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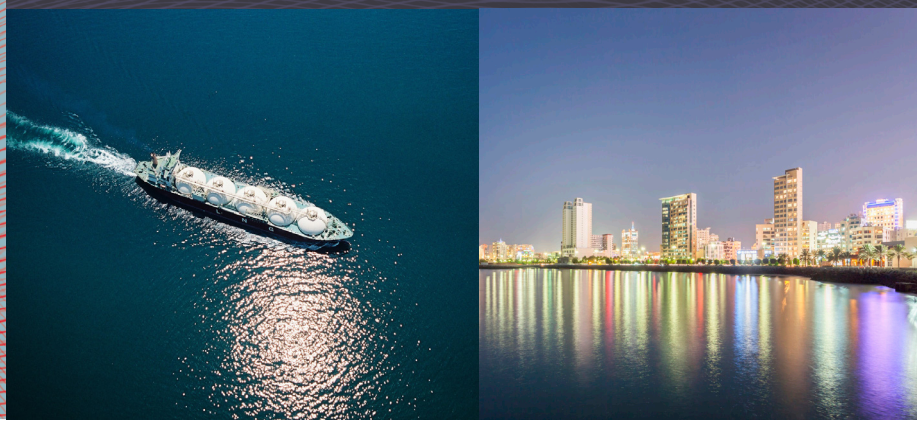
MENA Economic Outlook



1Q 2017

- GCC non-oil growth to begin improving as pace of austerity eases
- GCC should see deficits begin narrowing in 2017 on better oil prices
- Non-GCC growth expected to be steady as challenges persist

MENA Economic Outlook
1Q 2017

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MENA outlook

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World eyeing policy changes; oil prices recover, GCC non-oil growth at 3.0%

Overview and outlook

- **Trump election in US, recent Fed hike, and OPEC deal, pushed equities, interest rates, and the USD higher, and portend changes into 2017.**
- **The Fed hiked rates 25 bps in December, in its second move toward "normalization" in the current cycle, with more to come.**
- **Oil prices were boosted by an OPEC agreement to cut oil production from January 2017; prices are expected to rise toward $65 by 2018.**
- **GCC countries continue to reform and rationalize their finances to cope with lower oil prices.**
- **GCC growth in check by oil production cuts, at 2.0% average for 2017-18, non-oil growth better at 3.0%, led by Qatar, UAE, and Kuwait.**
- **GCC fiscal deficits should start shrinking in 2017; should narrow to average -5.2% of GDP in 2017-18. Debt rises to finance the gap.**

Significant changes lie ahead for the world economy. Three major events from late 2016 set the stage for 2017 and beyond, starting with the onset of a new US administration, an interest rate increase by the U.S. Federal Reserve, and an agreement by oil producers to curtail production in 2017.

The incoming Trump administration promises to be unconventional in many ways, and will likely have repercussions, both political and economic, on the world at large. We expect to see significant reductions in the US regulatory burdens (environment, finance, health...), lower taxes, increased defense, and infrastructure spending. While it is too early to quantify the impact of these actions, they will clearly improve economic growth in the US over time, provided there are no trade frictions or disruptions with major partners. It is reasonable to see US growth rising from the current 1.5-2.0% mire, and more toward 3.0%, over time. This outlook has led equities, interest rates and the USD higher, and is pointing to more of the same.

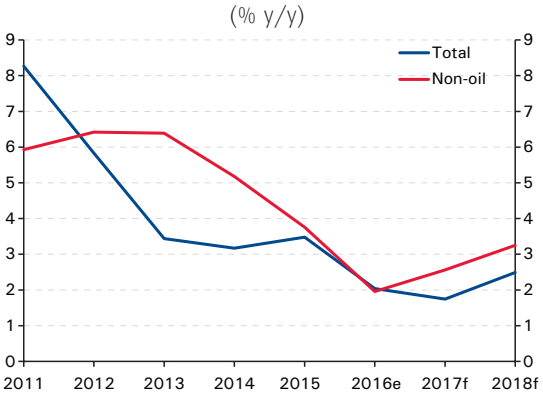
The potential Trump economic stimulus added to the Fed's and to the markets' confidence that a second policy rate hike would be needed in the current cycle. Indeed, the Fed raised the federal funds rate by 25 bps in December, to a target of 50-75 bps, and signaled it may move another three times in 2017. In response, the US 5-year note yield rose over 2.0% for the first time since 2011, and 10-year yields went above 2.5%. The USD kept rising (breaking 1.05 on the USD/EUR, and 115 on the JPY/USD), and US equities were reaching record highs, with the Dow Industrial Index near 20,000.

GCC economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD tn	1.4	1.4	1.5	1.6
Real GDP	% y/y	3.5	2.0	1.7	2.5
Oil	% y/y	2.7	2.2	0.6	1.4
Non-oil	% y/y	3.8	2.0	2.6	3.3
Inflation	% y/y	2.8	3.0	2.8	3.6
Budget balance	% of GDP	-10.0	-9.9	-5.8	-4.5

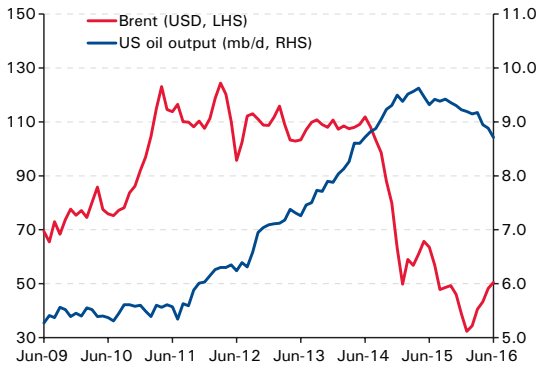
Source: National sources, NBK estimates

Chart 1: GCC real GDP



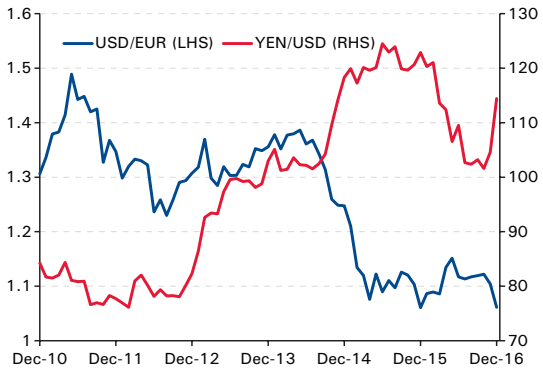
Source: National sources, NBK estimates

Chart 2: US oil production & Brent price



Source: International Energy Agency, Thomson Reuters Datastream

Chart 3: Key exchange rates



Source: Thomson Reuters Datastream

The US outlook is bound to somewhat support world growth, expected to improve marginally in 2017 to 3.4%, from 3.1% in 2016 (IMF). More to the point, as a trendsetter and cycle leader, the US developments may prompt similar moves toward more reliance on fiscal action in other economies, and less on monetary policy (where many suspect the limits have been reached, e.g. Japan, Europe). Also, watch the political ramifications; the Trump election (and Brexit earlier) may well embolden anti-establishment and anti EU sentiment, with important elections coming up in France and in the Netherlands (in March and May of 2017, respectively).

The positive stimulus developments above also further supported oil prices, though the recent main event there was OPEC announcing an agreement to cut production by some 4.5% (1.2 mn b/d), buttressed by an agreement with some non-OPEC producers to cut another 0.6 mn b/d. The announcement caused oil prices to shoot above, and sustain, $50 pb (Brent). This return to more "balanced" conditions in the oil market should support oil prices further, and could produce a gradual rise toward $65 pb by the end of 2018. This rise was, of course, welcome relief to the GCC countries, who will continue to post deficits and issue debt for a while, but at a more comfortable pace if oil prices improve.

The MENA region is expected to grow at about the same pace as the world economy, about 3%, virtually unchanged from 2016. While oil importers got some relief from lower oil prices, they were also held back by weaker performances in oil-exporting countries, who are major trading partners. In Egypt, growth is expected to improve towards 4-5% in 2017 and 2018 as the country implements much needed reforms and benefits from renewed confidence following the recent approval of an IMF deal.

The GCC countries are poised in our view to grow near 2.0% overall (real GDP) in 2017 and 2018, held back by oil production cuts. Non-oil growth however should be a decent 3.0% on average in 2017-18, led by Qatar, the UAE, and Kuwait, as the non-oil sector shows some resilience amid continued governmental efforts to control spending and waste, and raise revenues (fees and taxes). We see GCC regional non-oil growth rising gradually from 2017 to 2018, 2.5% to 3.3%, as the economies gradually digest the new reforms and measures. The consumer sector has in general retrenched, particularly in KSA, while public projects and government investments have been maintained, in particular in Kuwait and in Qatar.

Not surprisingly, the region will continue to grapple with deficits for another while, though these deficits should start to shrink in 2017. Deficits averaged 10% of GDP in 2015-16; they should shrink to 5.2% in 2017-18. Countries are financing the gap by drawing down reserves, but also with debt issuance, including international issuance. Among others, KSA was a large borrower overseas in 4Q16, taking in USD 17.5 billion, while Kuwait is readying to go international in 2017. Borrowing abroad diversifies the sources of funds, and relieves the pressure on domestic liquidity. The latter has been under some pressure, but remained very manageable. Moreover, of course, GCC central banks followed the Fed's lead, pretty much like last year, by raising their official rates by 25 bps, following the December Fed hike.

Bahrain outlook

Economy to be supported by resilience in non-oil sector

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Overview and outlook

- **GDP growth is set to be propped up in 2017 and through 2018 by the resilience in the non-oil economy.**
- **Non-oil growth to gather momentum on higher investment levels, particularly in the construction sector.**
- **Inflation to hold steady in 2017 before rising again in 2018.**
- **The budget deficit is set to narrow but remain high at 15% and 13% of GDP in 2017 and 2018, respectively, on solid levels of public spending.**
- **Liquidity constraints in the banking sector are poised to gradually ease as growth in deposits recovers.**

Real economy set to gradually pick up as non-oil sector holds strong

Economic growth is poised to gradually edge up in 2017 and 2018 on solid levels of activity in the non-oil economy. Growth in real GDP is envisaged to rise from an estimated 2.9% in 2016, to 3.4% and 4.2% in 2017 and 2018, respectively (Chart 1). Growth in real oil GDP is projected to remain flat in 2017 amid steady oil production levels, especially following the recently announced production cuts by OPEC producers. We expect growth in this sector to gather some pace in 2018 as production picks up. Non-oil growth is forecast to gradually rise from around 3.6% in 2016 to 4.2% in 2017 and 4.5% in 2018 on higher investment levels, particularly in the construction sector.

In the first quarter of 2016, real GDP growth recovered relative to 4Q15 and accelerated to 4.5% y/y. However, the acceleration was mostly attributed to a one-off jump in real oil GDP growth (Chart 2). Growth in real GDP slowed once again to 2.5% y/y in 2Q16, after real oil activity contracted by 1.7% y/y.

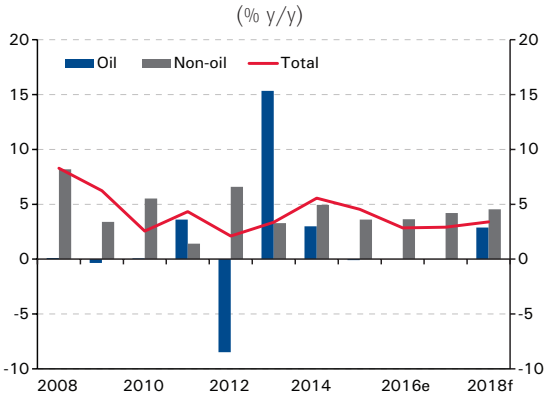
In contrast, growth in real non-oil activity climbed from 2.8% y/y to 3.6% y/y in 2Q16, helping shore up some of the weakness in oil activity. Non-oil GDP recorded its highest growth rate in a year in 2Q16, thanks to faster than expected utilization of GCC grants, which helped prop up investment. The GCC pledged $10 billion in investment over ten years; Bahrain has vowed to devote these funds to infrastructure and housing developments.

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	32	32	35	38
Real GDP	% y/y	2.8	2.9	3.4	4.2
- Oil	% y/y	-0.1	0.0	0.0	2.9
- Non-oil	% y/y	3.6	3.6	4.2	4.5
Inflation	% y/y	1.8	2.5	2.5	3.0
Budget balance	% of GDP	-16.1	-18.0	-15.0	-12.6

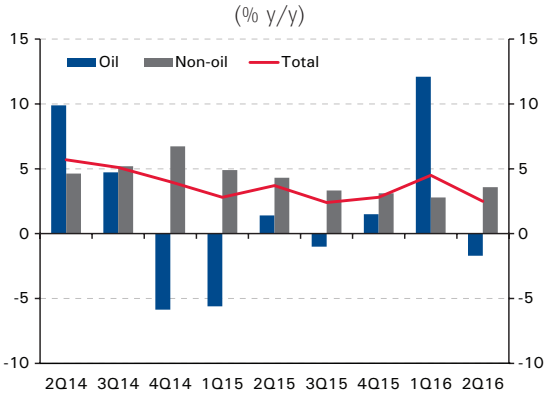
Source: Official source, NBK estimates

Chart 1: Annual real GDP



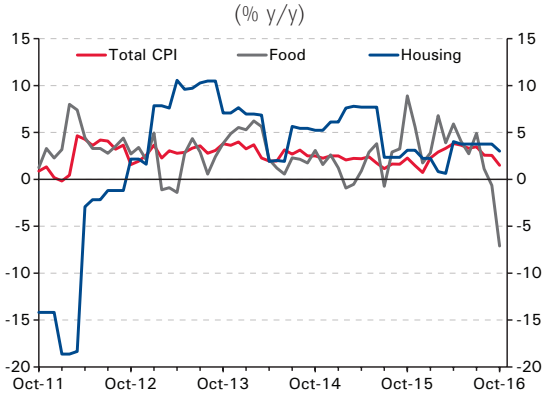
Source: Central Informatics Organization, NBK estimates

Chart 2: Quarterly real GDP



Source: Economic Development Board

Chart 3: Consumer price inflation by sector



Source: Central Informatics Organization

Inflation expected to hold steady in 2017 before rising in 2018

Inflation in the consumer price index (CPI) rose for most of 1H16 after subsidy cuts in the food and housing components led the respective inflation rates higher (Chart 3). However, the initial impact of the subsidy cuts appears to have subsided on the back of a slowdown in inflation in the housing component and a decline in food prices; CPI inflation peaked at 3.8% y/y in April and, as of October, stood at 1.5% y/y.

Despite the cooling inflation rate, we expect inflation to still edge up slightly and average around 2.5% in 2016, following the higher readings recorded in 1H16. We foresee the annual average inflation rate remaining at around the 2.5% mark in 2017 as both housing and food inflation stay in check. In 2018, headline inflation is expected to face some upward pressures, especially on the back of a planned introduction of a value-added tax (VAT) across the GCC region.

Budget deficit to narrow but remain high in 2017 and 2018

Bahrain is forecast to see one of the largest budget deficits in the GCC region. With the breakeven oil price estimated at around $120 per barrel and spending levels expected to remain solid, the budget deficit is forecast to narrow slightly from roughly 18% of GDP in 2016 to around 15% and 13% of GDP, respectively in 2017 and 2018 (Chart 4).

Bahrain remains intent on imposing fiscal reforms in line with the IMF's recommendations to help shore up its public deficit. Spending cuts have been concentrated on subsidies, whilst public spending levels on infrastructure and development projects have been counter-cyclical and have thereby remained broadly stable. In August 2015, the government lifted subsidies on meat products. In December 2015, the cabinet approved a new pricing system for diesel, kerosene and jet fuel to reduce subsidy costs and better reflect price increases in other GCC states. In 1H16, it approved the removal of subsidies on utilities.

There may be more subsidy cuts on the horizon to curb the rise in debt levels, but engaging in further significant cuts in public spending remains a challenge, especially since the two politically sensitive areas of spending, namely subsidies and public wages, make up two-thirds of government spending.

