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A petrodollar booster for MENA's underdeveloped private sector

Regional Economic Outlook MENA

Economic Research

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Executive summary

Real GDP growth in the oil-rich Gulf economies is expected to accelerate to above 5% in 2022, outpacing their net energy-importing counterparts in the Middle East and North Africa (MENA). However, non-oil sectors will also benefit from oil revenues boosted by the higher oil price and rising oil production. Petrodollars have traditionally been injected into the broader economy through government spending, bank liquidity and remittances. This will give a second breath to the economic rebound in MENA, as corona support measures are phased out by governments.

The oil upcycle is also mitigating regional economic weaknesses, buying time for structural reforms, particularly in net energy-exporting economies. Budget balances, for instance, will soon be (or are already) back in surplus in some of the Gulf states like Saudi Arabia, the United Arab Emirates and Qatar. However, the high oil price also brings negative side effects. For the net energy-importing countries in the region – Morocco, Jordan, Lebanon and Tunisia – it weighs on their current account deficits, which are persistent and still largely determined by the energy import bill.

Of great concern is that the oil price will continue to fluctuate in the medium term, while MENA's economy is far from immune to those waves. Economically, the private sector is underdeveloped and unable to grow robustly on its own. Financially, fossil fuel dependency will keep public and external debt levels rising. Learning to cope with oil price volatility is one of the key policy challenges for MENA. Investment laws have been revamped to attract foreign direct investment as a way to develop the private non-oil sectors. Other efforts towards economic diversification and private sector development are also underway, but all may need to be redoubled to make the region energy transition proof.

Key points

- The economic rebound from the corona crisis in the Middle East and North Africa (MENA) will continue into 2022. The higher oil price kicks in, the oil production restrictions of OPEC+ are being phased out and investment in hydrocarbon production capacity will pick up, despite the global energy transition. Meanwhile, corona-related downside risks to the outlook remain.

- Higher oil revenues will help maintain momentum in non-oil sectors by creating some leeway for increased government spending in the Gulf Cooperation Council (GCC) countries and by sustaining remittances to energy-importing economies.

- Monetary tightening due to expected interest rate hikes in the US will initially be limited in the GCC, as banking sector liquidity is simultaneously boosted by fresh petrodollars. We also expect no major financial stress or massive capital outflows in most energy-importing economies; Tunisia and Lebanon are exceptions.

- Medium-term economic growth prospects are less bright. The private sector in the region is underdeveloped and business is stifled by state interference. Despite private sector reform initiatives, inward foreign direct investment remains subdued and focused on the traditional state-owned hydrocarbon sector.

- With shock resilience eroded by oil price swings, sovereign risk has increased. The higher oil price is currently aggravating balance of payments pressure in Tunisia, while without significant progress on fiscal reforms Oman and Bahrain will struggle to withstand a future oil price decline due to unsustainable public finances.

Private sector development takes time

Vaccine and fuel injections boost economic recovery

The impact of the Covid-19 virus outbreak in combination with the subsequent collapse in oil price has left deep marks on the Middle East and North Africa (MENA) economy that is dominated by hydrocarbon exporting countries. At its trough in 2020, the losses in real GDP were 4.1% for the region as a whole and almost 5% for the Gulf Cooperation Council (GCC) members.[1] Those economic contractions exceeded the emerging markets' average. However, economic recovery has been underway since 2021. With the oil market no longer a drag, we believe that economic growth momentum will be maintained in 2022 and that real GDP will return to pre-pandemic levels during the course of the year.

