans for housing developers and reduced fees for small business.

Other countries have also introduced or will consider stimulus measures. Qatar, for example, has cut rents in logistics zones and is boosting the share of public procurement from local companies.

A major change in 2018 will be a sharp pickup in inflation in the Gulf due to the introduction of VAT. The IMF sees Saudi Arabia moving from mild deflation in 2017 to 5% inflation in 2018. However, delays in VAT implementation in some countries will shift part of the inflationary impact into 2019.

Business environment: GCC leads but non-GCC improves

Why are these indictors useful?

Business environment indicators, are important because they are one of the tools used by investors in evaluating where to start expanding businesses. They utilise very different methodologies and only present part of the picture and so are most useful when considered in combination. The World Bank's Doing Business Index looks mainly at the amount and cost of bureaucracy and the quality of legislation, quantified in largely objective ways. The World Economic Forum's Global Competitiveness Index overlaps in some areas but draws in data about the macroeconomic environment and the assessments of local business executives.

GCC leads...

The Gulf countries have largely led the other MENA countries since the inceptions of both indices, although methodological changes to Doing Business contributed to sharp declines for some of these countries a few years ago.

The UAE is the clear leader in both indices and advanced a further five ranks this year to 21st globally in Doing Business. At the other end of the spectrum Kuwait, the weakest performer in the Gulf, saw its Competitiveness Rank slip by 14 places, partly due to the difficulties it is facing in upgrading its aging infrastructure.

Saudi Arabia deserves special mention as the country with the most business environment related reforms in the last year, with the World Bank noting positive reforms touching on six of its ten pillars, ranging from reducing the number of documents required for customs clearance to implementing an online system for property registration. However, the overall impact of these reforms on its rank (92nd, the second worst in the Gulf) was only slight. However, more improvements are expected because the National Transformation Programme is targeting ranks of 20th in both Doing Business and Global Competitiveness by 2020. This follows in the footsteps of the UAE, which has even more ambitious targets of entering the top 10 for Competitiveness and reaching 1st place globally for Ease of Doing Business by 2021.

...whilst non-GCC advances

The biggest advances this year happened outside the GCC. Jordan, which was already the highest ranking of the non-GCC countries, progressed by 15 places in Doing Business to 103rd. Palestinian Territories moved even further, rising by 26 places.

Egypt meanwhile, slipped back a few places in this index but advanced by 15 places in Global Competitiveness. It saw even more impressive improvements in some categories such as infrastructure and financial market development, but still ranks near the bottom for its macroeconomic environment and labour market efficiency, key pillars.

Iraq and Libya languish close to the bottom of the Doing Business Index, but might progress in the future if conflict continues to ease and provides space for reforms.

The indices only provide a starting point for evaluations, for example by filtering out a shortlist of suitable locations. Bespoke sector-specific research is needed before finalising any business decisions.

Please see (page 1) for an overview of the region's business environment rankings.

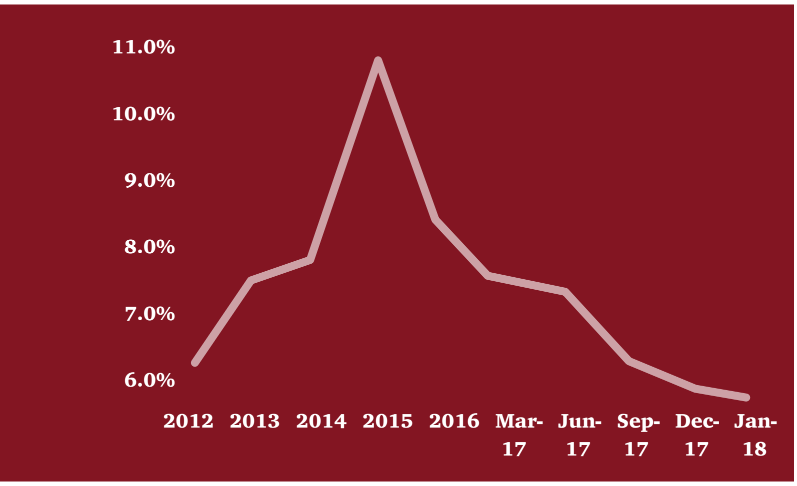
Data and projections: January 2018

	GDP share (2017)		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q3-17	2017e	2018p	Dec-17	2017e	2018p	2017e	2018p
Middle East	100%	100%	-	1.7	3.3	4.9	6.4	7.2	- 7.2	- 5.5
GCC	61.4%	67.5%	-	0.2	2.5	0.8	0.8	4.1	- 6.1	- 4.6
Saudi	32.5%	31.7%	- 0.4	- 0.7	1.6	0.1*	- 0.2*	5.0	- 8.9^	- 7.2
UAE	12.6%	17.7%	-	1.3	3.4	1.7*	2.1*	2.9	- 3.7	- 2.2
Qatar	6.2%	7.8%	1.9	2.5	3.1	0.6	0.4	4.8	- 1.0	0.5
Kuwait	5.5%	5.5%	-	- 2.1	4.1	1.1	1.9	2.7	1.5	1.5
Oman	3.4%	3.4%	-	0.0	3.7	1.7	1.6	3.2	- 13.0	- 11.4
Bahrain	1.3%	1.6%	3.6	2.5	1.7	1.4	1.4	3.5	- 13.2	- 11.9
Non-GCC	38.6%	32.5%	-	5.0	5.0	13.4	18.1	13.5	- 9.5	- 7.2
Egypt	21.8%	16.9%	N/A	4.1	4.5	21.9	29.6	21.3	- 9.5	- 7.3
Iraq	12.0%	9.0%	-	- 0.4	2.9	0.7*	2.0*	2.0	- 5.1	- 4.7
Jordan	1.6%	1.9%	1.9	2.3	2.5	3.2	3.3	1.5	- 2.5	- 0.4
Lebanon	1.6%	2.5%	-	1.5	2.0	5.0	4.5	2.5	- 9.9	- 10.3
Libya	1.1%	1.6%	-	55.1	31.2	25.7*	32.8*	32.1	- 43.0	- 23.3
Palestinian territories	0.4%	0.6%	5.0	3.1	3.0	0.0	0.2	1.6	- 8.4	- 7.8

