

Middle East Macro View

Why the GCC's Structural Challenges Matter

- Thanks to the unprecedented rise in oil prices over the past decade, the GCC economies have become among the richest and best-performing in the world, and beat global peers on virtually all indicators of sovereign risk. Consequently, their credit ratings have been converging with those of the strongest advanced economies over the past decade, and are generally just shy of the AAA gold standard. Markets have reflected this, with CDS spreads on sovereign debt of the oil-rich Gulf countries tighter than most emerging and advanced market peers.
- And yet, despite significant investment in the non-oil sector by most governments, the region has made little progress in addressing many of its structural underlying challenges. These include an over-reliance on oil and gas, public sector dominance in the economy, and labour market imbalances.
- We think it is likely that markets are discounting these structural challenges excessively. In our view, markets appear to be focused on the undeniable cyclical upswing that the GCC is currently enjoying, and the consequent strength of public balance sheets. We think markets tend to perceive the structural issues as being long-term and beyond their investment horizon. Moreover, the vast reserves of sovereign wealth that the region enjoys are seen as providing a backstop to any potential economic and financial risks that may arise.
- In this article, we highlight why we think that some of the structural challenges have put many of the GCC countries on a negative economic trajectory going forward, and how this may begin to impact the credit profiles of GCC countries sooner rather than later. In the absence of pro-active economic policies to counteract the negative economic trajectory, we believe this is likely to lead to a fundamental market re-pricing of GCC risk over an 18-24 month horizon.

Our argument is essentially that the space for revenue growth is extremely limited going forward, given our bearish global oil outlook, and that present expenditure growth rates will soon erode fiscal surpluses, and GCC governments will start posting deficits in the next couple of years. While sovereign wealth remains an important backstop to public finances and we do not expect anything approaching a fiscal crisis in any of the GCC countries, the shift to deficits is likely to be structural and will eventually require structural reforms, from expenditure rationalization to revenue diversification. The experience of similar attempts in Europe raises concerns regarding the economic and social consequences that may lie in wait for the GCC. It also suggests that such measures are best implemented in good times rather than in bad, which means the GCC should act now, before the window of opportunity closes.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Why the GCC's Structural Challenges Matter

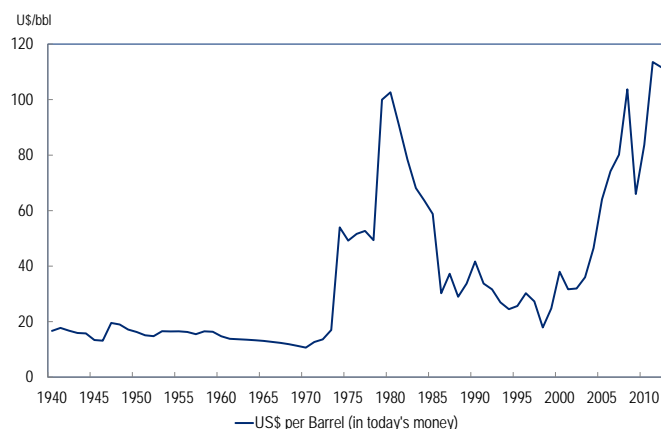
The oil boom from 2003 to present has resulted in a major cyclical economic upswing in the GCC. Today, there can be little doubt that on many measures, GCC economies are among the best performing in the world, especially as developed economies and certain emerging markets continue to grapple with the aftershocks of the global financial crisis.

That said, the region continues to exhibit a number of structural economic underlying challenges, including an over-reliance on oil and gas, public sector dominance, and labour market imbalances. In this note we look at how these structural challenges may put many of the GCC countries on a negative economic trajectory, and how this may begin to impact the credit profiles of GCC countries sooner rather than later. We argue that, in the absence of pro-active economic policies to counteract the negative economic trajectory, this is likely to lead to a fundamental market re-pricing of GCC risk over an 18-24 month horizon.

The current oil boom and the soaring GCC economies

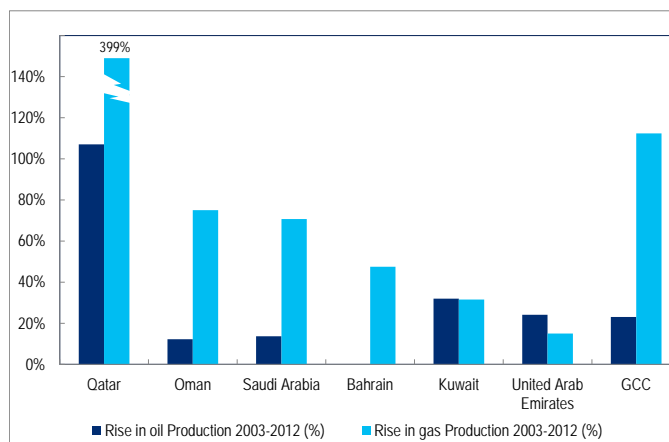
Between 2003 and 2008, oil prices surged from an annual average of US\$32 per barrel to well over US\$100 per barrel in today's money (fig 1). The global economic downturn led to a brief hiatus in the rise of oil prices, but oil has bounced back to average over US\$110 per barrel in the past two years, where it stood at the time of writing. At the same time, GCC oil and gas production boomed as the global demand push saw OPEC raise allocations from around 22 mbpd at the start of 2003, to 30 mbpd today. The GCC countries collectively raised production by 25% during this time (fig 2).

Figure 1. Oil prices are at record levels...



