UBS

Chief Investment Office WM
August 2016

Prosperity beyond oil

The Middle East at a crossroads

Publication details

This report has been prepared by UBS AG
and UBS Switzerland AG.
Please see important disclaimer and
disclosures at the end of the document.

This report was published on
31 August 2016

Editorial deadline
29 August 2016

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Foreword

In the past 50 years, the Middle East has exported more than USD 10trn dollars' worth of oil to the rest of the world. This has conferred an economic blessing on the region and led to one of the most rapid periods of wealth creation in modern history. UBS is honored to have been a trusted partner in the region during this transformative period.

The Middle East's position in the world continues to evolve. The region ran its largest deficit in history last year. Overdependence on oil has left some parts of the regional economy bloated and unproductive. New oil supplies and alternative technologies mean that oil prices above USD 100 per barrel may never again be seen long term. Conflict, often associated with the region, has taken on a new dimension with the emergence of ISIS in Iraq and Syria.

But, as we discuss in this paper, these challenges are not insurmountable. The example of economic diversification demonstrated by the UAE, a young and well educated population, exciting opportunities in solar power and the reintegration of Iran pave a path forward.

Necessary reforms will not be easy and the years ahead not without difficulties. Yet the Middle East's future remains in its own hands, and the professionalism, humility and realism of the clients and investors I have met in the region over the years give me tremendous confidence in its ability to shape its future.

I hope you find the paper thought-provoking, enjoyable and informative.

Jürg Zeltner
President Wealth Management

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We see numerous opportunities for the countries in the Middle East to diversify. The region enjoys advantages in industries that rely heavily on energy and materials like petrochemicals, automotive, construction materials, and metal processing. Tourism has room to grow, the service sector might benefit from growing economic diversification, and renewable energy offers opportunities. No matter which sectors are prioritized, however, successful reforms require an increase in productivity via investment in infrastructure and education as well as further privatizations.

22 Exchange rate pegs to remain in place, but not necessarily forever

Despite mounting pressure on currency pegs in recent years, our base case is that the countries of the Gulf Cooperation Council (GCC) will maintain their current exchange rate regimes over the coming years. Authorities still have the willingness and ability to maintain pegged exchange rates, we believe. However, some countries are better positioned than others. Looking at sustainability and suitability in the long run, we argue that pegged exchange rates might become a less dominant choice at some point, depending on reform and diversification progress as well as hydrocarbon prices.

26 Iran, striving for global reintegration

Iran is set to become one of the fastest growing countries in the Middle East over the coming years. The country not only benefits from its high degree of economic diversification; pent-up investment demand in Iran's large oil and gas fields and the sizable potential of its domestic market will likely attract interest from abroad. Low energy prices, limited resources for fiscal spending, and the necessity for a relatively tight monetary policy stance may hinder the pace of economic expansion. Risks to our view include a failure to comply with the nuclear deal, lower for longer energy prices, as well as adverse political and geopolitical developments in Iran and the region.

32 Obstacles and opportunities in shifting investment landscape

The decline in hydrocarbon prices has resulted in a drawdown of petrodollars invested in global markets. This has amplified the impact from lower energy prices on growth and financial markets. At the same time, the growing need of economic adjustments creates opportunities for international investors in regional financial markets. The GCC region will become a more important player in bond offerings, and there are attractive dividend yields in regional equity markets as well as private companies with a large potential. In our view, the region will likely play a growing role in the global investment landscape in the years ahead.

Introduction

Jorge Mariscal, Regional CIO Emerging Markets

Owing to their long, rich history, countries of the Middle East are accustomed to living and prospering under economic and political uncertainty. Yet, even for them, the current global and regional challenges appear daunting.

While they have navigated the cyclical ups and downs of hydrocarbon prices, never before had the supremacy of crude oil as the world's main energy source been as structurally challenged as it is today. New supply from countries like Iran and Iraq, the shale gas revolution, more serious efforts to curb global warming, and energy-saving alternative technologies are all likely to hinder vastly higher hydrocarbon prices. A more tepid rate of growth for most oil importing countries, including China, is also becoming a permanent feature in the economic "new normal."

Regional conflict has also been a recurring feature of the region's dynamics. The intensification of religious and political violence in places like Syria and Iraq, and the radicalization of a Muslim minority in the name of the Islamic State (ISIS) are impacting domestic growth, tourism, and investment flows, and causing humanitarian crises across the Middle East and North Africa region. On average, the region spent 18% of government budgets on the military in 2015, compared with 9% for the US. Countries like Saudi Arabia and Oman spend nearly one third of their budgets on defense. Current and expected trends in the region suggest a continued fiscal burden from these activities.

Dubai / iStock

The Middle East also faces important social challenges. With limited agricultural resources, governments need to ensure adequate food and water supplies. Furthermore, given that 47% of the region's 210 million population (Figure 1) is under 25 years of age, policy makers have to worry about generating sufficient jobs to absorb new entrants to the labor force.

Despite its many challenges, the Middle East has considerable strengths.

First, the combined wealth from oil and gas in the ground is staggering. Even assuming oil prices remain at USD 45/bbl, the value of proven oil and gas reserves would amount to USD 50 trillion, 25 times the region's GDP, according to our estimates. The region's holdings of foreign exchange reserves at USD 800 billion, or about 40% of GDP, give their central banks room in supporting their mostly pegged currency regimes. In addition to foreign exchange reserves at central banks, there is an estimated USD 2.9 trillion held by sovereign wealth funds, making the region an indisputable investment powerhouse in the global arena. The Middle East oil assets have to be contrasted with the region's liabilities. While budget deficits due to low oil prices this year are expected to average 10% of GDP, debt ratios are low by global standards. Even when including highly leveraged countries like Lebanon, Yemen and Jordan, debt to GDP averages less than 25%. Low leverage ratios give treasury ministries latitude to run fiscal deficits for several years.

Second, overall macroeconomic performance is sound. Despite the recent low level of hydrocarbon prices and thanks to established countercyclical policies, the region as a whole is expected to grow 2.7% in 2016, from 2% in 2015 (Figure 2). In Iran and Yemen, inflation in 2016 is expected at 9% and 27%, respectively, but elsewhere in the region, inflation is expected to be under 4%, low by world standards.

Finally, despite its focus on oil and its limited natural resources, the region is fairly advanced in several key development indicators (Figure 3). Cell phone subscription rates exceed those of the US, as does internet penetration in the UAE, Qatar, and Bahrain at or higher than 90%. Oman, Kuwait and Lebanon are not far behind with internet penetration rates above 70%. When it comes to education, the World Bank Index places the regional average well above the world's, though there is some regional variation. Furthermore, despite general perceptions of wealth concentration, a compilation of the most recent Gini Coefficients derived from Household Surveys by the World Bank shows that Middle East societies are about as unequal as those of the US, though inter-country wealth distribution is likely to remain uneven and a potential source of tension.

In sum, the Middle East has considerable wealth buffers and social safety nets to maintain economic and social stability for several years. However, these buffers are not inexhaustible and fiscal strains are starting to surface, raising the attention of credit rating agencies. Leaders in the region should implement structural reforms that promote diversified growth and create permanent jobs for the region's young and rapidly expanding labor force.

Figure 1

Middle East population, GDP, and area

	Population (mn)	Nominal GDP (USD bn)	Area (km²)
Saudi Arabia	31.4	653	2,149,690
Islamic Republic of Iran	79.5	388	1,648,195
United Arab Emirates	9.6	345	83,600
Qatar	2.4	185	11,586
Iraq	35.2	169	437,072
Kuwait	4.1	121	17,820
Lebanon	4.6	51	10,452
Oman	3.8	58	309,500
Jordan	6.8	38	89,341
Yemen	28.3	37	528,076
Bahrain	1.3	30	765
Total	**206.9**	**2,076**	**5,286,097**

Source: IMF data for 2015, World Bank

Figure 2

Countercyclical measures supportive of growth

Real GDP growth and inflation, in %

	GDP growth (in %)		Inflation (in %)	
	2015	**2016**	**2015**	**2016**
Saudi Arabia	3.4	1.2	2.2	3.8
Islamic Republic of Iran	0.0	4.0	12.0	8.9
United Arab Emirates	3.9	2.4	4.1	3.2
Qatar	3.3	3.4	1.7	2.4
Iraq	2.4	7.2	1.4	2.0
Kuwait	0.9	2.4	3.4	3.4
Lebanon	1.0	1.0	–3.7	-0.7
Oman	4.1	1.8	0.2	0.3
Jordan	2.5	3.2	–0.9	0.2
Yemen	–28.1	0.7	30.0	27.5
Bahrain	3.2	2.2	1.8	3.2
Average	**2.0**	**2.7**	**4.5**	**4.6**

Source: IMF. Regional average weighted by GDP estimates for respective years by IMF, April 2016

This white paper explores some of the key challenges and opportunities confronting the Middle East and argues that, to an important degree, the region's leaders have the ability to shape a promising future.

Chapter 2 of this report, "Oil, blessing and curse," presents the two sides of the region's oil wealth coin. It argues that crude prices are likely to gradually recover in coming years to around USD 75/bbl. However, reforms leading to economic diversification and higher overall productivity should remain a high priority item for most countries. Lower hydrocarbon prices are already eroding fiscal buffers in the region, requiring ongoing fiscal consolidation efforts and second, the road to economic diversification is long and winding, and full of pitfalls.

Chapter 3, "The long road to diversification," discusses the opportunities and challenges of attaining this goal, and the success story of the UAE in reducing economic dependence on hydrocarbons. We also show how the region can succeed in new areas, such as the industry for solar power.

In Chapter 4, we discuss the central economic issue of currency regimes. Most likely, Middle East pegs will be sustained in the coming years as these regimes are consistent with economies which are mono-exporters of commodities. However as, and if, these economies become more diversified, the peg regimes are likely to come into question.

We devote Chapter 5 to Iran, the second-largest economy in the region after Saudi Arabia. We believe that with the lifting of Western sanctions, Iran is poised to become one of the fastest growing economies in the Middle East. Its diversified economic base and the potential for its large domestic market should increasingly attract the attention of the investment world.

Our final chapter outlines implications of current and future developments in the region for global and local financial markets. In particular, we explore what a future of permanently lower revenues from energy exports means for issuance of the region's bond and stock instruments, as well as for outward investment patterns from the Middle East to the world.

We hope you enjoy this report and find it useful in your investment decisions.

Figure 3

Fairly advanced in key areas

Indicators of technology development, education, and distribution of wealth

	Internet penetration	**Cellphone subscription**[1]	**Education index**[2]	**Gini coefficient**[3]
	2015	**2016**	**2015**	**2016**
Saudi Arabia	64%	180	0.72	46
Islamic Republic of Iran	39%	88	0.68	37
United Arab Emirates	90%	178	0.67	
Qatar	91%	146	0.69	40
Iraq	11%	95	0.47	30
Kuwait	79%	218	0.65	
Lebanon	75%	88	0.63	37
Oman	70%	158	0.60	
Jordan	44%	148	0.70	34
Yemen	23%	68	0.34	36
Bahrain	91%	173	0.71	
Regional total/ Average	**62%**	**149**	**0.67**	**40**

[1] Per 100 ppl (2014)
[2] From UN Human Development indicators. Calculated using *Mean Years of Schooling* and *Expected Years of Schooling* (2013).
[3] Saudi Arabia Gini coefficient from CIA which might be overestimated versus those from the World Bank; others from World Bank/UNHDR.

Source: ITU, World Bank, UN, CIA, IMF, Bloomberg. Regional average weighted by GDP estimates for respective years by IMF

Oil, blessing and curse

Michael Bolliger, Head Asset Allocation Emerging Markets
Giovanni Staunovo, Commodity Analyst

No other region has gained as much wealth through energy exports as the Middle East. The energy sector is set to remain an important source of wealth in the years ahead, despite likely lower hydrocarbon prices for longer. However, the dominant role of the energy sector for so many years has left other sectors underdeveloped. Although many countries have put money aside for the proverbial rainy days, the region's destiny will strongly depend on its ability and willingness to engineer economic diversification while respecting manifold constraints that have emerged from decades of abundant export revenues.

Desert of Bahrain / iStock

The blessings…

In the last 50 years, crude oil exports alone have added more than USD 10 trillion to the public coffers according to our estimates (Figure 1). Saudi Arabia alone accrued more than USD 4 trillion, followed by the United Arab Emirates (UAE), Iran, and Kuwait, each of whom gained USD 1–1.5 trillion. Exports of natural gas and petrochemical products have been other meaningful sources of income.

The sizable energy sector has helped create many jobs in other sectors. Over the last 20 years, we estimate that an increase in crude oil production by 1% has been accompanied by an increase in GDP growth of more than 0.4% in countries like Kuwait, Oman, Saudi Arabia, or the United Arab Emirates. In addition, the energy sector has indirectly contributed to growth in other parts of the economy, via investment and private and public sector consumption.

