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MENA economic growth engine falters – refuel or renew?

Atradius Regional Economic Outlook

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Key points

- The coronavirus pandemic and the related oil price slump is a double whammy for economies in the Middle East and North Africa (MENA). While financially still highly dependent on the global oil market that has tanked, the countries have also been diversifying towards the tourism sector, which is severely affected by the coronavirus outbreak.

- A new oil market boom that could refuel the economies may be some time away and will not last in the long-run, as the global energy transition gains momentum. Meanwhile, public debt overhang continues to increase and requires urgent fiscal consolidation. Structural job losses and low capital investment could harm the region's economic growth potential.

- It is time for the economic model to be renewed and made more sustainable via acceleration of broad-based economic diversification efforts and a boost in technological innovation. Among stepping-stones identified in this crisis is pharmaceuticals. North African economies could also build on the ongoing shift to higher tech manufacturing and expansion of their trade networks.

- The region's growing interest in renewable energy projects needs to be taken to the next level, with investment in renewable energy capacity at the core of the economic renewal process. By providing a green way to satisfy the continued increase in local energy demand, fossil fuels could be freed up for the export market, reducing the risk of stranded assets in the transition period.

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Low on oil

Traditional MENA oil exporters have lost control over the oil price as they gradually lost market share to the US shale industry. Despite historically deep cuts in oil production following an agreement in April, the OPEC+ could not do more than put a shallow bottom in the market of about USD 40-45 per barrel. The sudden ramping up of oil production by Libya, which is exempt of the OPEC+ quotas, has been putting renewed downward pressure on the oil price. A possible easing of sanctions on Iranian oil exports now that Joe Biden is on his way to become the next US president is another risk to oil supply restrictions. Unlike the view of the International Energy Agency (IEA) that global oil demand will continue to grow for another decade, British Petroleum suggests in its Energy Outlook 2020 that oil demand may already have peaked. In any case, the oil price is likely to remain low for a longer period. In line with IEA's delayed recovery scenario, we do not expect the oil price to recover much beyond USD 60 per barrel by 2025.

Table 1.1 Real GDP growth, %

	2019	2020f	2021f	2022f
Egypt	5.6	3.6	-0.7	3.2
Morocco	2.5	-7.4	8.0	4.0
Qatar	0.8	-3.0	2.8	3.5
Saudi Arabia	0.3	-4.0	3.4	3.2
Tunisia	1.0	-10.2	8.6	5.5
United Arab Emirates	1.7	-7.7	1.1	4.0
MENA	**0.7**	**-7.0**	**3.6**	**4.0**

Sources: Oxford Economics, Atradius

Fewer petrodollars to grease the wheels

Overall, after a dramatic first half of 2020, economic activity in the region staged a cautious recovery. Readings of forward-looking Purchasing Manager Indices in some MENA countries returned to just above 50, the dividing point between growth and contraction. Some countries including Iran, Lebanon and Jordan are still coping with a surge in corona infections and have (partially) re-imposed lockdown measures. An unprecedented overall recession of -7.0% this year will be followed by an economic recovery of 3.6% in 2021 and 4.0% in 2022 (table 1.1). The non-oil sector will be the main driver of the recovery in 2021, with domestic demand picking up. Our assumption that the rebound will be reinforced by the oil sector in 2022 on the back of easing of the oil production cuts imposed by OPEC+ may prove to be too optimistic. Due to the strong interconnectedness of the oil and non-oil sectors, a steady flow of petrodollars is required to grease the wheels of private consumption and investment via banking sector liquidity and government spending on jobs and infrastructure projects. Together with the risk of a slower than expected rollout of an effective vaccine against the spread of the coronavirus, the uncertain oil outlook also clouds the economic recovery projections for net fuel importing economies. Those are burdened by an increased public debt overhang, and typically depend on Gulf states for financial support and remittances.

Political road bumps

Political upheaval has exacerbated the current economic downturn and will impede the economic recovery of several countries in the region. In Iraq, Iran, Syria, Yemen, Libya and Lebanon, (geo) political and social tensions run the highest. Infrastructure in those countries is worn-out by wars, explosions (Lebanon) or years of underinvestment. The agreement on a ceasefire in Libya could pave the way for a strong reconstruction-led recovery, while sectarian political division stands in the way of an economic rescue plan for Lebanon. In Tunisia and Algeria, where the democratic transition is at different stages, political uncertainty deters growth enhancing foreign direct investment (FDI) inflows. Iran and Qatar are still facing the consequences of respectively major US sanctions and a regional boycott. While Qatar's economy is well adjusted to the status quo, with the FIFA World Cup in 2022 and major expansion of its North Field gas production in 2025-28 to look forward to, Iran's ability to invest in the modernization of its economy depends on whether the new US administration will end Teheran´s financial isolation.

