How should GCC economies manage public finances, Opinion Piece in Gulf Business, Nov 2021

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How should GCC economies manage public finances

Governments can use sovereign asset liability management as a financial tool to manage public sector balance sheet risks

The Cop26 climate talks in November 2021 will confirm global commitments to counter climate change and move to a sustainable future.

At the core of the response is the energy transition away from hydrocarbons, the main source of wealth for GCC countries. While there is much focus on the energy system transition, part of the challenge for GCC countries is how they will manage their wealth and public sectors, assets and liabilities – much of which depend on hydrocarbons. That will require efficient public fiscal and financial management to ensure sustainability through a tool known as Sovereign Asset Liability Management (SALM).

At present, GCC governments run large non-hydrocarbon fiscal deficits despite major initiatives in recent decades to diversify their economies.

Governments have set up economic zones, infrastructure investments, state-owned enterprises (SOEs) and government-related entities (GREs). They have moved some public finances away from hydrocarbons through reforms to subsidies, public utilities pricing, and expenditures, along with the introduction of value-added tax. Despite these changes, the non-hydrocarbon primary balance as percent of non-oil GDP remains negative for all GCC countries.

Along with the fiscal dependence on hydrocarbons, GCC governments have future liabilities.

On the positive side of the ledger, decades of rapid economic growth have resulted in the accumulation of large international reserves and financial investments, a build-up of real assets and companies.

At the same time there has also been an increase in debt, contingent liabilities, and generous social programmes that governments have to finance. Adding to that burden is the size and extensive role of state-owned entities (SOEs) and government-related entities (GREs) in GCC economies.

In some cases, the liabilities of SOEs and GREs are estimated to constitute over 30 per cent of GDP, which has an effect the overall soundness of public sector balance sheets.

Financing these liabilities could be difficult during the energy transition as it implies lower prices in real terms for oil and gas.

GCC countries run the risk of an earlier than expected depletion of their net financial wealth. Their hydrocarbons and associated industries could become stranded assets.

These countries could also find it difficult to draw upon their sovereign wealth funds, which have stabilised government accounts during times of volatile commodity prices. Asset accumulation in these funds flattened following the drop in oil prices end of 2014, leading to a drawdown in reserves.

Over the long-term, as the IMF has warned, the net financial wealth of GCC countries could turn negative by 2034, turning the region into a net borrower.

To manage these financial risks, GCC governments should adopt SALM to handle the financial aspects of the energy transition. This system integrates multiple public assets, future revenues, and cash reserves, along with public debt and contingent liabilities into one sovereign balance sheet. That allows governments to manage liquidity, risks, savings, and commitments, to ensure macro-fiscal stability and long-term sustainable public finances.

They will be able to manage resources more adroitly, leading to a smoother transition away from hydrocarbons.

Denmark and New Zealand, for example, have implemented a comprehensive SALM framework successfully. They have improved their risk, fiscal and debt management significantly. They have also ensured intergenerational equity so that future generations do not pay for today’s spending. Their finances are now more resilient to shocks, and there is greater efficiency in the use of government assets, quality in the provision of government services, and wealth management.

To implement SALM, GCC governments will need an effective governance framework. They should institute clear mandates for the different public sector entities so that their data is transparent and should encourage cooperation, centralisation of risk management, and market-oriented valuations of assets and liabilities.

They should start their SALM journey by identifying the assets and liabilities of the public sector. That means creating a full register of public assets, followed by the collection of data and the construction of a comprehensive balance sheet. Then, they should develop dynamic tools that connect to each other, allowing a complete overview. That means policy making decisions that are evidence-based, impactful, equitable, and those that minimise risk.

The result will be an effective policy making and leadership decision engine.

In essence, the public sector would emulate the sound financial management tools used by modern private corporations in managing their balance sheets and risks.

As GCC countries move away from hydrocarbons, they will need SALM as a macro-economic and financial tool. SALM will allow them to manage risks in the public sector balance sheet and decide on policy tradeoffs during the move toward a sustainable future, ensuring that future generations inherit sound public finances.

The article is written by Nasser Saidi & Talal F Salman

Nasser Saidi is an economist and former minister and Central Bank vice governor in Lebanon, and Talal F. Salman is a principal with Strategy&

Weekly Insights 17 Dec 2020: Green shoots (of recovery) in

the UAE & Takeaways from Saudi 2021 Budget

Download a PDF copy of this week's insight piece here.

