The Gulf States

An embarrassment of oil riches

Dresdner Bank
Advice you can bank on

A company of Allianz

Your contact:
Dresdner Bank AG
Corporate Banking

Jan-Willem Sudmann
Tel.: +49 (0) 69 -2 63-6 43 99
e-mail: jan-willem.sudmann@dresdner-bank.com

Andreas Mende
Tel.: +49 (0) 69-2 63-6 34 75
e-mail: andreas.mende@dresdner-bank.com

Authors of this study:
Allianz Dresdner Economic Research
Emerging Markets Research

Dr. Ingrid Angermann
Tel.: +49 (0) 69-2 63-5 80 51

Dr. Rainer Schaefer
Tel.: +49 (0) 69-2 63-25 74

Dominik Thiesen
Tel.: +49 (0) 69-2 63-1 65 64

An embarrassment of oil riches.

Economic development and outlook on the Persian Gulf.

Oil sector dominance

The countries on the Persian Gulf are a byword for oil production. In no other world region does the commodity oil play such a dominant role. It is therefore hardly surprising that the development of the economies joined in the Gulf Cooperation Council (GCC), to which Saudi Arabia, Kuwait, Qatar, the United Arab Emirates (UAE), Bahrain and Oman belong, lives and breathes with the ups and downs in the price of oil. The fulminant latter-year rise in oil quotations has placed the region far more squarely in the economic limelight again than in the second half of the last decade.

Their abundance of oil and gas makes the Gulf States enormously important for the global economy. After all, with the oil they exported in 2004 the GCC countries could satisfy Europe's entire oil consumption. Their pre-eminent position is further underpinned by their high oil reserves, which make up almost 45 % of all known oil deposits. What is more, production costs are extremely low in comparison to other oil-producing regions.

What lies ahead?

Despite the dominance of 'black gold', the Gulf States are endeavoring to diversify their economies and gear them towards other branches of industry as well. The region's geographic situation between Europe and the dynamic economies in Asia is conducive to this. How will the GCC countries' economic prowess develop in the coming five years? Will they succeed in placing their economies on a broader foundation as a means of checking the hitherto front-line role played by the oil price? What can and will economic policy set in train to increase prosperity in the Gulf region beyond oil production? What implications will the attendant economic realignment have for economic relations with the EU and Germany?

Our study seeks to provide answers to these questions. This naturally involves making key assumptions. Foremost among these is that we continue to predicate political and hence economic stability in the GCC states, notwithstanding the present upsurge of violence and political tension in the Middle Eastern countries Iraq, Iran, and Syria. Of course, the relationship between politics and business is not a one-way street. If economic development could be steadied at a high level, this would also help defuse political and social conflicts.

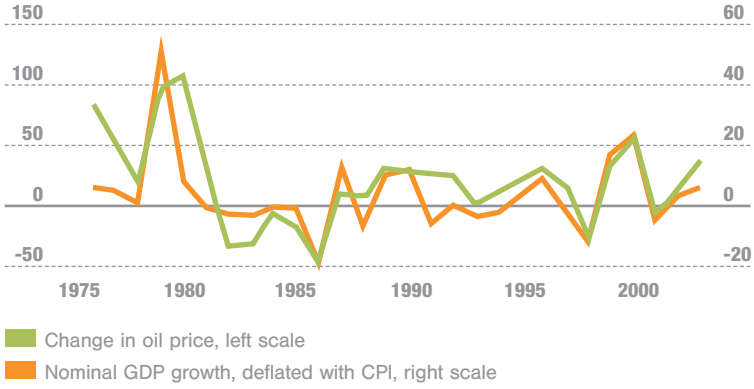
The starting point: growth and contraction in sync with the price of oil.

Oil prices and economic growth are inextricably linked on the Gulf.

Costly oil lubricates economy

As an indicator of economic output we take not the growth in real gross domestic product customarily applied to other countries but that in nominal GDP. In the case of the Gulf region, observing real economic growth would give an incorrect indication of the actual economic situation, failing sufficiently to reflect the full benefit to the economy as a whole of the rise in the price of oil. The terms-of-trade effect crucial to the Gulf economies would effectively be disregarded. Saudi Arabia, for example, curbed its oil production during the two oil crises in 1974 and at the beginning of the 1980s, when oil prices skyrocketed. This was reflected in a temporary decline and a mere uptick in real GDP respectively, which not only failed adequately to mirror the boom gripping the GCC states at that time, but indeed turned it completely on its head.

