June 2018

Middle East Economy Watch

Foreign investment: Can raising ownership limits catalyse diversification?

This report completes our first year of the Middle East Economy Watch report. A lot has happened in the region over that time, politically and economically.

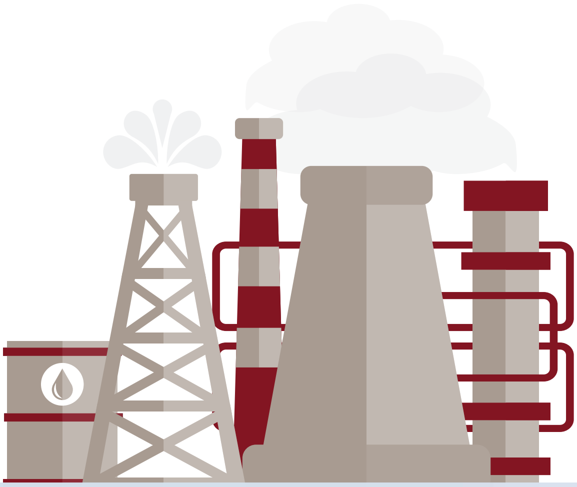
The OPEC oil cuts were extended twice and there were major reforms and initiatives in Saudi Arabia's implementation of its National Transformation Strategy. A number of major news stories in recent weeks (Iran nuclear deal, and KSA-Russian dialogue) have moved the price of oil around sharply. But it is also interesting to remember Bahrain's discovery of large oil resources. If they prove cost-effective to exploit, then this could transform the region's weakest economy.

This edition gives an overview of the major macroeconomic developments. This includes a strong final quarter of 2017 but some short-term weaknesses in early 2018, partly because of the rollout of VAT in the UAE and Saudi Arabia.

In the first of our series of brief country focus articles, we look at the UAE where Abu Dhabi's oil sector is rebounding and the groundwork has been laid for its next phase of expansion. Meanwhile, Dubai is preparing for Expo 2020 but also leading the way for the whole federation to embrace new technologies to drive long term growth, ranging from fintech to artificial intelligence (something which has potential for the whole region, as highlighted in our chart of the quarter on page 4). Our in-depth article this quarter focuses on trends in foreign investment in the Gulf, which is of increasing importance as the region looks to catalyse diversification into productive non-oil sectors.

Foreign direct investment is down sharply from its 2008 peak, but we expect that 2017 data, which should soon be available, will show signs of recovery. There is also good potential for growth in FDI in the coming years owning to reforms in foreign ownership rules, as well as broader improvements in the business environment (as discussed in our last edition).

There is a similarly encouraging story for portfolio investment, which has already benefited from market reforms and if, as expected, MSCI decides in May to add Saudi Arabia to its benchmark Emerging Markets Index, then this could sharply increase inflows into the region as a whole.



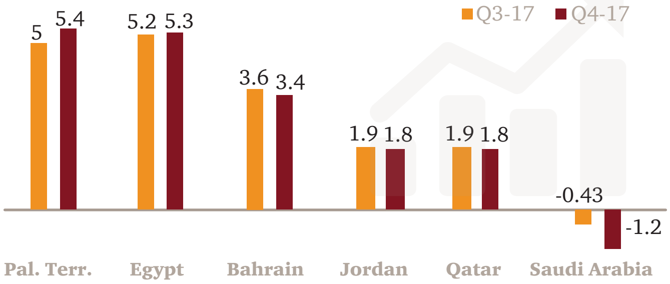
Economic update: A strong outlook despite the VAT rollout

2017 ended strongly

Many economies in the Middle East ended 2017 on strong footing. Higher oil prices naturally provided a boost, but that wasn't the only factor.

Bahrain, for example, which exceeded expectations the most of any country in the region, capping the year with another solid quarter of growth driven by smaller sectors like business services, rather than oil (or indeed financial services). In fact, the strongest Q4 growth figures came from oil importers- Palestinian Territories were up by 5.4% and Egypt up by 5.3%.

