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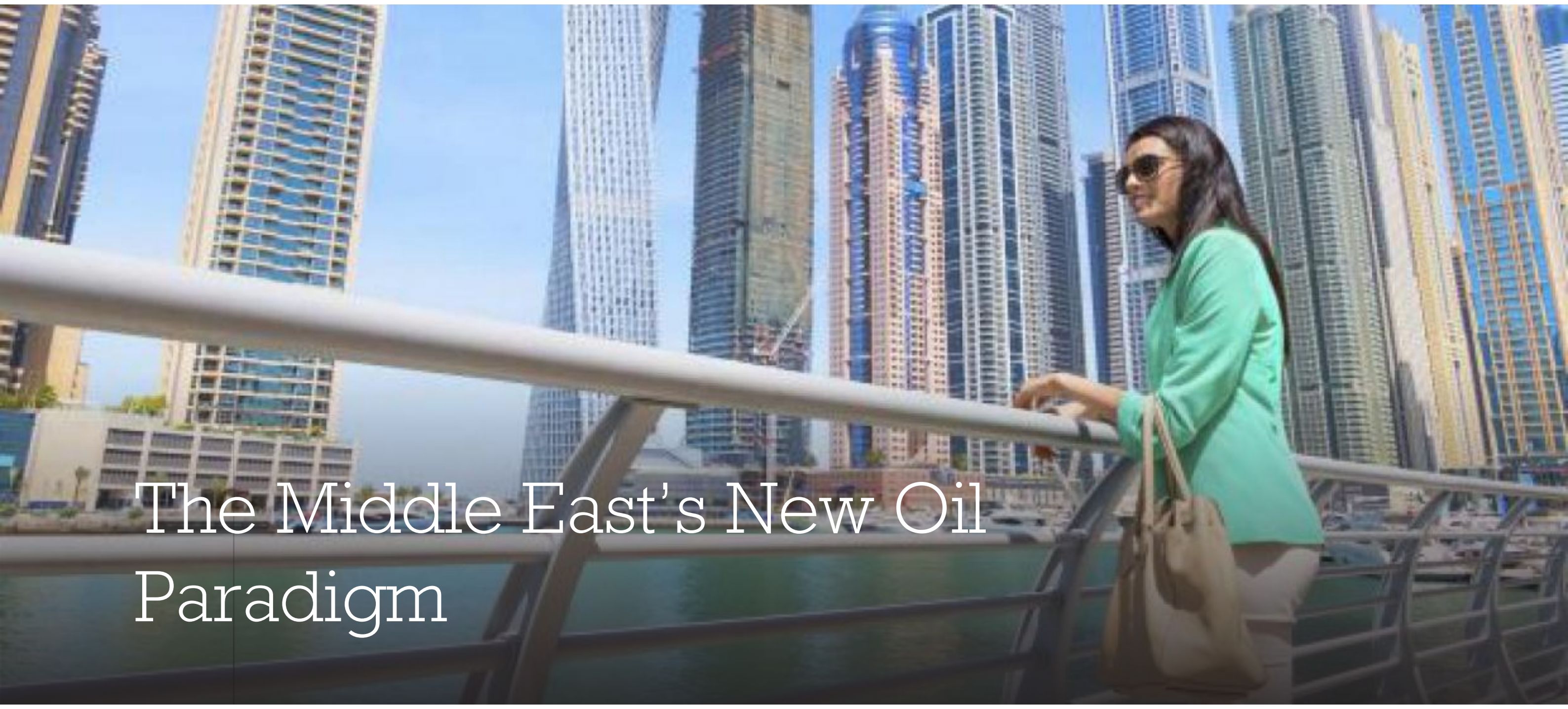

The Middle East's New Oil Paradigm

Saudi Aramco's proposed partial privatisation is the start of much needed GCC reform.

The prospect of sustained lower oil prices over the next decade offers the oil-dependent economies of the Gulf Cooperation Council (GCC) an unprecedented opportunity to implement economic diversification strategies and reform policies that will underpin more sustainable and resilient economies.

Lower oil prices, which knocked US$340 billion off GCC revenues in 2015, are expected to remain at between US$35-45 per barrel, prompting governments to revise their fiscal plans and budgets. Oil generates 85 percent of revenue for the region's economies, and the 70 percent decline in oil prices since June 2014 has had a huge impact on budgets, with deficits expected to run to about 13 percent of GDP in 2016. The GCC countries are able to finance these high deficits by drawing on accumulated fiscal buffers and substantial international reserves or by borrowing to offset the negative effects on economic growth. But this is a short-term palliative and cannot be sustained given the unfavourable prospects for oil prices.