A top-ranked fiscal position

The revenues from energy exports have strengthened the region's fiscal position. The most recent global competitiveness report from the World Economic Forum ranks Qatar, Kuwait, Bahrain, Saudi Arabia, and the United Arab Emirates within the top seven globally for competitiveness in terms of the overall tax burden. General government debt levels in 2015 were at 20% of GDP or below in many countries including Saudi Arabia, Kuwait, Iran, the UAE, and Oman. With the exception of Lebanon, Jordan, and Egypt, which are all net energy importers, as well as Yemen, these favorable fiscal positions leave most countries in the region well prepared to weather the current episode of low energy prices, even if it lasts for several years. In addition, the public sector plays a large role and government employees often receive highly competitive salaries. A large number of households also benefits from subsidies on energy and food items.

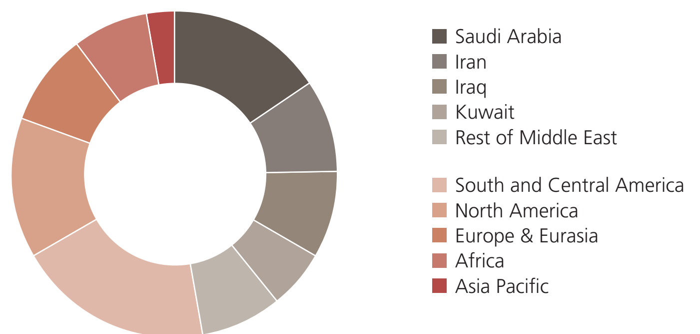
A tremendous pool of wealth still to be found

Equally impressive is the size of the wealth that still lies beneath the land and waters of the region. Roughly 50% of proven oil reserves globally and more than 40% of natural gas reserves are estimated to be found in the Middle East (Figure 2). Assessed at current prices of 45 USD/bbl and ignoring production costs and differences in quality, oil reserves are worth roughly USD 35 trillion, and gas reserves would add another USD 15 trillion. Evaluated at our

Figure 2

Where the world's energy reserves lie

Proven oil reserves, in % of total

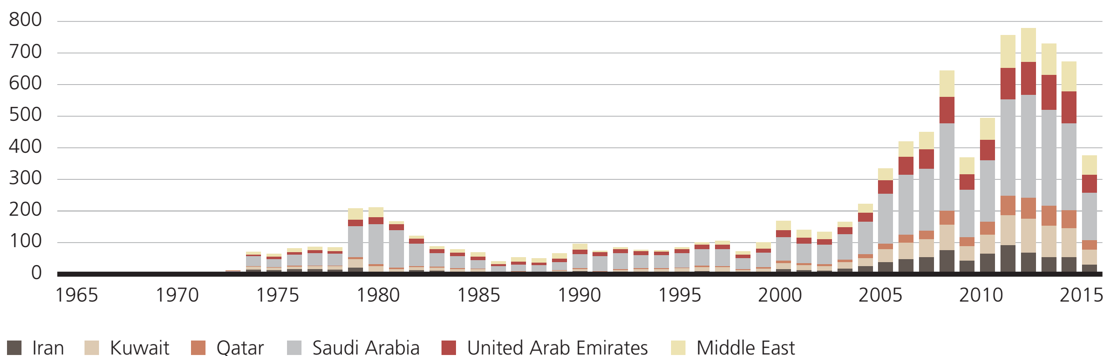


Source: UBS, BP, as of July 2016

Figure 1

Adding trillions of dollars to public coffers

Value of annual oil exports, in USD bn



Source: UBS, BP, JODI, as of July 2016

estimated long-term equilibrium prices of USD 75/bbl, this number increases to USD 80 trillion in total, representing a tremendous stock of wealth for a region that is economically not a lot bigger than Italy.

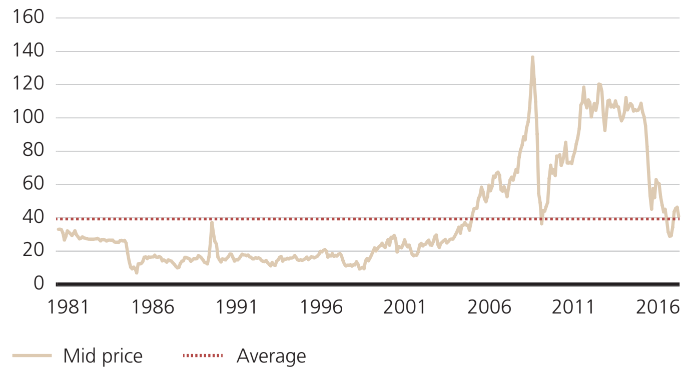
… and the curses

When a dam breaks, it usually begins with a small crack. This crack probably appeared for the first time a few years back, in 2012, when global energy prices began jittering and then tumbled (Figure 3). Since then, the price of energy has fallen by two thirds (as of July 2016), even when taking the recovery in 2016 into account. Although the region is less dependent on energy exports now than only a few years back, it remains vulnerable to price fluctuations. The dominant role of the energy sector for so many years has left the non-energy related sectors underdeveloped and the pegged exchange rate regimes prevalent in the region have become a growing barrier to the domestic economy, which is often referred to as Dutch Disease (see Info Box *Dutch Disease*).

Figure 3

A steep rise followed by a sharp fall

Arabian Gulf Dubai Fateh Crude oil price, in USD/bbl



Source: UBS, Bloomberg, as of July 2016

Important disparities exist though: the UAE and Bahrain, on the one hand, are a lot more diversified than Saudi Arabia and Oman. Hydrocarbon and government activities which are mainly funded by oil revenues account for the majority of the total GDP in all countries, except in Bahrain (35%) and the UAE (37%). Manufacturing activities tend to be tilted toward activities connected to the oil industry, such as refinery,

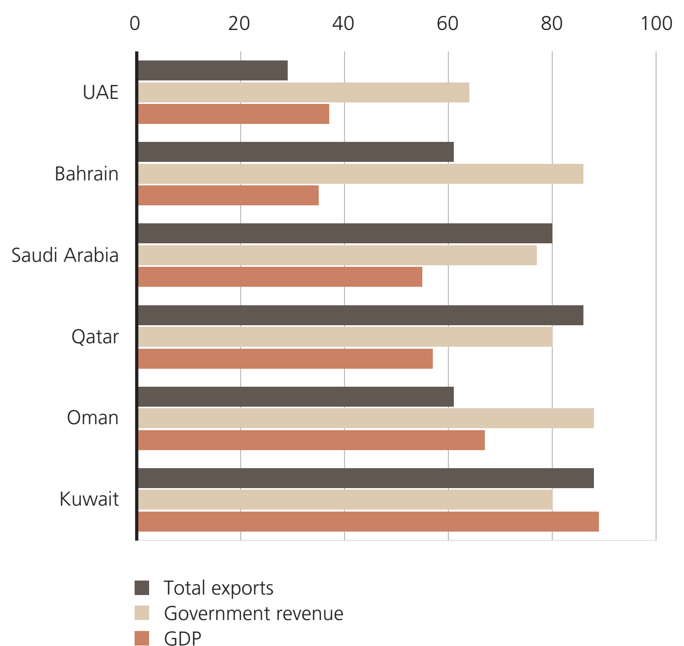
Dutch Disease

A Dutch Disease is an economic concept that originates from the British magazine *The Economist*. In 1977, the magazine described the decline of the manufacturing sector in the Netherlands after the discovery of a large natural gas field. It describes the economic consequences of a surge in foreign exchange inflow, resulting in an appreciation of the domestic currency versus other currencies. This prevents growth in other sectors as they become less competitive.

Figure 4

Overly dependent on oil

Share of oil in exports, government revenue and GDP*, 2014, in %



Source: WEO, IMF, UBS

* Also includes government activities, which are mostly funded by oil revenues

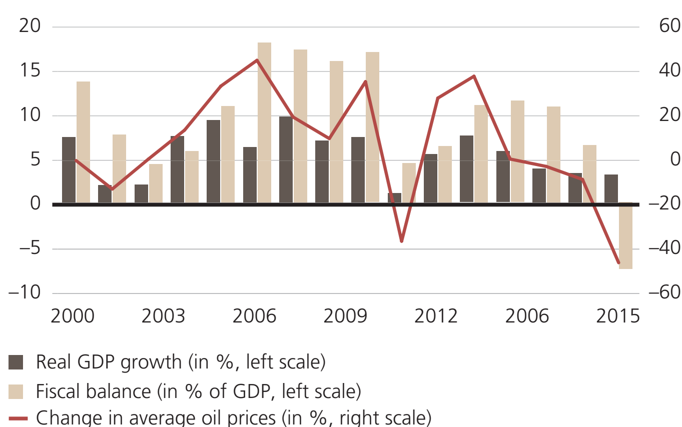
chemical, and mining or extractive industries. Several non-oil sectors like construction depend on government spending. Oil is also the primary source of government revenue in all countries, ranging from 65% for the UAE to 90% for Oman. Similarly, in all countries except the UAE, it is the main export good (Figure 4). Other indicators of economic complexity, diversity, or export quality are also lower than in many other oil-exporting countries such as Mexico or Malaysia. Most countries in the region thus are less well integrated into global value chains.

The reliance on oil is also reflected in the high correlation between oil prices on the one side, and GDP growth as well as fiscal and current account balances on the other side (Figure 5). This exacerbates macro volatility, which in turn weighs on economic performance through channels such as business and investor confidence or sovereign credit ratings. With low oil prices and sizable fiscal consolidation efforts undertaken, real GDP growth is expected to slow further in the region to around 2.5% in 2016 from 3% in 2015 and to remain below historical levels thereafter. Recently implemented fiscal measures are helping to ease the pressure on fiscal balance sheets, but the average fiscal deficit (as % of GDP) should remain at high-single to low-double digit territory in the years ahead. Current account balances will likely remain in deficit territory for now.

Figure 5

Over-reliance on energy prices

Real GDP growth and fiscal balance versus change in energy price
Simple averages calculated for GCC countries



Source: IMF, UBS, July 2016

Hydrocarbon prices: Investment dearth signals higher prices ahead

The return of Iran to the energy market and a failed agreement between the largest producers in the region to freeze production has pressured prices. At the same time, energy price dynamics are increasingly influenced by non-OPEC members. The rise of the shale gas production in the US has contributed importantly to the glut in the oil market in 2015. Nevertheless, we see room for energy prices to recover somewhat in the medium to long term. A return to triple-digit levels seems unlikely, however, given the rise of shale energy producers across the globe.

The International Energy Agency recently warned that an investment gap is building up in the oil industry, which might lay the foundation for tighter oil markets and create the basis for higher prices over the medium term. Capital expenditure by energy companies has fallen to just USD 400 billion from a peak of USD 660 billion in 2014. Looking ahead, forward guidance of exploration and development budgets raise even greater concerns. Wood Mackenzie, an industry consultant, estimates around USD 1 trillion of investment has been rubbed out through 2020 due to the oil price rout.

These cuts will impact oil supply in two ways: First, it reduces infill drilling at existing fields, leading to an acceleration of production declines in mature fields. Second, fewer new projects are set to start, reducing the number of projects that will come online over the coming years. That said, several projects are expected to start production in 2016 and 2017, since the final investment decisions were taken a few years back when oil prices were above USD 100/bbl. The impact will therefore only become more visible from late 2017 onwards. Lead times between price changes and the supply response are rather long outside the US because most conventional projects take years to complete.

Demand growth driven by emerging Asia
To assess the severity of the investment gap, global oil demand also needs to be considered. Our base case projects it growing by 1mbpd on average over the next five years, less than the average rate over the last five years (1.2mbpd). Although energy efficiency and developments in battery technology could drag down demand, the structural catch-up in energy consumption from emerging markets should not be underestimated. Emerging Asia will continue to fuel demand growth, as the region accounts for half the world's population but just one-quarter of worldwide oil demand.

Higher prices needed in the long term
We believe the market underestimates the adequate price level required to deliver sufficient capex investments to meet the world's growing oil demand. The current oil price forward curve does not provide the needed incentives for a sufficient and sustainable supply expansion, we think. If we take our depletion rate of close to 5mbpd and add our expectation for 1mbpd of demand growth, we see about 6mbpd of new extraction is needed just to tread water annually. The burden to keep up with the demand gap could be filled in the near term by Saudi Arabia, the other GCC countries, and Iraq and Iran. Tightening spare capacity and the lack of new projects will cap their ability to increase supply, however.

Covering this gulf will therefore require a price sufficiently high to spur investment from non-OPEC producers – first the US and, later, projects in West Africa, Latin America, the North Sea and Canada. We believe the incentive cost of the marginal barrels outside the US lies between USD 70–75/bbl. For this reason, we expect full-year average prices to trade at these levels in around five years. That said, the transition from the current oil prices toward these levels will probably not be smooth.

