Foreign & Commonwealth Office

GCC and Iraq: Economic Summary: Quarter 4 2013

British Embassy Riyadh

MACROECONOMICS

IMF Expects Average GCC Real Growth of 3.7% in 2013, and 4.1% in 2014

1. Following a meeting in Riyadh between its own director, and finance ministers and central bank governors from across the GCC, the IMF issued a statement saying that it expected real growth across the six GCC member states to average 3.7% for 2013. Whilst this is less than the 2010-2012 average of 6.4% (a result of historically high global energy prices), the IMF expect growth will increase to 4.1% in 2014, largely owing to increased oil production, state capital expenditure and non-oil private sector growth.

2. The IMF used the opportunity to re-state the risks and recommendations they identified in their Article IV reports for the Gulf, and highlighted that GCC member states need to work hard to create employment opportunities for their growing populations, and transition to models of high-skill, private sector led growth. The IMF saw the fiscal buffers most GCC states had built-up in recent years as bulwarks against future instability, though urged Gulf states to do more to rationalise public spending and develop better mechanisms for managing risks in their financial sectors.

Kuwaiti Government Sets Latest Priorities for the $110bn National Development Plan

Ahead of the first session of the new Kuwaiti Parliament on 29 October, the Kuwaiti government released their annual development proposal and an appraisal of the $110bn four-year National Development Plan (due to end this FY). The proposal highlighted a shift in immediate focus towards housing and healthcare, and importantly gave the first information on the Government's initial target for privatisation – the energy sector (specifically electricity production). More widely, Kuwait's recently released annual budget for FY 13/14 highlights clear signals of the Government's intent to begin making necessary social and economic reform, with wage bill rises capped at 1% (by far the smallest budgeted increase in many years).

The new focus on healthcare infrastructure projects is in evidence with the release of design, build and equip tenders for the expansion of Al Adan and Al Farwaniya Hospitals. These tenders include a number of specialist clinics and up to 1600 new beds, and have been assessed to include an accessible value of £112m for UK companies.

Oman Predicts Deficit in 2014 Draft Budget...

1. Darwish al-Balushi, the Omani Minister for Financial Affairs, addressed the Omani Consultative Council on 26 November to outline the draft 2014 budget. The Minister said the state's general expenditure has surged 70% over the last three years, rising from $20.5bn in 2011 to a record $35.1bn in 2014. He warned that the government is facing a real challenge to sustain the current level of spending, and forecasted GDP

growth of 5% and a fall in inflation to 1.5%. The Minister estimated the budget's deficit for next year at $4.68bn which amounts to 15% of the total revenues and 6% of the GDP. The final version of the budget was released in January 2014, and was in line with the headlines presented by the Minister.

...but the Government Hints at Possible Reform of Fuel Subsidies

2. The Omani Minister for Oil and Gas, Mohammad al-Rumhy, has made two widely covered public statements within the space of three weeks warning that fuel subsidies are a threat to economies across the GCC. More recently, Mohammed bin Abdullah al-Mahrouqi, Chairman of the Public Authority for Electricity and Water, said his organisation has been asked to carry out a wide ranging survey of energy usage in Oman with a view to establishing a National Energy Strategy. Fuel subsidies will come under the review.

Qatar Aims to Increase Macroeconomic Discipline

3. Qatar's Emir gave his first major economic policy speech since taking office in June, when he opened the 42nd ordinary session of the Advisory Council and the first under his rule. For Qatar to achieve sustainable and balanced growth, the Emir argued that Qatar needs to increase productivity and efficiency, promote economic diversification, encourage the private sector and entrepreneurship, reduce barriers to competition, tackle inflation, and focus on research and development, education, and health.

4. Qatar is investing significantly ahead of hosting the Fifa World Cup 2022, with up to $220bn on infrastructure, which is bringing debt and price pressures. Qatar's gross debt reached 36% of gross domestic product last year, the highest among the six GCC members and more than Iraq's 34%, according to the International Monetary Fund. Inflation was at 2.7% year-on-year in September. To combat this, Qatari authorities in November announced that state-owned companies, excluding Qatar Petroleum (QP) (the state-owned energy firm) and its subsidiaries, must now seek approval from the Ministry of Finance before undertaking any borrowing activity. A government committee has also been set up to propose ways to tackle inflationary pressures.

