GCC Economic Review

An uneven recovery

After last year's economic rebound which was fueled by oil prices and public spending, 2011 was expected to be marked by a steady consolidation of the recovery along with a transition to more broad-based growth. The recent period of political instability in parts of North Africa and the Middle East may now have called this into question by further reinforcing the leading drivers of last year's recovery. While the oil price rebound will likely support confidence, investor mood has been tested by the political instability as well as recurrent concerns about global growth.

- **The inflation outlook is uneven**. In recent years, inflation has developed some momentum across the region, albeit more slowly in the Gulf coast economies which have experienced housing market corrections. The near-term price pressures are mainly linked to global food prices but Saudi Arabia will likely face additional build-up from the increased government spending.
- **Regional fiscal policy is beginning to show signs of diverging.** Saudi Arabia has significantly ramped up government spending through recently announced measures, and similar steps are being taken to varying degrees in Kuwait, Bahrain, and Oman. By contrast, Qatar and especially the UAE are more cautious, in the latter case because of the need for fiscal retrenchment after an unusually sharp economic cycle.
- **Fiscal sustainability is presenting itself as a policy issue of growing importance.** The dramatic increases in government spending have been made possible in large part by higher oil prices. Most regional governments are retreating from their traditional caution and have significantly increased their oil price assumptions in recent years. While macroeconomic stability in the near term is not in question, greater attention is beginning to be paid to fostering the efficiency of government spending and crowding out. These are likely to remain key policy focus areas in the coming years.
- **Energy sustainability has moved up the agenda.** The highly energy-intensive mode of development of the Gulf economies has raised a growing number of issues about sustainability, especially since current patterns of energy demand and making the rapidly growing economic more – not less – energy intensive. The situation is particularly acute in gas where the region's three leading economies are becoming dependent on imports while the costs of exploration and development are increasing.

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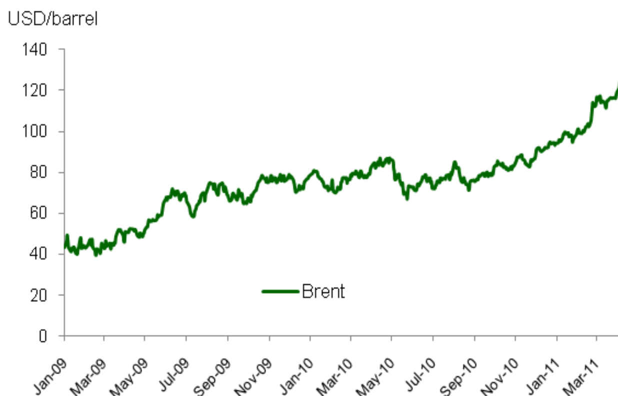
The return of uncertainty

The GCC region put up a show of considerable resilience during the global economic downturn. 2010 generally proved a year of normalization across the region, even if the rebound continued to hinge critically on government spending and the increase in the oil price. 2011 was widely expected to be characterized by a steady consolidation of this turnaround, partly due to the stronger oil prices translating into some production increases. But, above all, this year was expected to see a relative shift in economic activity from the public to private sector, relative fiscal consolation accompanied by a steady improvement in business conference.

This baseline scenario still appears fairly likely, although the ongoing turmoil in parts of North Africa and the Middle East has clearly undermined erstwhile optimism. While the situation in Egypt raised concern about oil supply security through the Suez canal and pipeline, the violence in Libya has potentially jeopardized the output of a fairly significant oil producer. Before the onset of its internal conflict, the country produced some 2% of the world's oil. The crisis is estimated to have reduced the country's pre-crisis output of 1.6mbd by up to three-quarters. These developments, along with fear over potential contagion, have pushed the oil price to its highest level since August 2008 as it has repeatedly tested the USD120 per barrel mark. In response, Saudi Arabia has signaled its intent to make up for any shortfall in production. Saudi Arabia currently produces some 8.6 mbd, although some private estimates now put it at as much as 9.4 mbd. The Kingdom is thought to be capable of increasing this to approximately 12 mbd. It was recently announced that Saudi Arabia has developed a new blend of crude which is close in quality to the supplies lost in Libya.

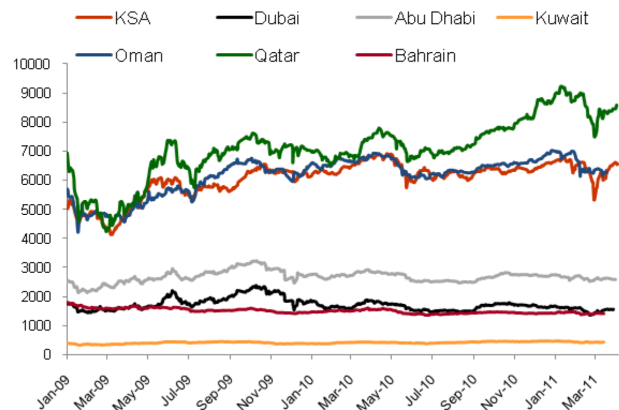
In the Gulf region, investor mood has been tested by the flaring up of social and sectarian tensions in Bahrain, relatively contained instances of violence in Oman, and turmoil in Yemen. The sharp stand-off in Bahrain eventually led to an intervention by GCC forces and, although the situation has stabilized, the eagerly awaited national dialogue is yet to materialize. While it is early to assess the ultimate economic costs of the crisis, it is obvious that Bahrain has been hard hit in ways that may have lasting consequences. The rapidly rising investments in real estate and financial services in recent years constitute points of vulnerability. More generally, these developments have fueled anxiety, especially among foreign portfolio investors, and the regional bourses

The oil price



Source: SAMA, NCBC Research

The performance of the GCC benchmark stock indexes



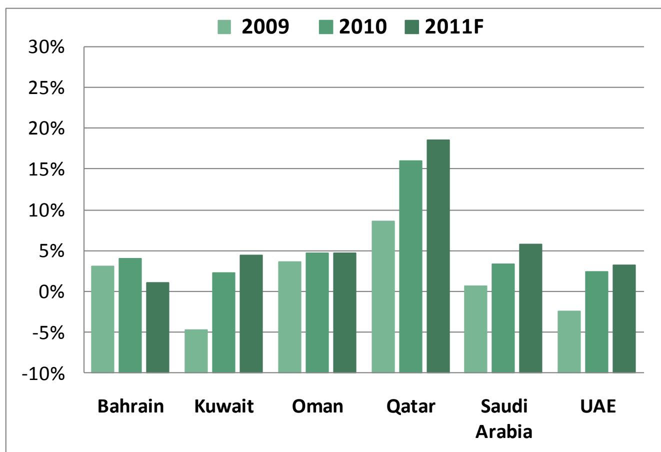
Source: SAMA, NCBC Research

have been sharply hit. This has created an unwelcome prospect of more of the same after a string of lackluster years in the equity markets.

As much as the region will have to face at least a period of uncertainty and investor caution, the effects of the turmoil have not been uniformly negative, nor have they equally affected the regional economies. In particular, Dubai has been presented with a significant opportunity to capitalize on its enhanced cost competitiveness in real estate as investors reassess their views about Bahrain. More generally, higher oil prices, potentially for an extended period, represent a major windfall for the regional producers. The GCC economies – led by Saudi Arabia – are globally best positioned to respond to any shortfall in oil production which means that any efforts to contain the oil price appreciation should still benefit them through greater revenues. This oil windfall will in turn enable the GCC governments to continue with their spending plans through a period of uncertainty.

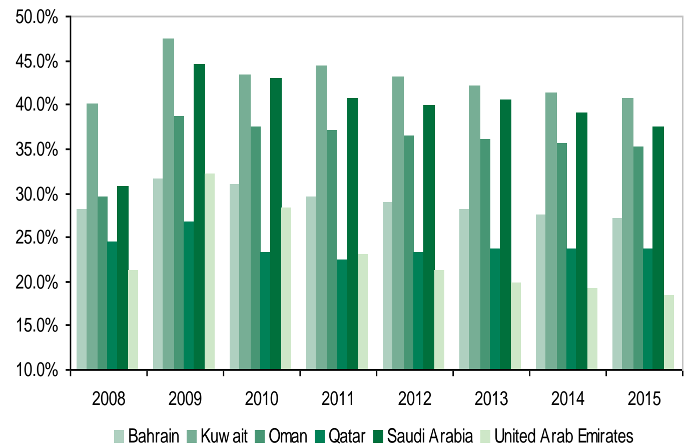
In an environment where risks still abound, the result of the current combination of investor caution and government activism may once again be a year of uneven growth, quite possibly a replay of the patterns observed over the past year or so. The mounting global inflationary pressures in conjunction with the regional political turmoil are likely to test and may well contain the recovery in business and consumer confidence, at least in parts of the region and for some time, something that is likely to slow down the normalization in the private sector. It also risks curbing the resumption in bank lending, which is a key precondition for full normalization in the private sector. Nonetheless, with oil prices strong and government spending on the way up, the region – and especially Saudi Arabia – is looking at a significant acceleration in its headline GDP growth over last year.

Growth projections, percent annual growth rate



Source: IMF Regional Economic Outlook, October 2010 and NCB estimates

Government spending in the GCC



Source: IMF

Fiscal policy refocus

The Gulf countries, thanks to their Dollars pegs (barring Kuwait), have been able to rely on the low interest rate stance of the US Federal Reserve as a source of relief during a protracted economic crisis. However, it is above all their fiscal policy activism that accounts for the resilience of these economies in the face of major global, as well as regional, shocks. Following the onset of the crisis, all the GCC governments quickly stepped in to support aggregate demand and to ensure the largely uninterrupted continuation of their ambitious development agendas. Government expenditure has underpinned economic growth in the region at a time when private sector behavior has been characterized by persistent risk aversion and credit constraints. For instance in Saudi Arabia, public sector GDP growth in 2010 attained 5.9%, whereas the private sector mustered a much more modest, but still internationally respectable 3.7%.

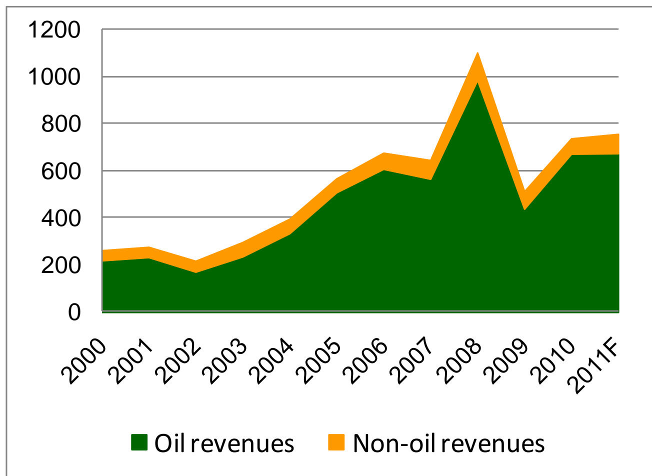
In spite of growing optimism about the global recovery until recently, the Gulf governments have been slow to embrace explicit exit strategies, even though government budgets have typically projected far slower expenditure than revenue growth. On the whole, however, policy-makers have typically recognized the exceptional uncertainty of the international environment and used continued fiscal stimulus spending to underpin confidence and growth. With the onset of a period of political instability in North Africa, this approach has left them in a position where policy continuity has once again presented itself as a logical response to the evolving circumstances.

