

Fiscal & Monetary Policy Challenges in the GCC

*Presentation at the Alternative Investment Management
Summit*

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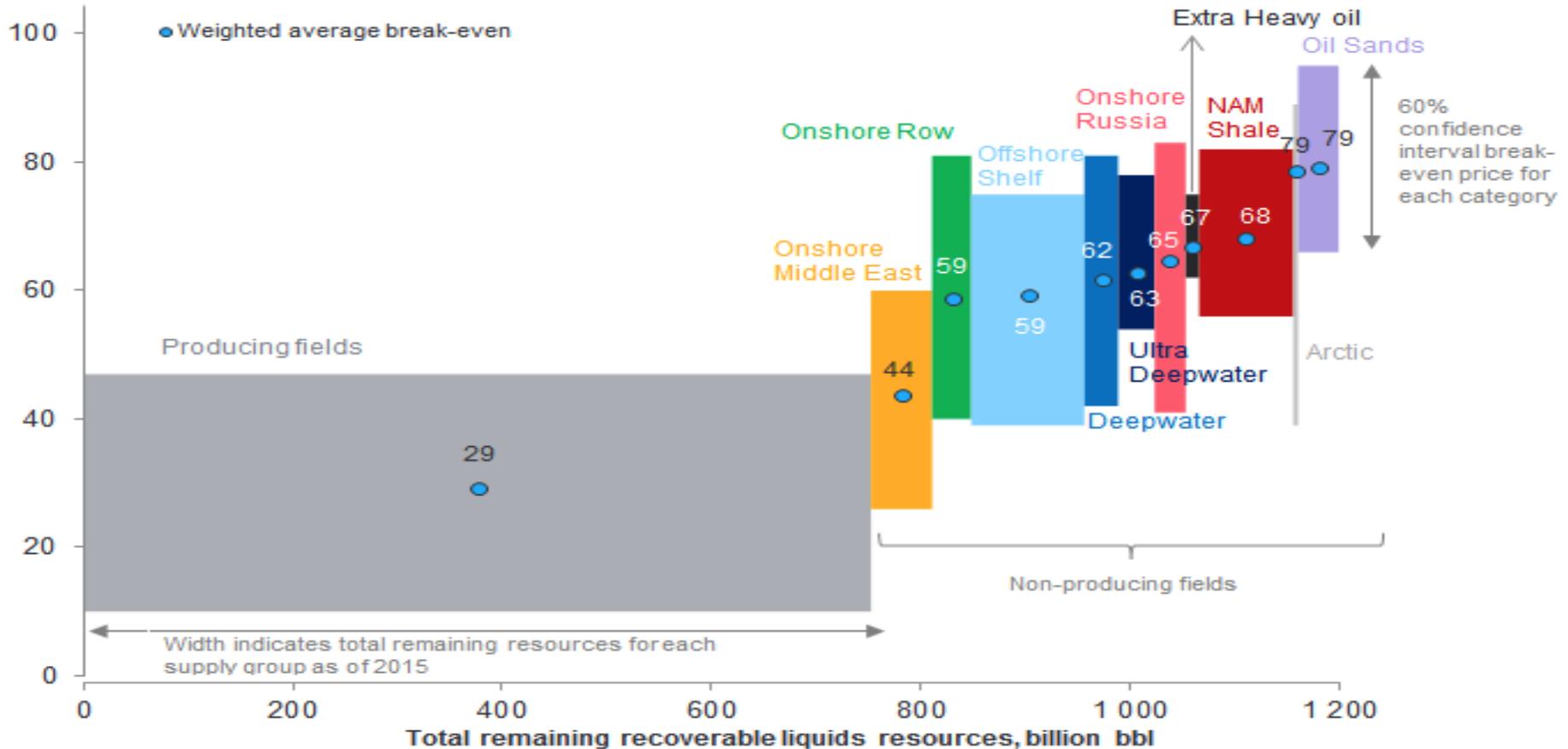
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Agenda

- ✓ **New Oil Normal: macroeconomic implications**
- ✓ **Policy reforms in GCC Economies: a “Blessing in Disguise”?**
- ✓ **Establishing counter-cyclical monetary & fiscal policies**
- ✓ **Key takeaways**

“New Oil Normal”: OPEC aims to drive out competition. Disruptive tech driving costs down for shale, renewables