Source: BP Statistical Review of World Energy (2013); Citi Research

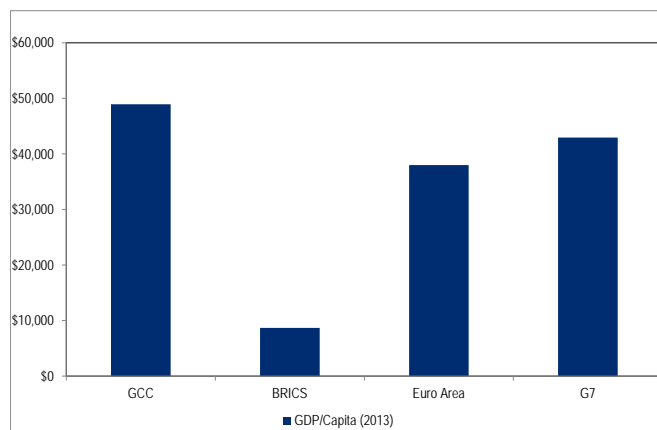
Figure 2. ...just when GCC oil and gas production has boomed



Source: BP Statistical Review of World Energy (2013); Citi Research

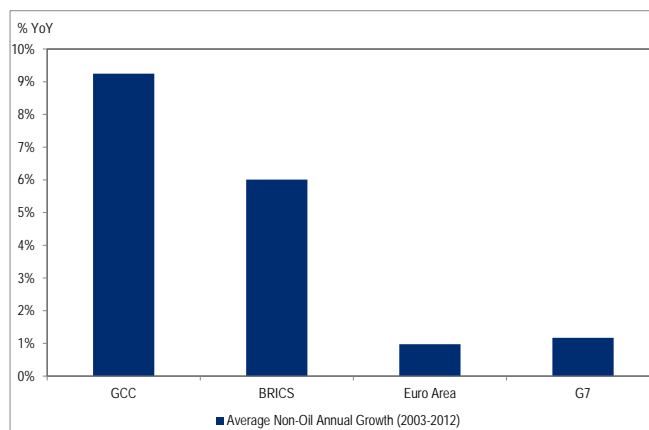
The result of record prices and record production has been the largest windfall to GCC governments in their history, which has fuelled a sharp cyclical economic upturn led by aggressive government spending. Today, the GCC economies stand head and shoulders above most regional and global peers on most measures of economic performance and sovereign risk.

Figure 3. GCC countries are among the richest in the world



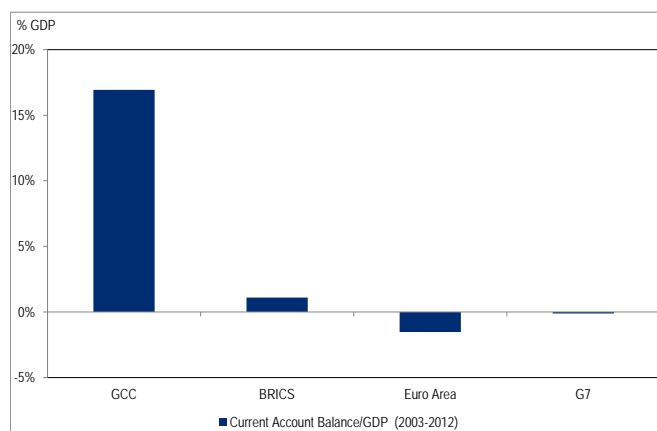
Source: Haver Analytics, Citi Research

Figure 4. Non-oil economic growth has been robust



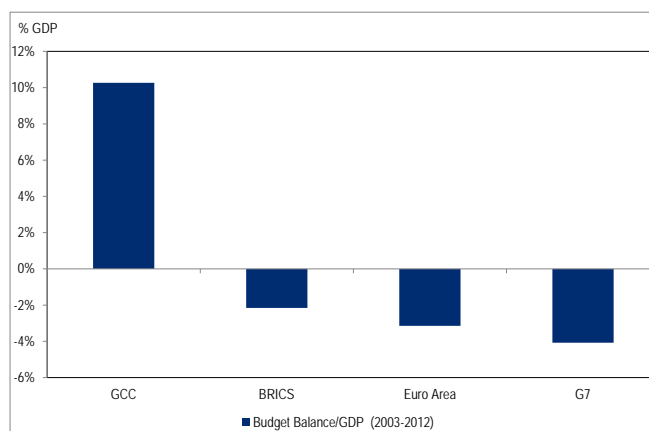
Source: Haver Analytics, Citi Research

Figure 5. Oil earnings have led to massive current account surpluses...



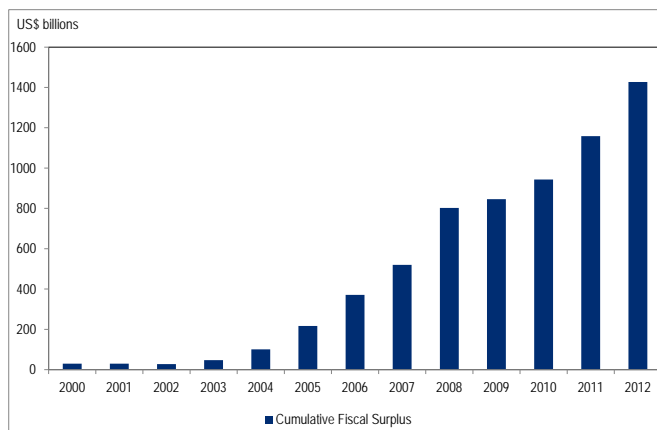
Source: Haver Analytics, Citi Research

Figure 6. ...As well as fiscal surpluses...



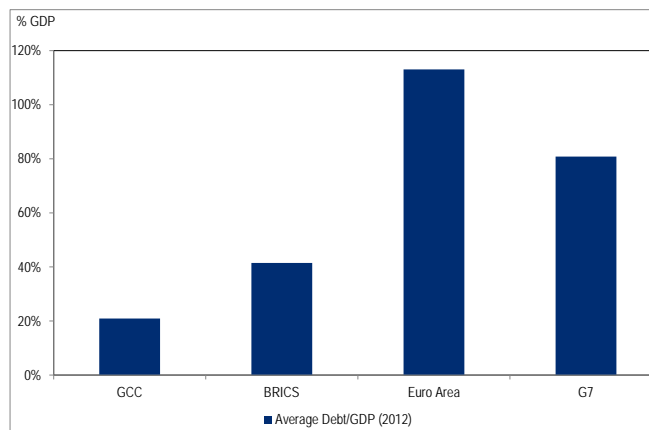
Source: Haver Analytics, Citi Research

Figure 7. ...Which have led to a significant accumulation of sovereign wealth over the past decade...



