

Investment Management Review

A Quarterly Update for the Investment Management Industry

Back on a growth path in the Gulf

After the upsets of 2009, what does the future hold for the Gulf economies? *Global Investment Management Review (IMR)* interviews Farouk Soussa, Chief Economist for the Middle East, Citi, to find out.



Investment Management Review: What is the general outlook for the Gulf Cooperation Council (GCC) countries?

Farouk Soussa: The headline story is that the GCC is set to outperform other parts of the world. We believe the region as a whole will grow at almost double the global average over the next five years. The main driver of economic growth will be government expenditure. Reserves of oil wealth are now being drawn on to fund infrastructure spending. Governments are also working hard to boost employment. Given their demographic profile, with more than 50% of the population under the age of 21, most GCC countries continue to view job creation as a priority, and growth remains a key policy objective.

How important is the oil price in sustaining growth?

Over the past 30 years, there has been a strong correlation between oil prices and government expenditure. But that boom/bust cycle has been detrimental to long-term economic growth. In the past couple of years, governments have demonstrated that they are willing to prioritize growth and push on with large deficits.

Saudi Arabia is a good example. In 2008, despite a fall in the oil price from over US\$140 a barrel to just over US\$40, the Kingdom was still prepared to lift 2009 budgeted spending by almost 20%, resulting in a 3% deficit. With huge reserves parked within sovereign wealth funds, Saudi Arabia could afford to fund a deficit of that scale for another 20 years without having to borrow in the markets.

Clearly, there are consequences to all this. With interest rates effectively linked to those of the U.S. through the dollar peg, the GCC is currently a low-interest-rate environment. The combination of high government spending, low interest rates and external inflationary pressures is bound to put upward pressure on prices. In Saudi Arabia, strong government expenditure is driving a recovery in nonoil economic growth, which we expect

will be in the order of 4.5% in 2010. But rising housing and food costs are driving up inflation, too. We recently lifted our forecast for the Consumer Price Index from 5% to 6% for 2010, and believe risks are on the upside. Policymakers face something of a conundrum: How do you maintain economic growth without stoking inflation when you have a passive monetary policy that is linked to that of the U.S.?

What about the debt problems in Dubai? Are they a potential obstacle to regional growth?

There is certainly a massive debt overhang, particularly among state-owned enterprises, while the correction in the property market has proved a double whammy for many of these companies. Unquestionably, the debt overhang will be a drag on the economy for some time to come as it reduces the incentive for lenders to supply credit and deters investment inflows.

But despite this, we see compelling reasons for optimism. The recovery in the global and regional economy is set to benefit Dubai as the premier regional hub. Dubai's non-real-estate sector accounts for about 75% of the economy and has the potential to lead a strong recovery in the near term. In our view, the property market correction has boosted Dubai's competitiveness in at least two ways. It has eliminated some of the supply bottlenecks that had developed in the boom years and reduced the cost of living and working in the Emirate. The key point is that there is a lot of surplus infrastructure. The economy can grow without having to sustain infrastructure spending at 2003 - 2008 levels. The underlying fundamentals are sound.

Despite a continued fall in investment in the medium term, we see GDP growth returning to positive in 2010 and increasing steadily to over 6% by 2012. The main beneficiaries of this growth will likely be sectors related to external demand – such as tourism, trade, logistics and transportation – and to domestic consumption.

What have these markets to do in order to encourage the return of positive investment flows?

After the Dubai World/Nakheel debt moratorium and issues affecting investment companies and banks in a number of GCC countries, you would expect some retrenchment by international investors – particularly at a time of evident derisking. But as debt issues from Qatar and Abu Dhabi last year and from the Dubai Electricity and Water Company in the spring of this year testify, there is still appetite for regional issues among international investors.

Local equity markets have grown substantially over the past decade – though some have more to do in terms of their market structure in order to lose the “frontier markets” tag. The primary problem is the lack of liquidity in the debt capital markets. Government issuance has been low, so there is little in the way of benchmark securities. Historically, demand from local investors has been low and local state pension funds have invested the bulk of their money overseas.

This may be about to change. In the past, the main source of finance for local companies has been the banking sector. That has been badly hit and credit growth will likely be flat at best. Local companies have recognized the need to diversify their funding sources. There is a very strong call for local debt issuance. At the same time, there is pressure on state pension funds to invest more of their assets in the local markets. These two factors should be a catalyst for the growth of the region’s debt capital markets going forward.

So the long-term outlook is positive?

Very much so. There is one other factor to bear in mind. Iraq’s post-war reconstruction represents a particularly strong opportunity for long-term growth in the GCC. The country is targeting a growth in oil production from around 2.5m barrels of oil a day to 12m by 2016. This may be ambitious, but achievement of anything like that target

would put Iraq on par with Saudi Arabia as the world’s largest producer and exporter of oil. Its current account surplus would make it a net exporter of capital, similar to Saudi Arabia or Abu Dhabi. Ultimately, Iraq’s ascendance represents opportunities and challenges to the GCC region. ■

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