GLOBAL LIQUIDS COST CURVE*
Real Brent USD/bbl



*The break-even price is the Brent oil price at which NPV equals zero using a real discount rate of 7.5%. Resources are split into two life cycle categories: producing and non-producing (under development and discoveries). The latter is further split into several supply segment groups. The curve is made up of more than 20,000 unique assets based on each asset's break-even price and remaining liquids resources in 2015.
Source: Rystad Energy UCube September 2015

New Oil Normal: downside risk for oil prices & resources

- **Demand side: cyclical, structural & tech factors imply downward trend in oil demand relative to activity**
 - Slowdown in EMEs, China
 - Greater Energy Efficiency Trend: falling (E/GDP) ratios
 - Climate Change & COP21 commitments; change energy mix
 - Tech innovation: energy storage, e-cars, flexible capacity, 4th Industrial Revolution
- **Supply side: tech is making RE, CE shale more competitive**
 - Shale: technology & exploitable resources widely available
 - Renewable & Clean Energy increasingly competitive
 - Return of Iran, Libya, Iraq
- ***Both demand & supply side factors increase downside risk for oil resources and prices***

Zaki Yamani: “The Stone Age did not end for lack of stone, and the Oil Age will end long before the world runs out of oil.” (2002)



Macroeconomic implications of lower oil prices for the MENA Region

Oil Exporters:

- Tighter fiscal constraints & budget deficits: GCC moves from fiscal surpluses to deficits;
- Current Account Deficits & ↓ Net Foreign Asset accumulation and/or decumulation
- Lower domestic credit growth & tighter conditions; crowding out
- Lower government spending & overall growth prospects

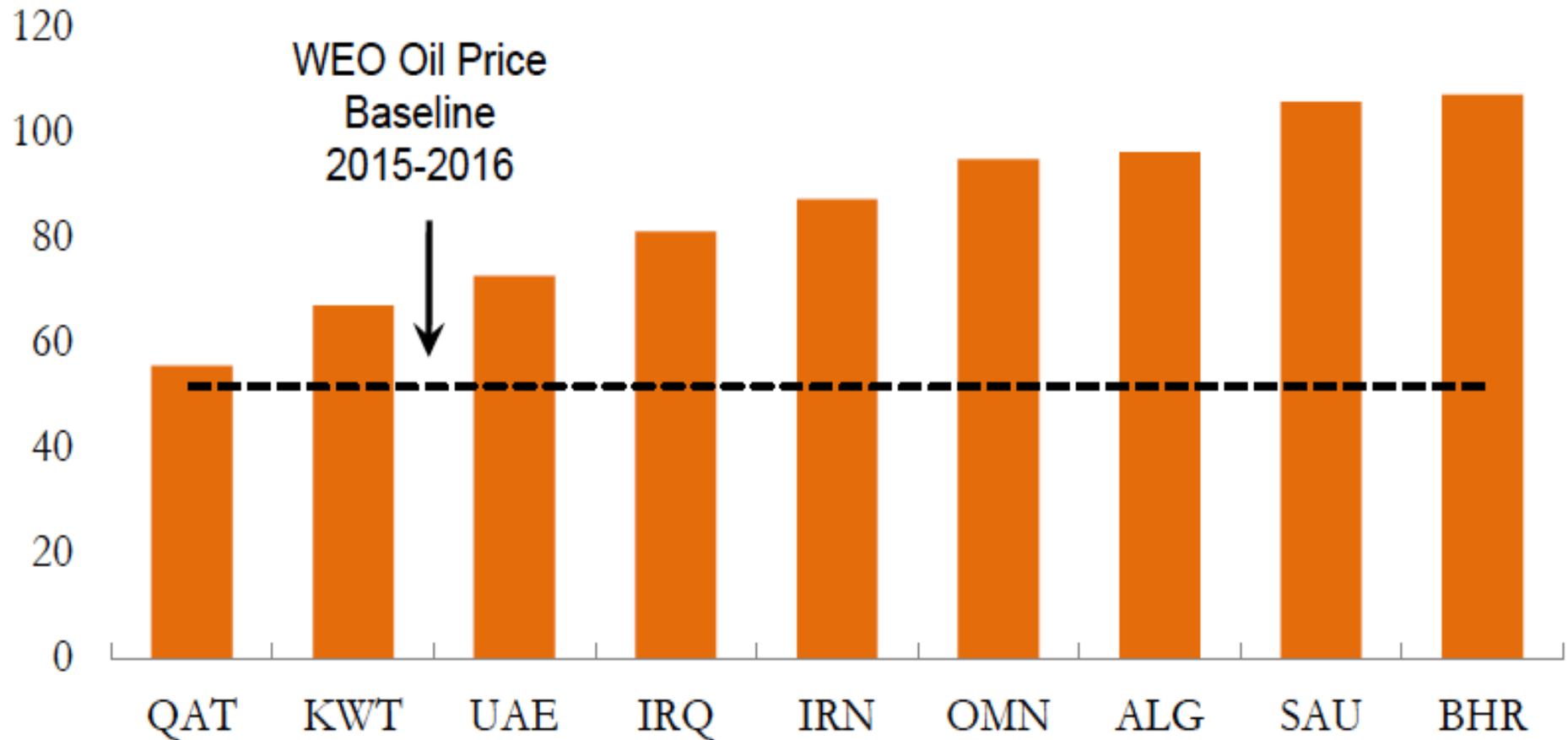
Oil Importers:

- Lower spending on oil imports improves trade balances
- But lower remittances & FDI from oil exporters could outweigh trade benefits
- Foreign aid levels are likely to decline as well

∴ fall in oil prices could hurt oil importers as well as exporters

No policy change means most MENA oil exporters will exhaust their financial buffers in less than 5 years, with financing needs of \$1 trillion over 5 years

MENA Fiscal Breakeven Oil Prices

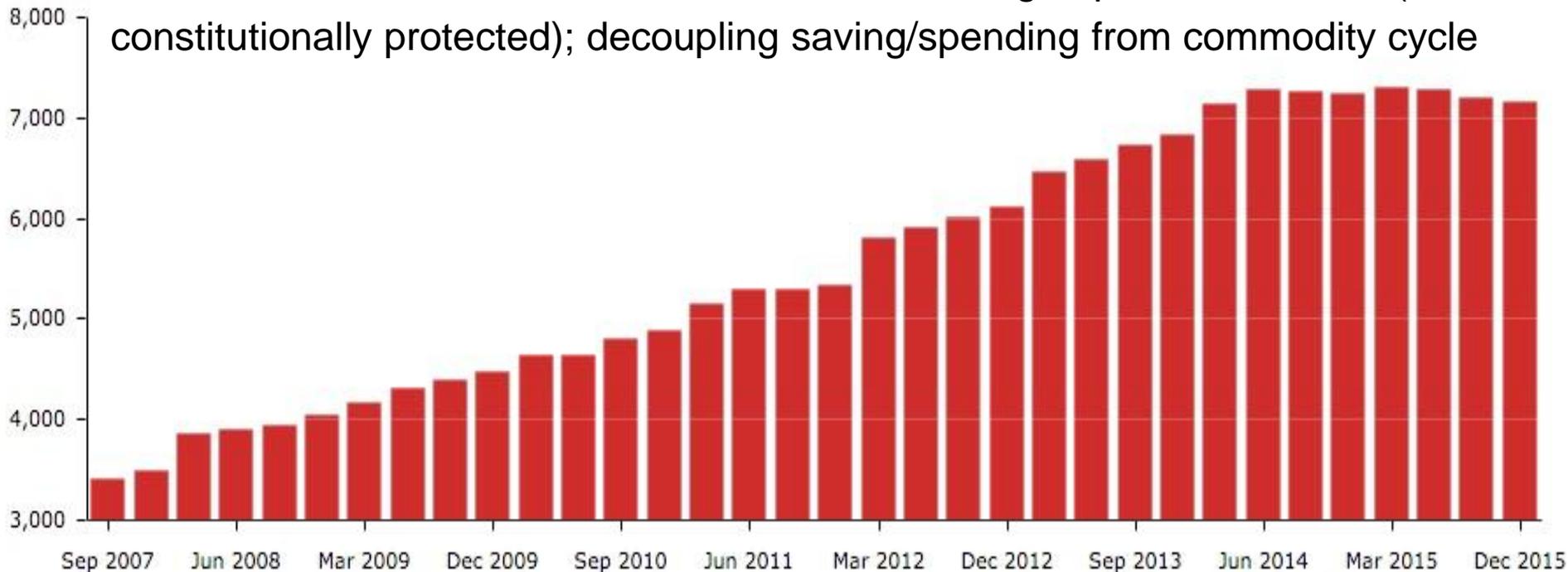


Decline in Oil Revenues by some \$360 billion in 2015

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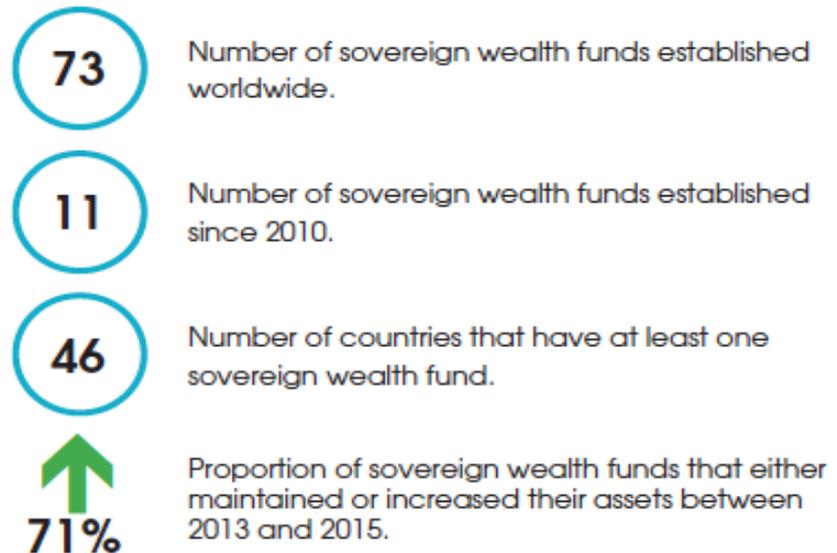
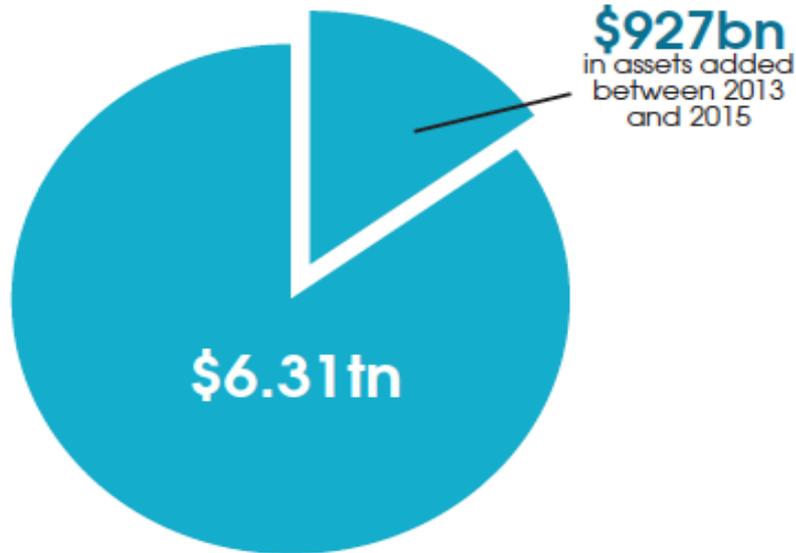
2000's mark rise of SWFs: ratio of assets managed by state funds relative to size of global equity & bond markets increased from 5% in 2007 to ~9% in 2015

- High commodity prices => massive redistribution of income to commodity/oil exporters => current a/c surpluses + rapid buildup of foreign assets
- Total assets of SWFs are concentrated in a few countries. This is estimated at \$7.2 trn (Dec 2015), of which \$4.0 trn are oil & gas related
- Focus for resource-based SWFs is now on: avoiding depletion of assets (unless constitutionally protected); decoupling saving/spending from commodity cycle



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Sovereign Wealth Funds Grow in Number and Capital



Sovereign Wealth Funds Are Becoming Increasingly Sophisticated



48% of sovereign wealth funds have been in existence for over a decade.



Proportion of sovereign wealth funds that utilize the services of an external manager.



Proportion of sovereign wealth funds that invest in at least one alternative asset class.



Real estate and **infrastructure** are the most favoured alternative asset classes by sovereign wealth funds.

Sovereign Wealth Funds Invest to Aid National Policies and Stimulate Financial Markets



Proportion of sovereign wealth funds that invest in economic infrastructure.



Proportion of sovereign wealth funds that invest in social infrastructure.