Rates of change in the oil price and nominal GDP on the Gulf % Y/Y



As well as economic growth, the national budget and current account also benefit from high oil prices, both notching up substantial surpluses at such times. The Institute of International Finance estimates the Gulf Cooperation Council states' current account surplus for 2004 at no less than 30 % of GDP. Conversely, a sharp drop in prices on the global oil market such as last occurred 1998/99 in the aftermath of the Asian crisis makes huge holes in the budget and current account. In the past, however, this has been the fault not only of the actual oil price trend, but partly also of the countries' own investment behavior. While oil revenues were flowing freely extensive projects were planned and work begun on them; but then, in periods of slacker oil receipts, their completion made severe inroads into the trade balance and national budget.

There is no question that the massive surge in oil prices since then has thus been a stroke of very good fortune for the GCC countries. Qatar, the country with the highest per capita income in the region, is a good illustration. In the 1990s Qatar began developing its extensive gas deposits. Much of this investment was financed with capital from abroad. During the oil price slump of 1998/99 high debt service consumed a large part of Qatar's revenues from oil exports and from the gas deliveries just getting underway. But thanks to the latest oil price boom and rising export volumes these start-up difficulties are past history.

In terms of their absolute level, oil quotations of more than USD 60 per barrel on occasion this year have set new records. However, factoring consumer price trends in the industrial countries into this reckoning takes a lot of the sting out of its tail. Adjusted by inflation in the US, the cost of 'black gold' is currently still more than 30 % below its highs during the second oil crisis. And this calculation does not even take account of real income growth in the global economy, in which the Gulf States naturally also wish to participate.

Gulf countries vary

Can we really talk of the Gulf or GCC countries, or are the individual member states too different to merit a common name? There is no clear answer to this question. On the one hand the states resemble each other in their economic focus on oil and gas production. On the other, of course, they differ vastly even in terms of their population sizes. Saudi Arabia is home to almost two-thirds of the roughly 35 million people who live in the GCC states. Added to this is a wide prosperity gap. As mentioned, Qatar registered the highest annual per capita income of around USD 28,000 in 2003, Oman and Saudi Arabia the lowest at USD 8,600 and 9,200 respectively.

Diversification: an attempt to shake off the shackles of oil

High population growth in the region imposes a heavy burden on welfare development in the Gulf States, at least until sufficient and productive employment is developed outside the oil and gas sector. Once profitable jobs can be created, the outlook is incomparably better. Bahrain and most notably the UAE are already role models in this respect with oil price-independent potential growth of fully 4 %.

An example of the problems to which population growth without commensurate economic expansion can lead is Saudi Arabia. The negative development in aggregate income over long periods, extremely unequal income distribution and the high percentage of foreign workers has sparked not insignificant social unrest and, indeed, fomented a hotbed of Islamic terrorism. The government is now under far greater pressure to create jobs than in Qatar, Kuwait or the UAE. After all, unemployment in Saudi Arabia is currently running at 15 %. Bahrain and Oman suffer from the same problem, with even slightly higher jobless rates.

In general, policy makers face a difficult tightrope walk between the economic necessity to generate profitable production facilities and jobs in the longer term through market reforms on the one hand and, on the other, the strong traditions in which the local population is rooted, albeit in varying degrees. In the past most nationals found employment in administration or at state-owned companies; but moving forward this route will be closed to them as most public enterprises labor under low profitability and high personnel costs, making it almost impossible for them to absorb more workers. Time is pressing: 40 % of the population in the GCC states is under 15.

Diversification steadies growth

In an effort to stabilize their countries' economic development, all the Gulf states pursue strategies designed to help them break out of the relentless cycle of highs and lows on the international oil market. All governments have therefore begun keeping part of their oil revenues distinct from their budgets and placing them in separate funds as a means of creating an intertemporal balance. Higher-than-average oil receipts swell the funds in good times, while capital for investment is withdrawn from them when oil prices are slack. This steadies economic growth over time.

