Growth remains under pressure in **Egypt**. The tourism sector has slumped further, foreign exchange shortages continue and electricity constraints are affecting manufacturers. Austerity measures are necessary to reduce the high fiscal deficit. We expect GDP growth of 3% in 2016 and 3.5% in 2017.

Variations in economic and political risk

In order to examine in more detail, specific areas of vulnerability in the Middle East we use our Risk Scorecard, developed using data from the Oxford Economics-Control Risks Economic and Political Risk Evaluator[1] (Figure 8). The indicators are based on a series of qualitative and quantitative definitions and calculations encompassing various dimensions including political (the risk of political instability), business environment (the regulatory and legal framework), economic (the resilience of the economy), exchange rate (the potential for sharp currency moves) and credit rating (sovereign debt default risk). Economies are ranked 1–10 on each metric (10 being the highest level of risk). Green circles denote scores of less than three, grey denotes scores of above three but less than six, and red denotes scores of six or above.

Our scorecard shows a wide variation between GCC states and the 'plus five'. Qatar, UAE and Kuwait score well on most measures of risk, while Iraq, Iran and, to a lesser extent, Egypt score poorly on all five. Saudi Arabia is broadly in the middle, though its ratings have deteriorated recently. This reflects the impact of a low oil price on growth, the budget balance and overall balance of payments. It also seems increasingly possible there will be an exchange rate devaluation, given both the impact of lower oil prices on foreign exchange inflows and the benefit this could have for competitiveness and diversification.

> **Qatar, UAE and Kuwait score well on most measures of risk, while Iraq, Iran and, to a lesser extent, Egypt score poorly on all five.**

Figure 8: Broad variation in risk metrics across region

	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

Box 1: Saudi Arabia's Vision 2030, and key measures for success

Vision 2030 (the key objectives for which are set out in Figure 9) sets out the Saudi Government's goals for transforming the economy over the next couple of decades, with detailed plans to be fleshed out over the months and years to come. In this box, we assess the likely 'signposts' that would mark progress towards a more fiscally sustainable and diversified Saudi economy.

The government has announced plans for trimming spending on non growth-enhancing areas. Price rises for petrol and utilities should lower subsidy bills, while a cut in headcount and wage freeze in the public sector should raise the efficiency of government employment. But these measures directly impact on household incomes, and so require careful implementation. Moreover, the measures remain very much a starting point. Fuel will remain very cheap by international standards, and even after the wage freeze a substantial premium over private sector wages will remain.

More widely, a substantial structural reform programme will be necessary to deliver a more diverse and internationally competitive economy. As in other countries, the Saudi Government aspires to attract inward FDI, particularly in manufacturing and other technologically-advanced sectors. But overseas firms will need a more transparent and clearly impartial judicial system if they are to make substantive investments. Privatisation of key state-owned sectors is also likely to be a means of raising competition and spurring growth, with energy, utilities, transport and public services all key target sectors. Finally, greater openness to overseas visitors and greater capacity to support religious tourists would help develop a tourism industry in Saudi Arabia.

Figure 9: Key economic objectives of Saudi Arabia – Vision to 2030 NTP

Objective	Planned change	End date
Raise private sector as share of GDP	from 40% to 65%	2030
Raise non-oil exports as % of non-oil GDP	from 16% to 50%	2030
Reduce the unemployment rate	from 11.6% to 7%	2030
Raise female labour participation rate	from 20% to 35%	2030
Raise Global Competitiveness Indicator rank	from 25th to 10th	2030
Reduce fiscal deficit as share of GDP	from 16% to balance	2020
Raise non-oil fiscal revenues share of GDP	from 5% to 20%	2020
Restrict the rise in Gov. Debt as % GDP	debt ceiling = 30% of GDP (currently 7%)	2020
Raise SMEs' share of GDP	from 20% to 35%	2030
Raise global GDP rank	from 19th to top 15	2030

Source: Oxford Economics

ENDNOTES

1 For more information on the Economic and Political Risk Evaluator, please see https://risk-evaluator.com/#/public/landing

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OXFORD ECONOMICS

ICAEW Economic Insight: Middle East

Quarterly briefing Q3 2016

Welcome to ICAEW's *Economic Insight: Middle East*, a quarterly economic forecast for the region prepared specifically for the finance profession. Produced with Oxford Economics, one of the world's foremost independent global advisory firms, it provides a unique perspective on the prospects for the Middle East over the coming years 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

Will tighter finance stifle non-oil growth?

