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Arab Petroleum Investments Corporation

BEYOND ENERGY: HOW MENA ECONOMIES EMERGE POST-2021

November 2020

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Authored by:

Leila R. Benali
Chief Economist, APICORP

Imane Gilles
Non-resident Research Advisor, APICORP

With contribution from:
Abdulrahman Al-Dafiri
Intern, APICORP

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About APICORP:

The Arab Petroleum Investments Corporation (APICORP) is a multilateral development financial institution established in 1975 by an international treaty between the ten Arab oil exporting countries. It aims to support and foster the development of the Arab world's energy sector and petroleum industries. APICORP makes equity investments and provides project finance, trade finance, advisory and research, and its headquarters is in Dammam, Kingdom of Saudi Arabia. APICORP is rated 'Aa2' with stable outlook by Moody's and 'AA' with a stable outlook by Fitch.

Introduction

Entering 2020, the MENA region had substantial financial reserves estimated at nearly USD1 trillion, with a few countries even considered underleveraged. As COVID-19 spread, most countries rolled out large-scale stimulus packages to counter the direct and indirect effects of the pandemic, including tapping existing reserves, debt capital markets, multilateral and bilateral financing, and foreign aid. In parallel, government spending was rationalized, including spending on critical infrastructure and development programs. Furthermore, a few countries halted the economic and fiscal reforms that they initiated pre-COVID-19.

The impact of the unprecedented 2020 triple crisis – health, economic and financial – across the region is multifaceted, and has widened income and productivity gaps between and within countries. At this stage, only a few countries possess the ingredients in terms of governance, policy credibility, public finances management and strong and sustainable economic basis, to be able to translate those stimulus packages into productive debt and sustainable recovery.

While a few countries in the region face difficult yet manageable trade-offs, others face rather daunting choices; having to choose between reining in generous social support programs or borrowing and overspending. There are clear signals that the borrowing ability of some emerging economies is nearing its limit.

For countries which are hydrocarbon importers, much will depend on their ability to quickly capture the opportunities of the post-COVID-19 world, namely the restructuring of certain global value chains (GVCs). For hydrocarbons producers, the groundswell of calls for economic diversification is coming at a time when the next decade might prove to be the last window for low-cost low-carbon MENA oil and gas producers to firmly establish their global market share.

Widening the gap: mixed recovery trajectories

The double whammy of COVID-19 and low oil prices caused a precipitous recession in several oil-exporting countries in the MENA region. In fact, all MENA countries are expected to experience a GDP contraction this year, with Egypt standing as the sole exception with a modest 2.5-3.5% in forecast GDP growth in 2020-2021.

Saudi Arabia's real GDP for example is expected to decline -5.4% in 2020. Not only did its oil GDP suffer from the double impact of lower oil prices and production cuts, but its non-oil GDP was similarly affected. Among the key contributing factors is the decision to restrict the Hajj and Umrah pilgrims to just Saudi citizens and residents to contain the spread of the pandemic. And while the total number of pilgrims has not been officially announced, it is clearly a fraction of years past, reaching 2.37 million pilgrims in 2019 – 1.76 million of whom came from outside Saudi Arabia *(source: The General Authority for Statistics, Saudi Arabia).* Moreover, the unemployment rate in Saudi Arabia reached 15.4% among Saudis in 2Q2020, an increase of 3% year-on-year.

GDP% change	2020	2021
KSA	-5.4	3.1
UAE	-6.6	1.3
Kuwait	-8.1	0.6
Qatar	-4.5	2.5
Oman	-10.0	-0.5
Bahrain	-4.9	2.3
Iraq	-12.1	2.5
Iran	-5.0	3.2
Jordan	-5.0	3.4
Libya	-66.7	76.0
Egypt	3.5	2.8
Algeria	-5.5	3.2
Tunisia	-7.0	4.0
Morocco	-7.0	4.9
Sudan	-8.4	0.8
Palestine	-12.0	8.2
Lebanon	-25.0	?
Yemen	-5.0	0.5