Source: Haver Analytics, Citi Research

Figure 8. ...While debt ratios remain exceptionally low



Source: Moody's, Citi Research

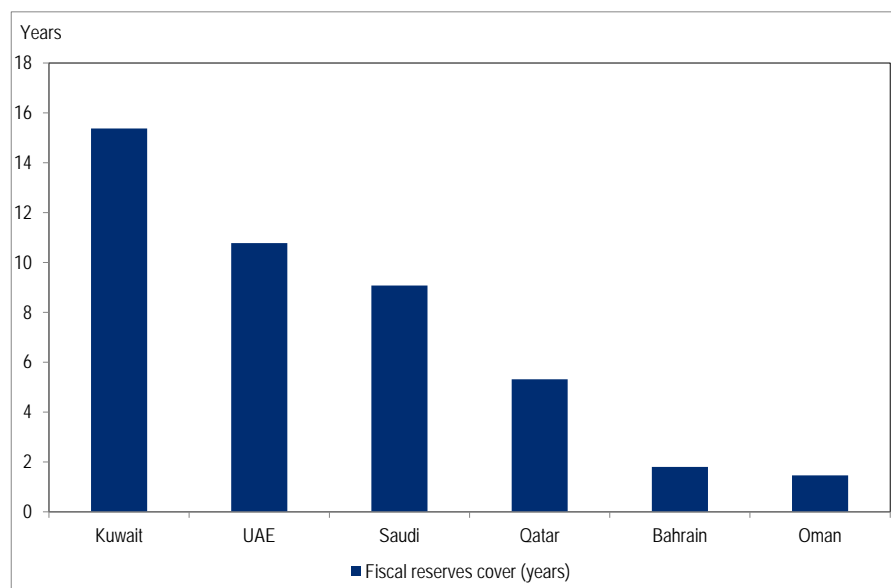
The GCC economies have become among the richest in the world. On average, however, the GCC region's national wealth is about six-fold that of the BRICS countries, and higher than the Euro area and G7 average as well (fig 3). The region's wealth may be rooted in record oil prices and production, but growth in the non-oil economy has been equally impressive. Average annual growth between

2000 and 2010 was 9% for the GCC as a whole, while in the fast growing BRICS countries it was 'just' 6%. In the Euro Area and G7, growth has tottered along at under 1% per year on average (fig 4).

The rise in oil revenues has also swelled foreign exchange and fiscal earnings, leading to stronger external and fiscal balances than among any emerging or developed market peers (figs 5 and 6). Indeed, the fiscal surpluses accumulated by the government have, according to our calculations, enabled them to amass savings approaching US\$1.5 trillion since the beginning of this century alone (fig 7). This is the keystone to the exceptionally strong balance sheets that the GCC countries currently enjoy, coupled with very low levels of national debt compared with other economies (fig 8).

As an illustration of the strength of the GCC governments' balance sheets, we have calculated the number of years each sovereign can fund a fiscal deficit equivalent to 10% of GDP purely from its own fiscal reserves. The results are staggering: Kuwait's reserves could fund such a deficit for over 15 years, while in the UAE, Saudi and Qatar the reserves would last between five and ten years, roughly (fig 9). In relatively oil-poor Oman and Bahrain, the cover is closer to one year.

Figure 9. Most of the GCC countries have exceptional fiscal space to fund deficits from reserves



Source: Haver Analytics, Citi Research

Arguably, these savings provide a formidable cushion to sovereign balance sheets, significantly reducing their vulnerability to downswings in oil revenues. To illustrate the importance of this, it is worth recalling that when oil prices fell sharply in the 1980s, GCC governments were forced to cut back on expenditure leading to a sharp downward spiral in economic activity. Today, GCC governments look less vulnerable: even if oil revenues were to fall, GCC governments have the fiscal space to maintain economic growth on track through spending financed from their reserves for a number of years. This also shields them from external financing risks. This kind of fiscal space sets the Gulf countries apart from any of their regional or global peers.

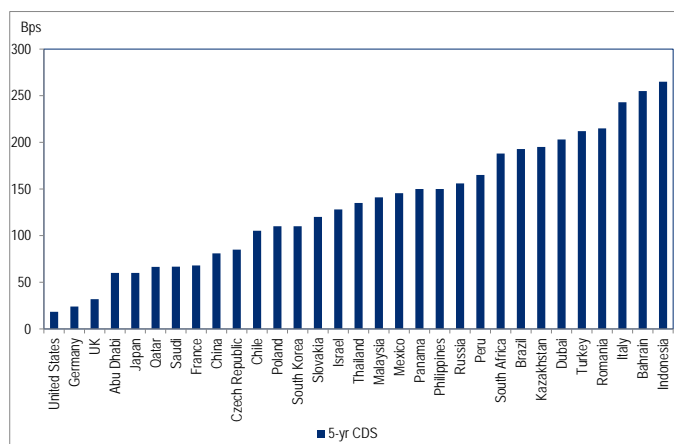
Figure 10. Sovereign ratings (S&P) have risen to reflect the fiscal strength of the GCC countries

	Year of initial (S&P) Sovereign Credit Rating	Initial Rating(S&P)	Current Rating (S&P)
Kuwait	1997	A	AA
Bahrain	2002	A-	BBB
Oman	1996	BBB-	A
Qatar	1996	BBB	AA
Saudi Arabia	2003	A	AA-
Abu Dhabi	2007	AA	AA

Source: Standard & Poor's, Bloomberg, Citi Research

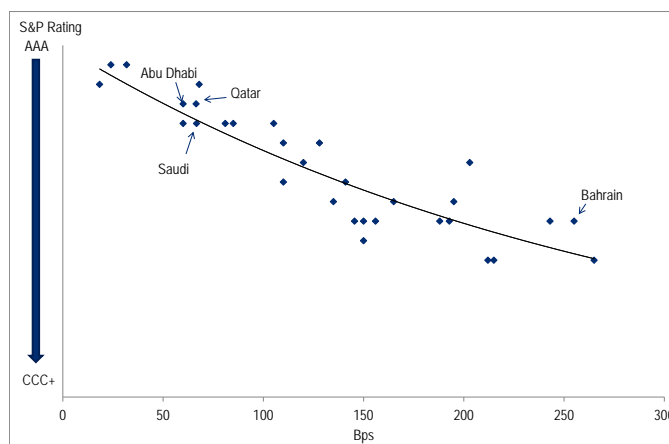
The sovereign ratings of GCC governments have risen to reflect the strengthening of government balance sheets and economic outturns. Excluding Bahrain, which experienced a series of downgrades since 2011 due to the domestic unrest the country has been experiencing, GCC countries have seen their sovereign ratings raised by an average of 4 notches since their initial ratings by rating agency S&P, with the four big oil-producing economies enjoying ratings in the AA category, just one rung below the coveted AAA. Markets seem to agree with the rating agencies regarding sovereign risk in the GCC, with CDS premia on GCC names trading relatively well and in line with the ratings (figs 11 and 12).

