

The GCC in 2020

Outlook for the Gulf and the Global Economy

A report from the Economist Intelligence Unit
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Contents

About this research	3
Executive summary	4
Section 1: Global trends and the GCC	6
The world economy in 2020: An eastwards shift	6
International institutions expand but individual states remain key	8
Global politics in 2020: Shift to a multi-polar world	9
The financial system in 2020: the diminishing dollar	9
Demographics in 2020: harnessing a young population	11
Energy in 2020: consumption, environment and alternatives	12
Section 2: Trade and investment flows	14
Section 3: The GCC as an economic bloc	19
Section 4: The GCC and the Middle East	21
Conclusions	23



About this research

The GCC in 2020: Outlook for the Gulf and the Global Economy is a white paper written by the Economist Intelligence Unit and sponsored by the Qatar Financial Centre (QFC) Authority. The findings and views expressed in this briefing paper do not necessarily reflect the views of the QFC Authority, which has sponsored this publication in the interest of promoting informed debate. The Economist Intelligence Unit bears sole responsibility for the content of the report. The author was Jane Kinninmont and the editor was Rob Mitchell.

The findings are based on two main strands of research:

- A programme of in-depth analysis, conducted by the Economist Intelligence Unit, which drew on its own long-term forecasts and projections for the six GCC economies, along with other published sources of information.
- A series of interviews in which economists, academics, and leading experts in the development of the GCC were invited to give their views. In some cases, interviewees have chosen to remain anonymous.

Our sincere thanks go to all the interviewees for sharing their insights on this topic.

March 2009

Executive summary

Over the past ten to 12 years, the Gulf Co-operation Council (GCC) region, which comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, has undergone rapid economic, demographic and social changes. Since 1998, the GCC's real GDP has expanded by an annual average of 5.2% and by a cumulative total of 65%. Meanwhile, the population has risen from just over 28m in 1998 to an estimated 39m in 2008.

The recent boom has focused world attention on the GCC economies—not only as exporters of oil and gas, but as investment destinations with major infrastructure projects, booming tourism and financial services sectors. As US economic growth has slowed, GCC investors have begun to diversify their assets more widely, making investments in Asia, Africa and within the Gulf region itself. Industrialising economies in Asia are intensifying their trade links with the Gulf and some of the world's poorest countries have become increasingly dependent on remittances from the millions of foreign workers transforming the skylines of Gulf cities.

The seizure in global financial markets, the recent fall in the oil price and the economic slowdown in key trading partners are all beginning to have an effect on the GCC economies. Yet over the next decade or more, strong economic growth should be underpinned by the GCC's demographics and energy advantages and by a range of major investments that are already underway.

This report is the first in a series that examines likely themes in the development of the GCC economies through to 2020. In the first report, we look at the role that the GCC will play in the global economy. Subsequent reports in the series will examine the impact of demographic change in the region; the prospects for diversification into non-hydrocarbon industries; and food, water and power security in the GCC.

Key findings of the first phase of our research on the GCC and the global economy include the following:

- **The GCC will grow in importance as an economic and trading hub.** In 2020, the GCC is projected to be a US\$2trn economy, providing nearly one-quarter of the world's oil supplies as well as increasing quantities of petrochemicals, metals and plastics. As economic weight gradually shifts southwards and eastwards, emerging markets will become increasingly important trading partners and investment



destinations. Gulf investors and sovereign wealth funds are likely to diversify their assets into Asia and Africa, and the region is likely to export more of its oil to industrialising countries.

- **There is likely to be closer economic and political integration between GCC countries.** Under our core scenario, the GCC is likely to continue gradual efforts at economic integration, including a single currency, a single central bank and greater harmonisation of legal and regulatory environments. But political will is key. Economic integration will depend on good political relations, but will take precedence over political integration. Development of a common foreign policy or a strengthening of shared security forces remains a longer-term project.
- **Monetary union will be in place and there may be a shift from the dollar peg.** By 2020, it is likely that the GCC countries will peg their common currency to a trade-weighted basket of currencies, although one or two states may opt out. Any such basket will be heavily weighted towards the dollar—unless there is a global shift away from the practice of trading oil in dollars. Commodity prices (e.g. for oil and gold) may also be included in the basket.
- **There will be a greater focus on manufacturing.** Production of hydrocarbons in the GCC could rise substantially by 2020, but one likely trend is that the region will be seeking to export a smaller proportion of its oil as crude – a low value added commodity that offers few employment opportunities. Instead, GCC states will aim to turn more of their oil into refined products or petrochemicals, and to use their oil and gas resources as feedstocks for industries that will add more value and provide more jobs. However, the GCC will remain dependent on foreign labour by 2020 despite a range of efforts to encourage the employment of nationals.
- **GCC spending on food imports is projected to more than double from US\$24bn in 2008 to US\$49bn by 2020.** An important reason for this growth in imports is water scarcity, which means that domestic agricultural production tends to be costly. Between now and 2020, GCC countries will explore wide-ranging purchases of agricultural land in regions such as Africa, Central Asia and Southeast Asia, in order to strengthen food security. While these investments could boost agricultural production in poor countries, there is a risk of political backlash, especially in times of food shortages.

Section 1: Global trends and the GCC

It is 2020 and the GCC has become a US\$2trn economy, exporting nearly 25% of the world's oil. Barack Obama has retired and the US has its 45th or even 46th president. The world has become more multi-polar, with a number of Asian states included among the top global economies. The US remains the world's largest consumer market at market exchange rates, but China has overtaken it in terms of purchasing power parity.

The economic pain of the late 2000s is long over—we have been through another full business cycle—but the experience has shaped the attitudes of a generation of businesspeople. The “Washington consensus” of free-market economics gave way in the late 2000s to a renewed belief in the power of policy, but by 2020 this broad consensus has fragmented into a range of competing, conflicting models of political economy.

The world economy in 2020: An eastwards shift

Over the next decade, the world's wealth will continue to be redistributed towards less well-off countries, although this distribution will be uneven. Countries that we now describe as emerging markets will have gained more weight in the world economy—so much so that the term “emerging markets” is likely to be an anachronism.

Nevertheless, the US is expected to remain the world's largest single economy over the forecast period, although its share of world GDP will decline. The European Union economic bloc will remain a larger economy than the US, and will benefit from high growth in some of its new member states, but its share will also gradually decline as other economies grow more quickly. That said, four of the original EU-15 members are expected to remain among the world's ten largest economies in 2020.