In the spotlight

Saudi Arabia

Given the self-inflicted extra blow to domestic demand via public investment cuts and a sharp VAT increase, the projected economic contraction of 4.0% is not that deep. Real GDP will recover by 3.4% in 2021. Pro-growth policies including home ownership programs, investments in infrastructure and mega projects such as Neom city could revive the construction sector. Structural reforms are implemented, and the relaxation of foreign ownership limitations will facilitate foreign investment inflows. Alongside diversification as part of Vision 2030, hydrocarbon investments will underpin growth in the medium-term. The exodus of expats, local skill shortages and pay mismatches are the main challenges for developing the private sector.

UAE

In 2020, a deep recession of 7.7% is expected. The impact of the coronavirus on top of weak oil sector performance is large, because of the UAE's role as a regional transhipment and tourism hub. Real GDP will recover by just 1.1% in 2021. The postponed World Expo will stimulate an otherwise protracted recovery of the tourism sector that accounts for 12% of GDP. The medium-term outlook looks more promising. The UAE is one of the most diversified Gulf states (more than 70% of GDP is non-oil) and one of the most attractive foreign investment destinations, ranking 16th globally in the World Bank's Ease of Doing Business report. The country is also a pioneer among oil exporters in the renewable energy transition.

Egypt

Egypt's economic outperformance since the currency devaluation in 2016 continues during this crisis. Positive real GPD growth of 3.6% in fiscal year (FY) 2019/20 will be followed by a minor 0.7% recession in FY2020/21. The negative impact of the absence of tourists on the retail sector is cushioned by the substantial easing of monetary policy on top of low inflation. From 2022 on, real GDP growth converges to its robust pre-crisis pace. Infrastructural projects alongside the completion of the new capital city will boost construction. New gas finds will expand gas exports and support Egypt's ambition of becoming a Mediterranean gas hub.

Morocco

For Morocco's steadily growing economy, the expected 7.4% contraction this year is unprecedented. The coronavirus pandemic caused a collapse in the tourism sector that normally contributes 12% to GDP and severely reduced merchandise trade, because of the simultaneous economic downturn in Europe as the main trade partner. This all coincided with a dry spell in the important agricultural sector (accounting for 15% GDP and almost 40% employment), which is prone to weather hazards. After a strong 8.0% economic rebound in 2021, growth will return to pre-crisis pace. A protracted recovery in tourism could be offset by expansion of trade with countries in Sub-Saharan Africa.

High financial vulnerability

Net fuel exporting MENA countries remain dependent on energy for between 40% to 95% of their fiscal revenues and export receipts. This is leading to unsustainable financial-macroeconomic positions. The traditionally low debt levels are steadily rising and financial buffers no longer seem infinitely large. Their net fuel-importing peers have always been financially weaker and do not necessarily benefit from the low oil price, as this reduces the inflow of recycled petrodollars from Gulf States via personal remittances (5-13% of GDP), investments and financial support.

Neighbourly support masks weak links

Bahrain, Oman and Algeria in particular are facing funding challenges. Financial backing by wealthier Gulf Cooperation Council (GCC) neighbours has so far helped to secure international capital market access for Bahrain and Oman, but external borrowing has become more costly as their credit ratings have been downgraded deeper into sub investment territory this year. External debt servicing costs for both countries are well above the critical ratio of 25% of exports of goods and services. Both Bahrain and Oman also had to tap into their relatively modest oil savings, which in combination with higher debt levels has resulted in negative sovereign net foreign asset positions. Algeria can only hope to cover its external payments for a few more years by its once large, but rapidly diminishing foreign reserves. The Algerian government has so far remained reluctant to borrow externally at all, although a new law allows it to do so. Even for the financially strongest fuel dependent countries like Kuwait, Saudi Arabia, UAE, and Qatar, financial buffers are not sufficient to maintain current living standards for coming generations.