Sources: *PwC analysis, National statistical authorities, IMF (Regional Economic Outlook, October 2017), IMF World Economic Outlook Update January 2018. *Latest inflation is Nov (Libya=Sep, Iraq=Oct) and 2017 is IMF estimate, ^ Official preliminary estimate for Saudi Arabia.*
Notes: *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.*

Chart of the quarter: Iraq bond yield (matures 2028)

The defeat of Islamic State in Iraq during 2017 has led to a marked improvement in investor confidence. The yield on Iraq's longest term bond, which matures in 2028, fell to a record low of 6.0% in the first week of 2018, dropping just below its previous low in 2013 and less than half its peak in early 2016. Levels of violence in the country are now close to their lowest since 2003. Although Iraq still has some significant political hurdles to overcome in 2018, including navigating elections in May, it is emerging as a more viable place to do business and post-war reconstruction will offer numerous opportunities by filtering out a shortlist of suitable locations. Bespoke sector-specific research is needed before finalising any business decisions.



Source: *Bloomberg*

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

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Middle East Economy Watch: Special Feature

Technology and education could boost weak productivity

The productivity challenge

Weak labour productivity is a persistent challenge across the Middle East. However, labour productivity data can give a misleading picture as few workers are needed to generate value in the oil sector or in capital-intensive downstream manufacturing.

In many other sectors, notably non-financial services, even the Gulf economies have weak labour productivity levels compared with peers, as they rely on low skilled expatriates. Meanwhile, public sectors across the region are heavily overstaffed. Significantly, productivity growth rates are weak in most countries. The International Labour Organisation estimated that real productivity grew by 10% globally in 2010-17, but only the UAE exceed this rate and many countries saw their productivity fall over this period, notably Oman and Lebanon.

The role of technology and education

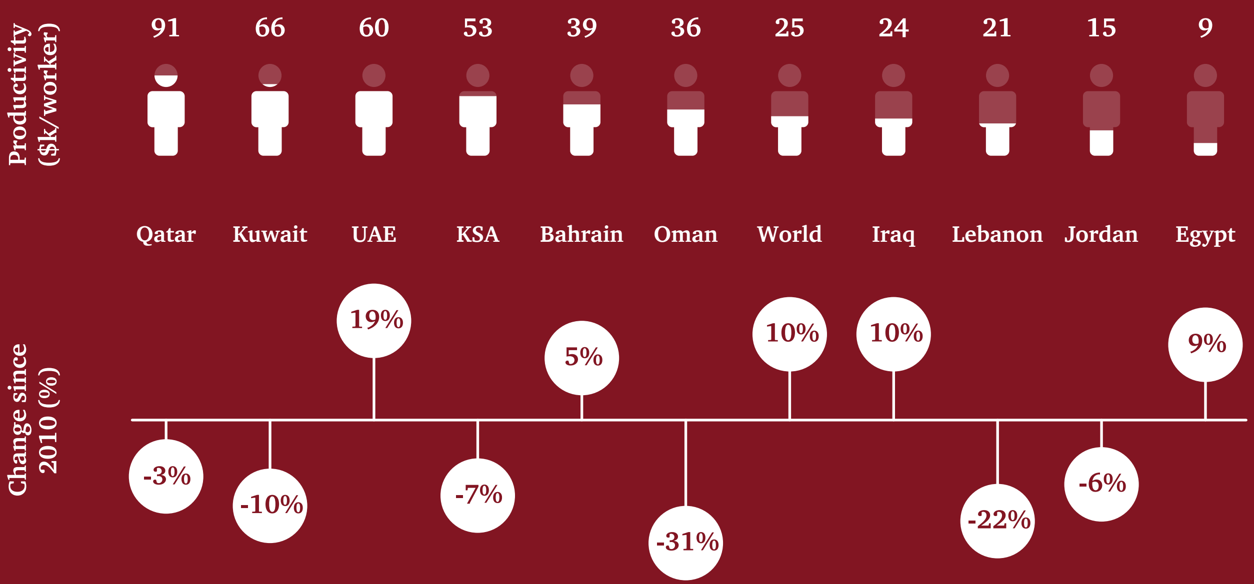
Efforts in many countries to improve education and motivate nationals to work in the private sector should boost productivity.

However, the biggest change will come from technology, notably AI and robotics, replacing jobs in the services sector. This could have a unique impact in the Gulf as expatriates, made redundant by technology, will just depart resulting in a less dense but more productive population. However, other Middle East countries, like the rest of the world, will have to struggle with potential threat of large scale unemployment.

Gulf countries have capital to invest in technology and some are taking bold steps, ranging from the Saudi Arabia vision for Neom city and the UAE's appointment of the world's first minister devoted to AI. The combination of investment, leadership and improving education could lead to substantial productivity gains.

We will be taking a closer look at the impact of AI on the regional economy in future research.

Labour productivity trends



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