Source: IMF, October 2020

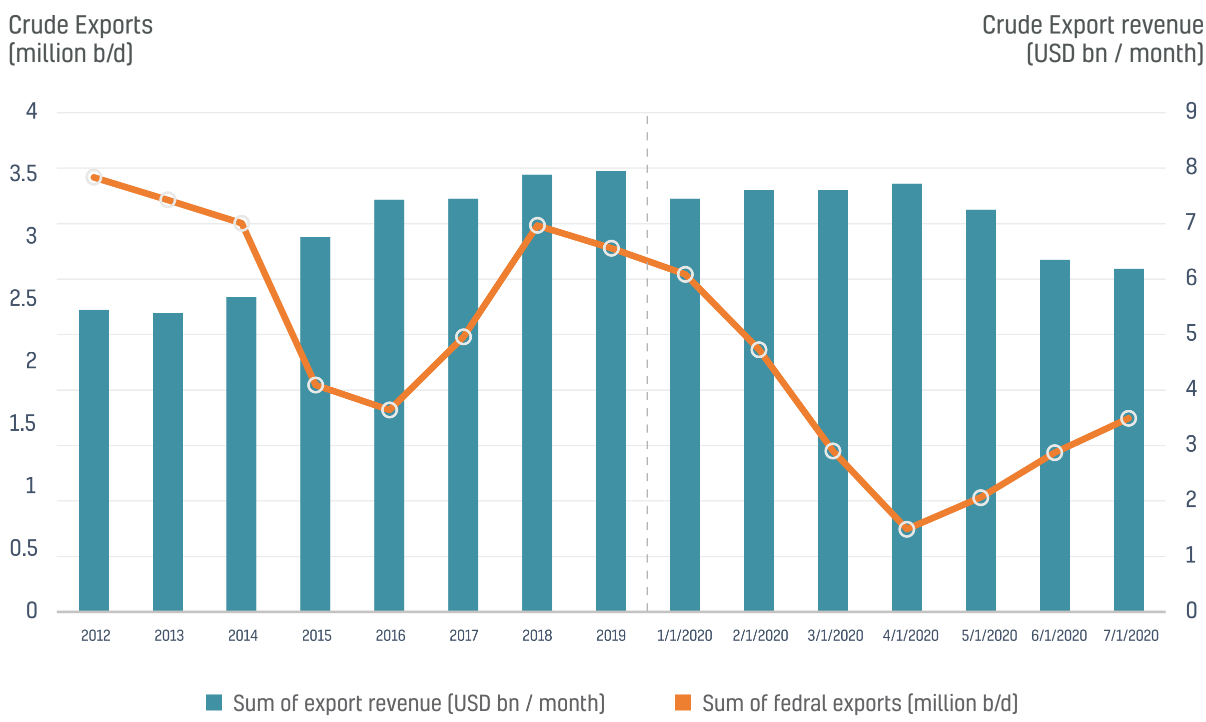
Hydrocarbons-exporting countries in MENA are living a transformational period. With an outlook characterized by a very gradual market rebalancing, coupled with oversupply that may last until 2021-2023 for oil and possibly to 2025 for gas, low-cost low-carbon producers with a strong fiscal position are well positioned to increase their market share in oil and gas markets post-2020.

Faced with the strongest contraction for oil demand in history (-20 mbd in April 2020), the non-oil economy of these countries is suffering the double whammy of real economic contraction and government spending cuts. Like other parts of the world, lockdowns forced the shutdown of businesses, manufacturing, travel, entertainment, logistics and retail.

- Kuwait's real GDP is expected to contract -8.1% in 2020, the lowest since 1980. Lower oil prices and lower production could balloon the fiscal deficit to 12% of GDP in 2020. Government expenditure is assumed to drop by 30%.

- Iraq faced a more complicated situation. As increased production levels did not translate into higher export revenue due to the falling oil prices, the winds of the triple crisis were further fanned by a wave of civil discontent. At 90% of the budget expenditure, Iraq's relatively higher dependence on oil revenue, coupled with a sizeable USD5 billion monthly public payroll, makes the need for a radical restructuring of its economy even more urgent.

