

# GCC Economic Review

## Growing confidence

Recent months have witnessed a palpable improvement in the market mood globally even as risks such as the Euro-zone crisis continue to loom large. The upswing has been particularly palpable in the GCC where markets have rallied and favorable economic growth prospects have reduced risk perceptions. Even if exogenous shocks remain a real possibility, the economic outlook for the region is generally benign with a steady consolidation of the ongoing recovery the likeliest scenario.

- **The global outlook has improved but persistent structural vulnerabilities mean that sharp reversals remain a possibility.** The mood within the European Union has improved as a result of the latest Greek bailout package while the US market has been characterized by growing, albeit uneven, signs of strength. But the structural causes of the crisis persist and may well result in renewed market stress. The fiscal situation of some peripheral Euro-zone countries remains unsustainable.
- **There is growing concern about the economic outlook for China, but the main objective of the authorities appears to be more sustainable growth.** The recent decision by the Chinese authorities to adopt a 7.5% GDP growth target for this year has rattled the markets as it modifies the earlier 8% floor. However, the move appears to be motivated by a desire to curb overheating after the recent bout of aggressive stimulus spending that triggered inflation and asset bubbles. Moreover, China has a history of overshooting its targets.
- **The GCC is likely looking at a year of normalization.** After a year of rapid growth fueled by increased government spending and high oil prices, economic growth in the GCC looks likely to revert to the norm. While activity in the public and the hydrocarbons sectors will remain strong, a growing proportion of the incremental growth is likely to come from the private sector. Overall growth in the region is likely to decelerate to some 4.0% from an estimated 7.2% last year.
- **The oil markets look likely to remain tight in spite of persistent concerns about demand erosion.** Global oil demand has rebounded clearly above pre-crisis levels and is continuing to grow, albeit more slowly than previously expected. The risk of supply disruptions remains unusually high due to the posturing around the Iranian sanctions. At the same time, concerns about the Euro-zone crisis and a potential slowdown in China are driving recurrent worries about demand.

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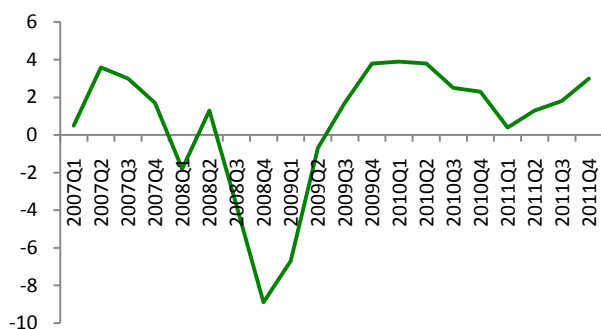
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## A sense of relief

The New Year has dawned with a sense of growing optimism that stands in marked contrast to the despondency about especially the Euro-zone crisis in the second half of 2011. Stock markets have staged a major rally and there are growing indications that the crisis is bottoming out in at least some key markets. This sense of optimism is particularly evident in the US where unemployment is edging down and parts of the housing market are bottoming out. In Europe, the prospect of a major collapse was likely avoided thanks to EUR130bn rescue package offered to Greece which should allow the country to get past its most immediate debt redemptions. Even though many structural challenges persist, the authorities have likely won some time and made reasonable headway in isolating the most acute problems.

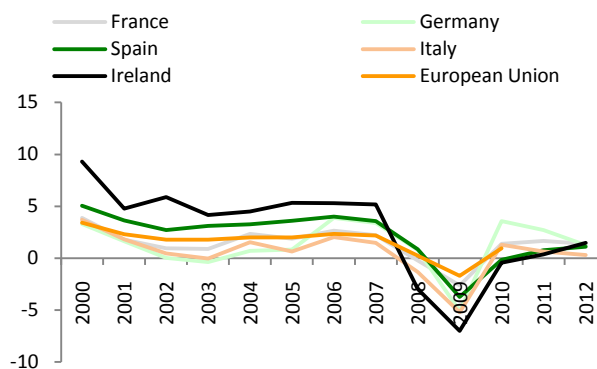
The global policy backdrop remains uneven, albeit generally very permissive. In the US, Federal Reserve Chairman Ben Bernanke recently indicated that more quantitative easing was not likely, although the current loose monetary stance is likely to persist until 2014. Progress towards meaning fiscal tightening will likely remain minimal during an election year. By contrast in Europe, monetary policy has been steadily loosened at a time when a number of governments pursue fiscal consolidation, whether voluntary or involuntary. The European Central Bank is effectively pursuing its own version of unconventional liquidity creation through its LTRO (Longer Term Refinancing Operation) auctions which provide banks with three-year collateralized loans at 1% interest. The second LTRO auction in late February attracted 800 bidders who took loans of EUR529.5bn, up from EUR489.2bn in December. While the first auction resulted in EUR193bn of new liquidity, the second one is likely to have provided at least EUR250-300bn. The main benefit appears to be some signs of normalization in the bond markets and stability in the financial sector. The operations have so far done little to fuel new lending as ECB deposits are at a record high. Also the Bank of Japan has embarked on the quantitative easing.

### US GDP growth



Source: Bureau of Economic Analysis, IMF

### Stagnation in Europe



Source: IMF

The outlook for the emerging markets is generally benign and they will remain the key drivers of global growth. The IMF expects emerging market growth to accelerate somewhat from 5.4% to 5.9% this year, whereas the advanced economies are expected to see an acceleration from 1.4% to 1.9%. The markets were rattled by the recent announcement by Chinese Premier Wen Jiabao that the People's Republic would cut its minimum growth target from 8.0% to 7.5%. In practice, however, the move seems to be above all a response to the imbalances created by the recent round of aggressive stimulus spending which fueled inflationary pressures and asset bubbles. In response to slower inflation, the authorities have already begun to loosen monetary policy, thereby reducing the likelihood of a sharp correction.

### **Are we out of the woods?**

The increased market optimism notwithstanding, the global economic outlook remains subject to considerable risks which in many ways are unchanged from before. High leverage levels persist and there has been minimal progress toward rectifying the global imbalances. Moreover, the market rallies experienced during the past several weeks are hardly a novelty even by the standards of the global crisis. For instance, aggressive government stimulus spending and creative monetary policy after the post-Lehman Brother collapse triggered potent asset market rallies.

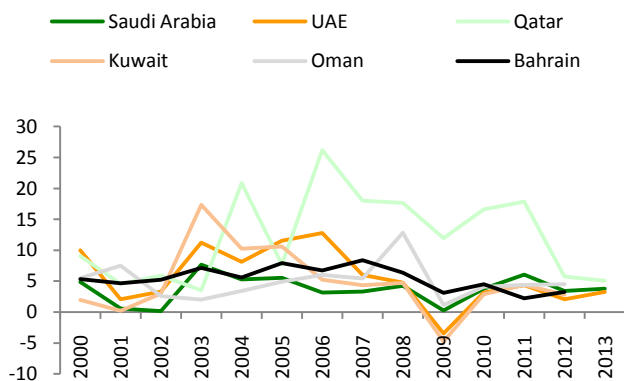
Because of the structural vulnerabilities, the risk of potentially significant discontinuities remains elevated. The European crisis is far from over and the needs created by any renewed market stress would have to contend with growing political weariness and resistance to additional bail-outs. Another major worry confronting the global economy and especially the West are the persistent high oil prices. While some of the price gains of recent months reflect the reduced global risk aversion and greater economic optimism, especially the situation in Iran has pushed up the risk premium, echoing last year's experiences with Libya.

