Making Business Sense

ECONOMIC INSIGHT

MIDDLE EAST

Quarterly briefing Q4 2013

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

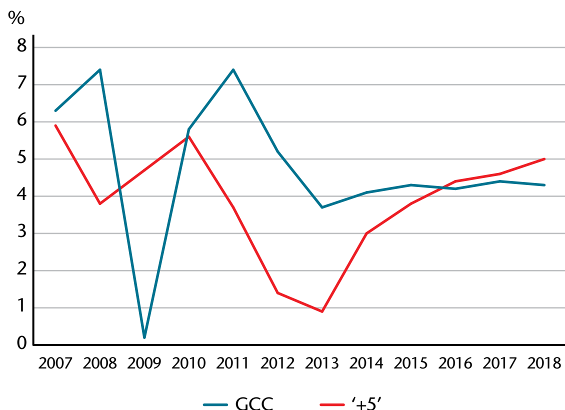
Regional instability creates divergence in economic fortunes

2013 has been a year of contrast in economic fortunes. Nowhere has this been more the case than in the Middle East, where political instability and violence have affected countries in completely different ways. Countries bordering Syria, including Jordan and Lebanon, have suffered from the ongoing civil war, as violence spilt across borders, curtailing trade and tourism – a major industry for both these economies – and bringing a significant influx of refugees. Egypt, meanwhile, has experienced its own disruption, setting 2013 up to be another year of very slow growth.

Oil-exporting states, by contrast, are set to gain as volatility across the region pushed up oil prices. States including Saudi Arabia, the UAE and Kuwait have increased production to record levels in response and are expected to achieve strong growth in the second half of 2013 as a result. The very different economic experiences of these two groups are illustrated in Chart 1. Growth in the GCC economies

at 4.1% is expected to be considerably higher than that in the '+5' group (1.2%). A reversal in this picture is anticipated by the end of the forecast period, however, as lower oil prices put a lid on growth in the GCC.

Chart 1: Annual GDP growth, Gulf Cooperation Council and '+5' group – Iran, Iraq, Lebanon, Jordan and Egypt



Source: International Monetary Fund, Cebr Prospects Service forecasts

Advanced economies push forward while emerging markets hesitate

Looking beyond the Middle East, a revival in advanced economies and slowdown across the developing world have made for a thoroughly mixed economic picture in 2013. The eurozone finally emerged from recession in Q2 2013 and the US, Japan and UK are all picking up speed. On the other hand, China and other emerging markets have begun to show signs of weakness. The balance of global growth is shifting.

Moreover, this pattern looks set to strengthen in 2014. While the Federal Reserve is likely to begin tapering its substantial quantitative easing programme early in the year, the potential for this to hurt growth prospects in the US is likely to be offset by a reduction in fiscal tightening. A new consumption tax will slow growth in Japan slightly, but the reinflationary policies of Prime Minister Abe will cushion the blow. The eurozone should finally shake off the shackles of recession, posting positive annual growth for the first time since 2011.

Meanwhile, fears over the sustainability of China's current growth trajectory are rising as returns on investment fall, risk builds in the banking sector and substantial increases in property prices look suspiciously like a bubble. Although GDP growth in the world's second largest economy sped up in Q3 2013 after slowing in the first half of the year, China's rate of expansion will almost inevitably cool in coming years. Growth forecasts for other emerging economies, including India, South Africa and Brazil, have also been revised downwards for this year and beyond. These economies have been buoyed by the cheap liquidity pumped into markets by central banks in recent years, however it is becoming increasingly clear that significant domestic reforms must be implemented if these countries are to regain their pre-crisis growth trajectories. Emerging economies are still battling bottlenecks, poor infrastructure, high levels of corruption and under-skilled labour forces – all preventing them from achieving the potential growth rates implied by their demography.

Given this turnaround in global growth prospects, advanced economies are expected to make a growing contribution to economic expansion in 2014. Their share of global growth is forecast to rise from 21% this year to 28% in 2014, while the share accounted for by emerging markets is expected to fall from 50% to 44%.

