Oil prices rebounded firmly in March-May 2019 as a result of strong compliance with production cuts by OPEC. The higher fiscal revenue and business confidence should underpin growth in much of the region, which seems to have been borne out by strong purchasing manager indices in the UAE and Saudi Arabia.

But oil is inevitably volatile, and as this report was going to publication in early June, the price was dropping back towards about $60/barrel, unwinding the gains of the previous three months. This was for a range of reasons including global growth concerns.

Already in April, the IMF had cut its forecast for global growth in 2019 to 3.3%, which would be the lowest rate since the financial crisis. Since then the breakdown of US-China trade talks and the growing likelihood of a “no deal Brexit” in the UK have added to the downside risks, which weighs on oil prices. At the same time, US oil production and inventory growth has continued to beat expectations. Nonetheless, the oil market could easily trend back up again in the second half of the year, depending in part on the outcome of the OPEC+ meeting in Vienna on June 25th. Irrespective of this, the non-oil economy will continue to exhibit positive trends in several countries.

Meanwhile, one area of concern is the onset of deflation in the GCC. The region as a whole recorded deflation in January to April, as prices declined in the three largest economies and only rose modestly elsewhere. This is the steepest price decline in decades, driven mainly by rents, but also affecting other sectors.

Deflation did ease in April, largely due to higher fuel prices, and may still prove to be a temporary quirk. However, there is a danger of deflation spreading to other sectors, as it has in Dubai, eroding corporate profits and harming growth.

This is not a foregone conclusion and a pause in interest rate rises in the US may give Gulf central banks a welcome opportunity to boost liquidity and mitigate deflationary trends.

Meanwhile, we continue to step back from the noise of the latest economic data to monitor more long-term trends that are relevant to the region. These include progress in integrating women in the workforce to unlock economic potential (see chart of the quarter).

In addition, in our economics blog series we looked at the shift in trade routes between Asia (particularly China) and Europe and Africa and their impact on the potentially disintermediated trade hubs in the region, above all Egypt and Dubai.
Better oil prices and PMIs point to firm non-oil growth in early 2019

Oil revives in March-May on OPEC cuts

The oil market initially appeared sceptical about the latest round of OPEC+ oil cuts, and Brent crude slipped another $10 in the weeks after its aftermath of its announcement to a low of just $50 in late December. However, this lost ground was quickly regained in early January, following signs that Saudi Arabia was cutting even more deeply than pledged.

A steady rally continued during Q1, pushing oil to a peak of $75 in late April, as Saudi overcompliance increased (to 275% in April) and the other participating Gulf states also achieved at least 100% compliance and even Iraq, usually a laggard, neared full compliance. OPEC voluntary cuts totaled 1.2m barrels/day (b/d) in April, 150% compliance with the cut targets and Russia also moved towards compliance.

Oil prices were further boosted by geopolitical developments affecting three OPEC countries which were exempt from the cuts–Iran, Libya and Venezuela. US sanctions began to bite in Q1, further harming Iranian oil output, particularly after sanction waivers on the purchase of Iranian oil to several Asian countries were unexpectedly ended in May. US sanctions have also contributed to the loss of about 400k b/d from Venezuela’s oil output in February. In Libya, output neared a recent peak of 1.25m b/d in May but ongoing conflict around the capital, Tripoli, means this remains vulnerable.

In May, most major OPEC+ producers remained in compliance with cuts, and Russia achieved compliance for the first time. However, the Saudi overcompliance eased. Also, Iraqi production rebounded back to its October benchmark level. Overall, OPEC’s aggregate cuts narrowed to 0.8m b/d (May data was not yet available for most non-OPEC countries at the time of publication). However, the impact of higher production on prices was mitigated for most of May by an additional geopolitical risk premium following attacks on oil tankers off the UAE and on the largest Saudi oil pipeline.

Oil outlook hinges on June meeting

Aside from the geopolitical developments, the outlook for oil for the rest of the year hinges on two things. Firstly, the trajectory of the global economy, which seems to be slowing and faces challenges from the US-China trade talks.

The second factor will be whether the oil ministers meeting in Vienna in June decides to end or extend the OPEC+ cuts. Saudi Arabia has signalled support for extending the cuts to year-end. However, Russia has repeatedly indicated that it wants to lift production to avert further price rises, which could encourage US shale production. US shale has already surged by a third to 12m b/d in the last two years, offsetting OPEC+ cuts, and in March Exxon announced ambitious plans to boost its Permian Basin output by over 1m b/d.

Russia also has a lower fiscal breakeven oil price than Saudi Arabia and many of the other OPEC states, which means that their short-term priorities may differ, irrespective of their views about how action today may impact long-term prices.

2018 ends well for many

Many countries in the region that publish quarterly GDP saw strong Q4 results. For Bahrain (4.6%) and Saudi Arabia (3.6%) this was largely due to higher oil output, although both countries did also see an acceleration in non-oil growth, to 3.2% for Bahrain and 2.0% for Saudi Arabia.

There was also strong performance for Egypt (5.5%) and Palestine (3.4%). However, Jordan (1.8%) is struggling with fiscal austerity and Qatar (0.3%) suffered LNG maintenance downtime and a slowing non-oil sector.