Europe is particularly vulnerable to oil price increases due to the fact that fiscal austerity virtually across the Union is already undermining growth prospects. The European Commission has revised this year's projected growth to a modest 0.5% from an earlier 1.8%. At the same time, any periodic market tensions associated with concomitant Euro weakness would risk pushing oil prices even further up. Some European economies are also vulnerable to disruptions in their oil supplies as Iran has vowed to discontinue shipments due to the planned sanctions, a threat it has already acted on with respect to France and the UK, although the total recent purchases of the two countries have been as little as 60,000 b/d. No measures have to date been taken against Italy and Spain, the main European buyers of Iranian oil which import a total of 320,000 b/d of it. In a positive development, the US this month exempted 10 EU countries and Japan from the sanctions. Iran's ability to export any slack to Asia may well be conditional on discounts.

## A year of normalization beckons for the GCC

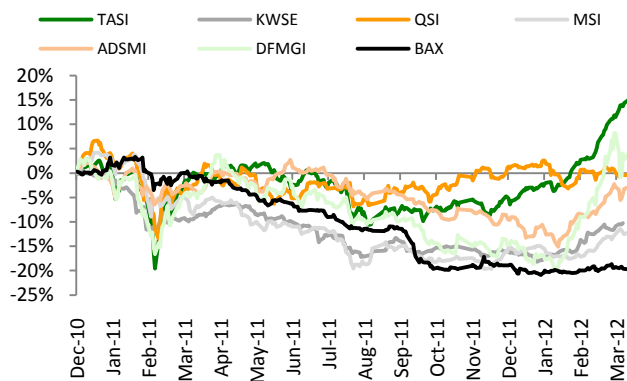
The GCC economies generally expected a year of robust growth in 2011. This was above all driven by high oil prices and increased production which in turn supported ambitious government spending plans. This often involved substantial increases in spending above the original budget targets as governments in the region moved toward a more inclusive growth paradigm, strengthening the emphasis on areas such as housing, job creation, and social benefits. The result was regional growth of some 7.2%, led by an estimated 18.7% in Qatar, 7% in Oman, and 6.8% in Saudi Arabia. Even the UAE made significant headway in terms of increased private sector activity, greater confidence, and progress in contain problems in areas such as real estate. However, bank lending in the country remains subdued and the overall rate of growth was still a historically modest 3.3%. Bahrain experienced the most severe disruptions in growth due to recurrent socio-political unrest starting in the spring. Real GDP growth dropped to approximately 1.5% with some estimates suggesting an even lower figure. Disruptions were particularly severe in the service sector while the energy and public sectors provided a source of continuity.

### GCC growth set to return to the norm



Source: IMF

### Regional equity markets are rebounding



Source: Bloomberg

After a year of a rapid pick-up in growth, 2012 is likely to prove significantly less impressive in terms of the headline growth figures. But it is obvious from the budgets unveiled by regional governments to date that public sector expenditure will remain strong while oil prices and production levels are generally expected to prove fairly stable. More positive progress, however gradual, is likely to materialize in the private sector where bank lending is recovering, supported by financially healthy institutions, and capital markets have regained much of their momentum. Nonetheless, due to a base effect alone, the headline GDP growth rates will probably fall back to the neighborhood of 4%. For most regional economies, this is likely to mark effectively a return to the norm.

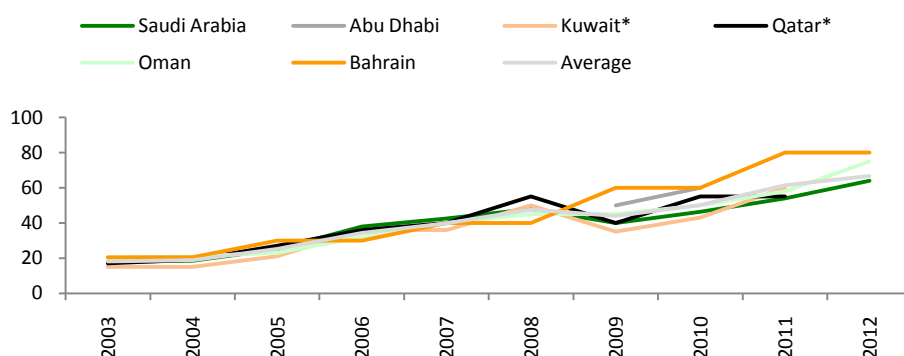
In spite of the generally benign growth outlook, potential vulnerabilities remain numerous. Regional risks are mainly external in nature with potential discontinuities due to the situation in the Euro-zone. Although the GCC

economies are relatively protected in terms of direct exports, any relapse would tighten the financial markets during a year of substantial refinancing requirements and revive oil demand erosion concerns. In the broader Middle East region, the posturing around Iran remains a source of recurrent market tension and potential discontinuities. Within the GCC, the main structural weaknesses are linked to the generally depressed real estate markets, especially in Bahrain and the UAE, as well as the persistent high leverage of especially UAE entities. Dubai alone is estimated to have refinancing requirements of more than USD10bn and these may pose difficulties in the event of market tensions, although the baseline scenario now looks likely to be one of minimal disruptions.

## The fiscal stimuli remain strong

2011 was an exceptional year in terms of the fiscal stimulus measures adopted by the Gulf governments. Much of this was inspired by a desire to address persistent social, housing, and labor market issues. Government largesse was in turn supported by the resilience of oil prices as the OPEC basket price averaged USD107.5/barrel last year, up on USD76.5/barrel in 2010. After this major refocusing of fiscal policy, 2012 is likely to represent a year of relative continuity by comparison. Because of the spending commitments and concern over the uncertain global economic situation, the fiscal stance of most regional governments should remain fairly permissive, underpinned in part by strong oil prices.

### Oil price assumptions used in GCC budgets



\* Fiscal year from April.

Source: Ministries of Finance, media, MEES, NCB estimates

The main challenge posed by the permissive fiscal policy, which in many regional economies has tended to go hand in hand with a degree of overspending, is the growing dependency on high oil prices. Although the oil prices assumptions used in GCC budgets tend to be comfortably below the current market price, the margin has shrunk significantly. In practice, the hydrocarbons rich regional economies have substantial cushions, along with low levels of government debt, that will enable them to weather periods of deficit spending. Bahrain, Oman, and Dubai are in the least comfortable fiscal situation due to the relatively advanced depletion of their hydrocarbons reserve.

### Saudi Arabia: Reaffirming the direction

Following a record-breaking year of 6.8% GDP growth fueled by strong oil prices and high government spending, the 2012 budget of Saudi Arabia positions the Kingdom for a year of relative normalization. But it does so with a continued emphasis on inclusive growth and a generally permissive fiscal stance for uncertain times.