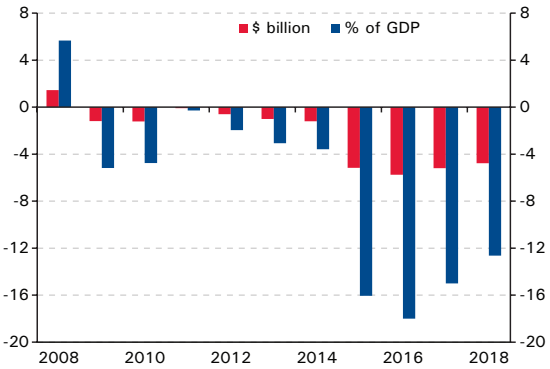
Given that the budget deficit is expected to remain high in spite of subsidy cuts, Bahrain may continue to turn to both domestic and international bond markets, to help finance its deficit. In 2015, Bahrain issued a total of $6 billion in bonds, $1.5 billion of which was in the international market. In 2016, the government of Bahrain issued $3.4 billion in bonds, $2 billion of which was issued externally. Subsequently, debt is projected to remain steady at around 60% of GDP.

Fiscal deficit and debt concerns have led to a bout of downgrades of the nation's long-term credit rating. In June, Fitch Ratings, in line with the other two major rating agencies, downgraded Bahrain's long-term credit rating to below investment grade. In early December, S&P lowered Bahrain's sovereign credit rating from BB to BB-, deeper into non-investment grade territory. The downgrades have made it increasingly difficult for the government to negotiate better bond deals.

Banking liquidity poised to improve over the next two years

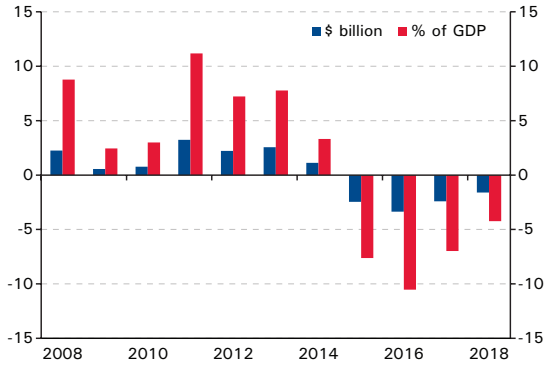
After recently starting to publish data again, the latest data from the Central Bank of Bahrain (CBB) showed growth in private sector claims softening

Chart 4: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates

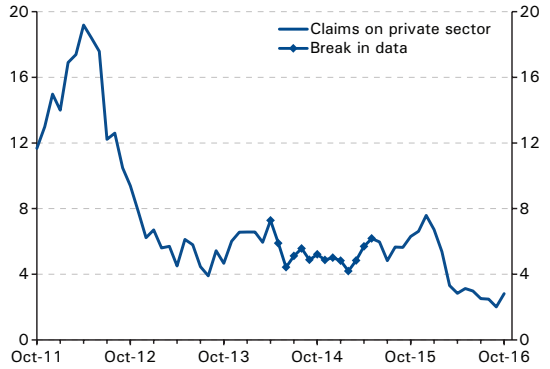
Chart 5: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 6: Private sector claims

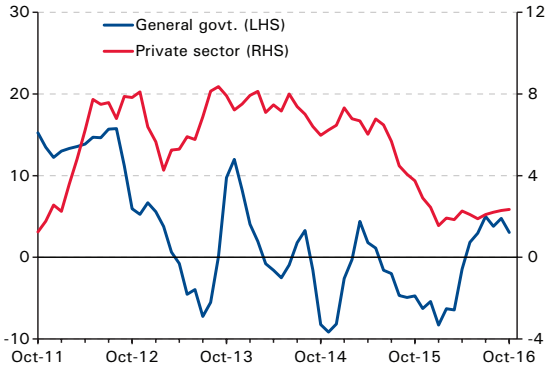
(% y/y)



Source: Thomson Reuters Datastream

Chart 7: Deposits

(3-month moving average % y/y)



Source: Thomson Reuters Datastream

for during most of 2016, against a backdrop of weak oil earnings (Chart 6). In October, it stood at a multi-year low of 2.8% y/y. However, we expect growth in this segment to improve during the course of 2017 and 2018 on the back of a recovery in oil prices and as credit demand, particularly in the construction sector, picks up.

Total deposit growth has been weighed down by an ongoing decline in government deposits (Chart 7). Government deposits have been hammered by lower oil revenues and high levels of government spending. According to the latest data, growth in government deposits slowed from 4.8% y/y in September to 3.0% y/y in October. At 2.3% y/y, growth in private sector deposits also remained relatively tepid. However, total deposit growth is expected to recover in the medium term, amid a recovery in oil revenues as well as bond issuances. This in turn should help ease liquidity constraints in the banking system.

Growth in the broad money supply (M2) witnessed a sharp slowdown in 2016 and remained rather sluggish in 4Q16. This has pushed interbank rates to multi-year highs over the course of 2016. In October, M2 money supply growth was at an almost seven-year low of 0.8% y/y (Chart 8).

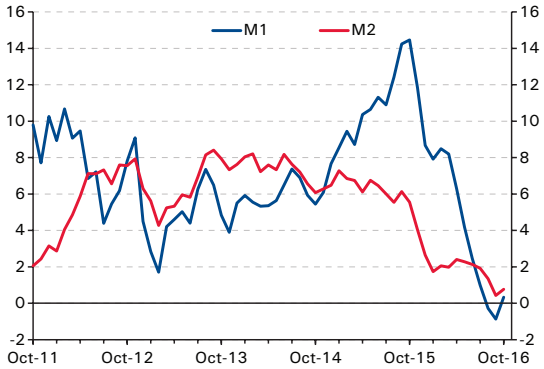
Bahrain's one-month and three-month interbank rates witnessed sharp increases in 2016, especially in the aftermath of the 25 basis points (bps) hike in the US federal funds rate in December, which led to a 25 bps hike in the CBB's key policy rate. As of mid-December, they were up 50 bps and 45 bps year-to-date, respectively (Chart 9). However, with liquidity constraints set to ease over the next two years and the initial impact of the policy rate hike set to subside in the near term, we should see interbank rates gradually come off their multi-year highs.

Bahrain stock market seen improving on oil price recovery

In tandem with regional markets, the Bahrain All Share Index is expected to enjoy higher gains on the back of a recovery in global oil markets as well as greater business confidence (Chart 10).

Chart 8: Money supply

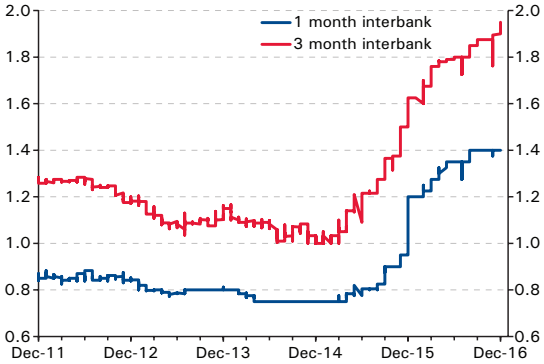
(3-month moving average % y/y)



Source: Thomson Reuters Datastream

Chart 9: Interbank rates

(%)



Source: Thomson Reuters Datastream

Chart 10: Stock market index

(all share index)

Source: Thomson Reuters Datastream

Kuwait outlook

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Projects drive non-oil activity as private consumption slows

Overview and outlook

- **Non-oil to maintain growth of 3.5-4% in 2017 and 2018 on strong investment, though softening consumer spending weighs on activity.**
- **Fiscal deficit to narrow in 2017 and 2018 on some fiscal adjustment and a rising oil price.**
- **Deficit manageable thanks to large financial buffers and ample borrowing capacity; strong credit rating maintained.**
- **Liquidity remains comfortable despite lower oil price.**
- **Dinar strengthened late in 2016 on rallying dollar.**

Economic activity has remained quite resilient despite the lower oil prices in 2016 and the vulnerability of the domestic economy. Non-oil growth is expected to hold up well under current conditions, especially in comparison to GCC peers, and it is expected to continue on an improving trajectory. Relatively limited fiscal adjustment and a strong government-led investment program should support non-oil growth at 3.5-4% in 2017 and 2018.

Still, not all sectors are expected to be doing well in Kuwait in the coming two years. Indeed, household spending appears to have slowed more quickly than anticipated. Consumer confidence appears to have taken a hit following the recent hike in fuel prices. Further subsidy cuts, this time in electricity and water tariffs, are expected in 2017. As a result, consumers have tempered spending growth significantly in 2016. We expect something similar in 2017 before things begin to improve again in 2018.

Nonetheless, the fiscal deficit is expected to narrow in 2017 as the price of oil gradually improves and the government implements some fiscal reform. We see Brent averaging around $55 a barrel in 2017 and $60 in 2018. As a result, Kuwait's budget deficit will narrow to around 8-9% of GDP. Nonetheless, the risk of weaker oil prices is a downside risk for the outlook. While unlikely in our view, weaker prices would put added pressure on the fiscal and external positions and could force the government to cut spending further, possibly at some point reducing or delaying capital spending plans.

Non-oil activity supported by capital spending plans

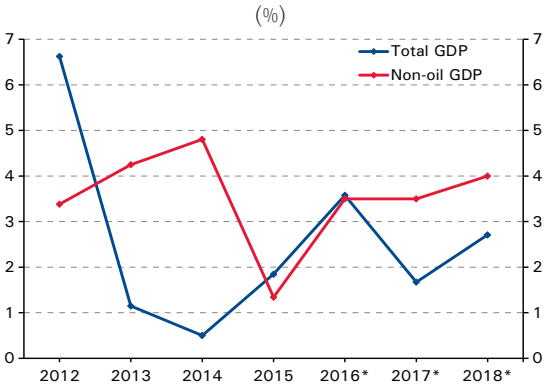
Overall GDP growth accelerated to 1.8% in 2015 from 0.5% in 2014, boosted by record high investment. While the figures show non-oil GDP growth slowing to 1.3% in 2015, we think growth will likely be revised higher when final figures are published (Chart 1). Data also show domestic

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	KD bn	34.3	33.3	37.9	41.1
Nominal GDP	USD bn	114	110	124	134
Real GDP growth	% y/y	1.8	3.6	1.7	2.7
- Oil	% y/y	-1.7	3.6	0.0	1.5
- Non-oil	% y/y	1.3	3.5	3.5	4.0
Inflation	% y/y	3.3	3.4	4.0	3.0
Budget balance *	% of GDP	-17.4	-18.3	-9.5	-8.4

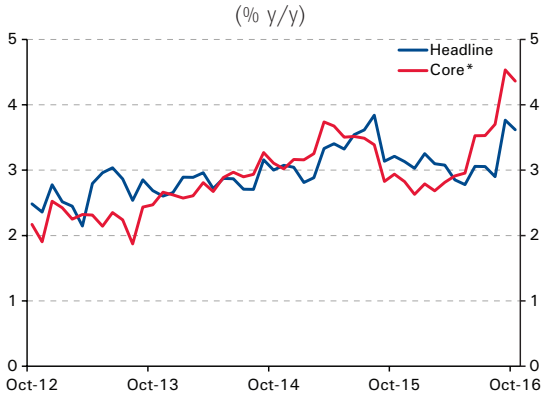
Source: CBK, MOF, CSB, NBK estimates; * after FGF

Chart 1: Real GDP growth



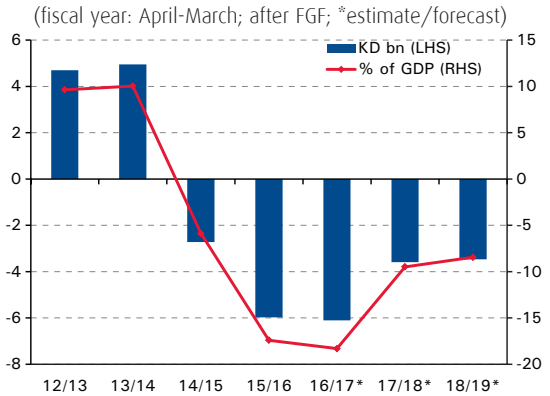
Source: Central Statistical Bureau, NBK estimates; *estimate/forecast

Chart 2: Consumer price inflation



Source: Central Statistical Bureau, NBK estimates; *estimated by NBK

Chart 3: Budget balance



Source: Ministry of Finance, Central Statistical Bureau, NBK estimates

demand growth improving in 2015, with stronger investment growth making up for some weakness in government and private consumption.

We estimate that non-oil GDP growth remained robust at 3.5% in 2016 and expect it to improve slightly towards 4% in 2017 and 2018 (Chart 1). The pace of growth is seen improving, supported by the faster pace of execution of the government's capital projects. Preliminary figures indicate that aggregate investment received a strong boost in 2015. Also, project awards remained relatively strong in 2016, indicating the investment boost is likely to persist into 2017 and 2018.

Private credit growth has reflected the improvement in economic activity, having accelerated to 7.2% year-on-year (y/y) through September 2016 (Chart 4). Credit growth has been particularly strong in the "productive" business sectors. There, lending excluding personal facilities, financial companies and the real estate sector grew 13.6% y/y, compared to growth of 6.4% y/y the year before. Total credit is likely to end 2016 with average growth of around 7.2%, up from 6% in 2015.

Overall GDP growth will likely slip slightly in 2017 to 1.8% in 2016 before improving again in 2017 to 2.7%. The weaker growth in 2016 is largely due to flat real GDP in the oil sector which is expected to be impacted by Kuwait's adherence to the recent OPEC decision to cut production; for Kuwait, that could imply a cut of around 4.5% initially, though we are unlikely to see that cut sustained through the year. In 2018, we expect growth in the oil sector to resume to around 1.5%.

Government's capital spending are driving non-oil growth

The outlook for economic growth is driven largely by an improving pace of implementation of government-led infrastructure projects. The government's development plan targets investment of KD 34 billion through 2020 and includes significant private investment. Among the projects are a number being implemented as public-private partnership projects (PPP), including the Al-Zour North and Khairan integrated power generation and water desalination projects.

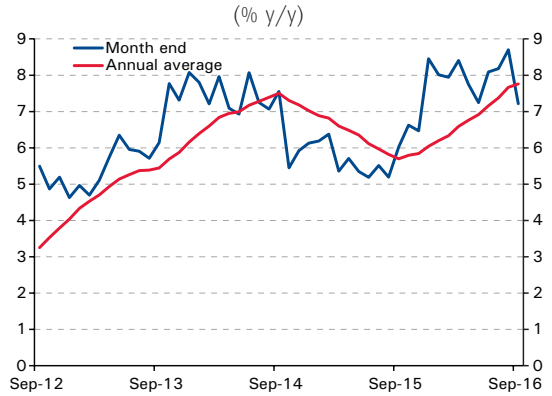
A clear pickup in the pace of project implementation has been visible since 2013. In 2014, more than KD 7.5 billion in projects was awarded with another KD 12 billion signed in 2015. Project awards in 2016 have kept up the pace, with KD 3.6 billion awarded through September 2016. Recent awards included the new airport terminal, which hopes to more than triple capacity by 2022, at an estimated cost of KD 1.3 billion.

The national accounts data have reflected the improvement in project implementation, with investment seeing a strong boost in 2015. Aggregate investment spending grew by 13% during the year, rising to 36% of non-oil GDP, a level that has not been recorded for over 20 years (Chart 5). We expect that level to improve still further towards 38% of GDP by 2018.

Consumer sector begins to flag on weaker sentiment

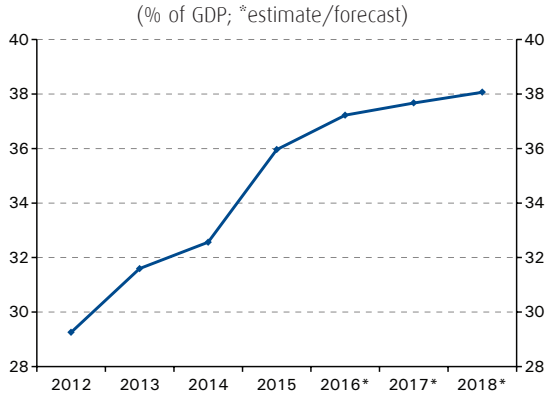
The consumer, or household, sector has long been a robust and reliable source of growth in Kuwait. This began to change in 2015 and 2016, following the persistent decline in oil prices when households took a more cautious view of things. While the sector continues to be supported by steady growth in employment and salaries, particularly in the government sector and among Kuwaiti households, it has exhibited clear signs of softness.