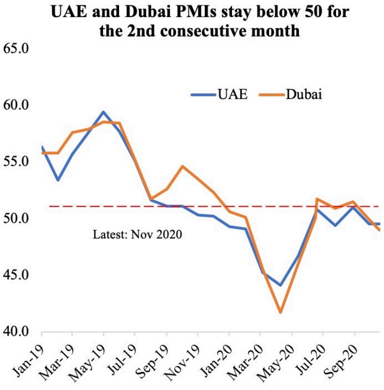
Chart 1: PMIs in UAE/ Dubai remain below-50 for the 2nd consecutive month; mobility & traffic pick up though demand remains weak

Though **UAE is one of the more "open" economies across the Arab world** (in the Covid19 era), the PMI readings in both UAE and Dubai stayed below the 50-mark for two consecutive months. Vaccine exuberance seems to have been overshowed by the decline in business, as business expectations turn negative for first time ever in Dubai.

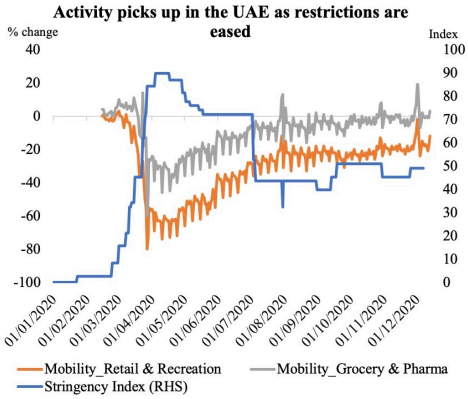
Demand weakness remains the main reason for the dip following an uptick after the initial lockdowns were lifted; with the recent surge in Covid19 cases in Europe & Asia, recovery has been slow in tourism and travel sector. **There is some signs of optimism**: flight bookings in the London-Dubai sector accelerated by 112% after the UAE-UK corridor was announced in early Nov; Israeli tourists are flocking to the city after the normalization of relations (& travel corridor) so much so that flydubai is now offering 4 Dubai-Tel Aviv flights daily.

UAE's recent liberalisation measures (rights of establishment, visas & immigration) add to the medium-term optimism and potential acceleration in the rollout of vaccines by next year offers hope for visitor arrivals in time for **Expo in Oct next year**. However, the **extent of business closures/ rising NPLs as an aftermath of the Covid19 crisis remains to be seen.**

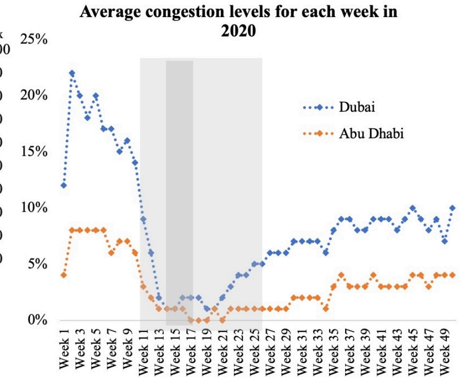
Mobility data from Google shows the **pace of recovery at grocery and pharmacy stores was much faster than that for the retail and recreation outlets** (restaurants, cafes, malls, theme parks etc); **congestion levels are still about 33% below 2019 levels**, though certain days in Nov-Dec showed positive readings (i.e. congestion this year at a higher rate than that day a year ago).



Source: Refinitiv Datastream, Nasser Saidi & Associates



Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government, Google Mobility Indicators, Nasser Saidi & Associates