By 2011, China will have overtaken Japan as the world's second largest economy after the US, having surpassed Germany in 2007. By 2020, China should account for just under 14% of the world's nominal GDP—nearly twice the 7% share estimated in 2008.

The rise of China and India in the past few years, coupled with mounting evidence of structural problems in the US economy, has created a widespread perception that economic power is shifting

Shifting weight

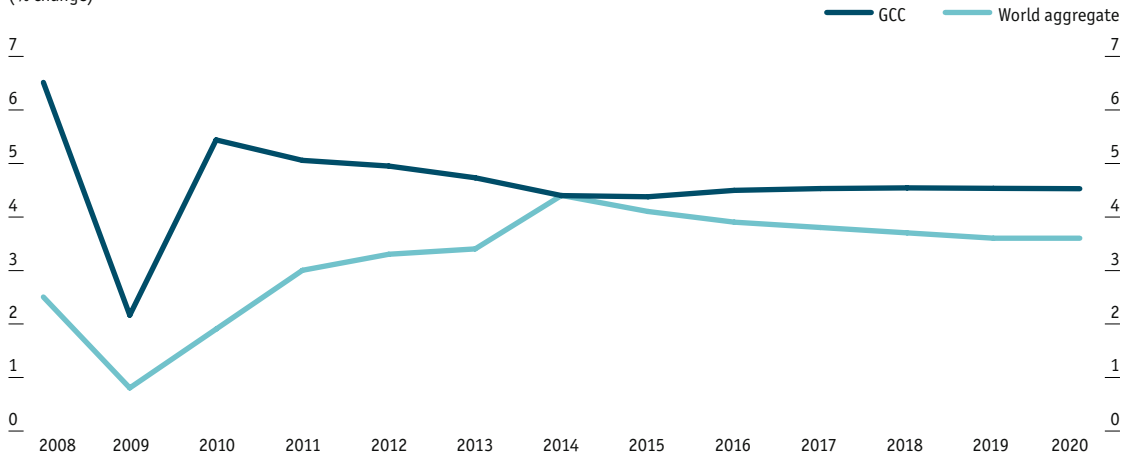
% of world GDP

	2000	2005	2010	2015	2020
US	30.7	27.7	24.4	21.2	19.7
EU15	25.2	28.8	25.1	22.7	19.9
EU27	26.5	30.6	27.6	26.9	26.5
Japan	14.6	10.2	9.1	7.2	5.6
China	3.7	5.1	8.9	11.8	13.8
India	1.4	1.8	2.3	3.3	4
Russia	0.8	1.7	2.9	3.4	3.2
Brazil	2	2	2.5	2.4	2.6
GCC	1.1	1.4	1.5	1.6	1.7

Source: EIU long-term forecasts



Real growth in GCC and the world
(% change)



Source: Economist Intelligence Unit.

eastward. Yet the experience of the current global slowdown has highlighted the degree to which emerging markets still depend on demand in the world’s biggest consumer market. The notion that emerging markets could somehow “decouple” from the large developed economies has so far been shown to be something of an illusion.

Our interviews suggested there was a strong consensus behind this broad view of the shifts in the world economy. Nevertheless, although all highlighted the increasing importance of Asia, none suggested that another country would overtake the role of the US within the next 11 years.

The GCC and the world economy

The GCC’s geographical location, and its cultivation of diplomatic and trade links with key Asian and African states, suggest that it is in a strong position to benefit from expected growth in the developing world. GCC states are already developing their trade and investment in these regions and seeking to build stronger links with key economies.

Top ten largest economies

By nominal GDP at market exchange rates (US\$bn)

2005		2010		2020	
USA	12,422	USA	15,002	USA	23,134
Japan	4,554	Japan	5,613	China	16,213
Germany	2,792	China	5,494	Japan	6,553
China	2,303	Germany	3,217	Germany	4,702
UK	2,277	France	2,671	India	4,616
France	2,146	UK	2,173	France	3,976
Italy	1,780	Italy	2,139	UK	3,782
Canada	1,133	Russia	1,812	Russia	3,764
Spain	1,131	Canada	1,549	Brazil	3,025
Brazil	882	Brazil	1,532	Italy	2,917

Source: EIU long-term forecasts



The GCC in 2020:

Outlook for the Gulf and the Global Economy

GCC long-term economic growth

Core scenario projections

	2005	2010	2015	2020
Total GCC real GDP, US\$m	615,431	788,406	991,985	1,237,651
% annual growth, five-year period		5.4	4.9	4.5
Real GDP per capita, US\$	17,542	18,643	20,260	22,543
% annual growth, five-year period		1.3	1.7	2.1

¹ Projections for GCC growth for 2009-11 are aggregated from the EIU's detailed short-to-medium-term models for each GCC economy. Projections for 2011-20 are drawn from our long-term growth forecasting model, which produces projections based on a wide range of factors, including the region's robust demographics and the significant potential for catch-up growth as more technology is adopted across the economies.

Yet in this respect, GCC states will face intensifying competition from other countries seeking to build similar trade and industrial links. They will also face increasing competition in some of their fledgling manufacturing and services subsectors, including knowledge-based industries. However, the GCC's energy-intensive manufacturing industries will maintain a competitive edge because of the region's natural energy advantage.

The GCC's share of the world economy is expected to grow steadily between now and 2020. The pace of growth will be slightly higher than aggregate global growth with an annual average of 4.5% in real terms, compared with 3.3% globally¹.

Oil prices are not built into our forecasts for long-term real growth, but the assumptions underlying our projections would be broadly consistent with oil prices of between US\$50-60/barrel for dated Brent blend. Prices at this level would provide sufficient government revenue to boost investment in infrastructure and human capital, although it is possible that these improvements could also be sustained with lower oil prices if sufficient foreign investment was forthcoming and if revenue streams were diversified. Conversely, there is an argument that much higher oil prices—of US\$100-200/b—could reduce the incentives for economic reform.

International institutions expand but individual states remain key

Rising powers may play a greater role in international institutions, pushing for better representation on the UN Security Council and improved voting rights at the International Monetary Fund (IMF). The fact that it was the G20, rather than the G8, which met in November 2008 to discuss the global response to the economic slowdown was widely hailed as a sign of a new multilateralism. But with the representation of a larger collection of governments, these institutions may find that it is even harder to make binding decisions.