Table 1 The economic rebound continues

Real GDP growth (%) - MENA

	2020	2021	2022f	2023f
Saudi Arabia	-4.1	3.3	5.0	2.6
United Arab Emirates	-6.1	1.8	6.2	6.7
Qatar	-3.6	2.2	3.6	3.5
Morocco	-6.3	6.2	3.5	4.0
Egypt	1.5	5.7	4.0	3.7
Tunisia	-9.4	2.8	3.4	4.1
GCC	**-4.9**	**2.6**	**5.1**	**3.9**
MENA	**-4.1**	**4.5**	**4.3**	**3.5**
Emerging Markets	**-1.6**	**6.8**	**4.6**	**4.8**

Source: Oxford Economics, Atradius

Non-oil sector briefly in driver's seat

Non-oil sectors were the initial driving force behind MENA's economic recovery in 2021. The oil market barely contributed. It is rather unusual for non-oil sectors to be in the driver's seat after an oil price shock, especially in economies that mainly export fossil fuels. Those economies lack a self-sustaining non-oil growth engine and usually depend on an infusion of petrodollars for economic recovery. The unique resilience shown recently can be explained by the GCC countries' more adequate response to the coronavirus and the rebound in domestic demand following the easing of lockdown measures. The United Arab Emirates (UAE), Bahrain and Qatar have been the quickest to vaccinate their citizens against Covid-19, already reaching high vaccination rates by early 2021. This has facilitated the removal of lockdown measures and the reopening of the retail and tourism sectors. The same countries are advanced in administering booster shots against the fast-spreading Omicron variant. Financial support to alleviate the corona crisis impact on businesses and households has also been more generous in the GCC. The last remaining measures will probably be phased out in 2022.

Net energy-importing countries in the region, with the exception of Morocco, have lingered with the vaccine rollout.[2] This is unfortunate as the parts of the economy most directly affected by lockdown measures and travel restrictions – private consumption and tourism – typically make up large proportions of their GDP. Tunisia has managed to catch up somewhat, reaching the milestone of one dose per person on average. A large part of the population remains unvaccinated in Egypt, Jordan and Lebanon. For the latter two, high infection rates contribute to weak economic growth.

Oil sector to take the wheel again

Going into 2022, the global oil cycle is changing in the GCC's favour. With the easing of corona-related lockdowns, global demand for oil is picking up. Since the summer of 2021, the oil price has been hovering well above USD 70 per barrel, topping USD 85 per barrel recently. A world of difference with the USD 20 per barrel in April 2020. As oil stocks will be rebuilt gradually, we expect the oil price to normalise on average in 2022 and 2023 to levels around USD 70 per barrel. This year, oil trade will also increasingly benefit from the gradual relaxation of oil production cuts by the OPEC+ cartel.[3] To put a floor under the falling oil price amid the impact of Covid-19, OPEC+ had tightened oil production restrictions in 2020, but is now aiming for a full phase-out by September 2022.

[1] The GCC consists of Bahrain, Kuwait, Oman, Saudi Arabia, Qatar and the United Arab Emirates

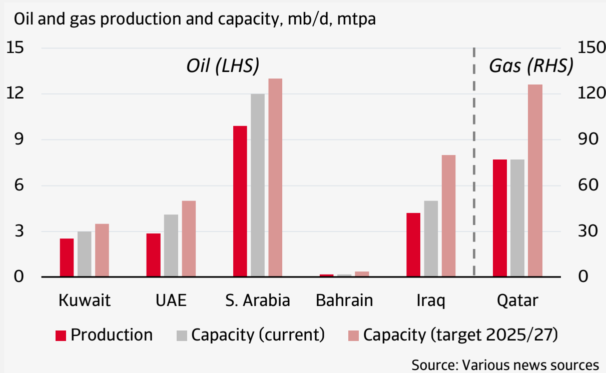
[2] Net energy-importing countries in MENA are: Egypt, Jordan, Lebanon, Morocco and Tunisia.

[3] OPEC+ consists of OPEC countries plus several other oil-producing nations, including Russia.

Hydrocarbon investments undeterred by global energy transition

The usual reflex of hydrocarbon-producing countries after an oil price shock is to ramp up production capacity with renewed vigour. The acceleration of the global energy transition and the prospect of a peak in global oil demand, possibly sometime in 2030-2040, do not serve as deterrents this time around. Rather, oil-producing countries in the region seem to be racing to get as much oil and gas out of the ground as possible before global demand for fossil fuels dries up for good. Hydrocarbon investments will therefore substantially contribute to economic growth in the coming five years (figure 1).

