Macroeconomic outlook

UAE: Resilient non-oil economy to support overall GDP growth

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Overview and outlook

- **Real GDP growth is expected to remain in moderation mode in 2016 before improving in 2017.**
- **Non-oil growth is poised to moderate further in 2016 but to continue to support overall GDP growth; non-oil growth seen picking up in 2017.**
- **CPI inflation slows sharply as the effects of the sizeable 2015 subsidy cuts subside.**
- **A higher fiscal deficit is projected for 2016, but it remains manageable thanks to ample fiscal reserves.**
- **The banking sector will continue to see tighter liquidity conditions in 2016, as deposit growth trails behind credit growth. Deposit growth remains soft amid lower oil revenues.**

Real GDP growth in non-oil economy moderating

We expect economic growth in the UAE to moderate to 2.5% year-on-year (y/y) in 2016, on the back of weaker oil GDP growth and moderating non-oil growth. The oil sector continues to be hampered by low international energy prices (Chart 1). Growth in the non-oil sector is envisaged to moderate, but it will continue to see pockets of strength in its hospitality, transport and construction segments.

With international oil prices not poised to see a strong recovery before 2017, real oil GDP growth is forecast to remain weak in at least the near to medium term. We expect the real oil economy to be "flat" in 2016. In 2017, we foresee a slight uptick on higher production levels.

Non-oil sector growth is losing some of its momentum, but our view is that it will remain moderate as gains in the tourism and construction sectors continue to hold. The number of passengers at Dubai International Airport was up by a strong 7.2% y/y in May. Despite some cutbacks, a sizeable portion of construction projects remains on schedule and in progress especially as preparations for the Dubai Expo 2020 continue. These include the construction of buildings, metro expansions, roads and bridges. In its 2016 budget, Dubai pledged Dh16.6 billion for infrastructure

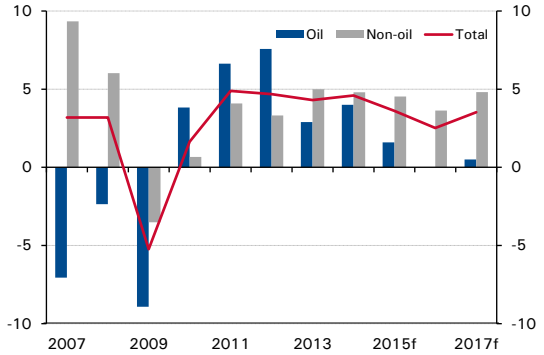
Table 1: Key economic indicators

		2014	2015	2016f	2017f
Nominal GDP	USD bn	399.4	356.6	366.7	417.0
Real GDP	% y/y	4.6	3.6	2.5	3.5
- Oil	% y/y	4.0	1.6	0.0	0.5
- Non-oil	% y/y	4.8	4.5	3.6	4.8
Inflation	% y/y	2.0	4.1	2.5	2.5
Budget balance	% of GDP	4.2	-1.7	-3.2	1.1

Source: Official sources, NBK estimates

Chart 1: UAE real GDP

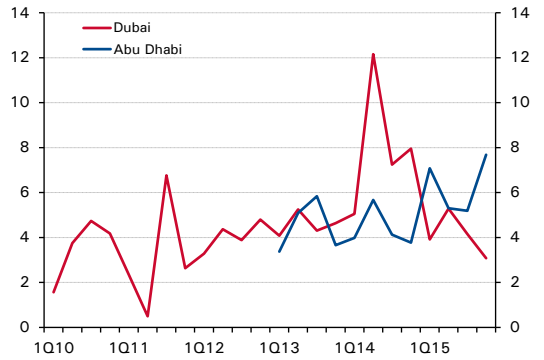
(% y/y)



Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Dubai & Abu Dhabi real GDP

(% y/y)



Source: Dubai Statistics Center, Abu Dhabi Statistics Center

Chart 3: Purchasing Managers' index

(index)

Source: Markit

projects, Dh1.8 billion higher than in 2015. In early 2Q16, Emaar properties, one of the biggest real estate developers in the UAE, announced that it would build a tower taller than Burj Khalifa (currently the tallest tower in the world) and a new 'mega-retail district' for the Expo 2020.

