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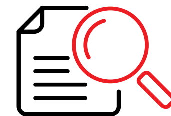
ICAEW Economic Insight: Middle East

Quarterly briefing Q4 2016

ICAEW's *Economic Insight: Middle East* is a quarterly economic forecast specifically for the finance profession. Produced with Oxford Economics, one of the world's foremost independent global advisory organisations, it examines future prospects for the Middle East as a whole and for the region's individual countries. 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.

Key findings



What's keeping businesses awake at night?

The Middle East encompasses a broad range of economic, financial, political and social risks on a regional and country-specific basis. Our report focuses on economic and financial risk.

- **Risks to an already-weak oil price.** Even in a more positive scenario, oil prices will not return close to the $100 per barrel (pb) averaged in 2010–2014. Our baseline forecast remains below $60pb until 2019.
- **Rising tax burden.** Businesses are concerned about potential tax increases and spending cuts to shore up government finances. This could prompt lower demand, administrative burdens for businesses (a particular blow to small and medium-sized enterprises), or loss of retained earnings for future investment. Moves to boost employment of national-born workers could also place a strain on business.
- **Exchange rate risk**. While pressure on exchange rate pegs has eased, businesses remain worried about the potential impact on costs if a move to more flexible exchange rates seems likely.
- These worries are keenest where set government budgets mean large deficits. Oman, Bahrain and Saudi are most exposed with fiscal 'breakeven' oil prices $30–$50pb above current levels.
- Thanks to the impacts of lower oil prices on business demand and financial liquidity, we expect only a modest pickup in economic growth in GCC+5, from 2.3% in 2016 to 2.6% in 2017. Average annual growth from 2005–2015 was 3.7%. However, Iran should perform better in the coming years following the easing of sanctions.

Economic insight Q4

All eyes on the oil market …

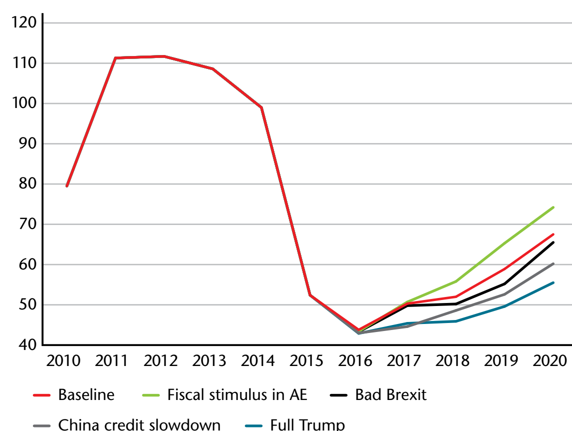
Given the importance of oil and gas to GCC economies, attention is understandably focussed on the outlook for world oil markets. Despite a surprise agreement to cut future production by a modest 0.2–0.7m b/d at an informal OPEC meeting in September, we do not expect this to have a sustained impact on oil prices. The agreement does have potential to push oil prices up further, but the lack of detail including, crucially, the allocation of cuts, and above all whether such cuts will actually be implemented, leaves us sceptical about the prospect for higher prices.

While the next OPEC meeting (30 November) will provide further detail, with US producers adapting to the low price environment, and weak demand growth in China and Europe, we see oil prices remaining range-bound for the foreseeable future. Brent crude is forecast to average $50.3 pb in 2017, after an estimated $43.8 pb in 2016. That said, the potential for new capacity in post-conflict economies such as Libya, additional investment in Iran's oil sector, and increased output in non-OPEC producers, all offer upside risks to world oil supply.

Moreover, there are other risks to even this central forecast. Using forecasts from Oxford Economics' *Global Scenarios Service,* Figure 1 demonstrates the impact possible risks to global economic stability could have on world oil prices.