Figure 1 Hydrocarbon production capacity is expanding

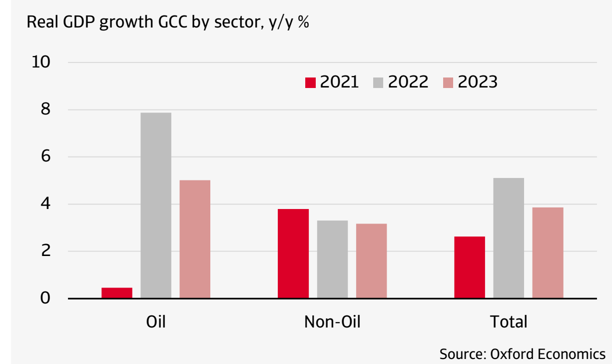


Abu Dhabi's national oil company ADNOC plans to invest USD 122 billion to expand its oil production capacity to 5 million barrels per day from about 4.1 barrels per day currently. Saudi Arabia is also investing in huge expansion projects for crude oil and gas production, including in the major Marjan and Berri fields. Bahrain, facing little remaining oil reserves, attempts to develop the large offshore oil field (Khalij al-Bahrain Basin) that was discovered in 2018. Even Iraq, the most oil income dependent economy in the world, aims to nearly double oil production to 8 million barrels per day by 2027.

Others focus on expanding the production capacity of gas, which is less polluting than oil and plays a role as a transition fuel in greening the global energy mix. Qatar is working on its North Field expansion project, planning to raise its liquefied natural gas production capacity by a total of 64% between 2025 and 2028. In Oman gas output is also on the rise, boosted by the development of new gas fields such as Ghazeer and a new LNG plan in Salalah.

Stranded assets in terms of prematurely obsolete oil and gas projects can be huge. However, the world economy will still require energy from fossil fuels on a large scale for several decades and low-cost producers like the Gulf states are bound to become the fossil fuel suppliers of last resort. GCC countries do acknowledge the need to change their carbon footprint. The planned increase in hydrocarbon production capacity does not necessarily conflict with the 'net-zero carbon by 2050' pledges recently made by Saudi Arabia, Bahrain and the UAE. Investments in renewable projects are being stepped up simultaneously to increase the share of domestic energy consumption that comes from renewable sources. The additional fossil fuel production will mainly be destined for exports.

Figure 2 Oil sector growth will outperform

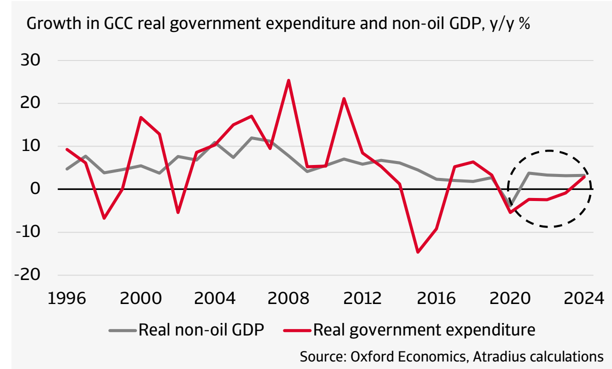


In the GCC countries, oil activity will grow by almost 8% in 2022, compared to only 0.5% growth in 2021 (figure 2). As a result, we expect GCC's real GDP growth to be lifted above 5%, surpassing economic growth rates of net oil-importing countries. These forecasts are subject to a high degree of uncertainty around the economic impact of Omicron and possible new corona variants. Growth performance in 2023 and beyond is even more difficult to predict. It depends on several other factors, such as how the oil price holds up, the ability of hydrocarbon dependent countries to develop non-oil private sectors and the extent to which some of the net oil-importing economies can finally overcome political deadlocks and policy paralysis. The picking up of investment in oil and gas projects will support medium-term growth (see box).