Dubai's non-oil GDP growth loses some steam but remains decent

Latest data showed Dubai's overall economy slowing from 4.2% y/y in 3Q15 to 3.1% y/y in 4Q15, as growth in the non-oil sector moderated from 4.1% y/y to 3.1% y/y during the same period (Chart 2). For the year 2015 as a whole, Dubai's headline GDP logged in a still decent growth rate of 4.1% y/y, thanks to moderate gains in the non-oil economy. Looking ahead, we may see a slight improvement in GDP growth in 1H16, as reflected in the Emirates NBD Dubai Economy Tracker Index (DET) which has been gaining traction of late. The DET is a forward–looking private survey that tracks the performance of economic activity in Dubai's non-oil private sector. In May it rose to an eight-month high of 54.5 on the back of solid improvements in output and new work, which are indicative of rising domestic demand (Chart 4).

Abu Dhabi's economy to be supported by revival of delayed projects

According to the most recent data, Abu Dhabi's real GDP witnessed a notable uptick in 4Q15, growing by 7.7% y/y versus 5.2% y/y in 3Q15 (Chart 2). The strong pick up came after its non-oil economy grew sharply by 8.2% y/y in real terms. Growth in real oil GDP also witnessed a strong bounce, rising from 3.0% y/y to 7.1% y/y, but this could be attributed to some base effect. Abu Dhabi is expected to continue to log in moderate rates of growth in the quarters ahead as government expenditures continue to hold and delayed projects, including a branch of the Guggenheim Museum, are brought back to the fore.

PMI sees some stabilization in 1H16

The UAE's Markit Purchasing Managers' Index (PMI), a leading economic indicator, appears to have steadied in 1H16 after moderating throughout 2015, thanks to improvements in output, new export orders and new orders (Chart 3). In May, the headline PMI climbed to 54.0 from 52.8 in April. (A reading above 50 indicates an expansion in activity; a reading below 50 indicates a contraction.)

Employment conditions were steady, even as oil prices remain weak, circumventing any strong fears of a major oil-induced disruption to domestic consumption and the overall economy.

Residential property price growth in Dubai poised to plateau in 2016

After trending lower for the most of 2015 on tighter regulations, higher housing supply and risk aversion, growth in Dubai's residential property prices are showing early signs of stabilizing. According to Asteco, a major real estate services company, prices of apartments and villas in Dubai fell by approximately 4.3% y/y and 9.3% y/y, respectively in 1Q16 (Chart 5), compared to declines of 8% and 11% seen in 4Q15.

The property market has also been hampered by a stronger dirham (higher US dollar) relative to key emerging market currencies. This has created a dent in sales to Russian and Asian buyers. Nevertheless, for the majority of buyers from the UAE or dollar-based GCC region, the impact has been more limited.

Furthermore, against a backdrop of greater housing supply and more spending-conscious tenants, sellers have been forced to lower prices to attract tenants. Also, buyers are increasingly favoring affordable (mid-

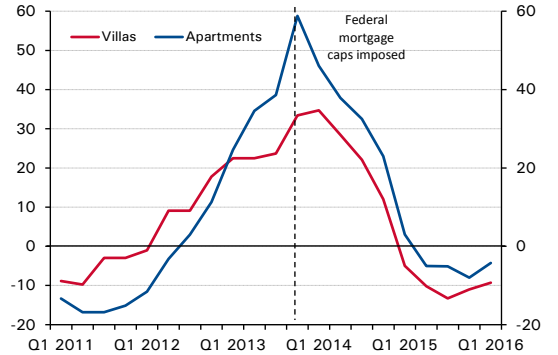
Chart 4: Dubai Economy Tracker

(index)

Source: Emirates NBD

Chart 5: Residential property sales prices

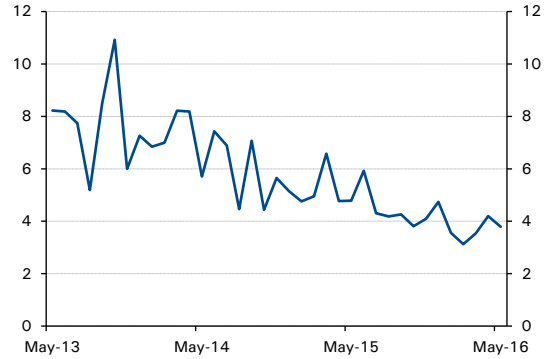
(% y/y)



Source: Asteco, JLL

Chart 6: Value of real estate transactions

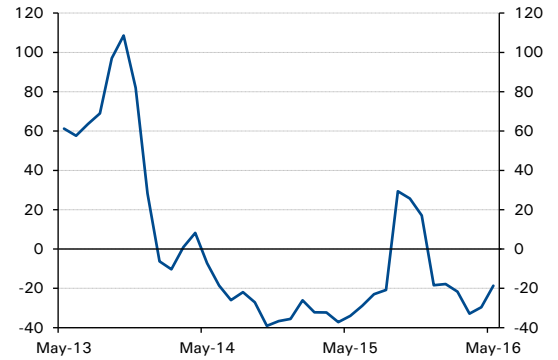
(AED billion)



Source: Dubai Land Department

Chart 7: Number of real estate transactions

(% y/y, 3-month average)



Source: Dubai Land Department

range) or end-use housing. Transaction values continue to trend lower, but growth in transaction volumes has been gradually recovering due to rising activity in the "more affordable" housing segment (Charts 6 and 7). We expect to see more of this shift towards mid-range housing, especially amid a low oil price environment and tighter lending restrictions.