This trend towards a new multilateralism appeared to be welcomed in the Gulf, whose economic power was acknowledged with the participation of Saudi Arabia as part of the G20; shortly afterwards, GCC states were

also courted as a potential source of new funds for the IMF. Yet while it was relatively easy for the G20 to agree on broad principles to counter the downturn, the group had less success in translating these into real policies; an agreement to work for the speedy completion of the Doha round of international trade talks was followed instead by the adoption of new protectionist measures in a number of countries. Nor did the GCC agree to inject new cash into the IMF's coffers².

Ultimately, GCC states may make an increased contribution to international institutions. But as far as aid and concessional lending goes, they are likely to prefer to work within regional and Islamic development banks where their influence is already well established.

² The possibility of increasing funding in the future has not been entirely ruled out, but the cash injection anticipated by some Western politicians in 2008 was not forthcoming



Global politics in 2020: Shift to a multi-polar world

This shift in economic weight will be paralleled by efforts on the part of the new economic giants to gain more representation in world politics, whether through international institutions, economic and cultural forms of soft power, or more traditional military might. Although the US is projected to remain the most powerful country in the world in 2020, with by far the world's highest level of military spending, other countries are likely to seek a more central position on the global stage.

The US role in the Gulf—and the role of rising powers

In our view, despite a testing period in recent years, the US is likely to maintain a significant presence in the Gulf, both to protect shipping and to guarantee the security of its allies in the region. European states will also continue to play a role.

Rising powers—notably India and China—are also likely to seek some role in the Gulf security system, although probably as part of a multilateral framework, for reasons of cost as well as diplomacy. Their own interest in protecting shipping links with the Gulf will grow as their trade with the region expands. They are also likely to be increasingly keen to project their own power overseas. It is notable—as several of our interviewees mentioned—that both China and India deployed ships to counter piracy off the coast of Somalia in late 2008, following attacks by pirates on Chinese and Indian vessels.

“I see the prospect of more powers being involved in protecting the sea lines,” says Zakir Hussein, a specialist in Indo-GCC relations at the Institute for Defence Studies and Analysis in India. “They would justify their presence as the bulk of their trade and energy passes through the same route. The piracy issue will continue to haunt the region for some time to come.”

Some interviewees suggested that Turkey could also potentially step up its involvement in the Gulf. As part of NATO, Turkish naval forces have already participated in a joint naval exercise with Bahrain under the Istanbul Co-operation Initiative, and as of February 2009 the Turkish parliament had approved a naval deployment to the waters of Somalia. There has also been some speculation that Russia could seek to project its force in the Gulf but it seems likely that it would be deterred from doing so by the US's predominance in the region. Our interviewees generally agreed that the US was likely to remain the dominant external security player in the Gulf, as well as the main supplier of arms, although some said that the GCC states might buy an increasing proportion of arms from Russia and from France.

The financial system in 2020: the diminishing dollar

The US dollar's role as the world's reserve currency is likely to be reduced as its economic pre-eminence wanes. Yet no single other currency will be in a position to overtake it. Rather, countries around the world will continue to diversify their foreign exchange reserves, a trend that has already begun in some countries (including in the GCC).

The GCC moves to a currency basket

Most of our interviewees thought it feasible that the GCC would have monetary union by 2020, though not by 2010. Under the EIU's core scenario, the GCC countries will peg their common currency to a trade-weighted basket of currencies by 2020, although one or two states may opt out of this initiative. The GCC



countries are unlikely to adopt a floating currency by 2020 as they will continue to view a currency peg as a force for stability and as a nominal anchor to reassure investors and trading partners³.

The GCC's maintenance of the US dollar peg during a testing period in 2007 and 2008 underlines their traditionally cautious approach to currency policy and their desire to avoid any hasty reaction to short-term trends. Speculation about a possible break with the dollar in late 2007 and early 2008 was largely fuelled by international banks—some of whom arguably had an interest in promoting a move to a flexible currency in which they could then offer trades—rather than by local economists. Nevertheless, we believe there is a growing consensus among local economists that, in the medium term, a currency basket would bring more flexibility to GCC interest rate policy.

According to Neil Partrick, a UAE-based business consultant and a political science lecturer at the American University of Sharjah, the GCC states may need to revisit their convergence criteria for monetary union. "When the convergence criteria were agreed, it was on the basis that there would be a peg to the US dollar," he says, suggesting that they might need to be readdressed if a currency basket is considered. There could also be some reluctance to be tied into co-ordinated interest rates. "The inflation issue that was experienced in the region prior to the financial crisis affected individual states in differing ways. This seemed to underline the desire to broaden the peg with the dollar but also to maximise options with regards to interest rates."

Assuming that oil is still being traded in dollars in 2020, a GCC currency basket is likely to be heavily weighted towards the dollar, as is already the case in Kuwait. "I just don't see a substitute for the dollar," says one interviewee. "The US may not be so dominant, but it's a country with a propensity to change when it makes a mistake, and that will help it remain the leader."

Jamal Shergill, CEO for Middle East and South Asia and Head of Global Wealth Management at United Bank for Africa, raises the possibility that commodities such as oil and gold might also be included in the basket⁴. It has been argued that commodities could act as a counterweight to currencies⁵. The inclusion of oil in particular would help the currency to at least partly reflect fluctuations in demand for the GCC's key export.

"Khaleeji"-denominated oil?

Some interviewees reflected on whether oil would still be traded in US dollars in 2020. Mr Shergill argued that Omani oil contracts would be traded in the "Khaleeji"⁶ and that other GCC crude grades would at least be quoted in "Khaleeji". "There are natural worker remittances to India, Pakistan, Egypt and other oil-consuming countries and these countries will prefer to have oil quoted in 'Khaleeji' to hedge currency risk," he says. Conversely, Jean-Francois Seznec, Associate Professor at Georgetown University's Center for Contemporary Arab Studies, argued that oil was unlikely to be traded in a new Gulf currency. "The relatively low volume of the new currency would make it subject to enormous swings from speculators and oil managers trading in it," he explains.

Another interviewee noted that the US would remain the single largest buyer of oil and that this would give it the power to require pricing to be in US dollars. A separate argument was put forward by Philip McCrum, a Middle East analyst and business consultant at Quill Analysis, who suggests that euro-denominated oil is a strong possibility, particularly as the EU-27 bloc grows in size and influence

³ Countries that are heavily dependent on exports of a single commodity, and which also have a floating exchange rate, tend to experience significant currency volatility. A fully flexible currency probably will not happen until the GCC economies have substantially reduced their dependence on oil by a much greater degree than is likely by 2020.