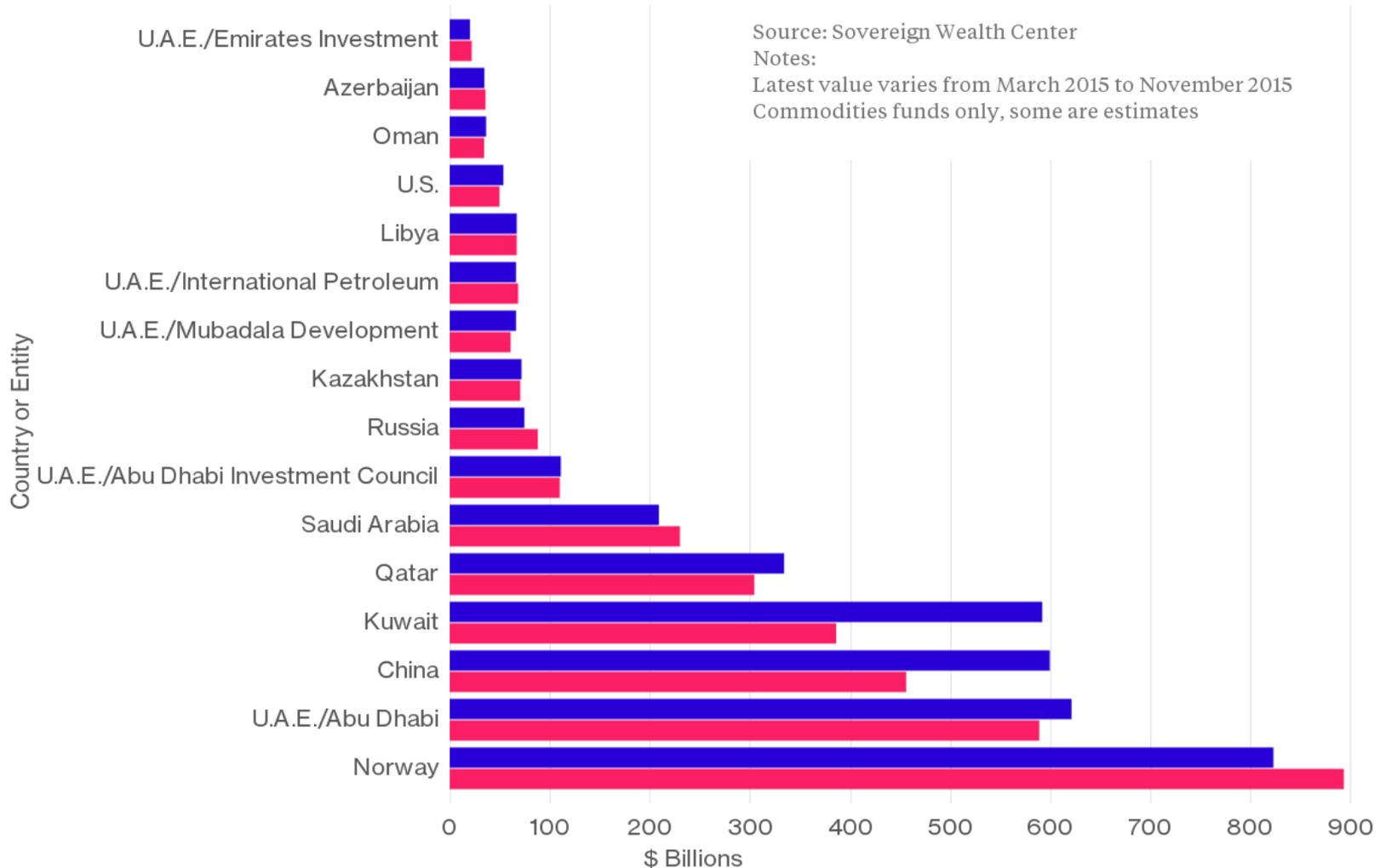
Proportion of sovereign wealth funds that invest in fixed income.



Proportion of sovereign wealth funds that invest in public equities.