Virtually all the GCC governments have embarked on the new fiscal year with a permissive fiscal stance. In some cases, this stance is further amplified by a pre-emptive desire to address mounting concerns emanating from the global commodity price pressures, most notably in the area of food. A series of measures adopted in recent weeks has further significantly loosened the fiscal policy of most Gulf governments. While these efforts to move towards a more inclusive growth paradigm build on a realistic recognition of social needs in important areas such as employment and housing, they also create new challenges in terms of ensuring the efficiency of government spending and the longer-term sustainability of policy. By contrast, near-term concerns over macroeconomic stability seem largely unwarranted in view of the significant windfall produced by oil price appreciation.

Saudi Arabia. Saudi Arabia responded to the global economic crisis with one of the most forceful stimulus packages among the leading economies. While fiscal policy has remained permissive, 2011 initially promised to involve some scaling back of the stimulus. Although the budgeted 7.4% increase in spending took the projected total for 2011 to a record SAR580bn (USD155bn), the increment was the slowest since 2003. At the same time, government revenues were projected to rise twice as fast – by 15% – to SAR540bn (USD144bn). Echoing the 2010 budget, the government foresaw a SAR40bn (USD10.7bn) deficit, equivalent to 2.3% of GDP on the assumption of a roughly USD54 per barrel oil price, up from approximately USD47 in 2010. The budget continued a well established pattern of prioritizing capital spending which was projected to account for a historically high 44% of total expenditure. Education remains a spending priority with a 26% share of the total, followed by 12% to health, social, and security services.

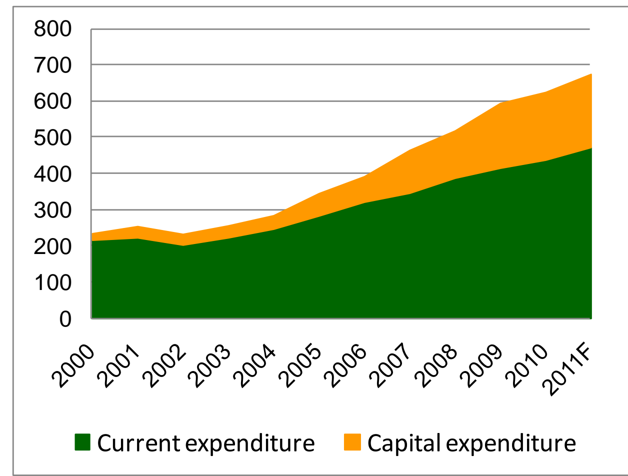
Saudi Arabia has recently taken steps to significantly boost government spending beyond the levels envisaged in December. A SAR135bn package of measures was announced in February, including one-year unemployment benefits and various loan write-offs. Social benefits for families were boosted, while SAR3.5bn was allocated support household expenses. SAR15bn was allocated to the General Housing Authority, SAR40bn to the Real Estate Development Fund and SAR30bn to the Saudi Credit and Savings Bank. All Saudi students studying abroad are now to be covered by a state scholarship program while another SAR100mn was allocated for financial support for students. Inflation allowances of state employees were made permanent.

Saudi Arabia breakdown of government revenues (SAR bn)



Source: SAMA, Ministry of Finance

Saudi Arabia breakdown of budget revenues (SAR bn)



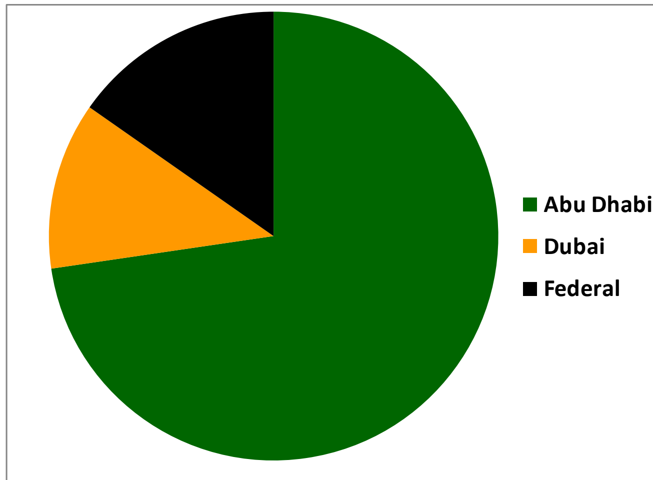
Source: SAMA, NCB estimates

An even larger SAR350bn set of measures was unveiled on 18 March, equal to some 20% of the country's GDP and some 56% of total government spending in 2010. Even though not all the planned expenditure is immediate, the package directly boosts living standards by providing for a special bonus worth two months' salary to all public sector employees while students will receive two extra months of scholarship support. The public sector minimum monthly wage is increased from SAR2,185 to SAR3,000. Adding precision to the commitment made in February, all job seekers are to be paid SAR2,000 a month. 60,000 new jobs are created at the Ministry of the Interior. Additional benefits go to members of the military. Significant funding was also devoted to the upkeep of mosques and the religious establishment.

Housing constitutes a key priority where, again, the measures promulgated in February are fleshed out. SAR250mn will be spent on building 500,000 new housing units around the country, something that should cover at least two years' projected housing deficit. The upper limit of the loans made by the Real Estate Development Fund is to be increased from SAR300,000 to SAR500,000. The Ministry of Health is provided SAR16bn and funding for private hospitals is due to be quadrupled to SAR200mn.

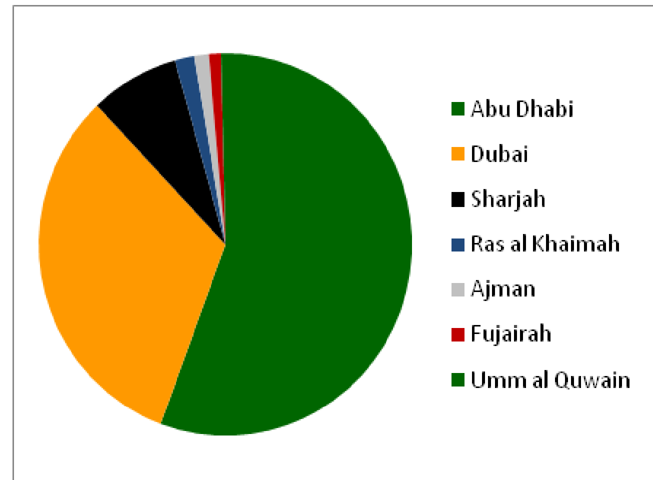
UAE. The UAE has the most complex fiscal system of the GCC states due to its federal structure. But it has also tended to follow its own course in fiscal policy, partly due to the severity of the most recent business cycle which saw rapid development in areas such as real estate followed by a dramatic crash, especially in Dubai. Unlike its Gulf neighbors, the UAE – both on the federal and the emirate levels – is pursuing a degree of fiscal consolidation having dramatically increased government outlays in the pre-crisis years.

Breakdown of UAE government spending, 2010



Source: Federal National Council, Government of Dubai, media, NCB estimates

Breakdown of the UAE GDP by emirate, 2008



Source: UAE National Bureau of Statistics

The UAE fiscal system is composed of three budgets, led by the Government of Abu Dhabi budget which in 2010 made up almost three-quarters of the national total, clearly in excess of the emirate's share of the aggregate national GDP. Also the Government of Dubai produces its own budget which in 2010 accounted for 12.5% of the national aggregate. Federal spending historically comprises up to a fifth of total government spending and its share in 2010 was just over 15%. In addition to federal government operations, the budget covers the finances of the five northern emirates.

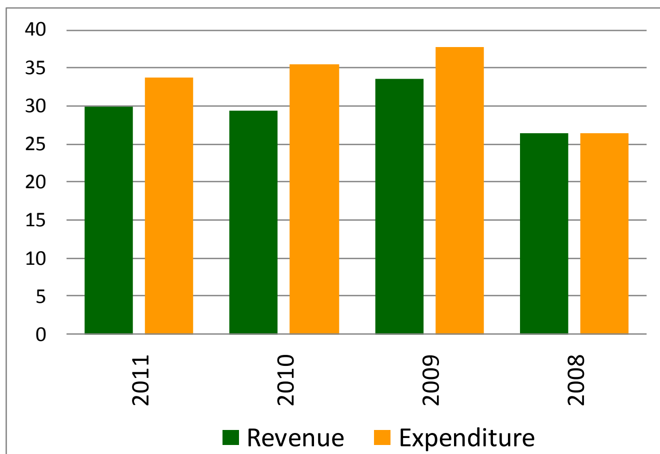
Little current information is available about the Abu Dhabi budget. The emirate's 2010 budget projected an AED84.9bn (USD23.1bn) deficit on the assumption of a USD60 per barrel oil price, an outcome that appears to have been at least largely avoided due to a far higher actual oil price. This marked a second consecutive year of planned deficit spending after an estimated AED126.5bn shortfall in 2009. The government had originally projected an AED42.6bn deficit on the assumption of a USD50 per barrel oil price. Reflecting the general nationwide thrust of fiscal tightening, Abu Dhabi government spending in 2010 was projected to fall from AED251.7bn to AED207.5bn. However, this was in part because the government had in 2009 undertaken important exceptional measures such as injecting AED16bn in local banks and UD10bn of Dubai bond purchases. Abu Dhabi's oil-related revenues in 2009 were estimated at AED121.8bn in 2009, followed by AED118.7bn in 2010. Total budgeted revenues in 2010 were AED122.6bn.

Continuing the consolidation trend of 2010, Abu Dhabi intends to balance its books this year. In reality, the fiscal position of the emirate is likely to be significantly stronger since the budget excludes revenues from important state-owned entities, including the Abu Dhabi National Oil Company. To date, Abu Dhabi appears to have covered its deficits through transfers from government-related entities, most notably the Abu Dhabi Investment Authority and the Abu Dhabi Investment Council.

Also Dubai's 2011 budget seeks to trim government spending with the objective of cutting the deficit from AED6bn (USD1.6bn) to AED3.8bn (USD1bn). Overall expenditure is set to fall to AED33.7bn (USD9.2bn), which is below the levels seen in 2009-2010. 43% of this is allocated to the 'economic sector,' which includes infrastructure, transport, and tourism. Social development, including health care and education, will claim 24% of the total. AED7.5bn (USD2bn) of the budget – or some 23% -- is allocated to infrastructure projects, down from

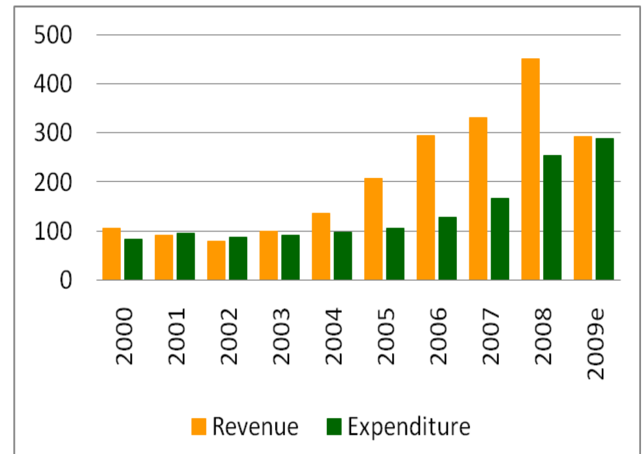
AED10.7bn in 2010. Government revenues are projected to reach AED29.9bn (USD8.1bn). Of this, 61.7% is due to come from fees and fines while 23.3% is tax revenue, Unlike elsewhere in the region, the proportion of oil revenues is a modest 8.4% and an additional 6.7% will be generated by investment income.

