The GCC: Prospering in uncertain times

Executive Summary

- Despite a global outlook fraught with risks and uncertainty the economies of the GCC are well equipped to meet the challenges ahead and prosper. They have abundant energy resources, sound public finances and banks, and governments that are committed to economic diversification and development. Having successfully steered their economies through the 2008-09 global slump, GCC governments have also gained new insights into how to navigate a global economy in transition.

- Although the buffer of large fiscal surpluses has certainly diminished, leaving GCC states more vulnerable to oil price volatility, public finances are still very strong and we expect them to remain so despite large spending commitments on both infrastructure development and recurrent outlays.

- Estimating budget break even oil prices is an imprecise art, but our best efforts suggest that most states will probably be able to maintain surpluses with prices in the $70-80/b range. We believe that sustained growth in emerging markets will support prices reassuringly higher than this. GCC states also have large external savings to draw on in the event of oil price volatility, and ample room to resort to borrowing if necessary.

- Mindful of their heavy reliance on hydrocarbons, all GCC states have embarked on strategies and programs designed to diversify their economies, enhance private sector activity, improve education standards and boost employment of nationals. There has been a prudent prioritisation of project spending since the global crash, but the commitment to move ahead remains firm and planned public expenditures are still very large.

- GCC populations are young, growing and relatively wealthy, helping drive economic growth. They also present challenges, key amongst which is promoting greater participation by nationals in the private sector where job creation has been very strong.
Given the current turmoil in global markets and uncertain outlook for the world economy we thought it timely to review the structural strengths of the GCC which we believe will allow the region to prosper despite the current challenges and uncertainties. We will provide a more detailed economic forecast in our pending GCC Outlook 2012 report, and instead focus in this report on the fundamentals of GCC economies.

Global background in brief
Growth will be hesitant and weak

The outlook for the world economy is fraught with risks and growth is likely to be hesitant and weak as countries in the developed world continue to grapple with large debt overhangs (both in households and governments) with diminishing policy ammunition. The process of deleveraging following the excessive build up of debt prior to the 2008 crash is likely to be painful and take a number of years to work out during which unemployment rates will remain high. The situation is particularly acute in the US and peripheral countries of the Eurozone where the sovereign debt crisis presents a major threat to world growth as it could precipitate another financial crisis if banks are hit with sovereign defaults.

Despite the dire risks, we expect a way will be found to muddle through, although this will probably mean some form of Greek default, and Eurozone growth will be muted. Overall, we expect a sharp slowdown in global growth for the remainder of 2011 with only a gradual improvement in 2012. Inflationary pressures are expected to recede next year on easing commodity and food prices, weaker growth in the OECD, and continuing effects of policy tightening in some emerging markets. Interest rates will remain low, but fiscal tightening in the OECD will act as a drag on growth.

Although our outlook is weak, we do not expect to see a full-scale recession developing and this will be important for the GCC as under such conditions we project that oil prices will steady (see below). With modest debt levels and robust fiscal balances, emerging markets will continue to be the bright spot and appear primed to maintain their historical development breakout story which will ensure sustained demand for commodities. We expect that income and wealth levels will continue to converge to those of advanced economies, although challenges will intensify including how to adjust the drivers of economic growth and avoid the so called ‘middle income trap’.
Oil prices expected to hold up

Vital to the prospects for GCC states is the impact of global developments on oil prices. This is difficult to determine with any precision given the myriad competing factors at play, including timing the return of Libyan output. Our view, in brief, is that as long as growth in emerging markets is sustained then prices will remain firm at around $100/b annual average for Brent. This may require some supply management action from OPEC, but this will be forthcoming if necessary.

More fundamentally markets will be supported by continued growth in oil demand from emerging markets which will offset declines in OECD demand (see chart) and prop up prices despite the weaker global growth environment. A key short-term issue will be developments in non-OPEC supply and the timing of expected increases over which there are widely varying estimates. On balance we think that combined increases in non-OPEC supply and OPEC NGL output will more or less match the projected increase in demand helping to balance market fundamentals over the next 12-18 months, although short-term over supply conditions are a possibility.