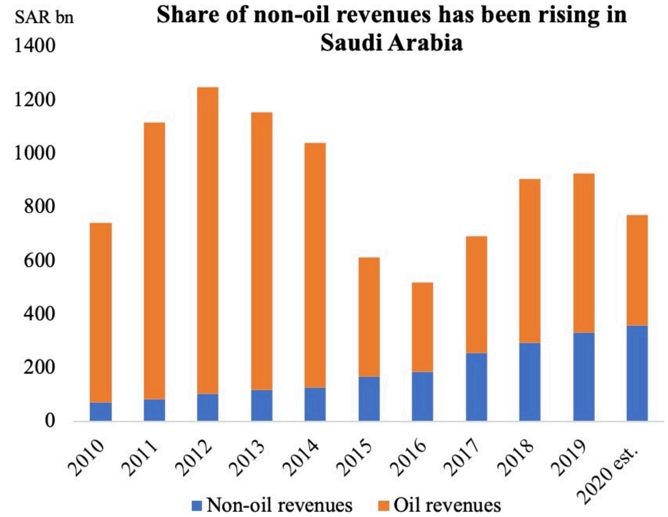


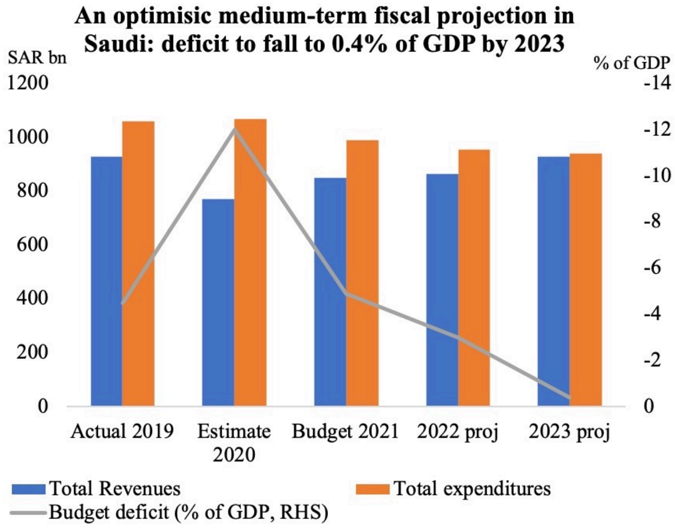
Source: TomTom Traffic Congestion Index, Nasser Saidi & Associates. Grey areas indicate Covid19 restrictions & darker grey the more severe weeks.

Chart 2: Saudi Arabia's plans to diversify away from oil needs to be accelerated

Global demand for oil is recovering but remains weak given the impact of Covid19 and ongoing lockdown restrictions, therefore, plans to diversify away from oil dependence will need to be accelerated. In this regard, **accelerated privatisation of state-owned assets is an essential structural reform**: it is promising that the government estimates the sale of government companies and assets to double to about SAR 30bn in 2021. This will also encourage private sector investment and attract capital inflows.

Is the Saudi target to achieve a balanced budget by 2023 realistic? It depends on how fast both the global economy, Asia/China (critical for the growth of oil and gas demand) and the Saudi economy can recover from the effects of Covid19, in addition to how the OPEC decision to raise production pans out. On the domestic front, rationalising spending by phasing out subsidies and lowering public sector employment/ wages will likely support the move towards a balanced budget.



