Middle East Economy Watch

Gulf exceptionalism: Strong growth, low inflation, fiscal surpluses

January 2023

The global economy faces another period of uncertainty in 2023, with many countries expected to face recessions and continued inflation putting pressure on both government and household budgets. Some Middle Eastern countries are facing these headwinds full on, but the GCC seems increasingly like an island of calm in this storm as it looks set to buck the trends of the forecasted global recession likely to hit at least a third of the world's economies in 2023, according to the IMF.

In this issue, we review the latest data on inflation, growth and public finances. Inflation in the region peaked at under 5% and has eased to 4% in late 2022, far below the levels seen in many major economies, with forecasts that it will decline further in 2023.

The region saw some of the strongest growth globally in 2022; indeed Saudi Arabia is expected to be the strongest growing G20 economy by some margin, with full-year GDP growth in 2022 projected at 7.6%, and having achieved 8.8% in the third quarter. The tapering of OPEC+ production cuts was obviously a major part of this, but non-oil growth was also robust in the Kingdom and elsewhere in the GCC.

Public spending and liquidity supported by oil revenue are certainly factors behind the non-oil growth, along with the ongoing recovery from the pandemic, but is not the whole story.

In fact, there are indications from 2022 outturns and 2023 budgets that Gulf states are being much more fiscally disciplined during the current oil boom compared with the two previous ones this century. This is part of the reason why credit rating agencies are now raising their assessments of Gulf sovereigns after years of downgrades.

The coming months will include the next OPEC+ meeting in early February, although at present the indications are that quotas will remain unchanged for much of the first half of 2023.

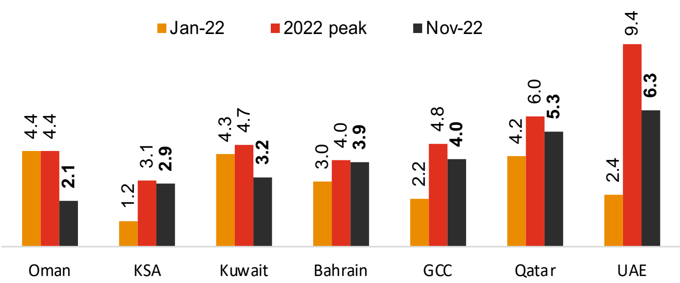
The region as a whole is more integrated than it has been for years both socially and economically, as seen during the FIFA World Cup, and 2023 is likely to bring a raft of cross-border investments along with many more IPOs to boost capital markets, another area in which it could be a positive exception to the global trends.

Non-oil growth is robust as inflation cools

Inflation cools in Gulf

Inflation remains a serious challenge for many countries globally, including commodity-importing countries in our region, such as Egypt. However, in the Gulf it peaked at an 11-year high of about 4.8% in July 2022 and since then has been steadily cooling, easing to 4.0% in November and is forecast by the IMF to average just 2.7% in 2023.

Inflation in the GCC (% y/y)



Source: National statistical agencies; UAE is estimated based on Dubai and national weights because it is no longer published monthly.

There are several reasons for this climate of moderate inflation. Subsidies and price controls on fuel, electricity and food help keep prices under control in most GCC countries. The strong US dollar, to which Gulf currencies are pegged, has played a supportive role in mitigating imported inflation in a region that relies heavily on imports. Despite the similarities of the GCC economies, there is still quite a range in inflation rates from 2.1% in Oman in November to an estimated 6.3% in the UAE.

