Macroeconomic outlook

UAE: Non-oil sector growth seen holding in 2016 and 2017

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Overview and outlook

- **Real GDP growth is expected to have moderated in 2015 on weaker oil GDP growth; it should hold in 2016 and 2017 as non-oil sector growth improves to around 5-6% on hospitality, transport and construction activity.**
- **CPI inflation expected to increase by 4.0% in 2015 on firmer housing inflation, before moderating to 3.5% in 2016 and 2017.**
- **A modest fiscal deficit is projected in 2015 and 2016.**
- **The banking sector may experience some tightness in liquidity as credit growth outpaces falling deposits. Deposit growth remains weak as oil revenues suffer.**

Real GDP growth in non-oil sector to remain somewhat resilient

Real economic growth in the UAE is estimated at 3.9% year-on-year (y/y) for 2015, as real oil GDP growth continued to be affected by conditions in international energy markets. (Chart 1.) A resilient non-oil sector and a recovery in oil GDP are expected to drive overall GDP growth higher in 2017.

Real oil GDP growth is expected to be weak in the near-to-medium term amid low global demand. Real oil GDP growth is estimated to slow down from 4.0% y/y in 2014 to 1.6% y/y in 2015. Growth is likely to be flat in 2016, before picking up in 2017 thanks to rising oil production.

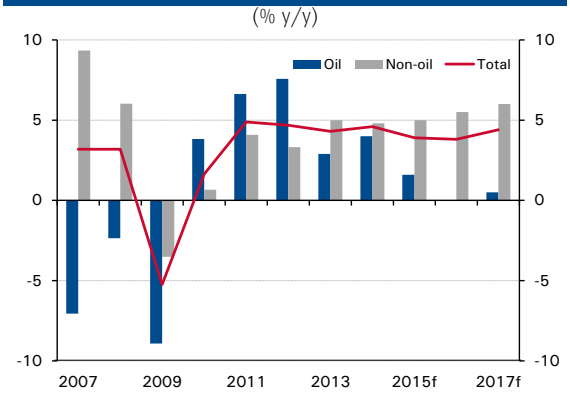
Non-oil sector growth is likely to accelerate to around 5.5% and 6.0% y/y for 2016 and 2017. This sector should be led higher by firmer activity in tourism, financial services and construction. Construction activity is set to accelerate as the Dubai Expo 2020 draws closer. Furthermore, the President, Sheikh Khalifa, recently announced that the federal authorities plan to invest more than Dh300 billion ($82 billion) domestically to foster a post-oil "knowledge economy". The plans also envisage tripling the labor force in the knowledge economy by 2021.

Table 1: Key economic indicators

		Year			
		2014e	2015f	2016f	2017f
Nominal GDP	USD bn	399.4	361.4	387.1	427.9
Real GDP	% y/y	4.6	3.9	3.8	4.4
- Oil	% y/y	4.0	1.6	0.0	0.5
- Non-oil	% y/y	4.8	5.0	5.5	6.0
Inflation	% y/y	2.0	4.0	3.5	3.5
Budget balance	% of GDP	4.2	-1.2	-1.5	0.3

Source: Official sources, NBK estimates

Chart 1: Real GDP

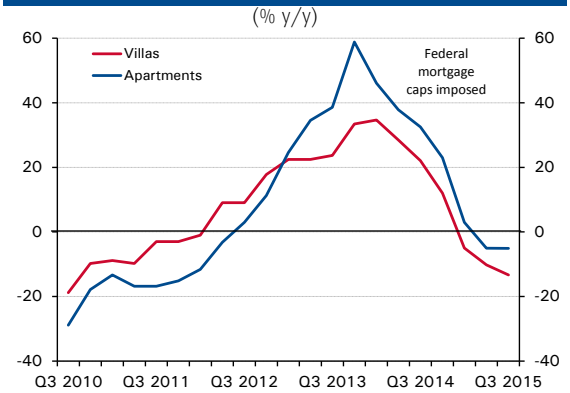


Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Markit Purchasing Managers' Index

Source: Markit

Chart 3: Residential property sales prices



Source: Asteco, JLL

PMI trends lower in 2015

The Markit Purchasing Managers' Index (PMI) trended lower throughout 2015, against a backdrop of a stronger US dollar (and thereby UAE dirham) and weak global demand. (Chart 2). In Q4 2015, the UAE's headline PMI (a forward-looking economic indicator) averaged 53.9, down from 56.7 the first 3 quarters of the year but still consistent with economic expansion. (A reading above 50 indicates an expansion in activity; a reading below 50 indicates a contraction in activity.)