The world to stay dependent on Middle Eastern oil

Oil production from the Middle East reached a record-high of 31.9mbd in July 2016, lifting the region's market share of global production to 33%, the highest level since the late 1970s. The region's production has risen constantly since 2009, primarily due to higher output from GCC countries, Iraq and Iran.

The world should stay largely reliant on oil coming from these low-cost producers. Iraq, Iran, the UAE and Saudi Arabia should dominate capacity expansion in the coming years. Saudi production should benefit from the Khurais oil field expansion, targeted for 2018–19, and a restart of production in the neutral zone, which requires resolving some environmental issues (non-compliance with new Saudi gas-flaring regulations). Saudi Arabia's production could increase as well, benefiting from a further reduction of the Kingdom's 1.5–1.8mbpd spare capacity. Iranian production has recovered more quickly than expected, with production already at pre-sanction levels of 3.6mbpd. We think a further increase toward 4mbpd in the coming quarters is possible. In the longer term, capacity growth will depend on access to international oil companies, capital and technological expertise. In Iraq, infrastructure bottlenecks, protests and budget cuts at oil fields due to cash woes should cap Iraq's output this year. New planned investments could increase production next year while new infrastructure in the south, expected to become operational in 2017–18, could help alleviate the existing bottle necks. UAE production should benefit from the expansions of the Sahil Asab Shah and Upper and Lower Zakum fields, which are expected to be completed in 2017.

No alternative solution to economic diversification

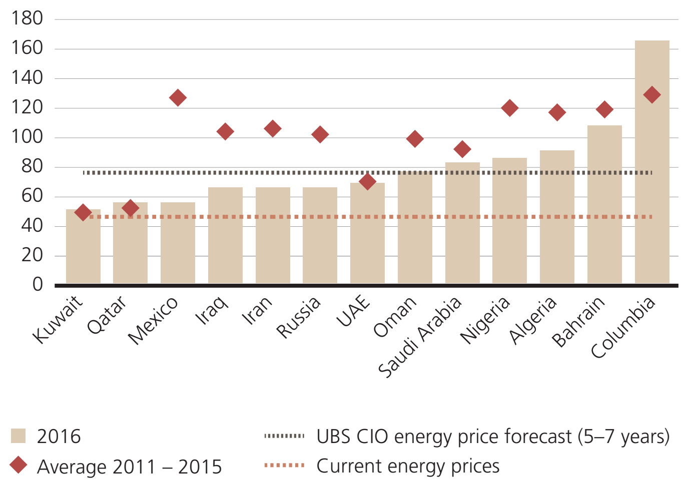
Despite some further upside, hydrocarbon prices will likely remain below the prevailing fiscal break-even prices for most countries in the region (Figure 6) in the years ahead. Most countries are responding to the deterioration of their fiscal and current accounts by initiating reforms, ranging from programs to foster higher growth in the non-energy sectors to labor market and fiscal reforms.

In a world of lower energy prices for longer, the region's destiny will strongly depend on its ability and willingness to engineer economic diversification while respecting manifold constraints that have emerged from decades of abundant revenues from energy exports. Including absorbing the flow of national entrants into the labor force will be key. The need for a sizable fiscal consolidation constrains economic growth, and currency pegs to the US dollar do not allow boosting non-energy exports via exchange rate devaluation, and limit the room for maneuver for several central banks in the region. As if this wasn't difficult enough, various interdependencies complicate matters further (Figure 7).

Figure 6

Reality bites

Fiscal break-even prices, in USD/bbl



Source: UBS, IIF, as of July 2016

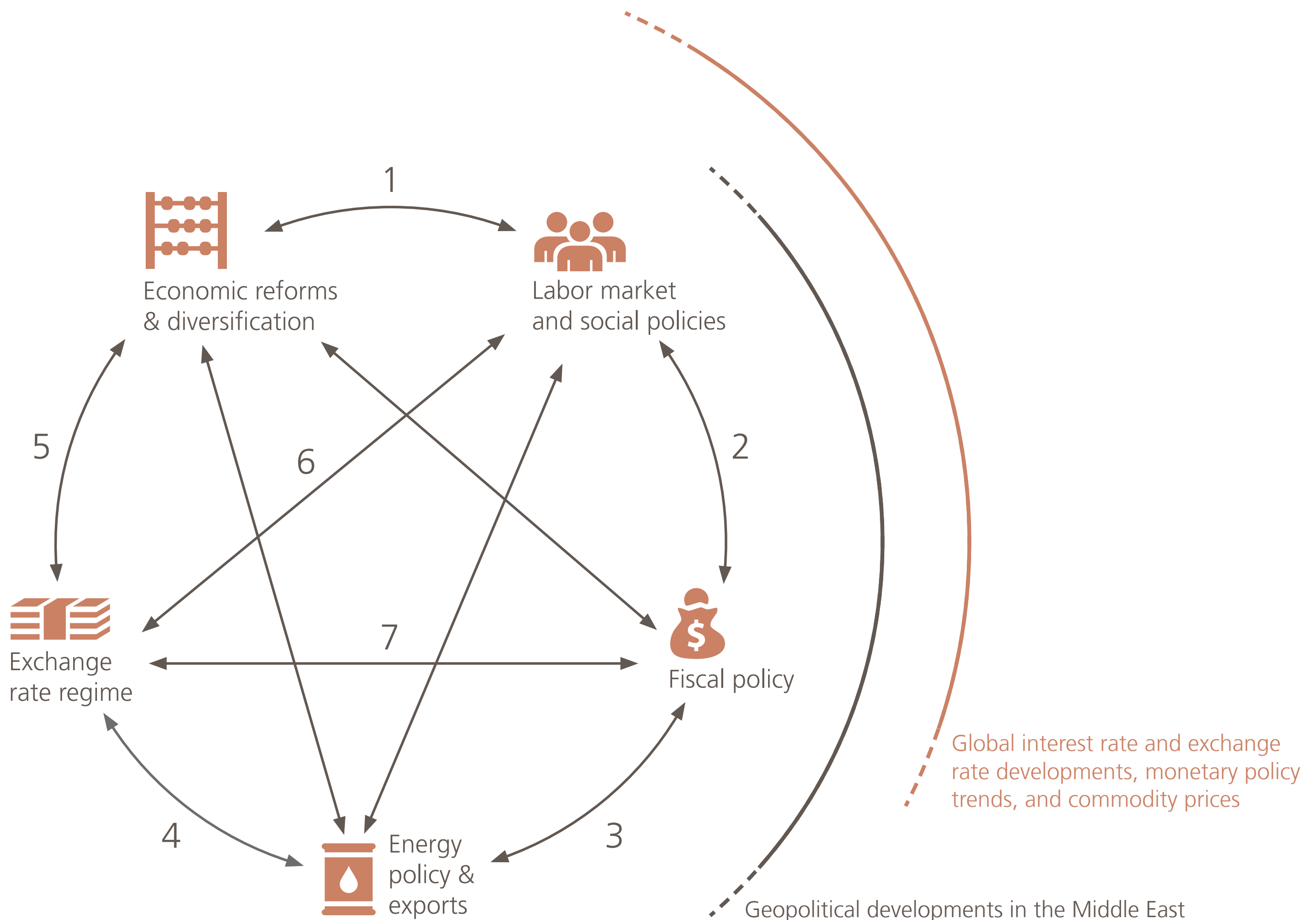
Although many countries in the region have put money aside for the proverbial rainy days, time is ticking away. There is no alternative solution to economic diversification, in our view.

Oilfield Aman (Oman) / iStock

Figure 7

It's complicated!

How policy choices can affect economic and social developments and the chances of reform success



1 The regulation of the foreign workforce and the female participation rate are important policy parameters that can help to reduce the risk of growing social tensions.

2 The need to tighten fiscal spending via cuts in subsidies, higher taxes and a declining role of the public sector as the prime employer increases the risk of growing unemployment and social tensions.

3 Revenues from energy exports account for a large part of fiscal revenues. Finding the price level that optimizes revenues from energy exports while taking constraints from the FX and fiscal policies and international (non-OPEC) supply and demand forces into account is a challenging task.

4 Inflows from energy exports and from revenues on public assets are an important pillar to defend FX pegs. Too low a price can rapidly lead to growing pressure on the FX system.

5 Benefits from a pegged exchange rate decline as economic diversification increases. Managing a potential transition from one regime to another is a delicate task. We discuss different scenarios in Chapter 4.

6 The prevailing pegged exchange rate regime severely limits the room for maneuver for the central banks in the region. This could adversely affect growth dynamics.

7 The pegged exchange rate system increases the need for a credible and prudent fiscal policy. An unsustainable public debt trajectory would ultimately lead to speculative attacks on a pegged exchange rate regime.

Source: UBS

The long road to diversification

Michael Bolliger, Head Asset Allocation Emerging Markets
Jérôme Audran, analyst
Soledad Lopez, strategist
Terence Klingman, analyst

We see numerous opportunities for the countries in the Middle East to diversify. The region enjoys advantages in industries that rely heavily on energy and materials, like petrochemicals, automotive, construction materials, and metal processing. Tourism has room to grow, the service sector might benefit from growing economic diversification and renewable energy offers opportunities. No matter which sectors are prioritized, however, successful reforms require an increase in productivity via investment in infrastructure and education as well as further privatization.

Dubai / iStock

Diversifying promotes itself, solid fundamentals ease transition

Many countries in the Middle East have adopted diversification strategies in recent years, underpinning their willingness and ability to reform. Ironically, the more diversified countries are in a better position to enact more reforms than their more energy-dependent peers, while the latter are under greater pressure to deliver reforms quickly and comprehensively. Within the region, the United Arab Emirates (UAE) is most advanced in terms of its economic diversification. Qatar, UAE and Kuwait benefit from a low fiscal and external break-even oil prices, large public foreign assets and a fairly stable political environment (Figure 1), supports their ability to reform. Countries such as Bahrain, Oman, or Saudi Arabia are on the other end of the regional spectrum. Break-even oil prices are higher and double-digit fiscal deficits rates are expected this year and possibly next. Bahrain and Saudi Arabia have a lower score in the political stability index ranking by the World Bank, and have a high youth unemployment rate. Lower credit ratings can increase the cost of capital, which might be needed to enact reforms.

UAE: A regional role model of diversification

Diversification in the UAE has been a key objective since the Emirates were formed in 1971. A business-friendly environment, excellent infrastructure, political stability, and openness to trade, capital and labor inflows have promoted high and resilient growth for many years. The Emirates have become a global financial center, an international transportation hub and a location of choice in the region for multinational operations. The country is a popular tourist destination, with tourism accounting for 9% of GDP in 2015. The government has played a key role in these developments, through investments and supportive policy decisions.

This successful diversification buys extra time to pursue further reforms, while limiting risks of economic, social and political instability. The financial sector has room to grow and the ongoing consolidation process should spur the competitiveness of the local banking industry. With an estimated total wealth of USD 3trn, prospects for the wealth management sector are flourishing. In addition, ongoing privatization and economic diversification efforts in the region will increase demand for financial services

Figure 1

Bahrain, Saudi Arabia and Oman require more drastic economic reforms

Selected indicators, 2016 forecasts, unless stated otherwise

	Political stability		**Fiscal profile**			**Economic profile**			**Sovereign ratings**	
Country	Political stability index, percentile rank (2014)	Youth unemployment rate (2013)	Fiscal balance, % of GDP	Public debt, % of GDP	Public foreign assets, % of GDP	Current account balance, % of GDP	Real GDP growth rate, %	Ease of Doing Business Rank (2015)	Moody's	S&P
Bahrain	14.6	28%	–18	82	12	–6.7	2.2	65	Ba2 / NEG	BB / STABLE
Saudi Arabia	35.4	29%	–14	17	110	–10.2	1.2	82	A1 / STABLE	A- / STABLE
Oman	68.0	21%	–20	36	61	–25.1	1.8	70	Baa1 / STABLE	BBB- / STABLE
Kuwait	52.4	20%	–13	19	520	–1.0	2.4	101	Aa2 / NEG	AA / STABLE
Qatar	83.0	1%	–3	46	210	–5.0	3.4	68	Aa2 / NEG	AA / STABLE
United Arab Emirates	75.7	12%	–11	21	191	–1.0	2.4	31	Aa2 / NEG	NR
Iran	17.0	25%	–2	18	28	–0.8	4.0	118	NR	NR
Algeria	10.2	25%	–15	15	90	–17.1	3.4	163	NR	NR
Yemen	1.5	34%	–10	67	–	–7.0	0.7	170	NR	NR
Egypt	7.8	34%	–11	89	–	–5.3	3.3	131	B3 / STABLE	B- / NEG
Lebanon	7.3	–	–8	143	–	–21.3	1.0	123	B2 / NEG	B-/ NEG
Jordan	26.2	–	–3	90	–	–6.4	3.2	113	B1 / STABLE	BB-/ NEG

Source: Moody's, S&P, World Bank, ILO, IMF, IIF, UBS

more broadly, generating additional opportunities for the banking industry. Tourism has further room for growth ahead of the World Expo 2020 in Dubai, and the Emirates might also benefit from other events, such as the FIFA World Cup in nearby Qatar in 2022 (see Info Box *Tourism as a pillar of growth*). Abu Dhabi has also announced industrialization plans lately, with the aim of building on existing industries, such as chemicals and plastics, and directing more investment into energy-intensive areas (e.g. steel and aluminum). Lastly, Western rapprochement with Iran heralds significant opportunities for the UAE's re-export sector.