In contrast to a budgeted 2011 deficit of SAR40bn, the government posted a robust SAR224bn surplus on the back of revenues of SAR1.11trn. Thanks to historically high oil prices and increased production, government revenues were double the 2011 budget projection of SAR540bn. But also actual expenditure of SAR804bn was a remarkable 38.6% ahead of the budgeted total of SAR580bn. This highlights both the fiscal resilience of the Kingdom but also the numerous new near- to medium-term spending commitments of some SAR500bn that were unveiled in the spring. The government also invested heavily into future development, among other things through 2,600 projects, worth a combined SAR148.3bn, signed with the private sector.

#### Highlights of the Saudi budget (SAR bn)

	2012	2011	% change 2011-12	2010
Total budgeted revenues	702	540	30	470
Total actual revenues	930	1,110	-16.2	742
<b>Education &amp; manpower development</b>	168.6	150	12.4	137.6
<b>Health &amp; social affairs</b>	86.5	68.7	25.9	61.2
<b>Municipal services</b>	29.2	24.5	19.2	21.7
<b>Transport &amp; communications</b>	35.2	25.2	39.7	23.9
<b>Water, agriculture &amp; infrastructure</b>	57.5	50.8	13.2	46
Total budgeted expenditure	690	580	13.2	540
Total actual expenditure	780	804	-3.0	654
Projected deficit/surplus	12	-40		-70

Source: Saudi Arabian Ministry of Finance, MEES, NCB

Overall, the Kingdom's fiscal position is exceptional by global standards. The 2011 surplus is equal to some 10.4% of GDP. But due to the increased fiscal largesse, public sector expenditure reached an almost European-style 37.2% of GDP. Nonetheless, the strong fiscal performance has brought public indebtedness down to historically and internationally modest levels. Government debt is estimated to have decreased from SAR167bn in 2010 to SAR135.5bn – or only 6.3% of GDP – this year, far less than the 2011 surplus. There are considerable expectations that this state of affairs will trigger government-backed sukuk financing as public debt of 10% of GDP had been previously indicated as a threshold for renewed government issuance. The King Abdulaziz Airport sukuk issued by the General Authority of Civil Aviation is the first step in this direction.

Fiscal policy in 2012 is marked by considerable continuity even though it also reflects the exceptional strength the Kingdom's fiscal position. Government revenues are projected to be SAR702bn, an impressive 30% above the 2011 budget plan, albeit clearly behind the actual estimated revenues for the year. This reflects a continued commitment to cautious planning with an oil price estimate still broadly comparable to last year's USD54/barrel. Expenditures are projected to reach SAR690bn, a 19.0% increase on the 2011 budget, which in turn translated into a small surplus of SAR12bn. In practice, however, the Saudi

government has historically significantly overspent its budget, often by 15% or more. The need for fiscal discretion is considerable this year as well in the face of the uncertain global economic environment. Nonetheless, the continued resilience of oil prices, at least barring a major economic shock in Europe or elsewhere, should once again translate into a far more substantial surplus of more some 7.1% of GDP.

Also in terms of spending, the 2012 budget accentuates the priorities established in recent years and months. Some SAR265bn will be allocated to new and ongoing projects. Reflecting the continued strong emphasis of human capital development, education remains the leading expenditure item at SAR168.6bn, accounting for 24% of total spending on the back of a 13% increase over last year. Health and social spending is set to increase by 26% to SAR86.5bn, or some 12.5% of the total. Water, agriculture, and infrastructure will receive SAR57.5bn (8.3% of the total), 13% up on last year. Transportation and telecommunications are due for a remarkable 40% increase to SAR35.2bn (5.1% of total spending), in large part thanks to the new King Abdulaziz Airport in Jeddah and six other airport upgrades, as well as 4,200 km of new roads. Municipal spending, largely on traffic infrastructure upgrades, is set to increase by 19% to a total of SAR29.2bn or 4.2% of overall spending. In addition, specialized credit institutions are expected to make SAR86.1bn worth of loans, which is nearly 20% of the total provided by them since their inception, in many cases in the 1970s. The King has ordered SAR250bn of last year's surplus to be allocated to building 500,000 affordable housing units.

## **Oman: A record budget**

Oman's 2012 budget echoes Saudi shift of emphasis toward the social infrastructure and job creation. At the same time, the broader commitment to infrastructure upgrades and expansion continues. With economic growth in the Sultanate set to remain robust – after an acceleration from 6 to 7% last year – overall government revenues are projected to rise by 20.9% to OMR8.8bn (USD22.9bn), of which hydrocarbons will account for OMR7.1bn, or 81%. Government expenditure overall is projected to increase by 23% to a total of OMR10bn (USD26.0bn). This is up on the revised 2011 annual target of OMR9.2bn which was presented in April 2011 in the wake of new spending commitments worth OMR1bn. Of the total spending, current expenditure accounts for OMR6.4bn. The defense and security budget stands at OMR2.6bn.

Education is the largest civilian expenditure area with total allocation of OMR1.3bn, followed by OMR500mn for health, and OMR130.5mn for social security, pensions, and welfare. Capital expenditure is set to total OMR2.7bn, of which OMR1.3bn will go into the oil and gas sector. The government intends to create 36,000 new public sector jobs as well as 2,000 additional opportunities in state-owned companies. The value of subsidies is estimated at OMR1.2bn, of which OMR649mn is for fuel and OMR230mn for electricity.

**Highlights of the Omani budget (OMR mn)**

	2012	2011	% change 2011-12	2010
<b>Oil and gas revenue</b>	7,128*	5,876	21.3	4,850
<b>Current revenue</b>		1,340	20.5	1,477
<b>Capital revenue and repayments</b>	1,672*	64		53
<b>Total revenues</b>	<b>8,800</b>	<b>7,280</b>	<b>20.8</b>	<b>6,380</b>
<b>Defense and security</b>	2,600	1,650	57.5	1,615
<b>Civilian Ministries</b>	3,500	2,730	28.2	2,480
<b>Oil and gas production</b>	300*	305		282
<b>Interest and Loans</b>		75		45
<b>Total current expenditure</b>	<b>6,400</b>	<b>4,760</b>	<b>34.5</b>	<b>4,432</b>
<b>Development and capital expenditure for civilian ministries</b>	1,400	1,220	14.8	970
<b>Oil and gas production expenditure</b>	1,300*	1,312		1,158
<b>Total investment expenditure</b>	<b>2,700</b>	<b>2,532</b>	<b>6.6</b>	<b>2,128</b>
<b>Interest subsidies for development and housing loans</b>		24		20
<b>Subsidies for the electricity sector</b>	230	199	15.6	140
<b>Other</b>		615		460
<b>Total Public Expenditure</b>	<b>10,000</b>	<b>8,130**</b>	<b>23</b>	<b>7,180</b>
<b>Deficit</b>	<b>-1,200*</b>	<b>-850</b>	<b>41.2</b>	<b>-800</b>

\*\* Raised to OMR9,200mn in April 2011.