Dubai budgets, 2008-2011 (AED, bn)



Source: Government of Dubai, Department of Finance

UAE general government budgetary position (AED, bn)



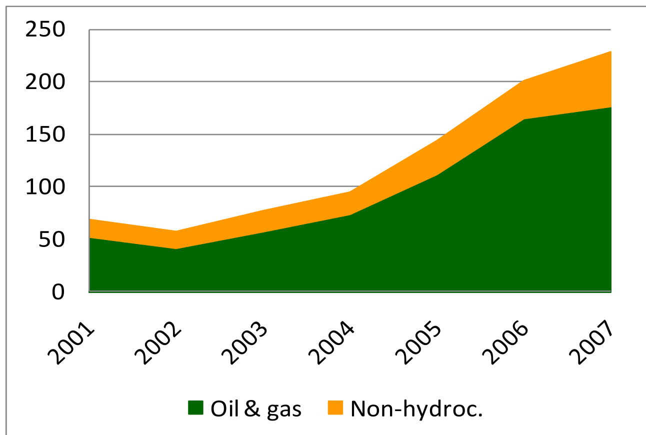
Source: IIF

Dubai is planning to use bonds as the principal way of covering its deficits. Although the emirate does not currently have a formal sovereign debt rating and concerns persist about the financial health of some government-related companies, Dubai five- and 10-year issues of USD1.25bn last year attracted subscriptions of USD5bn.

Also the UAE federal budget reflects the general theme of fiscal consolidation, reversing a 21% increase in spending to AED42.2bn (USD11.5bn) 2009. In November, the government approved an AED122bn budget for three years. The 2011 budget allocation of AED41bn is down on AED43.6bn in 2010. The budget effectively freezes a number of programs, something that has generated considerable controversy, given the acute spending constraints of various government-funded organizations, notably in health care and education. Education, health, pension, and social assistance account for 46% of the total spending. AED1.6bn has been earmarked for roads and public works. Federal government revenues are set to total AED38bn, something that would produce an unprecedented AED3bn budget deficit. The federal government has historically balanced its books.

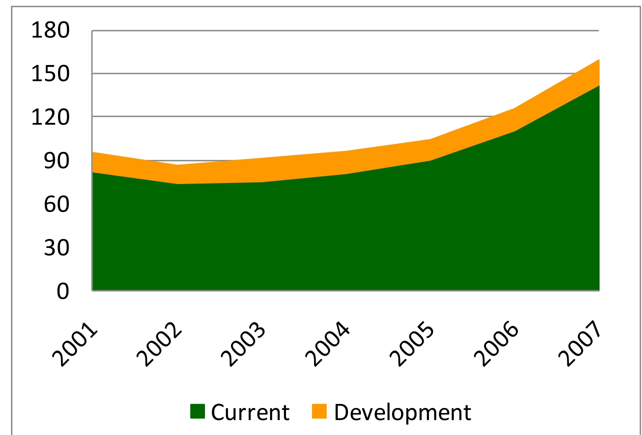
The revenue side of the federal budget reflects the multi-tier political system of the UAE. The AED43.6bn budget in 2010 was due to receive AED16.6bn of its revenues from Abu Dhabi, although the actual contribution appears to have been only AED14.3bn. AED1.2bn was due to come from Dubai, but only AED500mn had been received by November. Various federal bodies account for the rest, with for instance the telecommunications company Etisalat contributing 50% of its profits. Efforts are underway to obtain contributions also from the other emirates, especially as Abu Dhabi's contribution this year is expected to decline to AED11.6bn. The bulk of federal spending is devoted to the five northern emirates.

UAE breakdown of general government revenues (AED, mn)



Source: UAE National Bureau of Statistics

UAE breakdown of general government spending (AED, mn)



Source: UAE National Bureau of Statistics

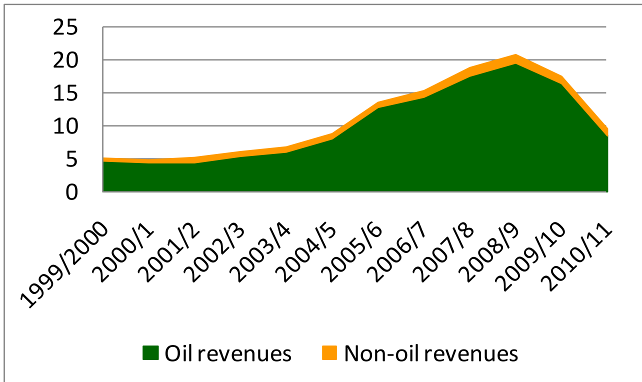
The prospect of a federal budget deficit has fueled ongoing efforts to establish a federal government debt market. The Federal National Council (FNC) in December authorized the government to issue federal debt "only if necessary" to fund the projected budget gap. The public debt law limits government debt to 25% of GDP or AED200bn, whichever is lower.

Kuwait. The Kuwaiti cabinet in January approved draft KWD17.9bn (USD64bn) budget for the 2011-12 fiscal year. The government projects a sharp 38.3% increase in revenues to KWD13.4bn (USD48.1) on the assumption of USD60 per barrel oil price, a figure that is 40% up on the USD43 estimate used last year Expenditure is set to climb by 9.9% to KWD17.9bn (USD64.3bn), a figure roughly equal to 50% of the country's GDP. Kuwait operates the most heavily oil-dependent fiscal system in the Gulf region, where oil revenues are due to make up an estimated 93% of the its total revenues in FY2011-12.

The FY2010-11 budget foresaw total revenues of KWD9.7bn (USD34.8) and expenditure of KWD16.3bn (USD58.4bn). In practice, however, the strength of the oil price is likely to have produced budgetary oil revenues of nearly KWD20bn. Moreover, it appears that government spending has fallen somewhat short of the original budget projections, which should allow Kuwait to close FY2010-11 with a surplus of approximately KWD4.5bn or more. The government recorded a surplus of KWD5.5bn (following allocations to the Reserve Fund for Future Generations) during the first three quarters of the fiscal year as revenues were 56% above the targeted levels. The budget revenues reached KWD15.1bn (USD54.2bn), of which oil made up KWD14.1bn. Actual expenditures totaled KWD8.1bn (USD29.0), including KWD1.5bn allocated to the Reserve Fund. The surplus typically declines in the closing months of the fiscal year as spending accelerates.

This year's projected budget deficit of KWD4.5bn (USD16.1) is 40.7% below the FY2010-11 figure, although it accounts for 14% of GDP, something that formally contravenes the commitments Kuwait has made under the Gulf Monetary Union. However, the spending total includes a second KWD1.1bn (USD3.9bn) payment to cover a deficit in the pension scheme. The third and final payment is due in FY2014-15. In reality, of course, the favorable oil price outlook is likely to produce a far more favorable fiscal outcome. The budget should be breaking even at a price of just over USD70 per barrel. A USD90 oil price should generate a surplus of close to KWD3bn.

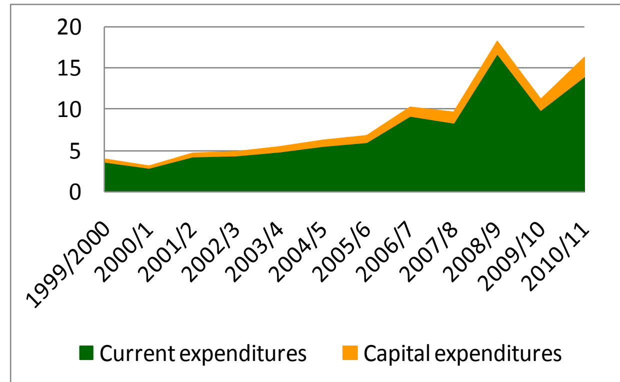
Kuwait breakdown of government revenues (KWD bn)



Source: Central Bank of Kuwait

N.B. The 2010/11 data covers the first three quarters of the fiscal year.

Kuwait breakdown of government expenditure (KWD bn)



Source: Central Bank of Kuwait

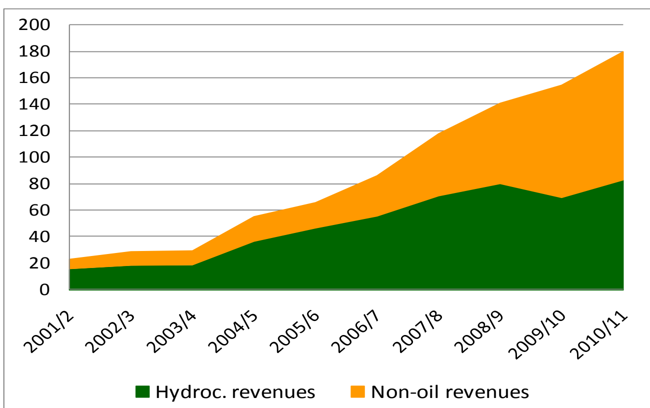
N.B. The 2010/11 data covers the first three quarters of the fiscal year.

"Current expenditures" include the categories ""Current" and "Other," which represents transfers to agencies and other public institutions.

One source of uncertainty concerning the fiscal outlook for Kuwait is the persistent stand-off between the government and the parliament, something that resulted in a virtual stalemate before the most recent elections. The tense relationship has once again delayed the implementation of the country's new five-year economic development plan and associated initiatives. Also a dispute over the management of Kuwait Petroleum Corporate has delayed key decision, among other things on the new Al Zour refinery and upgrades of the existing ones.

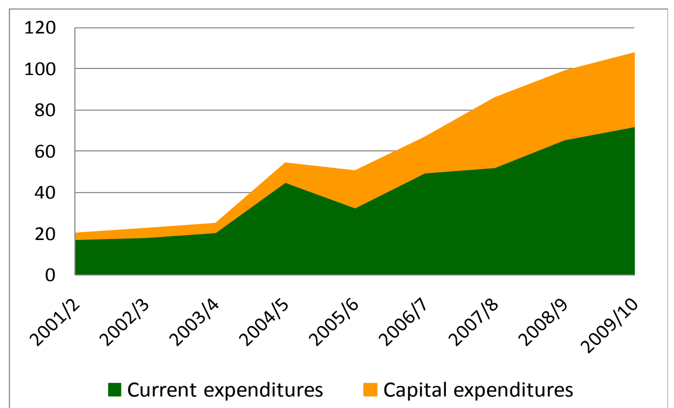
Qatar. Qatar's massive infrastructure commitments have resulted in stance rapid increase in government spending over a number of years, something that looks likely to carry over into the 2011-12 fiscal year. Nonetheless, FY2011-12 offers a contrast with Qatar's more fiscally permissive neighbors as the country envisages a QAR22.5bn (USD6.1bn) surplus. Government revenues are projected to increase by 27% to a record QAR162.5bn (USD44.5bn), while expenditure is set to total QAR139.9bn (USD38.4bn), a 19% increase on FY2010-11. The cautiousness of the fiscal stance is further underscored by the unchanged oil price assumption of USD55 per barrel, something that now appears relatively low by regional standards. The proportion of government revenues coming from oil and gas is set to remain fairly low – 46% of the total in FY2010-11, down from 64.6% in 2006-07.