5. These moves have been welcomed by analysts and investors, and follow-on from similar steps taken by Qatar's GCC neighbours. The UAE central bank in April 2012 barred banks from lending more than 100% of their capital to local administrations or government-related entities. Abu Dhabi has also set up a debt management office to coordinate borrowing by government-related entities after the crisis in neighbouring Dubai, which resulted in a $20 billion bailout and massive debt restructurings at state-linked entities.

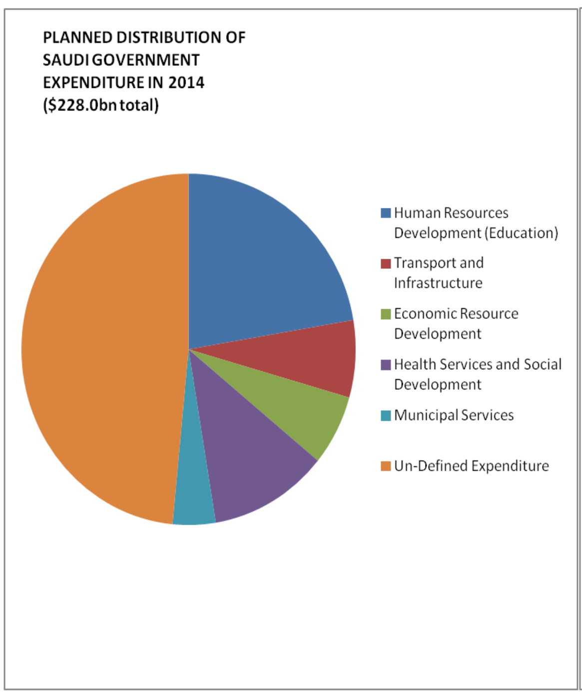
Saudi Arabia Releases Preliminary Economic Data for 2013...

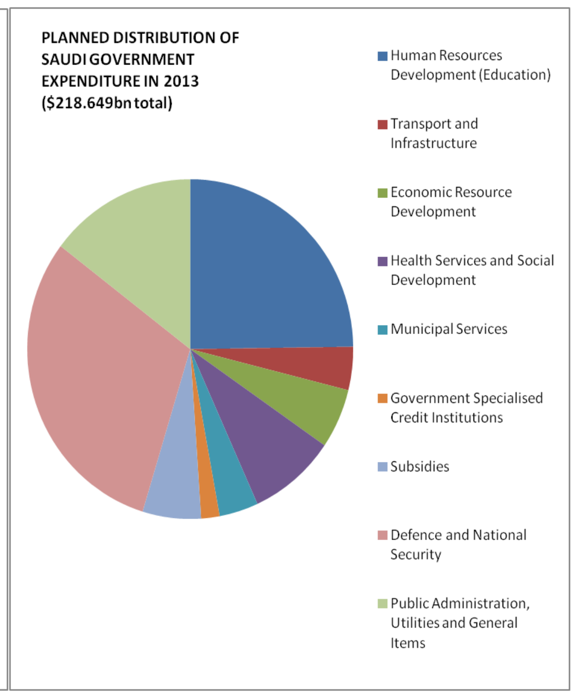
1. In late December, the Saudi Arabian Monetary Authority (SAMA; the Kingdom's central bank) released its annual report for 2013, and the Ministry of Finance (MOF) released its budget for 2014.

2. Preliminary government estimates suggest Saudi nominal GDP for 2013 will be $754.3bn. This would mean a real growth rate of 3.8% for 2013 (supported by a 3.73% expansion of the government sector and a 5.5% expansion of the private sector – even if a large proportion of this is likely to be directly related to hydrocarbon output). The real value of oil sector output declined by 0.61%, in part at least owing to reduced crude output early in the year. Inflation was 3.35% in 2013, compared with 2.9% in 2012, but down from 4.1% in 2009.

...And Announces a Big Budget for 2014

3. The Saudi state plans to spend $228.0bn in 2014, compared with $218.7bn in 2013 (a 4.25% increase). It also plans to spend as much as it receives, so no surplus or deficit expected at the end of 2014. The pie charts below (compiled from MOF and SAMA data) show the planned (as opposed to actual) distribution of government expenditure in 2013 and 2014. Key points below.





- Spending on **education** will increase by 3% in 2014 to $56bn, equivalent to 25% of planned annual expenditure.

- Spending on **healthcare** and **social services** will rise by 8% to $28.8bn.

- Spending on **municipalities** will rise to $10.4bn, a 9% increase from 2013.