Inflationary pressures appeared to be rather subdued as input costs edged lower and staff costs remained steady. It is also worthwhile to note that employment conditions have remained modest, even while oil prices trend lower. This should help allay fears of a major oil-induced disruption to domestic consumption and the overall economy.

Residential property price growth in Dubai maintained its downward trend in 2015

Growth in sales prices in Dubai's residential property sector continued to trend lower in 2015. However, data for the latter part of 2015 pointed to signs of stabilization, particularly in the case of apartment sales prices. According to Asteco, a major real estate services company, prices of apartments in Dubai fell by around 5.0% y/y in 3Q15 for the second consecutive quarter. Villa prices, meanwhile, had fallen by 10.2% y/y and 13.3% y/y in 2Q15 and 3Q15, respectively. (Chart 3.)

The imposition of higher transaction fees in 4Q13 and federal mortgage caps in early 2014 (before oil prices fell) undoubtedly delivered the results the authorities were looking for: cooling off the property market and curbing speculative buying. These measures have also been recently compounded by an on-going rise in housing supply and a change in preferences and risk appetite within the residential property market.

Against a backdrop of greater supply, sellers have been forced to lower prices. Also, more and more buyers are favoring affordable (mid-range) and/or end-use housing. While transaction values continue to fall, growth in the number of transactions has recovered of late thanks to rising activity in the "more affordable" housing segment. (Charts 4 and 5.) Looking ahead, we expect to see more of this shift towards mid-range housing, especially amid a low oil price environment and tighter lending restrictions.

The property market has also been hampered by a stronger dirham (higher US dollar) currency relative to key emerging market currencies. This has dented sales to Russian and Asian buyers. But for the majority of buyers, hailing from the UAE or GCC region (dollar-based), the impact is expected to be more muted.

It is safe to conclude that Dubai's property market is going through a significant correction and that the measures that were put in place have so far shepherded the market in the right direction, with perhaps further correction ahead.

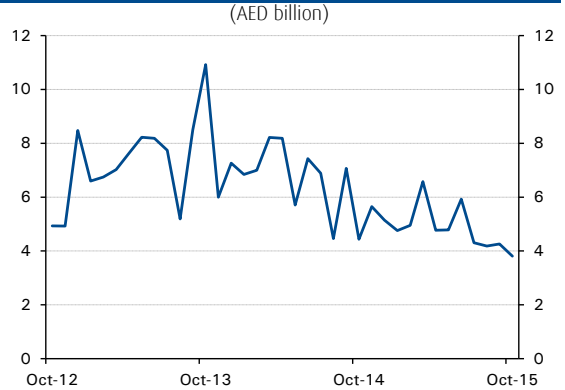
Consumer price inflation expected to moderate in the near-to-medium term

After accelerating throughout 1H15, headline inflation is expected to moderate over the coming months as housing inflation (rent, which weighs heavily in the index) stabilizes. September data showed inflation in the CPI slowing to 4.3% y/y as inflation in housing costs eased and food inflation remained subdued.

The rise in housing costs appears to have peaked at 10.2% y/y last June.

Chart 4: Value of transactions

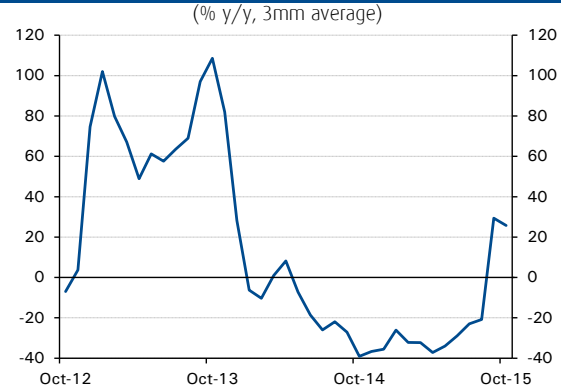
(AED billion)



Source: Dubai Land Department

Chart 5: Number of transactions

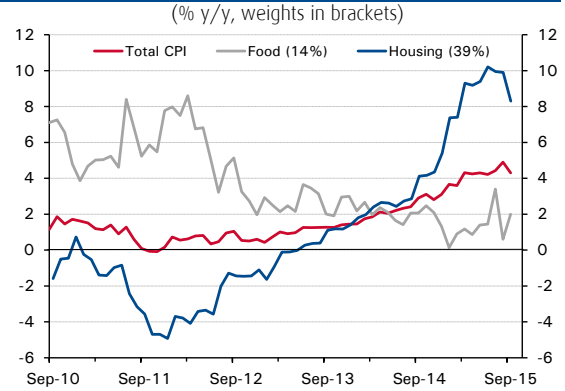
(% y/y, 3mm average)