Real GDP growth (%)



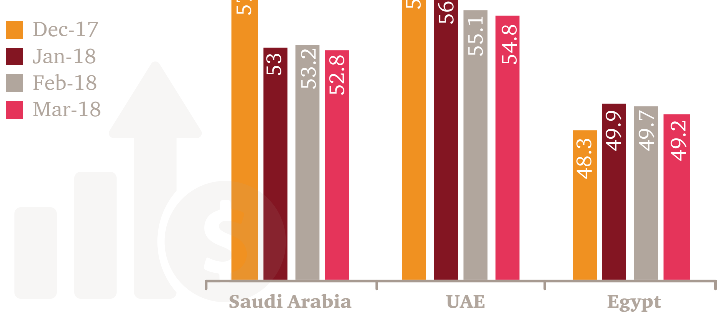
Source: National statistical agencies

Slowdown signs

Despite the Q4 performance, there were signs of a slowdown in places in early 2018. This was most evident in the purchasing manager indices (PMIs) for KSA and UAE. KSA had been close to a two-year high in December but dropped in January to a record low of 53 (albeit still above the 50-mark that signals economic expansion). UAE, which had been at a record level in December, slipped more gradually, down to 54.8 in March, its second lowest reading in a year. Dubai's Economy Tracker, a form of PMI, actually rose slightly in early 2018 (to 55.8 in February), suggesting that the slowdown is more focused in Abu Dhabi.

The PMI rises in late 2017 and falls in early 2018 are thought to be partly linked to increased activity ahead of the VAT implementation. However, the persistence pressure through the first three months of the year and the contrarian signal from Dubai suggest other factors are also at play. By contrast, the PMI in Egypt, which has long been weaker than the Gulf countries, edged a little higher in Q1 2018.

PMIs (points)

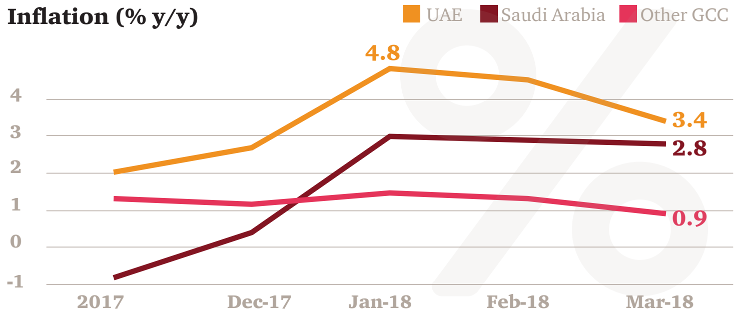


Source: Market Economics

VAT and Inflation

The short-term impact of VAT in those countries was certainly visible in inflation, leaping to 3.0% y/y in KSA in January, after a year in which consumer prices were largely suffering deflation, with a smaller step up in the UAE to 4.8%. This stood in clear contrast to the rest of the region where inflation was, on average, flat and much lower (in fact, below 1% in Kuwait, Qatar and Oman). The roll out of VAT in the other Gulf countries has been pushed back and few, if any, are likely to introduce it before the start of 2019 (which is theoretically a deadline under the regional agreement, after which penalties set in).

Inflation (% y/y)



Source: National statistical agencies

Positive outlook

Notwithstanding the impact of VAT and inflation, if oil remains buoyant and regional investment flows are boosted by IPOs and a rise in foreign inflows (see page 3), then non-oil GDP growth in 2018 should be slightly stronger than in 2017 which, combined with flat (rather than reduced) oil production, should result in stronger overall growth for the year.

Country focus: UAE

Diversifying

The UAE's economy has long been divided into three parts. Abu Dhabi focused on its vast oil reserves; Dubai took first mover advantage in developing as a hub for transhipment, aviation and business services. The northern emirates each have individual strengths and resources. Those near to Dubai serve as an extension of its metropolis and all rely heavily on financing from the Abu Dhabi-funded federal government.

Although this picture is still broadly accurate, the lines are blurring as Abu Dhabi invests to diversify, something that could be facilitated by the merger of three of its sovereign wealth funds under the umbrella of Mubadala, a regional champion in leveraging investments and partnerships to develop new business sectors domestically.

Rebounding from the oil squeeze

The UAE's diversification has meant that it has been less intensely affected than most of the Gulf by weaker oil prices and production cuts. Nonetheless, there have been real impacts, with the consolidated fiscal balance seeing the first multi-year deficits since the 1990s and growth slowing sharply in 2017. Non-oil growth, including in Dubai (whose mainly non-oil economy recorded 2.8% overall growth in 2017), partly offset the impact of the cuts.

Higher oil prices are now boosting confidence in the non-oil economy. Although adjustments such as subsidies cuts and the introduction of VAT this year have had short-term negative impacts (e.g. on the PMI), they should make the economy more efficient.

The latest IMF forecasts point to growth rebounding to 2.0% in 2018 and averaging 3.1% in 2019-23. The deficit is narrowing and should return to a surplus by 2022.