This measure is part of a generally more prudent investment and development strategy meanwhile, intended to avoid past mistakes. Particularly after the second oil crisis at the beginning of the 1980s, substantial funds flowed into the creation of an outsized infrastructure and into economic sectors not particularly profitable for the region, one example being agriculture. Since then governments have tended to focus on building up production facilities based on the resources available. These include, most importantly, energy-intensive processing sectors such as aluminum production and petrochemicals.

The industries newly developed in the Gulf States on the basis of local natural resources are extremely capital-intensive. This is a welcome factor for the smaller states, also to prevent them from being swamped by an even higher proportion of foreign workers. But as already mentioned, Saudi Arabia in particular needs to add extra jobs in order to forestall a further rise in unemployment, which is already high for the region. Happily, many jobs have been created there in recent years in rather more domestically focused business sectors.

Qatar, Oman and Dubai, as part of the United Arab Emirates, are adopting a different path. Qatar possesses the third largest gas deposits in the world, and early on it geared its investment strategy to their exploitation. Dubai, on the other hand, has increasingly established itself as a services center, with a flourishing regional financial center and an emerging tourist industry. Oman is looking to a mixed strategy, albeit on a more modest scale, by developing tourism on the one hand and gas production on the other. The country is driven in this by the depletion of its oil reserves, a fate shared by Bahrain.

The banking industry in the Gulf States is also being buoyed by the oil boom. A large part of the sizeable foreign currency liquidity finds investment at local banks and on the local real estate and stock markets. But given the limited receptivity of the capital markets in the region, most of the liquidity is channeled on to other financial centers. This is spurring the fortunes of Dubai in particular, where western banks have built up a strong presence over the past ten years. But for all the emirate's financial services dynamic, it will still be some time in catching up with other international financial centers. Just to put things into perspective: the banks in Singapore still have foreign currency receivables ten times higher than those in Dubai.

Integration into the global economy: the magic triangle of foreign trade

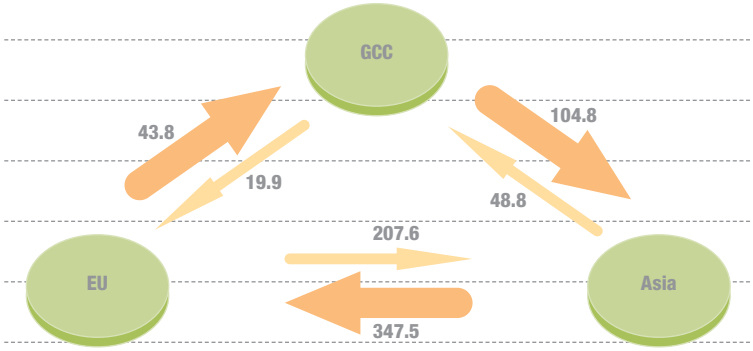
Beneficial globalization

All GCC states are open economies featuring a high proportion of external trade in their gross domestic product. Even in Saudi Arabia, the country with by far the largest domestic market in the region, exports in 2004 amounted to more than half its gross national product. International integration of the Gulf States will receive further impetus in the coming ten years from the dynamic economies of Asia. Already, almost half the Gulf States' exports head for the Far East and South Asia, and not quite one-third of their imports are sourced from there. The energy-intensive economic upswing in China and India will further fuel trade with the Gulf region, which already delivers half of China's oil imports. To secure the supply of energy in the long term, a growing number of Chinese companies are investing in energy production in the Middle East, although more so in Iran than in the GCC member states.

Major deliveries of oil and gas to Asia require the appropriate transportation. Gas is considerably more challenging in this respect than oil, which can be shipped by tankers on practically any scale. Capital expenditure on expanding facilities to transport natural gas is consequently one of the biggest projects on the Gulf. They include gas pipelines to South Asia and also gas liquefaction and subsequent transportation in special vessels, in which Qatar plays a pioneering role.