GCC structural strength will allow it to prosper

Public finances and external balances remain healthy

GCC states are well placed to deal with the continuing weakness in the global economy. During the oil boom of 2003-08 governments prudently used the increase in revenues to pay down public debt, build up external assets and begin implementing ambitious infrastructure and development programs aimed at diversifying their economies. They have run large fiscal and current account surpluses during 2003-08, and were able to draw on the accrued savings to implement strong counter cyclical fiscal policies to support their economies during the global crash.

The resultant increase in public spending combined with the slump in oil prices did push fiscal balances into deficit during 2009-10 in some states (see table), but all are expected to post healthy surpluses in 2011, despite additional spending commitments to address social concerns and boost employment. Rising oil prices together with an increase in GCC oil production (to offset the loss of Libyan output) have helped boost government finances in 2011, but even as such benefits wane next year, we still expect GCC fiscal balances to remain sound.
September 2011

Estimating budget break even prices is an imprecise art with much depending on oil output levels, the timing/amount of revenue flows from state oil companies to the budget, and the actual level of government spending for the year. The latter is particularly difficult to gauge in the wake of recent large off-budget spending commitments, some of which are temporary and some permanent, and whose implementation is bound to be spread out over time. However, our best estimates suggest that GCC 2012 break even oil prices will be significantly below $100/b, except for in Bahrain. In fact most states will probably be able to maintain surpluses with prices in the $70-80/b range.

Large official external assets help offset oil price volatility

Although the buffer of large fiscal surpluses has certainly diminished, leaving GCC states more vulnerable to oil price volatility, public finances are still strong and we expect they will remain so despite large spending commitments on both infrastructure projects and recurrent outlays such as salaries and pensions. Oil price volatility is a problem, but with large external assets to draw on, it is a manageable problem. GCC current accounts have been consistently in surplus since 2000, and although they have diminished somewhat in recent years reflecting government stimulus measures and fluctuations in oil prices, they remain large and have contributed to a dramatic build up in GCC external assets.

GCC states’ external assets have soared over the last decade. In Saudi Arabia’s case these are principally held by the kingdom’s monetary authority (SAMA) which has seen its assets surge more than tenfold since 2002 to just over $500 billion today, equivalent to nearly 100 percent of GDP. Other GCC central banks have also increased their foreign reserve holdings (see chart), but more significantly have also built up sovereign wealth funds (SWFs). With little official data available, it is hard to estimate the value of assets held by the region’s SWFs, but data from the Sovereign Wealth Fund Institute suggest a combined value of over $1 trillion. This is dominated by the $627 billion estimate for the Abu Dhabi SWF, ADIA, although it should be noted that other sources suggest its value is around half this.

Governments have room to borrow if necessary

As a result of sound fiscal balances, government debt levels in the GCC are generally low, giving them ample room to borrow to cover any temporary fiscal shortfalls. With strong international credit ratings, access to capital markets should not be an issue. GCC governments can also tap into local and regional liquidity. Even in the debt constrained emirate of Dubai, the government has been able to borrow in capital markets, having more clearly delineated its contingent liabilities on government related entity...
Large hydrocarbon resources provide reassuring backstop

Underlying the healthy finances of the GCC are the region’s large oil and gas reserves. While unevenly distributed within the region (see charts) the GCC accounts for over a third of global oil reserves and almost a quarter of gas reserves. Given the finite nature of these resources and the increasing demand from emerging markets, the long term outlook for hydrocarbon export prices is favourable, although there may be periods of volatility. As a result the GCC can expect to benefit from sustained large export earnings from hydrocarbons which can be used to support their economic diversification agendas. However, for Oman and Bahrain time is pressing as current estimated years of remaining production is relatively low (see chart), although in the case of Bahrain substantial progress has already been made in diversifying its economy. Elsewhere, the GCC states have a relatively long buffer of oil and gas production ranging from 45 to over 100 years.