In this issue of *Economic Insight: Middle East*, we examine the risk that lower oil prices could constrain the pace of economic diversification in GCC economies in the years ahead, just as diversification becomes more urgent.

- Lower oil prices have undermined governments' role as direct and indirect drivers of GCC business investment. Austerity, lower government deposits in banks and credit downgrades are all key channels in this respect.
- Ensuring firms have access to the finance will therefore require ambitious policy, including prioritisation of public spending, a more competitive banking sector, development of the financial sector and greater openness to foreign direct investment (FDI).
- The global oil market will remain crucial for economic prospects in the Middle East. We have revised upwards our forecast for oil prices for 2016 and 2017, but there are still substantial fiscal challenges.
- By and large, macroeconomic risks remain low relative to global standards in GCC economies, with greater risks in the 'plus five'. Exchange rate pegs in several economies are, however, coming under pressure as a result of the 'new normal' for oil prices.

Economic report Q3

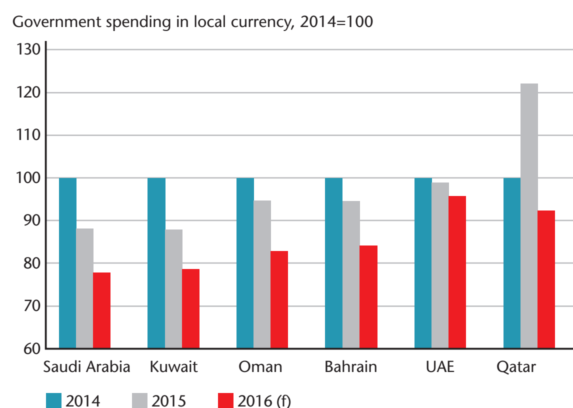
Pressure to diversify ever-more urgent

The need for economic diversification across the Middle East has become more urgent in light of the radical shift in global oil markets during the past couple of years. In early 2014 the prevailing consensus among economic forecasters was that oil prices would average $100 or so per barrel (pb) from 2016 to 2019. Oxford Economics' latest forecast is that this will be closer to $50 pb. Populations that have grown accustomed to generous public services and low tax burdens will have to adjust their expectations to this new fiscal reality, and be more open to working in the private sector in particular.

To facilitate this shift in perceptions, diversification requires the development of new industries and service sectors. In turn, this demands a ready supply of business financing to train workers, provide working capital and fund investment in the equipment which new sectors require to grow.

> **Just as the 'new normal' for oil prices has made the drive for diversification more urgent, it has also made it more difficult, by tightening financial conditions across the region.**

Figure 1: Major cuts in government spending



Source: Oxford Economics/Haver Analytics

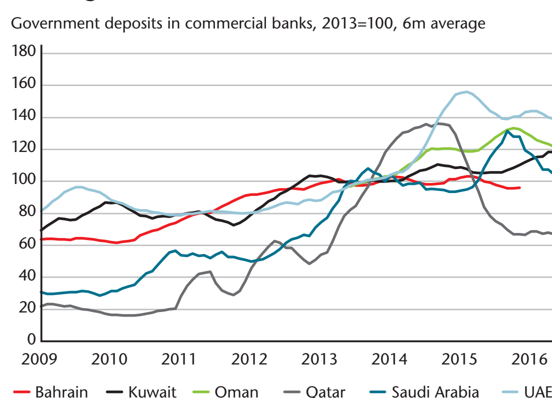
But financing conditions have deteriorated

Just as the 'new normal' for oil prices has made the drive for diversification more urgent, it has also made it more difficult, by tightening financial conditions across the region. Three specific channels are relevant in this context.

Most crucially, lower oil revenues means governments have less funding to support investment and development, through agencies such as investment authorities, state-owned enterprises and export credit agencies or by offering tax incentives or subsidies. In this context, the fiscal impacts of lower oil prices are particularly damaging. Total government spending is forecast to have fallen by 15-20% in Saudi Arabia, Kuwait, Oman and Bahrain between 2014 and 2016, with further expenditure restraint necessary in the coming years. Comparable data on the detail on public spending by sub-category is not available across the region, but there is clearly a risk that 'pro-growth' spending areas will remain vulnerable to cuts in order to protect politically sensitive spending.