Middle East GDP growth expected to accelerate

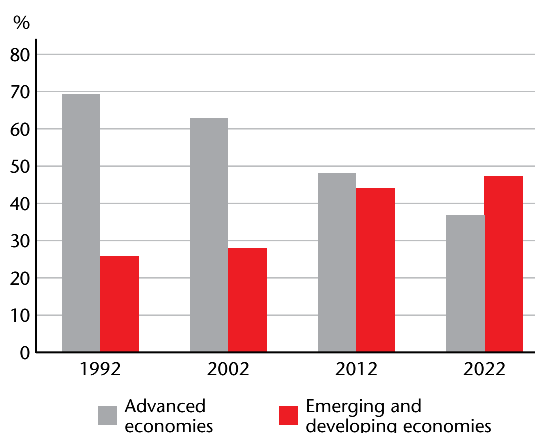
The Middle East's share of global GDP growth is expected to remain relatively steady over the next five years, at around 4.4%. The region's role as an energy exporter means that its output closely tracks the mood of the global economy, as this determines demand for its products. GDP growth in the Middle East is expected to rise from 3.1% this year to 3.9% in 2014, as the global economy picks up pace. The region will continue to accelerate gently over the coming years as the political situation stabilises, with annual GDP growth expected to reach 4.6% by 2018.

Exports to emerging markets soar

The slowdown in emerging markets could cause temporary difficulties for economies in the Middle East that have become increasingly reliant on exports to these countries, as Chart 2 illustrates. Exports to these economies, which include most of South East Asia, Africa, India, China and Central and Eastern Europe, accounted for just over a quarter of all goods sold overseas by countries in the GCC+5 (25.9%) in 1992, while more than three-quarters of exports were shipped to advanced economies (69.3%). Over the last decade, however, the Middle East's trade orientation has been transformed. Fewer than half of all goods exported are now delivered to advanced economies, and nearly the same volume are sent to emerging markets where demand for fuel to power factories and transport goods has soared.

With rapidly rising populations, countries such as China and India will be the economic powerhouses of the future. By 2022, we expect that the Middle East will be exporting more to emerging markets than to the advanced economies. With the centre of economic gravity shifting eastwards, the Middle East will also increasingly be at the crossroads of global trade, developing its role a logistics hub.

Chart 2: Destination[2] of goods exported from the Middle East, percentage of total exports



Source: IMF Direction of Trade Statistics, Cebr analysis

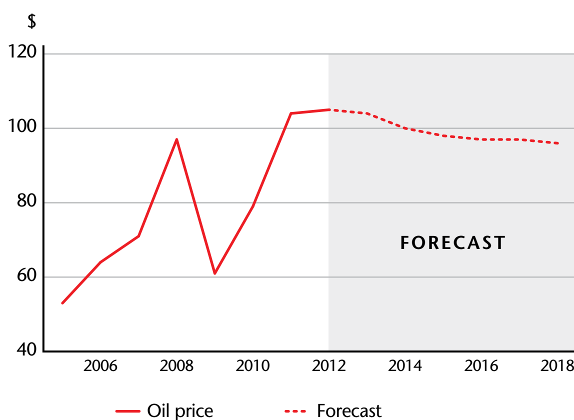
Changes in oil markets expected to push prices down

This reorientation in the Middle East's trade patterns towards emerging markets is being exacerbated by the rapid expansion of shale oil production in the US. The US is set to overtake Russia next year to become the world's second largest producer of oil, according to the International Energy Agency (IEA).

To date, the US's reduced appetite for imported oil has been countered by growing demand in emerging markets, meaning oil exporters in the Middle East have so far been relatively unscathed. Spare capacity in Middle Eastern oil exporters has allowed production to be ramped up to meet the needs of fast-growing economies like India. Just over two fifths of India's oil imports (44%) now come from Saudi Arabia, Kuwait, Qatar and the UAE, up from 36% in 2011. With developing economies slowing, however, demand from these markets too is likely to slacken in the short term. With a greater share of exports now being sent to these economies, Middle Eastern oil producers are increasingly exposed to the risk of emerging market slowdown.

In the medium term, the spread of shale technology means oil supply is likely to rise. Although global demand growth will also remain strong, prices are likely to fall as a result. The impact of the shale revolution on global markets has, to date, been limited by the US' embargo on exports of crude oil – a relic of the 1970s oil crises. American producers are increasingly concerned, however, that a domestic glut could depress prices and reduce production if the ban on exports remains. With cheap energy providing a new lease of life to American industries, it seems unlikely that any government will be willing to enforce measures which could turn off the tap. It is reasonable to expect, therefore, that the US export ban will be lifted at some point before 2018. Oil prices are thus expected to fall in the coming years, as illustrated in Chart 3.