Figure 11. GCC risk performs relatively well...



Source: Bloomberg, Markit, Citi Research

Figure 12. ...And generally in line with the ratings



Source: Bloomberg, Markit, Citi Research

Underlying structural challenges persist

Alongside the undoubted economic strengths of the GCC, a number of structural challenges persist that together we think represent a potential threat to the economic trajectory of the GCC countries going forward.

Continued dependence on oil

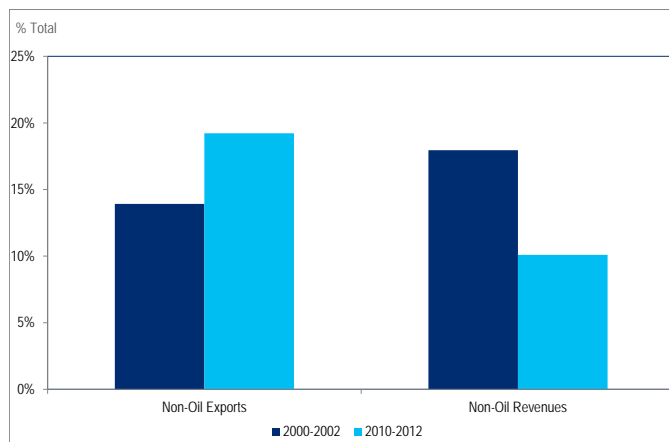
The experience of the collapse in oil prices in the 1980s and 1990s taught the GCC countries the importance of reducing their economic dependence on hydrocarbons. In 1999, the GCC countries unveiled a 'Long-Term Comprehensive Development Strategy (2000-2025)', which stressed the goal of diversifying the economy away from hydrocarbons through investments in the non-oil sector.¹ There is little doubt that a great deal of investment has occurred in the 'non-oil economy' since the start of the century, broadly defined as all economic activity that is not directly related to the extraction of crude oil and natural gas. However, this has not translated into a significant reduction in economic dependence on oil for a number of reasons. First, as mentioned earlier, oil and gas production has also boomed during this time, somewhat offsetting advances in the non-oil sector. Second, much of the non-oil activity remains highly correlated to the oil economy, such as refining and downstream industries such as petrochemicals. Fig 13 strips out these industries and shows that the non-oil sector has hardly grown in relation to the oil sector over the past decade, and has actually shrunk in nominal terms due to the rise in oil prices.

Figure 13. The non-oil sector remains stagnant in real terms, and has shrunk in nominal terms



Source: Haver Analytics, Citi Research

Figure 14. Non-oil exports remain limited while non-oil government revenues have fallen



Source: Haver Analytics, Citi Research

Another reason why non-oil economic activity still remains highly correlated to the oil industry is the fact that much of it is driven by government expenditure, which is derived from oil. We discuss this later, but mention it here to emphasize the fact that the economy remains as dependent on oil today as it was at the start of the century, despite government best efforts to diversify.

Oil dependence is also evident in the external and fiscal sectors. Fig 14 shows non-oil exports (excluding re-exports and petrochemicals) remain a fraction of overall exports, while non-oil government revenues have almost halved in the past decade, to under 10% of total GCC government revenues (this excludes income from investments). Indeed,

¹ The Cooperation Council for the Arab States of the Gulf (GCC) Secretariat General, 1999, 'Long – Term Comprehensive Development Strategy for the GCC States (2000-2025)'.

Figure 15. A snapshot of GCC oil dependence

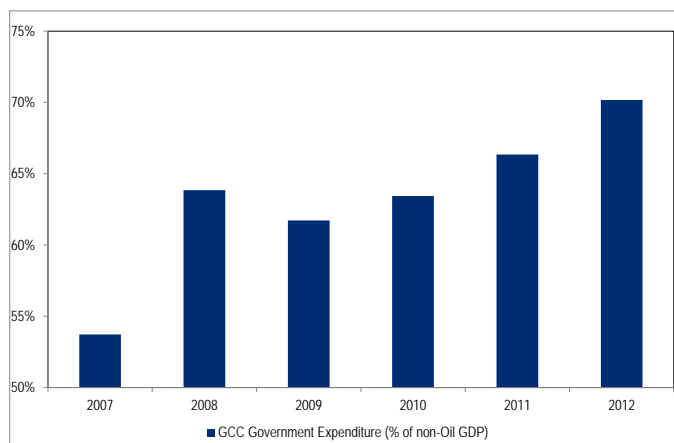
	Oil and gas as a share of		
	Government Revenues	Exports	Real GDP
Bahrain	87%	77%	25%
Kuwait	94%	95%	65%
Oman	85%	80%	50%
Qatar	73%	78%	57%
Saudi Arabia	92%	88%	50%
UAE	92%	55%	40%