GCC governments are committed to economic diversification

All GCC states have development plans and programs aimed at diversifying their economies and boosting nations’ participation in the private sector. The boom in GCC economies during 2003-08 was in large part driven by moves to implement such agendas with large scale spending on infrastructure, health and education. Since the global crash of 2008-09 there has been a reappraisal of the large project list and a prudent prioritisation of activities. But the commitment to move ahead remains firm and has in fact been accentuated by the recent unrest in the

(GRE) debt. Thus the Dubai’s government’s direct debt has been contained at around 38 percent of GDP.
GCC authorities recognise that structural change and diversification are key to the further development of their economies, and high levels of public spending will continue to be directed towards this. Much progress has already been made. The non-oil sector accounts for between 60-70 percent of GDP in Bahrain and the UAE, and most states have ample hydrocarbon revenues to support further efforts, while those with less, such as Bahrain and Oman, have recently been provided additional funding ($10 billion each) by the wealthier GCC states. We thus expect that the impressive economic transformations currently underway in the GCC will continue, resulting in sustained growth in non-oil sectors from construction and manufacturing to services and trade.

**BOX 1: Development Plans and Visions**

Mindful of their heavy reliance on oil and gas sectors, all GCC states have embarked on strategies and programs designed to diversify their economies, enhance private sector activity, improve education standards and boost employment for nationals. These efforts include large public spending programs on infrastructure, education and health with supporting investments envisaged from the private sector. Not all are fully costed out, but Saudi Arabia’s 9th Development Plan covering 2010-14 envisages spending of $385 billion. Kuwait’s development plan proposes $125 billion over the same time frame, while Oman’s 2011-15 plan envisages $78 billion in expenditure. Meanwhile, Abu Dhabi, Bahrain and Qatar have established Vision 2030 frameworks and national development plans/strategies to achieve those visions. The National Development Strategy for Qatar covering 2011-16 envisages spending totalling $226 billion.

Liberal economic policies and improving business environments will continue to play a part in fostering regional growth and development. The GCC has opened up to international trade and capital flows, and is actively looking to increase linkages with emerging markets (especially in Asia) which are a key source of future world growth. Foreign investment inflows (FDI) to the GCC have grown strongly over the last decade and averaged $43 billion a year during 2005-10, the bulk flowing to Saudi Arabia. This has been an impressive performance and in per capita terms FDI flow to the GCC are over ten times larger than inflows to the BRIC economies. FDI flows to the GCC held up in 2009 despite the global contraction, before weakening in 2010. There...
may be some further softening in 2011 reflecting investor caution in the face of broader MENA unrest, but inflows are expected to recover thereafter.

Still plenty of room for ‘convergence’

The relatively wealthy GCC states exhibit a mix of emerging market and advanced economy characteristics. They all score highly on the UNDP’s Human Development Index, and real per capita income levels in Kuwait, the UAE and Qatar are close to or higher than the G7 average (see charts). However, there is still plenty of scope for further convergence with advanced economies, not just reflecting the income gap in the other three states (Saudi, Oman, Bahrain) but also region wide in terms of institutional, technological and developmental aspects that could boost non-hydrocarbons productivity, investment and growth. That said, the biggest gains can be realised in Saudi Arabia, the largest economy in the region.

Saudi Arabia experienced a period of exceptionally rapid growth and development between 1950-80 which pushed real per capita incomes well above the G7 average. But the kingdom has fallen behind since. With strong government commitment, backstopped by healthy public finances, the coming decade offers a favourable opportunity to accelerate Saudi growth again, with the private sector providing the main impetus within a supportive policy and regulatory framework. However, this will require a deft and sensitive handling to promote the necessary changes in the existing incentive structures within Saudi society.

Growing populations provide opportunities as well as challenges (+ see Appendix)

GCC populations are young, growing and relatively wealthy, providing both opportunities and challenges. According to IMF data, the total GCC population has grown by nearly 19 million people since 1990, with more than half of the increase in Saudi Arabia, although the smaller states have grown at a faster rate (see chart). Growth has come from increases in national populations as well as large inflows of migrants. These expanding populations have been key drivers of economic development in the region, and the increasingly urbanised GCC middle class has provided a growing consumer base for businesses. In addition, GCC fertility rates have fallen while working age populations have risen providing the conditions for a ‘demographic dividend’.