Chart 3: Oil prices, average of Brent crude, West Texas Intermediate and Dubai Fateh spot prices, $ per barrel



Source: IMF, Cebr analysis

Oil prices are likely to be undermined further by the softening of sanctions against Iran. While the official removal of sanctions will involve years of political wrangling, efforts to block Iranian access to international markets are likely to become less effective over time. As relationships between the US and Iran appear to have softened slightly in recent months, we expect that some Iranian oil will come back on stream by 2017. While other OPEC members can cut supply in response, this expansion in global supply, together with US shale production, is likely to push average oil prices below $100 a barrel from 2015, driven by reductions in the price of West Texas Intermediate crude.

Falling oil prices increase urgency of diversification

Falling oil prices are one of a trio of inter-related difficulties facing GCC countries over the next few years. Exceptionally strong population growth across the region combined with industries which are traditionally capital, rather than labour, intensive has left governments facing difficulties in providing productive employment for their workforce. The result is very high unemployment; over the decade to 2011, average unemployment across the Middle East was 11.2%, nearly double the global average of 6.0%. In the face of unrest among large, youthful populations, many countries have increased fiscal spending. This spending, however, increases the importance of raising revenue. Where hydrocarbons are a major source of income, falling oil prices threaten this. Many countries in the region need to walk a tightrope to balance the conflicting demands of this situation – avoiding agitation, creating employment without excessive spending, and raising revenue.

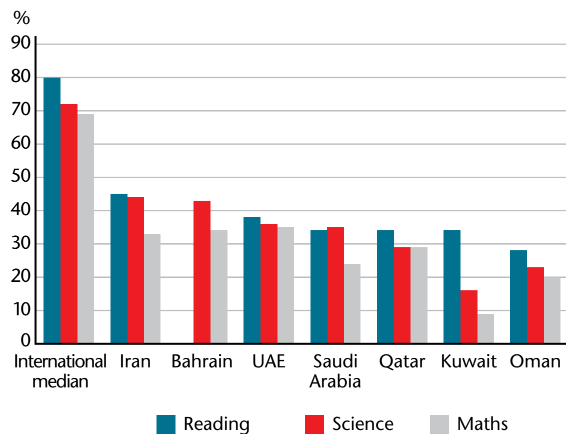
Twice as many executives in GCC dissatisfied with labour force skillset as in OECD

The single long-term solution to these difficulties is for GCC countries to continue to diversify. While this is already well-recognised, several sizeable barriers to diversification remain. Most notably, the benefit these countries are able to derive from the current population boom is severely limited by the relatively low skills of this new workforce. While a larger working-age population should provide a boost to GDP growth, the size of this gain depends on the extent to which young people are adequately prepared for the demands of the workplace. Evidence from the World Economic Forum suggests that in this area the Middle East is falling behind: across the GCC as a whole, 14.4% of executives report that the workforce lacks sufficient skills – more than double the average rate of dissatisfaction across the OECD (6.2%). Moreover, this problem affects all GCC members – not one country manages to beat the OECD average score.

The scale of this dissatisfaction makes it clear that improvements need to be made to the standards of education across the Middle East. The scope for this is apparent when we examine the performance of education systems across the Middle East. Across the region children fail to reach international benchmarks in maths, reading and science at the age of 9–10, as illustrated in Chart 4. The discrepancy between achievement in the Middle East and the other countries is highest in reading ability – while across the globe

80% of children reach the benchmark for reading at this age, fewer than half of all children in the UAE (38%), Saudi Arabia, Qatar and Kuwait (all 34%) reach this standard. In Oman the situation is even worse, with just over a quarter of children achieving the requisite level (28%). Middle Eastern countries are also lagging in maths and science – vital to the success of new technologically-intensive industries. Improvements to the education system would help countries across the region benefit from their demographic windfall and provide the labour inputs needed to compete internationally in complex manufacturing, logistics and service provision.