Source: Oman Ministry of Finance, MEES

The Omani budget foresees an OMR1.2bn deficit equal to 5% of GDP. This is higher than the OMR850mn projected for 2011 but unlikely to materialize in the current oil price environment. Highlighting the growing burden on the oil-reliant fiscal system, Oman increased its oil price assumption by almost a third from USD58/barrel to USD75/barrel. Although the revised deficit projection for 2011 was OMR2.6bn, an average Omani crude price of USD102/barrel generated a surplus of OMR1bn.

## UAE: Renewed consolidation

Following years of very rapid growth, the UAE economy, especially Dubai, experienced considerable turbulence after the onset of the global economic crisis. This triggered a number of policy interventions and a general increase in stimulus-style spending. Although the UAE authorities began to reverse some of largesse in their fiscal plans for last year, the onset of the Arab Spring led to a partial reversal, effectively delaying the consolidation agenda to this year. The consolidated UAE budget is now estimated to require a fairly high break-even price of some USD85/barrel.

**Estimates of the UAE consolidated general government fiscal position (AED bn)\***

	2010	2011e	2012e	2013e
<b>Consolidated government balance</b>	<b>-29.5</b>	<b>71.5</b>	<b>35.5</b>	<b>6.5</b>
% of GDP	-2.6	5.3	2.7	0.5
<b>Consolidated government revenue**</b>	<b>315.1</b>	<b>443.5</b>	<b>416.9</b>	<b>414.5</b>
% change over previous year	25.6	40.8	-6.0	-0.6
% of GDP	28.3	32.7	31.2	30.0
<b>Hydrocarbon revenue***</b>	239.3	353.5	314.9	312.5
% of total revenue	75.9	79.7	75.5	75.4
<b>Consolidated government expenditure</b>	<b>344.5</b>	<b>372.1</b>	<b>381.4</b>	<b>408.1</b>
% change over previous year	-8.9	8.0	2.5	7.0
% of GDP	31.0	27.4	28.5	29.6
<b>Consolidated total government gross debt</b>	<b>292.9</b>	<b>343.2</b>	<b>377.5</b>	<b>415.2</b>
% of GDP	26.3	25.3	28.2	30.1

\*Includes the Abu Dhabi, Dubai, and federal government budgets.

\*\*Includes estimates of the investment income of the Abu Dhabi Investment Authority and the profits of the Abu Dhabi National Oil Company (ADNOC).

\*\*\*Includes the estimated profits of ADNOC.

Source: IIF

The UAE fiscal system is composed of three main budgets. The budget of the Government of Abu Dhabi is by far the largest, accounting for close to three-quarters of overall government spending in the country. The remainder is made up, in roughly equal parts, of the Government of Dubai budget and the federal government budget. Of these, the details of the federal and Dubai budgets are announced, whereas the Abu Dhabi Executive Council only presents in spending categories.

The Abu Dhabi Executive Council in January unveiled a spending plan marked by a great deal of continuity in government spending as well as a general commitment to the strategic objectives of Abu Dhabi's Vision 2030. An estimated USD30bn worth of projects were on hold last year but a number of them now received the green light. The main emphasis will be on housing and infrastructure investments. Among key transport projects, the government reiterated its commitment to the Abu Dhabi metro venture while also allocating funds to a new AED25bn Midfield Terminal for the Abu Dhabi airport and the Khalifa Port and Industrial Zone. The government also revived the AED10bn (USD2.7bn) Mafrq-Ghuweifat Road project which had been originally conceived as a public-private partnership.

The execution of the metro project should in turn boost the plans for the Reem Island development which is supposed to accommodate 200,000 people. In general, the plans to build 50,000 homes over the coming 20 years appear to be on track. The government allocated funds to the North Wathba project which will have more than 13,000 resident plots, while the government hopes to deliver more than 7,600 villas this year. Beyond this, the Louvre, National Museum, and Guggenheim museum projects for Saadiyat Island were funded.

In the area of education, there will be 24 new schools and 10 refurbishments with a continued commitment to 100 new schools by 2018. 14 new health care

facilities received funding. Additional resources were also allocated to the Tamkeen Emiratization program which aims to attain 50% Emiratization level by 2015. Two new industrial zones were funded for the Western Region. The 100 MW Al Shams solar power plant received approval as a strategic commitment to renewable energy.

The increased spending will be supported by rising revenues. Abu Dhabi oil production rose to an average of 2.5 mbd in 2011, up from 2.2 mbd in 2009 and 2.34 mbd in 2010. Abu Dhabi earned AED278bn from its hydrocarbon exports in 2010, up on AED188.8bn in 2009. In general, the government's fiscal position is likely to remain strong. The Abu Dhabi Investment Authority has an estimated USD627bn in assets and the government boasts substantial reserves. Nonetheless, the recent ARD16.8bn bail-out of Aldar Properties highlights the risk still posed by contingent liabilities. The total debts of government-related entities in the UAE were recently estimated at 54% of GDP by Standard & Poor's.

Dubai has signaled its commitment to continue down the road of fiscal consolidation. The Supreme Fiscal Committee of Dubai last year asked government departments to reduce their outlays by 20-25% by 2013. The 2012 budget continues an ongoing program of deficit reduction which already brought down the fiscal shortfall from AED6bn in 2010 to AED3.77bn in 2011. The government expects revenues of AED30.43bn, of which 11% will come from oil. Total public expenditures are set to reach AED32.25bn which will translate into a AED1.82bn deficit, equal to some 0.6% of the emirate's GDP and down 53% on 2011. 41% will be for on roads, transport, aviation, and tourism. 29% will go on health care, education, housing, and culture. AED5.9bn, or 18% of the total, will go on infrastructure and development projects. The federal government agreed an AED41.8bn budget in October but a series of pay increases were announced a month later, boosting federal government spending by some 8%. The increases varied in the range of 35-100% with an aggregate annual cost of AED3.4bn.

## **Kuwait: Policy-making challenges**

The implementation of a number of important economic plans in Kuwait has been complicated by political disputes. Governor Sheikh Salim Abd al Aziz al Sabah of the Central Bank of Kuwait resigned on 13 February in protest against the government's economic policies, claiming that the loose fiscal stance pursued by the authorities was making it difficult for the bank to meet its statutory objectives. The decision appears to have been triggered by the draft budget for FY2012-13 which foresees an increase in government expenditure to KWD22bn (USD79.1bn) in a sharp departure from an earlier commitment to freeze expenditure at KWD19.4bn (USD69.8bn). Al Sabah also criticized the government's lack of progress in the area of economic reform. In spite of the political disputes, Kuwait's fiscal situation remains very strong thanks to the high oil prices. The overall surplus in the first nine months of FY2011-12 was KWD11.0bn (USD39.6bn) in spite of a projected deficit of KWD5.5bn for the fiscal year as a whole.