Chart 4: Private credit growth



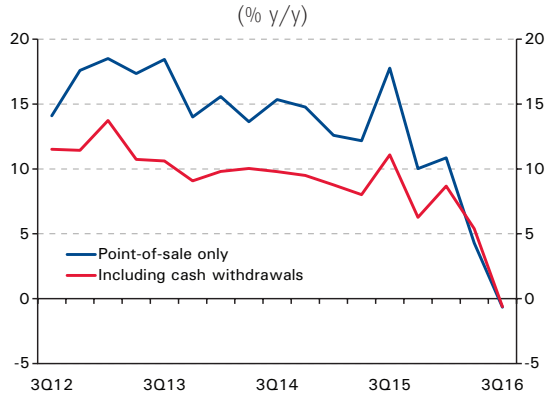
Source: Central Bank of Kuwait

Chart 5: Aggregate investment



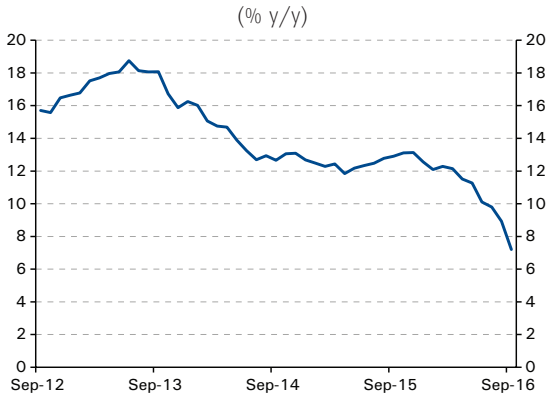
Source: Central Statistical Bureau, NBK estimates

Chart 6: Card transactions



Source: Central Bank of Kuwait

Chart 7: Household debt growth



Source: Central Bank of Kuwait

Weaker sentiment has been a key factor in this change. The Ara Research & Consultancy consumer confidence index, which had been retreating consistently over the last year, fell notably in August just as the government announced plans to hike fuel prices and has remained depressed since (Chart 8). The index average for 2016 through November was down by 8.9% y/y compared to the same period in 2015.

At the same time, card spending data has also been weak; total point-of-sale spending contracted by 0.7% in 3Q16 (Chart 6). Until just recently, growth was in the double-digits. Household debt growth has also slowed in recent months, slipping to 7.2% y/y at the end of September 2016 (Chart 7), down from over 12% growth a year ago.

Real estate remained weak, with prices seeing an orderly correction

Activity in the real estate market has been relatively weak. Sales during the 12 months through October 2016 were off by 31% y/y (Chart 9). Most of the weakness was in the residential and investment sectors, with both seeing 12-month trailing sales down by 37% y/y. Commercial activity, which had seen sales down in 2015, has done better in 2016. Sales in that sector were up by 9.1% y/y.

The cooler real estate market has coincided with the decline in the price of oil and may reflect a more cautious investor. It has also coincided with a concerted effort by the government, since 2014, to increase the distribution of subsidized housing plots and built homes. The government nearly tripled its annual housing distributions to over 15,000 units in 2015 from around 5,000 the year before. In 2016, it plans to distribute more than 12,000. Expectations of an imminent increase in supply in the market may have helped cool market activity.

The drop in sales activity has helped precipitate an orderly correction in real estate prices. The sectoral price indices developed by NBK indicate that price growth has turned negative in the investment buildings and residential sectors. Prices were down by 9.5-12.6% y/y in November 2016 in the various sectors (Chart 10).

Inflation rose following the rise in fuel prices

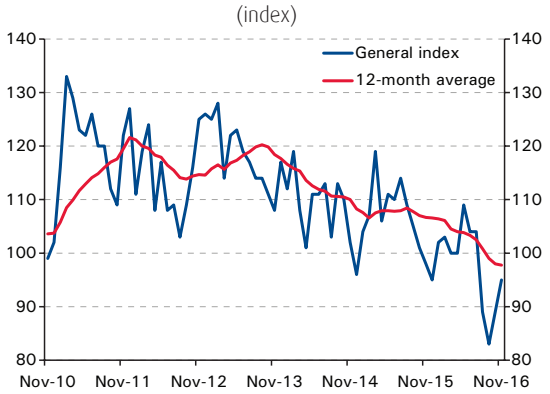
Inflation eased initially during most of 2016, as most sectors saw inflationary pressures diminish. However, the fuel price hike in September pushed inflation higher. Headline inflation rose to 3.6% y/y in October 2016 (Chart 2). Services excluding housing have been a main source of reduced inflationary pressures, with inflation in this segment declining to 1.6% y/y in October 2016, compared to 4% the prior year. Meanwhile, housing services inflation has been easing, as housing rents finally lose steam. Average inflation is likely to remain steady at around 3.4% in 2016 before it accelerates to 4% in 2017, on further hikes in energy and water subsidies. In 2018, we expect inflation to ease its way back to around 3%.

Fiscal deficits will persist, but remain manageable

Government finances are expected to remain in deficit in the medium term, with the price of oil staying around $55-60 per barrel. A deficit of 18% of GDP is expected in FY16/17, after the mandatory allocation to the Future Generations Fund (FGF). The deficit is likely to narrow to around 9% of GDP in FY17/18 and to 8% in FY18/19 as oil prices improve and further fiscal reforms begin to take effect. (Chart 3).

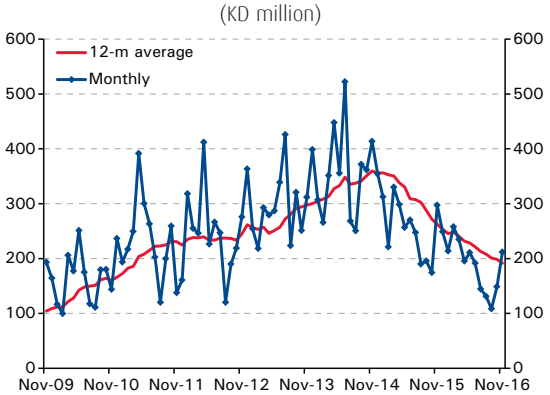
With Kuwait's massive sovereign wealth fund and low debt level, Kuwait is expected to weather lower oil prices relatively well without having to make

Chart 8: Consumer confidence index



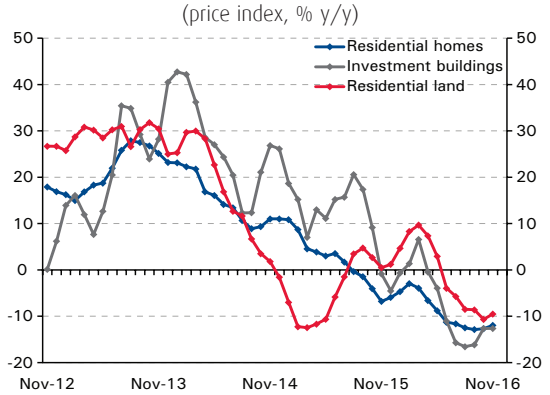
Source: ARA Research & Consultancy

Chart 9: Real estate sales



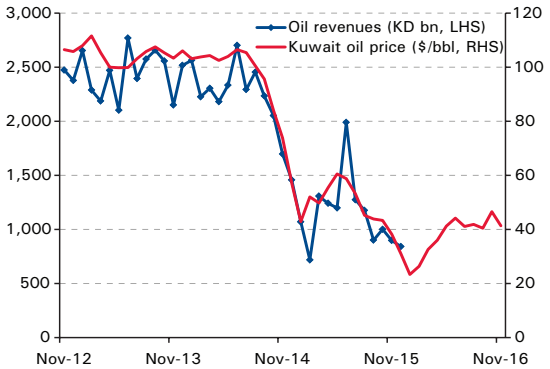
Source: Ministry of Justice

Chart 10: Real estate prices



Source: Ministry of Justice, NBK estimates

Chart 11: Oil price & govt. oil revenues



Source: Ministry of Finance, Kuwait Petroleum Corporation

large cuts in spending. Nonetheless, the government is taking steps towards fiscal adjustment. In March 2016, the government proposed a number of fiscal reforms. The package included cuts in energy and water subsidies, and the introduction of a corporate income tax and a value added tax (VAT). In April 2016, the National Assembly (NA) approved increases in electricity tariffs to take effect gradually from May 2017. The cuts could save the budget around KD 500 million, or 1.5% of GDP.

In September 2016, the government went ahead with plans to cut fuel subsidies, a move which did not require legislation. Gasoline prices were lifted by 42-62% for the various octane grades. The most popular 95 octane fuel, accounting for 80% of consumption, will see the price rise to 105 fils, a 62% increase. The annual savings to the state will be around KD 160 million, or 0.5% of GDP.

The government is also looking to introduce new taxes to boost non-oil revenues, though not before 2019. The government is proposing a 10% corporate income tax on local and foreign companies. The new tax is expected to replace several existing levies on corporate earnings in a measure that will broaden the tax base. Authorities are also preparing to introduce a 5% VAT in conjunction with other GCC countries. While the VAT measure is aimed for 2018, we expect it is likely to be delayed at least into 2019. Both measures will require legislation.

Kuwait's deficits remain relatively manageable given the state's substantial overseas financial assets and ample capacity to borrow. Kuwait's sovereign wealth fund assets are estimated to be near 450% of GDP. While the bulk of the assets are in the Future Generations Fund (FGF) and cannot easily be tapped, the General Reserve Fund (GRF), whose holdings are mostly liquid are available to finance the deficit; holdings in the GRF are thought to be around KD 25-30 billion.

Bond issuance is being ramped up in FY16/17

Despite Kuwait's substantial sovereign wealth fund assets, the government has chosen to rely on debt issuance to finance part of the deficit in FY16/17. We estimate the government will need to finance around KD 6.1 billion in FY16/17 after the mandatory payment into the FGF. Another KD 3.5 billion will be required in each of 2017 and 2018. The government has indicated it will issue around KD 5 billion in domestic and international debt in FY16/17. Issuance is likely to be toned down subsequently, though we think the government might still finance around 50% of the deficit through debt in 2017 and 2018.

By the end of November 2016, the MOF issued around KD 1.5 billion in domestic bonds and Islamic paper. The debt level rose to KD 3.1 billion or an estimated 9.4% of GDP. The issued debt varied in maturities between one and seven years and included a few first-time issuances of floating rate notes.

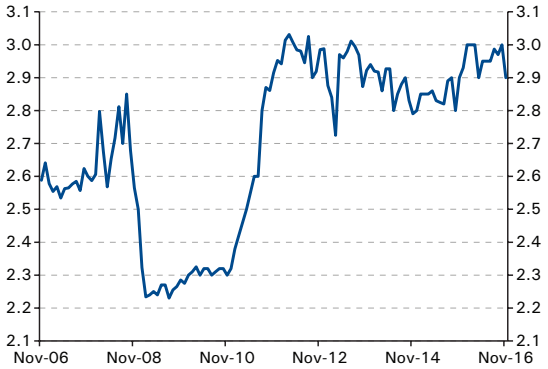
There are also preparations to tap the international debt market. The MOF has stated it plans to issue up to $10 billion (KD 3 billion) in foreign currency debt in FY16/17. Such a step will allow Kuwait to capitalize on its solid credit rating (Moody's: Aa2, S&P: AA, Fitch: AA) and low international rates. An international bond issue is now expected to happen sometime in 1Q17.

Liquidity remains comfortable despite some tightening

International debt issuance will also help relieve the pressure on domestic liquidity. With the government running a deficit and the current account seeing its surplus narrow considerably, system liquidity has come under

Chart 12: Crude oil production

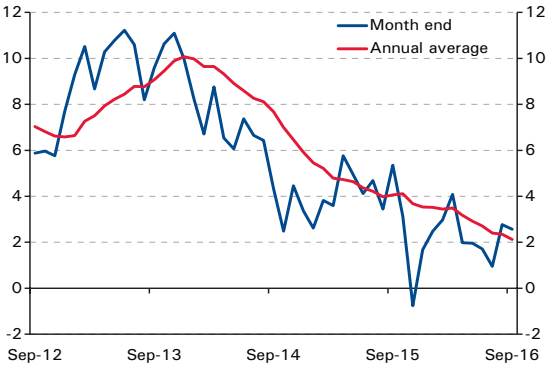
(million barrels per day)



Source: OPEC

Chart 13: Money supply growth

(% y/y, M2)



Source: Central Bank of Kuwait

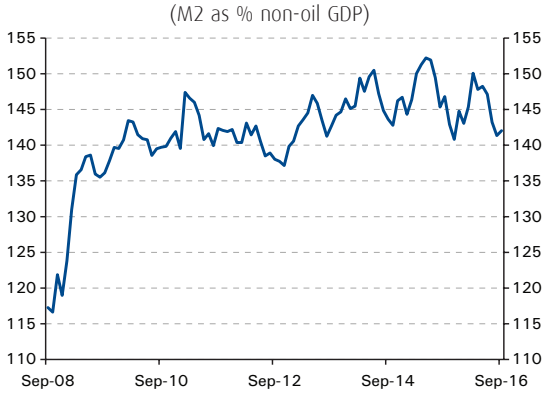
Chart 14: Banks' liquid reserves

(% of bank assets)

Source: Central Bank of Kuwait

Chart 15: Money supply to non-oil GDP

(M2 as % non-oil GDP)



Source: CBK, Central Statistical Bureau, NBK estimates

some pressure. Money supply (M2) growth slowed to 2.6% y/y in September 2016, down from double-digit growth before 2014 (Chart 13). Still, liquidity levels remain relatively healthy. Money supply (M2) to non-oil GDP is estimated at 137% in September (Chart 15).

Domestic interbank rates retreated during most of 2016, as the spread to US Libor tightened considerably. The Central Bank of Kuwait (CBK) hiked the discount rate by 25 basis points (bps) in December 2016 to 2.50%, immediately following a similar rate hike by the US Federal Reserve. The 3-month interbank rate rose 10 bps to 1.44% after the rate hike, but remained well below recent highs reached in March 2016 (Chart 17).

Strong dollar saw the dinar strengthen towards the end of 2016

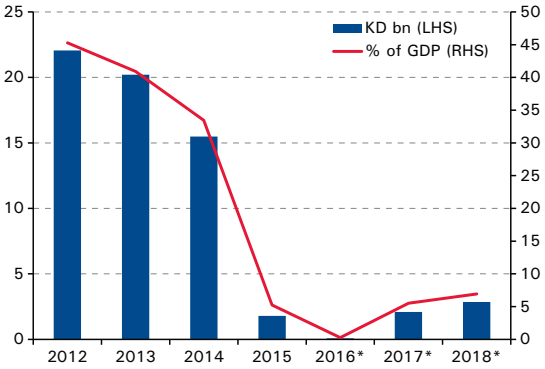
The Kuwaiti dinar (KWD) saw another year of strengthening in 2016, on the back of US dollar strength following the 2016 US elections. The dinar index, which reflects the trade-weighted value of the currency, rose by 3% year-to-date (ytd) through 18 December, after having registered gains of 2.9% and 2.8% in 2014 and 2015, respectively. The dinar, which is pegged to a basket of major currencies with the US dollar having the largest weight, declined by 0.8% against the US currency ytd (Chart 18).

Stocks outperformed in 4Q16 as volumes improved

Kuwaiti equities, which have typically lagged the region, outperformed during the last few months of 2016. The long-awaited catalyst was the acquisition of Americana by a UAE-based investor, a deal finalized in October 2016. Following declines during most of 2016, the Boursa Kuwait value-weighted index (IXW) gained 7.5% during 4Q16 through 18 December 2016 (Chart 19), though it remained down by 0.9% ytd. The MSCI total return index was up 5% ytd, reflecting the larger gains made by blue chips stocks.