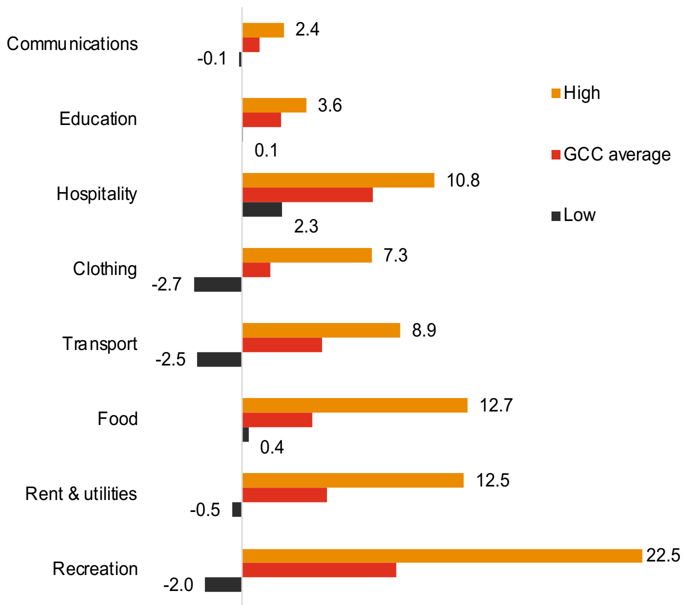
But some inflation components remain high in places

The divergences are due to significant differences between countries in the weights of components in their inflation baskets and certain local trends. One of the most notable areas of divergence is the recreation component which is responsible for nearly half of Qatar's inflation this year; without this Qatar would have the region's second-lowest inflation, rather than its second-highest. Recreation comprises 11% of Qatar's basket, compared with an average 3% for the rest of the Gulf, which was up by 23% year on year (y/y) in November vs just 2% for the rest of the GCC (excluding the UAE, which is likely also high because Dubai, another aviation hub, recorded 21% in November). This is because it is largely driven by the cost of air travel, which fell sharply in Qatar during the pandemic, given Qatar Airways' large spare capacity, but has since rebounded, with a further boost from World Cup demand.

Qatar has also seen a surge in housing rents, which hit a 14-year high of 12.5% y/y in November, a short-term factor related to the World Cup. By contrast, rents in Bahrain declined by -0.5% (although rents only comprise 21% of the basket in Qatar, vs a regional high of 41% in Dubai). Conversely, food prices are highly controlled in Qatar and were only up 1.2% y/y compared with a 12.7% surge in neighbouring Bahrain. Bahrain also led the region on hospitality, up 10.8% y/y as Saudi tourists return in large numbers, whereas in Kuwait it was just 2.3%.

Transport prices were up by 8.9% y/y in Dubai because fuel is not subsidised (the UAE stopped publishing national monthly inflation data in 2022 but it is likely to be similar to Dubai), although this was down from a peak of 39% in July whereas Qatar, where there are subsidies, saw a -2.5% decline in November. Some other components, such as communications and education, saw little inflation across the GCC.

GCC inflation components (Nov-22, % y/y)



Source: National statistical agencies

The GCC mirrors US rate rises

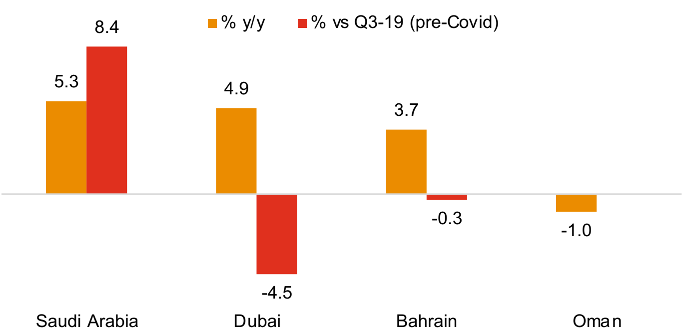
The modest levels of inflation in the region mean that there is little need to mitigate it with monetary policy interventions. However, pegged currencies mean that Gulf states are largely obliged to mirror interest rates hikes in the US or risk capital outflows. As a result, they continued to follow the US Federal Reserve's interest rate rises, which totalled +125 bp of hikes in November and December. Only Kuwait's policy rate of 3.5% is less than the US and was only increased by +50 bp in the same period. This is possible because of the slight policy flexibility that comes from Kuwait's peg to a basket of currencies, albeit one dominated by the dollar.