Source: Haver Analytics, Citi Research

The dominant state

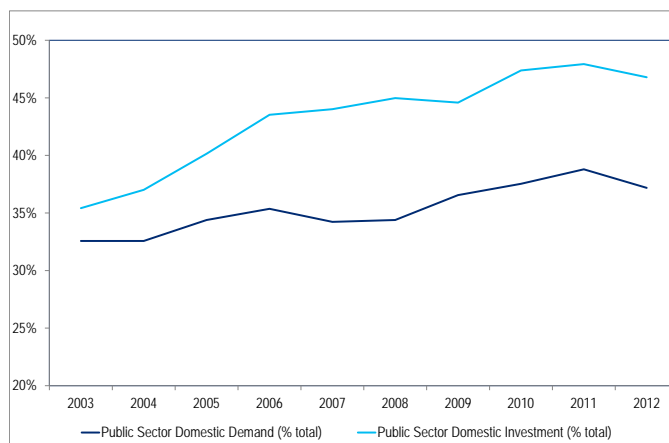
The prevalence of the state in the domestic economy in the GCC is evident through two channels. First, government expenditure is a major driving force of domestic demand and investment. In the GCC as a whole, government expenditure accounted for 70% of non-oil GDP in 2012, a number that has been rising in recent years (fig 16). National accounts data show that the public sector directly represents about a third of overall domestic demand, and about half of domestic investment (fig 17). We believe that indirectly and through state-owned enterprises the public sector is a much larger component of GDP than these numbers suggest.

Figure 16. Government expenditure in the GCC has risen to as much as 70% of non-oil GDP



Source: Haver Analytics, Citi Research

Figure 17. Public sector increasingly dominates demand and investment in the economy



Source: Haver Analytics, Citi Research

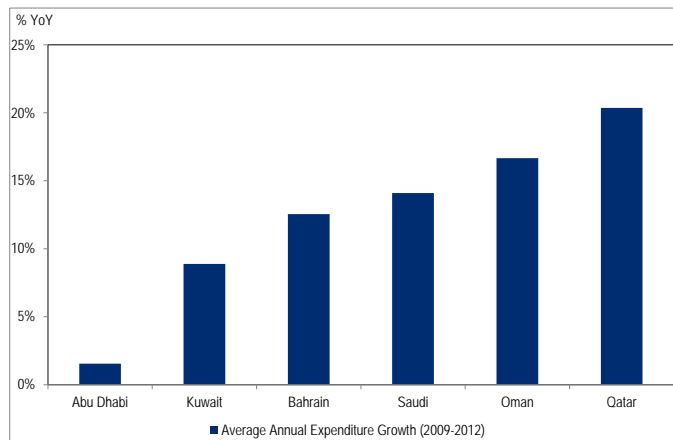
The second channel is through the government's ownership of many of the major players in the local economy. Companies from SABIC to Emirates, from Mubadala to Mumtalakat, are all government-owned and, along with other state-owned companies, dominate the local economy.

The debate on the extent to which the state should play a role in the economy has by no means been conclusively settled. There are many good reasons why over the past half century the state has come to play such an important role in the GCC, most notably because it controls the vast majority of wealth in the country (hydrocarbons). Nor is it technically necessary to increase private sector involvement in the economy in order to diversify – public sector can very ably lead the way in expanding the non-oil sector and reduce dependence on hydrocarbons.

However, we see at least two significant problems with the extent of government dominance of the local economy in the GCC. The first is, as alluded to earlier, this reinforces the link between oil revenues and economic activity. Insofar as government expenditure (and that of its wider public sector) is dependent on oil revenues, so then will wider economic activity.

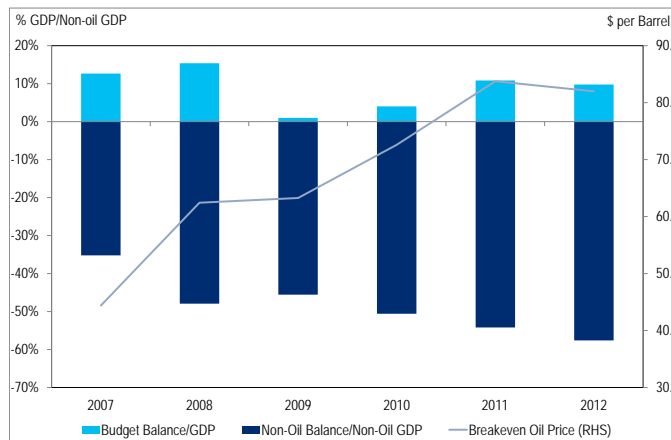
The second concern we have over the extent of government activity is with respect to the sustainability of public finances. Government expenditure has risen sharply in recent years, between 10% and 20% per annum in the GCC countries (with the exception of the UAE – fig 19). This aggressive fiscal expansion has been disguised largely by rising oil prices, meaning budget surpluses have remained healthy. However, the underlying fiscal stance, which is best measured looking at the non-oil balance in relation to non-oil GDP, has been deteriorating, with this deficit widening by 20 percentage points since 2007 for the GCC as a whole (fig 20). The result has been that the amount of money the government needs to earn in order to maintain its healthy surplus has increased from year to year, with the fiscal breakeven oil price rising from around US\$45 per barrel in 2007, to over US\$80 per barrel in 2012.

Figure 18. Government expenditure has risen relatively sharply in recent years



Source: Haver Analytics, Citi Research

Figure 19. Overall budget surpluses disguise a relatively aggressive fiscal stance and rising fiscal vulnerability