Chart 16: Current account balance

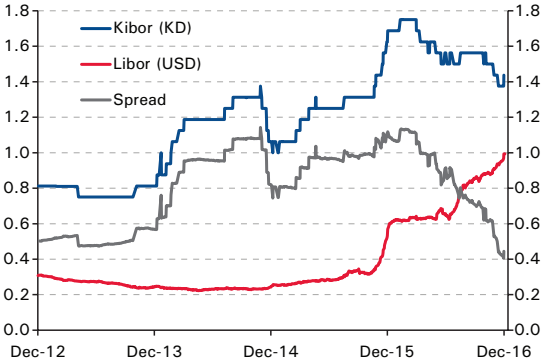
(*estimate/forecast)



Source: Central Statistical Bureau, NBK estimates

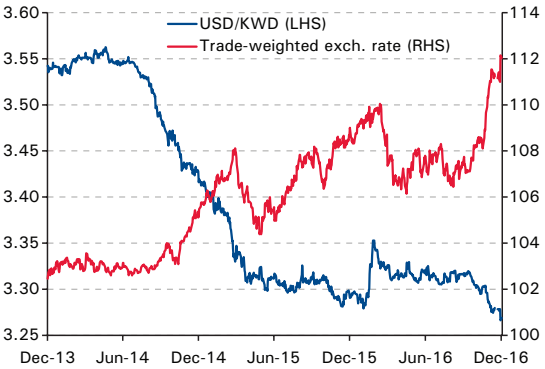
Chart 17: Interbank rates

(%, 3-month)



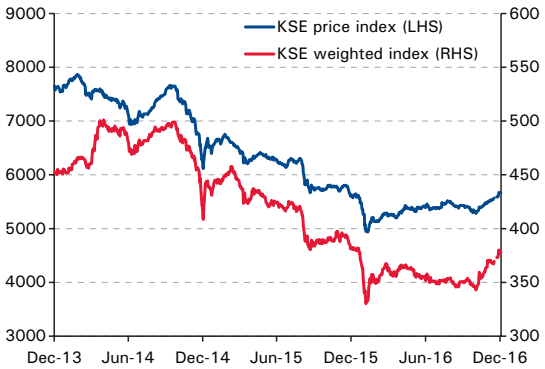
Source: Central Bank of Kuwait, Thomson Reuters Datastream

Chart 18: Exchange rate



Source: JP Morgan, Thomson Reuters Datastream

Chart 19: Stock market indices



Source: Boursa Kuwait, Thomson Reuters Datastream

Oman outlook

Real growth seen slowing in 2017 as fiscal stance tightens

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Overview and outlook

- **Real GDP growth is seen weakening to 0.1% in 2017, before picking up to 2.2% in 2018.**
- **Fiscal deficit expected to shrink to 14% in 2017 and 9% in 2018, though spending cuts disappoint.**
- **Credit growth is expected to moderate, while liquidity pressures seen subsiding slowly.**
- **Inflation picked up in 2016 following subsidy cuts with upward pressures to persist through 2017 and 2018.**

The economy is showing signs of slowing on the back of fiscal tightening. Consumer confidence is weakening, government projects are being pushed forward and market conditions have turned bearish. The persistence of low oil prices is projected to produce substantial deficits through 2018, increasing the urgency for fiscal consolidation.

Following fiscal reforms that failed to rein in the deficit in 2015, the government proposed new measures targeting excessive spending and better revenue collection. To that end, the government is poised to implement a valued added tax in 2018. This is expected to act as a damper on domestic demand and economic growth. Nonetheless, the launch of the BP Khazzan tight gas project in 2018 is likely to provide a much needed boost to growth. Meanwhile, liquidity in the banking sector is set to improve, on the back of recovering oil prices and future international issuances.

At the same time, the government has been pushing meaningful structural reform and improving trade relations, which should support growth in the medium to long-term. Recent government efforts show resolve in divesting away from the public sector. Reforms supporting small and medium-sized enterprises and foreign investors hope to spark growth in the non-oil sector. Deepening ties with Iran may also be a boon for both the non-oil and financial sectors.

Growth held back by weaker consumption and investment

Weaker household and government consumption, coupled with delayed private and public investments is likely to lead to a slowdown in real GDP growth in 2016 and 2017. Growth is set to recover in 2018 on the back of a boost in the oil & gas sector.

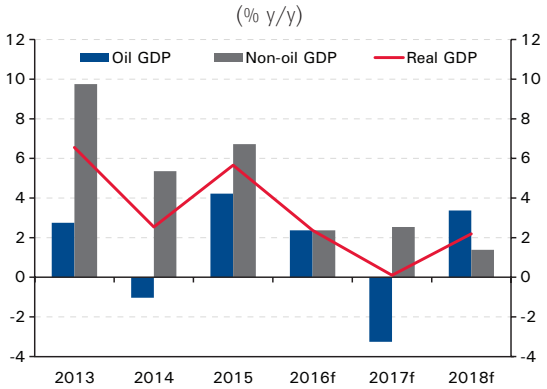
Real GDP growth is expected to come in at a modest 2.4% in 2016, as a pick-up in oil production offsets the weakness in both consumer and market

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	70	68	70	73
Real GDP	% y/y	5.7	2.4	0.1	2.2
- Oil	% y/y	4.2	2.4	-3.3	3.4
- Non-oil	% y/y	6.7	2.4	2.5	1.4
Inflation	% y/y	0.1	1.2	2.0	4.1
Budget balance	% of GDP	-17.3	-19.1	-13.9	-8.8

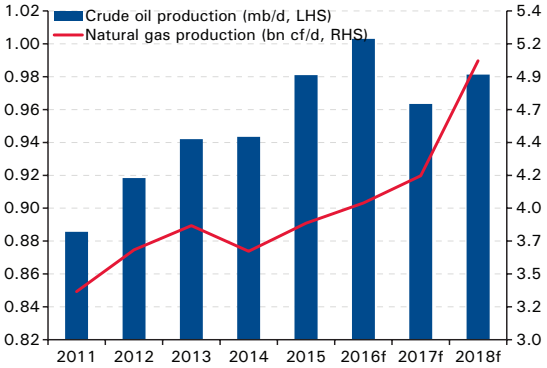
Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP



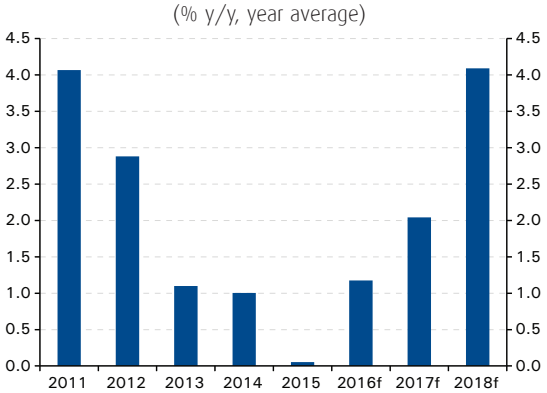
Source: National Center for Statistics and Information, NBK estimates

Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation



Source: National Center for Statistics and Information, NBK estimates

activity. However, this will fail to carry through into 2017 due to planned oil production cuts in accordance with the non-OPEC agreement. Growth in 2017 will also suffer from a thriftier government, which may see some investment spending delayed, dampening a potential uplift in household consumption ahead of the implementation of the value-added tax (VAT).

For these reasons, real GDP growth in 2017 is forecast to come in flat, at an estimated 0.1%. Increased revenue from the new VAT and recovering oil prices, however, may see government investment spending pick up in 2018, with growth further lifted by the launch of the BP Khazzan tight gas project that same year. Indeed, this may lead to stronger government consumption, gas production, and LNG exports. Nonetheless, household consumption is expected to remain subdued in 2018, with total GDP growth estimated at 2.2%.

Oman continues to pursue diversification initiatives in a bid to divest its economy from oil. Efforts, however, are being held back by the oil price crunch, posing a drag on the non-oil economy. Private and public investment spending has dried up in 2016. The value of awarded projects halved to $7 billion in 2016. Meanwhile, other than a few investment friendly laws introduced at the beginning of the year, other initiatives have since been few or lacking. As a result, the non-oil economy is expected to see real growth average 2% from 2017 through 2018. (Chart 1).

High breakeven price sees fiscal deficit persisting into 2018

With current and expected oil prices well below the sultanate's estimated breakeven price, Oman's coffers are expected to remain under duress, with substantial deficits to be potentially registered for 2016 and 2017, before recovering in 2018. (Chart 4).

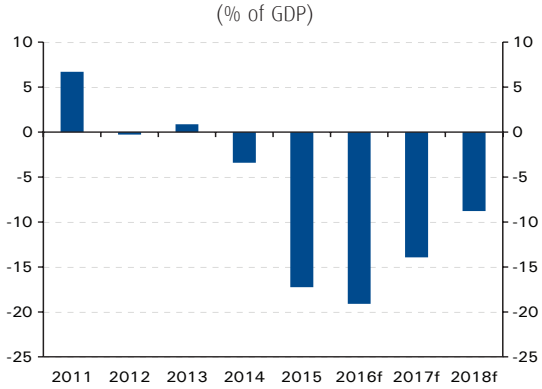
As of October 2016, Oman has recorded a deficit of OMR 4.8 billion, overshooting the government's expectation of OMR 3.3 billion deficit for 2016, on the back of disappointing spending cuts. With little expected change in spending behavior and an estimated breakeven price of $95 per barrel versus a 2016 market average that has hovered around $45 per barrel, the government is slated to register a deficit close to 19% of GDP, or OMR 5.0 billion, in 2016.

The 2017 budget may fare better, with the government floating early expectations of a OMR 3 billion deficit for that year. Their rumored budgetary strategy will focus on cutting expenditures and keeping revenues unchanged, with the average barrel of oil priced at $45. Given the government's current fiscal expenditure performance, such an outlook would imply further aggressive cuts in subsidies and a large cut in current expenditures. The likelihood of that happening, however, are slim, since such cuts may face public resistance.

On the bright side, revenues, both oil and non-oil, are expected to come in higher on the back of higher expected oil prices ($55 per barrel) and better fee collection, but will do little to limit expenditure growth. As such, we project a slightly larger deficit than the government's, at around OMR 3.7 billion, or 14% of GDP, for 2017.

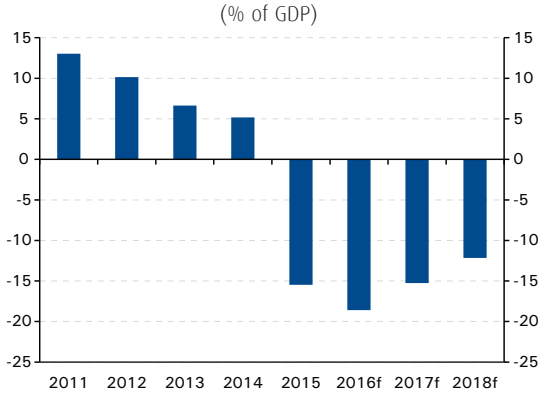
Implementation of the VAT in 2018, in addition to a pick-up in oil prices, will see revenues increase that year, helping improve the budget deficit. Current and investment expenditures are expected to pick-up, however, encouraged by the stronger revenue streams. Indeed, the government may offset the impact of the tax through wage increases and a more aggressive pursuit of its development plan. The deficit is expected to come in at 9% of GDP in 2018.

Chart 4: Budget balance



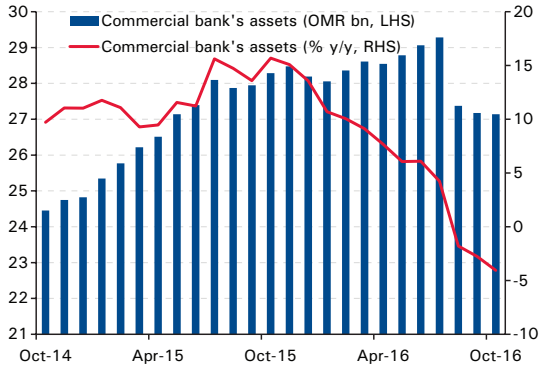
Source: National Center for Statistics and Information, NBK estimates

Chart 5: Current account balance



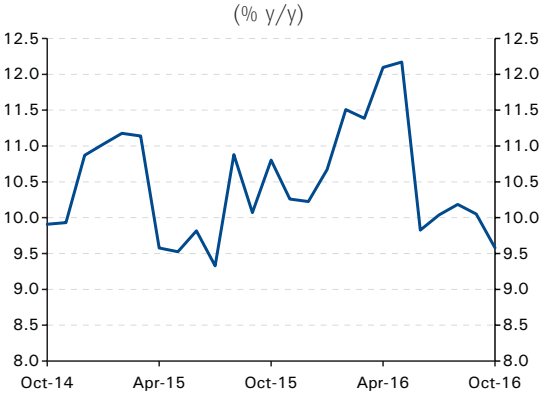
Source: National Center for Statistics and Information, NBK estimates

Chart 6: Commercial bank assets



Source: Central Bank of Oman

Chart 7: Credit to private sector



Source: Central Bank of Oman

In view of the low oil price environment, the government has adopted several measures to rein in their finances in 2016, such as fuel hikes, increases in government fees, corporate tax hikes, and spending cuts at government institutions. In recent months, the government also moved ahead with cuts in electricity subsidies, visa fee increases, and a privatization program.

Oman was successful in raising $5.5 billion worth of international debt to finance its 2016 deficit by way of international bonds and syndicated loans. The government's foray was facilitated by its investment grade rating, which it is still expected to benefit from in 2017. Oman's debt level remains low relative to its peers, though it is expected to have risen to around 21% of GDP at the end of 2016; it is seen rising further to 29% and 33% by the end of 2017 and 2018, respectively.

Oil & gas sector to pick up on gas production boost

After an exceptional year that saw average daily production breach 1 million barrels per day, Oman is expected to see its oil sector contract in 2017, as it complies with proposed oil cuts by non-OPEC members supporting a broader OPEC agreement. The recovery of oil prices over the forecast period, however, will offset the drop in crude oil production. The higher revenue potential may also imply a more modest uptick in 2018 oil output.

The launch of the BP Khazzan tight gas project in 2018, however, will see Oman's gas sector witness a strong boost as daily production capacity is increased by 1 billion cubic feet. As such, Oman's real oil GDP growth is seen at 2.4% in 2016, -3.3% in 2017, and 3.4% in 2018. (Chart 1 & 2).

With domestic gas demand still outstripping supply, and the bulk of gas output going towards Oman's LNG exports, the need for gas imports continues to grow. As such, an Iranian gas pipeline is proposed that will import 1 billion cubic feet per day from 2018. This could help Oman avoid disruptions to its LNG exports and even consider expanding them. Progress on the pipeline, however, has been slow.

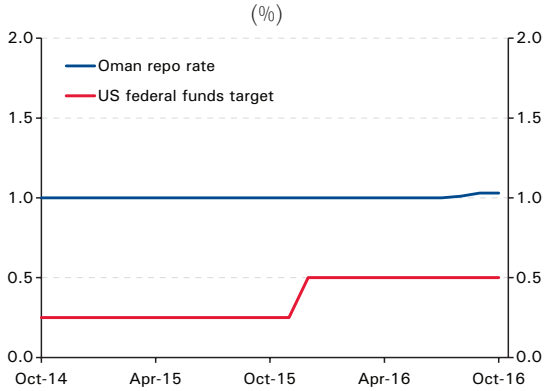
Banking system sees liquidity conditions improving

In light of the rise in oil prices, Oman's banking sector is projected to see liquidity pressures ease as government deposits recover. Further expected international borrowing by the government may also add some support. Indeed, liquidity pressures have come off recently, with the overnight interbank lending rate decreasing to 0.34% in November from 0.4% in September 2016, but was still up from December 2015's 0.19%. The improvement has been supported by a more contained decline in government deposits thanks to recent international government issuances. Government deposits were down 1% y/y in October 2016. The recent pick up in oil prices may add a further lift.

Credit growth, while still resilient in 2016, is expected to slow in 2017, on the back of weaker household spending, only to pick up in 2018, as individuals cope with the higher cost of living brought forth by the implementation of the VAT. As of October 2016, private credit growth has remained resilient at 9.6% year-on-year (y/y), and is set to finish the year on a similar note. (Chart 7).

Despite Oman's currency peg to the dollar, the Central Bank of Oman (CBO) refrained from increasing its main policy rate after the widely expected US Fed rate hike. CBO chief, Al-Zadjali, explained that current domestic liquidity and economic conditions did not warrant increased rates. However, the

Chart 8: Policy rates



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

Source: Muscat Securities Market

CBO did raise its overnight repurchase rate to 1.195% as of mid-December. (Chart 8).

