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ECONOMIC INSIGHT

MIDDLE EAST

Quarterly briefing May 2011

FUTURE OUTLOOK – CAN THE MIDDLE EAST DECOUPLE FROM THE GLOBAL ECONOMY?

Welcome to the first issue of the ICAEW *Economic Insight: Middle East*, a new quarterly economic forecast for the region prepared directly for the finance profession. Produced by the Cebr, ICAEW's partner, and acknowledged experts in global economic forecasting, it provides a unique perspective on the prospects for the Middle East region as a whole and for individual economies against the international economic background. We focus on the Middle East as being the Gulf Cooperation Council (GCC) member countries (United Arab Emirates, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait), plus Egypt, Iran, Iraq, Jordan and Lebanon (abbreviated to GCC+5)¹.

All eyes have been on the Middle East in recent months because of the Arab Spring. How will this affect the economy? If so, over what timescale? What will happen to the region's economies as oil pushes towards record price barriers? Can the Middle Eastern economies decouple from the global economy or are they fundamentally dependent on growth elsewhere? We also look at why growth in the region lags behind other emerging economies and if this is set to continue.

THE MIDDLE EAST AND THE GLOBAL ECONOMY – DRAMATIC CHANGE IN THE FUNDAMENTALS

We think that two of the fundamental factors affecting the Middle East have changed dramatically this year.

THE ARAB SPRING IS LIKELY TO LEAD TO FISCAL EXPANSION WHERE POSSIBLE

First, the Arab Spring has changed the underlying political dynamics and this will have an economic effect on the whole region. One obvious point is that some economies have been disrupted during the course of the popular uprisings, affecting production levels. On the other hand, there will be a boost to growth as output returns to more normal levels. But a longer term impact is that new or even existing governments are likely to have to adopt more politically popular programmes, which will mean more fiscal expansion in those countries with sufficient budgetary flexibility.

THE OIL PRICE WILL FLUCTUATE BUT AT A HIGHER LEVEL

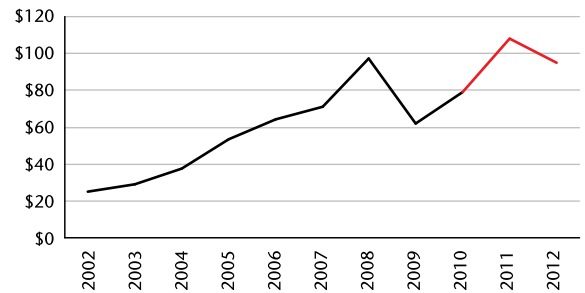
Second, the underlying dynamics of the oil market have changed. Until now there has been downward pressure on prices from some producer governments wanting to take a very long-term view of demand and being reluctant to allow the price of oil to go so high that it encourages substitutes. There has also been political pressure from the US to keep the price down. Now, popular unrest has forced some producer governments to shorten their horizons and the political influence of the US has diminished.

In addition, producers have in the past taken a cautious view about the elasticity of demand and have been concerned about raising prices too high for fear of choking off demand. The growth of the emerging economies has changed the tradeoff between price and demand and implicitly permitted the prospect of a higher price without damaging demand excessively.

OIL PRICE LIKELY TO FALL IN 2012 BUT TO REMAIN MUCH HIGHER THAN IN THE RECENT PAST

Our central view is that the price of oil is likely to fall back in the second half of 2011 and into 2012 as markets eventually respond to weaker growth in demand. [Figure 1](#) illustrates our latest projection for the price of oil, reflecting a cooling in global demand.

Figure 1: Oil price, simple average of three spot prices², \$ per barrel



Source: IMF, Cebr *prospects service* forecasts

However, the price could rise further, if the political situation causes disruption to production in a major oil producer. We would not rule out the price breaking through the \$150 a barrel mark, though our calculations of demand elasticities suggest that \$200 is the highest possible price in the short term and even that could only be sustained for a temporary period.

