



Middle East Economy Watch

After a difficult 2016, many economies look firmer and present immediate and long-term opportunities



We are delighted to present PwC’s first regular economic bulletin on the Middle East. It builds on a range of similar publications we publish on the global economy and various countries and regions.

The goal is to present a few easily digestible insights that we hope will be of value for your business. We welcome any feedback on the kinds of topics you’d like to see us cover in the future.

Oil prices remain the dominant theme currently driving most Middle Eastern economies. Despite historic collaboration on output cuts by OPEC and non-OPEC exporters (extended to March 2018 at the 25 May meeting), global inventories remain stubbornly high and US shale output is rebounding.

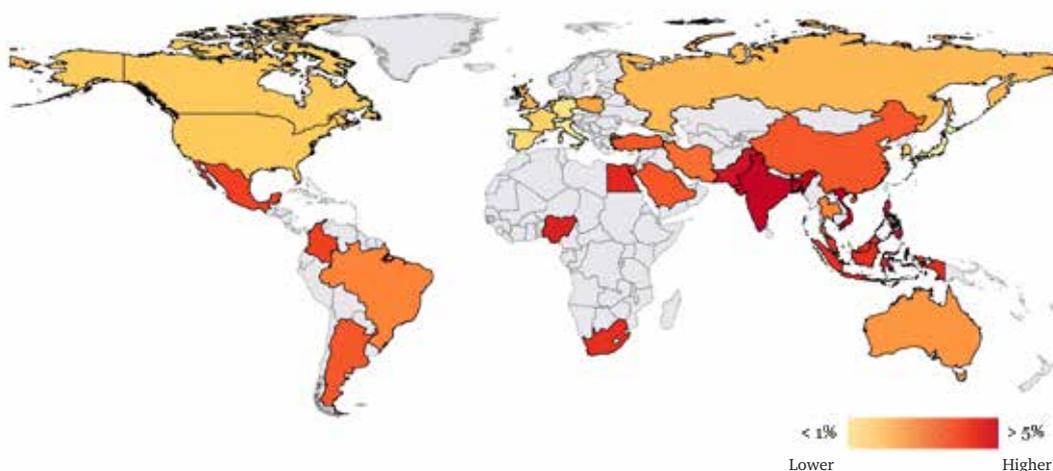
As a result, prices still remain well below break-even levels for most oil exporters and fiscal reform and deficit financing will continue to be key policy priorities in 2017.

This environment creates challenges for business, such as managing new taxes. However, there are also opportunities, particularly as the major Gulf economies look for alternative sources of financing. This includes the debt markets and privatisation initiatives, most notably Saudi Aramco’s 2018 IPO.

There has also been growing interest in public-private-partnerships (PPP), with more countries developing supportive legislative frameworks and preparing project tenders.

PwC recently stepped back to take a long-term view in our World in 2050 report. Our forecasting exercise helped shed some light on what we call “pockets of opportunity”: smaller economies which also have bright prospects. In the Middle East, we looked initially at Egypt and Saudi Arabia, and this issue highlights their growth potential.

Average annual growth rate, 2016-2050



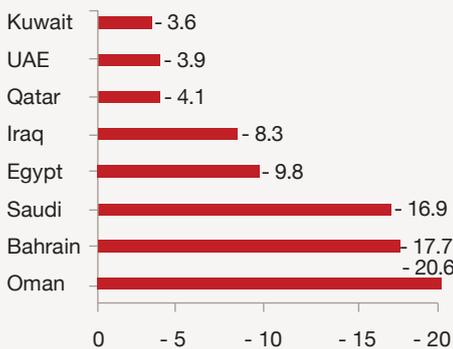
Source: PwC World in 2050

Economic update: 2016 was probably the low point for oil exporters

Deficits across the board

It seems likely that 2016 marked the low point in the current oil price cycle, with Brent crude averaging just \$44/barrel, the weakest in nearly two decades, in inflation adjusted terms. This resulted in large fiscal deficits for oil producing countries, including those that had previously posted many years of surpluses. The Gulf Cooperation Council (GCC) collectively saw a deficit of around 11.1% of GDP, ranging from an estimated 3.6% for Kuwait (boosted by an April-March fiscal year, skewed towards a period with higher oil prices than the calendar year) to a burdensome 20.6% for Oman.

Fig 1: Fiscal balances in 2016 (% GDP)



Source: National statistical agencies, IMF

Fiscal reforms focus on expenditure

Most countries pushed through quite aggressive fiscal reforms in response to a third year of lower oil prices. Energy subsidies were cut across the board in the GCC, even eventually in Kuwait, despite parliamentary opposition, which served to nudge up inflation (to a GCC average of 2.8%). There were also major cuts in expenditure, notably in Saudi Arabia, which dampened the non-oil sector and saw real GDP growth decline to about 1.8% in the region.