⁴ Harvard University's Jeffrey Frankel suggested in 2003 that the Iraqi dinar should be pegged to a basket comprising the dollar, the euro and a barrel of oil, and Brad Setser of the Council for Foreign Relations has recommended such a basket for the GCC.

⁵ On the basis that most of the currencies in the basket will belong to oil-importing states; other things being equal, a weak dollar is likely to be correlated with a higher oil price.

⁶ One of the suggested names for the new Gulf currency.



relative to the US. In general, however, the expectation that the US will remain the GCC's main external political ally appears to support a continuation of the status quo.

New entrants to the union?

One interviewee questioned for our research suggested that the GCC currency union could be expanded to non-GCC countries by 2020. The possibility of other Arab countries joining the currency union has generally been little discussed to date, although Yemen has been bidding for GCC membership since the mid-1990s.

In January 2009, however, the governor of the Lebanese central bank, Riad Salameh, called for a "uniform Arab currency" as a long-term goal. Mr Salameh suggested that Arab countries should begin by including other Arab currencies in their foreign exchange reserves, and proposed creating a common Arab financial market.

The history of previous efforts at Arab economic and political integration suggests a full-scale Arab currency would be highly unlikely by 2020. Yet in some ways Arab countries would be well placed—ignoring political considerations—to join a currency union. Most Arab states already peg their currencies to the US dollar and therefore already have only limited sovereignty over their own interest rates.

There may be potential in the long term for the GCC to offer membership in its currency union to other select Arab countries. For instance, GCC states have previously helped to support the Lebanese pound by direct transfers to the Lebanese central bank, and it is not unimaginable that they could purchase Lebanese pounds for their own reserves, or consider including Lebanon in a currency union at some point in the future.

Demographics in 2020: harnessing a young population

Falling birth rates will lead to ageing populations in many developed countries over the forecast period, but the GCC will remain an unusually young part of the world. This should help to make it an attractive investment destination and consumer market—although much will depend on the extent to which the young population can be harnessed as an effective labour force.

The GCC is expected to remain a major importer of foreign labour by 2020. However, it will face increasing global competition for migrant labour—especially in sectors where skills are scarce—as populations in OECD countries become older. This contest will not be evident in the early part of the forecast period, as a rise in global unemployment in 2009-10 means there will be more competition for jobs. Indeed, in the short term, there may be increased anti-immigrant sentiment in developed countries as migrants are scapegoated for unemployment among nationals. The number of migrant workers in the GCC is also likely to fall in the short term, as hundreds of thousands of workers are laid off, particularly in the labour-intensive and migrant-dependent construction sector.

Over the medium to long term, however, OECD countries with ageing populations will need a greater number of young migrant workers to fill jobs and to support the rising numbers of old-age pensioners. By world standards, the GCC will still have a low dependency ratio (the ratio of pensioners to working-age population) by 2020. Yet the increase in competition for migrant labour may drive wages up and could also increase pressure for better working conditions. Already, in 2007-08, there were signs of

such pressure emerging as Gulf demand for migrant labour expanded rapidly while job opportunities also improved in key Asian source countries. Labour issues could become an increasingly important aspect of relations with source countries.

The next report in our series will examine demographic trends in depth.

Energy in 2020: consumption, environment and alternatives

Between now and 2020, global energy consumption is projected to rise steadily in both absolute and per-capita terms, as more countries industrialise and as income levels rise. Numerous factors will accelerate this trend around the world, including a rise in ownership of cars and electrical consumer goods, a continuing shift from fires and candles to electric light and heating, and the entrenchment of more energy-intensive meat-rich diets.

Most interviewees questioned for this research expected that the world would still be largely dependent on fossil fuels during this period. One noted that the 1973 oil shock had prompted much talk of reducing dependence on imported oil at the time but added that public opinion is fickle on this issue. Meanwhile, greater global awareness of the environment, and fear of climate change, will play a key role in future energy trends.

In the early part of the forecast period, private-sector investment in alternative energy is likely to slow as a consequence of the global economic slowdown and the drop in oil prices. Yet public-sector investment in alternative energy and in energy-saving technologies may rise, as governments include green investments in their economic stimulus packages. In the US and Europe, subsidies for the automotive industry are being tied to progress in improving fuel efficiency and developing hybrid models. The US in particular is accelerating its efforts to promote renewables and to improve energy efficiency in the national grid.

In the medium to long term, regulatory changes are likely to support increasing investment in alternative energies. Governments in developed countries, particularly the US and Europe, have begun to entrench commitments to renewable energy and carbon-emission caps in laws.

In California for example, which is the largest US state by population and by GDP, utilities providers will be required to source 20% of their energy from renewable sources by 2010 and 33% by 2020. This is one of the most ambitious targets in the world, and reflects the local geography and climate, with vast expanses of desert and abundant sunshine. Many experts perceive this trend in California as being a bellwether for wider US policy.

Crucially, developing countries are also investing in alternative energy and fuel efficiency measures. Cost incentives and concerns about pollution have led some industrialising oil-importers—notably China—to invest in fuel-efficiency and alternative energy technologies and to pass laws on fuel efficiency. China aims to increase the share of its energy that comes from renewable sources (hydroelectric, wind, solar and biomass) to 20% by 2020, compared with around 8% in 2005.

For its part, the GCC will generate more of its electricity from renewable sources in order to free up oil for export and gas for industrial feedstock. GCC states are already investing in solar and wind technology. Nuclear power is also beginning to be developed.



As increasing volumes of gas are consumed by the growing manufacturing sector, energy efficiency will also become more important to the GCC. Currently, consumers have little incentive to rein in their consumption due to the cheap cost of electricity, which is heavily subsidised. Tariffs may gradually be increased, and may be targeted towards higher-income households (this would, however, require the publication of household income data which has traditionally been scanty and could be politically sensitive). Another option is that higher tariffs may be phased in at a progressive rate as a household's energy consumption increases in order to discourage high levels of consumption.

The GCC countries are not currently included in the Kyoto emissions cap, as they are not included in the list of countries defined as being industrialised. However, as the GCC industrialises further, and as its per-capita carbon emissions increase, there will be growing pressure to include it in any global framework for reducing carbon emissions. Legislation on carbon emissions in trading partners will also affect GCC businesses, particularly those operating in the EU. Notably, any airlines flying to EU destinations are to be included in the EU's Emissions Trading Scheme from 2012 onwards. Future free trade agreements could potentially include emissions caps among their conditions.