Qatar breakdown of government revenues (QAR bn)



Source: SAMA, Ministry of Finance

Qatar breakdown of government expenditure (QAR bn)



Source: SAMA, NCB estimates

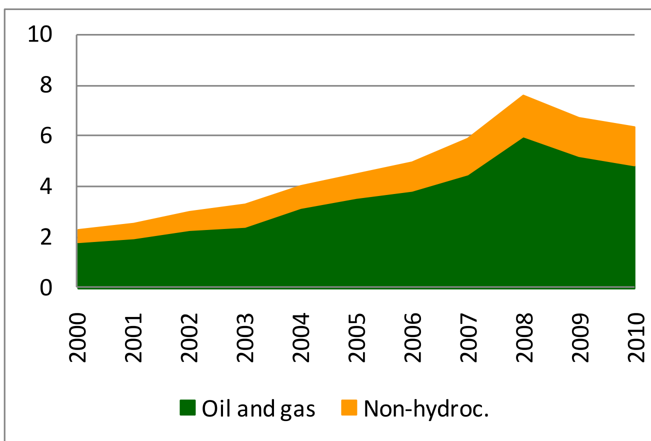
A remarkable 41% of the Qatari budget is allocated to infrastructure projects which include the ongoing Doha International Airport project, the New Doha Port, and a railway. The allocation for public sector projects is 19% above the previous fiscal year. The budget offers relatively few new initiatives in the area of social policy, however. Among other things, public sector salaries were increased by 10%. Even the allocation for the health care sector was raised by a relatively modest 3.6% to QAR8.8bn. Education is to receive QAR 19.3bn – up 12% over FY2010-22 – and housing QAR5.2bn – a 100% increase.

Having issued a USD50bn bond to local banks in January for the purposes of draining excess liquidity and funding infrastructure spending, the Qatari government has indicated that there are no near-term plans for further bond issuance. The Qatari budget recorded a surplus equal to 17.5% of GDP (QAR19.4bn) in July-September with government revenues doubling Y/Y. This followed a deficit equaling 23.2% of GDP in April-June.

Oman. The Omani budget for 2011 foresees a 14.1% increase in government revenues to OMR7.3bn (USD18.9bn), with oil revenues in fact projected to rise by 22.4% to OMR5.0bn (USD12.9bn) to make up 68.0% of the total. The assumed oil price of USD58 per barrel is up 16% on the USD50 applied in 2010. Gas revenues are projected to increase by 15.0% to OMR920mn (USD2.4bn), or 12.6% of total. By contrast, the proportion of other revenues is set to contract by 8.2% to OMR1.4bn (USD3.7bn).

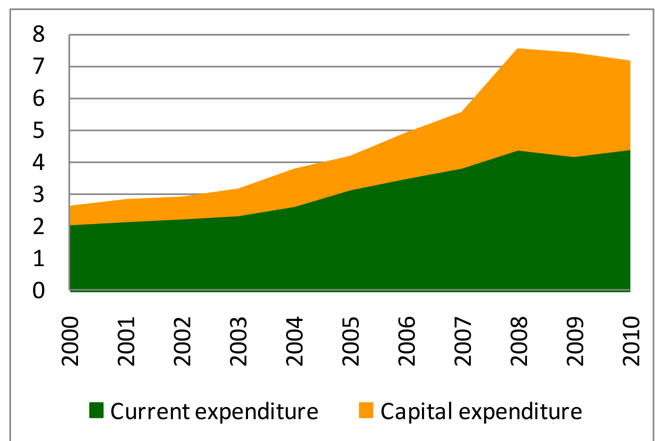
Government expenditure this year is expected to rise by 13.2% to OMR8.1bn (USD21.1bn). Reflecting the

Oman breakdown of government revenues (OMR mn)



Source: Central Bank of Oman

Oman breakdown of government expenditure (OMR mn)



Source: Central Bank of Oman

government's ambitions to boost hydrocarbons extraction, the budget foresees an 11.5% increase in the allocation to the sector to OMR1.6bn, or 19.9% of the total. Defense and security spending will account for OMR1.7bn, or 20.3% of the total. Education spending is set to total OMR927mn and health care spending 335mn, figures that still represent fairly low proportions by regional standards.

The government foresees an OMR850mn (USD2.2bn) deficit this year, which would be mainly financed from state reserves. Although Oman had budgeted for an OMR800mn (USD2.1bn) deficit last year, the average oil price of USD76 per barrel significantly exceeded the budget assumption of USD50 while there was a gradual increase in oil production volumes.

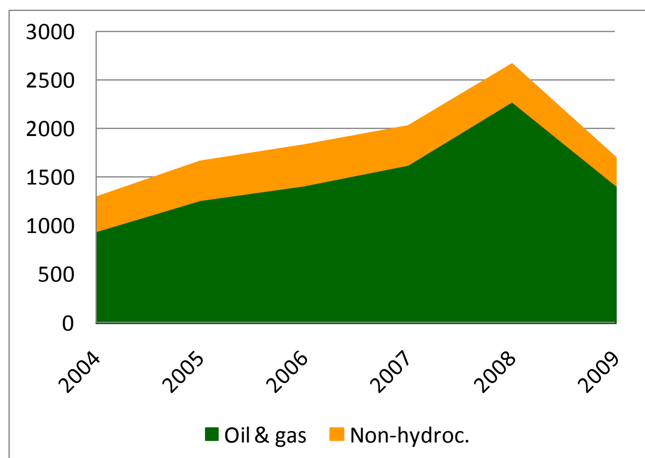
Bahrain. The fiscal situation in Bahrain was thrown into some confusion following a wave of unrest in February-March. Nonetheless, the budget approved by the government in January for 2011-2012 is likely to serve as a reasonable indication of future spending. The two-year budget projects an oil price of USD80 per barrel, a pronounced increase from the USD60 figure used in the 2009-2010. In spite of this, the government is projecting deficits as the break-even oil price is now estimated to stand at USD97-100 per barrel.

The aggregate government revenues of BHD4.4bn (USD11.8bn) in 2011-2012 are set to exceed the 2009-2010 level by 18.9%. BHD3.9bn of this total will come from the oil sector. Revenues are expected to be roughly equally split into BHD2.193bn in 2011 and BHD2.247bn in 2012. Government expenditure is due to rise by 26.2% to BHD5.3bn, of which BHD2.565bn is to be spent this year and BHD2.687bn next year. Of the two-year total, BHD1.1bn will be devoted to projects. Education will claim BHD657mn while spending on health projects will total BHD534mn. Infrastructure, including roads and sewage, will received BHD341mn. BHD150.8mn will be devoted to new housing. Total government spending on subsidies in the areas of essential foodstuffs, housing, and utilities will reach BHD868.4mn. The budget allocates BHD21mn a year into a reserve fund for future generations.

The government deficit is projected total BHD372.7mn in 2011 and BHD440.4mn in 2012. In addition, Bahrain in early February announced USD417mn on new spending to address social concerns. Families will receive BHD100mn, split equally between 2011 and 2012. Government subsidies on essential food will rise from BHD88.9mn to 132.9mn while social assistance spending will increase from BHD28.8mn to 40mn. The government has also relaxed its drive to enforce outstanding utility bills which are said to total BHD62mn. This continues a pattern of loose fiscal policy as the government in 2009-2010 spent BHD427.7mn in excess of the budgeted amount.

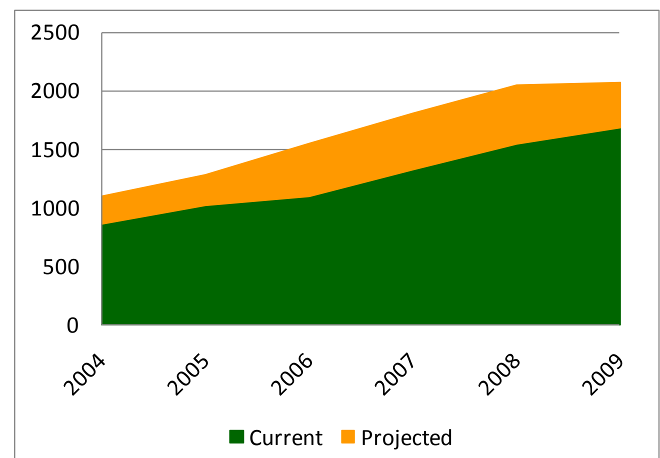
Additional pressures will be created by the downgrading of Bahrain's sovereign debt. Moody's in August revised Bahrain's rating from A2 to A3 and offered a negative outlook for the financial services sector. Standard & Poor's in March revised their rating from A- to the lowest investment grade rating, BBB. Also Fitch made two successive downgrades to BBB. On the other hand, Bahrain is set to benefit from a USD10bn support fund agreed by the

Bahrain breakdown of government revenues (BHD mn)



Source: Central Bank of Bahrain

Bahrain breakdown of government expenditure (BHD mn)



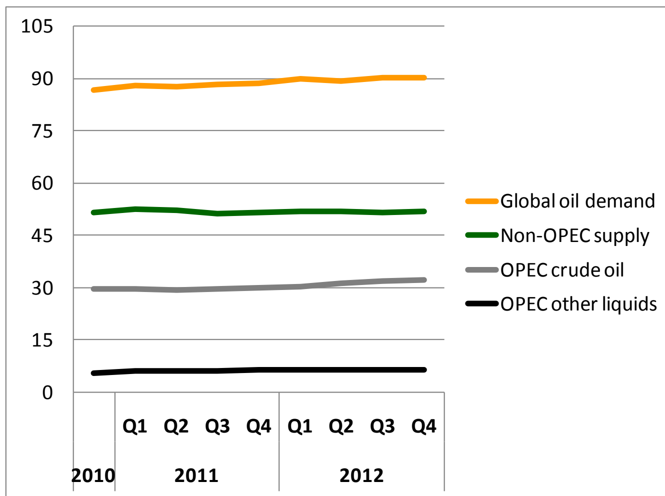
Source: Central Bank of Bahrain

Gulf Cooperation Council in March. This represents a potentially significant step by the GCC towards European Union-style cohesion funding for weaker member states and regions and for the benefit of general economic stability and growth. A similar commitment was made to Oman.

The oil boon

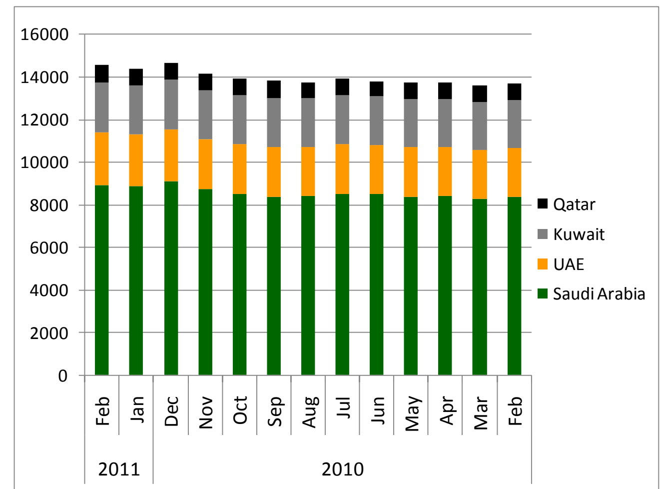
As much as the coming months – and potentially beyond – are likely to be characterized by increased government spending in the Gulf, this endeavor promises to be significantly facilitated by a benign oil price outlook which may well leave prices around an average of USD100 per barrel for the year as a whole. On current projections, this would allow all the regional economies to post budget surpluses even with the additional spending commitments that have been announced to date.

Global oil market outlook. mbd



Source: EIA

GCC oil production, '000 barrels/day



Source: OPEC, MEES, NCB estimates

While the price pressures are to a degree linked to the elevated uncertainty in the Middle East, as well as the concern over the aftereffects of the Japanese earthquake, they are fundamentally underpinned by structural factors at a time when oil demand is once again significantly strengthening. According to the US Energy Information Agency (EIA), the global demand for crude oil and liquid fuels grew by 2.4 mbd to a total of 86.7 mbd in the course of 2010. This was the second-largest annual increase in 30 years and more than offset the reductions in demand during the prior two years, thereby surpassing the 2007 figure of 86.3 mbd. The EIA forecasts additional demand increases of 1.5 mbd in 2011 and 1.7 mbd in 2012. On current projections, this is likely to shift the onus for meeting the demand to OPEC producers. The Centre for Global Energy Studies this month suggested that OPEC would have to boost its supply from the current 29 mbd to 30.3 mbd in Q2 to prevent oil price appreciation beyond USD110 per barrel. The EIA expects crude oil and products supply from non-OPEC countries to rise by 170,000 b/d in 2011, followed by a slight decline in 2012.

