EEMEA Region View

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MENA: Counting the costs, and benefits

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Fixed Income Research

Contributing Analyst

Ann Wyman
+44 20 7102 9287
ann.wyman@nomura.com

Icaro Rebolledo
+44 20 7102 1590
icaro.rebolledo@nomura.com

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It has been two and a half months since the revolution in Tunisia set off a wave of unrest and political change throughout the Middle East and North Africa (MENA) region. As the unrest continues to spread, we take stock of the economic costs and benefits of political instability and transition to democracy. We find that the near-term aggregate negative implications for non-oil producers are proving the highest, while ramped up fiscal spending in some producers will support economies already receiving the benefits of higher oil prices. Nonetheless, fiscal surpluses will not be as high as otherwise expected. Over the longer-term, economic and commercial opportunities should resurface in post revolutionary countries, but the road to recovery may be long.

The following piece looks at a series of transmission channels through which political instability and transition to more democratic institutions is affecting MENA economies. In sum, the implications are mixed, due in large part to differing effects from oil price rises and varied amounts of fiscal space for support measures. Because much of the regional growth improvement, where it exists, is expected to come from oil and fiscal stimulus, countries are not likely to make any significant headway in the important structural shift that is needed—increasing non-oil, private sector output. Moving toward economic diversification and increased private sector activity are key elements in helping to create longer-term sustainable employment opportunities for the large youth populations in many MENA countries.

We expect foreign direct investment to decline across the region, while tourism revenues look vulnerable in many popular destinations, aside from Dubai. Nonetheless, many regional investors will continue to focus on longer-term opportunities, particularly arising from the dividends of a new democratic environment. These should include increased transparency and accountability, as well as a more leveled playing field, though admittedly the road to reaching those improvements could prove long.

Near-term economic performance will diverge across the region

Not surprisingly, our economic forecasts for countries in the region have been shifting in recent weeks. We significantly downgraded our growth forecast for Egypt for this year (to 1.2%), and have increased the projected size of both the current account and fiscal deficits (to 3.2% and 10.4% of GDP, respectively). In the Gulf, we have actually upgraded our

Figure 1. Saudi Arabia economic forecast

	2009	2010	2011	2012
Real GDP % y-o-y	**0.2**	4.0	6.0	4.5
Hydrocarbon % y-o-y	**-8.7**	2.4	5.5	2.9
Nonhydrocarbon % y-o-y	**3.0**	3.7	3.5	3.2
Nominal GDP, USDbn	**370.1**	443.7	492.5	524.0
CPI % y-o-y *	**5.0**	**5.4**	5.6	5.0
Budget balance % GDP	**0.9**	4.5	2.0	3.5
Current account % GDP	**6.0**	11.5	20.4	15.0
External debt, USDbn	**101.0**	105.3	110.0	120.4
External debt, % GDP	**27.3**	23.7	22.9	23.6
Short-term interest rates %	**0.70**	**2.00**	2.00	2.50
USDSAR*	**3.75**	**3.75**	3.75	3.75

*End of period, **Period average, Bold is actual data

Source: Nomura Global Economics.

Figure 2. Egypt economic forecast

	2009	2010	2011	2012
Real GDP % y-o-y	**4.8**	5.3	1.2	3.1
Nominal GDP, USDbn	**187.4**	212.0	239.6	269.8
CPI % y-o-y *	**13.3**	**10.3**	12.1	9.5
Budget balance % GDP**	**-6.9**	-8.3	-10.4	-8.9
Public sector debt, % GDP	**70.5**	73.9	78.1	79.8
Current account % GDP	**-3.0**	-2.5	-3.2	-2.7
FX reserves, gross USD bn	**30.0**	35.1	29.0	31.0
External debt % GDP	**17.1**	16.3	17.7	18.2
Policy rate %*	**8.25**	**8.25**	8.25	9.00

*End of period, **Fiscal year ending June, Bold is actual data

Source: Nomura Global Economics.

forecasts for 2011 economic growth in Saudi Arabia, UAE and Qatar (to 6.0%, 4.8% and 20.2%, respectively). These upward revisions come on the back of higher oil and gas prices. Moreover, in Saudi Arabia, increased oil production (to compensate for lost Libyan output) and two large fiscal stimulus packages are all expected to have beneficial effects on growth, while an improved outlook for domestic demand could boost activity in the UAE (see Figures 1- 3). Nonetheless, even underperformers such as Tunisia, Egypt, and even Libya, have the potential to become outperformers over the following years if and when political stability returns.