SWFs feeling oil crunch; Sovereign institutions sold USD 1.1tn of assets in 2015 with bulk in fixed income assets

■ Latest Value ■ 2014



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- ✓ Key takeaways

Major economic policy reforms required to adjust to New Oil Normal

1. **Economic & revenue diversification**; focus on increasing private sector participation, PPP & privatisation (e.g. Saudi Arabia)
 2. **Implement expenditure reducing policies** (remove subsidies e.g. UAE) and **expenditure switching policies** to build social capital (health, education) and increase productivity growth and **efficient, equitable pricing of public services & utilities** (e.g. Abu Dhabi)
 3. **GCC economies require new tax regimes for economic policy management**, including broad-based (e.g. VAT, CIT, Property) & selective taxation (e.g. excise taxes).
 4. **Use domestic financial markets for deficit financing, development & infrastructure finance**
 5. **Develop & implement counter-cyclical monetary & fiscal policy**
- ∴ New Social Contract is required**

Main elements of a new GCC Tax Regime: policy recommendations

- **Mix of taxes:** a broad-based consumption tax, with selected excises; tax on business profits; recurrent property taxes
- **VAT** is the ideal revenue instrument: VAT @ 5% could generate 1.5-2% of GDP (or 2.5-3.5% of non-oil GDP)
- Selective **excise taxes:** gasoline/diesel, cars, tobacco, alcoholic beverages, telecom services, hotels
- *Domestic oil consumption in KSA was 142mn tonnes in 2014; introduction of a 52 cents per litre tax, could raise a potential \$53.3bn in revenue, compared to a declared 2015 budget deficit of \$98bn*
- Extend **Corporate Income Tax** to all entities earning business profits
- Recurrent **Property Tax:** efficient tax instrument due to difficult evasion & potentially large base.

Credible policy adjustment to New Oil Normal can improve investment climate & growth prospects

- Fiscal reform & new tax regimes will lead to greater fiscal sustainability & improved sovereign credit rating
- Removing fuel subsidies will provide incentives to energy efficiency investments, favour investments in clean energy & de-carbonisation
- Reduction of size of government, privatisation & PPP can promote greater private sector participation and economic diversification
- Greater diversification will favour innovation, more knowledge based economic activity & increase productivity growth

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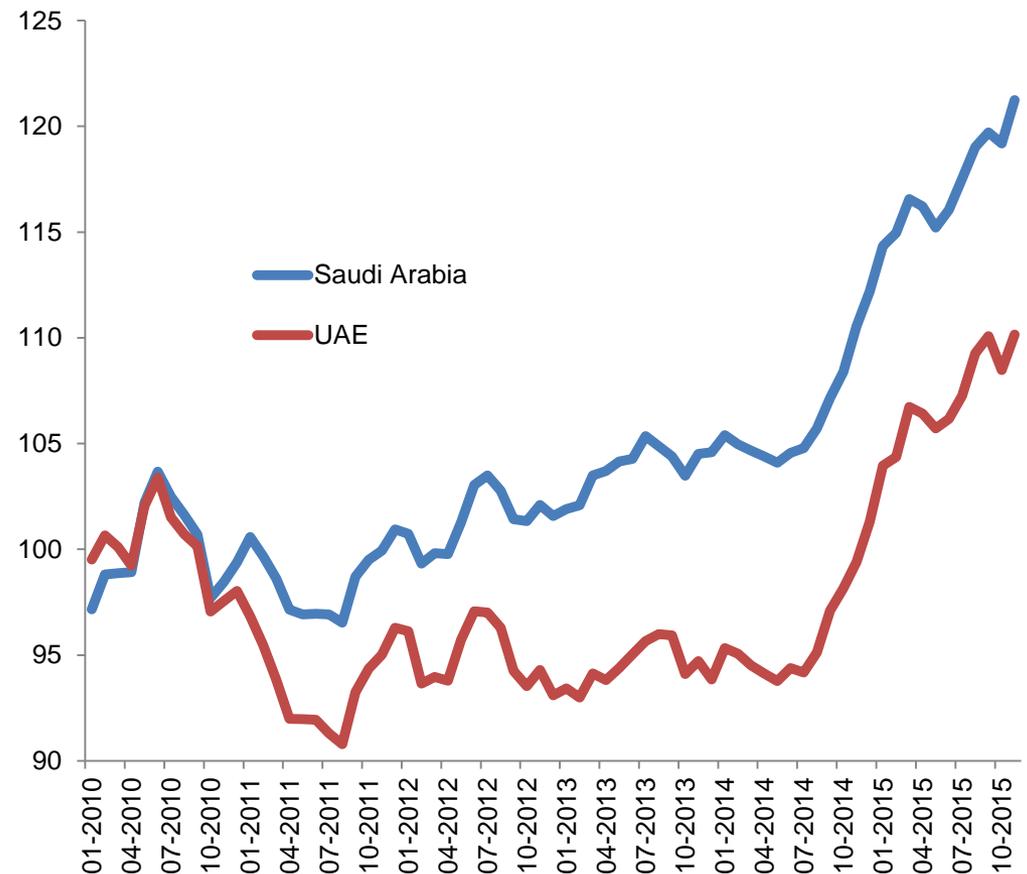
Counter-cyclical Monetary & Fiscal Policies