Dual crisis widens twin deficits

The corona/oil dual crisis has exposed liquidity issues that are inherent to the persistent current account and budget deficits of Jordan, Tunisia, Morocco, Egypt and Lebanon. Multilateral financial organizations had to come to the rescue of these fuel importers with limited international reserves to support their fixed or managed currencies. This will further lift their high public and external debt ratios. International donors and the IMF are so far withholding large-scale financial support to Lebanon, pending a sound economic rescue plan, for which a credible government is a precondition.

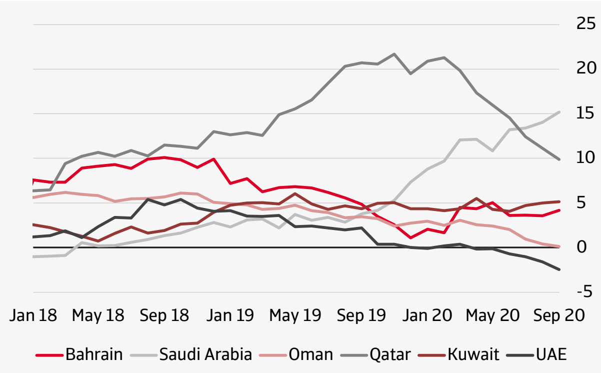
Fiscal support on a tight budget

Financial vulnerability does not interact well with corona-related government stimulus either. Across the region, fiscal support of the domestic economies has not been as lavish as in other emerging markets and leads to a financial backlash nonetheless. The public debt overhang could slow the economic recovery, as fiscal consolidation would have to shift to overdrive in order to bring public debt on a firm downward path. Saudi Arabia is one of the countries in the region that took the risky step to introduce some bitter fiscal measures in the midst of the crisis, including a steep increase in the rate of the (just recently introduced) VAT, from 5% to 15%. This will further slow private consumption and could result in damaging the growth potential of the economy via additional structural job losses and bankruptcies.

Monetary policy tools are blunt

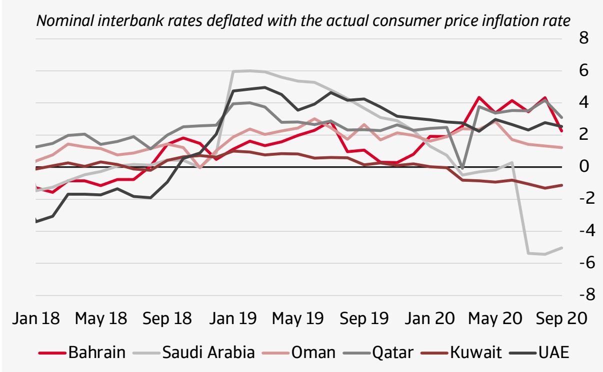
While liquidity support from MENA countries monetary authorities compensated for the lack of fiscal space and smaller petrodollar deposits, this has not resulted in the desired boost to private sector lending for every country (see chart 1.1). Conventional monetary policy tools are blunted by long-standing currency pegs to the USD in most GCC countries and Jordan. Even in Morocco, which is transitioning to more flexible exchange rates, the interest rate cut of 75 basis points (bps) in total was cautious, in order to avoid undue exchange rate pressure and large capital outflows. The size of interest rate reductions is restricted to the 150 bps by which the US Federal Reserve funds rate was cut earlier this year. Even if the Gulf states would be free to do so, there is not much space to ease further anyway, as interbank interest rates are less than 100 bps removed from the zero lower bound. An additional reason for sluggish loan growth could be that the limited nominal interest rate cuts have been offset by consumer price deflation, causing real interest rates to trend up on balance (see chart 1.2). The latest monthly figures show that consumer prices dropped by about 1.5% to 2.5% in Qatar, UAE, Bahrain and Oman compared to last year. It may not be a coincidence that the two economies with the most robust private sector credit growth – Saudi Arabia and Kuwait – do not suffer from deflation and are the only ones with supportive negative real interest rates.

1.1 Private sector credit, y-o-y % change



Sources: Macrobond, Atradius

1.2 Real interest rates (%)



Sources: Macrobond, Atradius

Time to diversify

In order to reduce financial vulnerabilities, rigorous fiscal reforms are needed, including mobilization of non-energy revenues. However, the ability to diversify the tax base depends on the degree of diversification of the economy. Moreover, sticking to the current economic model based on a (declining) hydrocarbon industry will increasingly become a drag on potential economic growth. Another reason why fuel-exporting countries need to diversify away from the one-directional energy trade is to enhance the region's notoriously low trade integration.