Fiscal multiplier in (slow) motion

Public spending contracted during the corona crisis in the GCC, despite financial corona support by the government. The higher oil price will now set a fiscal multiplier in motion, albeit less strongly than before. Traditionally, the revenues of an oil price upcycle that accrue to the state are shared with the wider economy through pro-cyclical fiscal expansion. Real government spending increased by an average of 5% per year between 1992 and 2019 (figure 3). Current expenditures – on wages and subsidies – have always been the largest, stimulating private consumption.

Figure 3 Oil-driven public spending supports non-oil GDP



Budget balances of Saudi Arabia, the UAE and Qatar are back in surplus, which gives those countries leeway for spending.

However, the fiscal impulse for the non-oil private sector will be more limited than before. The bloated wage and subsidy bill has become a burden on public finances and the government has become more careful with current spending increases in good times as those have proven difficult to reverse in bad times. Moreover, to reduce reliance on the finite stream of oil revenues, most GCC governments also continue to broaden their non-oil revenue base by introducing taxes and fees. This dampens the positive effect of public spending on consumption. On the bright side, not all spending is affected by budgetary pressures. Part of it will be off budget and will for example be done through Saudi Arabia's Public Investment Fund, which plans to invest about 5% of GDP annually in the domestic economy over the next few years. We predict that non-oil economic growth in the short-term will be strongest in Kuwait and Qatar, which are lagging behind on fiscal reforms and may not introduce VAT until 2023. Striking the right balance between fiscal reforms and economic growth is indeed one of the key policy dilemmas in MENA.

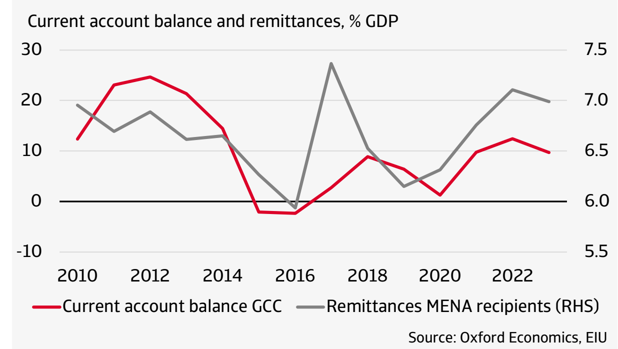
Remittances surprisingly resilient

While net energy-importing countries are negatively affected by current higher energy prices, their economies are also partly benefitting from the times of prosperity of their oil-rich Gulf neighbours through trade and foreign direct investment (FDI) and via remittances from employees working abroad. Since the GCC has a large expat population, it is a major source of remittances worldwide.

The resilience of remittance inflows in Egypt, Jordan, Lebanon, Morocco and Tunisia during the oil price shock in 2020 was surprising – as FDI and trade dried up. The exodus of expats from GCC countries – the source of remittances – at that same time makes the resilience of remittances even more counterintuitive. In Saudi Arabia, the outflow of remittances increased by more than 10% during this period. This makes sense, however, when realizing that those income flows are not only driven by income prosperity in the source countries, but also by income pressure in the recipient countries. The year 2020 was indeed a time of need, as the import cost reduction due to lower oil prices was overshadowed by the loss of income from the coincident corona crisis. So, migrants in the oil-exporting countries continued to send large sums of financial support to their home countries.

The current improvement in global trade is boosting export receipts, but with imports recovering more vigorously, trade balances of net energy-importing countries are actually worsening. At the same time, FDI inflows remain subdued. Fortunately, remittances are likely to remain a robust foreign source of income, supporting domestic demand and easing balance of payment pressures. Unlike in 2020, remittances will now be driven by the well-known push and pull factors of rising oil income in the GCC and decreased purchasing power in recipient energy-importing countries due to higher energy costs. The rise in oil price has already bolstered current account surpluses in the GCC to pre-crisis levels (figure 4). A gradual return of expatriates to the GCC will further contribute to remittances, particularly to Egypt, Jordan and Lebanon, which rely most on their Gulf neighbours. Migrants in Europe are also likely to continue to transfer more money to their families in Morocco and Tunisia to help offset the loss of purchasing power caused by the rise in the oil price.