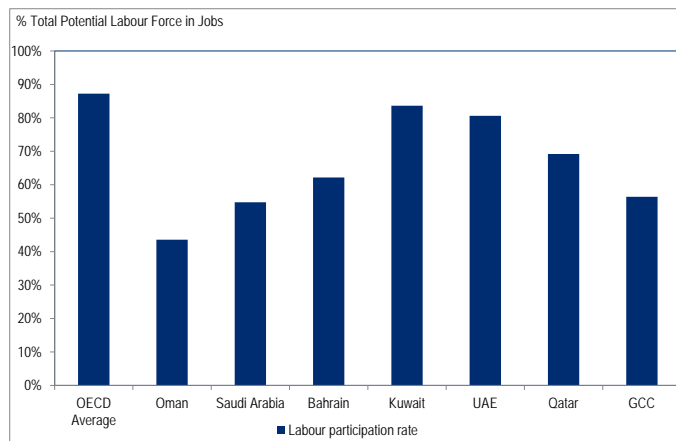


Source: Haver Analytics, Citi Research

Labour market distortions

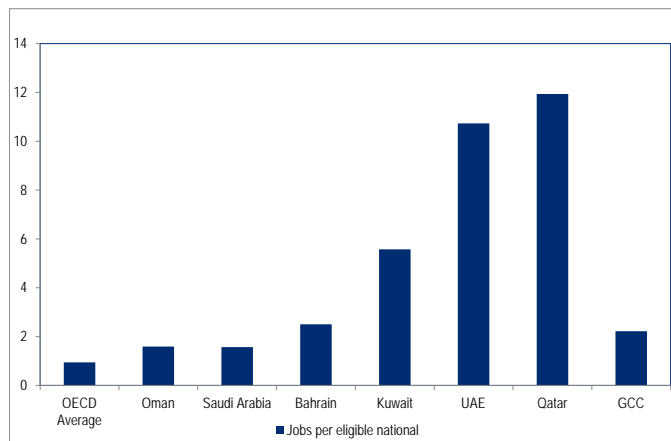
Another significant challenge facing the GCC economies is the low level of job participation among nationals. Only just over half of eligible GCC nationals (ie those of working age) are actually in a job (fig 20) compared with a number close to 90% in the OECD. This is patently not due to a lack of jobs – there is anywhere between one and eleven jobs available for each eligible national, depending on the country (fig 21).

Figure 20. Relatively few GCC nationals are in a job...



Source: National Statistical Sources, Citi Research

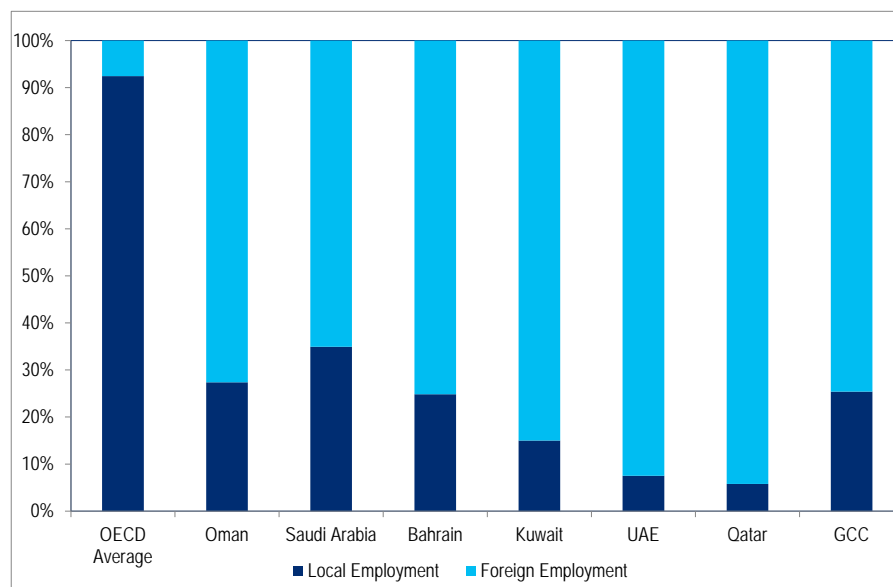
Figure 21. ...Despite there being more than enough of them to go round



Source: National Statistical Sources, Citi Research

The difference between the number of jobs available and those taken up by nationals reflects the extraordinarily high level of foreigners in the GCC job market. Foreign nationals make up the vast majority of the GCC labour force, around 70% on average, and over 90% in Qatar and the UAE (fig 22). There are many factors behind the GCC's dependence on foreign labour, including low female participation rates, little interest in private sector jobs on the part of locals, and little desire to employ locals on the part of employers. But what is clear is that there are many GCC nationals, particularly youth, without jobs, a situation that has proved somewhat destabilizing in other parts of the Middle East in recent years.

Figure 22. Dependent on foreign labour



Source: National Statistical Sources, Citi Research

Why the structural challenges matter

While oil prices are high and the economic performance of the GCC countries remains strong, it is understandable that the structural challenges facing the GCC should fade somewhat into the background. Arguably, these are long-term issues beyond the average investor horizon. Moreover, the very strength of GCC balance sheets cushions them from any near-term risks that may arise, say from a fall in oil prices, as outlined earlier.

We believe, however, that these challenges, left unchecked, are potentially setting GCC economies on a negative trajectory that will become increasingly apparent in the next couple of years, and may result in a re-pricing of GCC sovereign risk. At the heart of our argument is our view that the space for revenue growth is extremely limited going forward, given our bearish global oil outlook. Present expenditure growth rates will therefore, more swiftly than many anticipate, begin to erode the fiscal surpluses, and GCC governments will start posting deficits in the next couple of years. While sovereign wealth remains an important backstop to public finances and we do not expect anything approaching a fiscal crisis in any of the GCC countries, the shift to deficits is likely to be structural and will eventually require structural reforms, from expenditure rationalization to revenue diversification. Fiscal austerity is not something GCC countries have had to deal with in recent years, and the economic effects could be significant. We also have concerns regarding the social impact given low job participation rates and the demographic imbalance.

Citi's bearish(ish) oil outlook

Citi is bearish oil on a 5 year basis but not massively so. In the near term bullish support for the oil market is being driven by supply disruptions (mainly in Iran due to sanctions) and geopolitical strife across the Middle East. Recent events in Egypt, Syria etc have clearly added to the bullish side of the ledger. As a result oil prices look set to stay higher for longer than was previously forecast.

Longer term, however, we see the bearish drivers taking greater hold. These include:

- **A bearish global macro backdrop.** Our global growth forecasts are relatively sluggish, and we see risks to the downside for key economies such as China. Moreover, the inevitable tapering of quantitative easing in the US, rising yields and a stronger US dollar could all have a potentially negative impact on investor appetite for commodities and are bearish oil prices.
- **The shale revolution and wider gas-oil substitution.** The shale gas story is fundamentally changing the outlook for global oil demand, as cheaper gas is driving an accelerating move to substitute natural gas for oil in heavy duty trucks, ships, trains, power generation and the petrochemical industry. This move will accelerate with the advent of more shale- and LNG-related projects going forward.
- **Increasing fuel economy.** Vehicle fuel efficiency has improved markedly since 2007 when the US passed the Energy Independence and Security Act of 2007, and similarly robust mandates have been passed in several other key car markets since then, including the EU, Japan, Canada and China. Our Automobile Equity Research team's forecast of LDV annual fuel economy improvements of 3-4%, which we think will have a significant impact on oil demand.