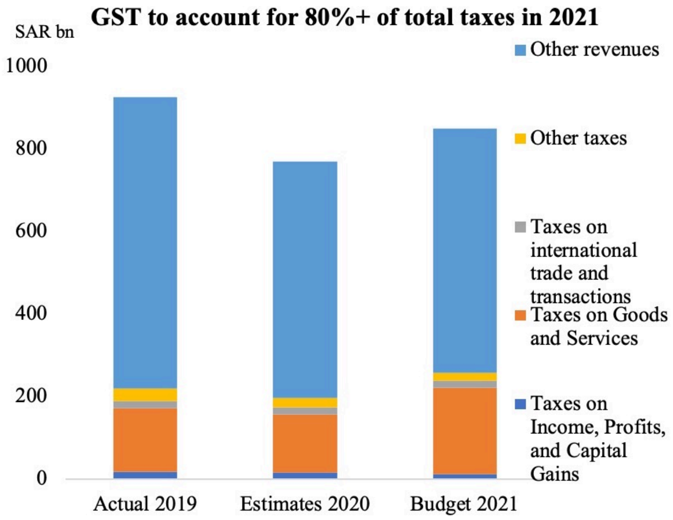


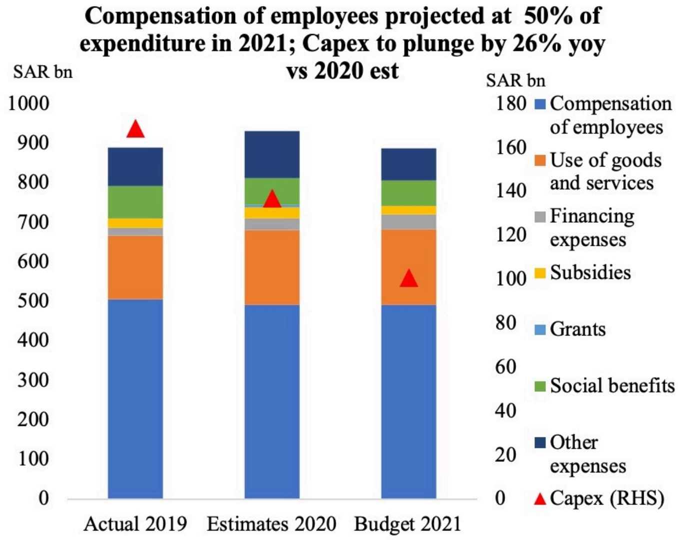
Source: Ministry of Finance, Saudi Arabia, Nasser Saidi & Associates

Chart 3: Saudi Arabia's tax revenue supported by VAT, while capex spending is scaled down

The estimated **rise in non-tax revenues** is likely due to a combination of the recent rise in oil prices (+33% since Nov) and OPEC's decision to resume oil production (plans to add 500k barrels a day to crude markets starting in Jan, with subsequent moves decided at monthly meetings). VAT hikes will contribute to the **uptick in tax revenues,** assuming there are no deferrals/ exemptions on taxes on goods & services next year. The **Aramco dividend** – of which 98% will accrue to the government – will also add to the government's coffers (though the allocation between PIF/ reserves at SAMA or MoF is not clear).

Though the government's capex spending has been significantly scaled down (-26.6%), it is a positive move, with the private sector being given more opportunities to execute infrastructure and developments projects (the massive NEOM project and others) and PPP, thereby supporting private sector growth and job creation (outside of the public sector).





Source: Ministry of Finance, Saudi Arabia, Nasser Saidi & Associates

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Weekly Insights 10 Dec 2020: Vaccine Exuberance, PMIs and Indicators of Economic Activity

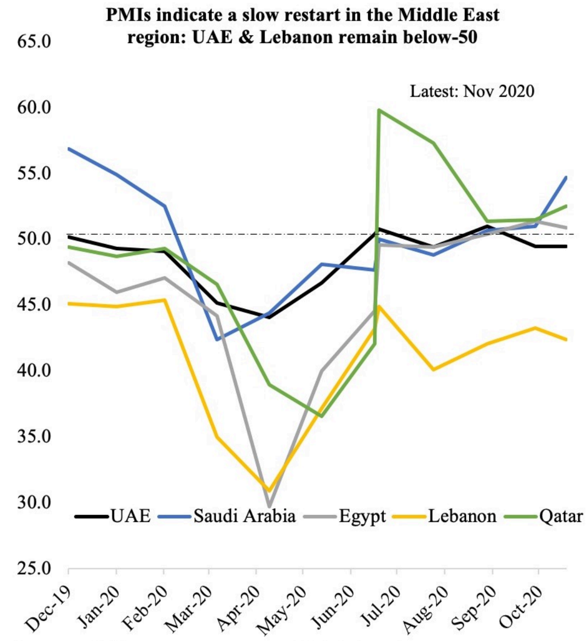
Download a PDF copy of this week's insight piece here.

Chart 1: PMIs in the Middle East/ GCC have had a slow restart compared to US/ Europe/ Asia post-lockdown, even during the latest wave

Manufacturing PMI readings have picked up in Nov across the globe, thanks to increases in export orders; global manufacturing PMI also showed employment rising for the first time in 12 months & business confidence at a 69-month high. **Vaccine announcements in early-Nov probably added to the mostly positive outlook.**

There is a distinct divergence in the Middle East, with **UAE and Lebanon still below the 50-mark in Nov**. Lebanon's reading is a clear reflection of its domestic economic meltdown while UAE's is pegged to subdued demand in spite of the nation being the least stringent (i.e. more "open", including for tourists) in the region.

