

February 2019

Middle East Economy Watch

Oil falters but the Middle East's outlook is still benign

2018 was the best in five years for Middle Eastern oil exporters.

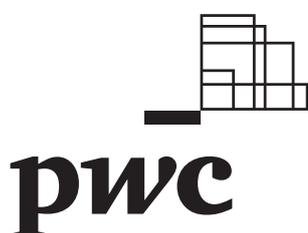
Stronger prices, combined with the fiscal and structural reforms that were developed during the low parts of the commodities cycle (including subsidy cuts), put these economies on a more stable footing for 2019. Regional connectedness from remittances, tourism, aid and investment should also result in some positive spillovers to oil importing countries

The oil market correction and broader global economic risks in the final quarter dampened the animal spirits that had begun to emerge last summer.

Furthermore, according to our survey of CEOs in the region, confidence is down. CEOs appear to be concerned about lower growth, changing customer demands and the rise of disrupting technology. (see: Chart of the Quarter).

This issue of Middle East Economy Watch previews the outlook for 2019. We also take a deep dive into the economic impact of the VAT roll out in the UAE and Saudi Arabia. With some caveats, the early data suggests that the inflationary impact of the tax has been contained, the impact on growth is limited and in Saudi Arabia it has raised more revenue than was initially expected. A fuller picture will emerge over the next six months or so, including from studying Bahrain, which joined the VAT club this year.

Meanwhile, political developments continue to shape economic and business prospects in the region. Iraq has a new government, albeit with a few posts still unfilled. A lack of stability and good governance has held Iraq back and there is a chance it could turn a page in 2019.



Growth should still pick up in 2019, despite fresh oil market weakness

Impact of OPEC cuts

Oil market developments are likely to be the dominant economic driver for the region once again in 2019. Following the sharp decline in prices in the final months of 2018, OPEC and its allies agreed in November to cut 1.2 barrels/day, compared with October output levels. This replaced the quotas that had been in place since January 2017, but which had been partly abandoned in the second half of 2018. Whether the new cuts are adhered to and persist beyond June will significantly shape real growth prospects.

Loosening compliance with the earlier quotas had contributed to the sharpest price crash since 2014, down from a four-year high \$86 at the start of October to a December low of \$50. However, in early January there was a modest rebound as Saudi Arabia cut output even more deeply than it had pledged.

Most leading forecasts for Brent crude are \$55-62, below the \$71 average for 2017. Even if the global economy is able to navigate crises such as Brexit and the US-China trade disputes without significant demand shocks.

Weaker oil would put pressure on expenditure in countries with higher break-even prices. This includes Saudi Arabia, whose 2019 budget envisages a 20% increase in capex and a 7% overall increase compared with the 2018 outturn. It appears to have a breakeven price in the mid-\$80s, well above the IMF's projection of \$73 in its latest Regional Economic Outlook (below). However, Saudi Arabia's low debt level (about 19% of GDP) means it can finance a larger deficit if needed, although it is still aiming to balance its budget by 2023.

Corporate transactions abound

Whatever happens at a macroeconomic level, 2019 is likely to be an active year for corporate transactions. This includes major M&A and IPO activity. The landmark deal could be Aramco's acquisition of a 70% stake in SABIC from the Public Investment Fund, although no final decision has been announced on whether it will go ahead. If it does then it will likely be partly funded with debt and would provide PIF with the financing to expand its local projects, boosting the domestic Saudi economy, and also invest internationally.

Banking sector mergers are under discussion in several countries. The region is widely recognised as being overbanked and has begun to consolidate over the past few years. As banks scale up through mergers, this should boost the sector's capacity to finance projects and businesses, supporting growth.

Meanwhile, efforts to attract investment will continue, including the announcement of which sectors are eligible for 100% onshore foreign ownership under a new UAE law. There should also be progress in privatisation efforts in Saudi Arabia, Oman and Kuwait.

Aid and reforms

The economic trajectory of some countries will depend partly on balancing domestic demands against reforms backed by aid. This includes Jordan and Bahrain, which both received pledges of support from Gulf states, much of which will be disbursed in 2019 and assumes that they continue with implementing fiscal reforms, such as a broadening of income taxes in Jordan.