Raising revenue

To address the challenges of lower oil prices, the GCC needs to undertake fiscal reforms and develop programmes and incentives for greater private sector participation, including privatisation of public sector activities (e.g. health, education and transportation) and public-private partnerships. Phasing out unsustainable subsidies (as in the U.A.E.) should be accompanied by increasing the prices of public utilities alongside increased revenue diversification policies via the introduction of broad-based taxes like VAT; property and corporate profit taxes; excise taxes on commodities such as cigarettes, sugary drinks, alcohol, luxury cars; and other taxes. These necessary fiscal reforms would improve fiscal outcomes and, by reducing the size of government, promise a new developmental model based on the private sector, leading to an improved investment climate and improved growth prospects.

The U.A.E. is a successful case of economic diversification. Non-oil revenues in the country topped AED 200 billion (US$54 billion) in 2015, representing 52.6 percent of consolidated government revenue. The growth in these revenue streams is supported in particular by Dubai, which has led the region in greater economic diversification by focusing on developing alternative sources of income from trade, finance, tourism, transportation, logistics and manufacturing. However, implementing policies to diversify GCC economies away from hydrocarbon dependence requires structural reforms, industrial policy design, and a holistic approach that includes investment climate reform to attract foreign investment and support business start-ups.

These reforms are imperative for the over-arching policy objective of job creation. Governance and transparency tend to be less emphasised in resource-rich economies, as the major firms are few, government-owned, and opaque. But creating a more diverse, competitive economy will require legal and regulatory reform as well as commitment by government and public institutions to be more transparent in order to avoid private sector capture and crowding-out.

Growing strains on job creation

The largest Arab economy, Saudi Arabia, will be the hardest hit by lower oil prices – the IMF estimates the country's budget deficit at US$106 billion in 2015, a tad higher than the official figure of US$98 billion. Additionally, the April 2016 revision of the IMF's World Economic Outlook cut Saudi Arabia's expected 2016 growth rate by a full percentage point, down to 1.2 percent. The kingdom has significant domestic demands, including employment and wage growth expectations from Saudi youth, who account for over 60 percent of the population.

The drop in oil prices has resulted in growing strains on job creation. The Saudi government added 93,000 new employees to the public payroll in 2015 compared to 103,000 in 2014. In the private sector, expansion slowed to its lowest rate since 2009 – companies hired 43,000 fewer Saudis than they did the previous year. Providing jobs and opportunities to qualified graduates will require a vibrant, internationally competitive private sector able to compete with the public sector for employees. Given Saudi's budget constraints, the government will no longer be able to subsidise high salaries and must look increasingly to the private sector to provide job growth. The private sector should be incentivised by 'education-for-employment' programmes, market-skills building and subsidised private sector on-the-job training coupled with education reform.

Saudi has recently identified around 146 state-owned entities, including state oil producer Saudi Aramco, as potential targets for privatisation and announced plans to cut public sector wages to 40 percent of spending by 2020 while reducing water and electricity subsidies by 200 billion riyals ($US53 billion).

Rebuilding the region

The oil price tsunami and collapse of government revenues comes at a difficult time, especially as the need for GCC financing in the region is growing. Unemployment, low economic growth and conflicts have led to soaring reconstruction costs. With a conservative estimate of US$1.4 trillion required to rebuild Syria, Iraq, Yemen and Libya and to support growth and infrastructure development, the region needs a new growth and development paradigm underpinned by sustainable revenues. These resources should be invested in rebuilding devastated regional economies in order to reduce unemployment and counter one of the main sources of extremism.

Infrastructure investment is the key to recovery, reconstruction and future growth prospects. The economic rationale is strong: every US$10 billion investment in infrastructure can create around 2.5 million direct, indirect and induced infrastructure jobs in the MENA region by boosting growth by roughly three percent among oil exporters and about 1.5 percent among oil importers in the region in the short-term.

But funding will not be so ample and forthcoming given oil crisis-hit budgets and growing domestic demands. For the region to meet increased demand it will need to both ensure strong economic growth in stable GCC countries and develop institutions regionally that can support reconstruction. Several regional initiatives have been advanced to meet these challenges: the Arab Bank for Reconstruction and Development and the Arab Stabilisation Plan.

These organisations not only highlight the need for reconstruction finance, they emphasise the need for private sector participation, job creation, and development of the financial sector in the region. These are all requisites to promote greater economic and revenue diversification, which is important both in the GCC and the broader region to underpin sustainable and sufficient economic activity.

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