The announcement of **the efficacy of the Sinopharm vaccine in UAE and planned deployment, in addition to the recent spate of announced reforms** – rights of establishment, long-term residency, remote working & retirement visas – **should support business and consumer confidence in the months ahead.**



Source: Refinitiv Datastream, Nasser Saidi & Associates

Heatmap of manufacturing PMIs

	US	Germany	EU	UK	Japan	China	India
Jan-19	54.9	49.7	50.6	52.8	50.3	48.3	53.9
Feb-19	53.0	47.6	49.5	52.1	48.9	49.9	54.3
Mar-19	52.4	44.1	48.3	55.1	49.2	50.8	52.6
Apr-19	52.6	44.4	48.4	53.1	50.2	50.2	51.8
May-19	50.5	44.3	47.9	49.4	49.8	50.2	52.7
Jun-19	50.6	45.0	47.6	48.0	49.3	49.4	52.1
Jul-19	50.4	43.2	46.6	48.0	49.4	49.9	52.5
Aug-19	50.3	43.5	47.1	47.4	49.3	50.4	51.4
Sep-19	51.1	41.7	46.0	48.3	48.9	51.4	51.4
Oct-19	51.3	42.1	46.2	49.6	48.4	51.7	50.6
Nov-19	52.6	44.1	47.0	48.9	48.9	51.8	51.2
Dec-19	52.4	43.7	46.4	47.5	48.4	51.5	52.7
Jan-20	51.9	45.3	48.1	50.0	48.8	51.1	55.3
Feb-20	50.7	48.0	49.1	51.7	47.8	40.3	54.5
Mar-20	48.5	45.4	44.3	47.8	44.8	50.1	51.8
Apr-20	36.1	34.5	33.4	32.6	41.9	49.4	27.4
May-20	39.8	36.6	39.5	40.7	38.4	50.7	30.8
Jun-20	49.8	45.2	47.4	50.1	40.1	51.2	47.2
Jul-20	50.9	51.0	51.7	53.3	45.2	52.8	46.0
Aug-20	53.1	52.2	51.6	55.2	47.2	53.1	52.0
Sep-20	53.2	56.4	53.5	54.1	47.7	53.0	56.8
Oct-20	53.4	58.2	54.8	53.7	48.7	53.6	58.9
Nov-20	56.7	57.8	53.8	55.6	49.0	54.9	56.3

Source: Refinitiv Datastream, Nasser Saidi & Associates

Chart 2: Will vaccines signal a recovery and rescue the airline industry?

Vaccines have been in the news since early-Nov, with the latest announcement from the UAE on the Sinopharm vaccine. As the vaccines are rolled out next year, the hope is that nations recover to the pre-Covid19 phase.

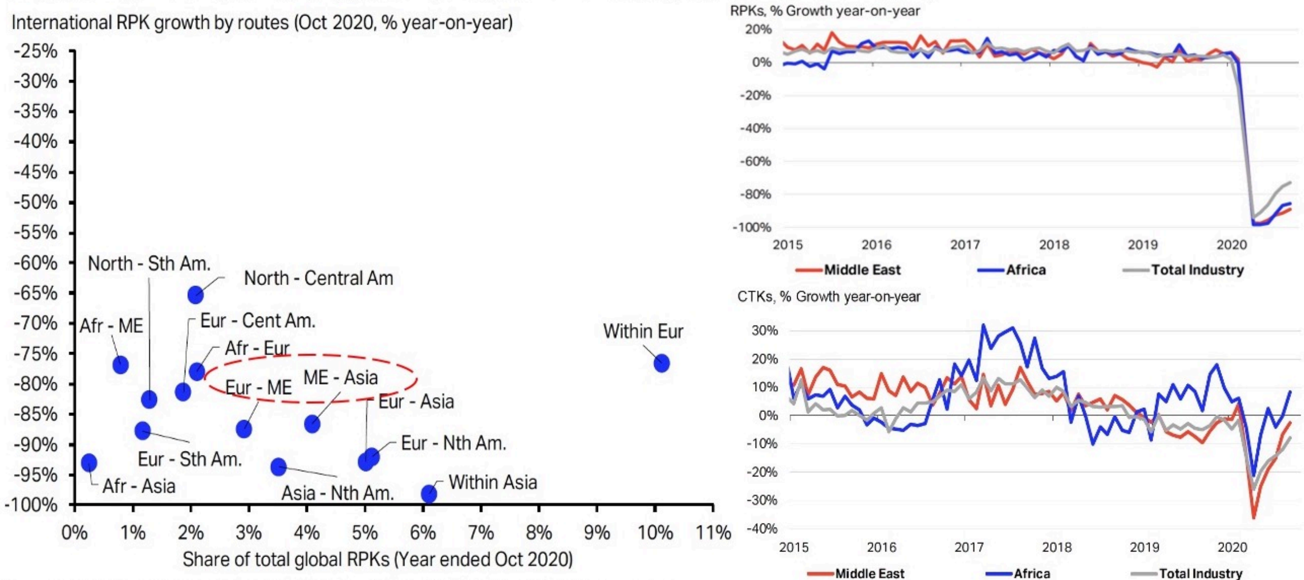
International travel markets remain weak: **Middle East airlines revenue passenger-kilometres (RPKs) were down by 86.7% and 88.2%** for international connectivity and long-haul traffic in Oct. This should benefit the airline industry in 2 ways: (a) in the near-term, the industry will **support distribution of vaccines** across the globe: being well-connected to global hubs and given its fleet size, UAE's Emirates and Etihad are well-placed to gain. Emirates SkyCargo transported more than 75mn kilograms of pharmaceuticals on its aircraft last year; (b) as more people get vaccinated, **demand for and willingness to travel will increase** probably by H2 next year along with 'travel bubbles'.