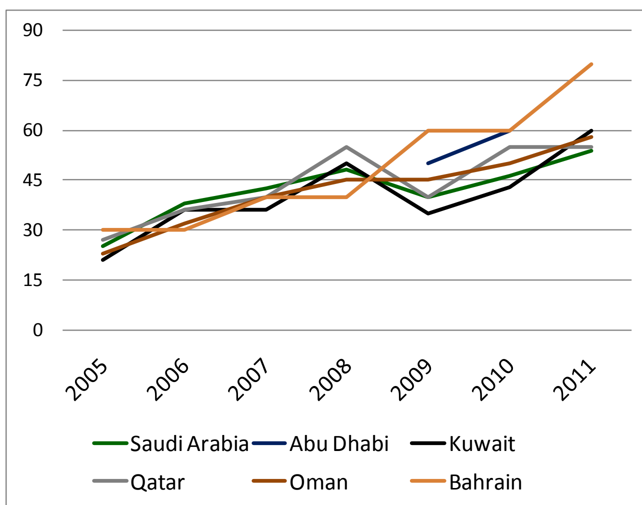
Even though any meaningful resolution of the tension in the Middle East and the restoration of relative stability may have a short-term adverse effect on the oil price, there is little in the current environment to suggest that the GCC producers will not continue to benefit from comfortable prices and increased production levels. Even though OPEC has so far resisted revisions to its quotas, the tighter oil markets have led to informal increases in output levels across the region. In the absence of significant and sustained further upward pressure on the oil price, this pattern of gradual production increases is likely to continue. OPEC has resisted quota revisions, citing high inventories. OECD commercial crude inventories stood at 2.71bn barrels at the end of 2010, the EIA said, the equivalent of 58 days of forward cover and roughly 75mn barrels more than the five-year average for the corresponding time of year. It forecast that OECD stocks would decline over the next two years.

Is fiscal discipline eroding?

The loose fiscal policy pursued by the GCC governments represents above all a reaction to unusual economic uncertainty. Many of the risks the policy seeks to mitigate are temporary in nature and for that reason, we can expect the fiscal stance to gradually tighten in the coming years. However, the sharp increases in spending have begun to generate growing concern about the sustainability of the current trends. In particular, there is a risk of a ratchet effect; measures intended to be temporary may generate expectations of their perpetuation, much as has happened with the Bush-era tax cuts in the US. This risks turning a temporary anti-cyclical measure into a structural fiscal burden.

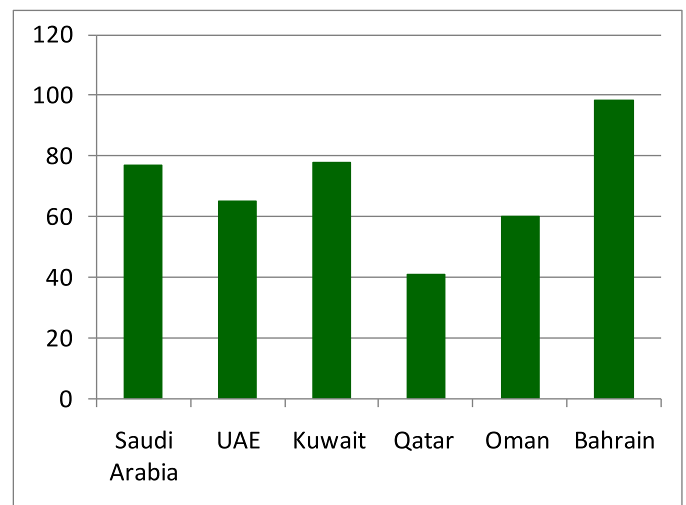
Much of the new spending announced in recent weeks has been social in nature. The Kuwaiti government at the beginning of the year announced generous benefit payments, including a cash allocation of USD3,572 to each

GCC budget oil price assumptions



Source: National authorities, NCB estimates

Estimated budget break-even prices



Source: NCB estimates

Kuwaiti citizen. In addition, citizens will receive free essential foodstuffs during the coming fiscal year. The total cost of the two programs is expected to be as much as USD5bn. The measures were formally adopted to commemorate the 50th anniversary of Kuwaiti independence and 20 years since the country's liberation from Iraqi occupation. The Kuwaiti government is also seeking to kick-start its infrastructure agenda through new spending under the auspices of a medium-term development plan. Also the Bahraini government in February agreed to a BHD1,000 (USD2,650) lump sum payment to each Bahraini family to mark the tenth anniversary of the National Action Charter. Oman in February increased the national minimum wage by 43% to OMR200. The Saudi measures announced in February-March involve a number of similar steps. In the UAE, the President recently ordered AED5.7bn of new spending on the electricity and water infrastructure of the northern emirates.

The increase in government spending is generally justifiable in view of the prevailing economic realities, nor does it do much in the near term to undermine the general macroeconomic stability of the Gulf economies. The massive reserves built on years of technocratic policy-making offer a formidable cushion while the current reality of elevated oil prices makes a temporary spending increase easy to justify. Nonetheless, it is clear that the sustainability of many of the current policy choices is becoming increasingly dependent on high oil prices. Both the price assumptions made by the regional governments in their budgets and the actual break-even oil prices have been trending up fairly consistently and sharply in recent years. The regional average oil price assumption for budgeting purposes has doubled from USD25.2 per barrel in 2005 to at least USD61.2 in 2011. The trend has been remarkably consistent, with the exception of a temporary reversal in 2009. Bahrain has the highest break-

even oil price in the region but even in Kuwait, the budget break-even price has increased by almost USD40 between 2006 and 2010 and now stands well in excess of USD70 per barrel. Following the latest stimulus measures, Saudi Arabia is expected to need an oil price of USD77 per barrel – by some estimates as much as USD85 – to balance its budget. The main risk facing the region under the circumstances is a sudden and sustained oil price reversal in an environment where oil revenues remain the predominant source of government income across the region.

The rapid increase in government expenditures creates a number of challenges, none greater than efficient execution. The government's administrative apparatus must ensure that the fiscal appropriations are indeed spent and directed to the desired causes with a minimal delay and financial cost. Some steps are being taken to instill higher quality standards in public administration. For instance in Abu Dhabi where the government's Excellence in Government Performance uses inspectors to assess strengths and weaknesses of government departments. In general, enhancing the government auditing functions is an important element of ensuring value for money. Saudi Arabia is establishing a National Commission for Fighting Corruption and will subject all government projects to review. Businesses guilty of price manipulation are to face higher penalties.

A more fundamental policy choice pertains to the appropriate role of the government in the economy. The efforts made over the past decade to boost the development of the private sector – in part through privatization and public-private partnerships – have stalled to a degree during the economic downturn. One of the key policy choices facing the authorities is redrawing the public-private demarcation line, especially given the stated desire to boost private sector job creation.

Greater attention will likely have to be paid also to the benefits accruing from government spending. One of the most laudable aspects of GCC fiscal policy in recent years has been the heavy emphasis on education and infrastructure spending. Boosting the human and physical capital of these economies can be expected to boost their productive potential in the longer term. In that sense, government spending, properly allocated, is necessary for the transition of these economies to their post-oil future. While the recent fiscal measures contain elements of infrastructure and human capital spending, their focus is more on broader social concerns. But even given that, their ultimate success will be determined by their ability to meet the ultimate policy objectives in these areas in a cost-effective manner. Efforts to boost housing should be aligned with steps to boost home ownership. In this sense, the adoption of the Saudi mortgage law is a particularly welcome development. Efforts to boost living standards should go hand in hand with employment creation, for that is the way to sustainably boost the income of individuals in need. As much as steps to support the unemployed are necessary, they should be matched with active labor market measures and incentives so as to boost labor market efficiency rather than creating a culture of welfare dependency – a costly mistake committed by a number of Western countries at various times. Moreover, a debate has begun about revising the current norm of universal entitlement benefits in favor of a more focused system that targets families in real need. As controversial as means-testing can be, it is a likely precondition of focusing government social spending on areas of real need.

GCC governments also have to face important questions about the intergenerational allocation of resources. An increase in current expenditure both reduces the amount available for future investment and typically results in the loss of the financial return that such investments could have generated. Naturally, current spending – especially in areas such as infrastructure and education – also generates returns which may mitigate the loss. This is not the case with money spent on current consumption. On the revenues side, the recurrent discussion about broadening and diversifying the revenue base is likely to gain traction going forward and it is clear that the model of relying on the hydrocarbons sector for the vast majority of government income will become increasingly difficult to sustain or justify in a more diversified economy.

Strategic anchors

Medium- to long-term strategic planning has established itself as a central element of economic policy-making in the GCC. Even though some of the plans are to a large extent aspirational, programmatic statements, they typically seek to set up longer-term guidelines on managing the countries' hydrocarbons wealth for the purpose of the transition to the post-oil era. All the regional economies embraced the practice of medium-term – typically five-year – economic development plans, a practice that goes back to the era of the first oil boom in the 1970s. Moreover, most GCC countries have adopted longer-term economic vision statements to offer guidelines on overriding policy objectives. For instance, the central goal of Abu Dhabi's strategy is to boost the share of the non-oil sector to 64% of GDP by 2030 from the current 45%.

Oman's 2011-15 development plan announced in connection with the budget seeks to achieve growth of at least 3% a year, although 5% growth with 4% annual inflation is seen as an achievable goal. The total expected investments of OMR30bn (USD78bn) are more than double the previous plan target. Tourism, industry, agriculture, and fishing are identified as priority sector. Spending on education and health care is set to rise by 55% and 88%, respectively, and he government has set a target of 200,000-275,000 job opportunities. A total of OMR5.6bn is allocated to new projects in addition to OMR6.4bn on ongoing projects and some OMR10.2bn of other project spending. The plan projects average oil output levels of 897,000 b/d and a price of USD59 per barrel while foreseeing average annual investment of OMR895mn in oil exploration and development as well as OMR764mn in the gas sector. Deficit expenditure is expected to continue with projected annual revenues of OMR7.5bn (USD19.5bn) and annual expenditures of OMR8.5bn (USD22.2bn).

Qatar's new announced **National Development Strategy** envisages investments of USD225bn in the course of 2011-2016. Fueled by gross investment in excess of 30% of GDP, Qatari GDP has almost quadrupled from USD31.7bn in 2004 to an USD110bn in 2010 with an annual average growth rate of 13.1% in 2001-2009. Looking ahead, real GDP growth is projected to slow down from 15.7% in 2011 to 5.1% in 2016 as the infrastructure project pipeline matures. The plan foresees cumulative gross domestic investment of QAR821bn in 2011-2016, of which the public sector will account for 42.3%. In spite of the slower growth, Qatar faces enormous employment challenges with a projected need for 1.6mn new workers over the plan period. One possible reform under consideration has to do with the sponsorship system which prevents expatriates from responding to labor market signals.

Shifting the focus. A number of GCC economies have reassessed their long-term strategies in view of the new economic realities produced by the global crisis. Slower population and economic growth has prompted governments to delay some infrastructures projects, even if the overall objectives remain largely unchanged. But the crisis has also led a number of countries to reassess the heavy emphasis they had placed on financial services and real estate development. Just as these activities were at the forefront of economic diversification in the pre-crisis years, they have been among the main victims of the crisis.