Will these stronger economic ties with Asia come at the expense of those with Europe? With oil exports to the Far East and the Indian subcontinent looking set to continue growing at an above-average rate, at first glance this appears likely. However, the trade surplus that the GCC states generate with Asia is set against the overhang that the Asian emerging markets earn in trade with Europe and, finally, the surpluses that Europe notches up vis-à-vis the Gulf States.

Trade flows 2003 USD bn



We see here the beneficial repercussions of globalization, which can no longer be measured in purely bilateral trade flows, but is reflected instead in global trade relations from which all concerned benefit.

Regional cooperation

The Gulf States' close integration into the global economy does not imply equally strong economic ties with one another, though, and given that their economies are heavily geared to oil and gas production and their supply structures therefore almost identical, this is hardly surprising. Economic integration thus lags the ever closer political connections between the states. Political integration began with foundation of the United Arab Emirates, which individual emirates joined to form a larger state. The GCC itself likewise reflects an intensified move for cooperation throughout the Persian Gulf. A customs union was successfully pushed through in 2003, and the states are also working together on tapping new gas reserves and on power supplies. The latest plans extend, most importantly, to the creation of a monetary union by 2010. In economic

terms, this is but a small step inasmuch as the currencies in practically all the Gulf States have been pegged to the USD for years. In the case of Saudi Arabia this is even underpinned by a currency board. The central bank restricts its activities purely to interventions on the foreign exchange market, so that current account and capital flows to and from other countries determine money supply. The conditions governing admission to the planned monetary union are similar to the Maastricht criteria in the euro area and are effectively already met by all the GCC countries.

What next? Three scenarios

Will the Gulf States be able to push ahead with the diversification of their economies? Will they succeed in building up employment? Key to all this is economic growth. And since the economy of the GCC states – for all their efforts to diversify – will initially continue to be driven directly and indirectly by oil and gas, trends on the international oil and gas markets therefore remain fundamental. As already mentioned, we cannot base our analysis on real-terms development in the gross domestic product. To make economic growth comparable nonetheless across the individual Gulf States and to minimize distortions from different rates of inflation, we deflate GDP with the Consumer Price Index (CPI) in each of the countries considered. The terms of trade effects resulting from changes in oil prices are thus still reflected.

Everything hinges on oil

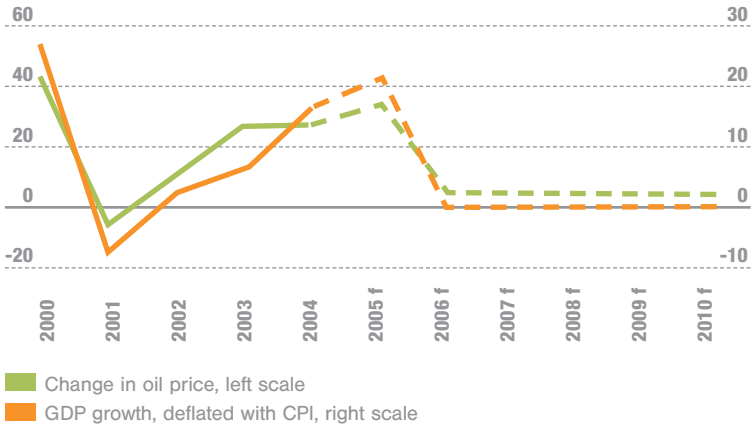
IIn the period from 1975 to 2003 a 3 % uptick in the price of oil led on average to a one percentage point acceleration in economic growth deflated by the development in consumer prices. Of course, reliance on oil by the various states in the region differs. Economic growth is least dependent on oil prices in Bahrain and most dependent in Qatar and Kuwait. This is not surprising, given that the oil and gas sector in Bahrain accounts for only 20 % of GDP, against 45 % in Kuwait and fully 60 % in Qatar.