Iraq's crude exports: volumes vs. revenues



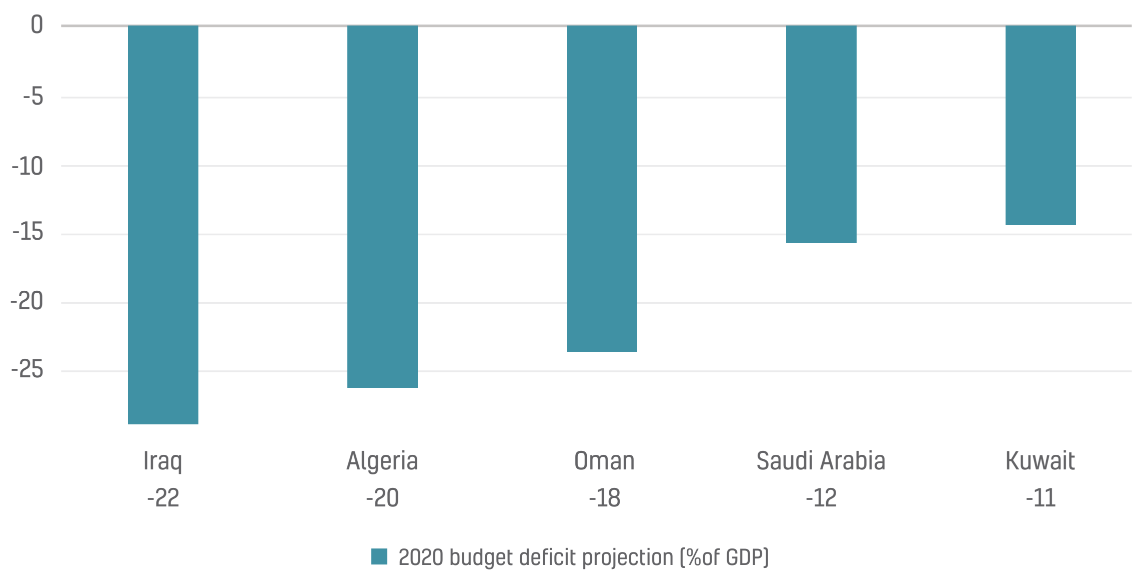
Source: State Oil Marketing Organization (SOMO), Middle East Economic Survey (MEES).

The situation grows even more complicated for gas exporters, particularly those entering export contracts renegotiations in a buyers' market. Natural gas exporters are facing compounded effects of a decrease in revenues because of oil-linked contracts and weaker spot prices. In their respective domestic markets, the upside is limited due to the decline in industrial and business activities and capped domestic prices (see APICORP's MENA Gas & Petrochemicals Investment Outlook 2020-2024 for details).

- Oman's real GDP is expected to contract -10.0% and non-oil GDP is expected to decline by more than -5.5% in 2020, with the fiscal deficit climbing to almost 17% of its GDP, the highest such deficit among all Gulf Cooperation Council (GCC) member states.

- Algeria forecasts USD10 billion in lost revenue in 2020 due to the fall in energy prices. Foreign reserves at the end of 2Q2020 stood at USD58 billion, less than one-third of 2013's record USD 195 billion. As a result, Algeria's budget deficit is set to double from 2019 to this year.

Countries facing large budget deficits



Source: International Monetary Fund (IMF), Bloomberg

While hydrocarbon-exporting countries face a sharper decline in GDP growth rate in 2020 on paper compared to their importing counterparts, this does not reflect the effect on the real economy and the recovery potential. The impact on the real socio-economy is strongly felt in many countries, particularly in already fragile states, and the impact may be felt even beyond 2021. All MENA countries are struggling with the decline in hospitality services, foreign direct investments (FDIs), workers' remittances and long-term unemployment, particularly in the informal sector. The effect on populations of oil-importing countries is even more acute. For example, the travel and tourism sector, one of the most severely impacted by the 2020 crisis, accounted for 5.3% of GDP growth and 6.7 million jobs across the MENA region in 2019.