Oman's financial sector is still well capitalized. According to the CBO's latest quarterly financial soundness statistics (June 2016), credit risk remains low in Oman with nonperforming loans (NPL) slightly higher at 2.2% of gross loans. Capitalization was also high, with a capital adequacy ratio of 16% in 2Q16 and a tier-1 capital ratio of 13% at the end of 2015.

More subsidy cuts and a VAT see inflation on an upward path

Inflation picked up following recent subsidy cuts. The increase is expected to be sustained in 2017 and 2018 as the government liberalizes prices on energy and other goods and services, offsetting downward pressures from global food and energy prices. Inflation in Oman's consumer price index (CPI) is seen at 1.2% in 2016 and 2% in 2017. The introduction of the VAT in 2018 may see consumer prices rise to 4.1% for that year. November's inflation reading came in at 1.9% y/y, on the back of increased housing, furnishing, and transportation costs, offsetting the sustained decreases in food prices. (Chart 3).

Current account to slowly improve

The deficit on the current account balance is projected to worsen in 2016 before improving in 2017 and 2018 (Chart 5). Weaker oil prices will more than offset the decline in imports and import prices, keeping the trade surplus modest well into 2018. The removal of international trade sanctions on Iran and the prospect of higher LNG exports is expected to provide strong support to the trade balance. The services deficit will continue to expand, albeit at a slower pace, as projects aimed at boosting tourism and transport come to fruition. Meanwhile, further growth in the expatriate population will see remittances grow. As of October 2016, Oman's foreign reserves stood at OMR 7.4 billion, or an estimated 9 months of imports.

The stock market outperforms regional peers supported by oil prices

Omani stocks, although down from their mid-year high, continued to benefit from 2016's rally in oil prices, which were recently further supported by OPEC's oil production cut agreement. (Chart 9). The MSM 30 increased by 6.0% year-to-date as of 19 December 2016, outperforming most of its regional peers.

Qatar outlook

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Non-oil activity cools but public investment to continue to drive growth

Overview and outlook

- **Growth is forecast to slow to 2.9% in 2016 from 3.5% in 2015 due to further cooling in non-hydrocarbon sector activity.**
- **Non-hydrocarbon sector growth should average 5.5% y/y in 2017-18 and remain supported by government spending.**
- **Qatar is expected to post its first fiscal deficit in years, of around -5.0% of GDP this year, despite laudable efforts at fiscal consolidation.**
- **Domestic and external debt issuance is helping the government plug the fiscal shortfall but also causing public debt to rise.**
- **Overall credit growth is slowly rebounding (11.2% y/y in Oct) but private sector credit activity is lagging.**
- **Non-resident deposit inflows have supported total bank deposit growth (7.4% y/y in Oct), but liquidity remains tight, with the LD ratio up at almost 119% and interbank rates still elevated at 1.7%.**
- **Qatari equities were buoyed by the OPEC supply cut deal, but concerns linger over corporate earnings and tighter liquidity.**

Qatari economic growth continues to slow as the effects of the oil price downturn filter beyond the oil and gas sectors and into the non-hydrocarbon sector. Government spending, the lynchpin of the economy, is expected to contract in 2016 for the second year in a row while the authorities continue their fiscal consolidation, merging ministries, scaling back infrastructure projects and cutting subsidies on domestic fuel and utilities in a bid to contain a widening fiscal deficit. Spending will still remain elevated by historical standards, however, helping to support infrastructure development and diversification and meet the country's Vision 2030 and World Cup 2022 goals. Fiscal deficits will continue to be financed primarily through bond issuance, pushing central government debt well above 50% of GDP. With the outlook for oil prices improving in 2017-2018, bank credit and deposit growth are also expected to pick up by 2018 and liquidity constraints to ease somewhat, though banks' reliance on foreign deposits and rising borrowing costs represent near-term challenges.

Non-oil economy cools on tighter government investment spending; hydrocarbon sector gains limited to the launch of the Barzan facility

Following the full completion of Qatar's LNG facilities in 2011-12, economic growth in the country has largely been driven by expansion in the non-hydrocarbon sector, with government infrastructure investment the key

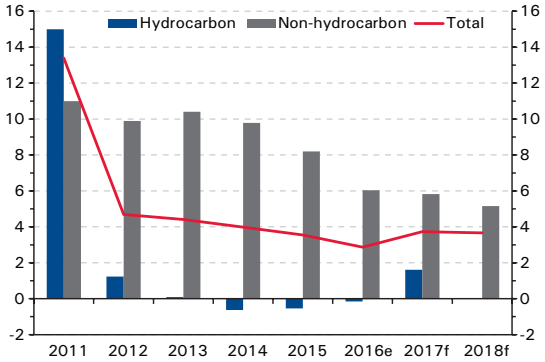
Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	164.6	161.1	183.1	199.7
Real GDP	% y/y	3.5	2.9	3.7	3.7
- Oil	% y/y	-0.5	-0.2	1.6	2.1
- Non-oil	% y/y	8.2	6.0	5.8	5.2
Inflation	% y/y	1.9	2.9	2.3	3.4
Budget balance	% of GDP	1.3	-5.0	-2.6	-1.7

Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP

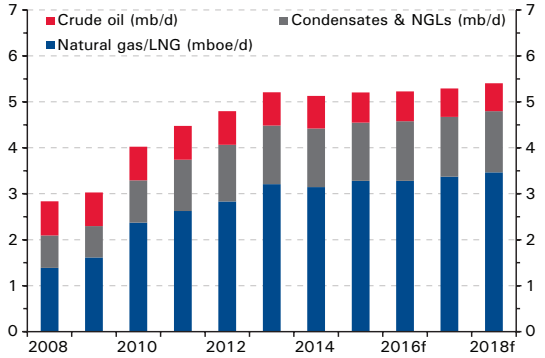
(% y/y, base year 2013)



Source: Ministry of Development Planning & Stats. (MDP&S), NBK est.

Chart 2: Oil and gas production

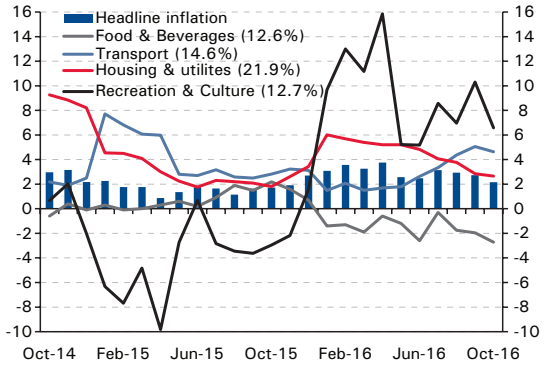
(million barrels of oil/oil equivalent per day)



Source: BP, JODI, OPEC, NBK estimates

Chart 3: Consumer price inflation

(% y/y, weights in brackets)



Source: MDP&S

driver. Led by average annual double-digit increases in the construction, manufacturing, financial services and trade and tourism sectors over the last five years, the non-hydrocarbon sector has grown by an impressive 10% y/y on average since 2011. This is easily the most robust growth in the GCC. With the oil price decline most pronounced in 2015, however, non-hydrocarbon growth moderated to 8.2% as the government pared back capital spending; projects, especially non-essential and non-FIFA-related, were streamlined, downgraded or cancelled altogether in an effort to maintain a tighter grip on spending. High profile infrastructure projects such as the Lusail Mixed-Use Development ($45 billion), the Qatar Integrated Railway ($40 billion), the Ashghal local roads and drainage program ($14.6 billion) and the new Hamad Port ($7.4 billion) are far too integral to Qatar's $200 billion development plan and have thus largely been spared. The cost-cutting exercise should reach its full extent in 2016 before the authorities loosen the purse strings somewhat in 2017-2018 in line with an expected rebound in oil prices and hence oil revenues. Non-hydrocarbon growth will likely moderate over the forecast period and average 5.5% y/y. (Chart 1.)

Meanwhile, sources of potential growth in the hydrocarbon sector will be limited to the full commissioning of the $10.3 billion Barzan gas production facility; the attainment of maximum LNG output capacity and continued declines in crude oil production from the country's ageing oil fields. Crude production was down to 0.65 mb/d in 2016, having reached as high as 0.85 mb/d in 2007. (Chart 2.)

However, the Barzan facility, which is expected to produce up to 1.4 billion cubic feet per day (bcf/d) of natural gas mainly for domestic power and water consumption, has been delayed, pushing back the expected output gains for the hydrocarbon sector to 2017 and 2018. Real output is therefore expected to contract in 2016, by -0.2%, before rising in 2017 and 2018, by 1.6% and 2.1%, respectively. (Chart 1.)

Headline inflation moderates due to deflation in food and rental prices; transport costs expected to pick up as subsidies withdrawn

Inflation in the consumer price index (CPI) eased in 2016 due to declines in international food and commodity prices as well as falling domestic rental costs. And this came despite the rise in transportation costs in 2016 (14.6% of CPI basket) which followed the government's hike in gasoline prices (cut to energy subsidies). Headline inflation fell to 2.2% y/y last October, having been as high as 3.3% y/y the previous February following the fuel hikes. (Chart 3.) December 2016 saw another round of fuel price increases as the government stepped up its efforts to equalize domestic and international fuel prices.

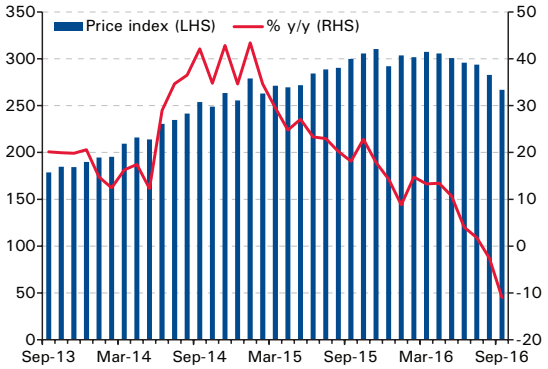
Meanwhile, inflation in the housing, water and electricity component of the CPI (21.9% of the CPI) slowed during 2016, from a high of 6.0% in February to a low of 2.7% y/y in October; the housing market is currently experiencing oversupply, triggering the moderation in rental inflation. The trend is echoed in the falling value of properties, with the country's real estate price index (REPI) showing a decline of -11.0% y/y by the end of 3Q16. (Chart 4.)

Looking ahead, we expect headline inflation to slow further from an expected 2.9% in 2016 to 2.3% in 2017 before rising to 3.4% in 2018 in line with an improvement in economic growth.

Qatar's first fiscal deficit in 16 years is expected in 2016 despite laudable efforts to control spending

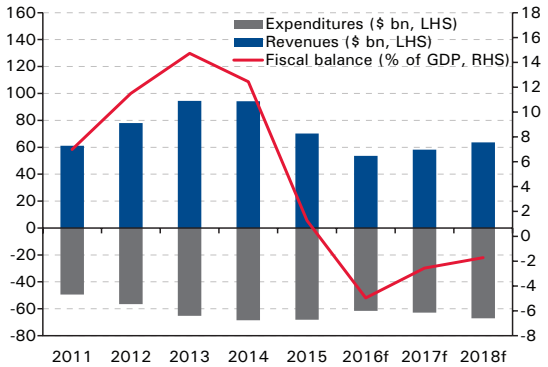
Sharply reduced oil and gas revenues since 2014 (-30% y/y on average)

Chart 4: Real estate price index



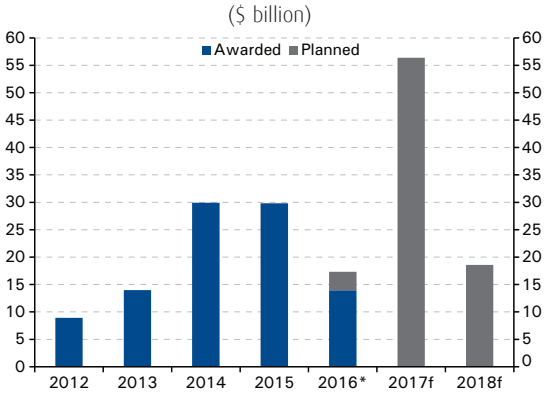
Source: Ministry of Justice (MOJ), Qatar Central Bank (QCB)

Chart 5: Fiscal balance



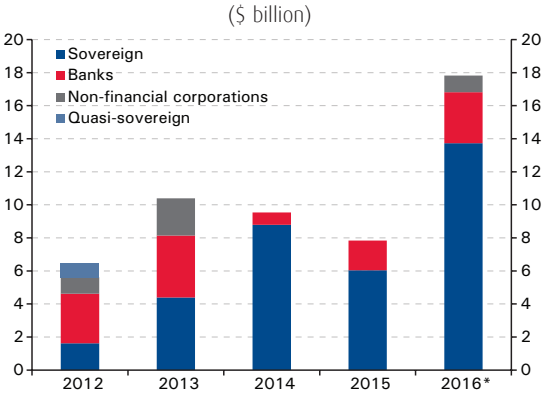
Source: QCB, NBK estimates

Chart 6: Project awards



Source: MEED Projects, *as of 13 December 2016

Chart 7: Bonds & sukuk issuance



Source: Thomson Reuters Zawya, *as of 6 December 2016

have motivated the authorities to embark on a concerted round of fiscal consolidation. But this will not be enough to forestall Qatar's first fiscal deficit, equivalent to -5.0% of GDP, in 2016. (Chart 5.) Nevertheless, the government's efforts to get a handle on spending have not been in vain: current expenditures have been curtailed through a combination of cuts in the number of ministries, lay-offs of expatriates and freezes in public sector pay; subsidies on fuel, water and electricity have all been reduced; and non-essential infrastructure projects have been scaled back or shelved entirely. According to MEED Projects, the value of projects awarded in 2016 dropped by 53%, from $29.8 billion in 2015 to $13.9 billion in 2016. (Chart 6.) As a result, 2016 could see total expenditures contract by as much as -9.7% y/y, the biggest cut in years. The deficit is expected to narrow in 2017 to -2.6% of GDP and in 2018 to -1.7% of GDP thanks to rising energy prices and revenues.

The government has tapped the debt markets, increasing the public debt

The government has increasingly sought to shift the burden of deficit financing away from its foreign reserves and towards the debt markets, where it actively participated to the tune of $13.7 billion in 2016. (Chart 7.) The largest sovereign issuance was a $9.0 billion triple-tranche USD-denominated international bond in May. Along with $4.7 billion in sovereign domestic bonds and sukuk plus a $5.0 billion syndicated loan secured earlier in the year, recourse to the debt markets has helped Qatar's finances and injected much-needed liquidity into the banking system.

In spite of rising debt issuance, the country's international reserves continued to decline. In the year to October 2016, net international reserves were down by $2.7 billion to $34.1 billion. (Chart 8.) The reserves are estimated to provide the equivalent of 6.7 months of import cover, which is more than twice the 3 months recommended by the IMF for fixed exchange-rate regimes.

Gross government debt (domestic and external debt) is projected to increase from an expected 60% of GDP in 2016 to 68.6% of GDP by end-2018. (Chart 9.)

Fiscal buffers appear sufficient for the time being, however, given that the government could also draw on an estimated $335 billion worth of assets under management at the Qatar Investment Authority (QIA), the country's sovereign wealth fund.

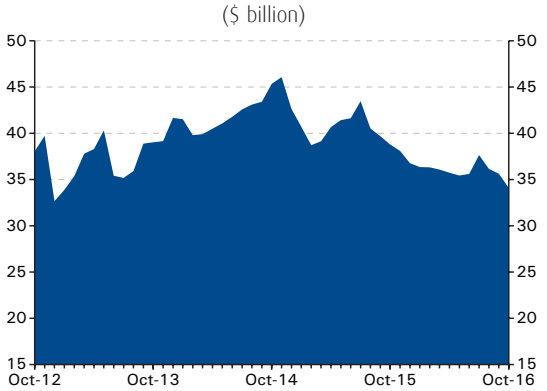
Credit growth boosted by public sector financing demands but reduced deposit flows have led to a tightening in bank liquidity

In 2016, total credit growth rebounded from the single digit lows of early 2015 to come in at a robust 11.2% y/y last October. (Chart 10.) Much of this was driven by the public sector (+16% y/y) as the government rekindled its appetite for bank credit.

In contrast, private sector credit growth was on a downward trajectory for much of 2016, slowing to 7.7% y/y last October. Demand from industry, contractors and retail consumers has been especially weak for much of the year as the effects of the oil price downturn filter through into the consumer sector and as the demand for further real estate projects recedes.