Saudi Arabia: Sun rises through the clouds

Countries like Saudi Arabia, Oman and Bahrain reflect the other end of the spectrum (Figure 1). Saudi Arabia, the biggest country in the region, recently announced its Vision 2030 and a comprehensive National Transformation Plan (NTP), which combines growth initiatives, fiscal consolidation measures and various privatization programs. Initiatives in several areas are aimed at boosting non-oil government revenues and private sector employment, and at attracting more foreign direct investment (Figure 3). The cabinet has already been revamped and ministries have been restructured to make the government

Tourism as a pillar of growth

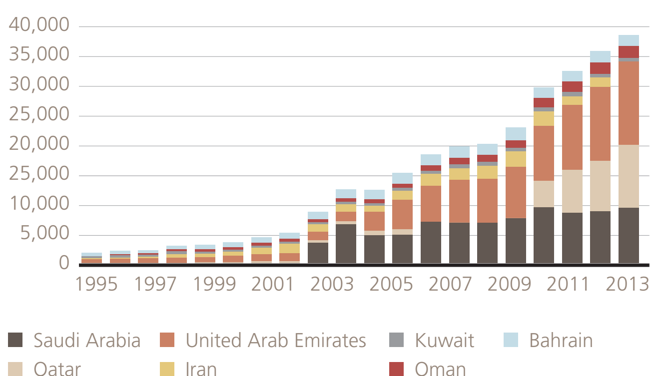
The Middle East had almost no revenues from tourism a few decades back. Several initiatives, however, have started to attract tourism beyond the long-established pilgrimage to Mecca or Medina. In 2014, Saudi Arabia, Qatar and the UAE generated inflows of USD 10–15bn (Figure 2), catching up to destinations like Mexico and South Africa, which have been tourism hubs for many years. Total inbound tourists' receipts for the region reached USD 40bn in 2014.

Dubai at the forefront…
Dubai has developed its tourism infrastructure for many years, and tourism has become an important driver of economic growth. Dubai International Airport was the third-busiest airport worldwide in terms of passengers in 2015, and also benefited from its growing role as a hub for international flights. Dubai's tourism is characterized by a luxury-driven industry with high-end hotels and airlines. Additionally, the UAE is also supporting tourism demand by hosting international events like the Formula One Abu Dhabi Grand Prix and the 2019 AFC Asian Cup in football.

… others to follow suit
While Dubai has been at the forefront for many years, other countries in the region are following suit: Qatar is hosting the FIFA World Cup in 2022. FIFA's decision to pick Qatar as the host for the football championship was a surprise to many. Despite widespread criticism, Qatar is set to become the first Arab State to host the World Cup in soccer. The country will likely spare neither trouble nor expense in organizing the tournament, helping to promote the country and the region to tourists. Abu Dhabi is planning to open two museums, Le Louvre and the Guggenheim Museum, bridging Eastern and Western cultures. Saudi Arabia is targeting an improvement in tourism and leisure in its Vision 2030. The goals include enhancing capacity for pilgrimage from eight million to 30 million persons per year, raising household spending on cultural and entertainment activities and increasing the number of more Saudi heritage sites registered with UNESCO.

The main challenges faced by the countries in the region are related to the environment, traditions and perceived security threats. The massive construction implies damage for the coastline and pollution, and international tourism might affect the conservativeness and religious traditions that define citizens' lifestyles in some countries. In addition, perceived security threats can quickly erode inflows from tourism as recent cases in Egypt and Turkey show.

Figure 2
Surging inbound from tourism
Receipts from tourism, in USD million



Source: UBS, World Bank, as of July 2016

more efficient, accountable and transparent, a development which we believe will facilitate the implementation of Vision 2030.

A multi-sector diversification strategy
The proposed diversification strategy involves a number of sectors to achieve the ambitious objective of tripling revenues from non-energy related industries to SAR 530bn or 22% of GDP by the year 2020. Although the NTP lists many different sectors, we see a natural advantage in vertical diversification strategies, i.e. in sectors where Saudi Arabia already enjoys advantages.

Increasing the Kingdom's refining capacity by developing the downstream operations of the state oil company Saudi Aramco looks like a logical next step, in our view. The company is already building refineries domestically, which may support demand for Saudi crude, lower imports of refined products and mitigate oil-price volatility risks by capturing margins.

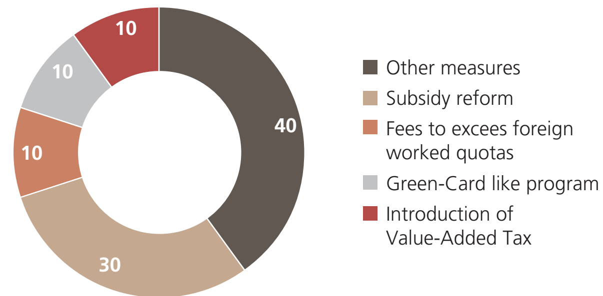
Sensitivity to the energy sector remains high, however, and the industry is not very labor intensive, limiting its potential for much needed job creation. Higher exports of mining products, such as zinc, uranium, gold, silver, copper and phosphate, present additional diversification opportunities. Moreover, several industries could leverage Saudi Arabia's advantage in energy, petrochemicals and minerals, including automotive, appliances, construction material, metal processing and packaging, and may become sustainable export-oriented parts of the Saudi economy.

Private healthcare, finance, real estate, tourism (see Info Box *Tourism as a pillar of growth*), as well as retail and wholesale trade are other industries that are targeted in the NTP to increase the country's share of non-energy dependent GDP. As the world transitions from fossil fuels to clean power, energy will remain at the forefront in the Middle East. Blessed with over 300 days of sunshine, solar power is starting to come into its own, with PV plants ramping up exponentially since 2010 across the region (see Info Box: *Solar power – the new yellow gold*).

Figure 3

USD 100bn in additional non-oil revenue targeted by 2020

Non-oil revenue, in USD billion



Source: Bloomberg, UBS

Productivity gains and more privatization required

No matter which sectors are prioritized, however, successful reforms are needed to enhance competitiveness and raise economic growth in non-hydrocarbon sectors. Shifting workers from the public sector to the private in a business-friendly environment, together with developing a more high-tech, knowledge-based workforce, are key objectives that can be enhanced through effective public-private partnerships. Productivity gains can also be achieved through higher investment in education and training, and more acquisition of foreign know-how and talent.

In Saudi Arabia, the partial liberalization of the energy sector is a key objective of Vision 2030. Its Public Investment Fund (PIF) could be transformed into a USD 2trn sovereign wealth fund, financed notably by selling a stake of less than 5% in Aramco. The government is looking to gradually invest the enlarged PIF's funds in assets abroad to boost diversification of public foreign assets and investment revenues. The recent purchase of a USD 3.5bn stake in Uber is an example of this strategy.

These reform measures will also help to attract foreign investment in the form of capital and know-how transfers. A gradual reduction of restrictions on foreign ownership (like the prevalent cap of foreign ownership in UAE at a maximum of 49% currently) can also help to achieve higher foreign investment activity in the region.

A delicate balance

Risks of economic, social and political instability remain an important constraint that can affect the pace of economic transition in Saudi Arabia and elsewhere. A challenge for the authorities will therefore be to find the right balance: too much, too quickly poses the risk of instability; too little, too late would be insufficient to maintain economic, fiscal and external stability.

The region has one of the youngest and fastest growing populations globally. Some 20–40% of the overall population is 15 years old or younger and a significant number of young people are unemployed (Figure 5). The expected increase in the female worker participation rate will add further to the rise in the labor force. At the same time, the public sector is an important employer for nationals, ranging from 40% in Bahrain to

Solar power – the new yellow gold

Blessed with over 300 days of sunshine per year and plenty of wide-open spaces, sunlight is arguably the Middle East's greatest resource. The region should have been well placed to be one of the major beneficiaries of solar energy. Instead, countries such as Germany, which enjoy far less solar irradiance, have led the world in the adoption of solar power. With access to the world's largest oil and gas fields, the Middle East enjoyed a surfeit of cheap hydrocarbon energy, and there was little incentive to develop renewable energy in the region. Now, however, it is catching up with a vengeance.

Without the prop of elevated energy prices, local energy subsidies look increasingly untenable in the face of increasing domestic demand. A rising population, a growing middle class and increasing reliance on the energy-intensive desalination of water and the development of petrochemical industries have turned the Middle East into a major energy consumer, increasing the fiscal burden of energy subsidies. Countries like Iran and Iraq have much lower electricity use rates than the global average, indicating that electricity demand has further room to grow. Electricity generation is also almost totally dependent on hydrocarbons, with gas accounting for 65% of generation and oil for 33%.

Progress on removing subsidies is complex, since the petrochemical industry relies on cheap feedstock and remains an important source of job creation. Nevertheless, many countries have moved to cut energy subsidies to consumers. A shift to more market-based pricing discourages wasteful electricity usage and improves diversity in the energy mix. This allows countries to divert more of the oil and gas production for export. In fact, with most of the Middle East's gas reserves concentrated in Iran and Qatar, the shift to renewables also reduces LNG imports for many Gulf States.

Declining costs of solar panels reinforces competitiveness

Several recent studies show that solar is getting close to gas and coal as an attractively cheap source of power. In addition, solar plants are optimally positioned to meet peak loads on the grids. This obviates the need for building expensive new base-load capacity, which suffers from lower utilization rates in cooler times of the day and in the winter season.

The Middle East Solar Industry Association expects that large-scale solar PV installations will stay competitive even with oil prices in the region of USD 30 per barrel and gas prices at USD 5 per MMBtu, although some persons question whether the trend to even lower prices than the Dubai tender is sustainable. Industry structure and regulation are coalescing around an Independent Power Producers (IPP) model which potentially makes room for private enterprise in a region that has been traditionally dominated by the government sector.

Exponential ramp up of capacity

Solar projects investments in the MENA region grew from USD 160m in 2010 to USD 3.5bn in 2015. The table below illustrates the massive pipeline waiting to come on-line (Figure 4). By 2020, solar energy will form a significant part of the region's power generating capacity. As the world transitions from fossil fuels to clean power, energy will remain at the forefront in the Middle East.

Figure 4

An impressive project pipeline

Solar installation overwiew, in Mwac

Country	Operational	Under Execution[1]	Tendered in 2016	% target in 2020[2]
Morocco	160	350	245	12
Algeria	270	80	2,000	15
UAE	128	200	1,150	10
Jordan	30	320	120	12
Egypt	70	1,800	250	8
Saudi Arabia	23	62	170	8
Kuwait	12	60	85	10
Total	**693**	**2,872**	**4,020**	

[1] PPA signing, awarded, construction, etc.
[2] Percentage of power generation capacity for 2020

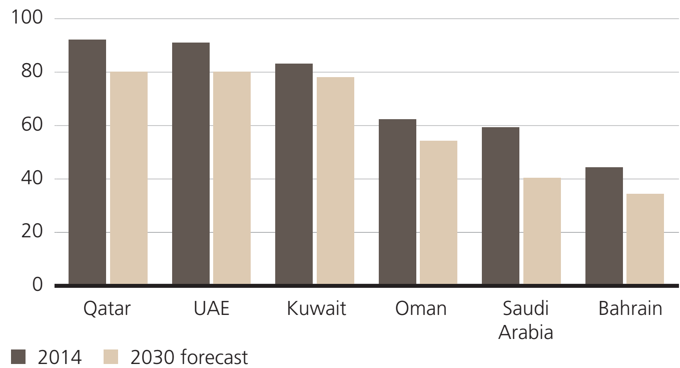
Source: UBS, Middle East Solar Industry Association (MEISA), 2016

65% in Saudi Arabia and 80–90% in Kuwait, Qatar an the UAE. The redistribution of oil revenues through public sector jobs has been a key part of the social contract, which looks increasingly unsustainable. A competitive private sector is thus paramount to provide a viable source of employment, and sufficient job creation will be key for a successful transformation.