Remittances, which play a vital role in the economies of many Arab countries, are estimated to fall by 19.6% to USD42 billion in 2020. Amounting to USD26.8 billion and accounting for nearly 10% of its GDP, Egypt is considered one of the largest recipients of remittances globally *(source: OECD)*. Lebanon's remittances totaled USD7.3 billion -- or 12.5% of GDP – in 2019, half of which come from GCC countries. In Tunisia, where remittances are also expected to fall from 5.5% of GDP in 2019 to 4.4% of GDP in 2020, the country's macroeconomic fundamentals are relatively stronger as import outpaces the fall in exports.

MENA countries' stimulus packages: Necessary yet risky

The impact and response to the COVID-19 pandemic by MENA countries has varied. Before the pandemic, several countries were actively engaged in weaning their economies off hydrocarbon dependence, while others such as Morocco and to some extent Tunisia focused on boosting their socioeconomic development plans post-Arab Spring. As soon as mid-March 2020, several MENA countries began implementing speedy precautionary public health measures while simultaneously preparing massive stimulus plans. Depending on each country's initial conditions, these plans were implemented through a multitude of fiscal and economic instruments detailed below. Looking at the region as a whole, 2.7% of GDP on average was allocated to fiscal measures, while 3.4% of GDP was directly injected by central banks into the economy.

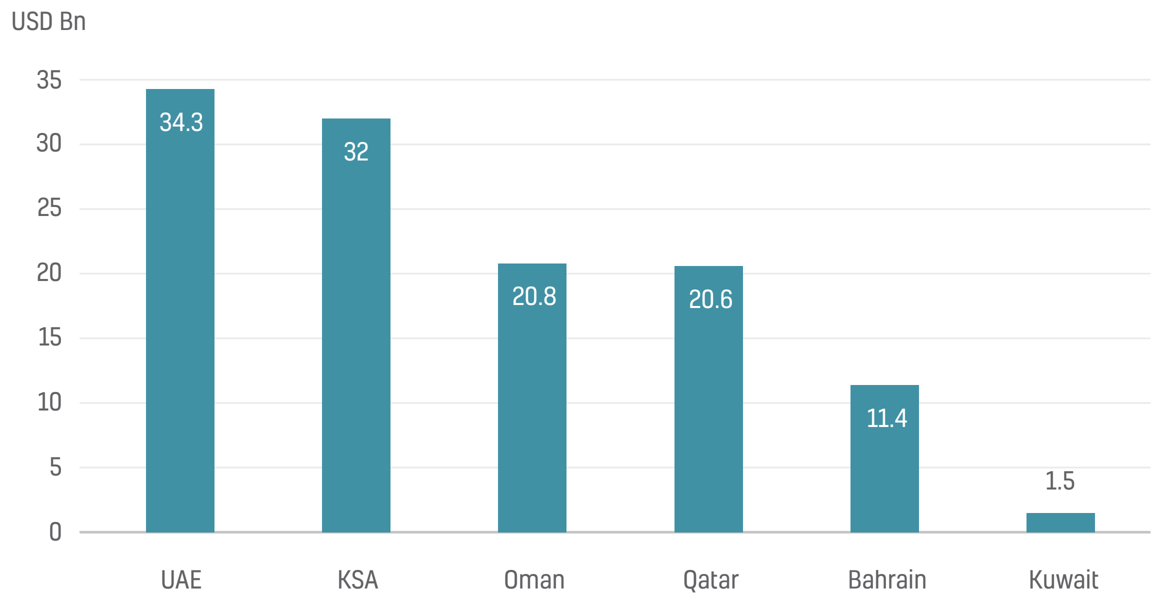
While there are concerns that massive stimulus plans might create enormous unproductive debt overhangs, the priority at the current stage is to induce growth as quickly as possible in the real economy. As in other parts of the world, questions around the specifics of the transmission mechanism by which these packages will actually find their way to the real economy are subdued. In addition to issuing bonds and scaling back spending, a few countries were able to tap into their large foreign assets to cover current account, inject dollar liquidity in banking systems and offset capital flight.