The higher rates have created some concerns that they could reduce demand for credit and in turn reduce private consumption and investment, hurting the non-oil economy. So far there is little sign of that and a policy paper on the GCC published by the IMF in November 2022 found evidence from historical analysis that non-oil growth in the region was not particularly sensitive to interest rate hikes at times when (as at present) oil prices are high and hence support domestic liquidity.

Non-oil growth trends look solid in 2022

The latest available data for Q3 shows solid non-oil growth in Saudi Arabia, Dubai and Bahrain. Oman suffered a -1% y/y contraction, but that was due to weakness in the construction sector (down -22% y/y) that has been ongoing since the start of the year. Excluding this, the rest of its non-oil sector grew by 4.2%. Saudi Arabia, in particular, is showing strong momentum, supported by government spending and economic reforms, and every individual sector was back to pre-COVID-19 levels in Q3 while the non-oil sector as a whole was 8.4% larger. Although certain sectors, particularly transport and hospitality, have not yet fully recovered in other GCC states, they are making good progress.

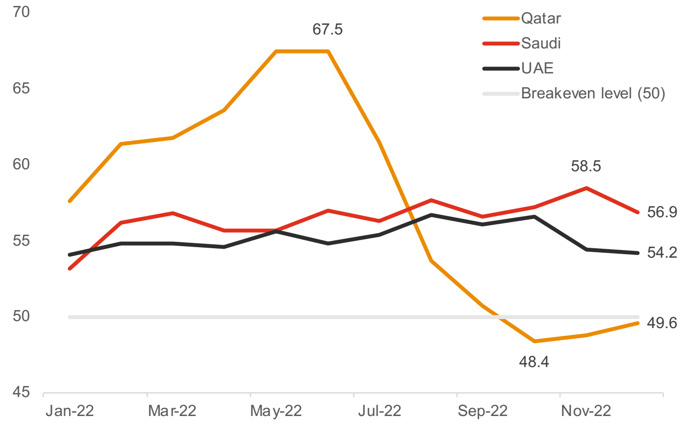
Real Non-oil growth in Q3 2022



Source: National statistical agencies. N.B. Q3 is not yet available for Qatar, Kuwait and UAE; Oman's quarterly series only begins in 2021.

Leading indicators point to continued robust growth in Q4, during which the Purchasing Managers' Index for Saudi Arabia reached a three-year high of 57.5 on average (with readings >50 associated with non-oil expansion) and the UAE a solid 55.1, albeit down slightly on Q3 (which was its own three-year high). The exception is Qatar which saw a sharp decline to 48.9 in Q4 as the frenetic construction activity observed in the run-up to the World Cup, came to an end. However, although this theoretically suggests a Q4 contraction in Qatar, this is unlikely to be the case given the consumption boost coming from the tournament itself. However, Qatar could face some weakness in 2023 as migrant workers and the tourism boost related to the World Cup depart.

Purchasing Managers Indices (points out of 100)



Source: Standard & Poor's Global Intelligence

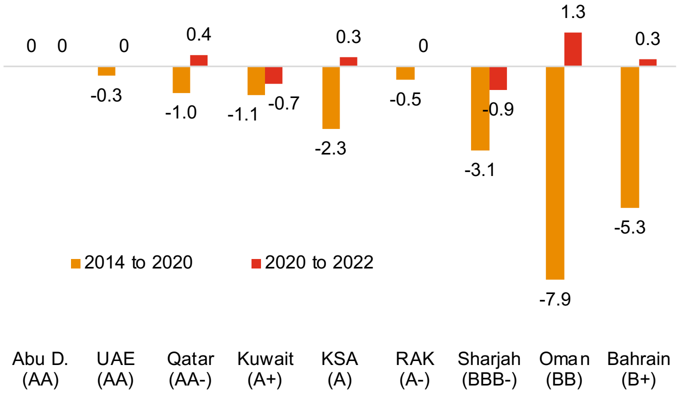
Credit ratings strengthen amidst oil boom

Ratings begin improving after years of decline

Strong oil prices combined with relatively restrained fiscal policy brought the GCC back into an aggregate fiscal surplus in 2022 for the first time since 2014, along with surpluses for most states individually. This has resulted in a series of positive actions by credit rating agencies, reversing a long period of decline in the aftermath of the previous oil boom that left several states struggling for years to bring bloated budgets under control, before facing an additional fiscal shock from COVID-19. However, that difficult period resulted in policy changes and stronger controls that have supported recent rating improvements and should make it easier for Gulf states to manage through future periods of weak oil revenues.