Figure 4 Remittances robust amid GCC current account surpluses



Oil liquidity blunts US rate hike

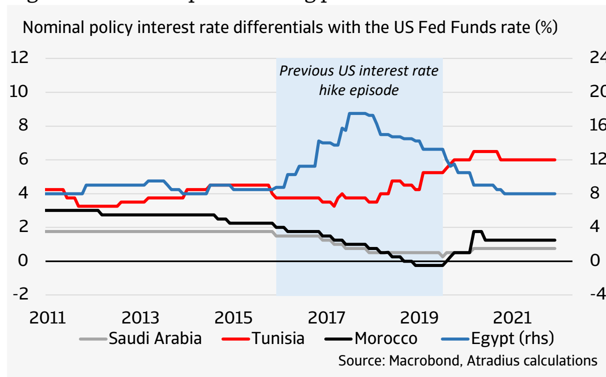
The US Federal Reserve has signalled multiple interest rate hikes this year. Monetary tightening in the GCC will follow, but we expect the negative impact on economic growth to be limited and the risk of massive capital outflows to be low.

As usual, most central banks in the GCC will move in sync to maintain their long-standing exchange rate pegs with the US dollar, even if business cycles in the US and the GCC are not perfectly aligned. Monetary tightening may come indeed a little too early for the GCC, as the rebound in non-oil economic activity appears to be losing steam and inflation is relatively subdued compared to the US. However, as tightening will initially be gradual, it is unlikely to upset the accommodative lending environment in the GCC, which is increasingly awash in oil liquidity and with real policy interest rates still in negative territory. Increased liquidity in the banking sector from oil revenues has historically proven to reduce the pass-through of policy rates to lending rates and mitigate the negative impact on credit growth. Currently, private sector credit growth is robust in Saudi Arabia at about 15% year-on-year and is recovering in other GCC economies from the corona crisis dip.

Worries of capital outflows are also limited. Small interest rate differentials with the US are usually sufficient to maintain the exchange rate pegs of Gulf currencies with the US dollar (figure 5). However, net energy-importing countries in the region are potentially more vulnerable to capital outflows due to high debt levels and persistent current account deficits. During the Fed's previous (later reversed) rate hikes by a total of 225 basis points between 2015 and 2019, the interest rate differential in Tunisia and Egypt widened considerably. This time around, the impact could be even more disruptive, as higher expected US interest rates are driven not by an improved outlook for US or global economic growth – which would benefit emerging markets. Instead they are mostly driven by concerns about US inflation, which would only lead to tighter financing

conditions. Even so, we expect Morocco, Jordan and Egypt to be able to withstand limited interest rate hikes in the US without having to apply the monetary policy brake excessively. Those countries have good access to external finance and adequate international reserves, while Egypt's floating of its exchange rate and successful completion of a comprehensive economic reform programme since the latest episode of US interest rate hikes should pay off. Tunisia and Lebanon are among the few in the region that need to brace themselves. While Lebanon has been in default since 2019 and is experiencing a protracted balance of payment crisis, Tunisia needs to preserve dwindling international reserves as the president's recent power grab and the lack of fiscal reforms complicate negotiations for a new IMF programme.

Figure 5 Mixed response during previous US rate hikes



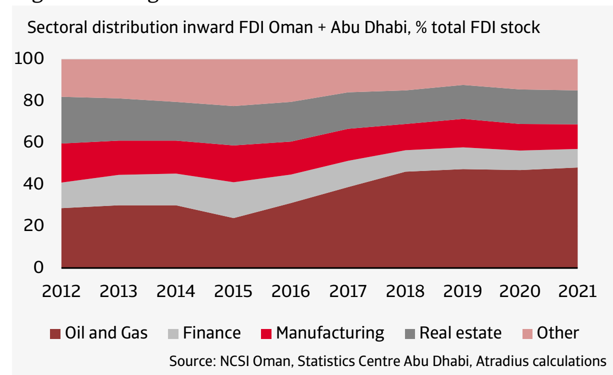
Private sector development needs more time