Economic diversification programs that many countries started years ago keep having difficulty to pick-up steam at any stage of the business cycle. This is because of an unresolved dilemma. When the oil price is very low, pushing ahead with economic diversification is opportune, but then there is little funding available. When the oil price recovers, renewed interest in hydrocarbon development crowds out investments in non-oil sectors. So far, export diversification attempts mainly focus on products closely related to the petrochemical industry. For example, the large oil refinery that is under development in Duqm (Oman) will be the cornerstone of the Sultanate's new industrial and commercial centre. The petrochemical industry is also considered the future backbone of Bahrain's industrial development, evident by multiple expansion plans. Even in the UAE's export portfolio, which is the most diversified in the Gulf, carbon intensive industries still account for more than 75%.[1]

Growth potential at stake

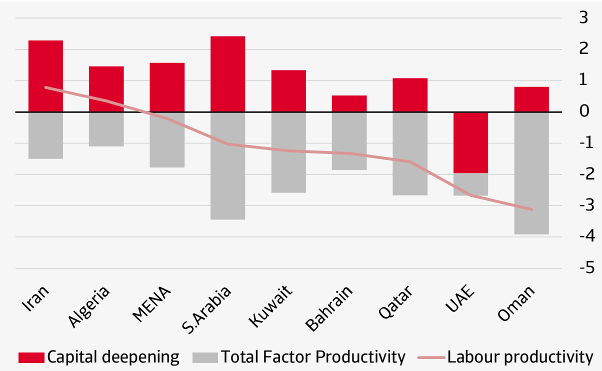
Sticking to the fuel income based economic model will have a negative impact on potential growth through labour supply and capital goods. Although labour intensity in the hydrocarbon industry is low, petrodollars used to be recycled into public jobs or state-funded construction works. This 'employer of last resort' solution to the unemployment problem is becoming less affordable, while

[1] Source: World Bank, Gulf Economic Update, December 2019

demographic pressures from a steadily growing working age population are mounting across the MENA region. Unemployment rates in many countries have reached double-digit rates, peaking around 20% or above in Iraq, Jordan, Tunisia and Lebanon. More than 15% of Saudi nationals are jobless. On top of fuelling social tensions, all this unused labour supply puts a break on potential growth. GCC's nationalist labour policies aimed at replacing expats with local workers will not solve the local job shortage. On the contrary, the exodus of expats will only delay the development of the non-oil-related private sectors. Due to the large wage differentials with the well-paid public sector and lack of right skills, Gulf nationals are often neither willing nor suitable to fill vacant positions in the private sector.

Labour productivity growth, which is already moderate, will come under further pressure given that fewer investments will be made in the hydrocarbon industry. As employees will have fewer capital goods to work with, their productivity will decrease. This main driver of labour productivity growth in the region is measured by capital deepening (chart 1.3). The contribution of innovation measured by Total Factor Productivity (TFP) has been negative in many oil and gas producing countries over the past decades. Development of high-tech sectors with positive TFP growth through innovation is therefore of great importance.

1.3 Labour productivity per employee, average % growth over 2000-2019



Sources: Conference Board TED, Atradius

Markets for the long-haul

The dual corona/oil crisis had a large negative impact on most sectors in the non-oil economy. In its latest Regional Outlook of October 2020, the IMF estimated that the default risk of corporates has doubled in general. We can confirm that payment performance across weaker sectors has deteriorated due to lower demand, cash flow problems and sometimes insufficient support from banks. The biggest quarterly contractions of activity were in wholesale & retail, transport (including aviation), manufacturing, construction, recreational services and hospitality. Although the direct culprits are of temporary nature (such as border closures, lockdowns and supply chain disruptions), it prompts careful re-evaluation of the medium-term prospects of certain sectors. While some key sectors head for uncertain times, others show new promise.