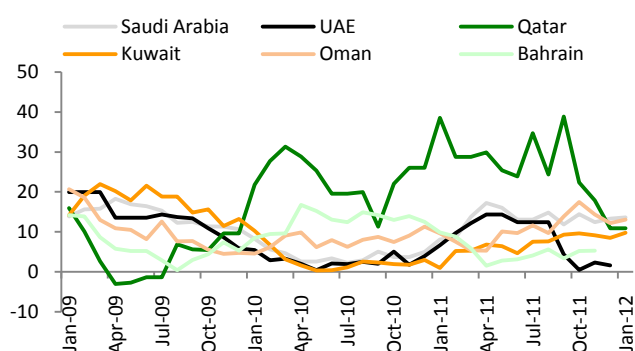
## A benign monetary outlook

After a period of relative stagnation in the face of elevated risk aversion, the monetary environment in the GCC is displaying increasingly consistent signs of improvement. This is partly due to the growing oil receipts and the recent sharp increases in government spending. The downside of these trends, however, has a slight increase in inflationary pressures, albeit against a backdrop of relative stability.

### Money supply growth accelerates

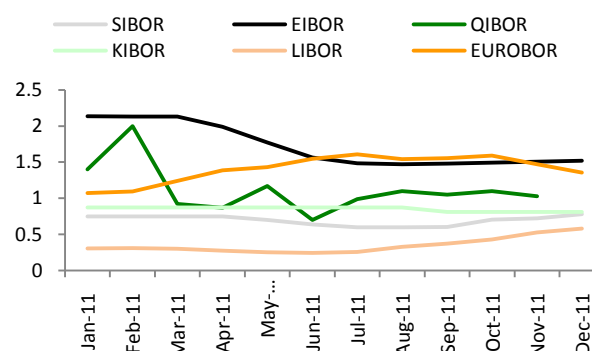
The broad measures of money supply are recording fairly steady growth in much of the region, although Bahrain and the UAE have experienced marked slowdowns in recent months. Qatar continues to be the regional leader, although the growth rate of M3 in Qatar decelerated to 17.9% as of November, a sharp drop from the pace of 38.8% seen in Q3. Deposit growth remained very robust at 18.6% YoY. In Saudi Arabia, broad money supply (M3) grew by 4.1% during Q4 while overall growth during 2011 attained 13.3%. The strong positive momentum was driven by a 12.1% growth in deposits during the year. Money supply growth in Oman fell from 17.5% YoY in October to 13.1% in January 2012. Kuwait has seen stability very gradual acceleration in recent months, with 8.5% growth in Q4 and 9.8% growth in January 2012. Deposit growth in Oman reached an annual 19.6% while Kuwait saw a much lower 9.1%.

GCC broad money supply growth



Source: National central banks

Interbank offered rates



Source: Bloomberg

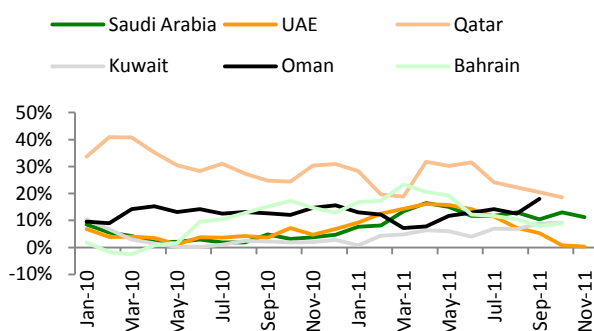
In the UAE, M3 increased by an annual 1.64% in December in a sharp reversal from 12.42% in June 2011. One of the challenges is persistent stagnation in bank deposits which grew by 0.4% YoY in November. This appears to be linked in part to delays in government spending but also evidently large-scale transfers of funds by Indian expatriates back home for more attractive yield. In Bahrain, M3 growth slumped to 9.8% in 1Q11 and further to about 1.6% in Q2. It subsequently recovered somewhat but remains historically low at 5.3% as of the end of 2011. This negative downturn was mainly due to the recent political events in the early

months of 2011. The interest rate environment in the region remains very permissive, largely thanks to the Dollar pegs of five of the regional economies.

## Credit growth gathers momentum

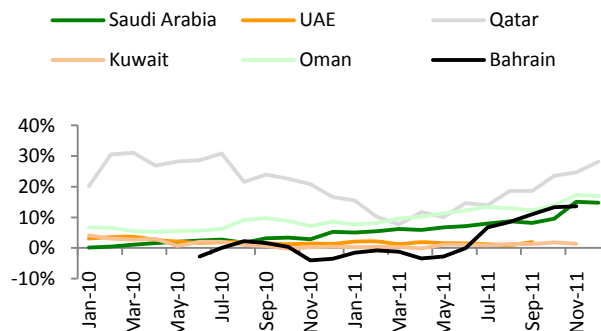
Although the regional financial sector – most notably the commercial banks – has weathered the global economic crisis with relatively minimal disruptions and strong results, bank credit has been fairly slow to recover. An increasingly consistent positive momentum has developed in recent months, however. With the notable exceptions of Kuwait and the UAE, bank credit is now advancing at or close to double digit rates across the region. This highlights greater confidence in the economic prospects and a growing appetite by the regional banks to mobilize their capital. In Kuwait, investment has been held back by political disputes where the UAE has been affected by tighter credit regulations and efforts by the Central Bank to bring down loan-to-deposit ratios.

**Bank deposits (YoY growth)**



Source: National central banks

**Bank credit (YoY growth)**

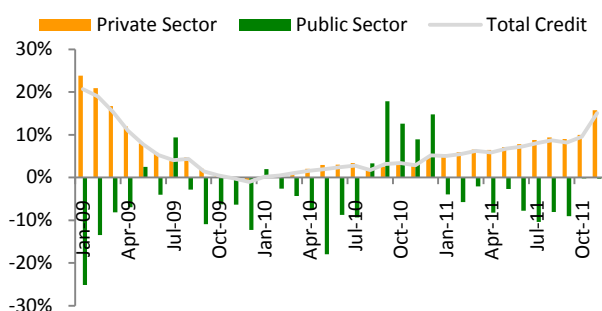


\*The Bahrain figures include housing credit by Eskin Bank as of July 2011.

Source: National central banks

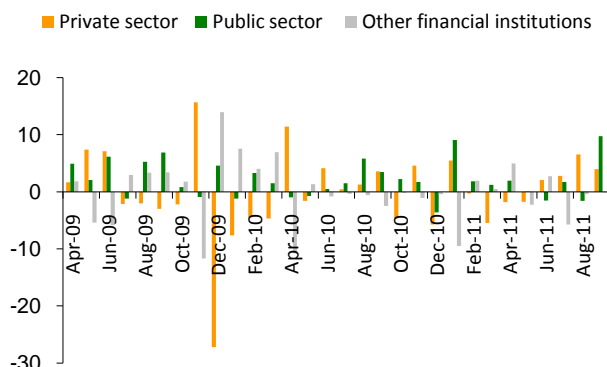
The turnaround in bank credit has been particularly pronounced in Saudi Arabia where total lending rose by 14.8% YoY as of December. The positive momentum has been entirely led by loans to the private sector which rose by 11% YoY during 2011. By contrast, credit to the public sector has declined even in the face of a significant boost to government spending. Private sector credit has been particularly robust in the construction and manufacturing sectors. Also consumer loans have picked up with clear gains in all segments, including mortgages. Qatar, Oman, and Bahrain are the other regional leaders in terms of bank credit with the latest annual growth rates at 28.2%, 17%, and 13.6%, respectively. However, public sector credit remains a key driver of growth in all three countries.