However, growing national populations also require jobs. Traditionally these have been provided in the public sector, while expatriates have been brought in to provide labour for the
private sector. But public sector jobs cannot absorb all the new entrants leading to unemployment and under employment problems, particularly amongst the youth. Circumstances differ between GCC states, but in the main the issue is not a lack of jobs, but rather a question of low participation rates by nationals in the private sector.

Measures are underway to address this with a particular focus on education and economic diversification. These efforts will take time to yield results and in the meantime GCC authorities have responded to social concerns (highlighted by recent MENA unrest) by using healthy hydrocarbon revenues to absorb more workers into the public sector. This has bolstered aggregate demand but, although currently affordable, is not a policy that can be pursued indefinitely. A more detailed discussion on demographic issues is included in the Appendix to this report.

Banking systems are sound, well regulated and can support development agendas

The GCC banking sector is generally sound and well managed, and compares favourably when viewed against US and European banks. GCC banks have been resilient in the face of recent global financial shocks and benefit from strong government support. Most hold capital in excess of statutory limits and are now highly liquid, bolstered by a healthy revival in deposit growth since the middle of 2010. Banks are also now benefiting from falling loan loss provisions following an initial surge in impaired assets reflecting in large part the crash in regional property prices, defaults at Saudi conglomerates, the Dubai debt crisis, and difficulties surrounding Kuwaiti investment companies. In addition, GCC bank access to international capital markets has improved, the cost of funding has declined, and most banks have maintained their high levels of profitability.

However, it would be unrealistic (and probably undesirable) to expect credit growth to return to the 40 percent p.a. booming levels seen prior to the global crisis, and in fact lending has remained muted despite the improvement in bank balance sheets and strong government fiscal stimulus. Credit grew by around 5-7 percent in most GCC states in 2010, although it remained stalled at less than one percent in the UAE and Kuwait. Lending activity has picked up in 2011 (see charts), although the rate of growth has been held back by uncertainty caused by widespread unrest in the broader MENA region, accentuating risk aversion by both banks and investors. Bahrain was of course worse hit by its own unrest, but headwinds also came from still weak real estate markets, particularly in the UAE, which is also still undertaking restructuring of its heavily indebted GREs.
That said, we expect that the revival in corporate and consumer credit growth will strengthen in 2012 as GCC economies continue to benefit from high oil revenues and sustained public spending. Banks should become more comfortable taking on risk, although economy wide confidence will still be vulnerable to global developments. Project financing will be an area of growth as progress is made with implementing state development plans. However, regional banks will not be able to cover all the long-term financing needs, and there are concerns that international banks could hold back due to their own home country concerns, including the debt crisis in the Eurozone and regulatory changes. It will thus be important that efforts continue to be directed at developing national and regional bond markets to provide alternative sources of long-term finance in the GCC.

A positive future

In conclusion we believe that the region has a bright future. It has abundant energy resources which are increasingly sought by growing emerging market economies. Its public finances are strong, its labour force is becoming more educated, its banks are sound, and its governments committed to economic development and diversification. Success will depend on a consistent set of policy prescriptions to deal with the challenges ahead. Good progress has been made to-date, and the recent experience of dealing with the global crisis has given GCC leaders new insights into how to navigate a global economy in transition.
Appendix: Demographic Dilemmas

The GCC’s unique population and employment issues will need to be carefully managed

The GCC’s young and rapidly growing population provides both opportunities and challenges. Growing populations are key drivers for economic growth both in terms of providing final demand (for goods, services, real estate, infrastructure etc) and to provide the labour needed for their production. However, the normally observed relationships between demography and economic development are somewhat distorted in the GCC due to the region’s reliance on expatriate labour who remit a large proportion of salaries to their homelands with associated negative impact on non-oil sector growth and the balance of payments. Also, the wealth generated by the capital intensive and dominant hydrocarbon sectors has excluded the need for an income tax.

