MARSH JLT SPECIALTY

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Oil Price Dynamics: Economic Risks in the Middle East and Africa

Energy market dynamics will generate sizeable economic headwinds for the Middle East and Africa (MEA) in 2020. Many of the region's governments rely on hydrocarbons revenues, and the low oil price environment will drive widening fiscal and current account deficits, currency pressures, and contracting economic growth.

COVID-19's impact is suppressing global oil demand, which fell by 29% in April 2020, estimates the International Energy Agency. The global oil market faces both demand- and supply-side pressures, meaning that market volatility and suppressed prices are likely to persist throughout 2020.

A production cut agreed by OPEC+ nations will initially see production fall by 9.7 million barrels per day (b/d) before progressively loosening. In recent weeks, market conditions have eased, as many major economies have eased lockdowns, unlocking some fuel demand, and compliance with OPEC+ cuts appears relatively robust.

However, oil demand is unlikely to be restored to pre-crisis levels until normal economic activity is restored. Any oil price recovery will be exposed to significant downside risks — for example, if "second peaks" emerge — and economic uncertainty will ensure a degree of market volatility. In 2020, Moody's now forecasts Brent prices to average US$35/bbl and West Texas Intermediate (WTI) US$30/bbl.

The macroeconomic pressures facing oil-exporting nations are acute, as government revenues fall. Fiscal dynamics will be particularly strained, with most governments modelling their 2020 budget on higher crude oil prices. According to Marsh JLT Specialty's World Risk Review ratings, 96% of MEA countries' economic risks increased between January and May 2020. As shown in Figure 1, some of the largest score changes were seen in oil-dependent economies, such as Congo, Saudi Arabia, Nigeria, and Iraq — reflecting the challenging conditions these markets face. Eight of OPEC's 12 MEA members feature in the 25 MEA countries with the largest score changes.

Weakening macroeconomic fundamentals are also feeding into rising sovereign credit risks. Ratings agencies have downgraded a number of sovereigns in the region (see Figure 2), in some cases reflecting the twin impacts of COVID-19 and low oil prices.

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FIGURE 1

Some of the largest recent economic risk changes in MEA were seen in oil-dependent economies.

SOURCE: MARSH JLT SPECIALTY WORLD RISK REVIEW

25 Largest Country Economic Risk Score Increases in MEA (January - May 2020)

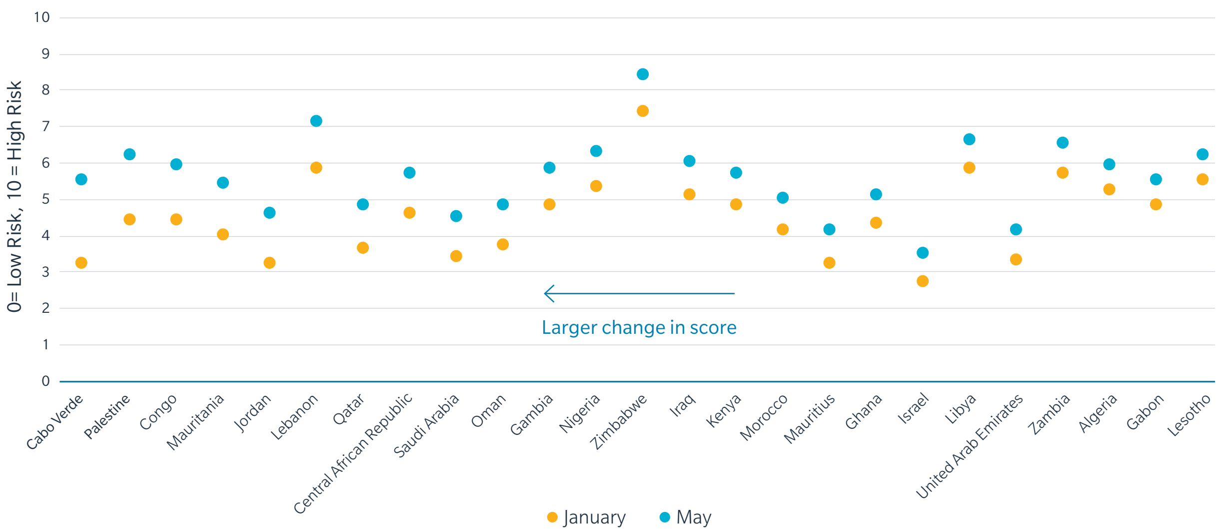
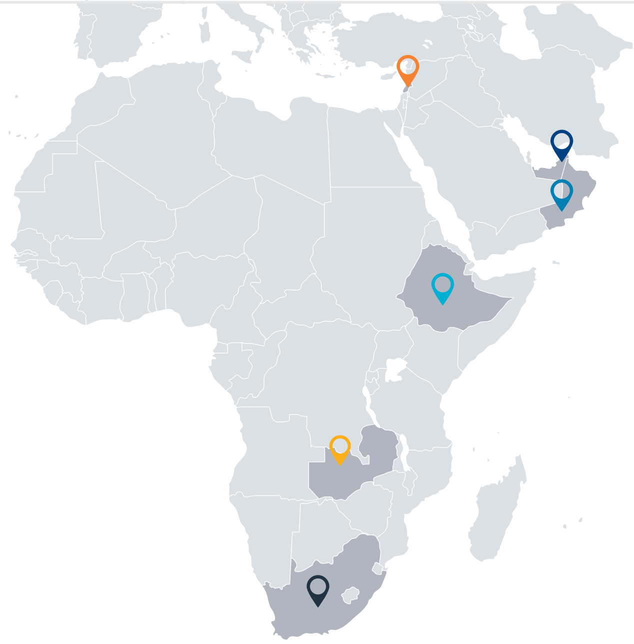