There are a few bright spots outside of the GCC. Morocco, for example, maintained its S&P investment grade rating. However, for other countries in the region, particularly those in a post-war reconstruction process or with existing unrest, the recovery remains on precarious footing.

Most countries used a diverse portfolio to mobilize stimulus packages

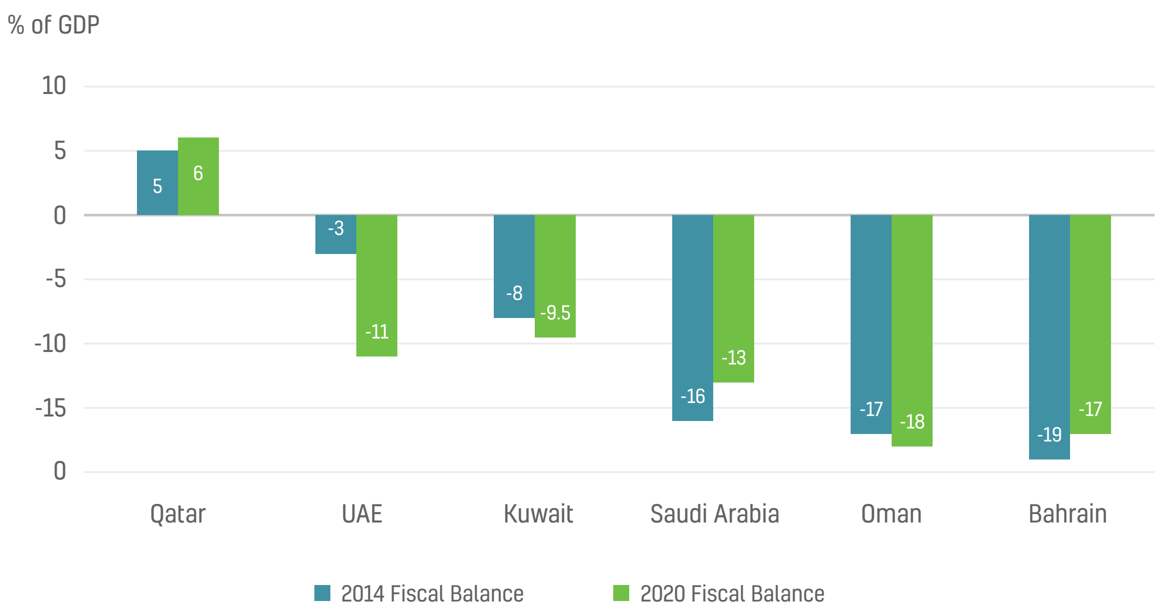
Extensive stimulus packages to fight the direct and indirect effects of the COVID-19 pandemic have been mobilized, either through debt capital markets, fiscal consolidation, tapping existing reserves, multilateral and bilateral financing, or foreign aid. The GCC has earmarked more than USD120 billion in the form of economic stimulus packages, while Egypt earmarked USD7 billion in stimulus for several sectors.

GCC economic stimulus packages by country



Source: World Bank, IMF

GCC countries are returning to double-digit deficits



Source: IMF

Debt capital markets

In 1H2020, GCC countries were able to raise more than USD45 billion in oversubscribed sovereign bonds, with the UAE topping the region with USD15 billion in issuances, followed by Saudi Arabia and Qatar at USD12 billion and USD10 billion, respectively. Abu Dhabi raised USD5 billion through a three-tranche bond offering in August; and Bahrain sold USD2 billion in debt instruments, USD1 billion in a 7-year sukuk at 3.95% and an additional USD1 billion in 12-year bonds at 5.45%. In September, Saudi Arabia tapped the market with a local currency sukuk issuance for SAR1.245 billion (approximately USD330 million). Outside the GCC, Morocco successfully priced a €1bn RegS/144A dual- tranche bond, the first Euro sovereign deal from the MENA region in 2020 to date and the lowest ever coupon for an African sovereign (*source: JP Morgan*).