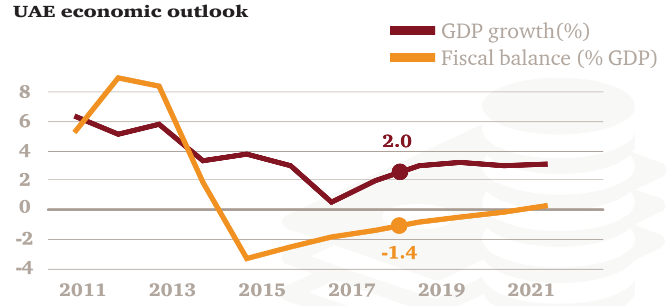
Ambitious plans

Longer term, the economy will benefit from a wave of investment in Abu Dhabi's oil sector and efforts by Dubai to take a lead in many new technologies. The UAE leads the region in both quantified medium-term planning, such as the Vision 2021, as well as much longer-term thinking such as the Strategy for the Future.

Abu Dhabi has just completed the once in a generation process of signing up new foreign partners for its main offshore and onshore concessions, bringing in new firms such as China National Petroleum Corp and negotiating better terms. This lays the foundation to boost oil and gas output, with $109bn in investment planned until 2022.

Meanwhile, Dubai is preparing for Expo 2020 and making progress with a host of initiatives to become a global hub for the development and deployment of new technologies such as fintech, 3D printing and AI (see chart of the quarter on p4). Although these will only make relatively small contributions to the economy in the near term, they add to its prestige and support the core real estate, transport and tourism sectors.

UAE economic outlook

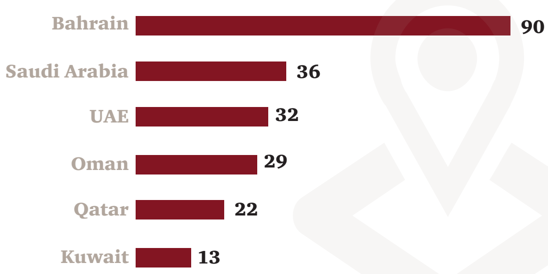


Source: IMF, WEO April 2018

Foreign investment: GCC raises ownership limits to catalyse diversification

For decades foreign direct investment (FDI)in the region has been limited to 49% stakes, in most countries and sectors, with even greater restrictions in equity markets and real estate. Minimum capital, local production rules and licencing processes also serve as barriers. The restrictions protected state-owned enterprises and merchant families, who have built large conglomerates by serving as the partners or sole distributors for foreign firms. Foreign investors came despite the limitations, given the appeal of rapidly growing economies, particularly during the oil boom years, and affluent consumers. However, lower oil prices since 2014 have led most Gulf countries to rethink the role of foreign investors as they look to ease fiscal burdens and restructure their economies for the twilight of the oil era. There is good evidence of positive links between FDI and growth in economies with similarities to the Gulf states, and their governments are particularly keen to leverage FDI to develop technology-intensive sectors. This is leading to a series of new investment and companies laws, updating decades-old legislation, as well as changes to capital market rules. We expect these reforms will lead to a pick up in both FDI, which in 2016 was barely a third of its 2008 peak, and also portfolio inflows.

Inwards FDI stock 2016 (% of GDP)



Source: UNCTAD

Permitting 100% ownership

Bahrain is the economy most dependent on FDI, with a stock of about 90% of GDP and has long permitted full onshore foreign ownership in many sectors, expanding it further in 2016 to tourism and mining, with remining restrictions only in a few areas such as media and workforce agencies.

Kuwait is at the other end of the spectrum, with just 12% of GDP in FDI, given its less diversified economy and weaker business environment. However, it has been an early mover in investment liberalisation, offering licences for 100% investment in many sectors such as infrastructure, tourism, IT and housing under a 2014 law; firms granted licences include giants such as IBM and GE.

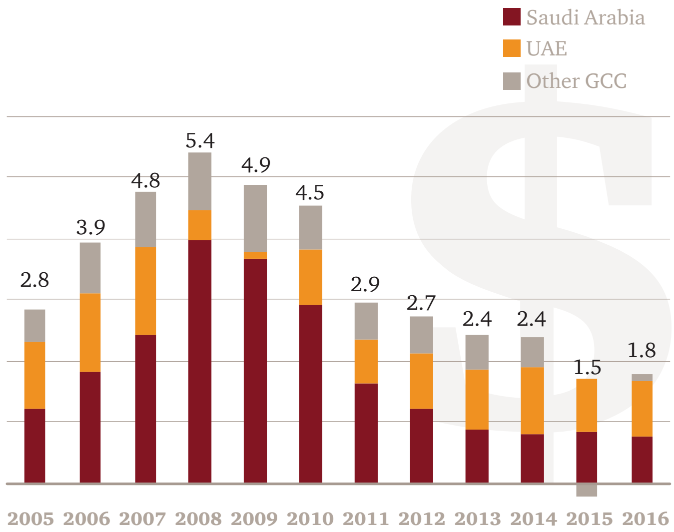
Oman has permitted 100% ownership for US firms since 2009 under a bilateral agreement, but limits other investors to 49%-70%, depending on sectors. However, a new draft law would permit any nationality to own 100%.