> **Despite a surprise agreement to cut future production by a modest 0.2–0.7m b/d at an informal OPEC meeting in September, we do not expect this to have a sustained impact on oil prices.**

Figure 1: Oil prices vulnerable to China and EU slowdown



Source: Oxford Economics/Haver Analytics

The greatest uncertainty for the world economy in 2017 is the attitude of President-elect Trump to free global trade and investment, and the impact of his domestic policy agenda on America's own economic outlook. Mr Trump's tariffs of 45% on Chinese exports to the US and 35% on Mexican exports, if implemented, would damage living standards, business confidence in the US, export prospects, and investment plans around the world. They would likely spark retaliatory action from affected economies, further undermining world trade and investment flows. Meanwhile, Mr Trump's fiscal proposals, to cut taxes on (mainly) high earners by around $1trn and fund this with government spending cuts, plus deport millions of illegal immigrants, would push the US economy close to a recession in 2017/18.

In practice, Mr Trump may well be constrained in many of these policy areas, and as such our baseline economic forecast assumes more modest tariff barriers (around half as high, with correspondingly more modest retaliation), a greater role for debt financing (versus growth-reducing spending cuts) for his tax cuts, and a slower rate of expulsion for illegal migrants. But political and economic uncertainty is clearly very high at the moment, and as such Mr Trump's more radical agenda cannot be ruled out. In Figure 1, we simulate the impact of these proposals on oil prices, in our baseline scenario and a 'Full Trump' scenario. In a 'Full Trump' scenario, oil prices remain $10 pb lower than baseline by the end of the decade. GDP in major oil exporting economies would be around 1 percentage point (pp) lower in the latter years of the decade as a result. This would accentuate fiscal and exchange rate pressures across the GCC+5 region.

> **A full implementation of President-elect Trump's policy proposals would lower oil prices by $10pb by 2020.**

Another key risk in this respect is in China, which has accounted for almost half of total global oil demand growth over the past decade, and now consumes 12% of the world's total (up from 8% in 2006). The achievement of China's growth targets from 2017–2020 looks increasingly dependent on more debt and bank lending, perhaps unsustainably so. If the government decides to rein in the pace of credit expansion this would slow China's growth, and with it global demand for oil.

Our forecast is that, under such a scenario, world oil prices would be $5–$10pb lower for the rest of this decade. In this scenario, GDP growth in many oil-exporting economies would be around 0.5–1 pp slower in 2017 and 2018.

More positively, there are (isolated) upside risks for the global economy, which could imply a slightly stronger outlook for oil prices in the years ahead. The low cost of borrowing across the advanced world, and the high 'fiscal multiplier' (ie, knock-on to the rest of the economy) is spurring interest in infrastructure investment in many major economies. A programme of ambitious infrastructure investment around the major economies could boost oil prices by around $10 pb by 2020, and GDP in oil exporting economies by around 0.5–1pp versus our baseline forecast.

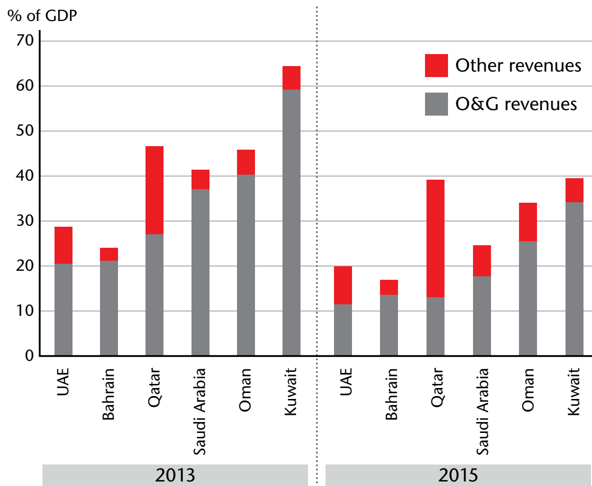
> **A programme of ambitious infrastructure investment around the major economies could boost oil prices by around $10 pb by 2020.**