Private sector support from the rising oil price won't last and without private sector reform economic growth will slow in the medium term. Private sectors in many MENA economies are underdeveloped. This includes economies in the GCC, where despite a relatively favourable business environment, the state-owned hydrocarbon sector remains dominant. In Algeria and Egypt, bureaucracy and state interference are additional factors stifling business. Algeria has extensive restrictions on imports and foreign investment to protect its domestic economy, but which in fact harm international competitiveness. Egypt's economy is riddled with numerous state-owned companies that get a preferential treatment, for example in tenders for government projects, crowding out private firms. Tunisia and Lebanon also rank poorly – 119th and 154th respectively – in the global economic freedom ranking of the Heritage Foundation, reflecting their low economic growth potential.

In light of the global energy transition, Gulf states have taken various initiatives for private sector development and economic diversification. The overall goal is to reduce dependence on oil income and to turn the private sector into a self-propelled growth engine that will continue to operate even if the volatile oil price hits another downturn and remains low for longer. Such initiatives include developing renewable energy projects, digitising the economy, upgrading the business environment and promoting public-private partnerships (PPPs). The UAE, for instance, is building the first green hydrogen plan in the Middle East; a first step towards eventually making it possible to replace fossil fuel exports with green energy exports. Bahrain is one of the first worldwide to have full 5G network coverage. Saudi Arabia is most active with PPPs as it passed a new Private Sector Participation Law in 2021 and launched a partner programme (Shareek) to further facilitate private sector-government collaboration. In Egypt, efforts are made to put the private sector at a level playing field with state-owned entities by improving corporate governance, increasing transparency and through privatisation.

However, overall progress with private sector development is slow. Since 2010, the share of the private sector in Saudi Arabia's economy has only increased in real terms from 38% to 42%. Attracting FDI, which is one of the cornerstones of the transformation strategies, proves to be particularly challenging. FDI inflows are at historically low levels and do not exceed 2% of GDP for most MENA countries including Saudi Arabia. The UAE and Oman are positive exceptions to some extent. Together they attract about half of all FDI inflows across MENA. However, the desired reorientation of investment away from the oil sector is not visible there either. The hydrocarbon sector remains one of the prime foreign investment targets in Abu Dhabi – the UAE's largest emirate – as well as in the Sultanate of Oman (figure 6). Restrictions on foreign ownership have always been a bit of an obstacle. New investment laws in several oil producing countries could change this. These laws make it easier for foreign investors to take a stake in local companies and even allow them to have majority ownership in certain – mainly non-oil – sectors. In the coming years, this could motivate foreign investors to stop overlooking growth opportunities outside of the traditional sectors and contribute to GCC's private sector development.

Figure 6 No sign of investment reorientation towards non-oil



Net energy-importing countries face other barriers to luring foreign investors. Political instability is a major issue, especially in Tunisia and Lebanon. Frequent changes in government have paralysed policymaking and have a negative impact on economic growth and financial stability. Uncertainty leads to postponement of investment decisions. The lack of multilateral and bilateral financial support for Tunisia and Lebanon is also discouraging foreign investors.

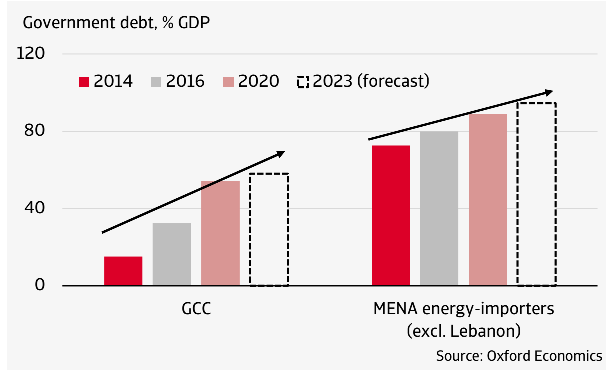
Oil price volatility ahead

Oil prices have fluctuated wildly over the past decade and are likely to remain volatile during the energy transition. A new oil price shock is the main risk ahead. Not only because the growth potential of non-oil sectors remains too limited to pick up the baton if the oil economy fails. Oil price shocks also erode shock resilience in both energy-importing and exporting economies. Increased debt overhang raises the risk of sovereign default and wider financial instability, and weighs on economic growth prospects. The impact of each new oil price shock could be greater than the last.