The wider picture for energy demand

Under our core scenario, the world's dependence on GCC oil and gas will rise between now and 2020. Most of the increases in oil supply are expected to come from the Middle East, which has the bulk of the world's proven reserves and relatively low production costs. Much will come from the GCC; Iraq and Iran have significant long-term output potential but their development will be hampered by political factors.

In the early part of the forecast period, global investment in oil production capacity will be held back by lower oil prices and by the difficulty of obtaining financing. However, large state-owned energy companies with access to state finance and government loan guarantees—like those in the GCC—will be relatively well-placed to invest in new crude capacity and refineries, taking advantage of falling project costs.

The scope for non-OPEC supply growth appears to be limited. Large new projects (in Brazil and Kazakhstan among others) will be partly offset by falling production in maturing fields (for instance in Mexico and the UK). Potential for higher North American production may be held back by environmental and ecological concerns unless there is another sustained oil price spike towards US\$90-100/barrel. Investment in technologies to extract oil from tar sands is also expected to slow if oil prices remain well below their 2008 levels; this technology could prove very productive, but it is costly, energy-intensive and uncertain.

The likelihood that investment in new capacity will slow in the next few years increases the chances of another oil price spike when world economic growth and oil demand begin to recover. Moreover, by 2020, the question of "peak oil" is likely to resurface as there is uncertainty about the scope for increasing world oil output capacity much beyond 100m b/d.

	2007	2008	2009	2010	2015	2020
GCC crude oil production total, 000 b/d	15877.2	15742.2	15752.6	15009.7	18691.9	24115.3
% of world demand	18.4	18.4	18.7	17.6	20.2	24.4
World oil demand	86.1	85.8	84.4	85.5	92.7	98.8
World call on OPEC	38.4	39.0	36.6	37.0	41.8	46.7

Source: International Energy Agency, EIU long-term forecasts

Section 2: Trade and investment flows

Exports

GCC oil and gas production capacity is rising, and could rise much further by 2020. Yet this key resource is likely to be managed in a different way. One likely trend is that the GCC will be seeking to export a smaller proportion of its oil as crude—a low-value-added commodity that offers few employment opportunities. Instead, GCC states will aim to turn more of their oil into refined products or petrochemicals, and to use their oil and gas resources as feedstocks for industries that will add more value and provide more jobs.

The volume of goods traded is likely to grow as new industrial projects, such as petrochemicals, aluminium and other resource-based industries, come onstream. The difficult international financing environment in 2009-10 means that some of the planned projects will be delayed, postponed or cancelled, but the region's demographics suggest it will remain attractive to investors and lenders in the medium term.

Visible goods trade will remain very important to GCC economies and the Gulf will remain the key maritime shipping route, although rail links will also open up new routes. In particular, the Saudi "landbridge" railway will sharply cut the time taken to transport goods from the Gulf to the Red Sea.

The planned high-speed rail and road link between Bahrain and Qatar, the so-called "Friendship Bridge", is scheduled for completion in 2013. This may be joined by other rail links between GCC states, which would facilitate intra-regional trade. A rail link to Turkey has also been proposed in the longer term.

Several interviewees highlighted finance as a priority sector for the future. It was generally felt that the GCC is likely to be a regional financial hub in 2020, with a similar status within the Middle East to that of Singapore within Asia. It is, however, unlikely to rival the more established centres of New York or London. Islamic finance will grow much more quickly in the region than conventional finance, says Majid Dawood, chief executive of Yasaar, an Islamic finance consultancy. "This could lead to the region becoming a hub for the sector internationally," he explains.

Although the region's financial services sector includes a higher proportion of nationals than many other industries, it will continue to depend on expatriate talent. The mobility of this talent could be a concern. Over the medium to long term, the GCC may need to step up efforts to retain this talent and develop its own sources. While other financial centres also utilise high levels of expatriate talent, cities such as London or New York offer workers a better chance of gaining citizenship and of building a permanent life for their families.

The GCC has not traditionally been seen as an important centre for technology, but some interviewees predict that this could change. "The region will provide platforms for research and development, open new research centres, and develop new seed and irrigation technology that is suited to an arid climate," says Mr Hussein.

The GCC states will also make increasing efforts to promote health and education "tourism" although, for the foreseeable future, these will be dominated by domestic demand. The quality of tertiary



education is perceived to be improving but wholesale improvements will depend on reforms to primary and secondary education, which will be a longer-term process. Ultimately, though, GCC universities will be promoted to foreign students, and this will play a role in deepening foreign relations.

Eastward exports

The share of GCC exports that go to Asia is almost universally expected to increase. Even if there were no policy moves to foster greater eastward trade, projected economic growth rates for key Asian markets (barring Japan) are higher than for more developed economies. This is likely to fuel greater increases in demand for imports. Moreover, since industry will be a key growth area for these economies, there will be a particularly high demand for the fuel, industrial chemicals and plastics produced by the GCC. "China will be the key trading partner for the Gulf in 2020, both for exports and imports," says Takeru Hosoi, Associate Professor in the Faculty of Economics at Kokugakuin University in Japan.

China's exports of low-cost consumer goods to the GCC have already been rising strongly in recent years, both in absolute terms and as a percentage of the total. "Strong historical and cultural ties with India, as well as contemporary economic ties, would benefit trade links in both directions, while commodity-rich Indonesia is another promising source of imports for the GCC," says Alastair Newton, Managing Director and Senior Political Analyst at Nomura International.

Mr McCrum agrees that India and China would be increasingly important trading partners, but also points to the potential for growing regional trade. "Intra-Arab trade will expand rapidly," he says, "helped in large part by the new rail network, but also by increased links forged by migrant Arab workers, who will form a larger part of the GCC expatriate labour force."

Inward investment

Inward investment is likely to be concentrated in the export-oriented industries outlined above, and in services sectors that cater to the growing resident population, including power, water, transport, education and healthcare. "Petroleum and petrochemicals are the GCC's most competitive industries," says Professor Hosoi, "but the shortage of infrastructure in the region, particularly related to water and power, make this another key investment sector."

There is little public transport in the GCC and the potential for railways and urban light rail is strong. There is also scope for more public-private partnerships in the provision of services, notably healthcare. Foreign participation in education may slow following a surge in recent years, as universities pause to assess the success of recent entrants. Some institutions will also be deterred by concerns about political constraints and censorship of the press and the internet in parts of the GCC.

Lending to real estate projects may be subdued for some time following the recent boom. However, there is scope for greater investment in some property subsectors, since investment in recent years has focused heavily on high-end property at the expense of affordable housing.