FIGURE 2

Ratings agencies have recently downgraded a number of sovereigns in the region.

SOURCE: MOODY'S



Ratings downgrades in MEA between January and May 2020.

- **Ethiopia** B1 → B2
- **Lebanon** Caa2 → Ca
- **Oman** Ba1 → Ba2
- **Sharjah (UAE)** A3 → Baa2
- **Zambia** Caa2 → Ca
- **South Africa** Baa3 → Ba1

Middle East and North Africa

Suppressed oil prices will place pressure on the credit position of many sovereigns in the Middle East and North Africa (MENA). In 2018, hydrocarbons accounted for an average 73.3% of exports across the region's principal exporters (Gulf Cooperation Council (GCC) states and Iraq). Alongside lockdowns and containment measures, oil sector weakness will inevitably feed into the wider non-oil economy, with growth in MENA forecast to contract by 3.1% in 2020.

The region's governments will post widening budget deficits in 2020 (see Figure 3). The fiscal impact of reduced oil revenues and a recession-induced fall in tax intakes will be exacerbated by stimulus measures, such as financial support for businesses. Fiscal buffers may also be eroded by a drawdown in foreign currency reserves. Governments are expected to cover budget deficits through increased borrowing, leading to increased public debt across the region.

These conditions are likely to push the region's governments towards austerity measures. Investment in infrastructure projects is expected to slow, while households will be hit by measures such as reduced public sector wages and subsidies. Such measures will elevate the risk of social unrest, given MENA's large youth population and relatively limited political freedoms.

Despite this, most governments in the region have the financial resources to maintain economic stability and meet payment obligations. Extensive sovereign wealth fund holdings in the United Arab Emirates (UAE), Saudi Arabia, Kuwait, and Qatar should be sufficient to protect currency pegs.

In March 2020, Saudi Arabia used US$27 billion in reserves to support its dollar peg. The UAE, Qatar, and Kuwait also benefit from lower current account breakeven prices for oil exports, than others in the region, such as Saudi Arabia and Bahrain.

Oman and Bahrain, which possess smaller reserves, elevated external debt to GDP ratios, and current account deficits will be least resilient to a sustained period of low oil prices. However, they should be able to rely on financial support from GCC allies.

In Saudi Arabia, production cuts will likely lead to reduced oil exports in 2020, with non-oil exports similarly impacted by suppressed external demand. Total exports are expected to contract by 3.8% in 2020. The government's fiscal position will deteriorate as a result, with oil accounting for approximately 65% of total revenues.

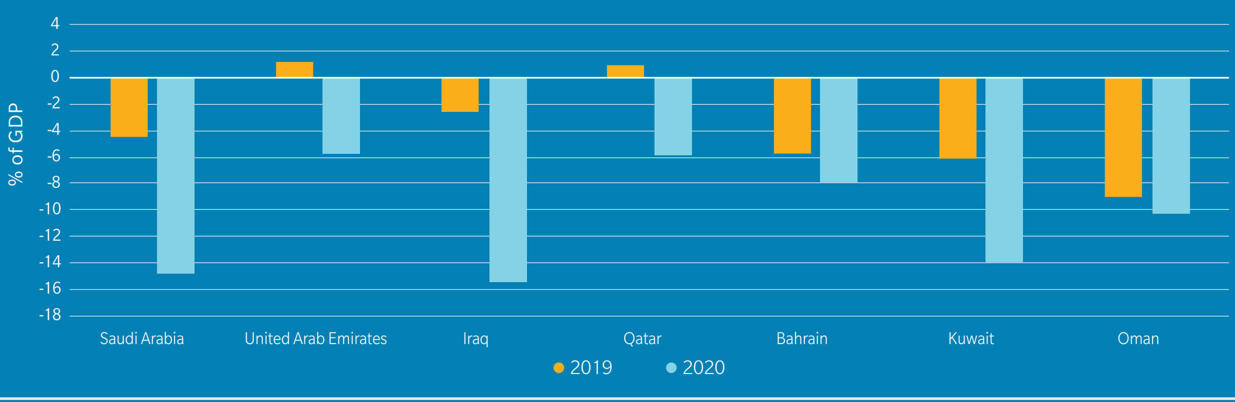
In the first quarter of 2020, the government ran a budget deficit of SAR34.1 billion, having run a surplus of SAR27.8 billion in the first quarter of 2019. The fiscal deficit is expected to reach 14.5% of GDP in 2020, from 4.4% in 2019. The Saudi government will reduce spending in response to weak oil fundamentals, slowing progress on the implementation of Vision 2030 (a strategic framework to reduce the country's dependence on oil and diversify its economy), having already announced a 4.9% cut in its annual spending target. Households will shoulder a large part of austerity measures; the government is also tripling VAT to 15% from July 1 and suspending a living allowance for state employees.