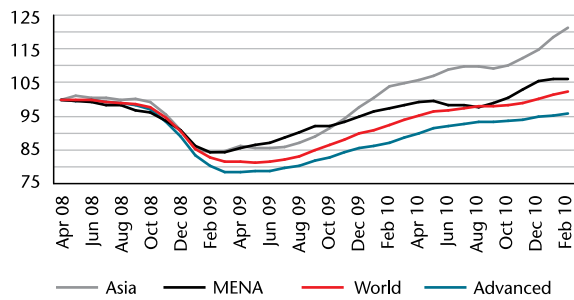
Ultimately, the higher oil prices provide a positive environment for the Middle East oil exporters – but we think there could be some downside on the oil price in the months ahead, which needs to be factored into growth forecasts. Indeed, the precipitous fall in oil prices in early May (which followed this forecast) suggests markets are now pricing in weaker global demand growth and the end of US monetary policy stimulus in the summer. Nevertheless, the prices are likely to remain high enough to encourage further investment to expand production capacity.

POLITICAL UNCERTAINTIES AND EXPORT WEAKNESS LINGER FOR MIDDLE EAST ECONOMY

Beyond the boom in the oil economy, there is a longer term issue. Relatively weak productivity levels and export performance by international standards in the non-oil economy remains a major concern for fundamental growth prospects in the region.

The Middle East and North Africa (MENA) saw a 19% peak to trough decline in the volume of imports and exports following the global recession. Trade volumes had recovered strongly in the region, surpassing the pre-recession peak in December 2010. However, there was a sharp decline in MENA trade in January 2011, as imports declined by 8.4% in January from December, probably reflecting the effects of political unrest on economic activity, although trade recovered some ground in February.

Figure 2: Export volume index; three month moving average; April 2008 = 100



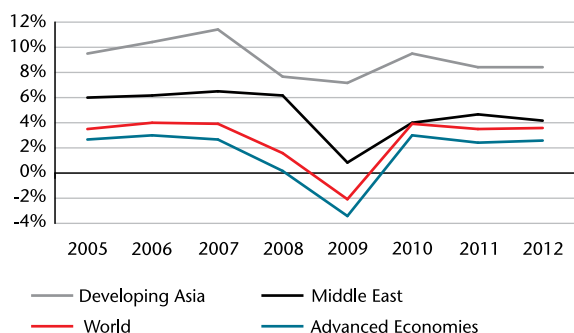
Source: CPB Netherlands Bureau of Policy Analysis, Cebr analysis

Moreover, in general the pace of growth in trade volumes – as distinct from values which are boosted by the oil economy – has been weaker in MENA than elsewhere. Export volumes from MENA grew by 8.8% over the quarter to February compared with the same period a year earlier. This is a far weaker pace of growth in export volumes than in emerging markets as a whole (at 14.5%) and Asia, where quarterly annual growth was 16.8% in February. **Figure 2** illustrates that the pace of recovery in the MENA region is closely aligned with global growth but that export growth has lagged behind Asian growth through the recovery.

THE MIDDLE EAST OUTLOOK: GROWTH CONTINUES AS THE WORLD ECONOMY COOLS

The Middle East economy saw a return to solid growth in 2010 in line with the recovery across the global economy. However, while the global economy now shows clear signs of slowing down, we expect growth across the GCC+5 to rise in 2011, despite some loss of production in the early part of the year in Egypt. This is supported by a rising oil price and higher Middle East oil production, and

Figure 3: Real economic growth in the Middle East (GCC+5), World, Advanced and Developing Asia economies, annual percentage change



Source: Cebr analysis and IMF World Economic Outlook

surpasses the modest pace of expansion seen in the advanced economies and indeed the overall pace of growth across the global economy. The GCC countries in particular will benefit from the high oil price, rising production and trade surpluses. However, we think that overall growth in the Middle East will continue to lag behind the robust performance seen in Developing Asia (see **Figure 3**).

Looking further ahead, we expect the global economy to slow down in 2012 due to monetary and fiscal policy headwinds in response to both inflationary pressures (partly caused by the rise in the oil price) and public sector deficits. The consequent effect on global demand and oil prices is expected to cause growth across the Middle East to fall back slightly in total in 2012 although for eight of the countries covered growth will be faster.