Depending on the oil price trend, we attempt in the following to forecast future medium-range economic growth and the development in foreign trade for the Gulf region on the basis of regression analyses. Datasets extending further back into the past are unfortunately the exception rather than the rule, which naturally undermines the stability of any predictions. What is more, economic developments in some countries have been subject to exceptional influences such as the war years in Kuwait or the period during which Qatar began producing gas. We attempt to isolate these factors and strip them out of our statistical analysis. Oil price assumptions mirror a trend around which it is highly likely that the actual level will fluctuate. But in our estimation there is no way of predicting what path prices will actually take. Even though this or that forecast is currently claiming high accuracy on the basis of supposedly self-evident determinants, we advise caution, because in the past most predictions focused too heavily on the state of the oil market at the time. High oil prices triggered forecasts of a continued boom, while low quotations were taken to justify prophesies of a further drop in prices. The most constant and reliable companion of the global oil market has proved to be volatility. To avoid succumbing to the danger of simply extrapolating the present situation on the oil market forward in time, we operate with three scenarios – to which, however, we assign by all means different probabilities of occurrence.

Scenario 1
Probability of occurrence 60 %

Oil price holds steady on average through 2010 at USD 55 per barrel.

Rates of change in the oil price and in GDP on the Gulf Scenario 1 % Y/Y



A slowdown in global economic activity, increased global production capacities, and greater use of natural gas, among other resources, argue against a continued climb in oil prices. They will therefore fluctuate in the coming years around their present level.

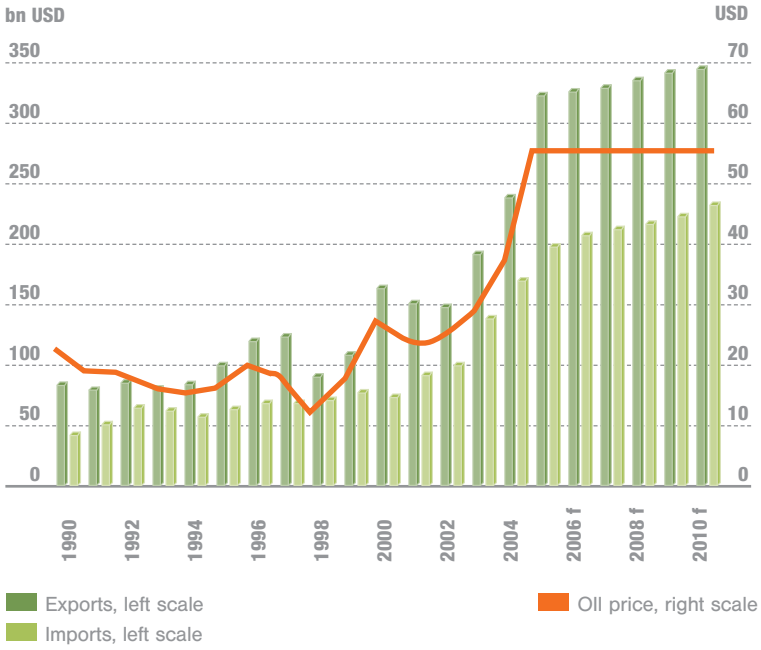
Economic growth

Such a development would imply lower but stable economic growth for the Gulf States. Annual nominal GDP growth rates deflated with the Consumer Price Index would presumably fall from more than 17 % this year to barely 3 %. Kuwait would be hit particularly hard, achieving economic growth in this scenario of around 1.5 % in the coming years. With rates of increase averaging 4 %, Bahrain and the UAE would likely be the most dynamic economies on the Gulf, whereas the heavyweight in the region, Saudi Arabia, would occupy a middle ranking with annual GDP growth of roughly 2.5 %. That would leave the Gulf States sufficient financial scope for a further reduction in their reliance on the oil sector and for the creation of more jobs.