Expanding populations have clearly played a large part in the growth and development of Gulf economies over the last decade (particularly in the smaller states of the UAE and Qatar), but to ensure that they continue to reap the potential benefits, including the oft cited “demographic dividend”, GCC states face a number of more local challenges. Job creation for nationals is a key issue given the region’s young and rapidly growing population, particularly in Saudi Arabia which has the region’s largest population and economy. Currently unemployment rates among GCC nationals are relatively high at over 10 percent, while the youth (ages 15-24) unemployment rate is often double that.

However, the issue is not a lack of jobs. The GCC has created plenty of jobs over the last decade (see chart). It is a question of low participation rates by the national labour force in the private sector which has meant these jobs have largely been filled by expatriates often prepared to work for low salaries. There are a number of complex issues at play here including a basic shortage of labour (particularly in the smaller states); the ease and attractiveness of employing low cost expatriate labour, the perceived unsuitability of many jobs, skills and qualifications mismatches between nationals and private sector needs, and GCC nationals’ preference for public sector jobs which tend to be better paid, less demanding, and more secure than those in the private sector. In addition, given the nature of GCC political systems the authorities are inclined to want to share their nation’s oil wealth through the provision of generous welfare systems and public sector employment which absorbs around
between 35-90 percent of national work forces in each state (see chart).

Box 2: What is the “demographic dividend”?

A demographic dividend is understood to occur in an economy when falling fertility lowers child dependency and when the working age population (age 15-64) expands, but before old age dependency starts to rise significantly. This dividend is associated with rising investment and accelerating economic growth and describes the situation that western economies have enjoyed for the last 30 years. However, for many developed economies the benefits are being exhausted as populations age and the supply of new workers needed to support them stagnates. Its application to the GCC states is clouded by the high youth unemployment rates, the role of expatriate labour, and state reliance on hydrocarbons revenues rather than taxes in providing for national populations.

That said, there is an increasing recognition in the region of the need for economic diversification and improved education as a means of boosting labour force participation, as well as to reduce the reliance on hydrocarbons. In addition, it is clear that the public sector cannot go on indefinitely absorbing new job entrants. The recent unrest in the broader MENA region has added greater impetus to these state led development efforts. Economic diversification is certainly gathering speed (see our 2010 report The GCC: Increasingly Diversified Economies), and sustained large-scale public investment projects will provide further momentum. However, by its nature the improvement in education standards will take time to filter into the national labour force. In the meantime, GCC authorities have responded to social concerns by increasing public sector employment, and in the case of Saudi Arabia, intensifying its ‘Saudiisation’ employment policies through its Nitaqat program.

Such labour policies need to be managed carefully so as not to unduly jeopardise productivity and competitiveness, although some cost increases are inevitable if the kingdom is to wean itself off a reliance on cheap expatriate labour. In this context the Nitaqat could go some way to closing the salary gap between public and private sector employees as companies compete to attract and retain nationals (who themselves may be inclined to attain more skills to secure the higher salaries on offer). However, its effectiveness would be enhanced by curbing the advantages of working in the public sector, making firing nationals in the private sector easier, and generally improving the flexibility and competitiveness of the labour market which is currently highly segmented (public-private, national-expat, male-
female). In addition, the Nitaqat measure should only be viewed as short-term expediency, with the longer term emphasis being on improving labour productivity. This requires a shift out of the government services sector, which is among the least productive, and into the manufacturing and private service sectors.

The smaller states such as Qatar and the UAE face a slightly different demographic challenge. With expatriates accounting for 80-90 percent of the population, their presence essentially provides the bulk of aggregate demand in the economy. In order to sustain population levels these states need to attract businesses that provide long-term employment (beyond the short-term boost that project and infrastructure construction provides), and also to address the more sensitive issues of legal and residency status of expatriates. Managing the needed transition to lower inflows of more skilled labour will be a tricky task for all GCC states, particularly as migrant labour is still needed to drive the region’s necessarily ambitious infrastructure and development programs.
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