Other MENA countries are struggling with the increasing bond yields due to the challenging global financial conditions brought about by the pandemic. These countries face the one-two punch of economic recession and depressed oil and gas prices. After credit risk premiums increased by at least 80-100 bps in 1Q2020 even for AA-rated countries, markets gradually calmed down during Q2 and Q3.

The following table provides a proposed comprehensive assessment of country risks premiums and shows the relative discrepancies between MENA countries.

	Moody's rating	Sovereign CDs	Adj. Default Spread	Equity Risk Premium	Country Risk Premium	Corporate Tax Rate
Algeria	NR	NA	9.65%	17.91%	11.90%	26.00%
Egypt	B2	6.83%	8.16%	16.08%	10.07%	22.50%
Iran	NR	NA	9.65%	17.91%	11.90%	20.23%
Iraq	Caa1	9.97%	11.12%	19.73%	13.72%	15.00%
Israel	A1	1.10%	1.04%	7.30%	1.29%	23.00%
Jordan	B1	NA	6.68%	14.25%	8.24%	20.00%
Kuwait	Aa2	1.77%	0.74%	6.92%	0.91%	15.00%
Lebanon	Ca	NA	15.00%	24.52%	18.51%	17.00%
Libya	NR	NA	4.45%	11.51%	5.50%	20.00%
Morocco	Ba1	2.81%	3.71%	10.58%	4.57%	31.00%
Oman	Ba2	7.09%	4.45%	11.51%	5.50%	15.00%
Qatar	Aa3	1.83%	0.90%	7.12%	1.11%	10.00%
Ras Al Khaimah (Emirate of)	Caa1	NA	11.12%	19.73%	13.72%	0.00%
Saudi Arabia	A1	2.32%	1.04%	7.30%	1.29%	20.00%
Sharjah	Baa2	NA	2.82%	9.49%	3.48%	0.00%
Syria	NR	NA	17.03%	27.03%	21.02%	28.00%
Tunisia	B2	5.83%	8.16%	16.08%	10.07%	25.00%
United Arab Emirates	Aa2	NA	0.74%	6.92%	0.91%	55.00%
Yemen Republic	NR	NA	17.03%	27.03%	21.02%	20.00%

Source: Aswath Damodaran, Country Default Spreads and Risk Premiums, New York University, January 2019

Fiscal consolidation

In Saudi Arabia, the government announced a 5% cut in its operational budget and tripled the VAT rate in July 2020 while it pressed ahead with its reforms aimed at boosting FDIs. However, some ongoing reforms continued. Following the new regulations introduced in 2019 allowing for broader foreign ownership of publicly traded firms, the Saudi Stock Exchange Tadwul in 2020 promoted trading and listing on the parallel market (known as Nomu) for small and mid-caps to support SMEs and the non-oil economy, in addition to its first exchange-traded derivatives product.

Another different example is Algeria. Facing a -17.4% decline in foreign reserves compared to last year, and a fiscal deficit that would surge to 15-20% of the GDP even with government cuts to public investment (-9.7%) and public consumption (-1.6%), the Algerian Government pledged USD20 billion in savings in 2020 through a reduced public budget, banking sector reform and lower imports after years of expansionary budgets.

Existing financial reserves

GCC countries boasting large foreign reserves were able to also inject liquidity in their economy and banking systems. In the UAE, Kuwait, and Saudi Arabia, surpluses from past hydrocarbon revenues are being used to plug the fiscal gap. Oman, however, is facing exhaustion risk if other financing instruments are not found.