Outward investment

The GCC's sovereign wealth funds will remain important investors, but the extent to which they grow will depend crucially on the future trajectory of the oil price, as well as on their own investment decisions.

If the average price of dated Brent blend were to stay at between US\$50-55/barrel over the forecast period, the GCC's aggregate current account surplus would be likely to dwindle to between 1-2% of GDP

in most years⁷. At this level of oil price, the GCC's hydrocarbons exports are unlikely to match the record value recorded in 2008 in any year between now and 2020. There is, however, a significant upside risk of a spike in oil prices when the world economy recovers from the current downturn. If Brent averaged US\$70/barrel per year from 2015-20, the GCC's aggregate annual current account surplus would be closer to 4-5% of GDP (allowing for higher import demand).

Meanwhile, as the population grows, demand for imported goods and services will continue to expand steadily. Transfer debits, mostly in the form of workers' remittances, are also expected to increase given the continuing reliance on expatriate labour. Income from foreign investments and from services exports will therefore become increasingly important to keep the current account in surplus.

Destinations for overseas investment will combine the traditional and the new. "Due to the maturity of the markets, Europe and the US will continue to be major investment destinations for the GCC," says Mr Dawood, "but China and India will gain importance as well as agricultural-based economies."

How will the strategies of sovereign wealth funds change?

GCC sovereign wealth funds have built up sizable assets as a result of the recent oil boom, even allowing for mark-to-market losses in the past year. A lower oil price suggests the rate at which these funds accumulate capital will slow. One interviewee predicted that some countries would make net withdrawals from their SWFs by 2020.

Governments will face competing pressures over how to manage these funds. Notably, they will need to balance the desire to increase returns and diversify their income streams, against the need to conserve assets for future generations. It is noteworthy that the SWFs have behaved cautiously during the 2008 downturn, defying predictions that they would make extensive, opportunistic acquisitions at low valuations. "SWFs will need to keep a large proportion of their assets in low-risk investment vehicles as they will be mindful of their underlying rationale to ensure the prosperity of future generations," says Mr McCrum. "Over time, though, they will gradually become prepared to take on more risk."

In the early years of the forecast period, GCC SWFs will face domestic pressure to increase

GCC aggregate current account

US\$bn

	2007	2008	2009	2010	2015	2020
Trade balance	294.5	365.8	4.9	86.6	98.8	105.9
% of GDP	36.0	35.9	0.6	9.3	7.1	5.3
Exports	559.3	698.2	332.1	438.5	621.4	860.6
Oil and gas	410.9	549.8	183.3	283.7	391.3	522.5
% oil	73.5	78.7	55.2	64.7	63.0	60.7
Non-oil	148.3	148.4	148.8	154.8	230.1	338.1
Imports	-264.8	-332.4	-327.2	-351.9	-522.6	-754.7
Services	-79.5	-104.8	-104.7	-110.3	-172.9	-248.1
Income	18.8	9.1	13.3	17.2	60.3	138.3
Current transfers	-40.0	-42.4	-41.1	-44.5	-62.7	-91.0
Current account balance	193.7	227.7	-127.5	6.0	14.4	33.3
% of GDP	23.7	22.3	-16.4	0.6	1.0	1.7

⁷ There is significant variation between the prices for different Gulf crudes but most trade at a small discount to Brent.



investments within their own region to help offset the impact of falling foreign investment and tight international credit markets. “The trend will be to invest at home or near home,” says Mr Shergill, noting that most GCC states have multiple SWFs and that each will have its own investment style.

At the same time, investment opportunities within the GCC will be limited in the short term and SWFs will want to ensure that their assets are geographically diversified in order to hedge against possible domestic downturns. “There is a limit to how much the region itself can absorb,” says Thomas Mattair, a US-based business and government consultant at the Middle East Policy Council. “The development of SWFs should be seen as part of the overall GCC diversification strategy.”

When SWFs do make investments abroad, they are unlikely to agitate for change. “GCC countries are likely to remain largely passive investors overseas,” says Gerd Nonneman, Professor of International Relations & Middle East Politics at the University of Exeter Institute of Arab and Islamic Studies, “as they don’t have the inclination or the personnel to start running foreign companies.”

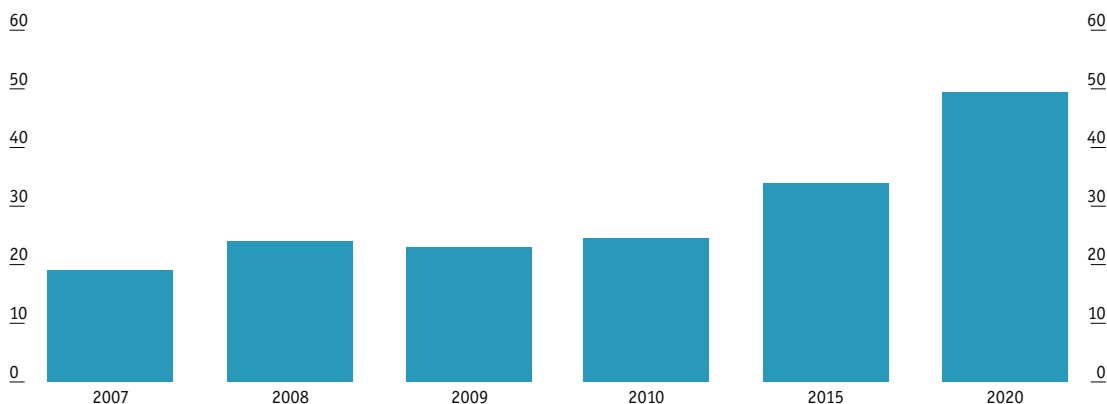
Overseas, the wariness and protectionism that some countries have exhibited over SWFs is likely to moderate, at least in the early part of the forecast period, as capital becomes more difficult to obtain from other sources. Yet while Western countries may place less of an emphasis on calls for SWFs to become more transparent, domestic pressure for greater transparency around SWF strategies may increase following reports of losses in 2008.

Buying up farmland

As food prices soared in 2007 and 2008, GCC government and private investors explored wide-ranging purchases of agricultural land all over the world—in Africa, Central Asia, Southeast Asia, Eastern Europe and other areas—to ensure future food security. This enthusiasm could subside as food prices fall in the early part of the forecast period. Yet it appears virtually certain that the GCC will become more dependent on imported food.