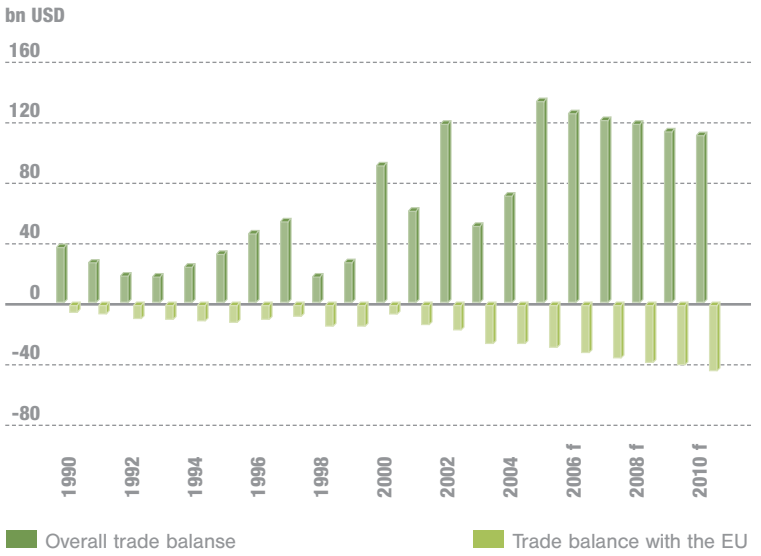
Prosperity trend

But can the population's prosperity also be raised further in this scenario? The development in per capita GDP is a good indicator of welfare effects. In view of the rapid population growth, GDP per head would edge up only slightly in the coming years. Whereas Saudi Arabia could generate welfare gains of just under 1 % per annum, per capita GDP growth in Bahrain and Oman would reach almost 3.5 %. Qatar and Kuwait, however, could presumably expect welfare losses. And although the UAE turns in the highest economic growth of the region, there too per capita incomes would decrease by more than 2 % a year. As well as the highest rate of economic expansion, the UAE also have the highest population growth on the Gulf. The negative welfare forecasts for Qatar and the UAE should not be dramatized, though, given that precisely these countries have already achieved an extremely high level of prosperity.

The Gulf States´ foreign trade and oil prices Scenario 1



The Gulf States´ trade balance Scenario 1



Foreign trade

Even when considering external trade, a stable oil price does not imply a stress scenario either, as export revenues will remain high. Indeed, the expansion of production capacities will make it possible to step up deliveries slightly. Specifically, annual export proceeds would rise from an estimated USD 330bn in 2005 to around USD 345bn by 2010.

More than half of all shipments will continue to head for Asia, whose economic momentum – notably in China – is expected to stoke its huge appetite for energy. That presages a further decline in the importance of the United States and the European Union as sales markets; even now each absorbs only about 10 % of exports. This trend will be encouraged as the industrial nations of the western world notch up only moderate growth and concentrate on the use of more energy-efficient technologies.

A glance at the import side shows that specializing their economies on oil and gas production has obliged the GCC states to import many consumer and capital goods. It is not therefore surprising that purchases from abroad account for about one-third of gross domestic product. We expect this currently high import growth to slow to an average of 3 %. In our simulations the Gulf region will import foreign products to the value of between USD 200bn and 235bn per annum. On the assumption that German companies retain their competitiveness in the Gulf region, German exporters can look forward to a gradual increase in annual turnover with the GCC countries from USD 12bn in 2004 to as much as USD 16bn in 2010.

Welfare losses as a result of open currency positions

The development outlined will enable the Gulf States to run down their trade surplus a little, although it will still be high. However, the situation is rather different in respect of the EU, where their trade balance is turning increasingly negative. In the next five years the Gulf States will accumulate a trade deficit of around USD 200bn with the EU.

Revenues in dollars, spending in euros

Petroleum is traded in US dollars, meaning that export revenues are also obtained in that currency. However, an important part of the Gulf States' imports comes from the EU and is increasingly being invoiced in euros or other European currencies. This constellation involves considerable currency risk for the Gulf States. After all, the danger of a (significant) dollar depreciation cannot be ruled out. Any drop in the value of the US dollar versus the euro makes imports from the EU correspondingly more expensive, the outcome ultimately being welfare losses. These are independent of the level of oil prices, although more readily tolerable at times when quotations are high. If the euro weakens against the greenback, imports from the EU become relatively cheaper, from which the Gulf States would, in turn, benefit.

Can the exchange risk be eliminated? Simple and direct ways will not solve the problem, because it is impossible simply to purchase from America goods hitherto imported from Europe. Invoicing oil deliveries in euros is hardly practicable either, particularly since the bulk of oil exports are not destined for Europe.