Figure 6

Large share of foreign labor in the GCC set to shrink over time

Foreign labor, % of total employment



Source: National Authorities, IMF, UBS

Given the relatively high share of foreigners in the local workforce (Figure 6), authorities can also regulate it by limiting the influx or reducing the number of foreign workers. Saudi Arabia's NTP foresees initiatives to restrict the number of foreign workers and to increase their cost. These measures, although likely sufficient to reduce the rise of the unemployment rate, will not prevent higher unemployment on a standalone basis, in our view. Foreign labor accounts for 60% of total employment in Saudi Arabia, and other countries have higher rates. However, replacing typically cheaper and less well educated foreign workers with locals will likely increase wage costs and result in qualification mismatches, adversely affecting the productivity and profitability of local companies.

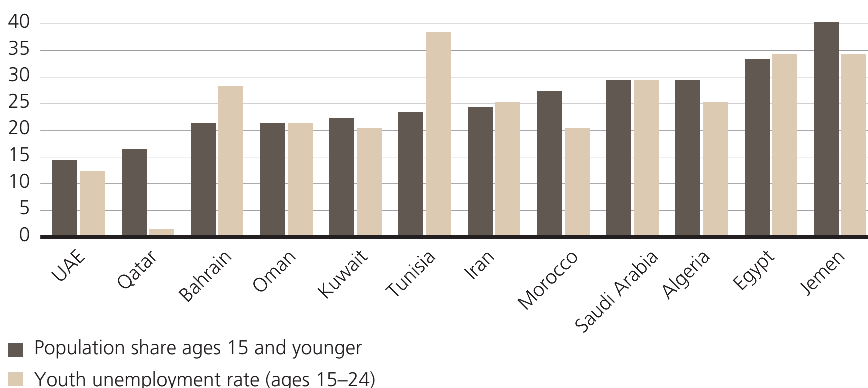
Another challenge will be to find a good equilibrium between economic and social reforms. It will be crucial, we think, to build a social safety net to lessen the adverse economic impact on low-income populations. Reforms could also create political tensions. Liberal reforms, such as those aiming to develop an entertainment industry for the young or increase female participation in the workforce, could jeopardize the political contract that has for decades allowed the monarchy and the religious establishment to work together.

Lower-than-expected energy prices represent another risk, in our view, as they would result in a further deterioration in economic performance and reduce the ability to implement reforms. The historical experience of countries that have been successful in diversifying their economies shows that the chances of implementing deep reforms are higher when oil prices are not too low. As a result, we expect domestic pressures to keep Saudi Arabia from trying to drive oil prices down again in the medium term to avoid the need for even more drastic fiscal consolidation.

Figure 5

Job creation is key given the large, unemployed young population

Indicators in %, 2013



Population share ages 15 and younger

Youth unemployment rate (ages 15–24)

Source: ILO, World bank, WEO, IMF, UBS

Exchange rate pegs to remain in place, but not necessarily forever

Jonas David, Head Emerging Markets FX and rates

Despite mounting pressure on currency pegs in recent years, our base case is that the countries of the Gulf Cooperation Council (GCC) will maintain their current exchange rate regimes over the coming years. Authorities still have the willingness and ability to maintain pegged exchange rates, we believe. However, some countries are better positioned than others. Looking at sustainability and suitability in the long run, we argue that pegged exchange rates might become a less dominant choice at some point, depending on reform and diversification progress as well as hydrocarbon prices.

Pegs under pressure

Beyond the adverse implications for economic growth, fiscal solvency, and external balances, the sustainability of currency pegs in GCC countries has also come under scrutiny in recent quarters (Figure 1). With the exception of Kuwait, all GCC countries have pegged their currencies to the US dollar for many years. Given their economic structure and high dependency on hydrocarbon exports, an exchange rate peg is generally a feasible approach, in our view. Current multi-year lows in energy prices, however, are testing policymakers' resolve.

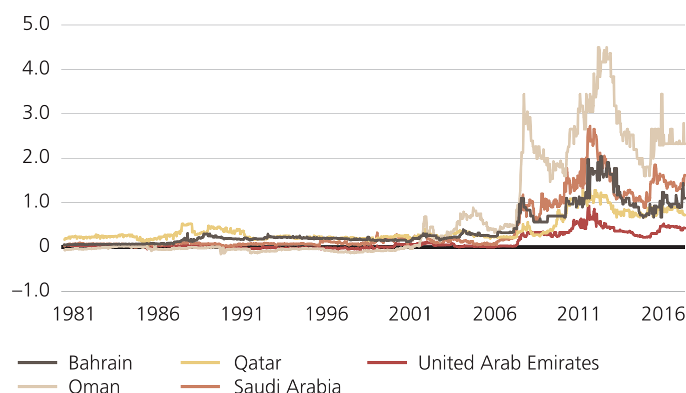
Need to adjust economic policies

With energy prices low, policymakers in the region will have to address major economic challenges and set fiscal and economic policies to sustain the pegs, especially if prices should stay low for longer. Although several of the reform measures that need to be addressed might prove difficult to implement, we think policymakers have the willingness and ability to pursue them before reassessing their commitment to the exchange rate regimes.

Figure 1

Lower hydrocarbon prices have increased pressure on pegged exchange rates

Forward pricing (measured by 12-month forward points) relative to spot rate, in %



Source: UBS, Bloomberg, as of end-July 2016

Benefits outweigh costs
Exchange rate pegs are popular among hydrocarbon exporters because oil and most other commodities are traded in US dollars. In the case of the GCC countries, the pegs withstood earlier periods of pressure, and authorities have built a strong track record over past decades. These regimes foster policy credibility and low inflation, and reduce transaction as well as hedging costs. Essentially, they act as an anchor of economic and financial stability in the region. Currency devaluation would lead to an erosion of income and higher inflation, implying a rising risk of social tensions. Also, capital flight would probably increase.

On the other hand, if an economy maintains a stable exchange rate and allows international capital mobility, it cannot pursue an independent monetary policy, as suggested by the "impossible trinity." This basic relationship also applies to the above-mentioned GCC economies, and means they have to follow the US Federal Reserve in hiking the policy rate at a time when growth is slowing in their own economies.

Also, when looking at external and fiscal balances of hydrocarbon exporters with a pegged exchange rate regime, an adjustment via the exchange rate is restricted. After the recent terms of trade shock (decrease of the ratio of export prices to import prices), a flexible exchange rate could increase fiscal revenue in local-currency terms and absorb pressure on the current account balance. As this has not happened in the GCC region, some countries are running significant current account deficits after years of large surpluses (Figure 3), and central banks have to fill these gaps with reserves. Therefore, the reserves that had been accumulated in previous years have started to erode. This means that without an exchange rate adjustment, the depletion of reserves will continue in the current environment. However, the high dependence on hydrocarbon exports limits the possible competitiveness gains from a potential devaluation. A considerable proportion of imports is denominated in US dollars, and gets more expensive from a domestic perspective in case of devaluation. This would imply higher inflation and thereby an erosion of purchasing power, again speaking against an adjustment in regional FX pegs.

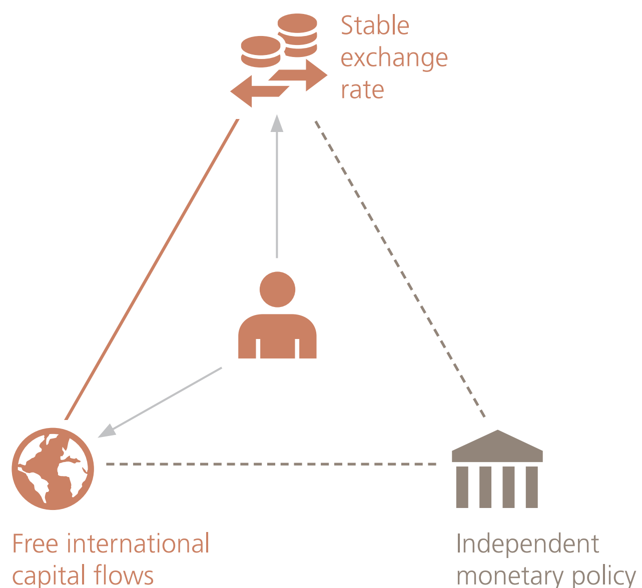
The impossible trinity

Economic theory suggests that policymakers cannot pursue a stable exchange rate, free international capital flows, and an independent monetary policy at the same time. Looking at the GCC region, countries currently give up on an independent monetary policy, which they largely import from the US, but can maintain free capital flows and a stable exchange rate. This choice might change over time.

Figure 2

Policymakers can only pursue two of the three goals, but objectives might change over time

Current policy objectives within the impossible trinity

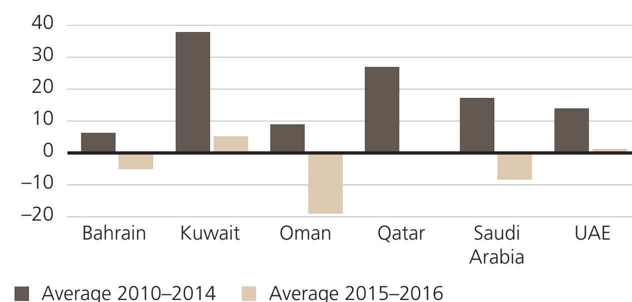


Source: UBS

Figure 3

Higher pressure on external balances

Current account balances, in % of GDP



Source: IMF WEO Database, as of April 2016

In our view, policymakers are aware of these costs and benefits, and have underpinned their commitment to currency pegs in recent statements. We expect authorities to maintain the current exchange rate regimes over the coming years. When looking at the ability to pursue such a policy, the region is in a good position overall. However, some countries are better positioned than others, especially over the medium to longer term (see Info Box: *Large buffers in place, but country differences matter*).

Large buffers in place, but country differences matter

Reserves as well as external and fiscal balances are key indicators regarding the ability to defend the exchange rate pegs. The former are sizable in the GCC region on aggregate, but are not indefinite, and significant differences exist between countries. The sustainability of the pegs will depend on a combination of factors that need to be closely monitored: First, the duration of oil prices staying at low levels, and second, the success of fiscal consolidation and external rebalancing without FX adjustments.

Saudi Arabia: Policymakers repeatedly reaffirmed their commitment to defend the peg, and we think the high level of reserves allows the Saudi Arabian Monetary Agency (SAMA) to maintain the current FX regime for now. Also, authorities have a proven track record since establishing the peg in 1986. However, challenges are significant, since financial buffers might be exhausted within five to six years without any adjustments, and if oil prices decline to USD 30/bbl again. Therefore, significant fiscal measures are required, and the budget dynamics will show how quickly progress becomes visible. In 2016, we will likely see another double-digit deficit. Meanwhile, efforts to diversify the economy and attract capital inflows have increased.

United Arab Emirates: Compared to the rest of the region, the UAE are better diversified, as shown by a lower dependency on hydrocarbon exports. Also, fiscal breakeven oil prices are lower, financial buffers higher, and the external balance more resilient. These conditions should enable the UAE to maintain the peg based on current conditions. Also, high external debt levels of quasi-sovereign entities argue against devaluation.

Qatar: Fiscal breakeven oil prices are among the lowest in the GCC region, and financial buffers among the highest. Although the external balance has deteriorated, the country still ran a current account surplus in 2015. These conditions should enable Qatar to maintain the peg based on current conditions. Also, high external debt levels of quasi-sovereign entities argue against devaluation.

Bahrain and Oman: These two countries are the weakest links in the region; financial buffers are significantly lower at current spending rates. In Oman, the current account balance deteriorated significantly last year (double-digit deficit, compared to a small surplus before). Bahrain's current account balance also moved into deficit, but looks more manageable. On a relative basis, Bahrain is also less dependent on hydrocarbon exports than Oman. However, fiscal breakeven oil prices in both countries are among the highest in the region. Estimates suggest that financial buffers will be exhausted in less than five years, assuming an average oil price of USD 50/bbl.At lower oil price levels, this process would be faster. However, these calculations are based on simplified assumptions of fiscal spending and raising of debt – policymakers can therefore influence these dynamics.

"Too small to fail"

We see a high likelihood of support by other GCC countries to contain spill-over effects. In a scenario where a first peg breaks in the region, the pressure on the remaining countries would increase significantly via higher dollarization of deposits and speculative pressure. Countries like Bahrain and Oman can therefore be seen as "too small to fail". We would reassess our base case if oil prices decline again and stay low for longer, reserves decrease sharply, US interest rates rise strongly, or if geopolitical/social tensions rise in the region.

Thinking beyond the next years
In the long run, the sustainability and suitability of the exchange rate pegs will likely change in one way or the other. In this context, we monitor a wide range of indicators, including financial buffers, progress on economic reforms, budget balances, debt levels, growth-inflation dynamics, and so on. Eventually, however, we can reduce complexity by looking at two key dimensions: hydrocarbon prices and progress on reforms, especially fiscal policy and higher diversification of the economies, to get a sense of how the situation might look in three to five years and beyond.