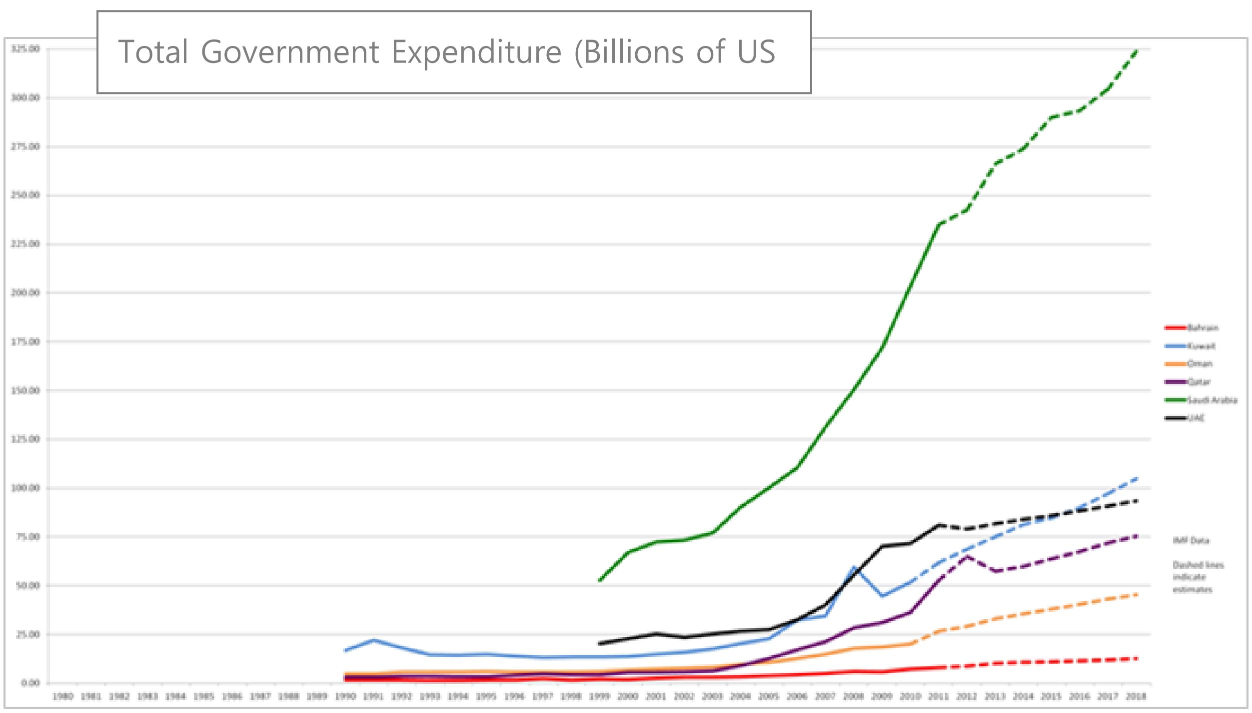
- The Share of spending on **transport and infrastructure** will rise by 2.5% to $17.8bn.

- **Economic resource development** will see its share of spending rise by 5.7% to $16.3bn. $8.8bn of this will go towards improving the Kingdom's water security.