Secondly, lower oil revenues mean a lower stock of government deposits in the local banking system, and therefore a shortfall in cash to lend to households and firms. Figure 2 shows the stock of government deposits in local banks in GCC economies over recent years. This fluctuates according to several factors, including government debt issues and the drawdown of other assets held by the government. Regardless, the flow of domestic currency from governments into local bank sectors has slowed through the past year, largely as a result of lower oil receipts. In the context that bank financing needs to become a greater driver of business investment, this is therefore likely to drag on investment and diversification.

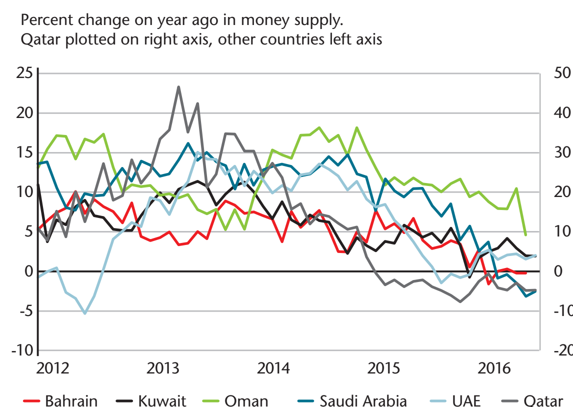
Figure 2: Falling government deposits in local banking sectors



Source: Oxford Economics/Haver Analytics

Finally, ongoing expenditure restraint is crucial given the damage lower oil prices have done to public finances and credit ratings. Government debt stocks remain low by international standards, but with deficits at double-digits of GDP, debt stocks are rising steeply. This has led ratings agencies to downgrade Saudi Arabia, Oman and Bahrain through the first half of 2016. Local banks, which hold government debt as assets, have therefore had to increase capital buffers, restricting their lending into the economy. There is also the risk that in order to finance budget deficits, governments increase issuance of domestic public debt, crowding out further business lending.

Figure 3: Money supply stagnating across GCC

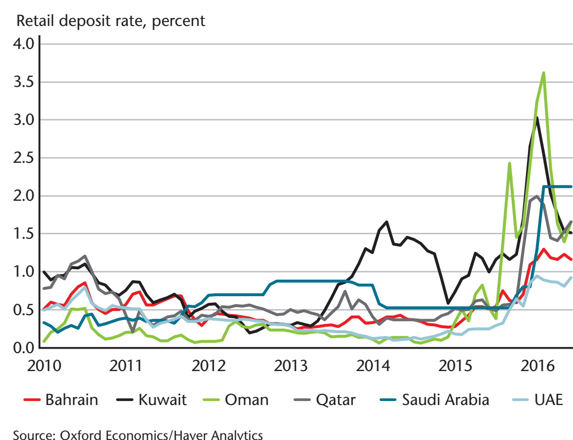


Source: Oxford Economics/Haver Analytics

The overall impact of these three channels is that bank lending, coupled with the overall money supply in GCC economies, has gradually slowed over the past couple of years and begun to contract in some (Figure 3). The effect of these drags on credit can also be seen in the spike in deposit rates, which have risen from 0–0.5% through 2015 to 1.5–3% through 2016 (Figure 4). Banks are having to attract increasing quantities of deposits to try and meet loan demand. The pass-through to borrowing costs is less quantifiable, given the differing regulations over lending at explicit interest rates. Nevertheless, higher funding costs for banks will increase the cost of firms' borrowing to some degree.

> **Bank lending, coupled with the overall money supply in GCC economies, has gradually slowed over the past couple of years and begun to contract in some.**

Figure 4: Spiking deposit rates demonstrate GCC liquidity crunch



Source: Oxford Economics/Haver Analytics

US monetary policy will add to the pressure

There could be further upward pressure on borrowing rates as the Federal Reserve raises interest rates in the US and GCC economies (almost all of which have dollar pegs) are in theory compelled to follow suit. With the Fed expected to hike in December, twice in 2017 and twice more in 2018, the necessary policy reaction in GCC economies is likely to raise banks' cost of financing by around 1.25 percentage points over this period. Of course, the pass-through from monetary policy to lending costs is more tightly regulated than in other parts of the world. Yet higher bank financing costs will clearly impact on either the cost of credit or quantity supplied.