Uncertain times for construction and tourism

The construction and real estate sector used to be a leading non-oil growth driver, and still contributes 10%-15% to the GDP of GCC countries. However, the industry´s volatile performance over the past couple of years has now become more obvious, as governments cut capital expenditure and decided to reschedule or even to stop some major construction projects in order to free up funds for coronavirus relief efforts. The decreased demand for housing due to the oil price-related liquidity squeeze and an exodus of expats adds to the structural problem of oversupply in the real estate market. Corporates and banks also follow a more cautious approach towards the construction business. Mainly affected are small-sized construction companies and subcontractors. Real estate prices have been falling for a couple of years now, contributing to deflation. The UAE has experienced the largest drop in housing prices of about 30% in total since 2014, followed by a 25% drop in Qatar since 2015.

The expected protracted recovery of the hard-hit tourism sector is a setback for the region's economic diversification efforts, as Gulf states have heavily invested in tourism. A new airport has been opened in Oman, and the international airports of Dubai and Bahrain have embarked on major expansion and modernization projects. While quarantine measures and virus testing requirements make flights less popular for the time being, anxiety among travellers about contamination could last even longer. Just before the coronavirus outbreak, the shares of tourism in GDP varied from 5% in Kuwait, the least diversified GCC member, to 13% in Bahrain. Other MENA economies such as Egypt, Jordan and Morocco are also heavily dependent on income from tourism. Aside from an expected temporary boost in tourist arrivals due to the World Expo in Dubai in 2021 and the FIFA World Cup in Qatar in 2022, the medium-term growth potential for this industry has become much more uncertain.

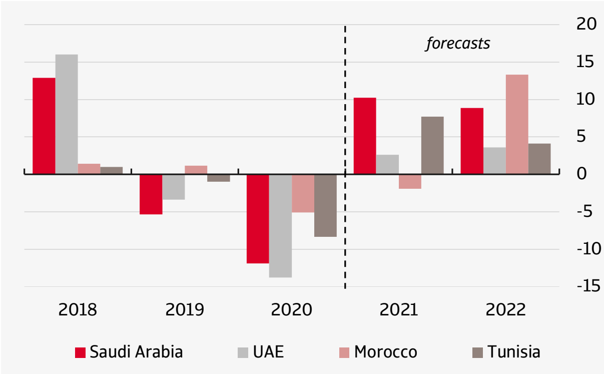
Promising sectors

Services and goods in the areas of education, finance, information & communication, and of course health care are the most promising stepping-stones for economic recovery (the equally bright prospects for renewable energy will be highlighted separately below). In its latest regional report, the World Bank has noted Jordan as one of the countries where the pharmaceutical sector is a rising star. In the midst of the corona crisis, the production volume of pharmaceuticals in Jordan increased by more than 25%. Egypt remains MENA's largest producer and consumer of pharmaceuticals and recorded rising demand for medical drugs during the pandemic. Although currently less buoyant, Saudi Arabia shows growth potential in this area, supported by a large population, high spending per capita on medicine and rising demand for chronic disease treatment. Recently, Riyadh passed a new law on pharmaceuticals relaxing restrictions on foreign ownership, which could enable Saudi's local pharmaceuticals production to increase by 20% in the short-term.

Trade outlook

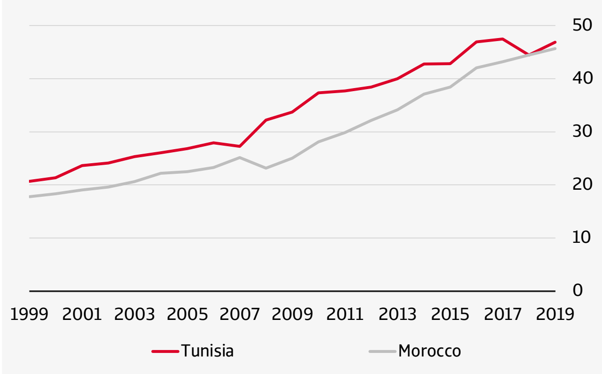
Short-term prospects for export-oriented non-oil sectors depend on the recovery of trade partners (chart 1.4). Gross value added of the textile and automobile sectors in Tunisia and Morocco decreased between 40% and 50% in Q2 of 2020, due to the high dependence on European markets. Global trade has only staged a frail recovery since then, and the WTO forecast of a 7.2% rebound in 2021 is subject to a high degree of uncertainty. Medium-term prospects depend on fuel exporters' speed in diversifying their export base, while some fuel importers can reap the benefits from their gradual move-up in the global value chain. Morocco has been upgrading its manufacturing base to produce higher-tech products, and its automotive industry is well positioned to benefit from the electrification of vehicles. Tunisia's shift from textile to electrical equipment and parts for the car and aeronautical industries has been equally impressive (chart 1.5). At the same time, both countries are strengthening their regional trade networks. They are negotiating more inclusive free trade agreements with the European Union, which is the destination of about 70% of their merchandise exports. Although trade shares with Sub-Saharan Africa are comparatively small (2.5% and 5% respectively), the two North African countries have started to make inroads by joining various African trade blocks. With more than 50 signatory countries, the soon to be launched African Continental Free Trade Area (AfCFTA) could be a major facilitator of trade integration for the African continent. Morocco is also expanding its banking sector deeper into Africa.