External financial assistance important for supporting activity

Assistance from external donors and multilateral lenders will likely play an important role in supporting economic activity in post-revolutionary MENA economies during their transition to democracy. Offers of assistance have already come from the US and the EU, including proposals to form both Egyptian-American and Tunisian-American Enterprise Funds worth US$60mn and US$20mn, respectively. Moreover, the EU has announced the immediate release of EUR17m in emergency aid for Tunisia and the extension of EUR258mn by 2013. The European Investment Bank, which last year lent around EUR900mn and EUR560mn to Egypt and Tunisia, respectively, has announced investments of EUR1.87bn in Tunisia. These will focus on sanitation, energy and road infrastructure, as well as support for small and medium enterprises, with the aim of encouraging job creation. The EU has also urged the European Bank for Reconstruction and Development (EBRD) to increase its involvement in region's transition to democracy. The EBRD has expressed its willingness to invest EUR1bn a year in Egypt subject to the approval of Egypt's request to be included in the bank's list of countries in which it can invest. The African Development Bank has also indicated that it may earmark US$0.5-1.0bn in credits to help Tunisia address what it sees as some of the most important structural issues including youth unemployment.

High oil prices: a mixed blessing

Within the Middle East and North Africa, there has always been a clear economic divide between net oil exporters and importers, and the effects that oil prices can have on their respective economies. Oil exporters such as Saudi Arabia, UAE or Qatar will naturally reap benefits from the recent increase in prices, with GDP increases as discussed above. On the other hand, Tunisia and Egypt stand to be negatively affected, with consequences for inflation, current account and fiscal balances. Under the current conditions of growing political unrest, this divide between oil importers and exporters also has important implications for the amount of fiscal space available to governments as they face increasing pressure to be proactive in improving living conditions and minimizing economic and social complaints.

Figure 3. Qatar economic forecast

	2009	2010	2011	2012
Real GDP, % y-o-y	**9.6**	16.5	20.2	14.0
Hydrocarbon % y-o-y	**13.2**	25.0	18.1	12.7
Nominal GDP, USDbn	**93.3**	114.7	132.0	150.4
CPI % y-o-y **	**0.5**	1.5	3.6	3.5
Budget balance % GDP	**12.2**	10.0	12.0	10.0
Current account, USDbn	**9.6**	22.8	34.0	36.0
Current account % GDP	**10.3**	19.9	27.9	23.9
Exteranl debt, USDbn	**76.5**	90.1	93.1	95.5
External debt, % GDP	**82.0**	78.5	70.6	63.5
Short-term interest rates %	**2.00**	1.50	1.50	2.00
USDAED*	**3.67**	3.67	3.67	3.67

*End of period, **Period average, Bold is actual data

Source: Nomura Global Economics.

Figure 4. Sensitivity to a 10% increase in oil prices

	GDP (pp growth)	Current Account (pp of GDP)	Budget balance (pp of GDP)
Egypt	-0.1	-0.1	-0.3
Kuwait	2.2	4.0	3.6
Qatar	2.1	3.9	4.1
Saudi Arabia	0.8	4.9	4.3
UAE	0.6	2.5	2.3
Other EEMEA			
Russia	*0.4*	*2.4*	*1.1*
Turkey	*0.0*	*-0.3*	*-0.3*

Source: Nomura Global Economics.

Looking at some of the economic variables in detail, we estimate that for every 10% increase in oil prices, Saudi Arabia's growth will be 0.8 pp higher, while the implications for Qatar and Kuwait are even more notable, with growth rising more than 2pp in each. External accounts for oil exporters are also likely to register higher surpluses (all the more so in Saudi Arabia where production has increased by almost 700k bpd in recent weeks). We see the current account surpluses in Qatar and the UAE widening by an additional 2pp of GDP and by almost 5pp of GDP in Saudi Arabia as a result of the recent increase in prices, which we expect will remain underpinned for the remainder of the year (Figure 4).

Governments react to political stress with economic measures

Governments across the MENA region have sought to alleviate growing political and social pressures through a series of announced spending packages. The most dramatic in terms of size have been the two announced by Saudi Arabia, including a US$36bn package targeting lower-income citizens, followed by a further US$93bn stimulus package creating 60,000 new security jobs as well as enhancing unemployment insurance and other social benefits. Some US$63bn of this amount is expected to support new housing projects and could take place over the next several years. Other countries in the region have also sought to ease economic stress on their populations through spending measures. For example, in Oman, the Sultan announced the mandatory creation of 50,000 new jobs (both public and private sector), as well as the increase of the minimum wage and of the unemployment insurance. In Egypt, public sector wages have been increased, and similar measures have been implemented in other countries across the region, including Jordan and Yemen.