The biggest improvement has been for Oman, which previously suffered the region's biggest rating decline, dropping by eight notches between 2014 to 2020. The turnaround under Sultan Haitham began with a five-year fiscal plan announced in late 2020. Reforms included spending controls, the introduction of VAT, and then reinvesting the 2022 windfall to reduce the stock of public debt by 15%. This all led to upgrades in 2022 from Fitch and Moody's and two consecutive upgrades from Standard & Poor's. Qatar also received an upgrade from Standard & Poor's, reversing its first-ever downgrade in 2017, and a positive rating outlook from Moody's. Negative outlooks for Saudi Arabia and Bahrain were removed in 2021 and Standard & Poor's now has positive outlooks on both, with Fitch also positive on Saudi Arabia, indicating the possibility of upgrades this year if fiscal improvements continue.

Trends in average credit rating (notches by period)



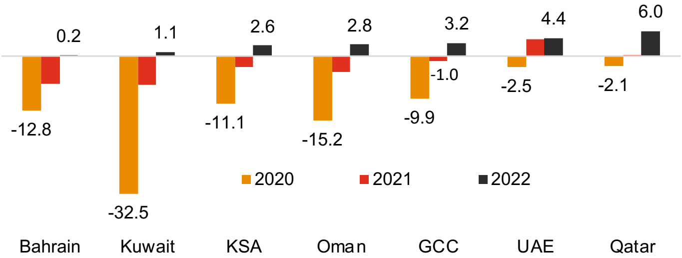
Source: Standard Poor's, Moody's, Fitch; outlooks are ±¼ of a notch; N.B. Bahrain's low point of May 2021 is used instead of end-2020.

There are two exceptions to the positive trends. Kuwait suffered downgrades in 2021, even as oil prices rose and its fiscal balance improved, because of governance challenges. Its ratings did at least stabilise in 2022 and could see improvement in 2023 if the new National Assembly and government, formed in November, continue to cooperate more effectively and pass a reasonable budget. The emirate of Sharjah suffered further negative actions in 2021-2, most recently a downgrade by Moody's in July, as it struggled to control a structural deficit and received little benefit from oil prices as it produces few hydrocarbons.

Public finances return to surplus

The GCC recorded a deficit of -10% of GDP in 2020, the weakest since the low oil prices of the early 1990s and the seventh consecutive year of aggregate regional deficit. The recovery was rapid, however; the deficit narrowed sharply to just -1% of GDP in 2021 and in 2022 returned to a surplus of about 3% of GDP (based on preliminary results from Saudi Arabia and Oman and estimates for the others). Bahrain may have eked out a tiny central government surplus, which would be its first since 2008 and two years ahead of target in its 2021 fiscal balance plan, although consistent off-budget expenditure means that there is likely to be a deficit at the general government level. Other Gulf states tend to have stronger balances at the general level, which includes off-budget income from sovereign wealth funds.

Fiscal balance (% GDP)



Sources: Ministries of finance. 2022 prelims for Oman and KSA, estimates from S&P for Bahrain and the World Bank for the others.

Spending restraint largely persists

Oil exporters always face the temptation of stalling or reversing fiscal reforms and ramping up expenditure during times of high or rising oil prices. During 2003-14, regional expenditure increased five-fold, an average of 15% a year with a peak of twice that in 2008. However, in the latest cycle things have been much more moderate to date. There was about a -2% y/y decline in 2021, even as oil revenue increased by about a half. In 2022, the IMF expected only about a 6% increase in expenditure even as revenue increased by a third. So far only Saudi Arabia and Oman have reported their preliminary outturns, showing higher than forecast spending growth of 9%, partly a consequence of fuel subsidies.