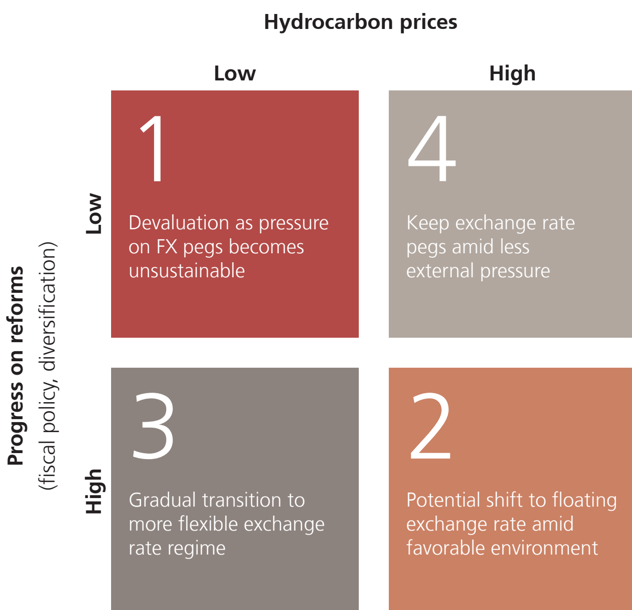
What is the most likely scenario? That's hard to say given the uncertainties about the progress on economic diversification and future hydrocarbon prices (Figure 4). In our view, a scenario of lower hydrocarbon prices compared to the above USD 100/bbl period from 2011 to mid-2014 and some progress on reform is a reasonable working assumption in the current environment. Accordingly, it will be pivotal to reassess benefits and costs of the pegged FX regimes on a regular basis.

As summarized above, the conditions in the individual countries differ significantly. At some point, sustainability and/or suitability considerations might lead to a reassessment of the current exchange rate regimes. In our view, however, abandoning the pegged regimes does not necessarily imply a sharp devaluation, except in the scenario of a prolonged period of low hydrocarbon prices and lack of economic diversification, in combination with rising fiscal and external pressure. Importantly, the transition to more exchange rate flexibility might be done in steps, for instance, through managed floating regimes or a basket of currencies (and potentially oil) as a reference instead of just using the US dollar.

Figure 4

Thinking beyond

Long-term scenarios based on hydrocarbon prices and progress on reforms



Scenarios

1 An environment of low hydrocarbon prices and low progress on reforms will likely prove pegged FX regimes unsustainable at some point. In this scenario, persistent high pressure on exchange rate pegs could ultimately force authorities to adjust the exchange rate regime. Devaluation would facilitate the required adjustment of the economy, but initially trigger a shock to confidence and inflation.

2 At the other end of the spectrum is a goldilocks scenario, where authorities have a high degree of policy flexibility. With high hydrocarbon prices and significant progress on reforms, it might make sense to move to a floating exchange regime in some cases. A better economic diversification raises questions about the suitability of a pegged exchange rate, while high hydrocarbon prices ease external pressure. This might shift the risk-reward of the current exchange rate regime: A more flexible exchange rate would allow pursuing an independent monetary policy, which is positive. This said, competitiveness gains for the non-hydrocarbon sector are not a given, because high energy prices might actually lead to an appreciation of the domestic currency.

3 A successful transition to a new and more sustainable growth model amid low commodity prices could raise questions about the sustainability and suitability of a pegged FX regime. In this scenario, we might see a gradual transition toward more exchange rate flexibility, which should support the non-hydrocarbon sector as weaker currencies would be a likely consequence.

4 Last but not least, a return to the earlier growth model with high hydrocarbon prices but low progress on economic diversification should see fading pressure on the exchange rate pegs. Current account surpluses would allow for a renewed accumulation of reserves. Incentives for reforms will likely remain low, but countries would remain exposed to renewed setbacks in energy prices.

Source: UBS

Chapter 5

Iran, striving for global reintegration

Michael Bolliger, Head Asset Allocation Emerging Markets
Jérôme Audran, analyst

Iran is set to become one of the fastest growing countries in the Middle East over the coming years. The country not only benefits from its high degree of economic diversification; pent-up investment demand in Iran's large oil and gas fields and the sizable potential of its domestic market will likely attract interest from abroad. Low energy prices, limited resources for fiscal spending, and the necessity for a relatively tight monetary policy stance may hinder the pace of economic expansion. Risks to our view include a failure to comply with the nuclear deal, lower for longer energy prices, as well as adverse political and geopolitical developments in Iran and the region.

Teheran / iStock

Improving growth prospects after sanctions

The removal of the nuclear-related sanctions in early 2016 should significantly boost future economic growth, after sanctions took a serious toll on the Iranian economy in recent years (Figure 1). Iran will initially seek to upgrade the oil and gas sector as well as its infrastructure capacities. The economic potential of the country is large; we estimate that its real economic growth rate could reach 4%–6% in the years ahead.

A diversified economy with large potential
With its population of 82 million people, of similar size to Germany, Iran can become one of the largest markets in the region. Iran ranks second after Egypt in terms of its population size (Figure 2), and with a nominal GDP of USD 380bn, Iran has the second-largest economy after Saudi Arabia (Figure 3). However, when comparing the country's GDP per capita with the rest of the region, Iran falls behind, especially versus peers with a comparatively high level of hydrocarbon resources. A simple regression that explains the size of the economies in the region by the size of their population and hydrocarbon reserves suggests that the size of the Iranian economy should be around USD 470bn, an upside of almost USD 100bn from its current size.

Iran's economic structure is more diversified than that of its Middle Eastern neighbors, a clear advantage at times of comparatively low energy prices. In 2015, the oil and natural gas sector accounted for 11% of Iranian GDP, well behind manufacturing (25%), agriculture (23%), services (21%), and construction (20%). To be fair, this comparatively better diversification is also a consequence of previous sanctions that largely prohibited energy exports and foreign investments. In our view, Iran's better diversified economy, as well as its large, young, and well educated population supports its growth prospects relative to peers in the region.

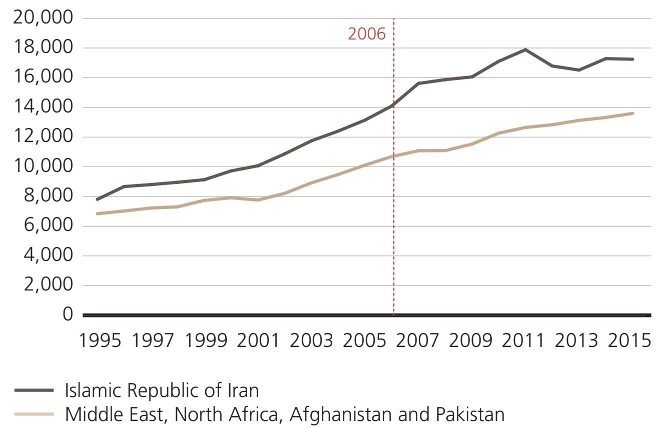
Growing interest from abroad
The removal of the nuclear-related sanctions will allow some foreign companies to invest in Iran. The pent-up demand and the sizable potential in the private sector has generated a lot of foreign interest in building up business relations. Since the removal of sanctions in January 2016, President Hassan Rouhani has visited Italy and France, where business deals worth USD 55bn were signed, and hosted leaders of several Asian countries, including India, China, and South Korea.

Figure 1

Sanctions taking a toll on the Iranian economy

GDP per capita based on purchasing power parity, in USD

In 2006, the UN Security Council imposed sanctions (Resolution 1696). Other sanctions were introduced earlier already.

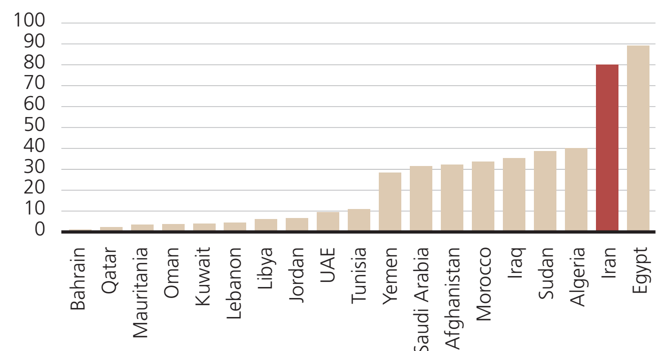


Source: IMF, UBS, April 2016

Figure 2

Number 2 in terms of population…

Population, in million

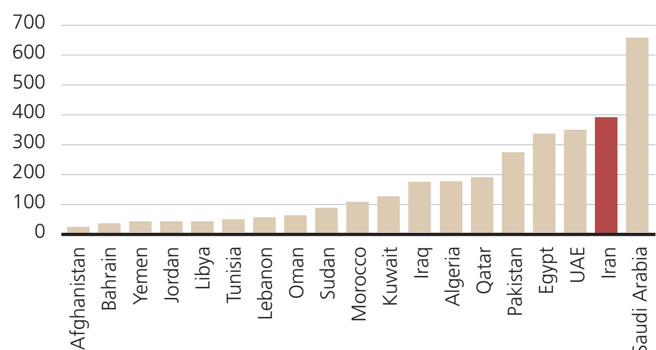


Source: IMF, UBS, July 2016

Figure 3

… and economic size

Gross domestic product, current prices, in USD billions



Source: IMF, UBS, July 2016

Russia is also growing business ties with Iran. Already back in 2015, President Vladimir Putin visited Iran's supreme leader, Ayatollah Ali Khamenei, and signed a number of provisional agreements. More recently, Russia's Ministry of Finance announced that it aims to grant two loans to Iran to finance a railway project between central Iran and its northern border, and a thermal power plant in Bandar Abbas. The long-standing close political ties between the two countries and Russia's willingness to offer project-related loans might put Russia in a favorable position to engage in business opportunities. With the ongoing sanctions against Russia from the US and Europe, the Kremlin might see this as an opportunity to diversify its economy and to grow its regional influence. We would not be surprised to see similar initiatives from other major global players such as China or India.

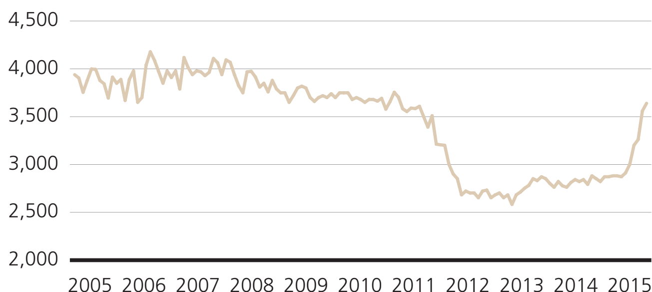
Ramping up energy exports
The oil and gas industry is probably the sector with the highest initial potential. According to data compiled by British Petroleum, proven oil reserves stood at around 160 billion barrels at the end of 2015, the fourth-largest reserves worldwide, accounting for almost 10% of the global total. Natural gas reserves of 34 trillion cubic meters are the highest proven reserves in any single country.

While Iran will unlikely grant unconditional access rights to its oil and gas industry to foreign companies, the necessity to ramp up production and increase exports is high, especially at times of lower energy prices. Energy exports have fallen sharply in recent years, and daily production declined in sync, from around four million barrels per day 10 years ago to about 2.7 million in 2014 (Fig. 4). The sharp drop in energy prices since 2014 amplified the pressure on the public sector and the economy. The renewed access to global markets, growing output, and the recovery in prices have helped to ease fiscal constraints in 2016, and further relief might follow. We see the pick-up in production and exports, but also investments in the oil and gas industry, as well as a growing petrochemical industry, as some of the key drivers behind the economic acceleration we expect for the years ahead. As such, the trend in energy prices will be a key factor for economic growth. The energy sector alone requires USD 50 billion of investment in the next five years, we think. The first of Iran's new oil and gas investment contracts for international companies should be launched in 2016 and will invite bids to develop 10–15 fields, according to the oil minister.

Figure 4

Ramped-up oil production

Crude oil production, in millions of barrels per day



Source: IEA, UBS, as of July 2016

Sanctions still represent uncertainty
However, many companies will likely hesitate to regain exposure. The US still maintains broad prohibitions on transactions by or involving US persons, and the US imposed new sanctions on companies and individuals connected to Iran's ballistic missile program only one day after the lifting of nuclear-related sanctions. Companies seeking to conduct business with Iran will need to ensure that their business partners are not linked to the Revolutionary Guards or other sanctioned companies or individuals, which can be difficult to prove.