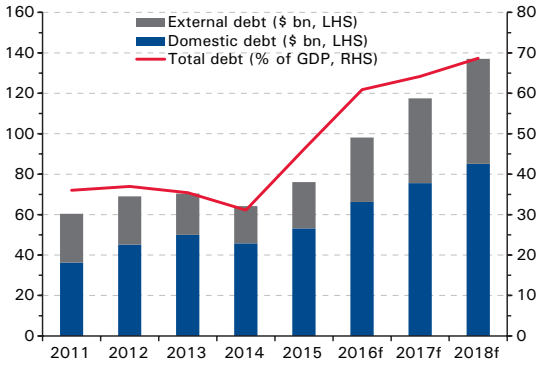
Meanwhile, deposit flows into the banking system, especially government-related deposits, have been hit hard by the decline in oil prices since mid-2014. As of last October, deposit growth looked to be improving, however, rising to 7.4% y/y, mainly on the back of increased non-resident deposit inflows, which almost doubled y/y. Private sector deposits were up only

Chart 8: International reserves (net)



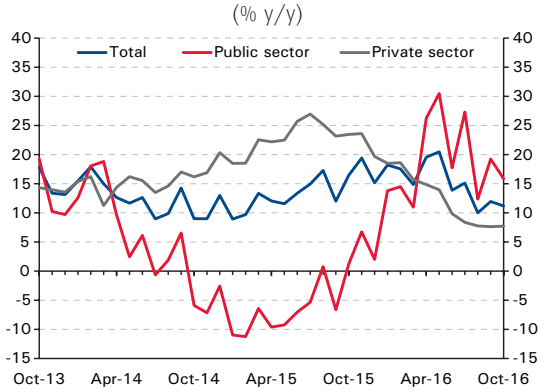
Source: QCB

Chart 9: Central government debt (gross)



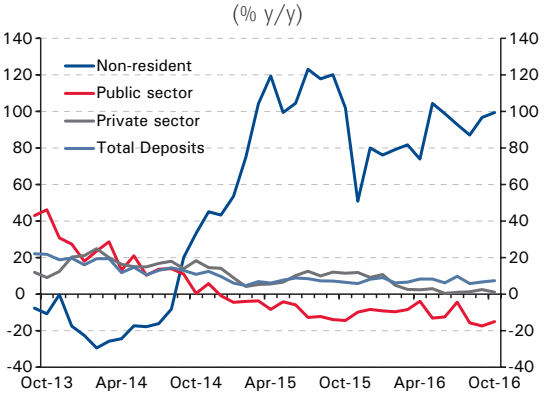
Source: QCB, NBK estimates

Chart 10: Credit growth



Source: QCB

Chart 11: Deposit growth



Source: QCB

1.1% y/y, while the public sector deposit base was still 15% smaller than a year earlier. (Chart 11.)

With deposit growth trailing credit growth, tight liquidity in the Qatari banking sector has been a key concern. The sector's loan-to-deposit ratio (LD) reached 118.7% in October, close to February's high of 119.9%, and interbank rates were still relatively elevated in December at around 1.7% for the 3-month QIBOR (Chart 12.)

Given that deposits from non-residents (mainly from the GCC and Asia) in the banking system have almost doubled in the span of a year and that monies due from Qatari banks to overseas banks have increased by almost 24%, concerns about over-reliance by Qatari banks on foreign funds have once more resurfaced. Indeed, the net foreign liability position of Qatari banks was up at $43.8 billion in October, equivalent to 166.0% of foreign assets, which is a record high. (Chart 13.)

The QCB follows the US Fed's lead and raises its benchmark rates by 25 bps in 2016

In view of the riyal's peg to the US dollar, Qatari domestic interest rates tend to be closely aligned with US interest rates. Following the US Fed's lead, the Qatar Central Bank (QCB) finally raised its benchmark lending and deposit rates by 25 bps on 15 December to 4.75% and 1.0%, respectively; the QCB had resisted raising its rates in December 2015 when the US Fed began normalizing monetary policy. (Chart 14.)

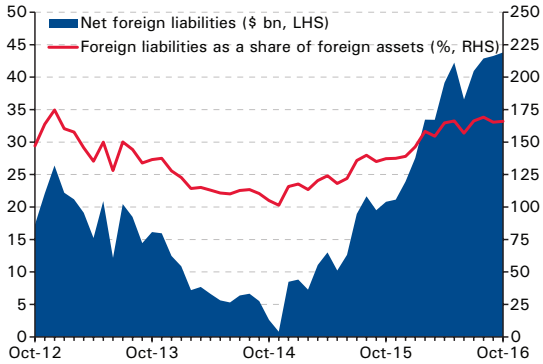
Qatari equities buoyed by higher oil prices but corporate earnings and liquidity concerns linger

Qatar's benchmark stock index, the Qatar Exchange Index (QE), had a topsy-turvy 2016, reaching a high of 11,408 in mid-August (+9.4% since the start of the year) ahead of its inclusion in the FTSE Emerging Markets Index before falling to a low of 9,636 (-7.6% since the start of 2016) at the end of November as market sentiment turned noticeably less bullish in response to a combination of weaker-than-expected corporate earnings and banking sector liquidity worries. (Chart 15.) The index was back up to 10,328 on 12 December (-0.96% since the start of 2016), buoyed by November's OPEC output cut deal, which gave oil prices a major boost.

Chart 12: Interbank rates (QIBOR)

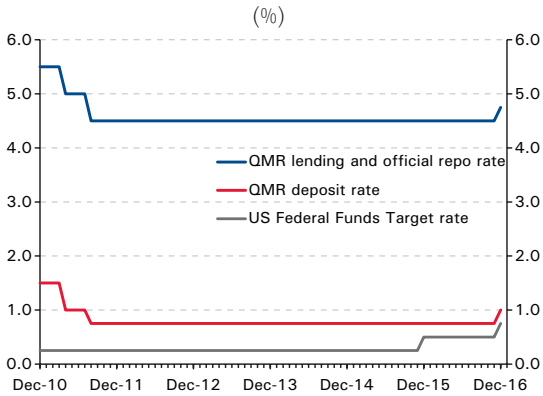
Source: Thomson Reuters Datastream

Chart 13: Banks' foreign liabilities



Source: QCB

Chart 14: Key interest rates



Source: QCB

Chart 15: Qatar Exchange

Source: Thomson Reuters Datastream

Saudi Arabia outlook

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Economic activity slows as fiscal consolidation proceeds apace

Overview and outlook

- **Growth is forecast to slow from 3.5% in 2015 to 1.2% in 2016 amid greater fiscal restraint and slower consumer activity.**
- **Inflation is expected to rise to 3.6% in 2016 following fuel and utility price hikes but moderate thereafter.**
- **The fiscal deficit should narrow to -12.1% of GDP in 2016 from -15% of GDP in 2015 as the authorities' fiscal consolidation proceeds.**
- **Debt is replacing government reserves as the main source of deficit financing, with rising domestic and international bond issuance.**
- **Liquidity appears to be improving following government repayments to contractors and thanks to the sovereign bond sale.**
- **TASI turned positive in mid-Dec on renewed optimism following the international bond sale and OPEC's output deal, which boosted oil prices.**

More than two years into the oil price downturn and Saudi economic growth has slowed significantly. Public investment has been pared back, credit growth has slowed and liquidity has tightened amid reduced deposit flows and rising debt issuance. Facing the prospect of widening fiscal deficits, the authorities have cut back on spending and embarked on a bold and ambitious program of fiscal consolidation. They froze public sector salaries and benefits, cut fuel and utility subsidies, scaled down public investment projects and raised non-oil revenues via tax hikes and privatization programs. These and other measures form part of the government's new strategic blueprint for economic restructuring, diversification and fiscal sustainability: the Saudi Vision 2030. Looking ahead, we see the authorities delivering on some of their goals, economic growth resuming, albeit, modestly, in 2018, helped by higher oil prices and by a recovery in consumer and investor confidence.

Real growth to slow in 2016 as fiscal consolidation and subdued private sector activity take their toll on the non-oil economy

Real GDP is expected to slow significantly in 2016 to 1.2% from 3.5% in 2015 amid cutbacks in capital spending and weaker consumer spending. (Chart 1.)

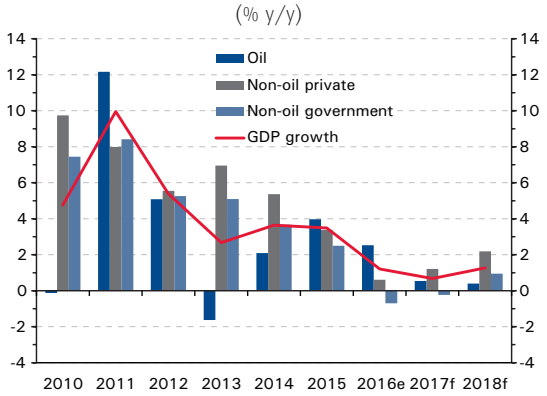
Non-oil growth is also projected to slow considerably in 2016, from 3.1% y/y in 2015 to 0.2% y/y, as the government pushed through with aggressive fiscal consolidation and as the private sector feels the impact of lower retail spending and the overall fall in consumer confidence. Indeed, the non-oil economy could be on the verge of a technical recession, should soon-to-be-

Key economic indicators

		2015	2016e	2017f	2018f
Real GDP growth	% y/y	3.5	1.2	0.7	1.3
Oil	% y/y	4.0	2.5	0.5	0.4
Non-oil	% y/y	3.1	0.2	0.8	1.9
Inflation	% y/y	2.2	3.6	2.5	4.3
Fiscal balance	% of GDP	-15.0	-12.1	-7.5	-6.7
Public debt	% of GDP	5.9	13.0	18.3	23.6

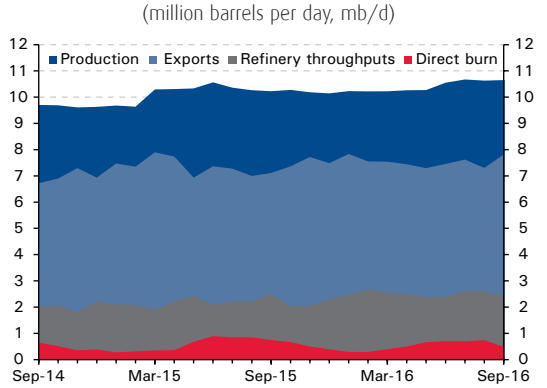
Source: Official sources, NBK estimates

Chart 1: Real GDP



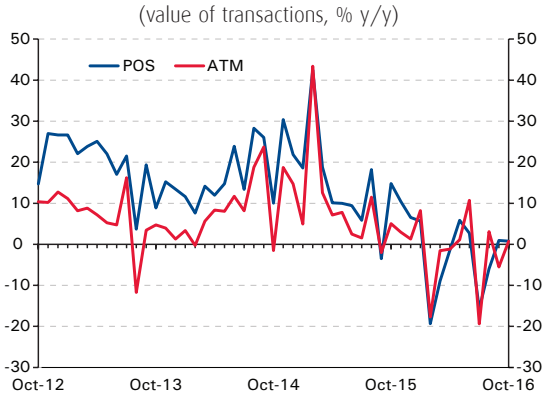
Source: General Authority for Statistics, NBK estimates

Chart 2: Oil production, exports & consumption



Source: JODI, OPEC

Chart 3: ATM and POS transactions growth



Source: Saudi Arabian Monetary Agency (SAMA)

published 3Q16 real GDP data show another quarter of negative growth. Key metrics of consumer and business activity, such as point of sale (POS) and ATM transactions, private sector credit growth and the Purchasing Managers' Index (PMI), all trended lower in 2016, although the latter was more volatile m/m and did not dip below 50, which would have suggested a contraction in business activity. (Charts 3-5.) Looking ahead to 2017 and 2018, activity is expected to pick up as the government resumes paying contractors and as deposits increase on higher oil prices and thanks to the international bond issuance. With deposit flows rising, lending should also pick up. We expect non-oil growth to reach 0.8% and 1.9% in 2017 and 2018, respectively.

Meanwhile, the oil sector continued to expand in 2016, with the kingdom ramping up both crude oil production-to a record 10.5 million barrels a day (mb/d) in 2016-and gas production following the commissioning of the Wasit gas plant. Since oil prices headed south in 2014, Saudi Arabia has pursued its strategy of maximizing market share and accelerated its plan to move up the hydrocarbon value-chain by expanding its refining capacity. The launches of the Satorp and Yasref refineries brought an additional 0.8 mb/d of refined products output capacity. Real oil GDP growth should clock in at 2.5% in 2016 before moderating to 0.5% in 2017 and to 0.4% in 2018 as output gains recede and as Saudi Arabia complies with its reduced production quota under the terms of the recent OPEC/non-OPEC production cut agreement. While Saudi crude output is expected to contract in accordance with the agreement, on a full year basis, we don't expect production to decline by as much as the 4.5% stipulated in the deal.

Inflation slowing as economic activity cools

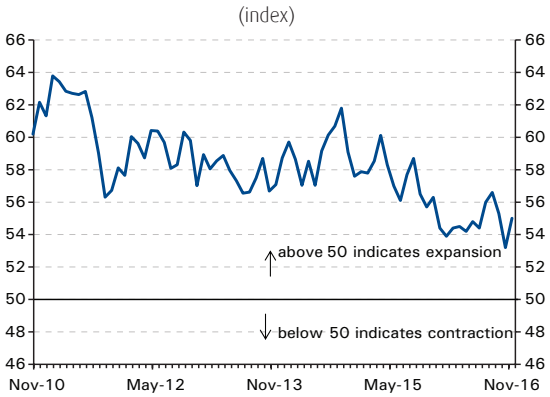
Inflation was on a downward trend in 2016, slowing for the seventh consecutive month in October, to 2.6% y/y. (Chart 7.) Food and beverages were the chief negative influence on the cost of living index. The moderation in inflation comes despite a significant uptick at the start of 2016 in response to the government's fuel and utility price hikes. With their effects on headline inflation receding throughout the year, increases in the CPI thus tended to reflect other factors such as falling import prices, especially food and clothing (related to the stronger USD and SR in 2016) and moderating house price inflation as well as, more broadly, the contraction in money supply that was a feature for most of the year. The trend should continue into 2017, bringing inflation down to 2.5% before rebounding in 2018 to 4.3% as the economy picks up. Higher energy and utility costs and higher taxes (including VAT) will also pressure CPI in 2018.

A third consecutive fiscal deficit is expected in 2016 but fiscal reforms and higher oil prices should see the budget in balance by 2020

Saudi Arabia's fiscal deficit, having widened significantly in 2015 to -15% of GDP ($96.6 billion), is expected to narrow in 2016 to -12.1% of GDP and further over the forecast period as the government reins in its spending, including its expensive subsidy bill. (Chart 8.) Of course, expectations that oil prices will be 33% higher in 2018 (averaging $60 per barrel) than their average in 2016, is central to the improvement in the fiscal outlook.