### Saudi Arabia credit growth



Source: SAMA

### UAE credit growth

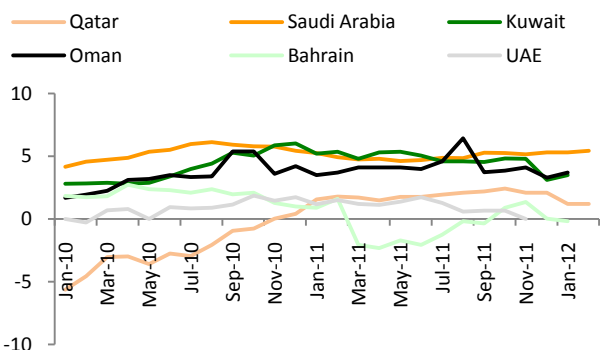


Source: Central Bank of the UAE

## Stable but persistent inflation

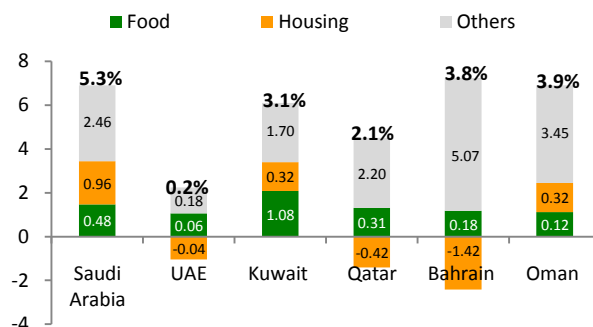
Although inflationary pressures in the region have been generally stable during the past year, there was some sign of renewed upward pressure towards the end of the year. Saudi Arabia, Oman, Bahrain, and Kuwait have the highest rates of inflation in the region, although in Bahrain's case the increase in price pressures is very recent. UAE inflation remains almost flat, reaching 0.15% YoY by December.

### Inflation in the GCC



Source: National statistical agencies, central banks

### Breakdown of inflation



Inflation for GCC countries are in December except for Oman in October

Source: National statistical agencies, central banks

The role of housing costs remains the main differentiating factor among the regional economies. Countries that experienced sharp real estate market contractions – notably the UAE, Qatar, and Bahrain – are still seeing a negative contribution from housing costs to the overall rate of consumer price inflation. Saudi Arabia represents the other extreme due to a significant structural shortage of housing. Commodity price pressures have abated somewhat during the year due to the European crisis but remain historically high. Increased energy prices, although their effects are cushioned by subsidies, emerged as a factor especially towards the end of the year.

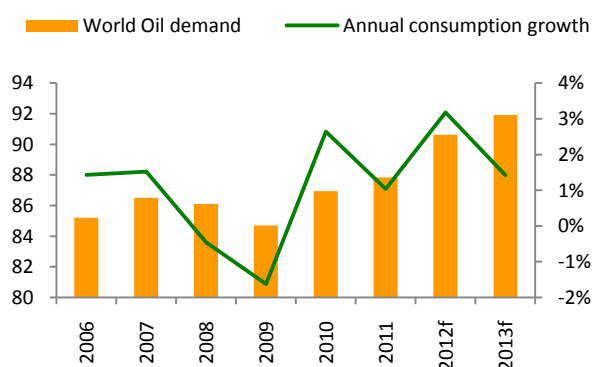
It appears that the increased government spending has fueled price pressures in much of the region. For instance Saudi Arabia has tended to be primarily driven by a combination of food and housing costs – the two main components of the consumer price basket. However, the role of other drivers has risen in recent months and came to equal the two main components by the end of the year.

## Oil market pressures

The global oil markets stand at a confluence of a number of powerful structural and cyclical forces. On the one hand, concern is mounting about demand erosion due to the economic weakness of above all Europe whereas emerging market consumption remains robust even in the face of worries about slower growth in China. Nonetheless, oil consumption has now more than recovered to its pre-crisis levels and emerging market demand looks set to continue to push it towards new highs even in the face of the global economic uncertainties. At the same time, the transatlantic divide in the market is growing at an unexpectedly brisk pace. North America is moving towards growing hydrocarbons self-sufficiency thanks to new developments in tapping unconventional oil and gas reserves while South America is benefiting from substantial new discoveries. These trends are likely to continue to intensifying trade ties between the GCC and the emerging markets of Asia which remain the main drivers of incremental oil demand globally.

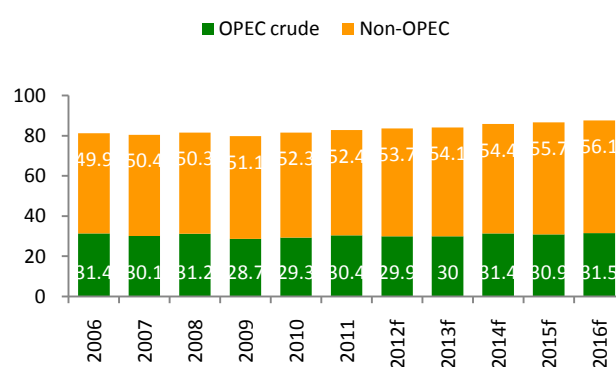
In recent months, the combination of the global economic crisis, high prices, and environmental policy initiatives has continued to erode Western demand for oil. The overall consumption of oil by the advanced OECD economies declined from 46.2 mbd in 2010 to 45.6 in 2011. European oil demand has been hit by the persistent crisis in the Euro-zone and the anemic growth triggered by fiscal consolidation. Simultaneously with 1.6% GDP growth in 2011, total oil demand of the European OECD members actually contracted by 2.1%. By contrast, in spite of a 9.5% YoY demand increase in December, Japanese oil imports declined by 4.4% YoY. However, oil product imports, including LNG, rose by 9.3% after a natural disaster in the spring caused significant disruptions in the nuclear power industry, triggering a search for alternatives.