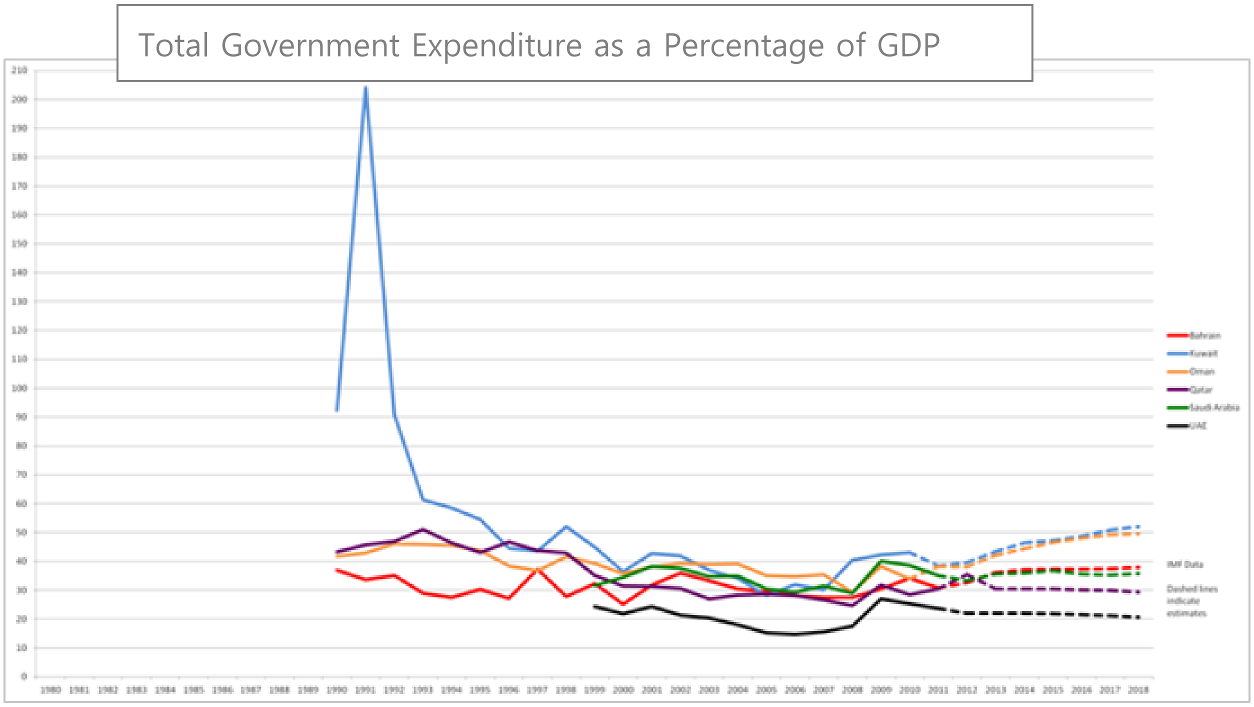
- **Un-defined expenditure** in 2014 will total $121.5bn, or 53.3% of the total. More clarity will probably emerge on how this money will be distributed. In 2013, the government spent $3.99bn on specialised credit institutions; $12.67bn on subsidies; $31.99bn on public administration, utilities and general items; and $67.01bn on defence and national security.

Saudi Government Expenditure in a Regional Context

4. Saudi government spending is enormous when compared with the rest of the GCC. The graph below shows GCC government expenditure in US Dollars (2013 base year) since 1990, together with projections to 2018. The raw data was released by the IMF in April 2013, so whilst it's eight months old and doesn't take account of things like geography and population, it still offers a yardstick with which to compare the direct economic power of the Gulf monarchies, both domestically and internationally.



5. But whilst in absolute terms, Saudi expenditure is well over twice that of its nearest Gulf competitor, the Kingdom is in the middle of the pack when it comes to government spending as a share of GDP. The graph below was again compiled from IMF data from April 2013, and offers a rough mechanism for comparing the extent of government involvement in each of the GCC economies.