However, it is encouraging that governments are showing restraint in core inelastic areas of spending, which are harder to row back. For example, salaries in Saudi Arabia only increased by 2%, returning to 2019 levels, and Oman's core current expenditure (excluding subsidies and gas purchases) only rose by 2%.

Part-year results from other Gulf states also show some signs of restraint. Consolidated UAE expenditure was only up by 4% y/y in the first nine months and salaries only by 1%, despite a 36% increase in revenue. Qatar's spending was up by 13% over this period, but the World Cup was a one-off driver. Bahrain has only released outturn data for H1, actually showing a -1.5% decline in spending.

This spending restraint is particularly significant during a period of high inflation. Although inflation in the GCC is lower than in many places globally (as noted), a 4% increase in prices in 2022 is still as much as in the previous five years combined.

New taxes planned for 2023

From the budgets published to date, another positive sign fiscally is that there have been no reversals in tax policy and even some significant new measures, which is unprecedented during an oil boom. Saudi Arabia maintained the 15% VAT rate, despite the Crown Prince indicating in 2021 that it would be reduced at some point, and Bahrain doubled its own rate to 10%. The UAE law to apply a 9% corporate taxation was issued in December, and comes into force in June this year, and Oman's parliament has begun debating a draft law for personal income tax - a first in the region.

2023 budgets also indicate plans for continued restraint. Saudi Arabia's budget plans a -2% cut in expenditure relative to its preliminary 2022 outturn and Oman's budgets a similar cut on an underlying basis (excluding fuel subsidies, gas payments and allocations for future debt obligations). Meanwhile, Qatar is budgeting a -3% cut compared with its 2022 budget. The picture in the UAE is more mixed with Dubai planning a 13% spending increase, the federal government a 7% hike and Sharjah a -6% cut, all relative to their 2022 budgets.

Looking ahead: five GCC trends to watch for 2023

2022 was another year of uncertainty, characterised by geopolitical tensions, the invasion of Ukraine, a global energy crisis, high inflation, continued supply chain disruption and financial market volatility. However, against this backdrop the region has generally been more insulated, buoyed by the stronger performance in the oil-exporting GCC countries, as well as playing host to successful international events such as Expo 2020 in Dubai, COP-27 in Egypt and most recently the FIFA World Cup in Qatar. As we look ahead into 2023, what key trends and themes will shape the GCC economies?

1. The GCC will escape the global slowdown

Global growth could lose momentum going into 2023 with a third of the world's economies entering a recession, while forecasts for the GCC in 2023 are more upbeat with 3.6% GDP growth expected this year.

2. The resurgence of the non-oil economy

The PMIs for the non-oil sector remained well in expansion territory for most of 2022, and this momentum is set to continue at pace as the GCC economies continue to diversify.

3. The liquidity squeeze will ease

The unprecedented speed of increase in the Federal Reserve rate, which has been largely mirrored in the GCC countries, has put significant pressure on market liquidity. This will ease with corrective action in 2023 and as banks seek longer-term sources of funding.

4. Continuing efforts to green the economy

All eyes are now on the UAE as the host of COP28 later this year. With most GCC countries making net zero commitments, the increased focus on the region will provide impetus for further reforms to invest in renewable energy, reduce energy consumption, and focus on sustainable finance as an enabler of the energy transition.

5. The war for local talent intensifies

Greater emphasis is likely to be given to the localisation of the private sector workforce in tandem with the increase in labour force participation amongst nationals, particularly in Saudi Arabia and the UAE.