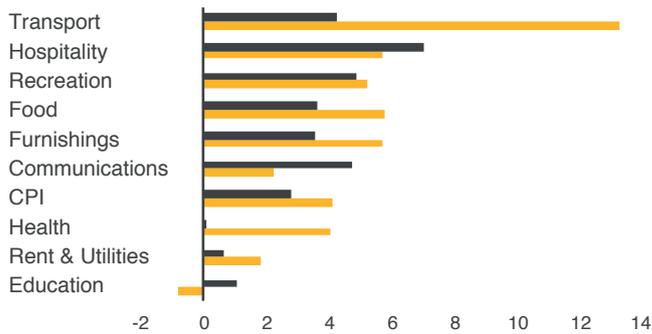
2019 breakeven oil price (\$/barrel)



Source: IMF (October 2018)

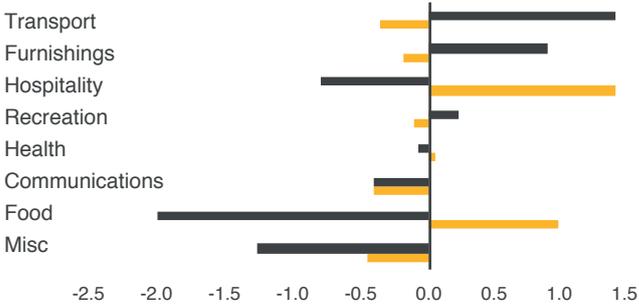
What has been the impact of VAT one year on?

Price changes in Jan 2018 (% m/m, selected components)



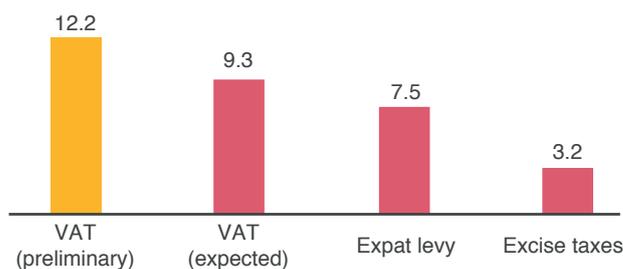
Source: National sources, PwC analysis

Price change in Feb-Nov 2018 (% Average CPI / Jan 2018)



Source: National sources, PwC analysis

Saudi fiscal revenue 2018 (\$bn)



Source: Ministry of Finance

It is a year since Saudi Arabia and the UAE became the first Gulf states to implement VAT. It will take a couple of years before the impact, including secondary and indirect effects, can be fully assessed. However, the initial data suggests that the new tax policy has been relatively successful in diversifying government revenue without producing excessive inflation. Nevertheless, there have been 'teething' problems which need to be ironed out. These lessons may help in facilitating its implementation in the remaining Gulf states.

Prices rise in January

The bulk of the impact of VAT was visible in the month-on-month price increases in January 2018. The overall consumer price index (CPI) jump was 3.9% m/m in Saudi and 2.7% in UAE. The main reason for the higher inflation in Saudi was a sharp cut in fuel subsidies, which was implemented alongside the VAT and caused transport prices to shoot up by 12.7% m/m. If fuel had only been subject to VAT, as in the UAE, the overall CPI rise would have been lower at about 3.1%. In both countries there was little increase in housing and utilities costs or in education despite some aspects being subject to standard rate VAT. However, there was a notable difference in the health sector, which is subject to VAT in Saudi Arabia (up 3.9%) but not UAE (flat). Meanwhile, within the UAE there were some differences between Emirates. Dubai saw only a 2.0% m/m increase in January, compared with 3.0% for Abu Dhabi, in part because zero-rated rent is a much larger component of its household expenditure, and hence the CPI basket.

Pressure eases during the year

Following the implementation of VAT's introduction, prices in many sectors declined on average during the rest of the year until November (the most recently available month). This seems to suggest that, so far at least, there has been little secondary inflation. The dominant price trends after February were unrelated to VAT: a weakening of rents in both countries and an increase in UAE transport prices, until they reversed in September, mainly due to the linkage of fuel to global oil prices (which Saudi does not share).

There is also little indication that the VAT has caused a significant drag on growth. In Saudi Arabia, the non-oil private sector grew by 1.7% in real terms in the first three quarters of 2018, up from 1.0% for the same period of 2017. That said, volatility in the oil market, which drives government spending and business confidence, complicates efforts to single out the impact of VAT on the economy.

Revenue boost

Saudi Arabia's preliminary fiscal outturn data, released alongside the budget in December, estimates that VAT raised \$12.2bn in 2018. This is nearly a third more than it had expected, in a January 2018 projection made by the General Authority of Zakat & Tax, and is equivalent to about 1.6% of GDP. This suggests a relatively high efficiency of collection in relation to private consumption by international standards. The VAT brought in more funds than the expat levy and excise taxes combined, and triple the amount from taxes on income and capital gains.