Qatari Privatisation Programme Aims to Distribute State Wealth Amongst Citizens

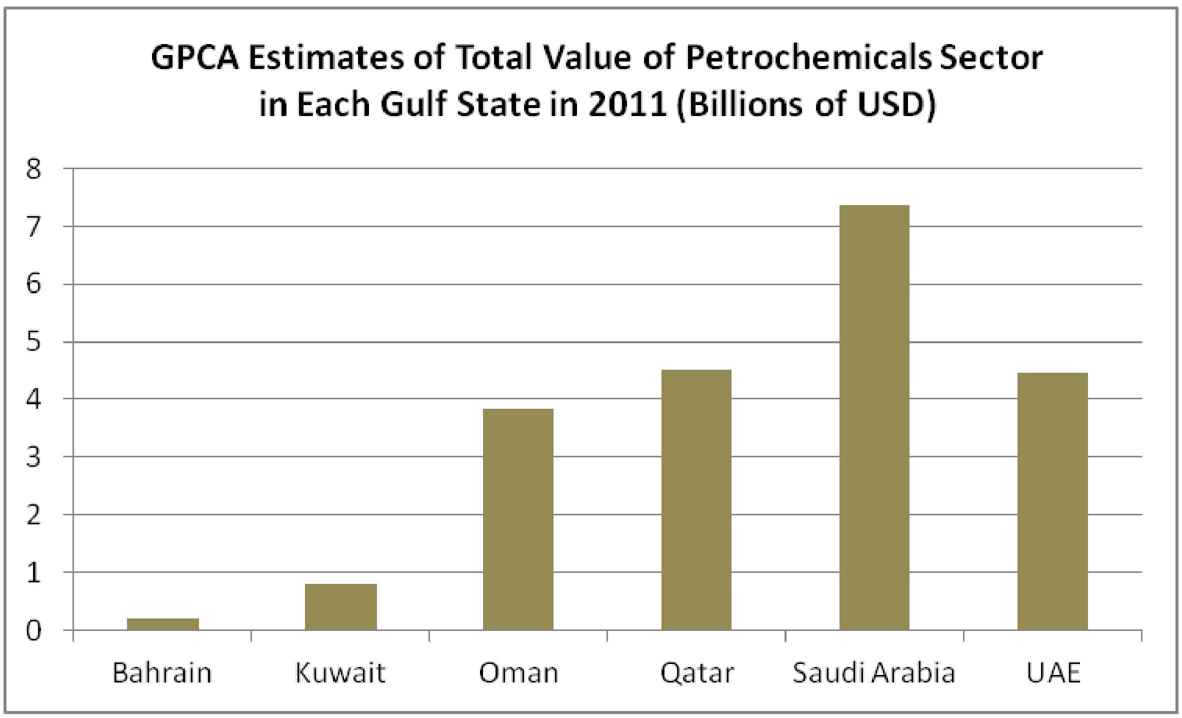
6. The Government of Qatar has announced a ten year plan to partly privatise state-owned energy companies, worth up to $13.73bn. The first phase began with the Initial Public Offering (IPO) for 26% ($879m) of Mesaieed Petrochemical Holding Company (MPHC), a fully-owned subsidiary of Qatar Petroleum (QP). MPHC's generated aggregate revenue of $1.18bn and net profit of $0.44bn in 2012.

7. The government has said the aim of the privatisation programme is to distribute the state's wealth amongst its c.250,000 citizens, and encourage a culture of personal saving and investment. The IPO is open to Qatari nationals only (though foreigners will be able to own up to 15% of MPHC in the secondary market when it is fully floated), and the government aims to give shares for free to disadvantaged Qataris. It's likely that QP leading from the front will strengthen investor confidence, which in turn will encourage other entities to come to the market and boost the local stock exchange. Demand for the IPO seemed high, with anecdotal reports that some Qataris were selling expensive cars to raise money for shares.

Growth in the GCC Petrochemicals Sector...

11. The Gulf Petrochemicals and Chemicals Association (GPCA) has revealed that in 2011, petrochemical production accounted for 1.5% of aggregate GCC GDP. Petrochemicals' share of member states' output varied from 5.5% of Omani GDP to 0.49% of Kuwaiti GDP. To illustrate what this means in terms of value added, petrochemicals accounted for 53% of the value of Omani manufacturing in 2011, compared with 4.6% for Bahrain. In terms of absolute value, Saudi Arabia topped the charts with $7.36bn worth of petrochemical output in 2011, whilst Bahrain was at the bottom of the scale with $0.207bn.

12. In terms of export earnings, petrochemicals represented 43% of GCC non-oil exports in 2011, compared with 41% in 2010. Broken down by state, this represented 72% of Saudi non-oil exports compared with 8.6% for Bahrain.



...But Competition from the US Looks Set to Increase

13. Existing petrochemical producers and exporters the world over are likely to face increased competition from the US in the years ahead, owing to increased production of shale gas. Gulf producers currently supply just over 10% of the $600bn global petrochemical market, but with some reports suggesting the US planning to invest over $100bn in production facilities, the US has the potential to become the world's lowest-cost producer. Everything, of course, will depend on domestic US gas prices (which in

turn will depend upon the future of the US's gas distribution infrastructure and LNG export policies). But the most obvious market for increased US petrochemical output is East Asia, which would place American producers in direct competition with their Gulf counterparts. This would leave Gulf producers with three overlapping options:

- compete with the US in East Asian markets;
- attempt to expand their share of other emerging markets; and
- develop and produce more specialist petrochemical products that attract higher margins.

14. From an economic sustainability point of view, the third option is the most attractive for the Gulf. Competing with the US on volume and price of existing products will do little to broaden the productive bases of regional economies, nor offer many jobs to qualified graduates. Opening new markets would be slightly more labour intensive, but again, would likely entail a degree of price and volume competition. The third option would make best of the Gulf's growing engineering and scientific talent, and offer opportunities for Gulf citizens to actively participate in the development of knowledge economies. Outside help may be required, providing opportunities for UK companies which are willing to base themselves in the region long-term, and develop mechanisms to transfer developmental and engineering know-how to their Gulf hosts.