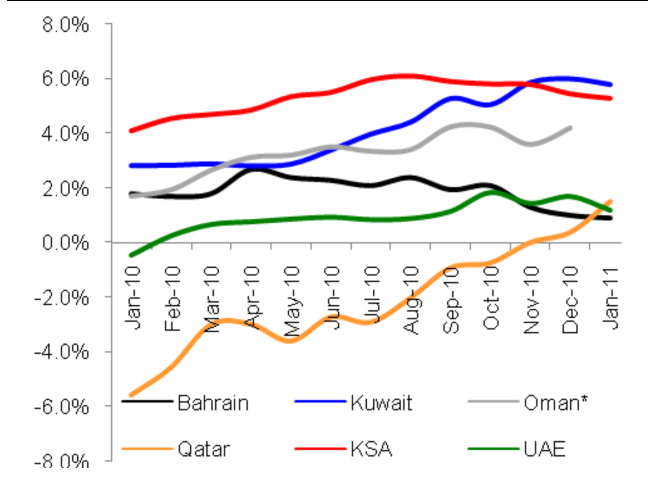
A good example of the changing emphasis is Bahrain's review of its Vision 2030. While downgrading the role of the financial sector and construction, the government is redoubling its efforts to create sustainable employment for nationals. The share of Bahrainis in the national workforce is projected to grow by 29% over the coming decade, a goal essential to meeting the Vision's central objective of doubling the real income of Bahraini families by 2030. The sectors that are now expected to play a leading role in this endeavor are manufacturing, transport, IT, and tourism. Dubai, similarly, is refining its Strategic Plan 2015, shifting the focus away from financial services and real estate to trade.

Inflation concerns

The GCC has experienced an unusually sharp inflation cycle over the past couple of years. An economic boom, supported by robust oil and food prices, took headline inflation to double digits virtually across the region in 2008. But this was quickly followed by a sharp reversal when the oil price dropped and the economic crisis made itself felt. Since 2009, inflationary pressures have begun to mount again, albeit with considerable intra-regional variation. The renewed price pressures are now primarily fueled by the commodity boom of recent months. In the course of last year, oil, agricultural products, and other commodities appreciated by 20.4%, 44.5% and 17.4%, respectively.

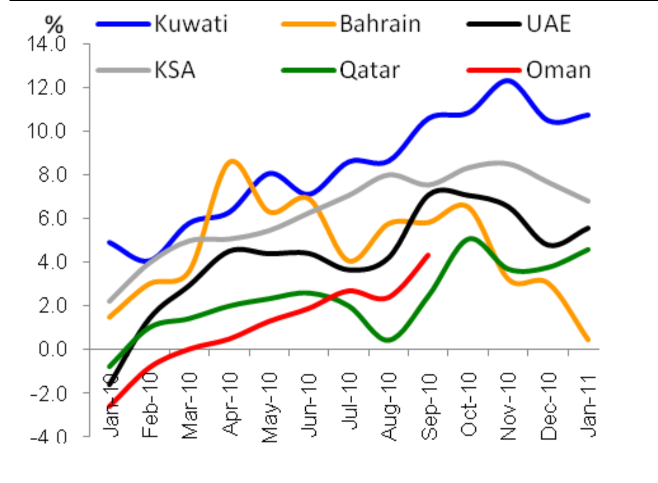
The differences in headline inflation across the GCC have tended to be above all linked to variations in the dynamics of the regional housing markets. While some of the Gulf coast economies – led by Dubai – experienced sharp corrections in their previously overheated real estate sectors, rentals have continued to climb in Saudi Arabia, which has a significant structural housing deficit. Regardless of the starting point, however, the dynamics of price increases have been remarkably similar across the region, especially food price pressures, which by the end of 2010 had pushed headline inflation into the positive territory even in Qatar, which had previously undergone a drawn-out period of disinflation.

Headline inflation in the GCC



Source: National authorities, NCB estimates

Food price inflation in the GCC, Y/Y



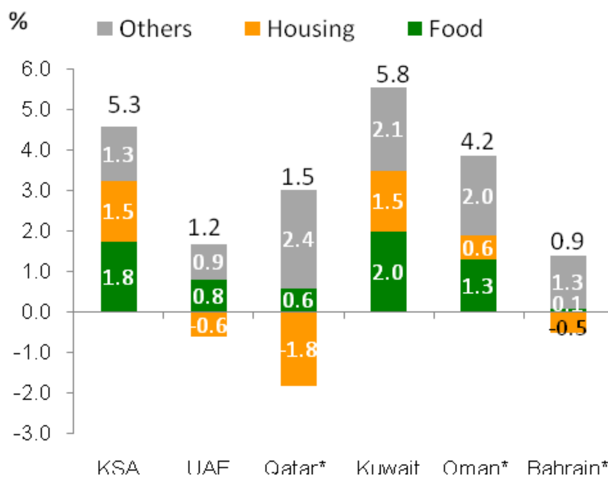
Source: National authorities, NCB estimates

At the moment, Kuwait – following a rapid pick-up in price pressures since the middle of 2010 – has the highest headline rate of inflation in the region: 5.8% as of January 2011. Saudi Arabia, having seen a period of relative stabilization in price pressures over the past couple of months, now has inflation running at an annual rate of 5.3%. Inflation in Oman reached 4.3% in December 2010. By contrast, the UAE, Qatar, and Bahrain all have headline inflation rates of less than 2.0%. Although pressures have been growing fairly rapidly in Qatar's booming economy over the past year, they have actually trended down in Bahrain and reached an annual rate of 0.9% in January.

The global surge in agricultural commodity prices last year emerged as the main driver of inflation in the GCC. A series of adverse weather conditions in 2010 significantly damaged a number of major crops in Australia, Russia, South America, and parts of Asia. Food prices face other cost pressures due to higher input costs as a result of energy inflation. At the same time, a range of structural factors are contributing to tighter markets. Rising living standards and evolving tastes in the populous emerging markets of Asia are pushing up the demand for many

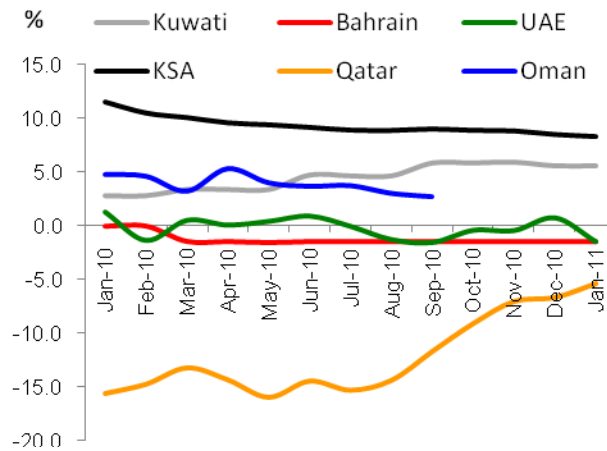
food commodities while the growing popularity of biofuels in recent years is restricting the availability of farmland. The GCC economies are particularly sensitive to these pressures given the heavy weight of food in the regional consumer price baskets and their near-total reliance on imports for most key staples. The most recent wave of food inflation appears to have been largely absorbed by the GCC economies and, due to the base effect alone, the contribution of food to headline inflation is showing signs of beginning to moderate. However, the global food markets remain tight and vulnerable to weather-related disturbances. There is widespread concern that the supply response during the coming growing season will not be sufficient to normalize the situation in key agricultural commodities and prices may continue to increase into 2012.

Breakdown of annual inflation, Jan 2011



Source: National authorities, NCB estimates *NCB estimates

Housing inflation in the GCC, YoY



Source: National authorities, NCB estimates

The second most important component in the regional CPI baskets is housing-related costs. This element has been the most important differentiator for the headline inflation rates of the regional economies. The contribution of housing is most substantial in Saudi Arabia (1.5%), Kuwait (1.5%), and Oman (0.6%). By contrast, it is negative in Qatar (-1.8%), UAE (-0.6%) and Bahrain (-0.5%) which have to varying degrees experienced pronounced downturns in their housing markets. The correction has been especially sharp during the past year in the case of Qatar where housing deflation exceeded 15.0% during much of 2010. The disinflationary impact of housing has diminished markedly in recent months although it remains in the negative territory at -5.4% as of January 2011. In Saudi Arabia, inflationary pressures in the area of housing have been moderating since September 2010 but remain elevated at 8.3% as of January 2011. While housing inflation is negative in both UAE and Bahrain, it recorded growth of 5.6% and 2.7% in Kuwait and Oman, respectively.

The economic policy backdrop in the GCC remains challenging from the perspective of inflation. The dollar pegs (excluding Kuwait) entail a strong link to the ultra-loose monetary policy of the US Federal Reserve. Even with concerns mounting about the pending end of the second wave of quantitative easing this summer, an abrupt reversal of policy is unlikely. The US Dollar is a related risk factor. Since the beginning of this year, it has depreciated by 6.4% and 3.3% against the Euro and the Pound Sterling, respectively. With the interest rate differential between the US and Europe set to the increase this year, we expect little near-term relief. At the same time, the increase in government spending in much of the region will further complicate efforts to combat inflation, which is likely to exceed previous estimates and, for instance in the case of Saudi Arabia, come in at close to 5.5% for the year as a whole.

Also global inflationary trends look likely to emerge as an increasingly acute challenge for the GCC. Euro-zone inflation attained 2.8% in February 2011, clearly ahead of the European Central Bank's 2.0% target. In China, the official inflation reading has already attained 4.9%. Even US inflation has risen to 2.1% and laid to rest recent concerns about deflation. These factors pose a major challenge for the GCC region which relies heavily on imports for its domestic consumption.

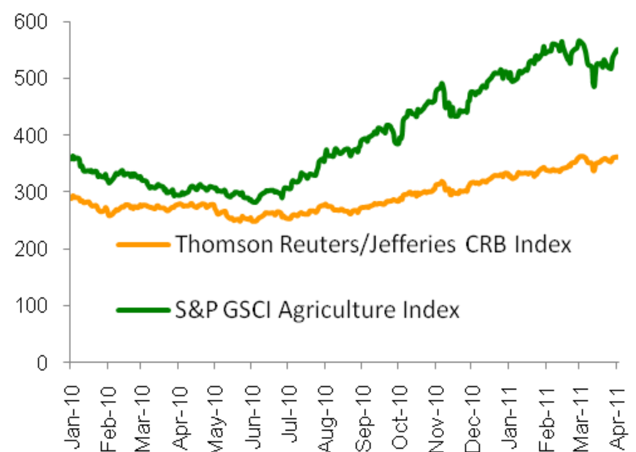
Inflationary pressures are likely to remain elevated in the GCC during the coming year, even if a repeat of the 2007-2008 scenario is unlikely. One significant break – for now – on price pressures is the slower-than-usual pace of financial intermediation. Credit growth is still moderate except in Qatar where it attained an annual rate of 15.5% in January 2011. At the other extreme, Bahrain recorded negative credit growth of 5.9%. Nonetheless, commodity pressures are likely to remain a persistent concern throughout 2011 due to growing demand for oil , especially from Asian emerging markets, and also increasingly likely by the West, where positive signs of a strengthening recovery are multiplying even if unusual risks persist. The uncertainty in the oil market, due to political unrest in North Africa and the Middle East, is likely to serve as another source of stress in the oil market, even though significant stabilization of the situation would likely result in at least a short-term correction. Since the beginning of this year, oil, commodity, and agricultural commodity prices have recorded growth rates of 31%, 8.1% and 9.4%, respectively.