Qatar's cabinet approved a similar law in January, which had been in development since 2016 but may have gained fresh impetus in response to the regional boycott. FDI in Qatar peaked in 2009 at $8bn, during the country's gas-industrialisation, but averaged just $1bn/year in 2014-16.

The UAE is the region's largest destination for FDI, with annual inflows steady at around $9bn a year, much of this is directed into the federation's many free zones, such as Jebel Ali. His Highness Sheikh Mohammad Bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai recently announced key changes to the country's residency programme, including foreign investors in the country to be offered a 10 year residency visa, as well as 100 per cent business ownership. This move aims to boost FDI by up to 15%.

FDI in Saudi Arabia is mediated by SAGIA, which issues licences and determines ownership rules. It has been expanding the range of sectors where 100% ownership is permitted, adding retail and wholesale trade to the list in 2016 and engineering in 2017, as part of efforts towards the Saudi Vision 2030; in other approved sectors, only 75% is permitted. This relative openness, and the size of the Saudi economy, explain why it ranks second in the region for FDI penetration. It has also seen flows remain relatively strong in recent years.

Inwards FDI flows (US$bn)



Source: UNCTAD

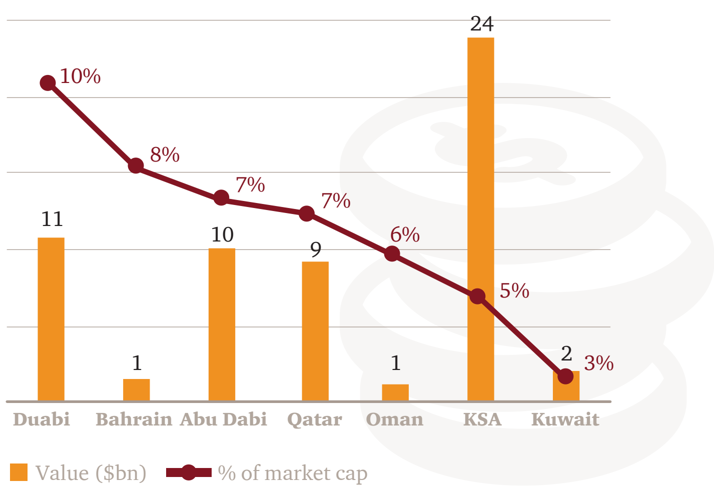
Emerging markets

Restrictions on foreign portfolio are also changing rapidly as Gulf countries look to attract capital into their markets to finance privatisations (such as Aramco) and help local champions to develop into multinationals. Saudi Arabia has been the laggard, opening up in stages, only permitting non-resident institutional investors to invest directly since 2015, and only then providing they meet strict qualification requirements, although they are steadily being eased. These and other market reforms caused FTSE Russell to decide in March to reclassify it as an emerging market, with the larger MSCI index expected to follow suit in May. Inclusion should drive sizable inflows, as happened in UAE and Qatar in 2014.

Foreign investors collectively are generally limited to holding 49% of listed equity, with individual companies sometimes having more stringent requirements (Abu Dhabi Islamic Bank, for example, does not permit foreign ownership). In March, large state-controlled firms in Qatar, such as QNB and Industries Qatar, announced plans to raise their foreign ownership limits to 49%, from 25%, sparking double-digit rallies in their stock price. This was despite the fact that their existing foreign ownership levels are modest.

Total foreign ownership of GCC equities stood at about $60bn at end-March 2018, about 6% of market capitalisation. In addition, other GCC nationals, not categorised as foreigners, are major investors, owning nearly 7% of the Abu Dhabi market, for example. The upgrade of the Saudi market may push it into the lead, a large part of existing foreign ownership is in historic strategic partnerships in various banking and industrial firms (e.g. HSBC's 40% stake in Saudi British Bank).