ENERGY

US to Become the World's Largest Producer of Petroleum Liquids, But Saudi Dominance in Crude Oil Production Will Continue

7. The US government's Energy Information Administration (EIA) estimated in mid-October that the US would overtake Saudi Arabia as the world's largest producer of petroleum liquids in 2013. EIA data shows the US overtook Russia in 2012 to become the world's second largest producer of petroleum liquids, with an average of 11.1 million barrels per day (mbpd). It estimated Saudi Arabia produced just over 11.7mbpd in 2012, and independent US energy consultancy PIRA predicted this figure will rise to 11.8mbpd over the course of this year. But they expect total US output to rise to just over 12.1mbpd over the same period due mainly to increased unconventional oil and gas extraction.

8. It's worth setting out what this means. The term 'petroleum liquids' includes all forms of petroleum products that are liquid at a standard atmospheric temperature and pressure. For the most part they comprise:

- crude oil (including condensates);
- natural gas liquids (NGLs);
- biofuels; and

- refinery gain (the additional volume of liquid that results from refining crude oil into less dense products like gasoline and diesel).

9. Most of the US growth appears to be the result of increased production of crude oil from unconventional shale production (PIRA estimate an increase of 0.8mbpd over 2013), whilst NGL production looks set to rise by 0.3mbpd (primarily owing to increased production of unconventional shale gas). Meanwhile, data from the EIA suggests refinery gain for 2013 is likely to decline to just over 1.06 mbpd, down from a historic high of 1.08 mbpd in 2011.

10. But the US (the world's third largest producer of crude in 2012) is unlikely to match Saudi crude output. EIA data showed the US produced an average of 6.48 mbpd in 2012, compared with 9.83mbpd for Saudi Arabia. Furthermore, EIA figures suggest that whilst the US benefitted from over a million barrels per day of refinery gain in 2012, Saudi Arabia's refineries produced 8,400 additional barrels per day (a figure which will likely increase as Saudi Arabia invests in its refining capacity and downstream infrastructure more generally).

11. Looking ahead, the EIA estimates total US petroleum liquid production will reach between 12.0 and 18.2mbpd by 2040. But In terms of crude production, Saudi Arabia looks set to continue its dominance. The EIA expects the US to produce 6.2 mbpd of crude by 2040, or in a best case scenario, 10.2mbpd. This is still below Saudi Arabia's current productive capacity of 12.5mbpad of crude, and well below the 15mbpd capacity that some Saudis are talking about trying to reach

Infrastructure Delays and Attacks on Pipeline Prevent Iraq from Reaching its 2013 Oil Export Target

Iraq's total oil export figures averaged 2.39 million barrels per day (mbpd) in 2013, lower than the 2.9mbpd estimated in the 2013 budget. The two main causes were planned infrastructure upgrades to Iraq's ports and associated export equipment, and frequent attacks against the Iraq-Turkey pipeline. The infrastructure upgrades have taken longer than expected owing to a decision to extend the work and reduce exports by a relatively small amount, rather than curtail exports severely, and complete the work sooner. Current plans are for the upgrades to be completed in mid-2014.

The upgrades to Iraq's maritime export capacity have highlighted Iraq's vulnerability to shocks such adverse weather, port closures, or terrorist attacks. At present, the majority of Iraq's oil (and all of that from its giant southern fields) is exported by sea from near Basra. Increasing the amount of oil that it can be exported through the Kurdistan region in the north of Iraq will help shield the economy from some of the risk.

Kuwait Moves Towards Solar Power

Kuwait has taken its first steps towards realising its aim of generating at least 15% of its energy needs from renewable sources by 2030. On the back of HSBC being awarded a consultancy contract for Kuwait’s first solar thermal power plant (planned to generate a massive 280MW and cost an estimated $3.27bn), the benefits of renewable energy are being focussed on for smaller scale off-grid power needs in the oil sector.

The Kuwait Oil Company has issued an invitation to tender for an off-grid five MW solar power plant at its Umm Gudair field to fully power the oil and natural gas extraction. The move is in line with attempts by oil producers across the region to preserve as much as possible of their hydrocarbon resources for export. If successful, the off-grid solar power plant model is expected to be rolled out across all Kuwait oil fields – enabling Kuwait to make considerable export gains as it looks to increase oil production from 2.8mbpd total petroleum liquids to 3.6mbpd by 2020.