Consumer price index basket weights in the GCC (%)

	Food	Housing
KSA	26.0	18.0
UAE	14.4	39.7
Qatar*	12.2	33.6
Kuwait	18.3	26.7
Oman*	30.4	21.4
Bahrain*	16.0	31.8

Source: National authorities, NCB estimates *NCB estimates

Commodity price indexes



Source: National authorities, NCB estimates

Annual growth in money supply and credit, January 2011

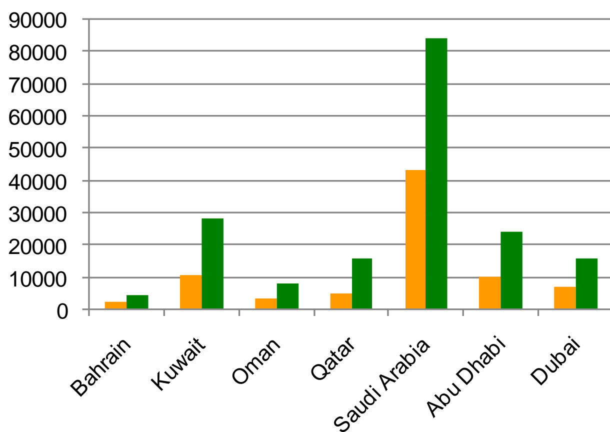
	Money Supply	Credit
KSA	8.1	5.0
UAE	6.7	1.4*
Qatar	21.0	15.5
Kuwait	1.0	0.6
Oman	10.9*	7.5*
Bahrain	13.9	-5.0

Source: National central banks, NCB estimates * Dec-2010 figures

Addressing the energy constraint

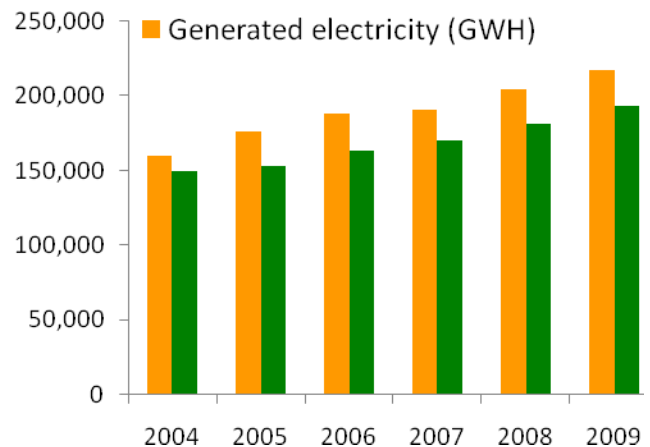
In spite of its unparalleled oil and gas wealth, energy security has emerged as an increasingly central policy challenge for the GCC region. The ongoing economic diversification efforts and rapid population growth, which is unlikely to slow down below 2% a year in the foreseeable future, are projected to continue to push up regional electricity demand at an annual rate of 10%. Saudi Arabia is projecting annual increases of 8%. With energy demand set to grow faster than GDP, the GCC economies, in spite of their ongoing commitment to economic diversification are in fact becoming steadily more energy-intensive. This momentum is in part underpinned by generous subsidies; 55% of Saudi power use is residential, supported by the low tariff of SAR0.08 per kWh. Furthermore, the regional industrialization agenda has relied very heavily on hydrocarbons, with an emphasis on sectors such as petrochemicals, aluminum, and steel which use above all gas as both a feedstock and fuel. For instance, the regional petrochemicals industry has seen its capacity rise from 4mn tn a year in 1985 to more than 100mn tn in 2010. Projected investments of USD50bn should further boost capacity by some 46%.

GCC power generation capacity



Source: MEED

Saudi electricity generation and consumption

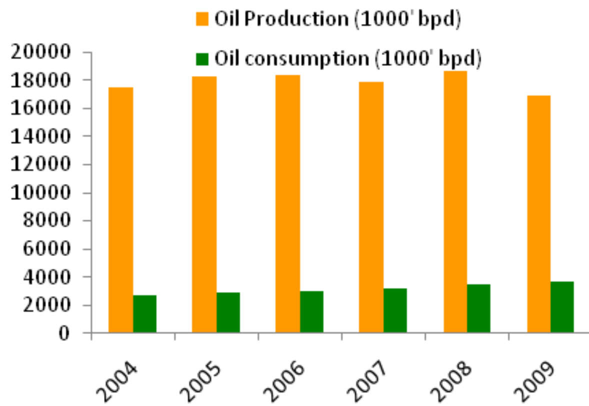


Source: Saudi Electricity Company

A sharpening trade-off in hydrocarbons

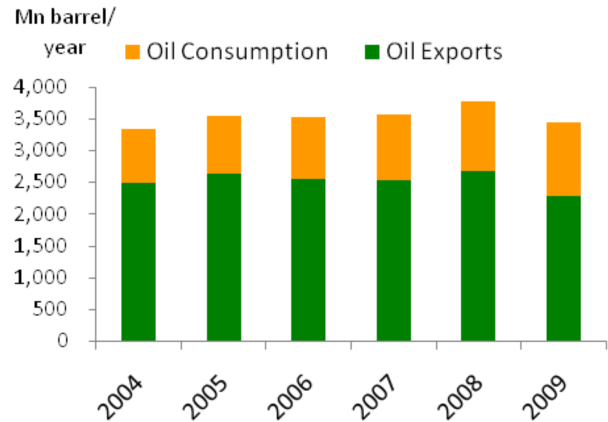
The challenges in the area of hydrocarbons mirror the broader picture. The rapidly growing domestic demand for power has forced the regional economies to divert a growing proportion of their oil and gas from revenue-earning uses to heavily subsidized domestic consumption. The domestic use of oil, gas, and refined products in Saudi Arabia has been growing at an annual rate of 5.9% in recent years, indeed accelerating from 6.5% in 2007 to 9.0% in 2008. The combined Saudi export of crude and refined products corresponded to 83.9% of the total hydrocarbons output in 2000. This figure has gradually fallen to 81.2% in 2009 and an estimated 78.4% in 2009. By 2010, Kuwait was forced to allocate 11-15% of its oil production to utility plants and blackouts have become increasingly common. Also Saudi Arabia is increasing its investments in oil-fueled power plants.

GCC oil production and consumption, '000 bpd



Source: BP

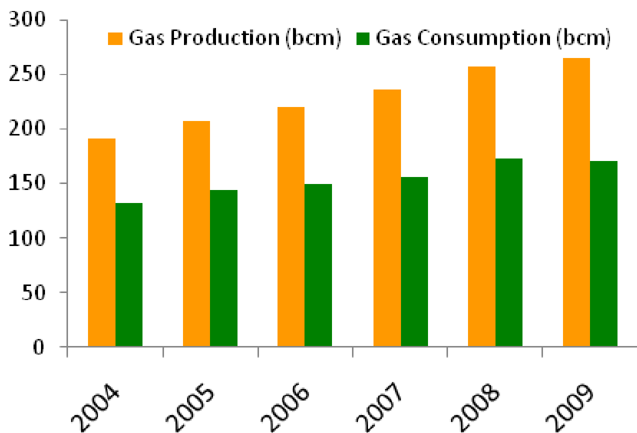
Saudi oil production and exports, mn barrel per year



Source: SAMA

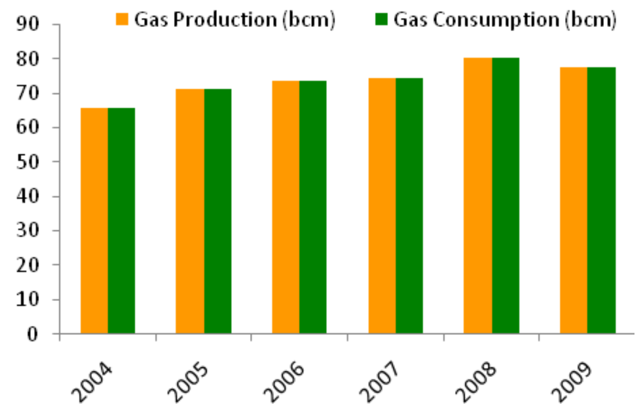
Gas represents a particular challenge for the GCC in spite of the fact that the region boasts estimated aggregate reserves of some 40trn cu m, or roughly 20% of the global total. However, demand is expanding rapidly as gas is the leading regional source of power and key input for the leading industrial ventures. Problematically, the regional gas wealth is extremely unevenly distributed, which means that the regional gas deficit has been estimated to be on track to double or more from 19bn cu m in 2009 to 31-50bn cu m in 2015. For instance, the UAE expects to be able to obtain only half of its projected peak electricity demand of 40,000 MW from gas by 2020.

GCC production and consumption of gas



Source: BP

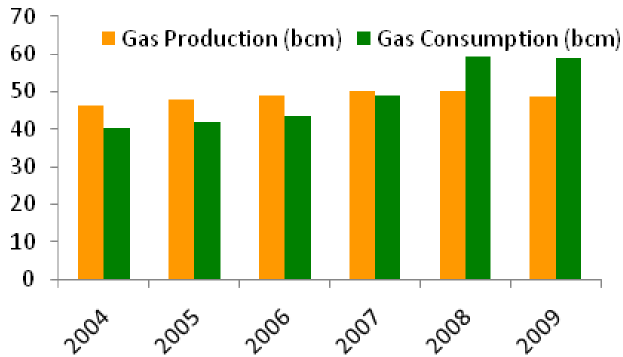
Saudi gas production and consumption



Source: BP

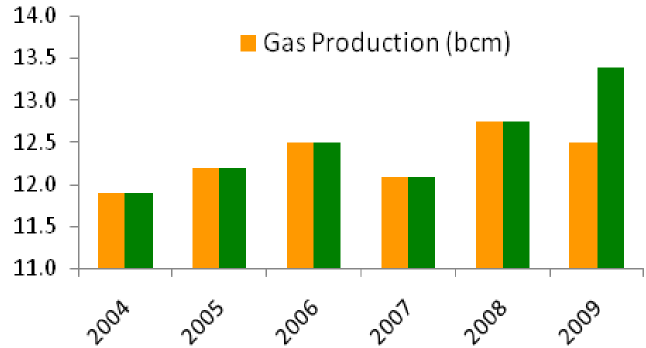
At present, Saudi Arabia consumes all of its domestically produced gas while Kuwait and the UAE are already significantly dependent on imports. As an extreme case, Dubai, which consumed 1.52bn cu ft/d of gas in 2009, now imports most of its gas: some 730mn cu ft/d from Qatar through the Dolphin pipeline, 400-500mn cu ft/d from Abu Dhabi, and about 150mn cu ft/d from Sharjah. Dubai has also started LNG imports, under a 15-year deal signed in April 2008 with Shell.