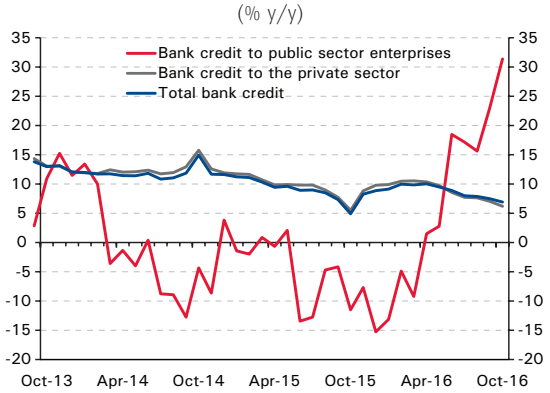
Indeed, given the surprising degree of progress achieved so far, in what is undoubtedly a very bold and ambitious fiscal adjustment program, there is a very realistic chance that the authorities will deliver on their National Transformation Program (NTP) target of a balanced budget by 2020. Subsidies on fuel and utilities have already begun to be reduced (working towards the NTP target of a cut of SR200 billion, or 8.3% of GDP, over 5 years), wages and benefits for public sector workers have been frozen for a year (the NTP sets a target of reducing the wage bill by 5% to SR456 billion by 2020),

Chart 4: Purchasing Managers' Index (PMI)



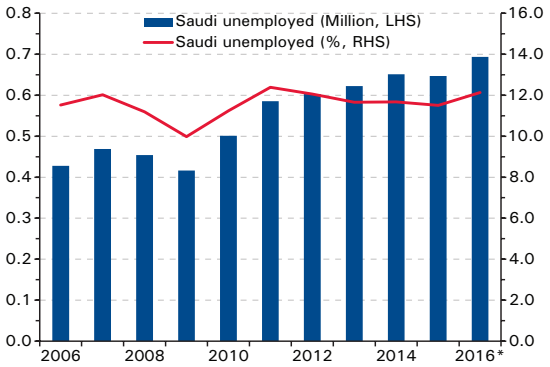
Source: Emirates NBD/Markit

Chart 5: Bank credit growth



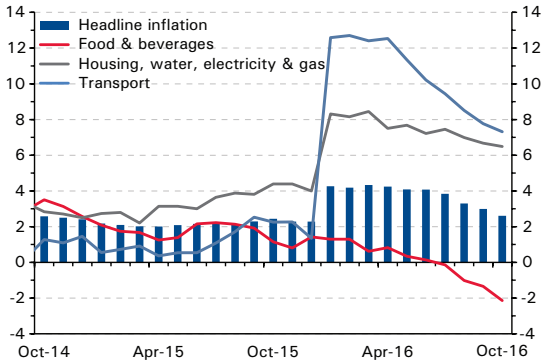
Source: SAMA

Chart 6: Saudi unemployment



Source: General Authority for Statistics

Chart 7: Consumer price inflation



Source: SAMA

and outlays on non-essential capital projects have been scaled back, by an estimated 12% in 2015 and 2016.

On the revenue side, though the NTP plan of more than trebling non-oil revenues to SR530 billion ($141 billion, or 17.3% of GDP) by 2020 still appears ambitious, the authorities have made some headway in tapping new non-oil revenues. These include: higher fees on public services, immigration and traffic violations; new taxes on cigarettes and soft drinks as well as on undeveloped urban land (so-called "white lands"); and the introduction of a value-added tax (VAT), which will come into effect in 2018 at a rate of 5%. A rough estimate of the gain to the Saudi treasury resulting from the VAT could be in the order of $10 billion, which would approximate to about 16% of projected non-oil revenues in 2018 and 1.4% of forecasted GDP in that year.

The privatization of state entities, including up to 5% of state oil giant Saudi Aramco, and the transformation of the Public Investment Fund (PIF) into the kingdom's official SWF with a global footprint and assets under management of at least $1.8 trillion by 2030, are key strategic objectives of the Saudi Vision 2030. (See table below.)

Key vision 2030 objectives

		2015	2030
Private sector	% of GDP	40	65
Small & medium-sized enterprises (SME) sector	% of GDP	20	35
Non-oil exports	% of non-oil GDP	16	50
Non-oil revenue	% of GDP	6.7	16.8
Domestic oil & gas production	%	40	75
Domestic procurement of defense equipment	%	2	>50
Public Investment Fund (PIF) assets	$ billion	160	1,866
Foreign direct investment (FDI)	% of GDP	3.8	5.7
Global Competitiveness Index	Rank	25	10
Unemployment rate	%	11.6	7.0
Female labor force participation rate	%	22	30
Number of pilgrim tourists per year	Million	8	30
Social Capital Index	Rank	26	10
Household savings rate	%	6	10

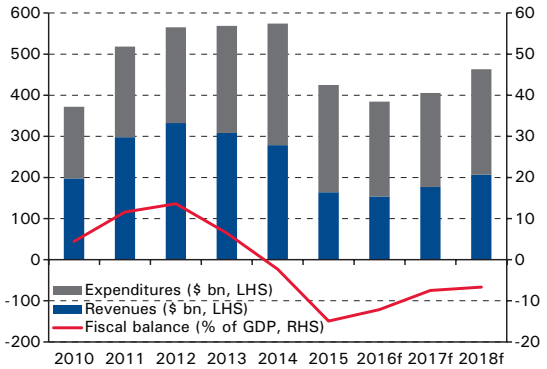
Source: Saudi Vision 2030

Public debt rises as the authorities proceed with their bond issuance program; the pressure on foreign reserves eases though

With Saudi Arabia expected to continue to post fiscal deficits over the next few years, public debt is projected to rise markedly from its historic low of 1.6% of GDP in 2014 to at least 23.6% of GDP in 2018. (Chart 9.) This is, however, still an extremely low level of debt by international standards. Up until mid-to-late 2016, when domestic and international bond issuance accelerated, the burden of deficit financing fell squarely on the kingdom's foreign reserves and the government's accounts at SAMA. Since June 2016, the rate of reserve drawdown has slowed significantly to $7.8 billion per month from an average of $10.9 billion per month in 1H16. Total net foreign assets stood at $572 billion in October, which is still an ample 30 months-plus in terms of goods and services import cover. (Chart 10.)

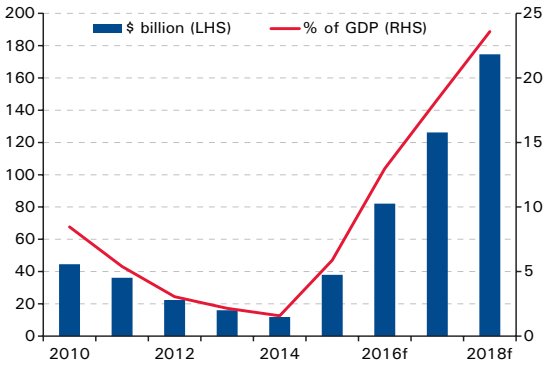
2015 witnessed approximately SR98 billion ($26 billion) worth of government bonds sold to local financial institutions, which helped to cover a quarter of the deficit. In 2016, the authorities augmented their domestic bond issuance program with an additional, record-breaking $17.5 billion international sovereign bond sale and a $10 billion syndicated loan from foreign banks. We expect bond issuance to proceed apace during the next two years, with probably at least another $80 billion added to central government debt.

Chart 8: Fiscal balance



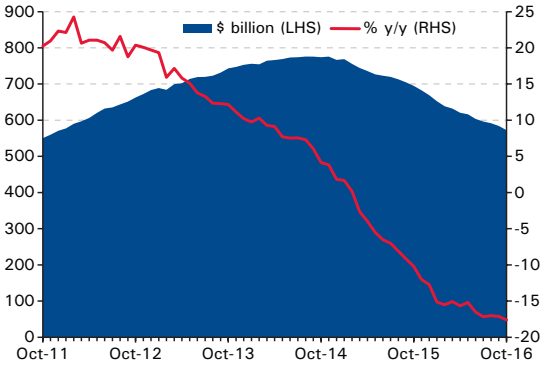
Source: SAMA, NBK estimates

Chart 9: Public debt (gross)



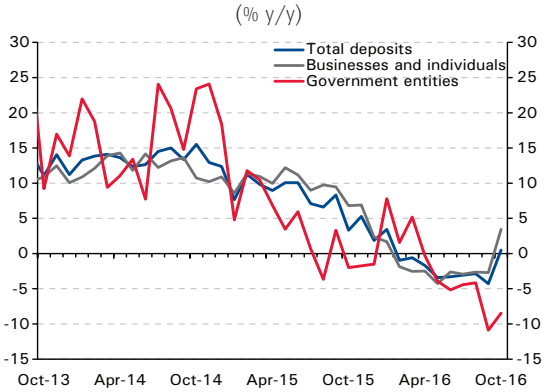
Source: SAMA, NBK estimates

Chart 10: Net foreign assets



Source: SAMA

Chart 11: Bank deposit growth



Source: SAMA

Liquidity conditions improving with a resumption of deposit growth; private sector credit growth remains lackluster, however

Deposit, credit and liquidity indicators continue to point to a banking system that has been pressured by the fall in oil prices, albeit, one that is showing some signs of a recovery following Saudi Arabia's record international bond sale in October 2016. Bank deposit growth turned positive in October for the first time in 2016, rising by 0.5% y/y on a slight improvement in private sector deposits (3.4% y/y) after the government resumed payments to private contractors. (Chart 11.) This should continue over the next few months as the government honors $26.7 billion in back payments. However, deposits from government entities still remain well down, by -8.5% y/y, and are unlikely to expand significantly without higher oil prices. The pick-up in deposits was also reflected in the money supply, with growth in the broadest measure, M3, turning positive in October for the first time since January 2016. (Chart 12.)

On the credit side, lending to the private sector has been lackluster; October showed a rise of only 6.2% y/y, which is one of the slowest rates since 2011. (See Chart 5.) In contrast, public sector credit growth accelerated significantly in 2016, rising to 31.4% y/y in October. This is the fastest pace of growth in more than three years, a trend that is likely to continue as the government borrows more from banks.

Despite overall deposit growth lagging credit growth, indicators of liquidity in the Saudi banking system have started to improve: banks' loan-to-deposit ratio (LDR) eased a little last October to 89.1%; the 3-month interbank rate has fallen by around 33 bps from its high of 2.38% in October to around 2.05% as of mid-December; and excess bank deposits at SAMA have increased 24% y/y to almost $53 billion, according to the most recent data. (Charts 13 & 14.)

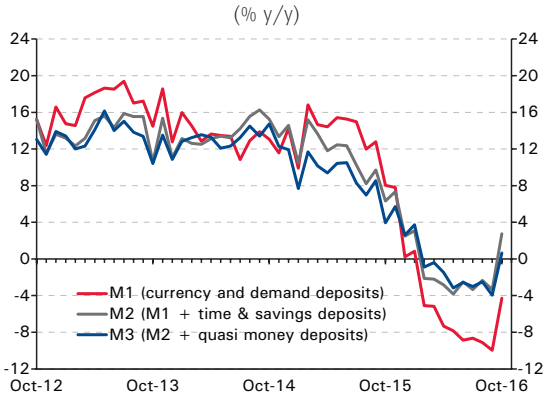
A number of measures, including the resumption of long-delayed government payments to private contractors, have contributed to this easing in liquidity. SAMA, for example, has alleviated some of the liquidity constraints through its broadening of the window for repo arrangements, reducing the size of its T-bill issuances and by injecting SR20 billion ($5.3 billion) into the deposits of public sector companies. Also, the kingdom's record-breaking $17.5 billion international sovereign bond issuance in October, of course, has the potential to significantly improve liquidity as well as the government's fiscal situation. The bond sale should indirectly help the private sector as well by lessening the pressure on domestic banks to finance the government, thereby freeing up credit lines for private enterprises. These are vital for a healthy and dynamic non-oil economy. Indeed, government bonds, as a share of total bank claims, went from a low of 3.3% in 2013 to a post-financial crisis high of 10.6% in October as bank holdings of government bonds skyrocketed in 2016 to $46.9 billion. (Chart 15.)

Market perceptions of Saudi sovereign risk moderating

The material improvement in banking sector metrics is reflected in the improvement in market perceptions of risk. In the currency markets, the difference between the spot and forward Saudi-US Dollar exchange rate (SR/USD) narrowed to around 300 forward points by mid-December, having hit its widest margin of 975 points in two decades earlier in the year on speculation that the authorities would be forced to devalue the riyal, in effect abandoning the 30-year peg to the US dollar. (Chart 16.)

The kingdom is, however, unlikely to shift away from an exchange rate regime that has served it well in the past, anchoring both the economy

Chart 12: Money supply growth

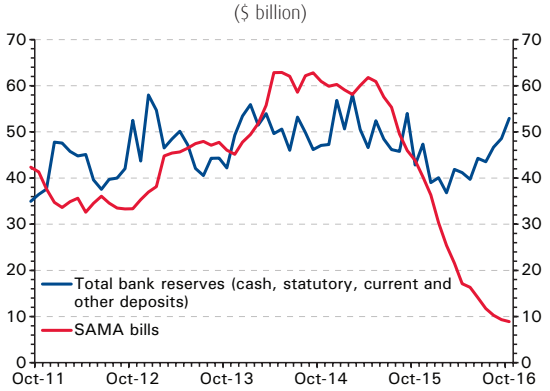


Source: SAMA

Chart 13: Interbank rates

Source: Thomson Reuters Datastream

Chart 14: Bank reserves & holdings of SAMA bills



Source: SAMA

Chart 15: Bank holdings of govt. bonds

Source: SAMA

and inflation. The dollar peg provides stability to trade and income flows, especially given the fact that oil, which is priced in dollars, continues to dominate the Saudi economy. Over the last decade, with the exception of 2015, oil has accounted for close to 90% of the kingdom's export and fiscal revenues.

5-year credit default swap spreads (CDS), though still elevated, have also fallen in the last few months as the outlook has improved. (Chart 17.) Expectations of higher oil prices in 2017 and beyond in the wake of the recent OPEC deal is also a key factor in the improvement in sentiment.

Borrowing costs rise after the US Fed raises interest rates

SAMA, following the US Fed's lead, raised its key interest rate, the reverse repo, by 25 bps to 0.75% in December. The repo rate remains unchanged at 2.0%. (Chart 18.) This, the second rate rise in this cycle, points to further rising borrowing costs, as the US Fed moves ahead with monetary policy tightening in 2017.

Optimism returns to the Saudi bourse following the successful sovereign bond sale and the OPEC output cut agreement

The main Saudi stock index, the Tadawul All-Share Index (TASI), reversed course in October after being down -21% ytd at one point in the year. As of mid-December, the index was in positive territory, up 3.3% ytd at 7,137, as it continued to ride on the marked improvement in optimism that came about in 4Q16 thanks to the international bond sale and the OPEC production cut agreement, which was positive for oil prices. (Chart 19.)

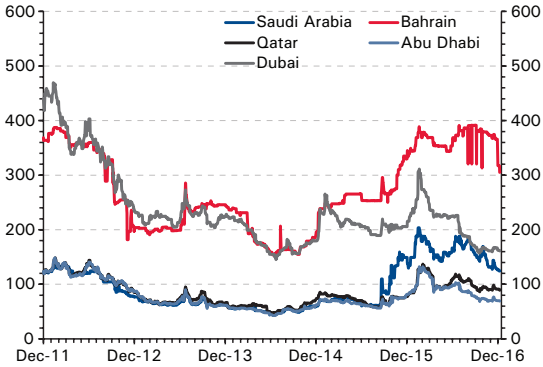
Chart 16: Saudi riyal 12-month forward rate

(SR/USD, riyals per dollar)

Source: Thomson Reuters Datastream

Chart 17: Credit default swaps (CDS)

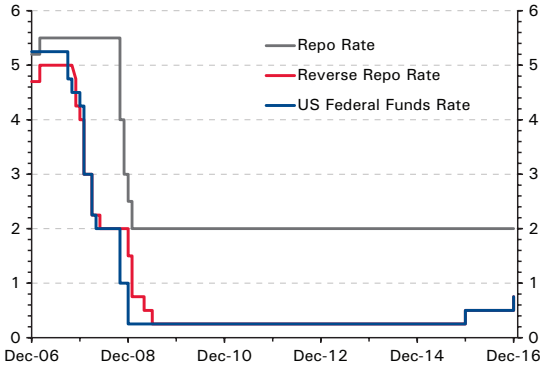
(bps, 5-year CDS)



Source: Thomson Reuters Datastream

Chart 18: Key interest rates

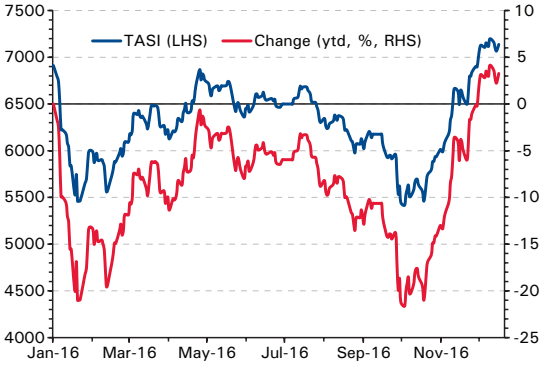
(%)



Source: Thomson Reuters Datastream

Chart 19: Stock exchange index

(Tadawul All-Share Index, TASI)



Source: Thomson Reuters Datastream

UAE outlook

Real growth set to climb in 2017 and 2018 on stronger non-oil activity

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Overview and outlook

- **Real GDP growth is slated to regain momentum in 2017 and through 2018 as non-oil sector activity sees a pick-up.**
- **After moderating for two years, non-oil growth is staging a comeback in 2017 and 2018 on stronger gains in the transport, tourism and construction sectors.**
- **Inflation is projected to see some more upward pressures, on the back of tax hikes or further subsidy cuts.**
- **The fiscal balance is forecast to remain in deficit in 2017, before edging back into a surplus in 2018 on higher public revenues.**
- **Bank liquidity is set to improve in 2017 and 2018 as deposit growth picks up on stronger oil revenues.**

Real GDP growth poised to strengthen in 2017 and 2018

Following two straight years of softer growth, real GDP in the UAE is set to gather pace in 2017 and into 2018 as the non-oil sector is likely to stage a healthy recovery and offset some of the moderation in the oil sector. We foresee real GDP growth edging up from an estimated 2.5% in 2016 to a solid 3.0% in 2017 and 4.0% in 2018 (Chart 1). Whilst we may see gains in the real oil economy capped by planned oil production cuts, the healthy recovery in non-oil activity is likely to more than make up for that, as we see the hospitality and construction sectors propelled forward especially in the run-up to the Expo 2020 event in Dubai.