Source: Dubai Land Department

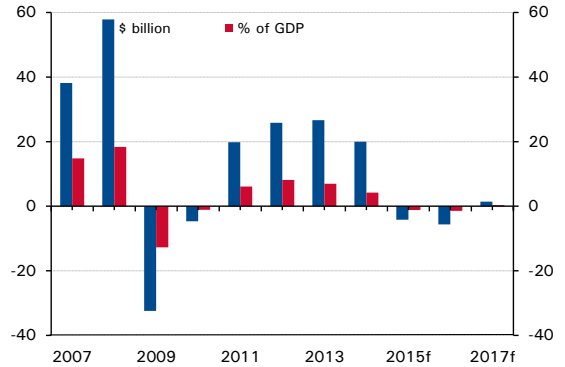
Chart 6: Consumer price inflation by sector

(% y/y, weights in brackets)



Source: Thomson Reuters Datastream

Chart 7: Budget balance



Source: UAE National Bureau of Statistics, NBK estimates
Note: Budget balance includes ADNOC profits & investment income.

It had been on an upward trajectory since the end of 2013 on the back of a recovery in the residential property sector. (Chart 6.) The steep rise in housing costs in 1H15 mainly came on the back of the one-off hike in electricity and water tariffs (for both nationals and expatriates) and the removal of the rental cap in Abu Dhabi. But with more housing set to enter the market and the effect of the one-off hike in utility tariffs set to wane, we should see inflation in the housing segment steady over the medium-term.

A stronger US dollar and lower commodity prices will also help limit any further gains in the headline rate. Consequently, we forecast inflation to average 4.0% in 2015 and 3.5% in 2016 and 2017.

Modest fiscal deficits in 2015 and 2016 on high spending levels and lower oil revenues

Amid steady spending and lower revenues, the UAE's fiscal balance (breakeven oil price is $70/b) is expected to swing from an estimated surplus of 4.2% of GDP in 2014 to a deficit of 1.2% and 1.5% of GDP in 2015 and 2016, respectively. (Chart 7.)

With abundant financial reserves (a staggering 200% of GDP) to help finance these deficits, however, it is unlikely that the UAE economy will need to carry out any significant fiscal consolidation in the medium-term. Both Dubai and Abu Dhabi are scheduled to maintain their high levels of public spending on infrastructure projects. In Dubai, infrastructure spending is expected to accelerate in the run-up to the Expo 2020 event.

That is not to say that the major emirates have not exercised some fiscal prudence and reforms recently. According to official reports, Abu Dhabi has curtailed and/or delayed spending on a number of projects designated as low-priority. Dubai is poised to pass a law covering public-private partnerships (PPP) late in 2015, to tap into private sector funding for key projects. Furthermore, the UAE government is expected to impose further reductions in subsidies. At the start of 2015, it took the decision to hike utility tariffs. Later, in August, it deregulated petrol prices. This will help lower subsidy costs. The fiscal balance is expected to return to a surplus in 2017 on the back of an expected (delayed) oil price recovery and a planned increase in oil production.

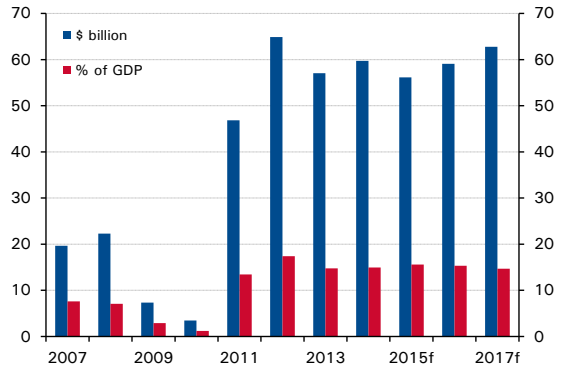
Current account surplus to remain resilient on strong non-oil earnings

The current account is expected to continue to post a surplus, of 14-15.0% of GDP in 2016 and 2017, on the back of strong non-oil export revenues. Downward pressures on the surplus from lower oil export earnings and higher imports are being partly offset by robust non-oil export revenues, especially from the tourism, trade and financial services sectors. (Chart 8.)