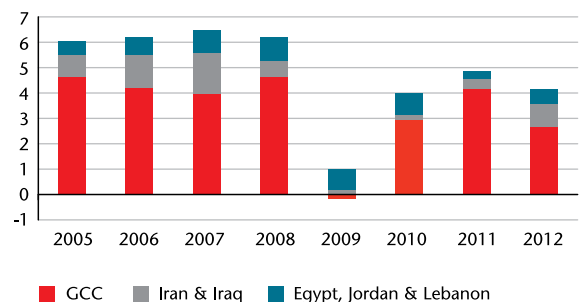
However, the overriding unknown is how the political situation across the Middle East and North Africa will evolve in the coming months. This has created an unusually uncertain outlook – there is a downside to our forecasts if popular unrest disrupts production but there could also be an upside if greater fiscal expansion takes place either in response to, or to head off, popular unrest.

CAN THE MIDDLE EAST DECOUPLE FROM GLOBAL GROWTH?

Central to our view on the growth fundamentals is that the non-oil parts of the economy still tend to lag behind. Indeed, the GCC countries – major oil producers – will drive an estimated 87% of the growth in the Middle East in 2011, as illustrated in **figure 4** below. Growth in the Middle East is closely tied to overall growth in the global economy; to break this link stronger productivity growth will be necessary.

The region needs to become much more open to the global economy and further improve the business environment. Illustrating this, most of the

Figure 4: Contributions to Middle East growth – percentage points



Source: IMF, Cebr analysis

region's economies rank relatively low on the World Bank Doing Business Survey; although some have made good strides forward in recent years.³ As long as these structural problems persist, beyond the oil economy, growth in the Middle East will struggle to take off and match, for example, growth seen in Developing Asia over the last few years.⁴

OIL EXPORTERS BOOM AS GROWTH PICKS UP IN 2011

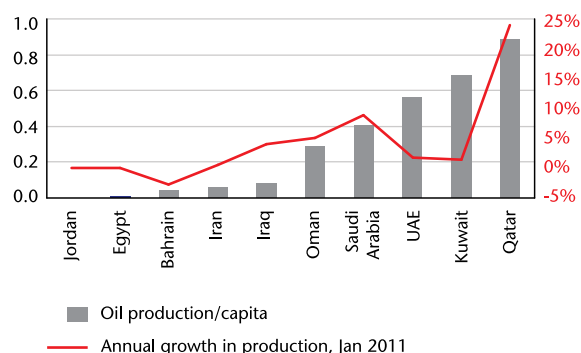
The extent to which the boost from higher oil prices stands to affect each economy varies considerably; **figure 5** illustrates oil production per head of population in the oil exporters within the GCC+5. The economies of Saudi Arabia, Kuwait, Qatar and the United Arab Emirates have the highest ratio of oil production to population and the latest data show that production is growing fastest in Qatar, followed by Saudi Arabia, Oman and Iraq – also in **figure 5**.

Given the above, we expect the main oil exporters will experience the strongest growth in 2011, with double digit real GDP growth in **Qatar** and 8% growth in **Iraq** (see **figure 6** for individual country projections). We expect robust growth to continue in Iraq in 2012 as rebuilding activity gathers pace and oil capacity comes back – the latest data suggest that output is still around 14% below the peak level before the war.

Oman accounts for 1.0% of global oil output, so stands to gain considerably from higher oil prices. In Oman, oil production is up by 4.2% year-on-year and while the economy is relatively small as a share of the GCC+5 at 3.1%, we expect solid 4.0% growth in 2011 and slightly lower in 2012. In **Kuwait**, there was a large downturn in 2009 as oil production declined sharply but output has risen steadily to stand around 10% below pre-recession lows. We expect robust GDP growth at 4.5% and 5.0% in 2011 and 2012 respectively.