Financial adversity and economic diversity

What then can be done to help deal with the pressures on financing for business investment? A start will be to ensure government spending is rationalised in a way that protects growth-enhancing expenditure, such as financing for state-owned enterprises, SME investment and export credit for new trading firms. The problem is that fiscal consolidation is a balancing act. For a given deficit target, growth-enhancing expenditure must come at the expense of potentially sensitive spending areas (such as public sector wages or welfare) or raised in tax and fees.

Governments could encourage more banking competition in order to lower the cost of finance. Firms in the GCC region enjoy ready access to finance – the 2015 *Global Competitiveness Report* (GCR) places four GCC economies in the world's top 10 for ease of access to loans. However, only one makes it into the world's top 10 for loan affordability (Qatar, sixth place). On average, GCC countries score seven places lower for affordability compared to access.

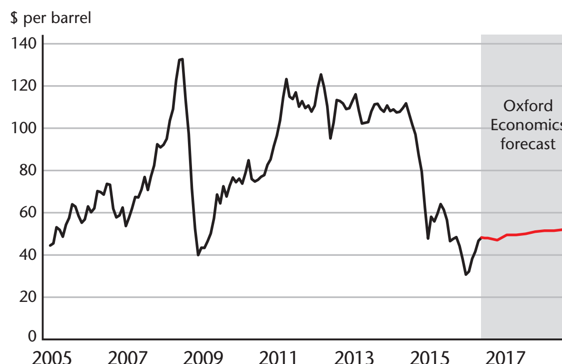
More generally, governments could offer a more attractive environment for inward FDI. This would have multiple benefits – access to foreign liquidity, transferring technology, and supporting exchange rate pegs. Although the UAE, Bahrain and Qatar are among the world's 20 most FDI-friendly economies (according to the 2015 GCR), Oman, Saudi Arabia and Kuwait are in 80th, 107th and 137th place respectively. In order to reap the rewards of FDI, governments will need to be more open to foreign involvement in key sectors of the economy.

> **Governments could encourage more banking competition in order to lower the cost of finance.**

Balance in the oil market expected in 2017

Economic diversification remains a long-term process. In the meantime, the outlook across the Middle East remains heavily influenced by developments in oil markets.

Figure 5: Brent crude oil price



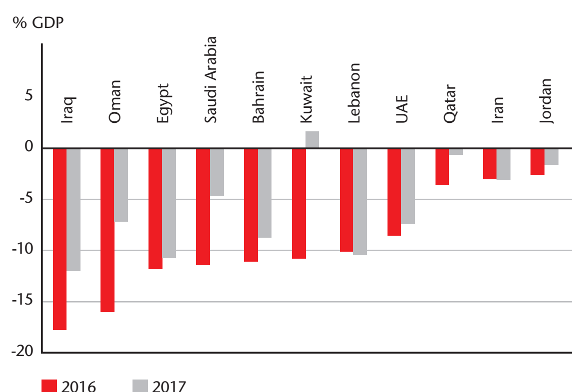
Source: Oxford Economics/Haver Analytics

Business implications

A tighter financing environment may mean that GCC firms struggle to get the finance they need in order to invest and expand, or get it at higher interest rates. There are ways in which this challenge can be overcome though. Encouraging governments on the costs of cutting funding to state-owned enterprises and running down deposits at commercial banks should help protect growth-enhancing spending areas of budgets. If governments are successful in attracting greater inward FDI, this will provide an additional source of financing and some domestic firms will benefit from supply chain and joint venture opportunities. Other firms will need to be ready to compete with new entrants. Meanwhile, banks and finance providers may find their profitability under pressure from any moves to boost competition in their sectors, and develop other financial sector areas.