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 are so far leading the market in the right direction.

Consumer price inflation to remain in moderation gear in 2016

Headline inflation has decelerated sharply since the middle of 2015, as housing inflation (which has a significant weight in the index) eased. Inflation in the consumer price index (CPI) stood at 1.6% y/y in May as housing inflation maintained its downward trend and food inflation softened sharply (Chart 8).

Looking ahead, inflation in housing costs is poised to continue to moderate in 2016 on the back of greater housing supply and as the effects of the electricity and water tariff hike imposed last year, continue to wane.

Food inflation is expected to remain soft in the near to medium term, especially after the Ministry of Economy announced that UAE supermarkets will be cutting the prices of 5,000 food items by up to 70% during the Holy Month of Ramadan in June.

A stronger US dollar and low commodity prices will also help limit upward inflationary pressures from any further subsidy cuts and/or tariff hikes. Consequently, we forecast inflation to slow from an annual average of 4.1% in 2015 to 2.5% in 2016.

The inflation data is more or less in line with the PMI data. According to the Markit PMI, inflationary pressures have remained subdued as staff costs and overall input prices remain moderate.

Fiscal deficit expected to widen in 2016, but remain manageable

The UAE's fiscal balance is expected to log in a deficit of 3.2% of GDP in 2016, on steady spending levels and lower oil earnings (Chart 9). The fiscal balance is expected to return to a surplus in 2017 on the back of an expected recovery in oil prices and a planned increase in oil production.

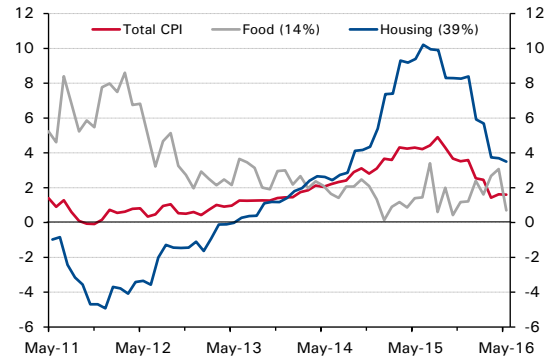
However, it is unlikely that the UAE economy will need to carry out significant fiscal consolidation in the medium-term, thanks to its abundant financial reserves (a staggering 200% of GDP). Both Dubai and Abu Dhabi are scheduled to maintain their high levels of public spending on infrastructure projects.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

Nonetheless, the major emirates have embarked on some fiscal adjustment and reform. According to official reports, Abu Dhabi has cut back or delayed spending on a number of projects designated as low-priority. Efforts have also been made to rely more heavily on the private sector for implementation of some projects. In November 2015, Dubai passed a law covering public-private partnerships (PPPs) to tap into private sector funding for key projects. Furthermore, the UAE government moved to reduce subsidies in 2015, raising utility tariffs and deregulating petrol prices.

An imposition of a departure-tax at the Dubai International Airport starting on 1 July 2016 may also increase non-oil revenues. A Dh35 ($9.54)

Chart 8: Consumer price inflation by sector

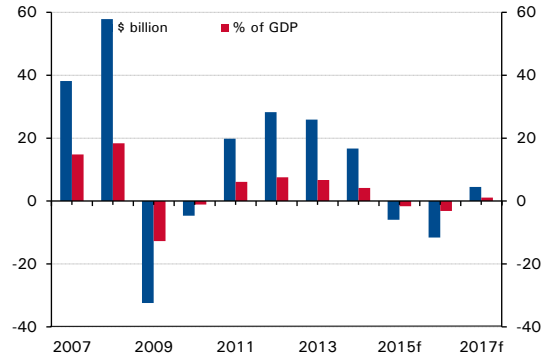
(% y/y, weights in brackets)