The upshot is that we see oil prices on a slow downward trajectory from here as outlined in fig 24, and we expect oil prices to settle into a US\$75-90/bbl range later this decade.

Figure 23. Citi's oil outlook is for a modest decline in prices going forward

	1Q13	2Q13	3Q13E	4Q13E	1Q14E	2Q14E	3Q14E	4Q14E	2013E	2014E	2015E
Brent (\$/bbl)	112.6	103.4	112.0	110.0	110.0	105.0	110.0	105.0	109.5	107.5	102.5
	1Q13	2Q13	3Q13E	4Q13E	1Q14E	2Q14E	3Q14E	4Q14E	2013E	2014E	2015E
WTI (\$/bbl)	94.4	94.2	108.0	107.0	108.0	103.0	108.0	102.0	100.9	105.3	99.5
	1Q13	2Q13	3Q13E	4Q13E	1Q14E	2Q14E	3Q14E	4Q14E	2013E	2014E	2015E
WTI-Brent (\$/bbl)	18.2	9.2	4.0	3.0	2.0	2.0	2.0	3.0	8.6	2.0	3.0
	1Q13	2Q13	3Q13E	4Q13E	1Q14E	2Q14E	3Q14E	4Q14E	2013E	2014E	2015E
US Henry Hub (\$/MMBtu)	3.5	4.0	3.4	3.4	3.7	3.6	3.7	3.9	3.6	3.7	4.5

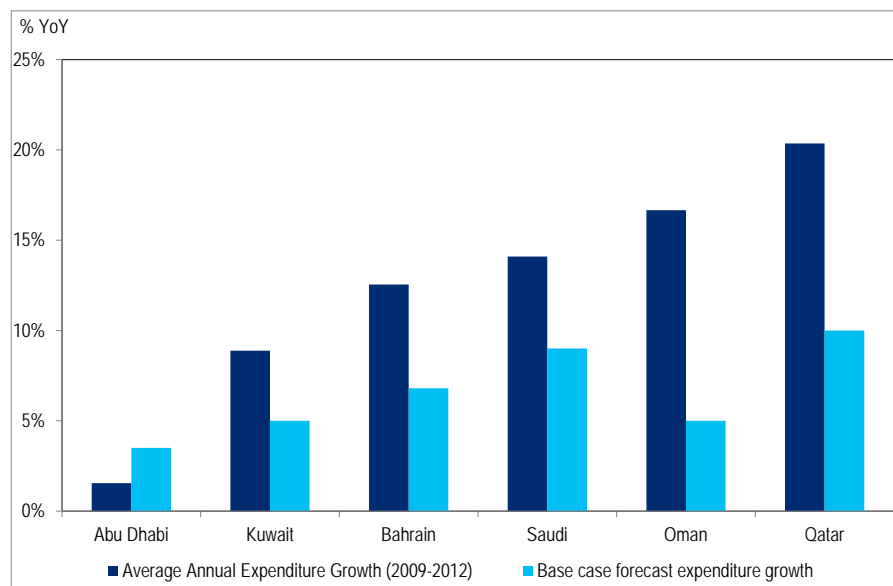
Source: Citi Research

Implications for GCC public finances

The gentle decline in oil prices is of great consequence to GCC economies as it implies, at the very least, a plateauing in government revenues. Crucially, GCC oil production is unlikely to increase to compensate for the decline in prices for two main reasons. First, this would require a new wave of investment as most GCC countries are currently producing near their maximum capacity. Second, raising supply in a declining market is counterproductive and will exacerbate the fall in prices – indeed production is likely to fall, in line with OPEC tightening, as prices decline and so risks to revenues are actually on the downside, in our view.

A plateauing in oil revenues presents a challenge to public finances if expenditures are expected to continue to grow. To demonstrate this point, we have carried out a simple scenario analysis capturing the likely trajectory of the budget balance in a number of scenarios over the next five years. In the base case, we assume oil prices move in line with our forecasts. We then look at three downside scenarios, where oil prices decline quicker than expected. In these scenarios, oil prices end up 10%, 20% and 30% lower than our current expectations in the fifth year. We assume the same rate of growth for expenditures for all scenarios. Expenditure growth rates are generally lower for each country than their recent historic averages, as shown in fig 24.

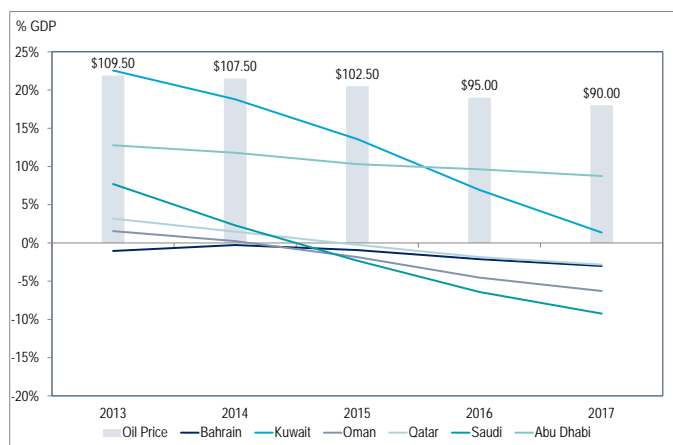
Figure 24. Our expenditure growth projections in this scenario analysis are relatively benign compared with recent historic averages