An important reason for this is water scarcity, which means that domestic agricultural production tends to be costly. Notably, Saudi Arabia has announced that it will phase out domestic wheat production by 2016 in order to save water. Across the GCC, aggregate spending on food imports is

GCC Food imports
(US\$ bn)



Sources: Individual country central banks, Economist Intelligence Unit long-term forecasts

projected to more than double from US\$24bn in 2008 to US\$49bn by 2020.

If the GCC presses ahead with investments in agriculture overseas, it could potentially give a significant boost to agricultural production in poor countries. GCC states might also be able to supply these countries with cheap fertilisers at cost price. At the same time, there could be a risk of a political backlash against GCC investors, like any foreign landowners, especially in times of food shortages.

“This so-called ‘plantation agriculture’ will attract increasing criticism of neo-colonialism from varying quarters,” says Mr McCrum. “Ever sensitive to criticism, Gulf states are likely to limit their agricultural investments and will choose them with care.”

Conversely, Mr Shergill suggested that the GCC would be competing with China and India for land in Africa in 2020—and that GCC countries will need to lease fishing rights overseas, as world fish stocks plummet and as Persian Gulf waters struggle with increasing salinity. In his view, African countries with large coastal borders would be well-placed to take advantage of this.



Section 3: The GCC as an economic bloc

There is still a great deal of scepticism among foreign investors over the degree to which the GCC states will really work together, given their historical rivalries. The liberalisation of trade and free movement of labour continue to face barriers, yet compared with other attempts at cross-national Arab integration, the GCC has already made some achievements, such as investment laws applying to GCC nationals rather than citizens.

To what extent will the GCC economies converge or diverge between now and 2020, and become a more coherent economic bloc? Here, we have sketched out three broad scenarios:

A. Status quo plus tentative steps

Under this scenario, the GCC proceeds with steps towards further economic integration, but the process is slow and cautious. Policymakers are preoccupied with developing their individual economies and regional integration takes a back seat. Based on current trends, this appears to be the most likely scenario.

- Intra-regional investment flows continue to grow but traditional political and economic rivalries prevent full implementation of the common market
- Monetary union initially adopted by just three or four countries
- Separate financial-sector regulatory systems in each country
- Different licensing frameworks and policies on foreign investment persist
- Attempts to harmonise taxation are discussed, and could result in a common GCC value-added tax rate
- Future free-trade agreements follow the model used in the 2008 FTA with Singapore, where each country made different concessions and set different conditions
- Movement of labour becomes freer but public enterprises still give preference to country nationals rather than GCC nationals

B: Divergence and competition

Under this scenario, the GCC states adopt divergent economic policies to deal with differing growth trajectories and very different fiscal positions. The existing customs union is maintained but the monetary union project is slowly abandoned as member states decide their economies are too divergent for interest rates to be centralised.

- The official GCC convergence criteria, based on Maastricht, focus on only a few indicators. A wider range of economic indicators are likely to diverge, as hydrocarbons production in some states dwindles. Fiscal policy will be directly affected
- Income and corporation taxes will be introduced in some states, while states with higher revenue from hydrocarbons and from foreign investments will maintain a low-tax environment to attract investors

- The less oil-rich states move to reduce subsidies on power, water and food—although education and healthcare will remain heavily subsidised across the GCC
- Oil-rich states will resist these moves for political reasons and will take measures to prevent subsidised goods from “leaking” into countries without subsidies. New non-tariff barriers will hamper regional trade
- Some countries will drop the dollar peg while others do not. Exchange rates will diverge, adding to trading costs
- Countries will negotiate FTAs unilaterally
- Each country has a separate financial regulatory system and the states compete fiercely to attract and retain foreign financial institutions and talent

C: Convergence and unity

Under this scenario, GCC policymakers push ahead with economic integration, believing that they need to pull together to confront a less favourable economic environment. The likelihood of this scenario will increase if the euro is perceived as having helped the Euro area to weather the downturn in 2009-10⁸. It will, however, depend critically on political will within the region.

- Monetary union is introduced towards the end of the forecast period—with a peg to a currency basket allowing policymakers some flexibility to decide interest rates
- A single central bank—with a rotating location—sets the key policy interest rates for the GCC
- A single financial regulatory framework is adopted using best practices from the existing regulator
- The GCC declares its intention to move towards EU-style financial services passporting, although this takes considerably longer to be implemented than expected
- A single stock market is considered as a means to pool regional liquidity, but individual countries engaged in privatisation still want to restrict IPOs in state-owned firms to their own nationals
- Fiscal policy moves towards greater harmonisation of tax and subsidy rates. There is greater fiscal redistribution to ensure economic convergence
- Gulf SWFs make more investments within the GCC
- There is greater harmonisation of legal and regulatory environments, so firms investing in any one GCC state find it easier to do business in the rest of the bloc
- A range of FTAs are signed with the EU, China, India, Japan, Mercosur and others
- Travelling within the GCC becomes easier as train links are developed
- In the long term, aims include the introduction of a single GCC business visa; and a GCC-wide work permit
- As with the EU, economic integration will depend on good political relations, but will take precedence over political integration such as the development of a common foreign policy or a strengthening of shared security forces

⁸ There are of course important differences in the size and economic structure of the Euro area and the GCC. However the Euro area will inevitably be seen as a key example of currency union as there are not many others in operation (two currently operate in Africa and the Southern African Development Community is considering another).



Section 4: The GCC and the Middle East

The economic boom since 2003 has highlighted the GCC's ability to grow strongly despite tensions elsewhere in the region, notably in Iraq, Lebanon, the Israeli-Palestinian arena, and between the US and Iran. Despite this achievement, regional security shocks have dented inflows of investment and tourist arrivals in the GCC in the past, notably after 9/11 and immediately after the US invasion of Iraq. Developments in Iraq, Iran and Yemen all present "wild cards" that could have an impact on international perceptions of the GCC.

Relations with Iran

Iran's role in the region is seen as one of the key uncertainties over the next decade. The evolution of the GCC's relations with Iran will be closely linked with developments in Iran's relations with the US, given the existing ties between the US and the GCC. But the GCC as a whole is unlikely to be either as openly hostile to Iran as the US is at present, or as comfortable with Iran as the US was under the government of the Shah.

Speculation about the possibility of a US or Israeli war with Iran has died down in recent months, particularly since the change of government in the US. Mr Dawood noted that a war is unlikely in the near future as the US has too many fronts open, given its deployments in Iraq and Afghanistan. This is a view that is widely shared. Given the new US administration's statements on dialogue with Iran, there is now more focus on the prospects for US-Iranian engagement, potentially leading to a rapprochement. "Iran may just extend the olive branch – with their budget balancing at \$90 oil, the sanctions are really hurting the country," commented Mr Shergill.