1.4 Export volume growth, non-fuel goods (%)



Sources: Oxford Economics, Atradius

1.5 Medium- and high-tech export shares (%)



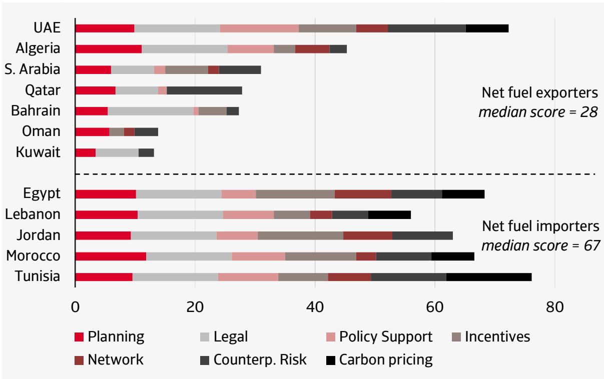
Sources: UNCTAD, Atradius

Renewables in focus

Besides developing the FinTech industry, which countries like Bahrain and the UAE are pursuing, investing in renewable energy technology will stimulate technological development, investment growth and job creation. This is also a way for energy importing countries to reduce their exposure to oil price shocks and to decrease the political leverage of oil states. The Middle East is well endowed with renewable energy sources, as its geographic location and climate conditions are highly suitable for generating solar and wind power. Renewable energy, excluding hydropower, still has a low 2% share in the total power generation mix, but this is starting to change.

Raising funds for renewable energy projects is becoming easier because of the increasing popularity of green bonds among international investors, with Egypt being the first MENA country to have successfully issued a USD 750 million green bond in September 2020. However, available financial means appear to not to be the most important factor for realizing a greener economy. So far, the financially weaker fuel importing economies have been more engaged in the energy transition than most higher-income Gulf states, with the exception of the UAE.

1.6 Regulatory indicators for sustainable energy



Sources: World Bank RISE, Atradius

The latest edition of the World Bank RISE report in 2018 about indicators for sustainable energy show that Tunisia, Morocco, Jordan and Egypt are ahead in setting in up a clear policy framework with targets, planning and financial incentives to stimulate renewable energy projects (chart 1.6). In 2018, this group of countries was responsible for almost 75% of installed renewable energy capacity in the Arab world (excluding hydro).[2]

While targets of energy importing and exporting countries are still far apart regarding the share of renewable energy in the total mix – an ambitious 30% for Tunisia and 52% for Morocco compared to only 10-20% for Bahrain, Oman, Kuwait and Qatar – energy-exporting countries have been catching up in terms of implementation since 2018. The IEA shows in its latest renewables report that although 2020 was a bad year, fuel-exporting countries will account for about half of the growth in photovoltaic solar panels in the period of 2020-25.[3] Saudi Arabia will also be the new driving force behind the construction of wind farms. This is promising, as Saudi Arabia has the highest total energy consumption in the region, and therefore faces the biggest challenge in meeting its own objective of generating 30% of its power from renewable energy sources by 2030.

While renewable energy has limited export possibilities and therefore does not offer a replacement for the fossil fuel based earnings model, it can be an interim solution during the period of broad-based economic diversification. Renewable energy can be used to satisfy the increasing domestic demand for electricity in order to free up more oil and gas supplies for the export market and the growing petrochemical (downstream) industry. This would result in a decreased need for fresh investment for the development of hydrocarbons, for which the outlook is uncertain, with a lower risk of stranded assets.

[2] Source: Arab Future Energy Index 2019

[3] Source: IEA Renewables 2020

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