Source: Haver Analytics, Citi Research

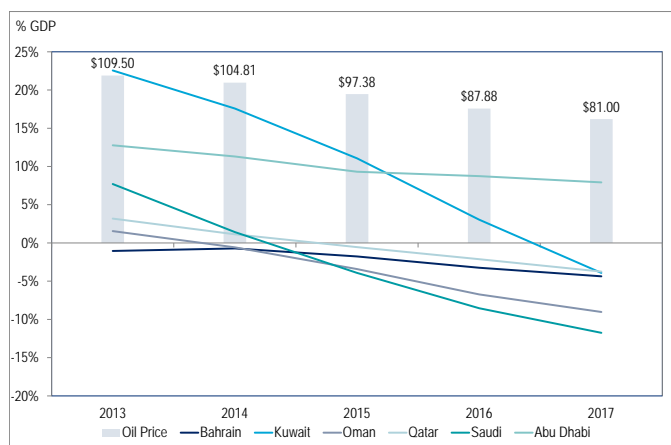
In our base case scenario, the projected decline in oil prices will tip most GCC countries into a budget deficit by 2015, and these deficits will continue to widen each year thereafter. While the deficits in 2015 are modest and easily financeable, in our view, the structural nature of the shift from surplus countries to deficit countries in itself is probably enough to shift risk perceptions of the GCC.

Figure 25. Our base case scenario for GCC budget balances



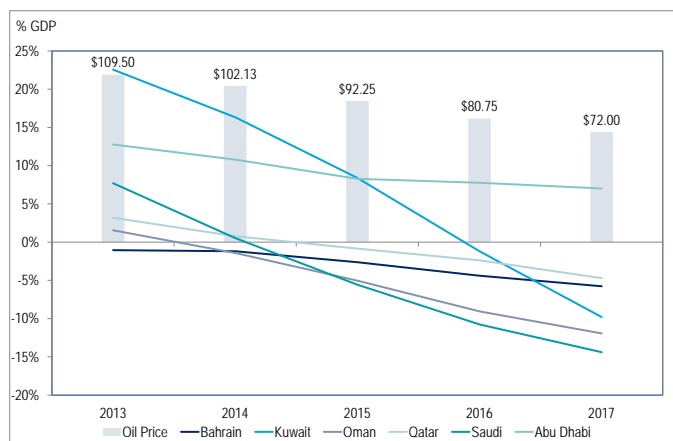
Source: Haver Analytics, Citi Research

Figure 26. 10% decline in oil prices relative to our current expectations



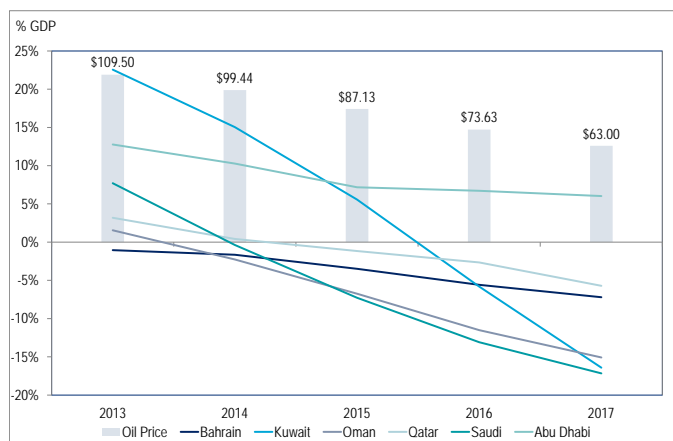
Source: Haver Analytics, Citi Research

Figure 27. 20% decline in oil prices relative to our current expectations



Source: Haver Analytics, Citi Research

Figure 28. 30% decline in oil prices relative to our current expectations



Source: Haver Analytics, Citi Research

The downside scenarios show a more aggressive descent into deficit territory, where all GCC governments bar Abu Dhabi are in deeply deficit territory by the end of the five year horizon. These scenarios are worth highlighting given the significant uncertainty in forecasting oil prices that far out, and the downside risks to the oil outlook as outlined earlier.

The economic consequences

As we have said, the fact that GCC sovereigns are likely to experience a structural flip from being in surplus to deficit within the next two years, possibly sooner if downside scenarios materialize, is in itself enough to prompt a re-assessment of sovereign risk of some of the GCC countries, in our view. Moreover, our scenarios already incorporate a significant deceleration in public spending, which means that economic investment and economic activity is likely to decline simultaneously.

Furthermore, reflecting the structural deterioration in the fiscal outturns and to set public finances on a more long-term sustainable footing, GCC governments are going to take remedial actions. In the first instance, this is likely to involve a more aggressive expenditure cuts than implied in our scenario analysis. This, in turn, will probably exacerbate the decline in investment and economic activity. As the structural nature of the deficit becomes apparent, however, it will become increasingly necessary to undertake more fundamental structural reform of public finances aimed at reducing the vulnerability of the budget to fluctuations in the oil price. Effectively, the end of the current oil boom will mean that the need to diversify the economy and public revenues away from dependence on oil will once again take centre stage on GCC policy-makers' agendas.

What this will mean in practice is hard to predict, but some measure of structural cost rationalization, such as subsidy reform (particularly in the water and electricity sector) will, in our view, become increasingly likely. Public sector employment will also come under increasing scrutiny, as this is a major source of government outlays across the GCC.

Reform of government revenues will also become necessary in our view. This implies potentially the introduction of taxation, possibly a sales tax/VAT, higher corporate taxes, and maybe even personal income taxes in the future. Raising non-oil revenues is, in our view, a necessity should the GCC governments wish to mitigate against the upcoming risks to public finances.

The economic consequences of such reforms, which are akin to austerity measures that are being forced on many Euro area economies, are likely to be significant. The GCC will, in our view, be forced to sacrifice some cyclical upswing in order to address some of the underlying structural weaknesses. As we have seen in Europe and elsewhere, such reforms also carry with them the risk of creating social unrest, a risk we feel is present in the GCC despite high income levels, given the labour market and demographic distortions discussed earlier.

Insofar as there is a cyclical cost to implementing such reforms, we believe the best time to do so would be during a cyclical upswing, rather than a downswing. One of the key lessons from Europe is that austerity is much tougher when the economy is doing badly. Given the strength of the cyclical upswing in the GCC today, and our view that this is unlikely to last, we believe the conditions are right for governments to confront the structural challenges now, and that the window of opportunity to do so is narrowing.

Appendix A-1

Analyst Certification

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