The UAE's non-oil exports may be slightly affected by the strength of the dirham. The stronger dollar has led to an appreciation in the UAE's trade-weighted index increasing the costs of its exports and making it a more expensive place to visit and invest in for expatriates outside the GCC region and the US. (Chart 14.) The UAE's major trading partners are in Asia, and those countries that are not pegged to the dollar could see further depreciations in their currencies vis-à-vis the dirham. However, given that the majority of tourists visiting the UAE are from the GCC region and that UAE nationals are the predominant investors in the country's real estate sector, the non-oil economy should continue to perform well in the current low oil price environment.

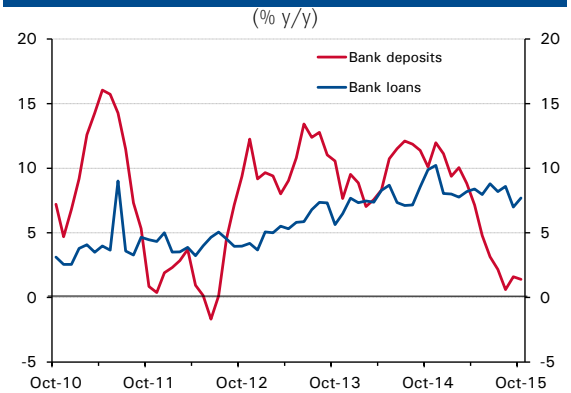
Furthermore, a potential removal of sanctions on Iran by the West in early 2016 could be a huge boost for UAE trade, particularly in the non-oil

Chart 8: Current account balance



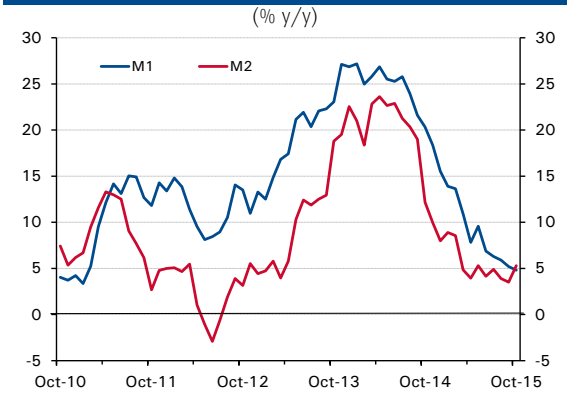
Source: UAE National Bureau of Statistics, NBK estimates

Chart 9: Bank loan and deposit growth



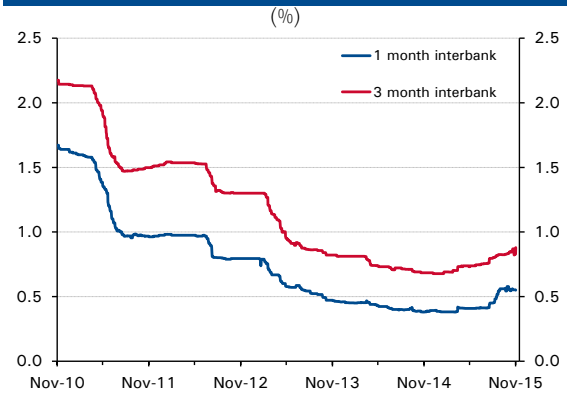
Source: Central Bank of the UAE

Chart 10: Money supply



Source: Thomson Reuters Datastream

Chart 11: Interbank rates



Source: Thomson Reuters Datastream

sector. The UAE is Iran's biggest non-oil trading partner and its biggest source of imported goods.

Banking sector poised to undergo some liquidity tightness as deposit growth weakens

Growth in bank loans continues to hold on to its recent moderate pace, even amid softer oil prices and a slowing real estate market. Within the non-oil sector, lending to the construction sector has proven robust. In October 2015, loan growth was hovering at 7.7% y/y. With capital spending expected to increase further in the run-up to the Expo 2020 in Dubai, we should continue to see healthy gains in loan growth. (Chart 9.)

Bank deposit growth has, however, been trending lower in 2015 as a result of a slowdown in government deposit growth. As of October 2015, total deposit growth stood at 1.4% y/y. (See Chart 9.) Growth in government deposits, which is closely correlated with oil revenues, has slowed. With deposit growth trailing credit growth, the loan-to-deposit ratio has consequently edged higher in recent months. In October 2015 it climbed to a three-year high of 103.2%.