Foreign investment in GCC equities (latest data)



Sources: Local market reports (Qatar, Saudi, UAE), PwC estimates using Bloomberg data (Bahrain, Oman, Kuwait)

Data and projections: April 2018

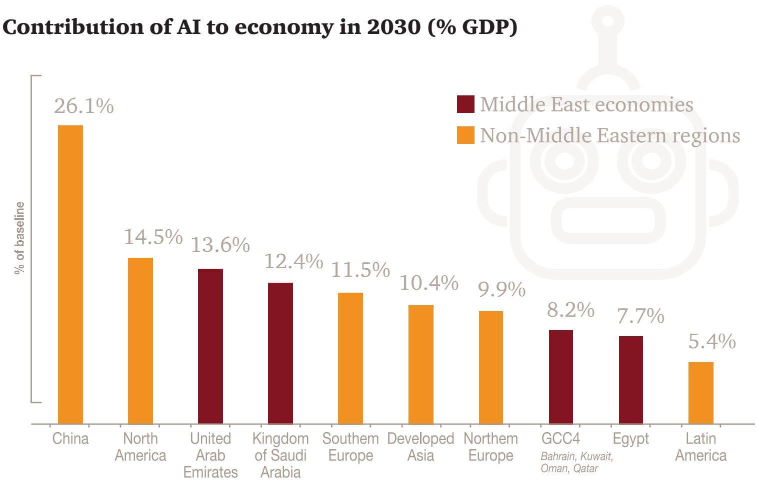
	GDP share 2017		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q4 - 17	2017	2018p	Mar - 18	2017	2018p	2017	2018p
Middle East	**100%**	**100%**	**-**	**1.3**	**2.6**	**3.5**	**4.4**	**5.7**	**-6.5**	**-4.5**
GCC	**61.2%**	**71.8%**	**-**	**-0.2**	**1.9**	**2.4**	**0.5**	**3.7**	**-5.4**	**-3.5**
Saudi	32.4%	33.7%	-1.2	-0.8	1.7	2.8	-0.8	3.7	-8.9	-7.3
UAE	12.5%	18.6%	-	0.5*	2.0	3.4	2.0	3.7	-1.8*	-1.4
Qatar	6.2%	8.2%	1.8	1.6	2.6	0.4	0.4	4.2	-1.6*	2.8
Kuwait	5.3%	5.9%	-	-2.9	1.3	0.6	1.9	3.9	4.0*	7.1
Oman	3.4%	3.7%	-	-0.3*	2.1	0.1	1.6	2.5	-11.4*	-5.7
Bahrain	1.3%	1.7%	3.4	3.9	3.0	2.6	1.4	2.9	-13.2	-11.6
Non-GCC	**38.8%**	**28.2%**	**-**	**5.1**	**4.5**	**6.5**	**14.6**	**10.9**	**-9.4**	**-7.3**
Egypt	21.9%	11.7%	5.3	4.2	5.2	13.3	29.6	20.1	-11.4*	- 10.0
Iraq	12.0%	9.7%	-	-0.1	3.1	0.8	0.2	2.0	-3.8	0.3
Jordan	1.6%	2.0%	1.8	2.0	2.5	4.4	3.3	1.5	-2.6	-0.4
Lebanon	1.6%	2.5%	-	1.2*	1.5	5.4	4.5	4.3	-7.3*	-10.6
Libya	1.2%	1.5%	-	55.0	16.4	18.7	28.5	24.3	-43.0	-39.3
Palestinian territories	0.4%	0.7%	5.4	3.1	3.0	-2.1	0.2	1.6	-8.4*	-7.8

Sources: PwC analysis, National statistical authorities, IMF (WEO, April 2018) estimates for 2017 (*) and projections for 2018. ^Libya inflation Feb-18, Iraq Dec-17
Notes: The Middle East region is defined here based on PwC's business coverage, excluding non-Arab countries and two conflict affected countries (Syria and Yemen).

Chart of the quarter

In a recent PwC report "The potential impact of AI in the Middle East", we estimated that Artificial Intelligence (AI) related technologies could contribute around $320bn to the region's economy by 2030, with the UAE and Saudi Arabia seeing the largest impacts, in both absolute and relative terms. The biggest benefits could be to the retail sector and public service delivery. The UAE was the first country in the world to appoint a Minister for AI, in October 2017, and also has a national strategy to take advantage of the emerging technology. The Gulf's high-capital economy combined with large amounts of low skilled labour make it particularly ripe for transformation from AI.

Contribution of AI to economy in 2030 (% GDP)



Sources: PwC Report: US$320 billion by 2030? The potential impact of Artificial Intelligence in the Middle East

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