However, **the success of the vaccine distribution is also dependent on the last mile delivery hurdles and vaccine storage facilities.**

Middle Eastern carriers' improvements in international travel since the crisis have been slow (LHS)

Middle East passenger traffic still under pressure (RHS, top panel)

Cargo's sharper V-shaped recovery (bottom panel), but ME's recovery is slower vs. total industry



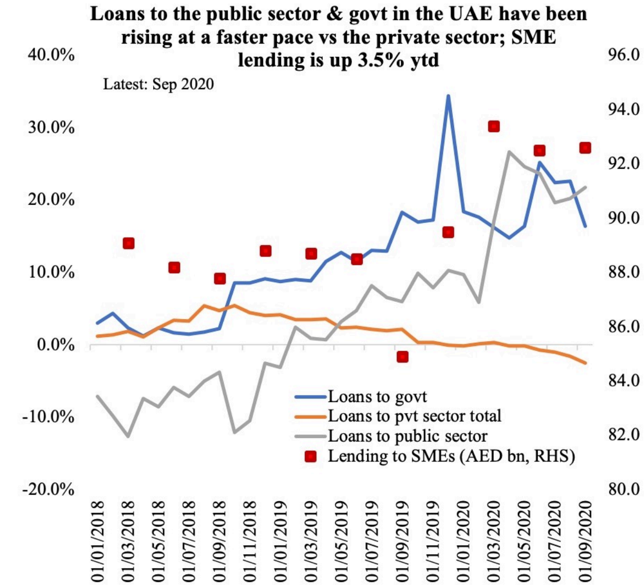
Source: IATA Air Passenger Market Analysis, Oct 2020; IATA Economics

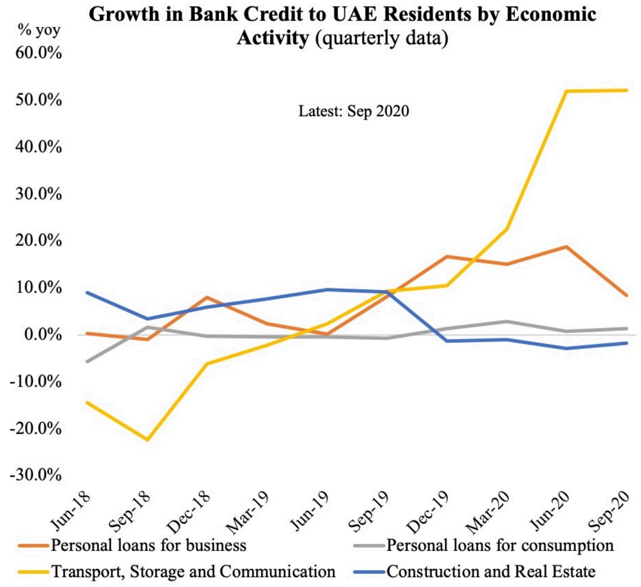
Chart 3: Bank credit in the UAE

The UAE central bank extended its **Targeted Economic Support Scheme** (Tess) for another six months until June 30, 2021

During Apr-Sep 2020, the overall pace of lending to GREs (+22.7% yoy) and government (+19.6%) have outpaced lending to the private sector (-1.0%). The pace of SME lending has been slow as well, but up 3.5% year-to-date.

Breaking down lending by sector, there has been upticks in credit to both transport, storage and communication (+52.1% yoy as of end-Sep) as well as government (13.6% yoy); mining & quarrying and construction sectors saw declines of -14.4% and -1.9% respectively.