Global oil demand trends



Source: IEA, IMF and OPEC

OPEC and Non-OPEC crude oil production



Source: IEA, IIF, NCB estimates

**Crude oil demand by region (mn barrels)**

Year	IEA					OPEC				Year
	2008	2009	2011	2012f	2012f	2011	2010	2009	2008	
North America	24.2	23.3	23.5	23.4	23.6	23.6	23.8	23.3	24.2	North America
Europe	15.4	14.7	14.4	14.3	14.3	14.4	14.6	14.7	15.4	Western Europe
Pacific	8.1	7.7	7.9	7.9	7.9	7.9	7.8	7.7	8	Pacific
China	7.7	8.1	9.5	10.0	28.2	27.6	27	26.2	25.6	DCs
Other Asia	9.7	10.1	10.7	11.0	4.3	4.2	4.1	4	4.1	FSU
Latin America	6.0	6.0	6.5	6.7	0.8	0.7	0.7	0.7	0.8	Other Europe
Middle East	7.3	7.5	7.9	8.2	9.8	9.4	9	8.3	8	China
Africa	3.3	3.3	3.4	3.5						
<b>Total OCED</b>	<b>47.6</b>	<b>45.6</b>	<b>46.2</b>	<b>45.3</b>	<b>45.8</b>	<b>45.9</b>	<b>46.2</b>	<b>45.6</b>	<b>47.6</b>	<b>Total OCED</b>
<b>Total Non-OCED</b>	<b>38.9</b>	<b>39.9</b>	<b>43.3</b>	<b>44.6</b>	<b>43</b>	<b>41.9</b>	<b>40.9</b>	<b>39.2</b>	<b>38.5</b>	<b>Total Non-OCED</b>
<b>Total World</b>	<b>86.6</b>	<b>85.6</b>	<b>88.3</b>	<b>88.3</b>	<b>88.9</b>	<b>87.8</b>	<b>86.9</b>	<b>84.7</b>	<b>86.1</b>	<b>Total World</b>

The emerging markets have remained the main source of global demand growth with Chinese oil imports rising by an annual 7.2% to 5.48 mbd in 2011. Overall, Chinese demand expanded from 9.1 mbd in 2010 to 9.5 mbd in 2011. However, the pace slowed down somewhat toward the end of the year, reflecting the ongoing efforts by the authorities to contain inflationary pressures. Indian demand rose by some 4.2% to 3.5 mbd, partly because power shortages have driven the popularity of independent diesel-operated generators. Oil demand growth in the Middle East reached 0.17 mbd, led by Saudi Arabia and Iran.

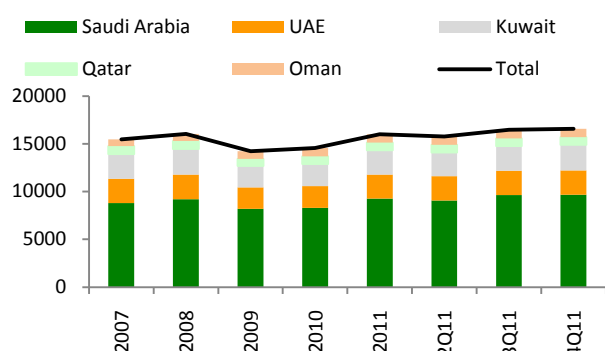
## Production trends

Oil production globally continues to be affected by structural challenges with the progressive depletion of many mature fields and the mounting cost of some of the new developments. Additional short-term complications have been caused by political factors, among which the Libyan civil war was the most important one. Nonetheless, global production levels have now largely recovered to pre-crisis levels. The January 2012 total OPEC output was 30.9 mbd, the highest figure since October 2008, reflecting higher output by Saudi Arabia, the UAE, and Libya, whereas Iran and Nigeria have experienced declines.

OPEC in December agreed to increase its production above 30 mbd, although Iran has repeatedly warned against attempts to use higher output levels to replace its production. Saudi Arabia, the only real swing producer, has been driving the increases, producing 9.85 mbd January 2012, an increase of 400,000 b/d since October 2011. Libyan production by January 2012 rebounded to an estimated 1.3 mbd, only 300,000 b/d below the levels seen before the civil war. The positive trend is expected to continue thanks to ongoing pipeline repairs and field maintenance. OPEC production currently accounts for 34% of the global oil supply, a share that is expected to gradually increase going forward.

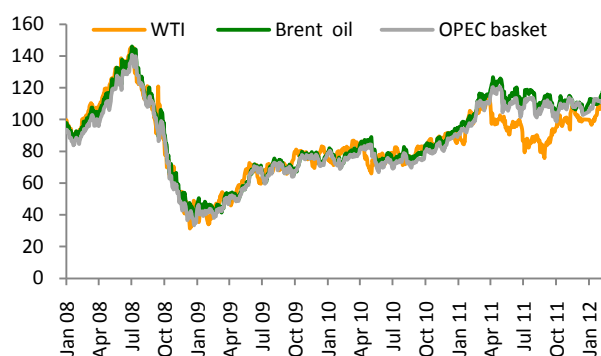
But it is increasingly clear that, supported by their large unconventional hydrocarbons deposits, the US and Canada are rapidly evolving into some of the most dynamic producers. The total Canadian output, thanks in part to the tar sands, rose to 3.7 mbd in 2011 as compared to 3.6 mbd in 2010. US production rose by 300,000 b/d in 2011, the first increase in a decade, to a total of 5.8 mbd. 2012 production is expected to reach 5.9 mbd.

**GCC oil production (mb/d)**



Source: OPEC, Oman Ministry of Petroleum and Gas

**Oil prices**



Source: Bloomberg, OPEC

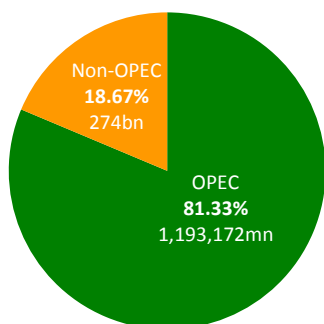
## Political price pressures

Oil prices experienced recurrent volatility during last year as they faced conflicting pressures from demand erosion concerns and persistent political risk factors. However, the fluctuation took place within a historically fairly narrow range with the monthly average of the OPEC basket price, for instance, fluctuating in the range of USD92.8-118.1/barrel. Political risk considerations generally ensured a floor under the prices and their impact has grown in recent weeks due to the tensions surrounding the Iranian nuclear program and threats to block the Straits of Hormuz in response to new Western sanctions. OPEC Basket prices ended 2011 with a significant 30% increase over the 2010 level to an average above of USD107.47/barrel – up from USD76.45/barrel. Prices have generally continued to rise during the beginning months of 2012, attaining a monthly average of USD111.75/barrel in January. Beyond the general momentum, the past year has seen a recurrent and increasingly persistent divergence between the North American and European benchmark prices, reflecting the different dynamics of the two markets. While the West Texas Intermediate (WTI) rose by 21.4% to an average of USD96.53/barrel in 2011. The ICE Brent benchmark gained 38.1% an average to USD110.91/barrel.

Describing the recent price hikes as excessive. Saudi Arabia has in recent days signaled its determination to stabilize the global oil market with Petroleum Minister Ali al Naimi suggesting that a 25% immediate increase in production was possible. Recent Saudi production in the neighborhood of 10 mbd compares to an excess capacity of 2.5 mbd. The US Energy Information Administration

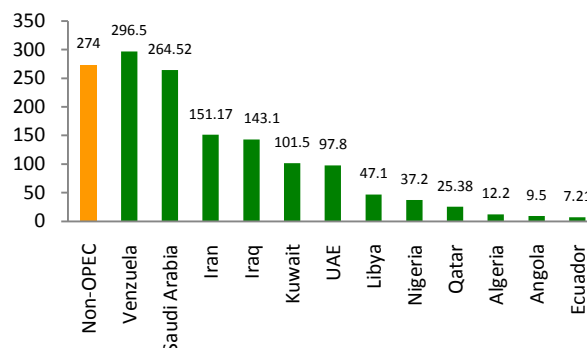
expects the WTI to average USD106/barrel in 2012. Our current projection for the Arab Light oil price in 2012 is USD105/barrel.