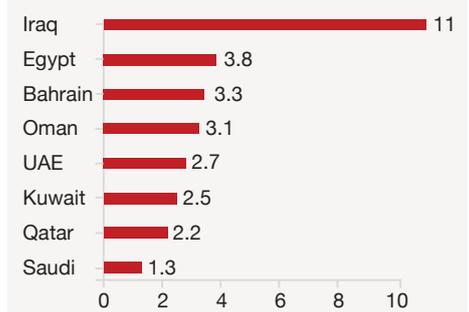
Although tax reforms were discussed in a number of countries, including controversial measures such as remittance taxes on expatriates, there were few new measures actually implemented during 2016. There were some easy to implement measures, such as increasing fees for government services, but introducing new classes of tax is both politically and technically difficult, and Gulf finance ministries are already stretched in preparations for the launch of VAT in 2018.

Oil output varies widely

Some countries opened the pumps in 2016 to maximise oil revenue while others suffered from maintenance outages, notable in Qatar where the giant Pearl gas-to-liquids plant faced technical problems in Q4 contributing to an annual decline in its oil sector GDP.

Outside the GCC, prior investments caused Iraq's production to rocket so much that its overall GDP grew by about 11%, according to the IMF's latest estimate, despite a further non-oil contraction resulting from the war with Islamic State and austerity. This was possible because most of Iraq's facilities are well removed from conflict zones, unlike in Libya, where civil war periodically inhibited oil exports and contributed to a fourth consecutive year of contraction.

Fig 2: Real GDP growth in 2016 (%)



Source: National statistical agencies, IMF

Oil importers see direct benefit from low oil, but there are hidden costs

The oil importing countries, such as Egypt and Jordan, received an immediate benefit from low oil prices, reducing their current account deficits and inflation. However, although low prices helped ease subsidy costs in places, sizable structural fiscal deficits remain in some countries, particularly Egypt.

The low oil price environment is also having some negative indirect impacts on the importing countries because of their deep links with the GCC through remittances and exports, as well as aid and investment flows. Meanwhile, domestic challenges had a significant impact in these countries, ranging from the sharp depreciation in the Egyptian pound, after its depegging in November, to weaker fiscal support from donors to Palestine.



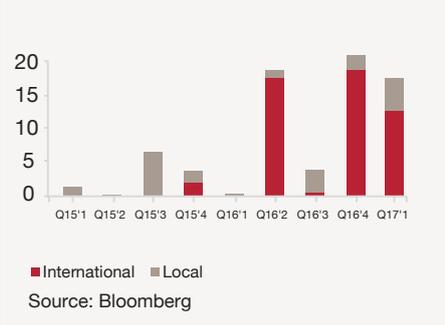
Gulf countries look to international investors for financing

The wealthier oil exporters had become used to consistently high oil revenue for most of the last decade, funding vast infrastructure investment programmes. However, they are now looking for new means of financing, as it has become increasingly accepted that lower oil prices are here to stay. This will continue to be a focus in 2017 and beyond as even if prices improve slightly on 2016 (around \$50-60 is widely viewed as a likely level during the next few years), most countries will still be facing fiscal deficits.

The first step was to tap the international bond markets, so as not to crowd out private sector borrowers domestically, as local banks are already being stretched by reduced oil revenue deposits. (Saudi deposits returned to y/y growth in March 2017, after having been in decline for most of the previous year – the first declines since 1995.) While some countries, notably Qatar, had a track record of issuance even during the boom times, others had long steered clear of the debt markets.

October 2016 saw the first issuance by Saudi Arabia, an emerging market record of US\$17.5bn, and Kuwait followed with its own \$8bn debut in March 2017. \$45bn in sovereign bonds were issued in the GCC in 2016, nearly quadruple the level in 2015, with a further \$18bn in Q1-2017.

Fig 3: GCC sovereign bond issuance (\$bn)



Another major Saudi issuance is expected later this year and most others are also likely to return to the market. Qatar, however, has said that it might not need to go to markets if oil prices remain close to its fiscal breakeven level (which the IMF projects is \$53).

Another source of financing is through asset sales, whether securities held by sovereign wealth funds or the part-privatisation of state-owned companies. There was initially some scepticism about Saudi plans to IPO Aramco, but serious moves have been made towards a 2018 dual listing on the Tadawul plus a major global exchange, including hiring advisors and cutting its tax rate from 85% to 50%, which significantly boosts its potential market value.