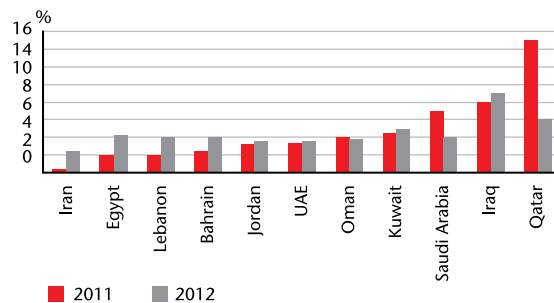
In the **United Arab Emirates**, the GCC+5's third largest economy, growth is expected to be a solid 3.3% in 2011, edging up from 2010 but a way below the robust growth seen in the decade before the credit crunch. Given the economy's size after a decade of strong expansion, even with growth slightly stronger at 3.5% in 2012, this is still enough to drive 0.6 percentage points of the 4.2% growth across the region that year.

Figure 5: Oil production per head of population (million barrels per day per head) and annual growth in oil production, January 2011, quarterly annual percentage change



Source: US Energy Information Administration, IMF, Cebr analysis

Figure 6: Real GDP growth across Middle East economies, annual percentage change



Source: Cebr analysis

EXPANSIONARY FISCAL POLICY IN SAUDI ARABIA WILL BOOST GROWTH

The government of **Saudi Arabia** is to push on with a major expansion in public spending. King Abdullah first announced a \$36bn expansion in spending in February and has followed this up with a \$130bn package in March. We expect this to result in far stronger growth in 2011 at 7% – the highest since 2003 – while robust growth around 4% is expected in 2012, but there are upside risks to this.

The Saudi spending plans involve the creation of additional public sector jobs, higher wages for public sector workers and building an additional 500,000 homes. None of these measures are likely to significantly improve productivity and hence long-run growth but will certainly provide a significant short-term boost to economic activity.

POLITICAL UNREST AND INFLATIONARY PRESSURES ARE DOWNSIDE RISKS

The political circumstances are likely to impede growth in **Bahrain** and **Egypt** through 2011 and pose risks to growth across the region. However, looking ahead, the political protests could, in a strange way, drive growth as the governments are focused on promoting economic growth for educated populations that are seeking work. Hence, we expect growth to pick up to around 4% in both Bahrain and Egypt in 2012.

In **Lebanon**, political concerns remain and the third weakest performance in the region at 2.0% growth is expected in 2011, although we expect growth to pick up slightly in 2012. In non-oil exporting countries like Lebanon and **Jordan**, growth is highly dependent on export market competitiveness. The latest data show signs of promise with 18.3% year-on-year growth in Jordan's exports. However, we expect growth to come in below the Middle East trend at 3.2% in 2011, rising to 3.5% in 2012.

Across the Middle East, inflationary concerns remain significant – as throughout the global economy. In March, the annual rate of inflation in Egypt was 11.5%; higher than in India and Brazil. In Saudi Arabia the annual rate of inflation was 4.9% in February 2011. In an extreme case of this trend, inflation in **Iran** is likely to surpass 20% in 2011; such high levels of inflation create an uncertain investment environment and put downward pressure on real income growth. Indeed, we expect weak growth in Iran at 0.3% in 2011 as the government removes key oil subsidies – a key factor driving inflation – and consumers are squeezed. We do expect the Iranian economy to benefit from high oil prices and increased production, however, so foresee stronger growth at 2.5% in 2012.



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¹ The phrase 'Middle East' is often used to cover different parts of the region. Much of the internationally available economic data relates to the Middle East and North Africa region which we call MENA (this covers the seaboard countries in North Africa from Somalia to Mauritania and all the states in the Arabian peninsula including Israel plus Iran and Turkey in the north). Political discussions often treat the Middle East as synonymous with the Arab world. Where we refer to wider definitions of the region we will try to point this out explicitly.

² Brent crude, West Texas Intermediate and Dubai Fateh

³ For example, Egypt ranks 106 out of around 180 countries globally for its ease of doing business while the United Arab Emirates rose from 47 in 2009 to 33 in the World Bank Ease of Doing Business Rank 2010.

⁴ The latest World Bank *Doing Business in the Arab World* report shows: 'Of 174 economies, 17 Arab economies improved business regulation over the past 5 years, although the pace was slower over the past year.' However, there are still major factors that hold back growth and job creation; for example, businesses in the Arab world on average need to wait 657 days to enforce a contract through the court, the third longest average globally.

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