Also, despite the heavy burden of combined 2020 crises, GCC banks seem well positioned to weather the crisis. With a combined USD2.3 trillion in assets at the end of 2019 according to S&P Global Ratings, GCC banks can absorb up to USD36 billion in extra provisions before their capital bases erode. However, in April 2020, Moody's changed its outlook on five GCC banks to negative. Additional consolidations could occur -- e.g. the National Commercial Bank-SAMBA merge in Saudi Arabia. Furthermore, banks with the highest exposure to affected sectors, such as airlines, transport, cross-border, energy, retail, entertainment, SMEs, could uncover significant difficulties with NPLs, and bad debt. At the time of writing, Emirates NBD, Dubai's largest bank, posted a 69% decrease in quarterly profit for 3Q2020 due to bad debt charges.

Multilateral financing and foreign aid

Iraq, Egypt, Tunisia, and Jordan were already burdened with substantial debt from multilateral creditors and development banks, and all increased their credit position in 2020. Egypt acquired a USD2.7 billion loan from the IMF in May and a USD3.5 billion loan from Afrexim Bank in Q3. Tunisia meanwhile secured USD1.3 billion in March and USD745 million in April from the IMF through an array of instruments. Morocco tapped all available resources under the already agreed Precautionary and Liquidity Line of about USD3 billion, or about 3% of its GDP. Even Iran requested a USD5 billion emergency loan for the first time in nearly 50 years. And although dozens of countries worldwide have received similar emergency funding from the IMF and the World Bank, the amounts have been comparatively smaller.

Besides multilateral loans, countries turned to traditional country donors. Such a strategy however will further deepen some countries' structural dependence on foreign grants (e.g. Jordan where such aid represents 11% of revenue over the last five years *(source: IHS Markit)*. The fall of oil and gas prices is also negatively impacting GCC countries' investment and donation in other countries of the region, leaving space for other emerging markets donors.

Only a few MENA countries have the mechanisms to translate stimulus into productive debt and quick recovery

Several MENA countries implemented measures to defer or exempt entities of payments due to the government. A few opted to support the private sector by easing and guaranteeing local loans or with temporary discount on electricity bills. Saudi Arabia for example gave key economic sectors a 30% discount on their electricity bills. Morocco and Egypt created new credit lines to make cheap loans available for SMEs. Support funds were also to inject liquidity in different sectors, such as in Tunisia and Egypt. In the UAE, federal and state authorities are trying to ensure banks and companies' liquidity. Other measures include Saudi Arabia covering 60% of salaries in private sectors affected by the pandemic, as part of a larger USD2.4 billion private sector relief package.

Parts of the private sector are also suffering from contract or payment delays in their government contracts. The massive stimulus plans and wider economic impact of the ongoing global recession poses severe threats for MENA economies due to fiscal stress and risk of accumulating unproductive debt. Countries in more precarious positions – such as Lebanon, Yemen, Libya – or countries with slim fiscal buffers – such as Oman, Bahrain, Algeria, Iraq and Iran – will be particularly exposed. Others will likely engage in deficit financing, thus risking currency depreciation. If the pandemic is prolonged and if reforms are not pursued to reduce private sector dependence on government spending, such high levels of debt could become unsustainable. However, sluggish domestic demand has curbed inflation, and with all GCC countries currencies -- expect for Kuwait -- pegged to the US dollar, non-oil sector could benefit from a prolonged weak dollar during the post-COVID-19 recovery. For these countries, the question is more of a management of the medium term.

The reforms to reduce the private sector's dependence on government spending will have to go hand in hand with larger economic and regulatory reforms. A few countries have already started on this path, with Egypt declaring that it plans to both ameliorate and reduce governments' expenditures. With the crisis laying bare the region's structural issues, pursuing or triggering reforms is becoming urgent. Yet, it is through their support to the economy that MENA countries can make this needed shift. Massive stimulus plans give countries the ability to implement policies that will induce growth, support consumption, boost the private sector and attract investment. The 2020 triple crisis can provide new opportunities for such ambitious economic choices.