A Busy Quarter for Qatar’s Gas Industry

6. November has been a busy month for Qatar as it seeks to maximise returns from the supply of gas, whilst simultaneously expanding into higher yield areas of the global energy supply chain. Developments have included:

- Centrica signing a $7.23bn deal with Qatar to import 3m tonnes of liquefied natural gas (LNG) per year over four and a half years (equivalent to about 13% of UK’s annual residential gas demand). The deal extends a $3.2bn, three-year LNG supply agreement between Centrica and Qatargas, which expires in July 2014;

- the President of Congo visiting Qatar to sign a framework agreement on co-operation between Qatar Petroleum International and Total E&P Congo;

- reports suggesting that Ivory Coast is close to finalising an agreement with Qatar for LNG supplies from 2015;

- negotiations between Qatar and India on a deal covering LNG and air transport, with India seeking discounts on gas imports in exchange for concessions on Qatar Airways increasing its capacity between the two countries;

- an announcement from Poland's Supreme Audit Office that it would look into the country's deal to import LNG from Qatargas, whose supplies could potentially be more expensive than existing sources of gas.

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BP Signs Deal with Government of Oman to Develop the Khazzan Tight Gas Field

BP signed the final agreement on its deal to develop the Khazzan tight gas field in Oman. The total investment will be $16bn. 40% will come from the Oman Oil Company (OOC), the investment arm of Petroleum Development Oman (the national oil company in which Shell has a 34% share). The first Khazzan gas will be produced in 2017, and plateau production of 1bn cubic feet a day will be reached in 2018. This will represent 30% of Oman's total output. Production is expected to continue for at least 30 years. BP also signed an MOU with the OOC to build a major petrochemical plant in the Duqm Free Zone. This will be the largest plant of its kind in the region and the UK's first investment in any of Oman's free zones.

LABOUR MARKETS

Saudi Labour Market Crack Down

8. On 3 November, the seven month amnesty period offered by the Saudi government to illegal foreign workers in the Kingdom ended. During this period, foreigners without work permits corresponding to their actual job were given the opportunity to exit the Kingdom penalty-free, correct their paperwork, or find a job with a company that had a sufficient proportion of Saudi workers (as defined by the Ministry of Labour's 'Nitaqat' system).

9. Following the end of the amnesty period, Saudi police, accompanied by Ministry of Interior and Labour officials have been inspecting workplaces and carrying out spot-checks on streets to identify illegal workers. Those without the correct paperwork have been arrested, transferred to detention centres and deported. So far it appears that up to 140,000 people have been arrested since early November, with around 120,000 of those already deported.

FINANCE

Closer Co-operation Among Gulf Stock Markets?

15. Saudi Stock Exchange Tadawul (which means 'dealing') has signed memoranda of understanding (MOUs) with the Abu Dhabi Securities Market (ADX), and the Bahraini stock market Bursa (which means 'stock market'). The MOUs focus mainly on the operation of the three markets, and cover staff development and operational knowledge exchange.

16. People working across the region's finance sectors have been discussing for years now the possibility of a combined Gulf stock exchange. While this is unlikely to become a reality in the short to medium term, clauses in the MOUs covering market development and policy alignment may serve as a foundation on which more focused discussions at some point in the future could build.

Qatari Telecoms Company Issues $1.25bn Sukuk

17. Ooredoo, Qatar's biggest phone operator with revenues of US$9.3 billion in 2012 and operations across the Middle East, North Africa and Southeast Asia, launched a $1.25 bn, five-year sukuk. This was the firm's first Islamic bond under its recently established US$2 billion Trust Certificate Programme, which was four times over-subscribed. The Ooredoo offering was Qatar's first corporate Islamic bond sale in two years, with the last country's last Shari`a-compliant corporate issue being the US$215m sale from Almana Group in June 2011. The move illustrates Qatar's desire to compete with Kuala Lumpur, Manama and Dubai as a global centre of Islamic Finance, and may herald a shift towards Islamic finance as Qatar's government and private sector look to tap debt markets to finance up to $220bn of investments in preparation for the 2022 World up.