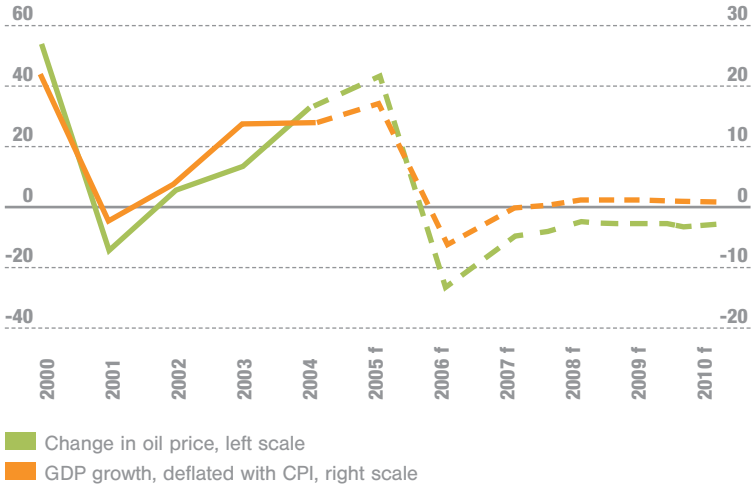
Less exchange rate risks via investments in euro

The most sensible policy would therefore be to contain this risk through increased investment in the euro area. Although investment in the regional capital and property markets has climbed sharply, the limited absorption capacity of the Gulf States' domestic capital markets means they are, anyway, obliged to invest much of their current account surpluses abroad. Unfortunately, there are no official statistics on the amount and composition of the Gulf States' investment abroad. However, the Institute of International Finance estimates that in the past five years alone USD 250bn has been invested internationally, the bulk of it presumably denominated in US dollars. The magnitude of these investments also illustrates that interest and dividends are turning into a second source of income. In Kuwait interest and dividend income has now reached as much as a quarter of the value of its oil and gas exports. Stronger reallocation of capital investments to the euro area would therefore be a sensible way of generating revenues in euros.

Scenario 2
Probability of occurrence 20 %

Oil price drops by 2010 to USD 30 per barrel.

Rates of change in the oil price and GDP on the Gulf Scenario 2 % Y/Y



The Gulf States´ trade balance Scenario 2

Our second scenario assumes less favorable conditions for the Gulf region, postulating a slump in world economic growth – as the result, say, of a severe drop in asset prices in the industrial countries, foremost among them the US. The consequent decline in demand for energy, in conjunction with increased supply, would cause the oil price to sink fast and furiously. We would subsequently expect quotations to soften only slightly, bringing them down to around USD 30 per barrel after five years.

That would seriously impact the Gulf States' economic strength. CPI-deflated nominal GDP would backtrack through 2010 by an average of almost 1 % a year. Bahrain, being more highly diversified, would be the only exception with GDP growth of still around 2.5 %. The UAE economy would stagnate and that of all other Gulf States contract – in some countries and years even at double-digit rates. Population growth on the Gulf would render the development in prosperity even more dramatic. In such a situation the creation of new jobs outside the petroleum sector would presumably call for the mobilization of monies from the stabilization funds.

In external trade, the more marked slide in the oil price would trigger a severe slump in exports. Imports on the other hand, which have expanded massively during the period of soaring oil quotations, would presumably hold flat at their high level. Rapid population growth, bolstering demand for consumer goods from abroad, argues against any major cutback in imports. The build-up of production capacities in sectors other than oil and gas means that investment – and hence demand for imported capital goods – would presumably be less cyclical in nature. Import demand will therefore be dented less acutely than in earlier periods of tumbling oil prices. This would cause a strong meltdown in the trade surplus and drive up the deficit in trade with the EU.