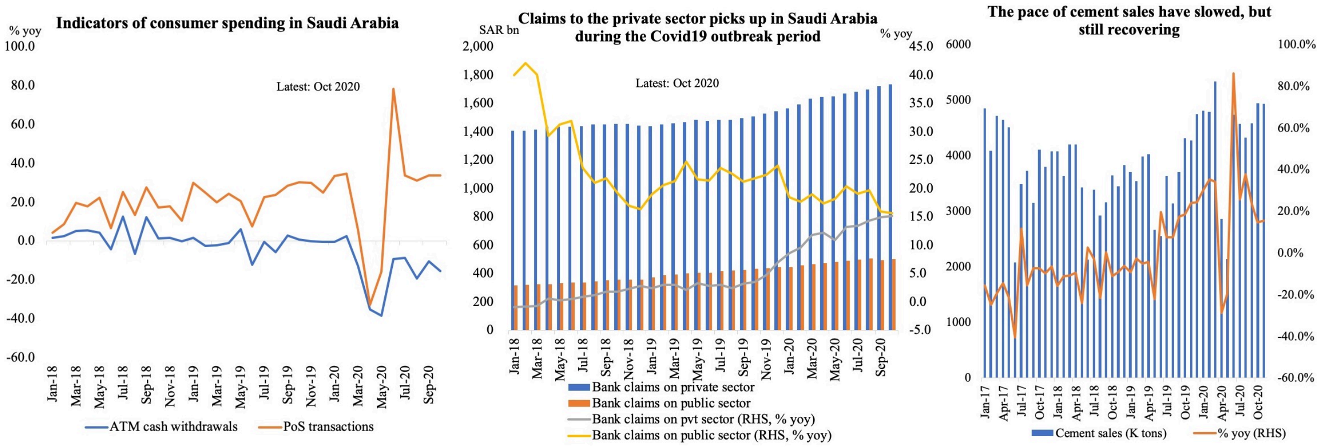
Source: UAE Central Bank, Refinitiv Eikon, Nasser Saidi & Associates.

Chart 4: Indicators of economic activity in Saudi Arabia

Among the proxy indicators for **consumer spending** – ATM withdrawals and PoS transactions – the latter is picking up faster, supported by transactions in food and beverage (+28.9% during Jan-Oct 2020) and restaurants and cafes (+68.9%); in comparison, transactions at hotels are down by 33%. ATM transactions dropped by one-fourth to SAR 499.87bn in Jan-Oct.

Loans to the private sector in KSA has been growing at a double-digit pace since Mar this year, with the year-to-date growth at 12.4% yoy.

Cement sales have been on the uptick, supported by the number of **ongoing mega-projects** (like the Red Sea development) as well as residential demand: real estate loans by banks are up 38% till Q3 this year, outpacing growth in both 2018 & 2019 while PoS transactions in the construction and building materials is up 44.2% this year (a large 247.4% uptick in Jun, ahead of the VAT hike).



Source: SAMA, Refinitiv Eikon, Nasser Saidi & Associates.

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Comments on Dubai’s Indebtedness in Bloomberg, 17 Sep 2020

Dr. Nasser Saidi’s comments appeared in the Bloomberg article titled “[Dubai May Be as Indebted as South Africa If S&P Proves Right]()“, published 17th September 2020.

Comments are posted below:
By drawing the line around what Dubai considers its direct liabilities, the government is sending a message that it won’t be held responsible for other debt, said Nasser Saidi, who worked as chief economist of the Dubai International Financial Centre during the city’s debt crisis. By contrast, rating companies have to adopt the view of an external investor, which means taking all liabilities into account.

“Creditors will always try to claim the sovereign guarantee,” he said. “Claiming under a sovereign guarantee is less costly and potentially less protracted than trying to claim against companies.”

When it comes to borrowings from commercial banks, Saidi said some of the money may be offset by government deposits, since there is usually a working relationship between authorities and lenders. Dubai’s biggest bank, Emirates NBD PJSC, reported its aggregated sovereign loan exposure at almost 162 billion dirhams as of June 30.

The lesson of Dubai’s brush with default in 2009 is that creditors failed to show the government’s guarantee, but the risk of spillover and damage to the creditworthiness of the UAE as a whole prompted Abu Dhabi to intervene, Saidi said. Dubai has since set up a public debt office to monitor the borrowings of the GREs, especially their foreign-currency liabilities.