Source: Thomson Reuters Datastream

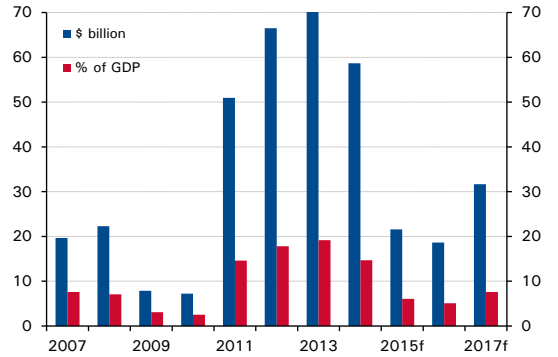
Chart 9: Budget balance

(revenues include ADNOC profits & investment income)



Source: UAE National Bureau of Statistics, NBK estimates

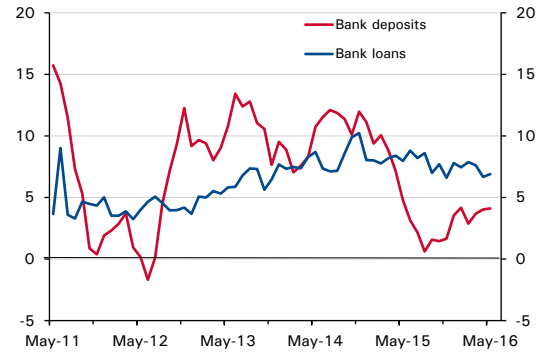
Chart 10: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 11: Bank loan and deposit growth

(% y/y)



Source: Central Bank of the UAE

departure tax per passenger will be introduced to help finance the emirate's development projects. Given that the Dubai International Airport was the world's busiest in 2015, with 78 million passengers passing through the airport that year, the tax is forecast to raise $500 million annually. Abu Dhabi recently stated that a Dh35 fee will also be levied on passengers using the emirate's airports from July onwards.

In April, Abu Dhabi announced that it will impose a municipality fee on hotel stays, in an attempt to raise revenue for municipal authorities. The new decree will place a 4% fee on hotel bills and a Dh15 charge per night per room. The new fee follows a similar move by Dubai in 2014. It is not expected to have a significant impact on tourism given that hotel rates have come off this year. Abu Dhabi also introduced a 3% municipal fee on home rentals paid by expats, again somewhat in line with Dubai. The new fee will be collected with monthly utility bills.

Furthermore, it appears that the UAE will be one of the first GCC nations to implement a value added tax (VAT). The first phase of implementation, scheduled for 2018, will require UAE companies with annual revenues greater than $1 million (Dh3.75 mn) to collect and pay VAT. At 5%, the VAT is expected to generate around $3.3 billion (Dh12 bn) in tax revenues.

In an attempt to preserve foreign assets, the UAE is also looking to raise debt on international markets to plug its budget gap. In April, Abu Dhabi sold $5 billion in sovereign bonds, the first issuance since 2009. With a relatively low level of external debt estimated at around 30% of GDP, the UAE has ample room to raise further debt.

Current account surplus to narrow on lower oil export receipts

The surplus in the current account will continue to narrow in 2016, as oil export earnings remain in decline and non-oil export growth moderates. Non-oil export revenues are expected to see some downward pressure, but are nevertheless expected to hold thanks to the modest gains in the trade and tourism sectors (Chart 10). As a result we project the current account balance to narrow slightly from 6% of GDP in 2015 to 5% of GDP in 2016, before edging higher in 2017 on the back of a recovery in oil prices and as non-oil export growth gathers momentum.

The UAE's non-oil exports will be under some pressure due to the stronger dirham. The stronger dollar has led to an appreciation in the dirham's trade-weighted index, increasing the cost of its exports and making it a more expensive place to visit and invest in (Chart 16). The UAE's major trading partners are in Asia, and those countries saw a further depreciation 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 is envisaged to continue to perform well in the current low oil price environment.

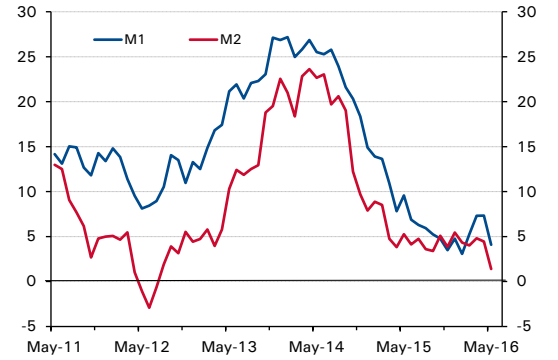
Banks continue to see liquidity constraints amid low oil prices

Credit growth has moderated slightly, but continues to log in healthy readings as loan demand from the construction sector continues to hold. Loan growth logged in a reading of 6.9% y/y in April. As capital spending is expected to increase further in the run-up to the Expo 2020 in Dubai, we should continue to see healthy gains in credit lending (Chart 11).