FIGURE 3

MENA governments will post widening budget deficits in 2020.

SOURCE: FITCH SOLUTIONS

Budget Balance in Select MENA Economies



Sub-Saharan Africa

In Sub-Saharan Africa, the immediate outlook is equally challenging. A number of the region's major economies are oil producers, with their governments reliant on the commodity for export revenues and hard currency earnings. Oil price weaknesses will generate acute economic pressures in the coming months, as many lack the deep, extensive financial resources of their Middle East counterparts.

Since the collapse in global commodity prices in 2014, few countries have made meaningful progress in reforming government finances, with some accumulating debt at an unsustainable rate. Many have increased their reliance on non-concessional external financing, weighing on debt affordability. At the same time, persistent fiscal and current account deficits are common.

Significant pressure on export revenues is likely to drive current accounts deeper into deficit across the continent. Financing these deficits will be problematic, given "risk off" sentiment in financial markets. Inadequate foreign exchange reserves will further limit financing options.

Amid balance of payments weakness, depreciatory currency pressures are likely to mount in the continent's oil exporters. In the year to May 2020, the South African rand and Zambian kwacha both lost more than 20% of their value against the US dollar. While the G20 agreed to suspend debt service repayments for low-income countries for the remainder of 2020, the cost of meeting foreign currency-denominated debt obligations to private creditors will rise.

It is increasingly likely that governments will look to restructure debt. In May 2020, Zambia announced that it would look to restructure loans, as foreign exchange reserves fell to record lows in January 2020, making them insufficient to cover external debt servicing in 2020.

Nigeria's trade balance is expected to deteriorate in 2020, amid slumping global oil demand and prices. Anticipated compliance with the OPEC+ agreement and lower oil prices will lead oil production to contract by 2.8% in 2020. Generally, oil accounts for 90% of Nigeria's annual goods exports, making a sizeable contraction in export growth likely.

A simultaneous fall in import demand amid lockdown measures is unlikely to offset the impact of falling oil exports. As a result, the current account deficit is forecast to widen to 5.6% of GDP in 2020, from 3.7% in 2019. Economic activity will also contract in 2020, as oil market dynamics feed through into the wider economy — real GDP growth is expected to contract by 3.4% in 2020.

Markets to Watch

Angola

Angola is vulnerable to oil price shocks, with oil accounting for 62% of its total revenues in 2019. It also depends on mainland Chinese crude oil demand, making it particularly exposed to the scale and pace of any economic recovery in China. A weak oil price outlook in 2020 will exacerbate an already weak fiscal and debt position. General government debt reached 100.5% of GDP in 2019, and is likely to rise further. An anticipated slip into a current deficit will weigh on foreign reserves. A recovery in oil prices and/or Chinese demand in the second half of 2020 would ease pressure on Angola's sovereign credit position.

Iraq

Iraq's foreign exchange earnings will drop markedly as a result of suppressed crude oil prices, given that oil accounts for approximately 94% of total exports and 90% of overall government revenue. China is Iraq's largest trading partner, and increased its oil purchases from Iraq in February 2020. However, while Iraq sold more oil in March 2020, earnings fell from US$ 5.5 billion in February to US$2.99 billion in March.

The situation is likely to limit hard currency availability and place significant pressure on the Iraqi dinar, while the fiscal deficit is expected to double in 2020. As fiscal pressures mount, contractual risks are likely to rise. The state-owned oil company has requested a delay in payments by six months, while the government declared force majeure on all projects and contracts from February 2020, with the oil and gas sector likely to be hardest hit.

Navigating Political Risk

Presented with challenges from COVID-19 and oil price volatility, companies operating in the MEA will face a complex and dynamic political risk environment. Weakening public finances will elevate sovereign credit risks, particularly in those markets with poor pre-crisis macroeconomic fundamentals.

At the same time, austerity drives may lead to project delays or suspensions in key infrastructure projects, limiting opportunities for private sector companies. Cutbacks and reduced social spending will also drive the risk of civil unrest, with protests expected in response to government economic policies.

More than ever, companies will benefit from a nuanced understanding of their political risk exposures in the region. To support clients in understanding and monitoring their risk exposures, we developed World Risk Review (WRR), a proprietary country risk ratings platform that provides risk ratings across nine insurable perils for 197 countries.

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