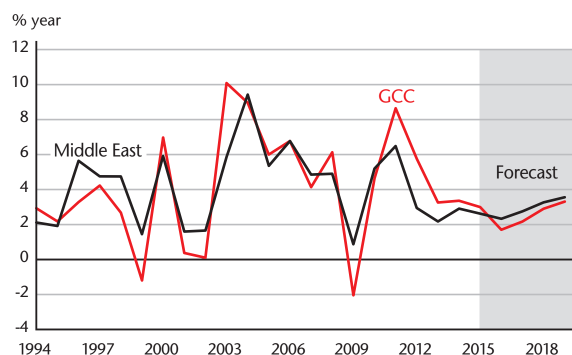
Brent crude oil prices are forecast to average US$44 per barrel (pb) in 2016, edging up to US$50 pb in 2017 respectively (Figure 5). These are $6-7 higher than our Q2 forecast, thanks to the success of OPEC's strategy to keep production high and try and freeze out higher cost producers, particularly those in the US. However, this is still well below breakeven oil prices for government budgets, which consequently remain in deficit across most of the region (Figure 6). We expect GDP across the Middle East region to grow by 2.4% this year and 2.8% next year, compared to 2.8% in 2015 (Figure 7). This includes genuine improvements in Iran, which is re-engaging with the world economy as sanctions ease, and also statistical rebounds in countries where output previously plunged.

Figure 6: Deficits remain high in most Middle East economies



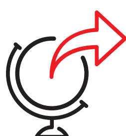
Source: Oxford Economics

Figure 7: Modest GDP growth rebound ahead



Source: Oxford Economics

Regional economic outlook



Prospects in the Middle East, 2016–2017

Despite the expected rebalancing in the oil market, and suggestions that **Saudi Arabia** will return to its swing producer role, we see production remaining broadly stable for the rest of 2016. Non-oil growth will remain weak due to continued austerity policies but rise by nearly 1% in 2016. Overall, we forecast GDP growth at just 0.8% in 2016 and 1.5% in 2017. In Box 1, we examine in more detail Saudi Arabia's ambitious plan for diversification, *Vision 2030*.

Renewed fears of property market weakness in the **UAE** stem from oversupply and weak demand. House prices fell 7.4% in the 12 months to 2016 according to real estate analysts REIDIN. Non-oil growth shows signs of slowing, owing to fiscal consolidation, the strong dollar and tighter monetary conditions. We expect total GDP growth of 2.3% in 2016 and 2.7% in 2017.

Following **Bahrain's** downgrade by S&P in February, Moody's cut one notch to Baa2 (with negative outlook) in mid-May. Meanwhile, despite subsidy cuts, higher government fees and general cost cutting, the state budget deficit will likely reach 11% of GDP this year. GDP is expected to be 11.7bn Dinar in 2016 and 11.9bn Dinar in 2017 (both in 2010 prices).

The fiscal situation in **Oman** remains a concern, with doubts around Oman's willingness to address its large deficit. Until now, the deficit has been mostly funded by issuing debt, drawing down the State General Reserve Fund plus loans and grants from other countries. Domestic financing conditions are, however, becoming tighter. The recent sovereign dollar bond should reduce the dangers of crowding out of the private sector, but at the cost of rising public debt. GDP growth is forecast to slow to 2% in 2016 and 2.1% in 2017.

Qatar is set to remain the fastest growing country in the Gulf region. Hydrocarbon production will benefit from increased pipeline gas production from the Barzan gas field and the new Ras Laffan II refinery in 2017. However, this will be broadly offset by slowing growth in the non-hydrocarbon sector, leaving total GDP growth at a forecast 3.5% in 2016 and 3.7% in 2017.

Kuwait is to follow the lead set by other GCC countries and tap international debt markets to help plug its budget deficit. Although the government has pledged to continue cutting overall spending and raising non-oil revenues, it is still prioritising investment, as underlined in the development plan for 2015–20. We see a growth of 2% in the economy in 2016, picking up to 2.2% in 2017.

Freed of sanctions, oil exports from **Iran** have surged to 2m barrels per day, with further rises in production expected, leading to an anticipated 30% increase in oil production this year. We expect GDP growth of 4.3% in 2016, with the non-oil sector benefitting from increased confidence and foreign investment.

With the government cutting spending in **Iraq**, the growth impetus from state spending is fading. The ongoing military conflict with Islamic State is a major drain on resources. Growth is forecast at 2.6% this year.

We expect an acceleration in GDP growth to 3% in **Jordan** in 2016, and 3.5% in 2017. Hosting 1.3m refugees (around 14% of the population) is creating immense fiscal pressures but a US$700m IMF loan should relieve some of these in the short term.

Lebanon continues to suffer from a protracted political crisis, partly related to the ongoing civil war in Syria. Similarly to Jordan, the cost of hosting 1.5m refugees in Lebanon is undermining the fiscal position and wider economic confidence. We see GDP growth at just 1% in 2016 and 2% in 2017.