Although bank deposit growth has been gaining some ground, it remains relatively soft due to tepid government deposit growth, which is closely correlated with oil earnings. In May, total deposit growth was at 4.1% y/y (Chart 11). As deposit growth continued to trail behind credit growth,

Chart 12: Money supply

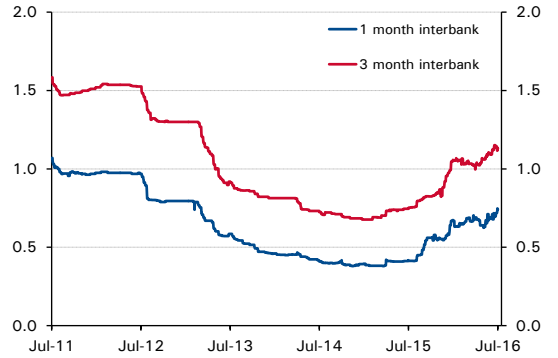
(% y/y)



Source: Thomson Reuters Datastream

Chart 13: Interbank rates

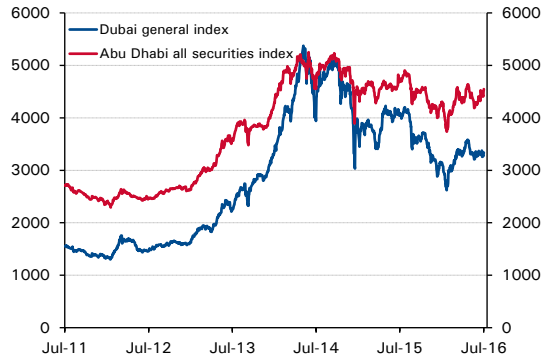
(%)



Source: Thomson Reuters Datastream

Chart 14: Stock market indices

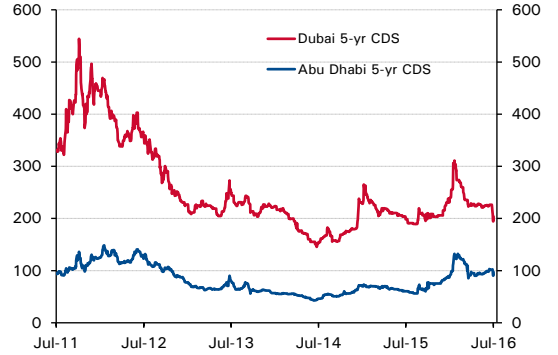
(index)



Source: Thomson Reuters Datastream

Chart 15: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

we saw the loan-to-deposit (LTD) ratio rise slightly from 101.1% in April to 101.7% in May. Although the LTD is currently above the lows seen during the year prior to the oil price drop in 2014 when the LTD averaged 97.7%, it is still rather modest when compared to the 101.5% average seen over the past year.

Growth in the broad money supply (M2) continues to be weighed down by weaker deposit growth. In May, it was also weighed down by a decline in quasi-money (foreign exchange and longer-term dirham deposits). Consequently, it decelerated from 4.5% y/y in April to an almost four-year low of 1.4% y/y in May (Chart 12).

Both the UAE's three-month and one-month interbank rates continue to rise, and are currently hovering at near three-year highs (Chart 13). We expect these rates to rise further, especially if the US Fed hikes its federal funds rate again this year.

Markets and interest rates

The main Abu Dhabi and Dubai markets have remained subdued in tandem with international and regional markets, which have been roiled by global growth concerns, the low oil price environment and more recently, economic uncertainties following the Brexit vote.

The main credit default swaps (CDS), which are bellwethers of the level of risk within an economy, have come down slightly further recently (Chart 15). At the start of July, the CDS on five-year Dubai and Abu Dhabi government debt stood at 204 and 98 basis points, respectively.

US dollar-dirham peg is here to stay

The dirham has been pegged to the US dollar at a rate of $1 = Dh3.673 since 1997. The current exchange rate policy has helped the UAE economy anchor macroeconomic stability, keep the rate of inflation in check and maintain investor confidence. Although the peg has come under pressure due to the decline in oil prices and a stronger US dollar, in June the Central Bank Governor reiterated that the UAE remains committed to the dollar peg. The UAE has ample reserves to defend its peg to the US dollar if necessary.

Chart 16: UAE trade-weighted exchange rate

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK

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