Business braced for rising tax burden

Even in an optimistic scenario for the world economy, it is highly unlikely oil prices will return to anything close to their 2010–2014 averages. The loss in oil and gas revenues from 2013–2015 ranges from 7% of GDP in Bahrain to 24% of GDP in Kuwait (Figure 2). Given the outlook for oil prices, much of this is likely to be permanent. In the near term, much of the shortfall will be made up by borrowing

(recent bond issues are discussed later), as well as drawing down sovereign wealth funds and foreign exchange reserves. But fundamentally, the work of putting public finances on a more sustainable long-term footing has to begin, and is likely to include substantial tax rises (as well as subsidy reform, spending cuts and freezes on public sector recruitment and pay).

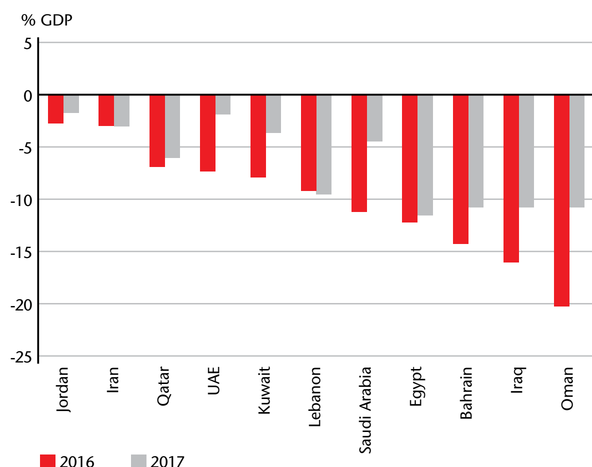
Figure 2: GCC governments too reliant on oil revenues



Source: Oxford Economics/Haver Analytics

A GCC-wide VAT of 5% is already due to be implemented in 2018 and IMF estimates suggest this could raise as much as 1.5%–2% of GDP across the region. More widespread use of duties on specific products (eg, tobacco, alcohol, soft drinks) could produce a smaller gain with less administrative burdens. Either would be a start to address deficits, but neither is a 'free lunch'. By increasing the cost of living, these measures could raise wage demands and thereby undermine organisations' competitiveness. Moreover, it would clearly impact on consumer spending, particularly in the economies with lower incomes (or more unequal income distribution).

Figure 3: Government deficits in Middle East



Source: Oxford Economics

That being said, there is plenty of scope for other tax measures to help close the fiscal gap (Figure 3). For instance, GCC economies have long been able to spare workers a personal income tax (typically the major contributor to government revenues in high-income economies). However, since social security systems treat nationals and non-nationals differently (Figure 4), while it seems unlikely in the near term such a tax will be implemented for nationals the same cannot be said for non-nationals. Raising non-national workers' wage demands could be consistent with government targets to 'nationalise' workforces (see Figure 5), and might be preferable to quota systems that force companies to employ locals regardless of the availability of suitable employees.

> **There is plenty of scope for other tax measures to help close the fiscal gap.**

Figure 4: Plenty of scope for new taxes

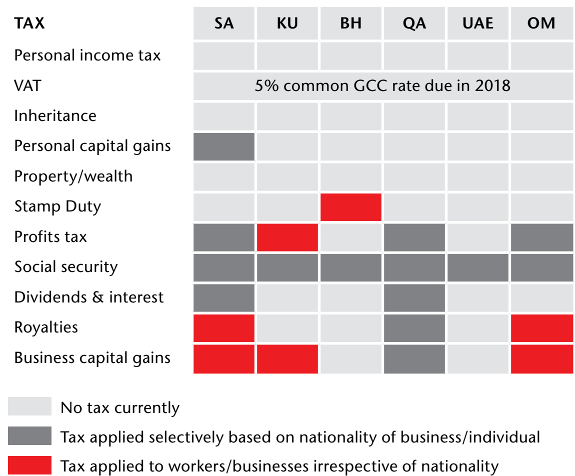
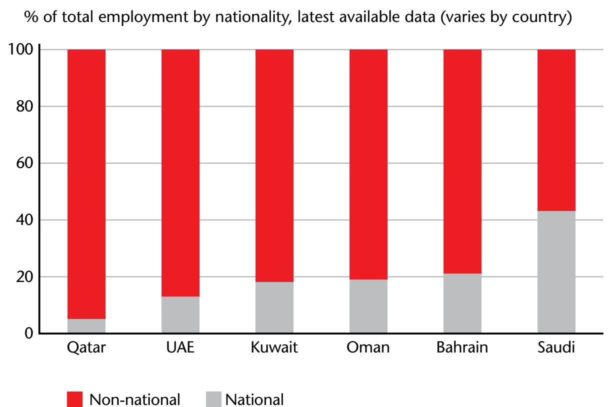