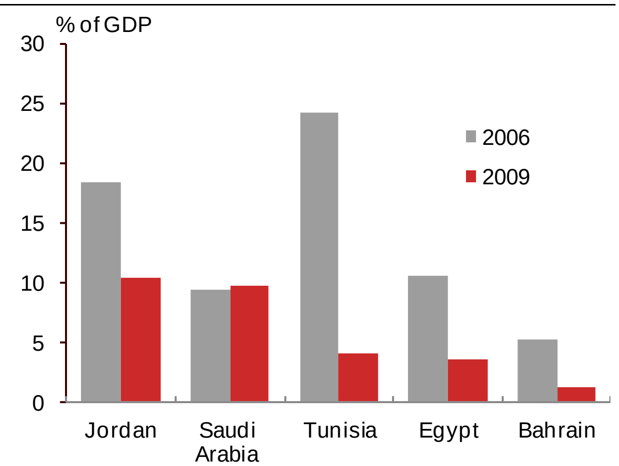
The affordability of such measures differs by country given the varied state of government finances. For oil producers the increase in government spending is being offset in part by higher oil prices (and in the specific case of Saudi Arabia, by higher production as well). But for others like Egypt and Jordan, such measures can be costly, and put government finances under considerable strain.

FDI recovery was expected in 2011, but prospects have dimmed

As a result of the global financial crisis the majority of countries in the region saw significant decreases in the level of foreign direct investment (FDI) in 2009 compared to the peaks in 2006 (Figure 5). While most estimates pointed toward a pickup in FDI last year, it was hoped that further increases in 2011 could help in making progress in tackling growing infrastructure needs in some cases, and important structural reforms in others. But since political crises have swept the region, expectations for FDI in 2011 have diminished substantially, given the increased uncertainty in the region.

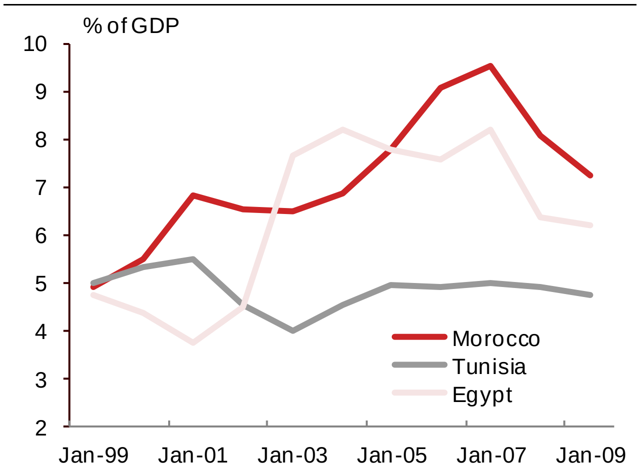
The likely decrease in FDI will hit hardest those countries needing to finance large current account deficits. Within MENA, Lebanon stands out having a current account deficit of around 15% of GDP, with FDI accounting for more than 7.5% of GDP. Despite the relatively

Figure 5. Foreign direct investment in 2006 and 2009



Source: CEIC, Nomura Global Economics.

Figure 6. Tourism in MENA



Source: CEIC, Nomura Global Economics.

strong foreign reserve levels and generally solid banking system, political stability continues to be crucial for the region to continue attracting FDI. Jordan, Tunisia, Morocco and Egypt also show current account deficits although at levels below 5% of GDP. Yet, the financing of the current account deficit will not only be affected by decreased FDI, but also by the decreased foreign currency revenues from an expected slowdown in tourism.

Tourism also likely to suffer, for now

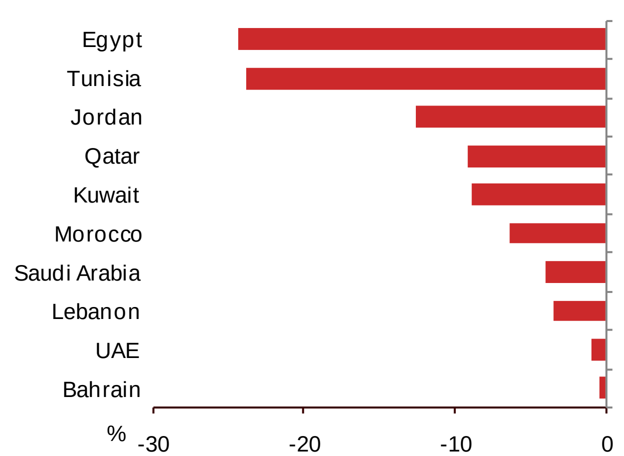
Many MENA countries, especially those in North Africa, depend on the tourism industry as an source of growth, employment and foreign currency. Tourism receipts were close to 10% of GDP in Morocco and around 8% of GDP in Egypt prior to the global financial crisis (Figure 6). Moreover, a booming tourism industry in Lebanon has been a key component of this country's recovery with a 53% increase in visitors in the 12 months up to July 2010 compared to the same period in 2008. Nevertheless, tourism will likely be hit hard as a result of the unrest and the longer uncertainty dominates MENA headlines the longer it will take for tourism to recover.