- GCC monetary & fiscal policy stances have been pro-cyclical:
 - Expansionary in booms: government spending increases & monetary/liquidity expands
 - Contractionary in busts: government spending declines & monetary/liquidity contracts
- Pro-cyclicality has been exacerbated by peg to US\$ due to divergent policy objectives
- GCC need to design and implement counter-cyclical monetary & fiscal policies
- 2 specific proposals

Monetary & Exchange rate policy

- GCC lack monetary policy independence given US\$ peg (except Kuwait which pegs to a basket)
- Recent strong appreciation of US\$ => Loss of competitiveness in GCC non-oil sector but devaluation unlikely to generate growth in non-oil exports
- Current exchange rate regime does not reflect structural changes in GCC economic & financial links over past three decades

Real Effective Exchange Rates (2010=100)



Source: BIS

A Currency Basket + Oil Price proposal

- Many options available in moving from tight US\$ peg to greater exchange rate flexibility: **an intermediate choice** between an adjustable peg and full flexibility is a peg to a **currency basket**
- Currency basket composition: US\$, Euro, Asian currencies including RMB as China is #1 trading partner for GCC and include price of oil so currencies will depreciate (appreciate) if oil price falls (rises)

Two caveats:

- Building monetary independence requires development of domestic money & debt markets
- Policy sequencing is important. Exchange rate regime change should be preceded by fiscal reform to anchor expectations

Fiscal Rules: necessary to ensure inter-generational equity & fiscal sustainability

- A fiscal rule imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates
- Fiscal rules typically aim at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability
- Counter-cyclical budget-balance rules: stabilizes macroeconomic volatility of oil-exporting nations; a larger countercyclical response is warranted for external demand-driven shocks relative to external supply-driven shocks due to their impact on the non-oil economy
- Permanent Income Hypothesis - one of the solutions - an annuity value that can be consumed forever based on a NPV of oil wealth i.e. addresses inter-generational equity concerns & will enable sustainable government consumption

Fiscal Rule Proposal à la Chile

- First, institute a **Structural Budget Rule**. Structural budget deficit should be zero or positive. Structural defined as output and oil price equal to their long-run trend values
- Deficits are allowed only to the extent that (a) real output falls short of trend, in a recession, or (b) the price of oil is below its long-run trend. In a boom the government can only spend increased revenues that are deemed permanent; any temporary oil bonanzas must be saved
- Second, formalise structural budget rule into law
- Third, ten-year trends are projected by two panels of independent experts, outside the political process

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Key Takeaways I

- Lower commodity & oil prices implies shift away from higher to lower marginal propensity to save countries: global saving & market liquidity likely to decline leading to higher (real) interest rates but offset by monetary easing and QE.
- New Oil Normal requires economic policy and structural reforms by oil & natural resource dependent countries
- New Oil Normal is a 'perfect storm' opportunity for privatisation, PPP & new private sector-led economic development model
- GCC & natural resource based economies will need to focus on revenue diversification, introduction of tax regimes & phasing out of subsidies

Key Takeaways II

- Era of rapid accumulation of sovereign wealth (FX reserves plus assets managed by SWFs) by commodity producers and non-commodity EMs is over. Future growth will reflect ROA, not new net inflows.
- GCC need greater monetary independence & more flexible exchange rate regimes but optimal policy sequencing requires fiscal reform to precede exchange rate flexibility
- GCC should consider establishing counter-cyclical monetary & fiscal policies: (a) Structural Budget Rule, (b) Currency basket including oil price

Growth & Investment themes: driven by Demographics & New Oil Normal

Demographics themes:

- Urbanisation/Smart Cities/Infrastructure (hard & soft)
- Health & Education
- Retail
- Water/ Food Security
- Islamic economy

New Oil Normal themes:

- Energy Efficiency/CleanTech/ Renewable Energy
- Government Finance & Capital Market development
- Privatisation & PPP

Thank you

*“If we want everything to stay the same,
everything must change”*

Tomaso di Lampedusa, Il Gattopardo

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