Data and projections: January 2023

	GDP share (2022)		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q3-22*	2022p	2023p	Nov-22*	2022p	2023p	2022p	2023p
Middle East	**100%**	**100%**	**-**	**6.2**	**3.9**	**7.3**	**4.7**	**4.4**	**4.2**	**4.1**
GCC	**59.1%**	**70.3%**	**-**	**6.4**	**3.6**	**4.0**	**3.7**	**2.7**	**5.8**	**6.0**
Saudi Arabia	32.5%	34.3%	8.6	7.6	3.7	2.9	2.7	2.2	2.6	3.9
UAE	13.1%	17.1%	-	5.1	4.2	6.3	5.2	3.6	7.7	4.9
Qatar	4.9%	7.5%	*6.3*	3.4	2.4	5.3	4.5	3.3	12.5	16.0
Kuwait	4.0%	6.2%	-	8.7	2.6	3.2	4.3	2.4	14.1	14.1
Oman	3.1%	3.7%	5.5	4.4	4.1	2.1	3.1	1.9	2.8	2.3
Bahrain	1.4%	1.5%	4.2	3.4	3.0	3.9	3.5	3.4	-4.7	-6.0
Non-GCC	**40.9%**	**29.7%**	**-**	**5.9**	**4.7**	**15.1**	**7.2**	**8.3**	**0.6**	**-0.4**
Egypt	26.8%	15.9%	4.4	6.6	4.4	18.7	8.5	12.0	-6.2	-7.4
Iraq	8.5%	9.6%	-	9.3	4.0	4.5	6.5	4.5	11.1	9.2
Jordan	2.0%	1.6%	2.6	2.4	2.7	5.0	3.8	3.0	-5.9	-6.6
Libya	2.1%	1.4%	-	-18.5	17.9	3.8	5.5	4.0	15.8	22.1
Lebanon	1.3%	0.6%	-	-	-	142.0	-	-	-	-
Palest. Terr.	0.4%	0.5%	5.0	4.0	3.5	4.3	4.9	3.4	-3.5	-3.1

*GDP: Qatar Q2; Inflation:Iraq Oct, UAE estimated based on Dubai as monthly national inflation is no longer being published

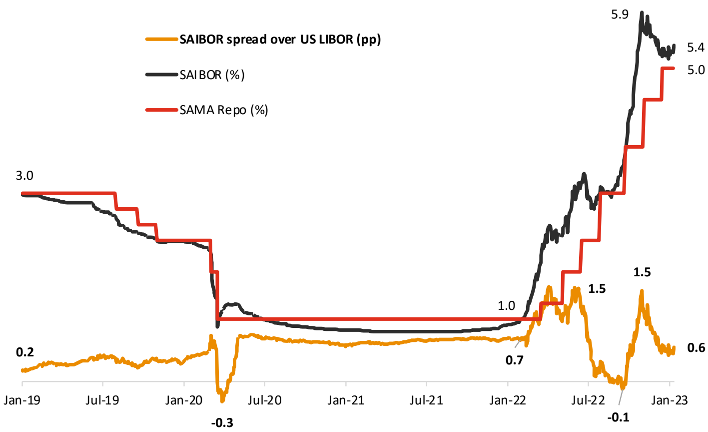
Sources: PwC analysis, National statistical authorities, IMF estimates and forecasts (WEO, Oct 2022). *GDP: Qatar Q2; Inflation: Iraq Oct, UAE estimated based on Dubai as monthly national inflation is no longer being published

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

During 2022, Saudi Arabia experienced periods of unexpectedly tight liquidity in the banking sector, which was visible in spikes in the spread of the local riyal interbank interest rates relative to international rates lending dollars (US LIBOR). These spikes peaked at about 1.5 percentage points in April, June and October but in early 2023 had eased back to 0.6pp, similar to the average during 2020-21, although still higher than in 2019. The spikes were unexpected because high oil prices usually result in strong domestic liquidity, and hence low interbank spreads. However, the government has not been depositing as much of its oil windfall in local banks as in previous cycles. More importantly as the fastest growing G20 economy, Saudi Arabia has been experiencing strong credit growth, linked in part to Vision 2030 investments and the post-Covid recovery, whilst deposit growth has not kept pace. The tight liquidity led SAMA to intervene on several occasions, most recently in October, to ensure the banking sector can still support the credit expansion. This was all happening in the context of a rapid increase in SAMA's policy rate, mirroring the US Fed, but other Gulf states implementing hikes did not see a similar volatility in spreads.

Saudi three-month interbank rate (SAIBOR)



Source: Bloomberg, SAMA

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