Real GDP (% change y/y)

Source: National statistics, PwC

PMIs mainly look positive in 2019

Although the oil cuts inevitably depressed Q1 GDP (data on this should be available by late-June or early July), higher oil prices have boosted government revenue and business confidence. This should feed through into the non-oil sector.

Purchasing Manager Indices (PMIs) are a useful lead indicator and signal very robust expansion in Saudi Arabia and the UAE. Qatar, however, has been fluctuating around the neutral level of 50 points. Egypt had been even weaker during Q1 but its score in April rose solidly to 50.8, the highest since 2015.

Source: IHS Markit
Deflation persists for Gulf economies

At the start of 2019, the GCC’s two largest economies, Saudi Arabia and UAE, suddenly fell into deflation. Qatar was already in a period of deflation, which has continued, and the other Gulf states have only been experiencing very mild inflation. Taken as a whole, this means that consumer prices in the GCC overall fell into deflation for the first time since 2000 and are in the steepest period of decline in many decades. There was a shift from 1.3% y/y inflation in December to -1.6% deflation in January, deepening to a low of -1.8% y/y in February, before easing to -1.4% in April. (We have estimated regional inflation by weighting each country according to its nominal GDP at purchasing power parity (PPP), the methodology used by the GCC’s in-house statistical agency. A different weighting method, such as by population, would give a broadly similar result.)

VAT masked the trend

The sudden decline caught some forecasters by surprise. For example, as recently as October 2018, the IMF was expecting 2.0% inflation for Saudi Arabia in 2019 and 2.4% for the GCC overall. Its updates published in the April World Economic Outlook adjusted this down to -0.7% deflation for Saudi Arabia and 0.5% inflation for the GCC. However, even these may prove to be an underestimation of the trend, which could result in overall GCC deflation for the year.

Part of the reason that the deflationary trend seemed surprising is that the introduction of VAT in UAE and Saudi Arabia in 2018, together with cuts in fuel subsidies and excise taxes in some countries, masked underlying trends. The 5% VAT rate probably added about 3 percentage points to inflation in Saudi Arabia and 2 points in UAE (owing to a narrower scope than Saudi Arabia and household expenditure that is skewed more heavily towards VAT-free items such as rent). If the VAT impact were excluded, Saudi Arabia would have likely suffered deflation in 2018 (as it did for most of 2017) and the GCC as a whole would have seen flat prices.

Within the UAE, a significant gap has opened up between Dubai and Abu Dhabi. Dubai is undergoing the sharpest deflation in the region, (peaking at -3.9% y/y in February) whereas the price decline is much milder in Abu Dhabi. This is a notable shift, because as recently as late 2017 Dubai was experiencing higher inflation than Abu Dhabi.

Rent drives deflation

The predominant driver of deflation is rents, which saw both the largest decline (5.6% overall in April) and is the largest component of the regional Consumer Price Index (CPI) basket (28%). A confluence of factors is causing this, including oversupply of property and a decline in expatriates in places (particularly as a result of Saudi nationalisation efforts). Saudi rents are down the most, by 7.8% y/y in April. Although Dubai’s decline is not quite so steep (-6.3%), rent and utilities comprise 44% of its CPI basket, compared with just 25% for Saudi Arabia, meaning the impact is greater. Rents were also down in Abu Dhabi (-3.6%), Qatar (-2.7%) and Kuwait (-0.5%) and Oman (-0.2%).

During the first quarter, transportation saw the second largest decline (-1.8% y/y in Q1) and made the next largest contribution to overall deflation. However, this was a temporary factor owing to the dip in oil prices in December and January, as the UAE and some others now set domestic fuel prices on a monthly basis, and fuel rebounded to inflation in April (though just 0.1% y/y). There were also declines in communications, clothing and miscellaneous goods and services. Food prices, the second largest component of the CPI, are in deflation in UAE and Qatar but rising elsewhere.

Policy offsets

The regional deflation has happened despite the introduction of VAT in Bahrain and excise taxes in Qatar and would have been even steeper without these measures. There will be further policy boosts to prices later this year, including excise taxes in Oman from June 15th. However, the region may see flat or falling prices for the year as a whole. Dubai stands out because its deflation is broad-based, spanning 83% of its CPI basket. This may be due to its more competitive economy and could provide advanced notice of trends that will hit other countries later in the year. Overall, deflation is a boon for consumers but will squeeze corporate profit margins and could stifle investment and growth.
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Data and projections: May 2019

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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

Our Women in Work report, which surveyed over 3,000 men and women across the UAE, KSA and Egypt, provides insights on the regional workforce and where we can improve gender diversity.

The majority in UAE and KSA felt positive about progress in national women’s empowerment programs. And more felt that there is equality in promotion in the UAE than in Egypt and KSA.

There have been significant improvements in some countries, with Kuwait and Qatar now both achieving 58% female participation, on par with Denmark. Other countries, like KSA, have active social reform programs underway.

Women in Work survey (% agree)

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<td>UAE</td>
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Source: PwC

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