The “Global Reset”: Opportunities brought by COVID-19

The changing GVCs and the transformation occurring in many sectors, including the energy sector, are also opening up new opportunities for a few MENA countries. Capitalizing on these opportunities will determine who could emerge as regional champions in a post-COVID-19 world, including opportunities to reshore production closer to consuming markets, increase digitalization of the economy, and channel investments into burgeoning areas which drive energy transitions (e.g. large-scale renewables for hydrogen or other net-zero output.

The pandemic has disrupted global production, parts of the trade and accelerated protectionist trends. As GVCs are reshaped, even at the margin, a few MENA countries can seize new opportunities for reshoring or nearshoring, provided they act swiftly. From automotive and textiles and apparel production to electronics and mid-range machinery, multinational corporations’ (MNCs) quest for more resilience, security, and efficiency amidst the COVID-19 mayhem is driving their search for new production locations that can offer them those benefits. Thanks to the proximity of MENA countries to large consumer markets, mainly the European Union, the region can position itself as an attractive investment partner for MNCs looking to shorten their supply chains. This unique moment brought about by an unprecedented pandemic can provide tremendous thrust to the respective diversification strategies of oil and gas exporting countries, as well as an opportunity for the region at large to increase its relatively low participation in GVCs.

For example, Tunisia is proactively looking to seize opportunities through its 2021 planned investment promotion strategy by focusing on European companies relocating from China in sectors in which Tunisia already has a comparative advantage – e.g. agribusiness, textiles and manufacturing.

Egypt and Morocco are pursuing a similar path in their existing and competitive automotive sector as global automotive players consider moving production from China to other markets. Morocco in particular could further move up in the automotive value chain.

The same trend could occur, albeit with lower-added value, in other manufacturing sectors such as textiles and apparel production, particularly in countries with cheap labor costs and a large active population such as Egypt. Stimulus plans should also be a game-changing opportunity for largescale technological upgrades, provided they are funneled towards digitalization, energy transition and smart infrastructure development.

The crisis has already led to import reductions, export bans, and even import substitution policies in a few countries– Algeria and Lebanon, for example– in strategic sectors such as healthcare and sanitary products. Egypt encouraged the reorientation of activities towards these sectors in its free trade zones (*source: OECD*).

With advancements such as mobile technologies offering an efficient tool to support informal sectors, the COVID-19 pandemic also accelerated the path towards digitalization in a few MENA countries. Tunisia, Morocco and Jordan have deployed several tools such as digital payment mechanisms and online services. Countries which are lagging in digitalization behind the relatively more advanced GCC countries could strongly benefit from technological upgrades and attract knowledge-intensive FDIs. Network deregulation or reforms and public implementation capacities must be built, especially at the local levels. Depending on their respective characteristics, each country should develop its own digitalization strategy in order to make targeted sectors more agile and better prepared for future disruptions.

In the energy sector, the MENA region already has the built-in advantages of the few winners who will emerge post-COVID-19. The region boasts a high concentration of low-cost low-carbon producers, including in the oil and gas value chain and utilities. A few countries – such as Saudi Arabia and Morocco – are already positioning themselves as low-cost exporters of blue and green hydrogen, in addition to net-zero ammonia and other low-carbon products.

Conclusion

Ultimately, the respective characteristics of MENA countries will play a determining role in their ability to take advantage of the changing global environment. In addition to labor costs, demographics, regulatory frameworks, trade relations and the state of infrastructures, improvement of the business environment and skill pool will be especially critical to emerge on stronger economic footing post-COVID-19. Efforts towards liberalization could boost foreign investment. A few GCC countries such as the UAE and Qatar are considering allowing 100% foreign ownership in certain sectors, while Egypt and Tunisia have already allowed expanded market access to investors under specific conditions. The degree of success in MENA countries' investments in infrastructure and digitalization and ability to draw investments will also be a key determinant for success in a post-COVID-19 world.

Arab Petroleum Investments Corporation

P.O.Box 9599
Dammam 31423
Kingdom of Saudi Arabia

info@apicorp.org

www.apicorp.org

@APICORP