Figure 5: Raising local employment also a key goal

% of total employment by nationality, latest available data (varies by country)



Source: Oxford Economics/Haver Analytics

Another option is the broader application of corporation or profits tax. The highly-regulated nature of several GCC economies means that profits in some sectors are higher than in comparable economies. A broader application of this type of tax is therefore an obvious source of additional government revenue. But applying it to more competitive sectors could undermine companies' ability to use retained earnings for investment and, therefore, economic diversification. There are also logistical challenges posed by the implementation of a VAT or profits tax – both would require companies to invest substantially in accounting and financial management systems to deal with potentially complex taxes. This would be particularly burdensome for small and medium-sized enterprises (SMEs) which will be crucial to any successful diversification in the region.

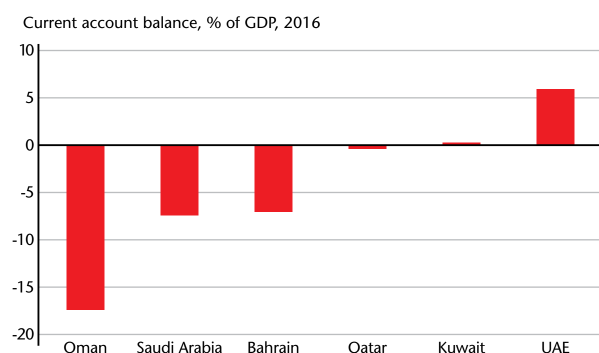
Overall, there is clearly a need to raise substantially the level of non-oil government revenues to maintain financial and social stability. But few tax policies are free of wider economic consequences, so it will be important for

governments to ensure that tax policies are considered as part of broader economic diversification strategies, such as those in Saudi Arabia's Vision 2030.

Exchange rate risk still a concern

Pressure on oil prices is also a key worry for business from the perspective of exchange rate stability. All GCC economies operate a pegged exchange rate regime, with the value of the local currency linked to the dollar (other than Kuwait, which manages its rate against a basket of other currencies). All have seen current accounts deteriorate sharply through 2015/2016 (Figure 6), requiring central banks to draw upon foreign exchange reserves to meet demand for foreign currency. The immediate pressure has eased a little recently, as sovereign bond issues have increased capital inflows – but nevertheless the longer-term pressure on reserves and pegs remains.

Figure 6: Current accounts lurch into deficit



Source: Oxford Economics/Haver Analytics

In Bahrain and Saudi Arabia, reserves should be more than adequate to defend the peg until current accounts improve. But there are increasing concerns about the resources available to do so in Oman. Regardless of timing though, the fact is that across the GCC weaker exchange rates looks to be a necessary part of any longer-term plan for diversification. However, as countries in the region rely on imports, any depreciation will have a short-to-medium term impact on business costs, output prices, and ultimately household spending power. As such, even in economies where there is little short-term pressure on pegs, concerns over the eventual impact of currency movement will remain (Figure 7).