"An agreement between the US and Iran isn't going to be like under the Shah—it would be more of a *modus vivendi*," says Mr Nonneman. "If a transition to better US-Iran relations is managed well, a more relaxed regional environment could make the GCC less dependent on US protection, which would be good domestically. Most of the GCC opinion-formers don't want a war with Iran, but they do want the US to keep up the pressure."

Mr Hussein flagged up the possibility of a "grand bargain" between the US and Iran, as part of a wider settlement of regional issues, including the Israeli-Palestinian conflict. Mr Mattair noted that in his view, the GCC would want to be consulted on the shape of a US-Iranian deal. Mr Partrick suggested that while it is possible that Iran will have nuclear arms capabilities by 2020, an arrangement that prevents a declared, public weapons capability being achieved is also possible. "This may come about as part of a package for better understanding with the US, which may involve Iran compromising some of its ambitions for civil nuclear power," he says.

Over the medium term, however, the risk of an attack on Iran's nuclear facilities could increase again if efforts at engagement fail to achieve an agreement on the sensitive nuclear issue. (Iran says its nuclear facilities are purely for civilian energy purposes.) There is some uncertainty about how effective military means would be in ending, or significantly setting back, Iran's nuclear programme.

“If there is an attack and the regime survives, it would be likely to proceed [with a nuclear programme] again,” says Mr Mattair. “If there was a wider attack, it could lead to an anarchic situation looking more like Iraq with the Revolutionary Guards behaving like Baathists.”

Given the uncertainty about the potential for either engagement or conflict to deter Iran from pursuing its nuclear programme, several of the interviewees questioned for this report envisioned a “poly-nuclear Middle East” by 2020, with other states in the region seeking to balance Iran’s capabilities. “The GCC will probably have to live with a nuclear Iran and Iran probably will have to live with a nuclear GCC,” says Mr Seznec.

While the GCC states are unlikely to pursue overt weapons programmes, their development of civilian nuclear energy could create some ambiguity about their capabilities. “The GCC will have become a ‘peaceful’ nuclear-electric power with some punch in it with increasing nuclear co-operation with Pakistan. The loser of this race will be Iran, which will go bankrupt in the process,” says Mr Seznec.

“Iran will continue to develop a covert enrichment program and will have a nuclear bomb by 2020,” says Mr Shergill, also predicting a race for nuclear power within the GCC and pointing to France’s interest in providing nuclear technology to the region. Others were less sure that Iran would be a nuclear power by 2020, but agreed that the poly-nuclear thesis was likely should it succeed. “If we do have a nuclear Iran by 2020, and my sense is we will not, we will have a ‘poly-nuclear Middle East’ with very serious security implications for the region as a whole,” says Mr Newton.

Elsewhere in the region, GCC investors are likely to be at the forefront of investment in Iraq assuming its security situation continues to improve, given the size of its market and the great potential of its oil sector. Yet GCC countries may have divergent policies towards Iraq – for example, they have shown different degrees of enthusiasm towards re-opening embassies. The risk of “blowback” from militants operating in Iraq was acknowledged as a security concern but not seen as a fundamental threat to the region.

“Extremism in Somalia and Yemen is the greatest security threat across the region,” says Mr Newton. Of all the Middle Eastern states, Yemen has the shortest history of being a unified state, and the central government’s hold over parts of the country is weak. Mr McCrum argued that intensifying north-south rivalry and rising militancy could destabilise Yemen. “If that happens, the GCC will have to step in and pick it up off its knees,” he says. “They will have to give it membership and help it start to develop an industrial base that will help employ lower-skilled workers.”

We also asked the provocative question of whether the GCC would be trading directly with Israel by 2020. Most of the interviewees who responded to this question felt that the GCC has gone about as far as it can in reducing tensions with Israel in the absence of an Israeli-Palestinian agreement—and few wanted to bet on the likelihood of such an agreement even by 2020, a question beyond the scope of this study. Mr Hussein judged that a two-state solution was likely by 2020 but that any trade between the GCC and Israel would take far longer to develop.



Conclusions

Our projections of long-term trends in the GCC, and our interviews with a range of external experts, found a broad consensus that the GCC will continue to diversify both its foreign alliances and its economic relationships towards newly industrialising countries. By 2020, it will remain primarily an oil-exporting region, providing an even greater share of the world's oil than at present. GCC firms will also be gaining market share in energy-intensive industries including chemicals, metals and plastics. Over the next decade, the GCC will also develop further as a regional financial hub and a place for intra-regional tourism, notwithstanding some turbulence in both of these sectors in the early part of the forecast period.

The US is likely to remain the key foreign ally and security backer. Yet emerging economic powers will also seek to play a security role in the region and there are diverging views over whether the US would still play such a dominant role by 2020.

The US dollar is projected to remain the world's reserve currency, but reserves are likely to become more diversified. There is a debate over whether oil will continue to be priced in dollars, which would clearly affect the future of the GCC's currency link to the dollar. GCC investors will continue to hold US assets and will make direct investments in sectors where the US has a strong lead (notably high-tech sectors). Yet GCC investors are also likely to diversify their assets into Asia and Africa in search of higher returns.

The labour market is one of the areas deemed likely to change only slowly. Structural dependence on low-cost expatriate labour and on exports of oil are factors that have hardly changed over the past ten years and are likely to take more than another decade to address. Current investments in overhauling GCC education systems and promoting labour-force participation remain in their early stages. These will have their impact on the next generation of GCC graduates, but will not address the cost gap that currently encourages employers to recruit expatriate workers. As a result, the GCC's large-scale imports of labour and exports of remittances will remain one of its key exchanges with the rest of the world.

While every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in this white paper.

LONDON

26 Red Lion Square

London

WC1R 4HQ

United Kingdom

Tel: (44.20) 7576 8000

Fax: (44.20) 7576 8476

E-mail: london@eiu.com

NEW YORK

111 West 57th Street

New York

NY 10019

United States

Tel: (1.212) 554 0600

Fax: (1.212) 586 1181/2

E-mail: newyork@eiu.com

HONG KONG

6001, Central Plaza

18 Harbour Road

Wanchai

Hong Kong

Tel: (852) 2585 3888

Fax: (852) 2802 7638

E-mail: hongkong@eiu.com