INTERNATIONAL COMERCE

Dubai to Host 2020 World Expo Trade Convention

18. Dubai has beaten Yekaterinburg in Russia, Ismir in Turkey and Sau Paulo in Brazil to host the 2020 World Expo trade convention. This will not only reinforce the emirate's

position as a global trade and business hub, but also boosts Dubai's future economic performance. Experts estimate that the global event will add 0.5 percentage points per year to real GDP growth over 2015 -2017, rising to 1.0 percentage points per year over 2018-2020. Dubai's trade, tourism and transport sector will benefit the most from the event, and 277,000 new jobs will likely be created. Infrastructure spending is expected to be around $5.45bn and investments will be directed mostly towards the addition of 80,000 additional hotel rooms, and the development of tourist attractions and transport facilities (eg. the metro extension). There will of course be opportunities for British companies.

19. Winning the Expo has crowned a strong year for Dubai. The Emirati Central Bank estimates growth during the first half of 2013 was 4.9% (the highest in six years and 0.2 percentage points better than expected). Most of the growth has come from growth in non-hydrocarbon industrial, hospitality and tourism sectors, and Dubai's success in being chosen as the venue for the 10th World Islamic Economic Forum will provide a further boost to the emirate's financial sector. But some analysts fear the additional stimuli risks generating another property bubble. Careful macro-level policy making will help lessen the risks of a return to boom-and-bust, and ensure that the major international events the emirate is hosting contribute to sustainable growth.

Competition Heats up among GCC States for Title of Region's Islamic Finance Hub

11. 2013 witnessed a growing challenge to Bahrain's unofficial title as the Gulf's hub for Islamic finance. Dubai has been the most high profile contender, when Shaikh Maktoum launched his emirate's *Capital of the Islamic Economy Initiative* in January 2013. Aside from boosting the profile of the emirate through hosting events such as the *Global Islamic Economy Summit*, and the 2014 *World Islamic Economic Forum*, the Dubai authorities are also trying to regularise definitions of shari`a compliance by establishing a shari`a council to oversee the work of Islamic banks.   The push will be supported by an official Islamic finance centre. We have not seen any data to indicate whether Dubai's initiative has resulted in an increase in shari`a compatible financial transactions (it's probably too early to tell), but it does appear that business leaders and politicians are already talking about the emirate as a global Islamic finance hub.

12. With 26 Islamic banks managing over $25bn worth of assets, and 9 Islamic insurance and re-insurance institutions, Bahrain has been working to retain its position as the region's Islamic finance centre. In addition to being the base for the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and International Islamic Financial Market (IIFM), it hosted the *World Islamic Banking Conference* in early December. Bahrain has highly developed regulatory and oversight mechanisms, which have helped keep the finance sector in good health following the 2008 crash and unrest of early 2011.

13. Qatar has a strong and growing Islamic Finance market (fuelled to a considerable extent by the government's need for liquidity ahead of the 2022 World Cup). Standard and Poors ratings agency anticipates that the asset base of Qatar's four Islamic banks will increase from $54bn at the end of 2012 to $100bn by the end of 2017. And Qatar has a strong presence in international Islamic Finance at senior official level: the Qatar Central Bank Governor, Shaikh Abdulla, is Chairman of both the Islamic Financial Services Board (IFSB) and the International Islamic Liquidity Management Corporation (IILM).

14. Oman has the youngest and smallest Islamic Finance sector in the Gulf. But its central bank has plans to set shari'a compliance standards centrally.

15. Looking ahead, Dubai's PR push might well see it attract a growing share of growth in Islamic finance during 2014. Disagreement and changing definitions over what constitutes shari`a compliance (both among competing financial institutions, and even over the life-span of issued products) has discouraged greater use of Islamic finance in the past. If regulators in the Gulf manage to harmonise definitions of shari`a compliance, and win broad acceptance for these, they will have taken a major step forward in promoting Islamic finance globally.

Qatar Becomes Global Leader in Helium Exports

Qatar has become the world's largest exporter of helium and the world's second largest producer (after the US), with the start-up of the $0.49bn Helium 2 Plant at Ras Laffan. Helium is in high demand globally, with China, India, and Japan being the largest global importers. Uses for the gas include medical diagnosis, scientific research, high-tech manufacturing, and space exploration. With a combined annual production of 2bn standard cubic feet a year, the two plants at Ras Laffan will meet about 25% of the current global demand for liquid helium (the first plant's production currently represents around 10% of total global production). In 2010, Qatar signed off-take agreements with three companies for its helium: Air Liquide (a French multinational, which will receive 50% of annual production till 2032); Linde Gases (German, which will receive 30% of production), and the Iwatani Corp (Japanese, which will receive 20% of production).

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