The next oil price drop could be one too many for the GCC

GCC governments almost had no debt to speak of before the oil price crash in 2015, but the public debt burden has increased incrementally ever since (figure 7). External debt has risen in tandem, as much of the financing gaps created by oil revenue shocks are financed externally. Continued reliance on volatile oil revenues in combination with rising government spending have made public finances unsustainable. While, in times of crisis, the majority of Gulf states can still fall back on large savings of oil revenues in their sovereign wealth funds, Oman and Bahrain seem to have reached the limits of shock resilience. Their external debt levels exceed 100% of GDP, dwarfing their relatively modest financial buffers. Their vulnerability to changes in market sentiment became apparent during the oil price low in 2020, with soaring external funding costs and partially impaired access to the international capital market. It remains to be seen whether Oman and Bahrain's fiscal reform programmes will get back on track after being derailed during the corona crisis. Their governments' fiscal reform track record is poor and austerity measures are difficult to implement for fear of domestic unrest. A balance of payment crisis in Bahrain has so far been averted by ongoing financial support from its wealthier Gulf allies. Downside risk to Oman and Bahrain are significant if such support fails to materialise in the future.

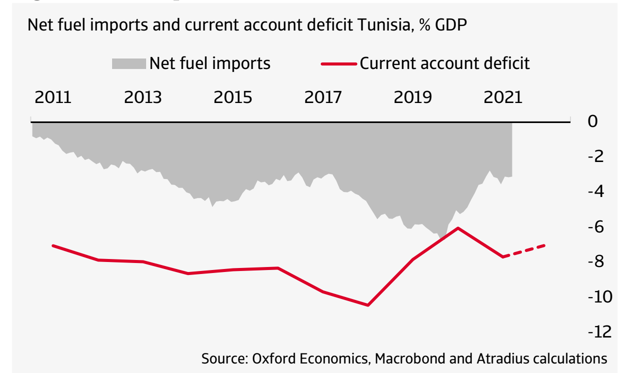
Figure 7 High and rising debt erodes economic shock resistance



Oil importing countries not (yet) immune to higher oil price

The current higher oil and gas prices put extra pressure on the current account balances of energy-importing countries in MENA via a higher energy import bill. Countries that import most of their energy do so because they possess few fossil energy sources of their own. Renewable energy development is changing this reality. Home-grown renewable energy sources will gradually replace imported fuel. By 2030, most energy-importing countries aim to have about 30%-40% of the power mix generated by renewable energy. Current renewable energy shares for Morocco (31%) and Jordan (31%) show significant progress in this direction[4] and Morocco has recently raised its target to 64%. Progress in reducing energy dependency is also reflected in a trend decline in net fuel imports by Jordan and Morocco to lows of 3.8% of GDP and 5.5% of GDP in 2020 respectively. Egypt has even almost ceased to be a net importer of energy since it has ramped up gas production capacity in line with its ambition to become a regional gas hub. Nevertheless, energy import bills still account for the bulk of the persistent current account deficits of Morocco and Jordan, and especially of Lebanon and Tunisia, where there is little progress with renewable energy development (figure 8). The higher oil price adds to balance of payment pressures that are already substantial due to various other factors, with slow fiscal reforms being a common denominator. We therefore also expect external and public debt in energy-importing countries to remain high, limiting their economic resilience.

Figure 8 Fuel imports dominate current account deficit Tunisia



We see reducing the extent to which oil price volatility reverberates through the economy as the key policy challenge in MENA. Both the energy importing and exporting countries in the region need to redouble their efforts on fiscal reforms, renewable energy investment and private sector development to make their economies financially sustainable and energy transition proof.

[4] Source: IRENA Renewable Capacity Statistics 2021

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