Scenario 3
Probability of occurrence 20 %

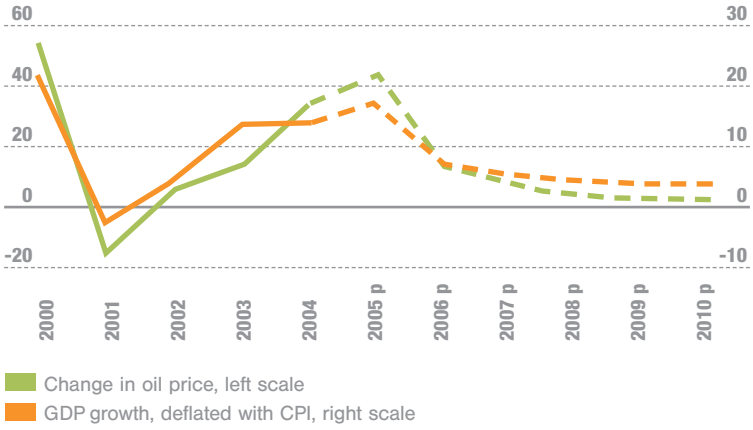
Oil price jumps to USD 75 per barrel by 2010.

The third scenario describes a world with persistently strong economic growth. Demand for energy remains high, and oil prices continue to head north, climbing to USD 75 per barrel through 2010 despite capacity expansion.

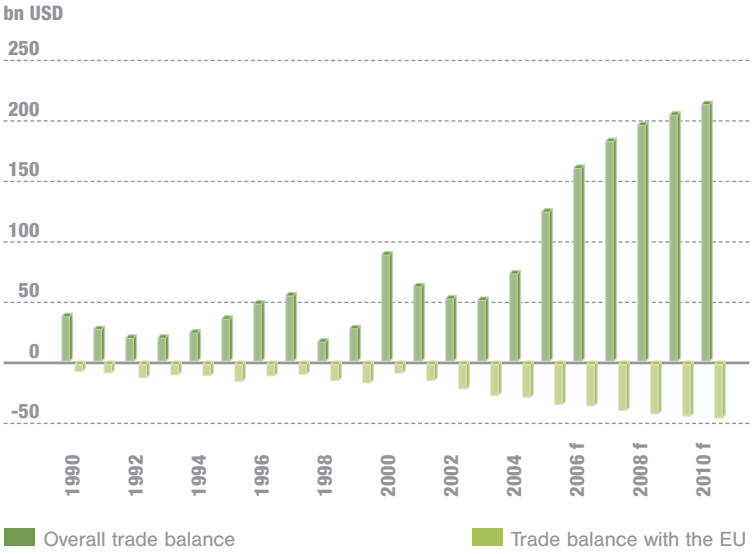
That would also imply dynamic growth in the coming years for the Gulf economies. With such positive framework conditions, heavyweight Saudi Arabia could expect to develop particularly well and reckon on average rates of expansion hitting almost 5 %. That would still be equivalent to per capita GDP growth of around 2 %. Such an environment would enable the Saudi government to create jobs and alleviate the social tensions in the country. The other Gulf States, too, would expand at average rates of between 4 and 6 %. However, even such rapid growth would hardly suffice to maintain the level of per capita incomes in Qatar and the UAE. On the contrary, both countries would see an average annual decline of around 1 %. Here too, though, a glance at the high level of prosperity already reached softens an at first sight overly negative picture.

Surging oil prices would run up enormous surpluses in external trade, escalating from an estimated USD 120bn in 2005 to USD 200bn in 2010. Although the trade gap with the EU will narrow, it will nevertheless remain significant.

Rates of change in the oil price and in GDP on the Gulf Scenario 3 % Y/Y



The Gulf States´ trade balance Scenario 3



Conclusion

Setting aside high population growth, with its particularly negative impact on per capita incomes – some of which are, anyway, high by international standards – our simulations show that economic growth on the Persian Gulf is highly likely to remain comparatively robust. Only a steep drop in the oil price – the likelihood of which, however, we rate at no more than 20 % – would throttle the economic momentum of recent years. While the Gulf States will remain reliant on the energy sector in the coming five years, too, other sectors such as tourism, heavy industry and commerce will make an increasing contribution to growth. Furthermore, the construction of new transport routes for oil and gas, most importantly to the emerging markets of Asia, will also have positive repercussions on economic performance. Given this perspective, the Gulf region will remain an attractive trade partner for the EU and Germany.

2006
Dresdner Bank AG
Jürgen-Ponto-Platz 1
60301 Frankfurt am Main
www.dresdner-bank.com