No data is available on the UAE yet, but it is likely to be higher in relative terms than in Saudi Arabia because private consumption makes up a larger share of the economy. 70% of the revenues will be distributed to Emirate level governments, potentially providing a substantial boost for some emirates.

Next up

Bahrain became the third state to implement VAT at the start of 2019 and Oman has indicated that it expects to follow later this year. Qatar announced in its 2019 budget that it would not move ahead until at least 2020 and Kuwait, which faces particular challenges given the role of its parliament in approving legislation, has indicated that it is looking at 2021.

Data and projections: February 2019

	GDP share 2017		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q3 - 18	2018e	2019p	Nov- 18	2018*	2019p	2018e	2019p
Middle East	100%	100%	-	2.8	3.6	3.2	3.6	3.8	- 2.5	-1.9
GCC	61.0%	72.38%	-	2.5	2.8	1.7	2.2	2.2	- 1.8	-0.8
Saudi	32.2%	33.6%	2.5	2.2	2.4	2.8	2.5	2.2	- 4.6^	-3.2
UAE	12.7%	18.9%	-	2.9	3.3	1.3	3.2	2.3	1.2	1.3
Qatar	6.2%	8.2%	2.2	2.7	2.8	-0.2	0.3	2.0	1.9	2.8
Kuwait	5.3%	6.3%	-	2.3	3.4	0.1	0.5	1.9	3.8	5.3
Oman	3.4%	3.7%	-	1.9	3.1	1.1	0.9	2.7	-5.7	-5.3
Bahrain	1.3%	1.7%	1.6	3.2	2.8	0.7	2.0	3.3	-8.0	-6.8
Non-GCC	39.0%	27.7%	-	3.7	5.5	7.2	7.4	7.9	-4.6	-4.9
Egypt	22.5%	10.9%	5.3	5.3	5.2	15.7	14.4	138	- 9.6	- 8.4
Iraq	11.7%	10.1%	-	1.5	6.5	0.8	0.4	2.0	- 5.6	3.8
Jordan	1.6%	1.8%	2.0	2.3	2.3	4.7	4.6	3.4	- 2.9	- 3.0
Lebanon	1.6%	2.5%	-	1.0	2.2	5.8	6.2	3.6	-8.6	- 8.1
Libya	1.2%	1.9%	-	10.9	10.8	-1.8	10.8	17.9	-25.1	- 26.9
Palestine Terr.	0.4%	0.6%	-0.5	1.4	1.4	0.1	-0.2	1.5	- 8.3	- 10.4

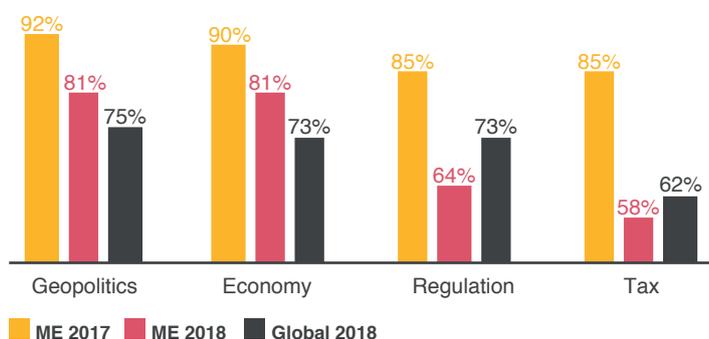
Sources: PwC analysis, National statistical authorities, Bloomberg consensus forecasts (as of end-2018), IMF (WEO, October 2018) estimates and forecasts for Iraq, Libya & Palestine (not covered by BB). *Estimated based on the Jan-Nov outturn, ^Official preliminary estimate.

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

PwC's annual CEO survey shows that in the Middle East, CEOs are less concerned about four major potential threats to growth than in 2017: geopolitical uncertainty, uncertain economic growth, over-regulation and increasing taxes. The biggest shift was in tax, which only 58% reported concerns compared to 85% in 2017 (ahead of the launch of VAT in Saudi and UAE). There was also a significant decline in concerns about regulation, from 85% to 64%, which is encouraging for the business environment and also better than the global average. The survey was conducted just before global market turmoil and declining oil prices at the end of 2018, and so concerns about the economy may have increased since then.

Chart: How concerned are you about the following economic, policy, social and environmental threats to your organisation's growth prospects?



Source: PwC Middle East 22nd CEO Survey: Confidence down, disruption all around

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