Chart 4: Proportion of children achieving standard international benchmarks at age 9–10[3]



Source: TIMSS & PIRLS, International Association for the Evaluation of Educational Achievement, 2013

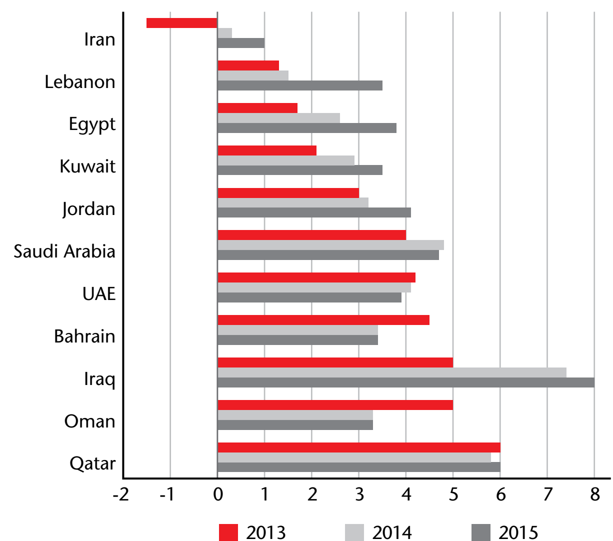
There is also scope for improvement in the higher education sector. To compete in skill-intensive industries such as engineering, chemical processing and financial services, economies require access to a skilled workforce, with a sizeable proportion of young people holding degrees from high-quality universities. In this area, the GCC lags behind the economies it is trying to compete with. Only two universities from the GCC enter the Times Higher Education's top 500 university rankings for 2013–14 – King Abdulaziz University and King Saud University, both in Saudi Arabia. The rest of the region only had one entrant to the global rankings – Sharif University of Technology in Iran. The Middle East is not just being outrun by advanced economies in the race to educate its workforce – emerging markets are increasingly investing in training and skill development. China, for example, has 10 universities in the top 500, while India has five. The proportion of young people entering tertiary education is also low across the Middle East. Only in Lebanon do more than half of young people (57%) enrol in tertiary education. While 41.2% of Saudi Arabian youth go to college or university, this falls to 28.7% in Oman and just 11.6% in Qatar[4]. These countries will struggle to compete in skill-intensive industries when 68.3% of young people in OECD states receive tertiary education. Improvement in higher education will be critical if the Middle East is to succeed in its bid to diversify.

Skill shortage drives immigration

With the domestic population unable to meet the needs of growing industries, companies operating in the Middle East have recruited abroad. The scale of this immigration, however, has created political problems – particularly against the background of high unemployment. This in turn has encouraged the development of 'Saudiisation' policies. Firms across the GCC are increasingly forced to meet quotas of national employees, and where they fail to do this are charged additional taxes. However, as skilled migration to GCC economies is largely a function of unmet demand, these levies could damage firms by raising costs and placing them at a disadvantage in competitive international markets. A focus on improving education, to raise skill levels among the domestic workforce is likely to be more fruitful in the long term.

GCC economies push ahead while conflict disrupts growth elsewhere

Chart 5: Annual percentage change in GDP, forecasts by country



Source: Cebr Prospects Service forecasts

After slow growth in the first half of 2013, **Saudi Arabia** has raised oil production dramatically in the last few months in response to higher oil prices. Output rose to 10.2m barrels a day in August, according to the International Energy Agency – the highest level on record. This remarkable upswing is expected to drive GDP growth of 4.0% this year. Output is expected to continue to expand at a relatively strong rate, rising by 4.8% in 2014 and 4.7% in 2015 as growth in the non-oil sector counteracts the effect of falling oil prices. The **UAE** also hit an oil production record this summer, rising to approximately 2.8m barrels a day. The economy is expected to expand at a rate of 4.2% this year, and to maintain similar levels of growth in 2014 and 2015 (4.1% and 3.9% respectively). Investment in new oilfields aims to increase production to 3.5m barrels a day by 2020, but spending on other projects will be more important in supporting the country's medium-term growth. Investor confidence is recovering following the Dubai debt crisis of 2009, and foreign direct investment (FDI) is expected to improve over the forecast period, setting the scene for robust long-term growth in the UAE.

Kuwait also raised production in response to rising prices, but has struggled to make progress with other reforms due to uneasy relations between the government and parliament. GDP growth is expected to be limited to 2.1% this year, rising to 2.9% in 2014 and 3.5% in 2015 as private consumption and government spending rise. Elevated oil prices to 2016 will support Kuwait's economy, but concerns remain about long-run fiscal sustainability.