In the case of Egypt for instance, looking at past exogenous shocks to the tourist sector like the Luxor attacks in 1997, tourist visits declined by 45% y-o-y in the three months following, resulting in a decline in revenues of approximately 20% in that fiscal year. Applying a similar drop to the current environment would leave arrivals lower by over 3 million people in the next 12months (compared to the same period last year) and probably result in a loss of at least US$3bn in revenues. On the other hand, while it is perhaps too early to say, the tourist industry in Dubai could get a lift from the rest of the regional unrest, given its reputation as a regional safe haven. As tourists shun North Africa, Dubai is an alternative destination, and indeed, volumes of passenger traffic at the Dubai International Airport were up more than 5% in February.

Financial and currency markets off, but implications limited

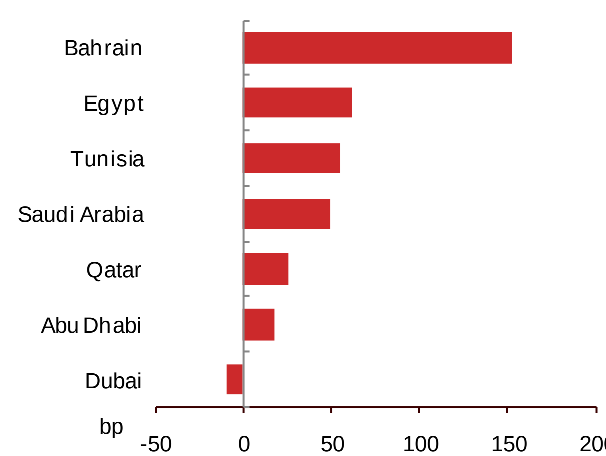
Regional equity markets have declined notably since the start of the crisis, with Egypt and Tunisia not surprisingly being the most affected, down around 24% (Figure 7). In the (sovereign) fixed income space, the greatest impact has been felt in external debt and CDS markets, given that these are the most widely traded instruments (see Figure 8). The most dramatic sell off has been seen in Bahrain, where spreads have widened 152bp since the mid-January. In local debt markets, the impact has mostly been felt in Egypt, where treasury bill auctions have seen yields continue to climb upwards. The central bank has just announced the details of its new repo facility that it hopes will alleviate some upward pressure on interest rates, though at this stage is it unclear whether this approach will be effective.

Figure 7. Equity markets performance since January 14



Source: Bloomberg, Nomura Global Economics.

Figure 8. CDS performance since January 14



Source: Bloomberg, Nomura Global Economics.

The effects of the financial market losses, while important for the investors in those markets, are likely to have a very limited impact on the individual economies, given the relatively limited retail investor involvement in all but a few equity markets, and generally low leverage. Moreover, the widening of external debt spreads is not likely to have meaningful cost, given that private sector external borrowing in the region remains relatively low. The most notable impact from financial market weakness in the region is coming from the increase in Egyptian t-bill yields, which are affecting local bank balance sheets as well as government finances.

High costs in Libya, frozen assets can eventually aid recovery

As the campaign of air strikes continues, and Qadaffi hangs on to power, the near-term costs of oil production stoppage, economic paralysis and destruction of infrastructure in Libya continue to mount. While recent days have seen increasing hopes of some resumption in oil production, it is still unclear how/if rebel forces will eventually be able to export, given current international sanctions as well as challenges around shipping. For now, the lost of oil export revenue is one of the main channels through which the political turmoil is translating into a significant damage to the economy. With production estimated to have been reduced by 60% and assuming constant domestic consumption at around 250,000 bbl/ day, oil available for export would be 400,000 bbl/ day, down from around 1.4 million bbl/day. As a result, assuming (for the sake of the exercise) a price of US$100 per barrel this would translate into loss revenues of around US$100 million per day. Nevertheless, Libyan frozen assets in the US and Europe amount to more than US$55 billion and part of this could be used to off-set the cost and invest in the future, though this remains a distant possibility for now.

Disclosure Appendix A1

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