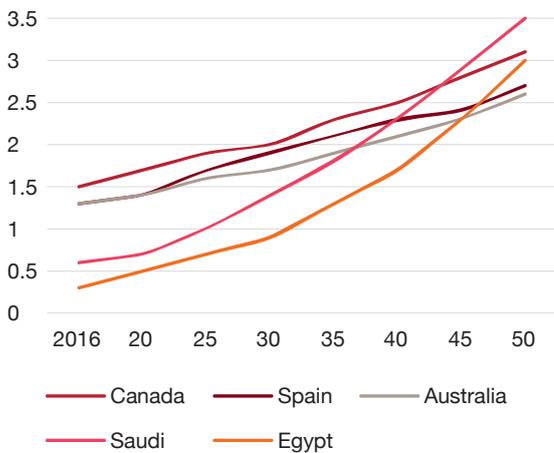
Many other privatisations are planned in Saudi, from flour mills to electricity, and this could add impetus to long-standing plans to sell off stakes in state-owned firms in Oman, Bahrain and Kuwait.

Now that Gulf governments have less capacity to finance infrastructure projects, significant steps have been made towards developing PPPs. Qatar is expected to finalise a PPP law by the summer, similar to ones enacted recently by Dubai and Kuwait, and Oman is also drafting one. Saudi Arabia lacks a formal legal structure, but is already moving ahead with PPP tenders, including one signed in March to build a new terminal at Yanbu airport, and its new National Centre for Privatisation will accelerate the trend. Meanwhile, Kuwait is tendering wastewater plants and Qatar is considering a PPP model for one of its World Cup stadiums.

The flurry of activity in debt markets, privatisation and PPPs has only just got started and should generate interesting business opportunities in the next few years and help to partially rebalance the roles of the state and private sector in the GCC.

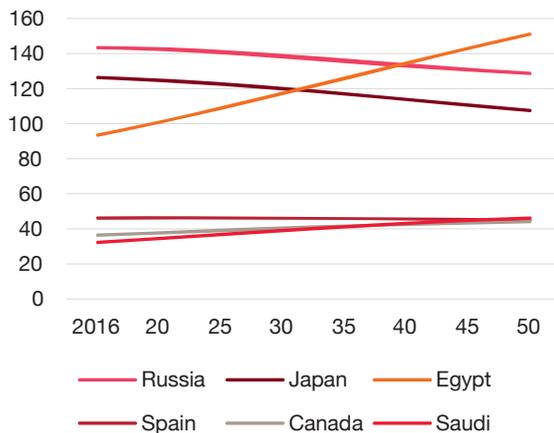
Pockets of Opportunity: Egypt and Saudi Arabia in 2050

GDP (\$ trillion, MER)



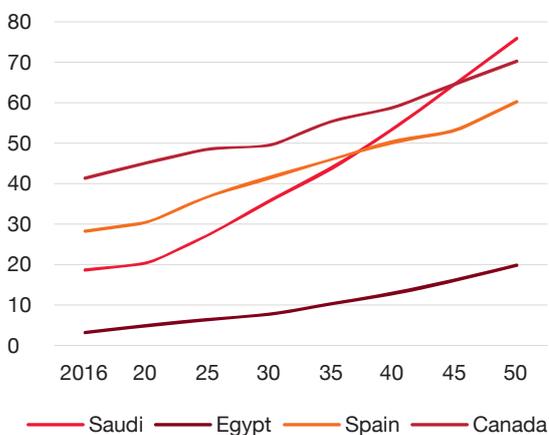
Source: PwC analysis

Population (million)



Source: PwC analysis, UN

GDP per capita (\$ thousands, MER)



Source: PwC analysis, UN

Global rebalancing

The Middle East has already been profoundly influenced by global rebalancing since the start of the 21st century, as the region's trade and investment flows shift increasingly towards emerging markets such as China and India. These trends will continue in the coming decades, and PwC's World in 2050 report provides some projections of the potential shifts that could take place for the world's 32 largest economies.

A handful of major emerging economies are set to leapfrog most of the G7 countries to become the largest players in the global economy, further entrenching their importance as partners for the Middle East. In addition, there is a second tier of emerging economies that have significant growth potential - what we call "pockets of opportunity" - including Saudi Arabia and Egypt in the region. Also among this tier are countries that are likely to become increasingly important trade partners for the region, such as Pakistan and Vietnam.

Expanding GDP and population

The projections show that by 2040 Saudi Arabia is expected to grow larger than three major developed economies - Canada, Spain and Australia - and Egypt will also surpass two of them by 2050. The rise of these two countries is a result of both higher population growth and rising per capita incomes.

Our projections see Saudi's population growth averaging 1.1% a year over the 34-year forecast period. This brings its population to 46m by 2050, ahead of both Spain - whose population is expected to decline slightly owing to falling fertility rates - and Canada, which we see growing, but only at about half Saudi's rate. Egypt's expected population boom is even more dramatic given its youthful population and high birth rates. It is projected to grow at an average of 1.4% a year to 151m in 2050, pushing it well ahead of Russia and Japan, two countries that are much larger today but are already firmly locked into long-term fertility decline.