These sanctions are not only relevant to US companies, they can also affect non-US companies or international investors wishing to buy shares of companies listed domestically. For example, a USD 25bn Airbus deal to provide 118 aircraft to renew the fleet of state-owned Iran Air requires a US approval, as some components are manufactured in the US. Sanctions on local entities and individuals, some of them connected to listed companies, can prevent foreigners from investing in Iranian companies. The capacity build-up will therefore likely be a multi-year story, with ongoing sanctions, subdued energy prices, and limited fiscal leeway being key hurdles, despite the vast interest from abroad.

Reforms needed to regain competitiveness
In addition, Iran's economic fortune will crucially depend on its ability and willingness to get the domestic economy back in shape, tackle domestic reforms and reintegrate the economy back into global value chains. Beside the uncertainty related to remaining sanctions, structural factors have been barriers to investment, both for domestic and foreign companies.

Palangan, Islamic Republic of Iran/ iStock

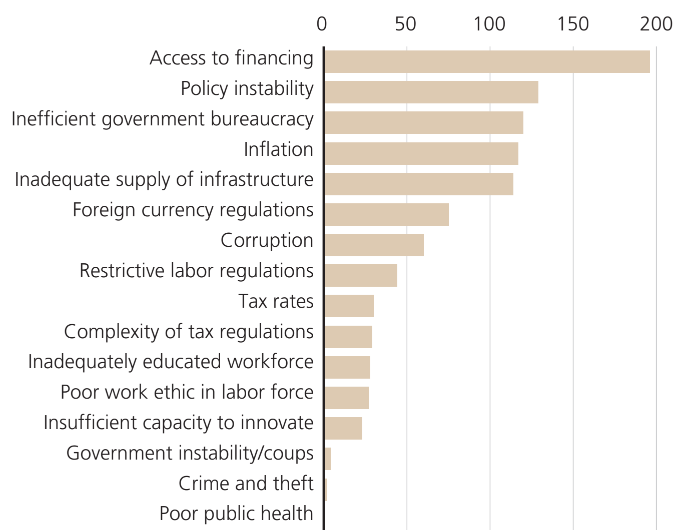
The World Bank's Ease of Doing Business ranking, which placed Iran 118th out of 189 assessed countries in 2015, ranks Iran lower than several of its peers in the region, including Saudi Arabia (ranked 82nd in 2015), Qatar (68th), and UAE (31st). From the larger economies in the Middle East and North Africa, only Egypt (131st) and Iraq (161st) rank lower than Iran. The WEF Global Competitiveness Index (2015–2016) also sees Iran behind the more developed economies in the Middle East.

Limited access to financing, policy instability, an inefficient government bureaucracy, elevated inflation, and an inadequate supply of infrastructure were seen as the most pressing obstacles to doing business in Iran, according to the WEF (Figure 5). In the World Bank survey, trading across borders and the protection of minority investors are areas where Iran is seen lagging its peers in the region (Figure 6).

Acknowledging the manifold challenges, we think it is fair to assume that the removal of nuclear-related sanctions, the investment in infrastructure, and the pick-up in energy exports should result in progress on several of these issues. In addition, several Iranian banks were reconnected to SWIFT, a system for international financial transactions, following the removal of nuclear-related sanctions. This will facilitate exports to European countries, and ease the repatriation of profits and access to international financing for foreign companies operating in Iran. On the other hand, political and economic resistance to reform and low energy prices might compromise the painful but necessary reform agenda of President Hassan Rohani and his supporters.

Figure 5

Hurdles to running a business in Iran

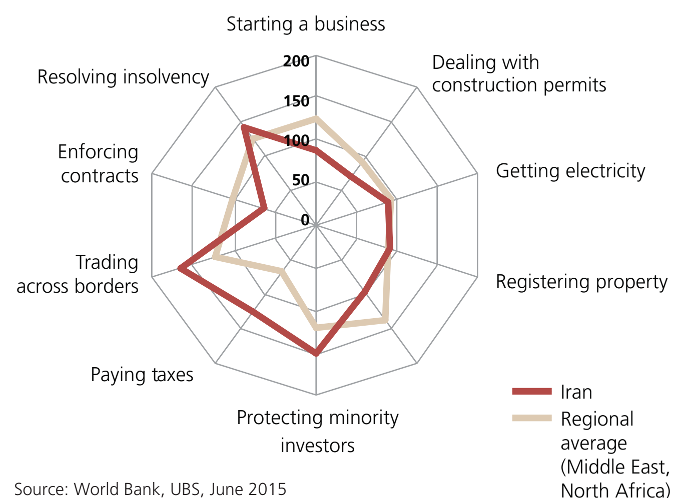


Source: WEF, UBS, June 2016

Figure 6

Iran versus its peers in the region

Ease of Doing Business Survey



Source: World Bank, UBS, June 2015

Exchange rate: Rial expected to adjust further

The Iranian central bank, Bank Markazi, devalued the Iranian rial back in June 2013 to USDIRR 24.800 from USDIRR 12.260, and the currency has since depreciated further versus the US dollar to around USDIRR 30.955 in August 2016. At the same time though, the unofficial exchange rate stands at around USDIRR 35.000 in August, implying that the access to foreign exchange via official channels is still not sufficient to meet demand.

The pick-up in inward investment and energy exports after the removal of nuclear-related sanctions is set to boost the availability of foreign exchange. Together with the access to foreign assets that were previously frozen abroad, we think this should improve the room for maneuver for Bank Markazi, while accelerating growth domestically should help to grow confidence in the rial. On the other hand, the growing presence of foreign companies will result in higher income repatriation. Pent-up demand for import goods after the sanctions should result in a rapidly expanding import bill. The net effect on the exchange rate might be mixed, however, as the growing availability of foreign goods and services should have a deflationary impact, too.

Beyond energy exports, the country's ability to foster competitiveness will be of high relevance for the future trajectory of the rial. Bank Markazi's commitment to containing inflationary pressure, a challenging task amid the sharp rise in money supply following the removal of sanctions, will be another important driver of the rial in future.

Monitor the gap between the official and parallel exchange rate
Overall, we expect the rial to continue its depreciation trend versus the US dollar in the years ahead. A narrowing gap between the official and the parallel exchange rate can be seen as an indication of growing confidence in the rial, a sound monetary policy stance, and sufficient access to foreign exchange. This will be important for companies increasing their investment and business activity in the country. Recent comments by Bank Markazi also point in this direction.

Fiscal policy: Ongoing pressure from low energy prices

The fiscal windfall from the pick-up in energy exports and the repatriation of previously frozen assets will not be sufficient to alleviate all the pressure on the fiscal balance sheet. As elsewhere in the region, energy prices are currently too low to balance the fiscal account, which requires painful and unpopular adjustment. Diversifying the economy and the tax base further away from the oil and gas industry will therefore be crucial in keeping public debt on a sustainable trajectory. Moreover, the government will have to rely mainly on domestic banks to fund the fiscal deficit for now, despite efforts to obtain a sovereign credit rating from international rating agencies.

Youth unemployment: A possible source of instability

While Iran's young population is an important pillar for its significant growth prospects, it also represents a possible source of instability. According to the UN, roughly 40% of Iran's total population was younger than 25 years in 2015. Insufficient job opportunities for young people have led to instability in the region, and Iran is clearly at risk too, with reported youth unemployment of 25% in 4Q 2015. Although UN forecasts point toward declining population pressure in coming years, Iran's ability to provide sufficient job opportunities for its young population will be important in reducing the risk of instability and unrest.

Political outlook: Gearing up for the presidential elections in 2017

Parliamentary elections, which took place over two rounds in early 2016, resulted in a victory of more moderate forces, undoubtedly benefiting from the positive momentum following the removal of nuclear-related sanctions in January 2016. As moderates and reformists now have a greater say in the newly elected parliament, we would expect President Rouhani's reform agenda and the nuclear deal to get more support from the parliament. However, conservatives and hardliners still dominate or hold some of the country's main institutions of power, including the Assembly of Experts, the Islamic Revolu-

tionary Guards, and above all, the Supreme Leadership. The government will also have to confront a range of vested interests, as they could block reforms. The outcome of the presidential elections in June 2017 will therefore be crucial in maintaining the trend toward greater political and social freedoms, supporting the nuclear deal, and more broadly speaking, fostering a pragmatic dialogue with the West. Incumbent President Rouhani will likely run for re-election. We expect the economic gains from the nuclear deal to support his campaign, but note that it is too early to call the outcome of the election.

Geopolitical concerns: Risks to the nuclear deal and stability in the region

The possibility that President Rouhani will not be re-elected in June 2017 is only one of many factors that threaten the nuclear deal. The deal has been facilitated by the close relationship between Iran's foreign Minister Javad Zarif and US Secretary of State, John Kerry, the pragmatic stance of US President Barack Obama and President Rouhani, and, the approval of the Supreme Leader. The US will have a new administration in January 2017, Iran might have a different president in June 2017, and questions over the supreme leader's health also pose risks to the longevity of the deal. We find it important to note that the Joint Comprehensive Plan of Action between Iran and the P5+1 group (i.e., the five permanent members of the UN Security Council and Germany) was designed in a way that sanctions can return immediately if Iran is seen not to comply with its commitments.

The balance of power between moderate and conservative forces will also be crucial for the region more broadly. A shift toward more conservative forces in Iran might result in a more radical rhetoric toward the countries in the region and the West. In addition, Iran's return to the global stage and a period of above-average growth will likely be accompanied by growing influence in the Middle East. This might fuel the rivalry with Saudi Arabia and weigh on the relationship with other GCC member states. A direct confrontation between the two biggest countries in the region seems highly unlikely, in our view, due the high costs of such a conflict, as well as existing pressure points on their economies from low oil prices. Instead, both countries will try to leverage their economic power to maintain or grow their influence in the region.

Opposing views might also weigh on the various conflicts in the region, be it in Syria or Yemen, for instance. This represents another risk to stability in the region. Iran's backing of groups such as Hizbullah in Lebanon or Hamas in Palestine could also lead to growing tension with Israel.

Growing threats from terrorism

The rise of terrorism in the region is another concern. Several countries in the MENA region, such as Afghanistan, Iraq, Syria, Yemen, and Libya are regularly confronted with violence, humanitarian crises, and subdued economic prospects, at least in parts of their territory. This provides a fertile ground for terrorism organizations, such as ISIS, to expand their reach and influence.

Despite some terrorist attacks, economic growth in MENA has been fairly resilient to the heightened threat level. The tourism industry would be most at risk from a flare up in violence, in our view, and hydrocarbon prices could also spike on a rising perception of growing violence in the main energy exporting countries. International investors are therefore well advised to closely monitor geopolitical developments, as they could affect not only the economies and financial markets in the region, but also global financial markets via bouts of elevated energy prices.

Obstacles and opportunities in shifting investment landscape

Michael Bolliger, Head Asset Allocation Emerging Markets
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The decline in hydrocarbon prices has resulted in a drawdown of petrodollars invested in global markets. This has amplified the impact from lower energy prices on growth and financial markets. At the same time, the growing need of economic adjustments creates opportunities for international investors in regional financial markets. The GCC region will become a more important player in bond offerings, and there are attractive dividend yields in regional equity markets as well as private companies with a large potential. In our view, the region will likely play a growing role in the global investment landscape in the years ahead.

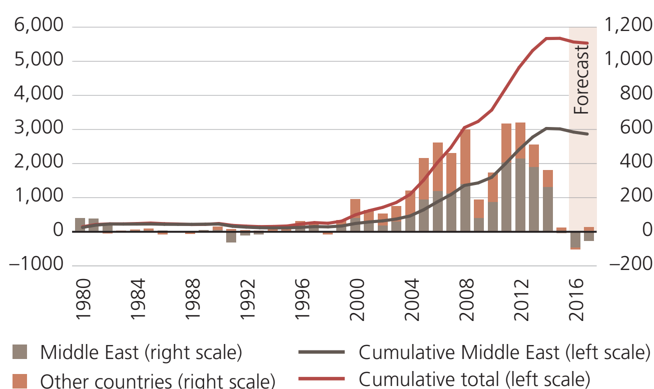
A bird's eye view

Current account surpluses from oil-producing emerging economies exceeded USD 400 billion per year between 2005 and 2014, or 0.6% of global GDP every year, out of which the countries in the Middle East accounted for USD 270 billion, according to our estimates (Figure 1). As a consequence, the Middle East has accumulated substantial wealth. Current holdings in foreign exchange reserves, sovereign wealth funds and other vehicles might exceed USD 3 trillion according to our calculations. The proceeds of energy exports, so called petrodollars, are invested globally and play an important role for financial markets.