> **Across the GCC weaker exchange rates looks to be a necessary part of any longer-term plan for diversification.**

Figure 7: Exchange rate risk a region-wide concern

	Political	Business Environment	Economic	Exchange Rate Risk	Credit Rating
Bahrain	Grey	Grey	Grey	Grey	Grey
Egypt	Grey	Red	Red	Red	Red
Iran	Red	Red	Red	Red	Red
Iraq	Red	Red	Red	Red	Red
Jordan	Grey	Red	Red	Grey	Grey
Kuwait	Grey	Grey	Green	Green	Green
Lebanon	Red	Red	Grey	Grey	Red
Oman	Grey	Grey	Grey	Grey	Grey
Qatar	Green	Green	Green	Green	Green
Saudi Arabia	Grey	Red	Grey	Grey	Grey
UAE	Green	Green	Grey	Grey	Green

Risk scores out of 10
zero = no risk
10 = maximum risk

- Green: less than three
- Grey: above three but less than six
- Red: six or above

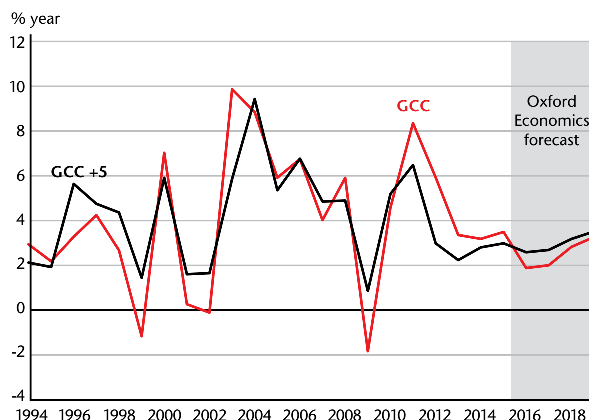
Business implications

Businesses in the GCC need to brace for a long-term effort by governments to close fiscal deficits and raise much more substantial revenues from the non-oil economy, as well as implement other offsetting populist policies like the drive to increase the national share of the workforce, especially in the private sector. This could place many pressures on businesses, including higher labour costs, weaker consumer demand, and the loss of retained earnings for investment. To ensure that the adjustment in public finances is consistent with ongoing growth, businesses should make the case for accompanying measures that will allow tax increases to be absorbed with minimal impact on activity. Offsetting measures could include welfare reforms to incentivise more citiziens to compete for jobs with migrants, more flexbility to negotiate wages, and deductions from profit taxes to protect investment spending. Moreover, in countries with high current account deficits, businesses should think about how a devaluation would impact on costs and demand, as well as how to insure agains these risks.

Oil price forecast and economic outlook

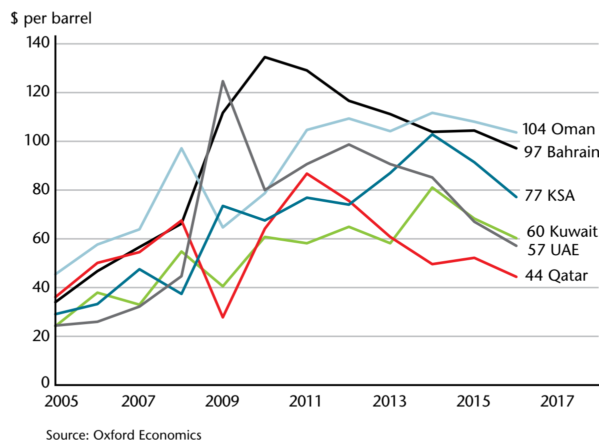
We expect GDP in GCC+5 to grow 2.6% in 2016, improving very modestly to 2.7% in 2017 (Figure 8). Growth will be held back by weak oil prices and associated fiscal consolidation programmes (that have resulted in declining, if still high, budget breakeven oil prices across the Gulf – see Figure 9).