An expansion in liquid natural gas (LNG) capacity in recent years has supported GDP growth in **Qatar**. Although lower investment means growth will be slightly slower this year than last, output is still expected to rise by 6.0% as a combination of strong demand for gas from South East Asia and China and falling supply in Europe keeps prices high. Spending on infrastructure for the 2022 World Cup is unlikely to have a substantial impact on growth in the forecast period, but should provide additional thrust from 2017.

Oil and gas continue to dominate the economy of **Oman**, but diversification is also occurring with Muscat's new airport, due to open in 2014, expected to boost the tourism industry. Growth of 5.0% is expected this year, slowing to 3.3% next year as oil prices fall. **Bahrain** is expected to experience a similar growth trajectory, growing at 4.5% this year as oil output recovers following an outage in 2012 before slipping to 3.4% in 2014. The services sector continues to suffer due to concerns over political tension, with protests a regular occurrence. The economy is more vulnerable than others in the GCC with significantly smaller oil reserves and a less attractive offer to international investors than Saudi Arabia or the UAE.

The ongoing civil war in Syria has depressed **Jordan's** growth, with tourist numbers falling dramatically. The government has also completely removed fuel subsidies – a worthwhile step in improving long-run fiscal sustainability, but in the short term this has pushed up inflation. Large firms are already feeling the impact, while households will be hit in 2014. We expect growth of 3.0% in 2013, improving slightly to 3.2% in 2014. **Lebanon** has also been hit hard by the crisis in Syria, which has affected the country's government. Hezbollah, Lebanon's most powerful political group, brought down the government in March, and a replacement has yet to be formed. The state is caught in the middle of the battle for influence within the region, and as a result growth this year is expected to be limited to 1.3%. Next year may bring a slight improvement, but with the crisis in Syria likely to drag on through 2014 we do not expect to see growth above 2.0% until 2015.

Renewed political violence in **Egypt**, following the removal of Mohamed Morsi from the presidency in July, continues to weigh heavily on the country's growth prospects. Although the stock market has been relatively buoyant following the announcement of financial support from several GCC countries, growth will be limited to 1.7% this year, and just 2.6% in 2014 – far below the economy's potential. Despite ongoing violence, rapid output expansion continues in **Iraq** as oil production resumes after the prolonged conflict. We expect GDP growth of 5.0% this year, rising to 7.4% next year and 8.0% in 2015, driven by private investment around the country's significant oil reserves. Neighbouring **Iran**, meanwhile, continues to suffer from international sanctions, and output is expected to fall by 1.3% this year. A thawing of hostilities with the US, however, and the apparent recognition of the country's difficulties by new president Hassan Rouhani suggest that the outlook may improve in coming years. We expect the economy to stagnate in 2014, growing by just 0.3%. It will take a long time to undo the damage inflicted by lengthy sanctions.

Ongoing conflict masks potential of Middle East

Despite regional turmoil, the Middle East continues to grow faster than the world as a whole. Output from the region's economies is expected to rise by 3.1% this year, 0.6 percentage points faster than the global economy. Continued efforts towards diversification are needed, however, if this momentum is to be sustained in the face of falling oil prices. An escalation of conflict within the region, while not included in our central forecasts, could do enormous damage to the region's potential, and this is not beyond the realms of possibility. Careful management, cooperation and collaboration will be needed to steer the Middle East through this decisive moment in its development.

ENDNOTES

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 Mauretania 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. But if we refer to wider definitions of the region, we will try to point this out explicitly.

2 Advanced economies as defined by the IMF, including the US, eurozone, Japan, UK, Canada, Australia, Singapore, Sweden, Korea, New Zealand, Norway, Iceland, Hong Kong, Denmark, Israel, Switzerland, Taiwan and San Marino. The advanced economies and emerging markets and developing economies shares do not add to 100% as these definitions only cover 90% of countries. The IMF defines emerging markets and developing economies as 153 countries, including members of the Commonwealth of Independent States, developing Asian countries, states in Latin America and the Caribbean, Middle East, North Africa, Afghanistan, Pakistan, and countries in Sub-Saharan South Africa. A full list is available in the Annex of the IMF's World Economic Outlook, available here: http://www.imf.org/external/pubs/ft/weo/2013/01/pdf/text.pdf

3 No reading data is available for Bahrain.

4 Data from World Bank, figures apply to 2011 – the most recent year for which data is available.

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