Slowing deposit growth is also evident in the slowdown in annual broad money supply (M2) growth. This has been trending downwards since mid-2014. (Chart 10.)

Monetary policy remains accommodative, and there is room for monetary tightening if need be. The UAE's three-month and one-month interbank rates both saw a slight uptick in 2H15, but they both remain low and below 1.0%. (Chart 11.) A rise in the US Fed rate is expected to further tighten liquidity conditions in the banking sector.

Small and medium-sized enterprises (SME) in Dubai have been struggling of late due to delayed payments by their customers. Since the summer of 2015, there have been anectodal reports of defaults or late payments.

According to the Dubai SME report (2013), SMEs account for about 95% of the enterprise population in Dubai, 43% of the workforce and 40% of the total value-added to the Dubai economy. Thus, they are one of the main driving forces behind the economy. The trading sector accounts for the majority (around 57%) of SME businesses in Dubai. Given that the trading sector is dominated by commodity trading, it has been hurt by the on-going weakness in commodity prices. Also, with around 51% of the SME businesses heavily dependent on trade/exports, they have been hit by the appreciation in the dirham against most major currencies (with the exception of the US dollar).

The UAE Banks Federation estimates that among SMEs, loans amounting to between Dh5 billion and Dh7 billion ($1.36 billion-$1.9 billion) are at risk of default. While provisions for non-performing loans (NPL) have remained steady in 2015, loan defaults among SMEs would ultimately lead to a pick up in NPL provisions. The government has vowed to step up its efforts in formulating a new bankruptcy law to help support SMEs and reduce the risk of default. However, with gross credit valued at Dh1.4 trillion and SME loans at risk of a default valued at Dh7 billion, the impact on the banking sector should be limited.

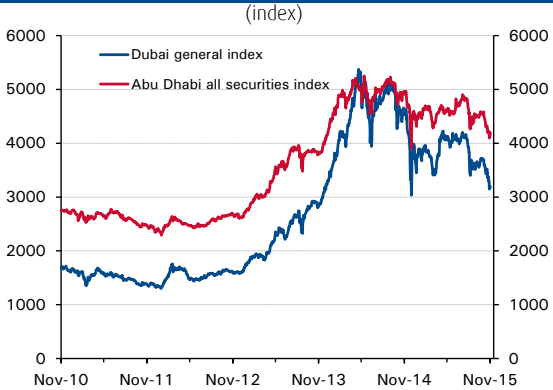
Markets and interest rates

The main Abu Dhabi and Dubai markets were under pressure in the second half of 2015, in sync with international and other GCC markets, and amid a softer oil price environment.

The main credit default swaps (CDS), good indications of the level of risk within an economy, have stabilized recently. (Chart 13.) In mid-

Chart 12: Stock market indices

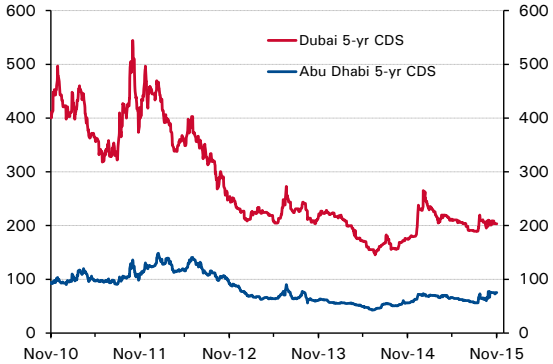
(index)



Source: Thomson Reuters Datastream

Chart 13: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

Chart 14: UAE trade-weighted index

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK

November, the CDS on five-year Dubai and Abu Dhabi government debt stood at 206 and 75 basis points, respectively.

In the near-to-medium term we may see the nascent effects of the long-awaited changes in the UAE's companies' law. One of the changes includes lowering the minimum percentage of equity that a company needs to float, from 55% to 30%. This should lead to an increase in initial public offering (IPO) activity; the 55% requirement was deemed too high by entrepreneurs, many of whom were reluctant to divest too much from their own businesses.

US dollar-dirham peg is here to stay

The dirham has been pegged to the US dollar at a rate of $1 = 3.673 Dhs since 1997. The current exchange rate policy has thus far helped the UAE economy instil macroeconomic stability, keep the rate of inflation in check and maintain investor confidence. However, the peg has come under pressure of late against a backdrop of falling oil prices and a stronger US dollar against most other currencies. Nonetheless, thanks to the country's abundant foreign reserves, the UAE has enough ammunition to defend its peg to the US dollar.

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