Figure 1

A sizable surplus

Current account surpluses of energy exporters, in USD bn



Sample includes Algeria, Angola, Bahrain, Gabon, Iran, Kuwait, Libya, Nigeria, Norway, Oman, Qatar, Saudi Arabia, UAE, Russia, and Venezuela

Source: International Monetary Fund, World Economic Outlook Database, April 2016

Changing tides
The structural decline in hydrocarbon prices is changing the tides of petrodollar flows, and has important implications for global financial markets beyond the direct relevance of energy prices to global growth and investor sentiment. Current account surpluses of most oil-exporting economies in the Middle East became deficits in 2015, and are set to remain in negative territory in the years ahead. This is in particular the case for the GCC region, where currency pegs do not allow for external adjustments. As a consequence, foreign exchange reserves and assets held in sovereign wealth funds (SWFs) have started to shrink, leading to the repatriation of petrodollars.

For the energy exporters in the region, the most direct impact is that liquidity has tightened in the domestic banking sector. Governments have started to withdraw part of their deposits held with local banks and issue more bonds than in the past. This crowds out lending to the private sector to some extent and adds upward pressure on interest rates which, in turn, weighs on growth. Meanwhile, the collapse in internal capital flows into the emerging markets can be seen as part of a vicious cycle that links fewer petrodollars and falling growth to weaker capital flows into the emerging markets.

Importantly, the need for economic diversification and fiscal consolidation will likely imply that more money will be required locally. Again, this could result in further repatriation of assets invested overseas, potentially weighing on global financial markets and growth prospects in certain countries or regions.

At the same time, current reform prospects and efforts to diversify away from energy-dependent industries create opportunities for international investors in regional financial markets.

Sovereign wealth funds – global investment giants

The Middle East is home to several sovereign wealth funds (SWFs), including some of the largest globally. According to data compiled by the Sovereign Wealth Fund Institute, SWFs in the region hold an estimated USD 2.9 trillion, or roughly 40% of global holdings in such entities (Figure 2) – remarkable for a region that only accounts for 4% of global GDP.

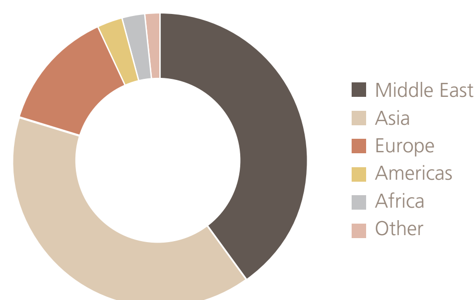
Restructuring to improve efficiency and effectiveness of SWF
Saudi Arabia's Deputy Crown Prince Mohammed bin Salman recently announced a plan to create the world's largest sovereign wealth fund, which should eventually control more than USD 2 trillion in assets and also include the shares of state-owned oil giant Aramco. The entity will be at the center of the Kingdom's development strategy for 2030 and play an integral part in its plan to diversify the economy away from oil. Abu Dhabi recently announced the merger of two of its largest government investment vehicles, Mubadala Development Company and International Petroleum Investment Company (IPIC). The Emirate aims to achieve costs savings, enhance economic value, and broaden sector diversification.

Limited transparency on asset allocation, but global financial markets of high relevance
The assets are typically deposited in the domestic banking systems or invested globally in the form of portfolio and foreign direct investments Although it is hard to trace the ultimate allocation of these petrodollars due to a lack of data, some estimates show they are invested in a wide range of assets globally, in particular equities and liquid bond markets, and deposited with domestic and foreign banks.

Figure 2

Accounting for 40% of global holdings

Estimated shares of holdings in sovereign wealth funds, in %



Source: UBS, SWFI, August 2016

GCC to become a more important player in EM bonds

With weaker oil prices, the GCC sovereigns have experienced a significant decline in fiscal and export revenues. Despite consolidation efforts, government expenditures and imports remain at elevated levels, resulting in large fiscal and external deficits. In addition, spending cuts put downward pressure on growth. As a consequence, sovereign credit fundamentals have deteriorated, in particular those of Bahrain, Saudi Arabia, and Oman. Many corporate issuers have been downgraded, underscoring the tight links between corporate and sovereign credit fundamentals in the region. Most downgrades occurred at a time when sovereigns were scaling up external borrowing, increasing the costs to finance deficits.

Record high new issuance

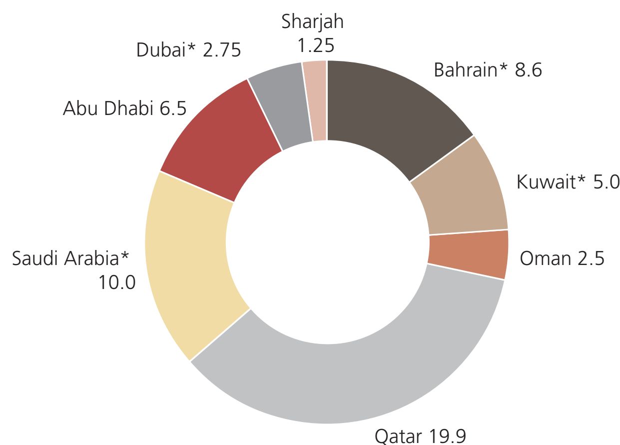
External debt issuance from GCC sovereigns has reached record levels this year. Around USD 18 billion has already been issued, with Eurobond placements from Qatar, Abu Dhabi, and Oman. We expect a similar amount during the rest of the year, the bulk likely coming from Saudi Arabia and Kuwait, two new issuers. Iran is also exploring a return to the Eurobond market for the first time since 2002, although the timing is unknown. The country has increased its efforts to secure a credit rating, which could help attract bond investors, if successful. The total net financing could thus reach an impressive USD 33bn in 2016, equivalent to the combined net issuance from all emerging market sovereign issuers between 2013 and 2015.

This would increase the size of the regional Eurobond market and its issuer base rapidly. We forecast the total amount of publicly listed sovereign Eurobonds outstanding to more than double this year and cross the USD 50bn mark (Figure 3) for the first time in history. The market should continue growing at a sustained pace thereafter, we believe. Consequently, we expect the region to gain in importance and also to attract higher interest from international investors. Although the correlation among bond issuers is high, given their common exposure to energy prices, we think the entrance of new issuers enables investors to enhance portfolio diversification by gaining exposure to the region and to idiosyncratic stories. This also holds for the corporate sector, which we expect to grow in terms of market capitalization and issuers.

Figure 3

GCC Eurobond market set to cross the USD 50bn mark in 2016

Forecast amounts for Eurobonds outstanding, in USD billion



* Bond issuance expected for the remainder of the year: Saudi Arabia: USD 10bn; Kuwait: USD 5bn; Bahrain: USD 1bn; Dubai: USD 1bn

Source: Bloomberg, UBS, as of July 2016

Choose carefully

Demand for bonds has historically been skewed toward local investors, particularly banks, who often follow "buy and hold" strategies. This has supported valuations while making the bonds less liquid compared to similar instruments from other countries. Local demand has softened in recent quarters, however, due to lower oil prices. As sovereigns withdrew deposits from banks, liquidity has tightened and local banks' demand for regional bonds has declined.

This technical backdrop, coupled with a challenging fundamental outlook, has been putting pressure on bond valuations. Although spreads might still feel upward pressure for a while, growing evidence of a successful transition toward a more diversified growth model, sustainably higher hydrocarbon prices, or declining geopolitical uncertainties could all trigger a decline in the risk premium. Investors need to follow the issuer-specific developments carefully, however, in order to pick the most interesting opportunities.

Attractive dividend yields in regional equity markets

Equity markets in the Middle East countries are quite diverse in terms of their size and liquidity. Capitalization exceeds USD 100bn in the UAE and Qatar. Both countries have been part of the MSCI Emerging Markets Index since May 2014, although with relatively small weights of around 1%, similar to Poland or Chile. Equity markets in Kuwait, Bahrain, Lebanon, Oman and Jordan are even smaller. These markets are part of the MSCI Frontier Index, an equity index that covers smaller, less liquid markets. These countries have foreign ownership restrictions and/or capital controls, but fulfill the criteria of a minimum market capitalization of USD 630 million.

The trend toward more privatization and an easing of foreign ownership restrictions should lead to growing market capitalizations, eventually resulting in more upgrades to the MSCI Emerging Markets Index. Often, such index inclusions result in growing interest from abroad, leading to periods of outperformance in the run-up to the actual index inclusion.

Attractive dividend yields

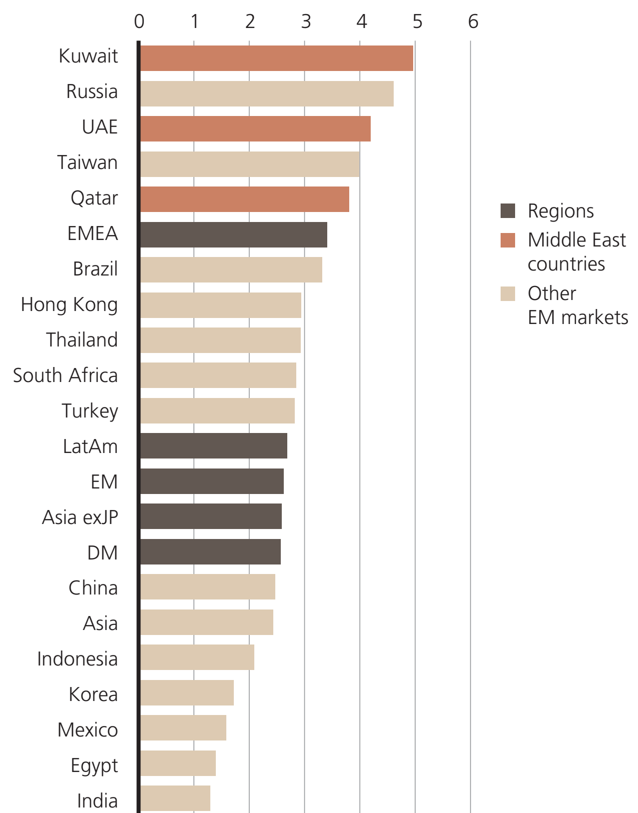
UAE, Qatar and Kuwait provide exposure to high dividend-yielding companies. More than 60% of the indices are financials, in particular banks, with strong dividend payout ratios. In fact, these countries rank among the highest yielders in MSCI Emerging Markets (Figure 4). Dividend yields of 5%, 4.2%, and 3.8% in Kuwait, Qatar and UAE, respectively, compare favorably to MSCI EM or MSCI World, with yields around 2.6% (all numbers based on 12-month forward consensus estimates as of August 2016). In addition, yields in UAE and Kuwait are above their 10-year averages and consensus estimates also imply a high 12-month forward EPS growth.

Financials and real estate are two of the most widely represented sectors in the region. In the banking sector, loan growth has stalled in recent years due to lower hydrocarbon prices, and the net interest margin has contracted slightly due to higher deposit costs. Non-performing loans have been on the rise, again driven mainly by lower energy prices. However, there are several banks that boast low operating costs and maintain their return on assets at comparatively high levels.

Figure 4

Offering among the highest dividend yields globally

Dividend yields, 12-month forward, in %



Source: UBS, Bloomberg, August 2016

Private companies with a large potential

Beyond the publicly listed companies, we see a wide range of interesting opportunities in privately held companies. Agriculture, renewable energy and tourism are three areas with a large potential in the Middle East, we think.

Food security has always been a high priority issue for Middle Eastern countries given the dearth of arable land and water scarcity. In recent decades, this issue has been compounded by a sharp increase in population, increasing the strain on land and water resources. Governments in the region are taking a closer look at the integrated supply chain management across the entire agro value chain. They are modernizing the techniques employed to reduce national exposure to international price volatility and enhance the reliability of supply. This means, inter alia, upgrading storage capability, investing in agribusiness to secure supply, and using derivatives to hedge price volatility. Despite the numerous challenges Middle Eastern countries have faced, they appear to have made progress over recent years. Poorer countries across the region are more vulnerable, but selected self-help opportunities exist and a number of countries stand to benefit from the Middle East's growing importance as a global food hub.

Across the Middle East, solar power is coming into its own, with PV plants ramping up exponentially since 2010 (Chapter 3 Info Box *Solar power – the new yellow gold*). The Middle East faces growing energy needs driven by a rapidly expanding population and energy intensive desalination. Faced with budgetary constraints, wasteful energy subsidies for electricity generation and gasoline are being phased out. Solar energy now compares favorably with oil and LNG for use in electricity generation and serves as a useful peak energy provider. As the world transitions from fossil fuels to clean power, energy will remain at the forefront in the Middle East.

The Middle East had almost no revenues from tourism a few decades back. Several initiatives, however, have started to attract tourism beyond the long established pilgrimage to Mecca or Medina. In 2014, Saudi Arabia, Qatar, or the UAE generated inflows of USD 10–15 billion, catching up to destinations like Mexico or South Africa, which have been tourism hubs for many years. We believe this trend has further to go, supported by various initiatives in the region (Chapter 3 Info Box, *Tourism as a pillar of growth*).

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