UAE gas production and consumption



Source: BP

Kuwait gas production and consumption



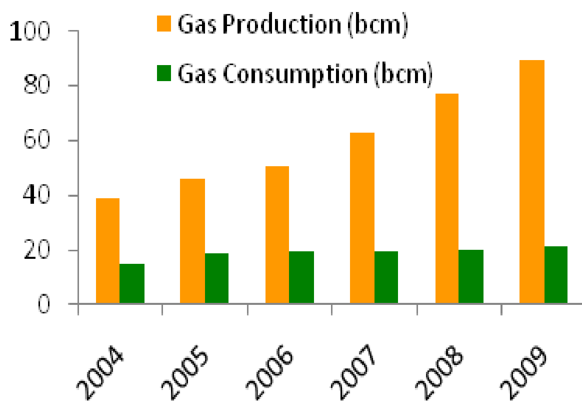
Source: BP

While its regional neighbors are struggling to meet their gas needs, Qatar has emerged as the world's third-largest gas power after Russia and Iran and a leading liquefied natural gas (LNG) exporter. In particular, Qatar has made massive investments in LNG exports to Asia, but the current export capacity of 77mn tn a year is in excess of its current commitments. This has done relatively little to ease the constraints facing the rest of the GCC region, however. There is no integrated GCC gas market and, in spite of discussions of a regional gas grid, one is unlikely to materialize any time soon. Moreover, the Dolphin pipeline set in somewhat of a troubling precedent by committing Qatar to supplying its neighbors at heavily subsidized prices, far short of what can be realized in Asia. The pricing structure is likely to have to undergo significant review before regional exports can grow significantly further.

Costs are becoming an increasingly important consideration more generally as the other regional countries take pains to boost their domestic gas production after years of relative underinvestment. A number of new developments are underway for instance Saudi Aramco has identified gas as a key investment priority as the Kingdom – home to the fifth-largest reserves in the world – seeks to boost gas reserves by 5bn cu ft/day within five years. Problematically, however, the quality of the regional reserves is deteriorating, which is rapidly pushing up costs and accentuating the incompatibility between the investment needs and the current pricing structure. For instance, Abu Dhabi is beginning to develop its south-western Shah sour gas fields which are characterized by 30% concentration of toxic hydrogen sulfide. Gas production will require shipping 10,000 tons/day of sulfur 264km to the coast.

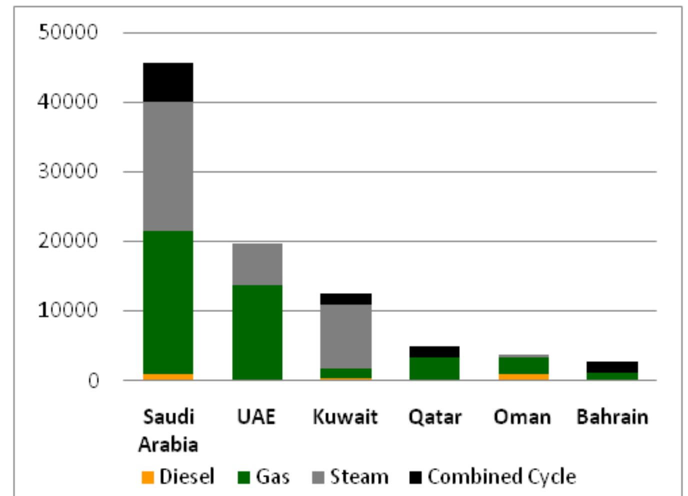
Faced with these economic realities, Oman, following a significant increase in the cost of its gas extraction, is understood to be considering withdrawing gas price subsidies for any future projects that rely on gas feedstock. For instance the Khazzan and Makarem fields are old and deep and the number of wells required to develop them is estimated to be 5-10 times the industry norm. Oman is currently renegotiating its gas pricing with BP after a policy reversal last summer when BG abandoned the Abu Butabul gas field development on pricing grounds.

Qatar gas production and consumption



Source: BP

Installed power generating capacity, 2009, MW



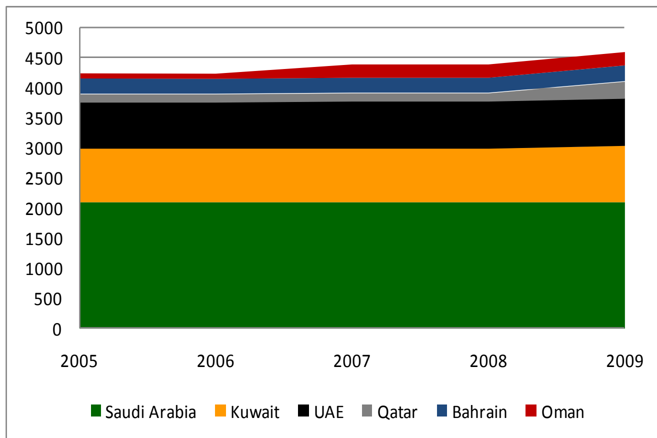
Source: MEES

Reviewing energy policy

In an environment where the Middle East and the developing economies of Asia are expected to account for nearly all incremental oil demand in the coming decades, the GCC economies will have to revisit some of the key tenets of their energy policy. The key challenge is to maximize the export of regional hydrocarbons to Asia at a time when the North American market is becoming more independent thanks to shale gas. For instance Chinese oil imports rose by 17.5% to 239.3mn tn in 2010. Saudi Arabia, as the leading exporter, accounted for 44.6mn tn of this.

The main near-term policy response to the demand pressures is likely to involve efforts to boost the regional energy supply but this is increasingly being accompanied by efforts to diversify the energy mix and measures to manage demand more effectively. Problematically, the current efforts to increase regional hydrocarbons extraction create the challenge of bringing nearer the day when oil runs out even if progress is being made to increase the efficiency of extraction. This has allowed mature producers such as Oman and Bahrain to reverse secular declines in their output. Oman increased its oil production by 6.6% Y/Y in January-November to an average 862,700 b/d and is officially targeting 1 mbd capacity by 2012. The Sultanate has also managed to boost its gas production, supported by an ambitious USD10bn program for hydrocarbons sector development approved in 2007. The region as a whole is expected to boost its oil extraction by 3.7mbn over the coming decade, an approximately 20% increase. Gas production is on track to advance by 70% to 23 bn cu ft/d. Efforts are also underway to control more of the hydrocarbons value chain. Projected refinery investments may boost regional capacity by 60% to 7 mbd.

GCC installed refining capacity, mbd



Source: MEES

Major regional refinery projects in the pipeline

Country	Project	New capacity, mbd	Estimated completion date
Bahrain	BAPCO Sitra expansion	0.09	2015
Kuwait	Al Zour	0.68	2015
Oman	Sohar expansion	0.10	2013
	Duqm	0.15	2015
Qatar	Ras Laffan expansion	0.15	2015
Saudi Arabia	Jubail	0.40	2013
	Yanbu	0.40	2014
	Jizan	0.40	2015
UAE	Ruwais expansion	0.42	2014

Source: Media, industry sources

Also the GCC energy infrastructure boom is continuing apace. The Gulf region in 2009 had total generation capacity of 87.8 GW while electricity production reached 391.5 TWh. Some 48-60 GW is expected to be added to this by 2015, which will require investments of at least USD53bn. Saudi Arabia alone is likely to have to invest over USD80bn in power over the coming decade; its additional energy needs in the coming 20 years are put at 30-40 GW, a near-doubling of the current installed capacity of 50 GW. Saudi Electricity Company has increased its capacity from 22 GW in 2000 to 43 GW in 2009 and currently has 641 projects underway with a total cost of USD34bn. It recently announced plans to invest some USD80bn to boost generation capacity from 50 GW to at least 70 GW. Kuwait is expected to have to increase its power generation capacity by some 10 GW by 2020, again a near-doubling of the current 11.3 GW.

In a bid to accelerate the supply expansion, the regional governments are looking for ways to increase the involvement of private capital. 30-40% of power generation in Saudi Arabia is expected to involve independent power projects (IPPs) in which SEC will likely hold 20-50% stakes. Two such projects are already underway, a 1,200 MW heavy fuel oil plant in Rabigh and a 1,800 MW gas plant in Riyadh. Dubai has launched its first Independent Power Project, Hassyan 1 on a BOO basis. In Kuwait, Law 39 applies to all power projects with a capacity of more than 500 MW and mandates private sector participation. Kuwait is understood to award its first independent water and power project this year. The Al Zour venture is expected to generate 1.5 GW of electricity using natural gas and fuel oil. Of the projected USD235bn of spending under Kuwait's National Development, USD35bn is due to go on public-private partnerships.

An important element of boosting supply involves diversification into other types of energy. These are likely to include mainly nuclear, renewable, coal, and unconventional gas. For instance Dubai Electricity and Water Authority (DEWA) – operating in the regional jurisdiction facing the most acute demand-supply mismatch – is planning to build a 4.0 GW coal fired plant which could be on line by 2015.

In spite of the Fukushima effect after the Japanese earthquake, which is now leading to a global re-evaluation of nuclear power, the GCC looks likely to persist with its plan to develop regional generation. Not only are geological risks far less important in the region, but nuclear energy also constitutes the only established and cost-competitive alternative to hydrocarbons, especially as the fiscal system does not permit easy incentives to

support the more costly renewables. The UAE in December 2009 issued a USD20bn contract for four reactors to a Korean consortium. The first 1,400 MW facility is due to begin production in 2017 and the rest by 2020. Saudi Arabia has established the King Abdullah City of Atomic and Renewable Energy in Riyadh and entered into talks with potential providers. Kuwait has shortlisted three nuclear sites for 1-2 reactors with the capacity of at least 1,000 MW each. Even Bahrain requested expressions of interest last April.

In spite of delays to the flagship Masdar City, also alternative energy is beginning to draw increasingly serious attention both at the level of research and development and in commercial development. Officially, the GCC countries are planning to generate 7-15% of power through renewable energy within the next 10-20 years. In a landmark development, Shams Power Company, a joint venture between Masdar, Total, and Abengoa Solar, last month announced the USD600mn financial close of Shams 1, one of the world's largest concentrated solar power projects. Also DEWA is also planning a 100mw capacity solar power plant which should be on-line by 2015. Polysilicon Technology Company, a Saudi-Korean joint venture, this year signed a SAR1.43bn contract for a polysilicon plant in Jubail.

Following the impressive progress in exploiting the shale gas reserves of North America, attention is also beginning to turn into similar opportunities in the GCC. The potential shale gas reserves of Saudi Arabia were recently described by Saudi Aramco CEO Khalid al Falih as "hundreds of trillions of cubic feet." The Qusaiba area of Rub' al Khali is considered particularly promising. More frustratingly, though, shale gas represents an even more extreme case of the rising cost curve that is affecting many conventional gas projects in the region. Due to capital and technology constraints, large-scale exploitation looks unlikely in the near term.

Even as the main focus of energy policy remains on boosting supply, an increasingly vocal debate has erupted on demand management. This currently involves mainly awareness campaigns and pilot ventures such as the decision by the Kuwaiti Ministry of Electricity and Water to equip its offices with solar energy panels in order to assess the potential for their more widespread use in the country. Solar panels have also increased in popularity among homeowners. There are also efforts to encourage the use of more shadow or real pricing in order to highlight the true costs of energy and to foster energy sustainability. Abu Dhabi's virtual billing is a case in point and virtual accounting is beginning to gain traction for new projects in a bid to seek most technologically efficient solutions There is particularly significant potential for further progress if smart technologies begin to be incorporated in the region's ongoing infrastructure and housing boom.

Some of thorniest issues about regional energy policy have to do with pricing. Access to cheap energy has been a key tenet of the regional industrialization driven in recent years but this can be guaranteed to be sustainable over the longer term only if it builds at least on virtual pricing that allows for the possibility of more market-based pricing. For instance, Saudi industrial users and utilities currently obtain their methane and ethane gas at USD0.75/mn BTU while production costs at the Hasbah and Arabiyah fields are understood to exceed USD4/mn BTU. Representatives of the Saudi petrochemicals industry are understood to favor a price of some USD1.25/mn BTU. Even though significant tariff increases are unlikely, steps are being taken across the region to nudge up tariffs and to better differentiate among users.

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