Figure 8: Growth outlook in GCC and GCC+5



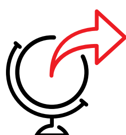
Source: Oxford Economics

Figure 9: Budget breakeven oil prices



Source: Oxford Economics

Regional economic outlook



GCC + 5 country outlook for 2016–17

At $17.5bn, **Saudi Arabia's** inaugural bond issue in October was the largest emerging market bond in history. High demand for the bond underlines the Kingdom's ability to source cheap credit (the bond carried an average interest rate of just 3.25%). This should relieve some austerity pressure, allow non-oil growth to recover to 1.5% in 2017 from -0.2% this year, and support investment in pursuit of the Vision 2030 agenda. Overall, we expect GDP growth of 1.2% in 2016 and a similar rate in 2017, due to flatter oil production next year.

The **UAE** is one of the most diversified economies in the Gulf, but oil price developments are still key. Output in the oil and gas sector, which makes up around one third of the economy, is expected to rise by only 1% in 2016 after growing 5% last year. Non-oil growth is also expected to slow a little further this year to 2.9% as the cumulative impact of low oil prices, tighter fiscal policy and liquidity feeds through. We expect overall GDP growth of 2.3% this year, rising to 2.7% in 2017 as both oil and non-oil sectors improve.

Thanks to GCC support and higher oil production, GDP growth in **Bahrain** should hold up in 2016, unchanged from 2015 at 2.9%. However, with oil output expected to fall, prices remaining low and spending dropping back, we expect growth to slow to 1.7% in 2017.

For 2016 we expect GDP growth in **Oman** of just 2.3%, slowing further in 2017 to just 1.7%. This reflects fiscal consolidation, stagnant wage growth, lower subsidies and tightening financial conditions. The budget deficit remains the highest in the GCC, forecast at 20% of GDP in 2016. Cuts in subsidies, together with measures to raise non-oil revenues, should see the deficit fall to 11% of GDP next year.

Liquidity in **Qatar** remains fairly tight despite sovereign bond issues in May, August and September. With government spending forecast to drop 10.2% in 2016, we project non-oil GDP growth to slow to 5.8%, but pick up to 6.6% in 2017. This will leave overall GDP growth at 2.6% in 2016 and 3.7% in 2017.

Consumers in **Kuwait** remain resilient thanks to continued employment growth. Subsidy cuts are being implemented, but unevenly. Nationals are being protected from some measures, supporting household incomes. Government investment also remains positive, so that non-oil GDP is forecast to grow by 1.5% in 2016, with overall GDP up by 2.8%. We expect a slight dip in 2017 to 2.3%, due to a slowdown in the hydrocarbon sector and political instability, with Parliament being dissolved in October.

Iran's growth prospects have improved after being freed from sanctions this year, allowing oil exports to surge by around 75% compared to 2015, and oil production now close to pre-sanction levels. GDP growth is forecast at 4.3% this year (compared to 0.7% in 2015) and 4.5% in 2017. Improved policymaking and the prospect of increased foreign direct investment should underpin this more optimistic outlook. There is also hope for lower interest rates as well as greater exchange rate stability.

Weak non-oil activity, undermined by the impact of low oil prices on government spending and investment, coupled with the drain on resources from conflict, means that GDP growth is slow in **Iraq**. However, with high public investment in the oil sector this year we anticipate growth of 4% in 2016, easing to 3% in 2017.

Despite a continuing difficult regional environment, **Jordan** continues to show resilience, with GDP growth forecast to average almost 2.9% in 2016 and then 3.5% in 2017. Economic confidence is being boosted by the progress made in strengthening the fiscal and external positions and by a new IMF programme.

The recent parliamentary election of Michel Aoun as President breaks the political logjam in **Lebanon**, but is unlikely to meaningfully improve policymaking or business confidence. The Syrian conflict and sectarian divides continue to destabilise the country and are having a drastic impact on tourism, trade, unemployment and confidence. We expect the economy to grow by just 1% in 2016, accelerating to 2% in 2017.

Underlying factors suggest domestic demand is at an unsustainable level in **Egypt.** GDP growth is likely to slow thanks to further subsidy cuts, faster inflation and the need for fiscal austerity. Our estimate of GDP growth in 2016 is 3.6%, but we see it falling to 2.7% in 2017.

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