**OPEC has a lion's share of global oil reserves 2010**



Source: OPEC, NCB estimates

**OPEC and Non-OPEC reserves 2010 (bn barrels)**



Source: OPEC

**Replenishing the reserves**

OPEC currently estimates the total global oil reserves in 2010 at 1,467,012mn barrels. Highlighting their growing market strength in the coming years, OPEC members account for some 80% of this total, a figure that stands in marked contrast to their 34% share of current production. OPEC has in fact sharply increased its share of total global reserves from an estimated 68% in 2010. Venezuela and Saudi Arabia are currently thought to have the largest reserves globally. Venezuela's reserves are estimated at 296.5bn barrels while those of Saudi Arabia stand at 264.5bn. The largest reserves outside OPEC are in Russia, Canada, and Kazakhstan.

At the same time, however, the dynamics of the global oil markets are beginning to experience potentially transformative changes thanks to the development of unconventional deposits in the Americas. The Athabasca oil sands in western Canada, increasingly considered the world's second largest oil deposit, have recoverable holdings of at least 170bn barrels. The US Geological Survey estimates the tight oil holdings of the Bakken area in the Dakotas to be more than 4.3bn barrels of recoverable light oil, although some estimates are as high as 24bn barrels, a figure that could further increase through technological change. North Dakota's oil production alone reached 546,000 b/d by January, overtaking California. Other large deposits exist in California, Ohio, Texas, and elsewhere. However, extraction still remains costly, technologically complicated, and environmentally controversial.

Brazil has recently discovered a number of off-shore pre-salt fields in the Santos and Campos basins with an estimated 14.2bn barrels of oil, where Petrobras expects to begin production by late 2014. Also Colombia's reserves climbed to 1.9bn barrels in 2011 as further investment and exploration continues. Peru has similarly encouraged foreign investment in both existing oil fields and gas,

boosting their reserves. Venezuela has some of the world's amplest oil sand reserves in the Orinoco field.

Potentially significant discoveries may materialize also in key non-OPEC countries. Norway has discovered 22 new oil fields in the Barents Sea which jointly are estimated to hold some 300mn barrels. Russia is planning to expand its presence in the Arctic where potential reserves are estimated at 100-500mn barrels. Global warming is boosting interest in exploration in the far north which in some cases is now becoming less costly.

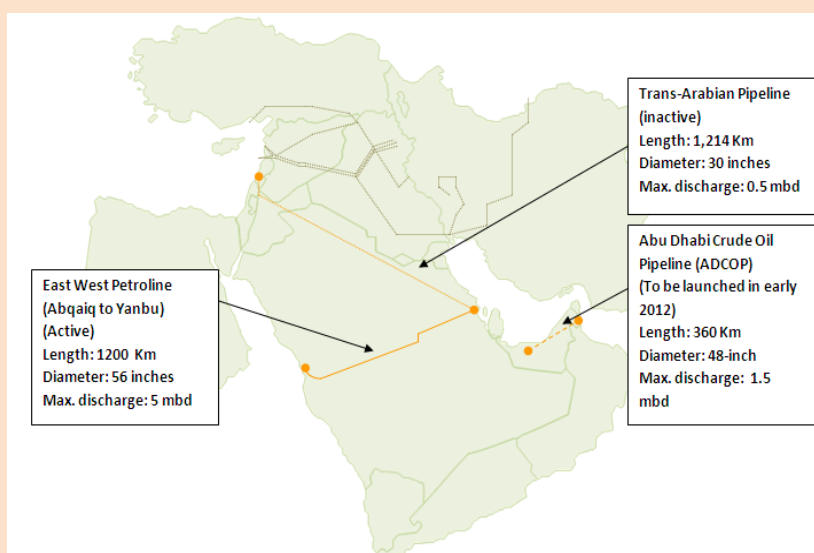
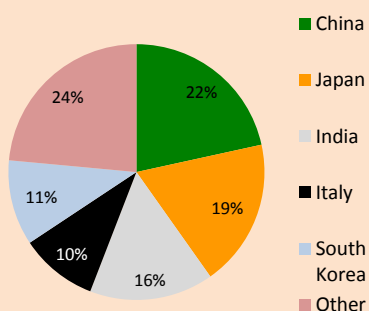
## Iran and Hormuz

The rhetoric is hardening in the stand-off between Iran and the West over the application of new sanctions designed to dissuade Iran from its nuclear ambitions. Iran has threatened to block the Straits of Hormuz in the event that the European Union stops importing Iranian oil as planned on 1 July. Iran is heavily dependent on oil exports for its economic wellbeing. Crude accounts for 80% of Iran's total exports and generates half of the government's revenues.

In spite of the adverse effects of years of sanctions, Iran remains an important player in the global oil market. It has total estimated reserves of 151bn barrels which equal some 9% of the global total and more than 13% of OPEC's reserves. In addition, Iran has substantial gas reserves estimated at some 33bn cu ft. More than 85% of Iran's proven reserves are located in the southwestern Khuzestan Basin close to the Iraqi border. Iran is the second largest OPEC oil producer after Saudi Arabia as well as being the third-largest crude exporter globally after Saudi Arabia and Russia. According to OPEC, Iran produced 3.5 mbd of crude oil in 2010 while its exports reached some 2.58 mbd. The main export destinations are China, Japan, India, and South Korea. Exports to Asia stood at 1.57 mbd, as compared to 878,000 b/d shipped to the European Union. The main EU buyers of Iranian oil are Greece, Italy, Spain, and France. Among Iran's trade partners, Sri Lanka has the highest level of dependency on Iranian oil which accounts for more than 90% of the country's oil imports. Sri Lanka recently announced plans to source new supplies from Saudi Arabia and Oman.

While the disruptions caused by the planned sanctions to the global oil market are likely to be fairly manageable, any attempt to close the Straits of Hormuz would likely prove highly disruptive. Some 20% of the global oil trade and 35% of seaborne oil pass through the Straits. In addition to an estimated 17 mbd of oil, some 70mn tn of LNG flow through the straits. Any disruption could push up the price of oil to USD200/barrel within 72 hours. The main challenge for the Gulf exporters in the relative lack of alternative routes in the event that the straits are closed. While road transportation would offer some relief, for instance Saudi Arabia has only one functional alternative in the Abqaiq-Yanbu Petroline whose spare capacity is unlikely to be more than 3 mbd. Even this would involve additional risks due to congestion in the Suez Canal and piracy in the Gulf of Aden Other pipelines circumventing the Straits are in disuse while the 1.5 mbd Abu Dhabi-Fujairah pipeline has been delayed to 2013.

Iran top export destinations 2010





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