Higher incomes

The expansion of the global economy over the next generation is expected to see average incomes rise in most countries, both because of inflation and also in real terms. However, the rates of increase are not expected to be uniform. Whereas developed countries such as Spain and Canada will only see incomes roughly double, only slightly outpacing inflation, the increases in many emerging economies will be much greater.

We see Saudi's GDP/capita increasing by more than 4-fold, moving it ahead of both Spain and Canada, and several other developed economies. Although Egypt will still remain a middle-income country in 2050, its growth rate is expected to be one of the highest among major economies, with GDP/capita rising by over 6-fold during this period.

Megatrends

Last year, we conducted a more qualitative long-term outlook exercise, which complements these World in 2050 results. It considered the implications for the region of five megatrends - demographic and social change, urbanisation, shifts in global economic power, climate change and resource scarcity, and technological breakthroughs.

The report highlighted challenges, such as aging - with elderly nationals expected to comprise 20% of the GCC population in 2050, from just 2% today - and potential transformative changes, such as the expansion of solar power, which is expected to replace hydrocarbons in meeting two-thirds of the Middle East's domestic power supply by 2050.

Thinking about these trends can help businesses identify market opportunities. An aging population in Saudi Arabia, for example, will require new health care and recreational services.

Risks and uncertainties

Of course, the road to 2050 will not be as smooth as the lines on our graphs suggest. There will be global booms and recessions, periods of oil price volatility and other developments that cause blips in the road. While demographics are relatively predictable, political and technological change are major wildcards. In fact, these are not unconditional forecasts but rather projections of potential growth conditioned on the assumption of broadly growth-friendly policies being pursued. Nevertheless, understanding the rough trajectory helps inform business decisions, particularly long-term investments.

Data and projections: May 2017

	GDP share 2016		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	2016	Q16 - 4	2017p	2016	Mar - 17	2017p	2016	2017p
Middle East	100%	100%	3.0	-	2.0	4.5	6.0	6.8	- 11.1	- 6.9
GCC	62.0%	68.3%	2.0	-	1.0	2.8	1.1	3.4	- 11.1	- 6.1
Saudi	32.8%	31.8%	1.3	1.2	0.4	3.5	- 0.4	- 3.8	- 16.9	- 9.8
UAE	12.5%	18.5%	2.7	-	1.5	1.6	3.0	2.8	- 3.9	- 2.6
Qatar	6.2%	7.8%	2.2	1.7	3.4	3.0	0.9	2.6	- 4.1	- 3.1
Kuwait	5.7%	5.5%	2.5	-	- 0.2	3.2	2.6	4.2	- 3.6	3.6
Oman	3.5%	3.1%	3.1	-	0.4	1.1	2.8	4.1	- 20.6	- 10.0
Bahrain	1.3%	1.6%	3.3	1.1	2.3	2.3	0.8	1.3	- 17.7	- 12.2
Non-GCC	38.0%	31.7%	5.0	-	4.2	8.1	16.9	14.1	- 11.1	- 8.7
Egypt	21.2%	16.5%	3.8	3.8	3.5	13.8	30.9	22.0	- 9.8	- 10.9
Iraq	12.1%	8.3%	11.0	-	- 3.1	0.4	0.3	2.0	- 8.3	- 4.2
Jordan	1.6%	1.9%	2.1	-	2.3	14.2	4.3	2.3	- 3.4	- 2.9
Lebanon	1.6%	2.6%	2.0	2.0	2.0	- 0.5	5.1	2.6	- 8.1	- 8.8
Libya	1.0%	1.7%	- 4.4	-	53.7	- 0.8	N/A	32.8	- 53.4	- 16.4
Palestine	0.4%	0.7%	4.1	1.3	3.5	- 0.2	1.7	1.3	- 5.6	- 7.6

Sources: PwC analysis, National statistical authorities, IMF (mission reports and the World Economic Outlook). All inflation indicators relate to the Consumer Price Index (CPI). Only 6 countries publish quarterly GDP data. 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

The Middle East countries which have a quarterly Purchasing Managers Index (PMI) - this is an advance indication of the private sector economy using variables - all show an ongoing upswing in Jan-Apr 2017, which are positive lead indicators of improved economic growth. Saudi and the UAE are showing strong expansion, close to their two-year highs. Although business activity continues to decline in Egypt (a reading below 50), this is much less pronounced than in Q4 2016.

Chart of the quarter: Regional PMI indices trend up in 2017



Sources: PwC analysis, Markit and Emirates NBD

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