Growth in the oil economy is expected to be limited in at least the near-to-medium term on the back of planned production cuts. On 30 November, OPEC agreed to an oil production cut for the first time in eight years, in an attempt to prop up oil prices. The 13-member group agreed to cut output by 1.2 million barrels per day for six months starting January 2017. To that effect, we see real growth in the oil sector slowing from an estimated 2.4% in 2016 to 1.6% in 2017 before rising to around 2.8% in 2018 as production is gradually restored to its pre-production cut levels.

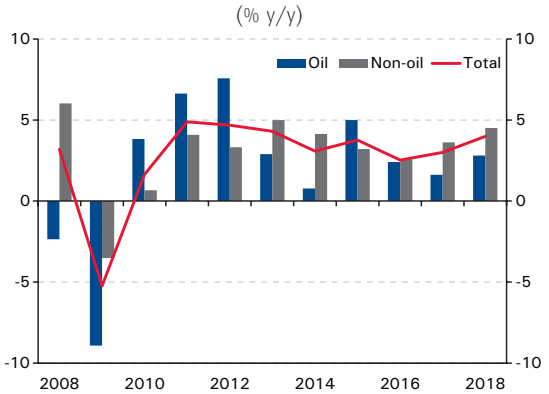
The non-oil economy is forecast to witness a healthy bounce in 2017 and maintain that stronger momentum going into 2018, as the transport, construction and tourism sectors (some of the biggest contributors to non-oil GDP growth) gather pace. Activity in the residential real estate sector is also seeing signs of stabilization, after almost two years of slowing growth. We

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	370	362	398	433
Real GDP	% y/y	3.8	2.5	3.0	4.0
Oil	% y/y	5.0	2.4	1.6	2.8
Non-oil	% y/y	3.2	2.6	3.6	4.5
Inflation	% y/y	4.1	2.5	3.0	3.0
Budget balance	% of GDP	-2.2	-3.3	-1.1	0.5

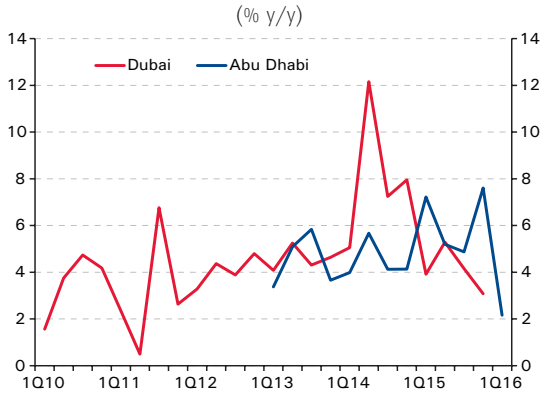
Source: Official sources, NBK estimates

Chart 1: UAE real GDP



Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Dubai & Abu Dhabi real GDP



Source: Dubai Statistics Center, Stastics Center - Abu Dhabi

Chart 3: Purchasing Managers' index

Source: Markit

anticipate a jump in real non-oil growth from around 2.6% in 2016 to 3.6% and 4.5% in 2017 and 2018, respectively.

The latest data on the UAE's Markit Purchasing Managers' Index (PMI), a good gauge of non-oil sector growth, also suggest that non-oil sector activity is set to rise in the near-to-medium term (Chart 3). The headline PMI rose from 53.3 in October to 54.2 in November, as relatively stable local economic conditions helped offset the weakness in external demand. The PMI's employment component also trekked upwards, rising to a four-month high of 51 and dispelling fears of weaker business and employment conditions.

Overall non-oil economy continues to be driven by Dubai's resilience

Much of the resilience of the non-oil economy continues to stem from Dubai's hospitality and construction sectors. The number of passengers passing through Dubai International Airport continues to hold strong. In October, this number reached 6.4 million passengers, up 2.7% year-on-year (y/y). Despite the ongoing decline in average daily room rates at hotels in Dubai over the past year, the demand for hotel rooms remained relatively solid as reflected in the average occupancy rate, which came in at a still high 75.6% in October.

Dubai's construction sector will also continue to be a key driver of non-oil growth. Construction activity is expected to remain robust, especially as Dubai prepares for the Expo 2020 event. Projects include the construction of buildings, metro expansions, roads and bridges. The construction sector is also set to benefit from plans to foster the UAE's Vision 2021 and long-term strategy to establish a post-oil "knowledge economy" via the "UAE Strategy for the Future" blueprint. The strategy aims to bolster the nation's non-oil economy and enhance its economic diversification.

The resilience in Dubai's non-oil economy is reflected in the Emirates NBD Dubai Economy Tracker Index (DET) (Chart 4). The DET is a forward-looking index similar to the PMI which tracks non-oil activity in Dubai. It recently witnessed a healthy pick-up thanks to buoyant levels of activity in the travel & tourism and wholesale & retail trade segments.

Dubai residential property price growth in stabilization mode

Following almost two years of slowing growth amid tighter regulations, higher housing supply and risk aversion, residential property price growth in Dubai appears to have largely stabilized. According to the latest data published by Asteco, prices of apartments fell by approximately 2.0% y/y in 3Q16 versus a decline of 2.8% y/y in 2Q16; prices of villas fell by 3.4% y/y in 3Q16 versus the 4.0% y/y decline in the previous quarter (Chart 5). We expect the stabilization period to continue at least until the end of 2017, after which we may see residential price growth pick up on the back of stronger demand.

The value of real estate transactions continued to trend lower throughout 2016, while growth in the number of transactions remained subdued but steady; the latter may be reflective of the pockets of strength in the "more affordable" housing sector (Charts 6 and 7). The recent surge in the real estate transaction value may also be indicative of a nascent recovery in the luxury housing segment.

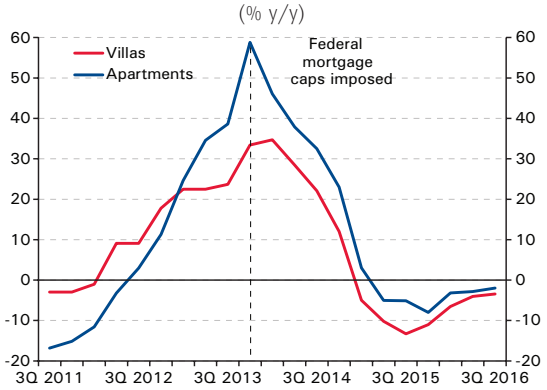
Inflation to face some upward pressure

After continuing to trend lower for most of 2016, inflation in the consumer price index (CPI) has been gaining some traction of late, as housing inflation (which weighs more heavily in the index) appears to be reversing its

Chart 4: Dubai economy tracker

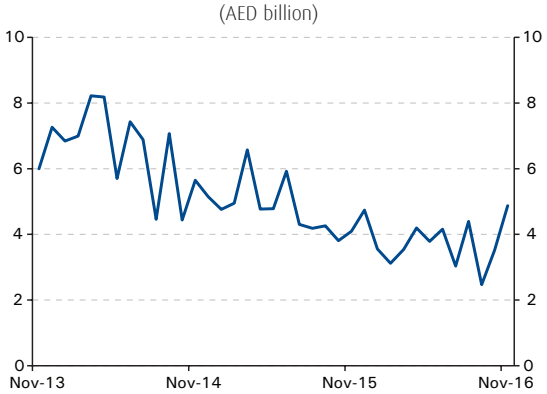
Source: Emirates NBD

Chart 5: Residential property sales prices



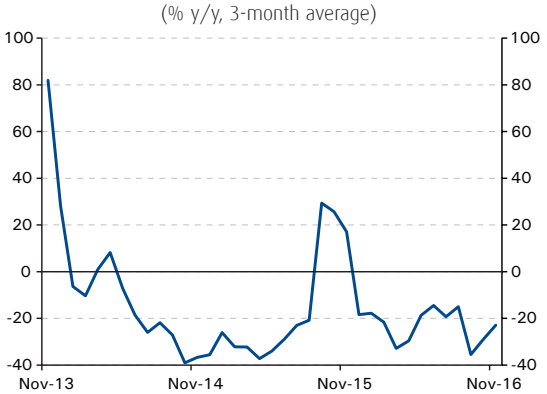
Source: Asteco, JLL

Chart 6: Value of real estate transactions



Source: Dubai Land Department

Chart 7: Number of real estate transactions



Source: Dubai Land Department

downward trend. The latest numbers showed overall inflation rising from 1.4% y/y in September to 1.9% in October (Chart 8). As well as seeing some upward pressure from housing inflation, a mild acceleration in food inflation recently also pushed the overall inflation rate higher. However, food inflation remained soft after coming in at 2.3% y/y.

Looking ahead, we expect CPI inflation to gradually edge higher in 2017 and average at around 3% for the year, as a recovery in global oil markets pushes inflation in the transport & communications segment up and housing inflation gathers pace. With the housing market seeing some nascent signs of a recovery, we may see those gains gradually feed into housing inflation over the course of 2017 and 2018.

Fiscal balance expected to return to surplus in 2018

We expect the fiscal balance to remain in deficit, albeit a manageable one, in 2017 before returning to a surplus in 2018 on the back of higher revenues (Chart 9). The fiscal balance slipped into a deficit in 2015 for the first time in six years, after a drop in oil prices sent oil revenues tumbling. But against a backdrop of a global recovery in oil markets, together with some fiscal reforms, the deficit is seen narrowing from an estimated 3.3% of GDP in 2016 to 1.1% in 2017, before turning into a slight surplus of 0.5% of GDP in 2018.

Thanks to the UAE government's abundant financial reserves that stand at over 200% of GDP, the fiscal deficits have been manageable. This has widely helped both Dubai and Abu Dhabi maintain their high levels of public spending, particularly on infrastructure projects. In Dubai, infrastructure spending is expected to accelerate in the run-up to the Expo 2020 event.

Nonetheless, the major emirates have embarked on some fiscal adjustment and reform, including subsidy cuts and the introduction of fees on certain services. 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.

Furthermore, it increasingly looks like the UAE will be one of the first GCC nations to implement a VAT. The first phase of implementation, scheduled for 2018, will include UAE companies with annual revenues greater than $1 million (Dh 3.75 million). At 5%, the VAT is expected to generate around $3.3 billion (Dh 12 billion) in tax revenues or around 1% of GDP.

In an attempt to preserve foreign assets, the UAE has also tapped into international debt markets to plug its budget gap. In April, Abu Dhabi sold $5 billion in sovereign bonds, the first issuance since 2009.

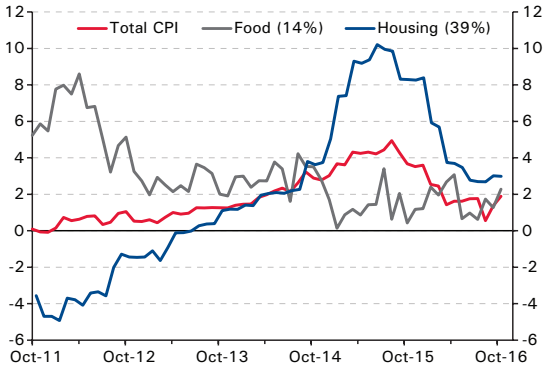
Thus far, sovereign issuance has been at the level of individual emirates rather than at the federal level. This is about to change, with the UAE in the process of finalizing a federal debt law by early 2017 allowing the federal government to issue bonds. With investors globally in search for yield amid a low global rate environment, UAE bonds are likely to attract healthy demand.

Current account surplus to expand in 2017 and 2018

The surplus in the current account balance is projected to expand for the first time in four years in 2017, as oil export earnings recover and non-oil export growth gathers steam. We foresee the current account surplus rising from a six-year low of around 4.6% of GDP in 2016 to a projected 5.7% in 2017 and 6.8% in 2018 (Chart 10).

Chart 8: Consumer price inflation by sector

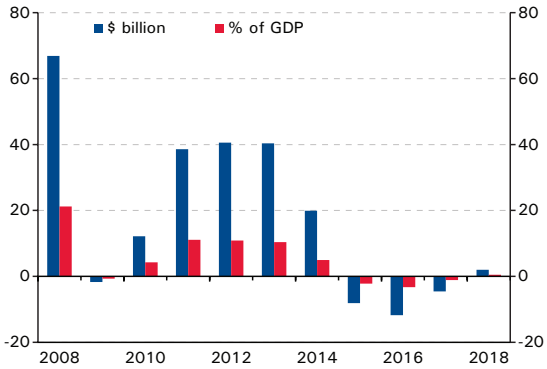
(% y/y, weights in brackets)



Source: Thomson Reuters Datastream

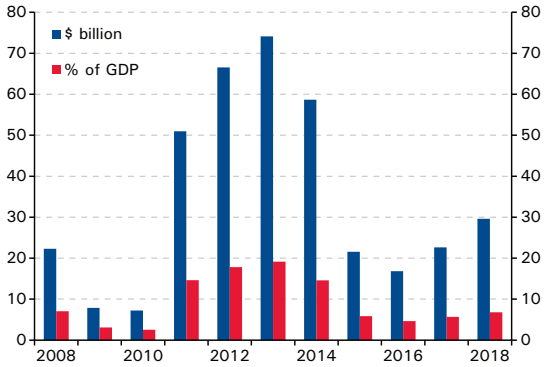
Chart 9: Budget balance

(revenues include ADNOC profits & investment income)



Source: UAE National Bureau of Statistics, NBK estimates

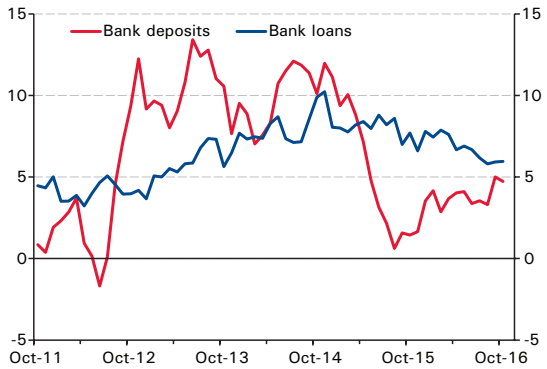
Chart 10: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 11: Bank loan & deposit growth

(% y/y)



Source: Central Bank of UAE

Non-oil exports may continue to face some headwinds going forward due to the stronger dirham. The stronger dollar has led to an appreciation in the dirham's trade-weighted index, increasing the cost of exports and making it a more expensive place to visit and invest in (Chart 16). Trade with Asian markets has been most affected by the stronger dirham, which has seen their currencies weaken against a stronger US dollar. Tourism, however, has been less affected, given that a majority of tourists are from the GCC, and so has investment in real estate, which depends far more on UAE nationals. The gains in the tourism and real estate sectors are expected to more than offset the costs of a stronger dollar. This should help non-oil exports continue to log in a decent performance.

Banking liquidity to improve as oil revenues trek upwards

Following almost two years of moderation, we expect lending activity to gradually rise in 2017 and 2018 as growth in the real estate and construction sectors improves. The latest data is pointing to early signs of stabilization in lending activity. In October, lending growth remained modest and relatively stable at around the 6.0% mark for the third straight month (Chart 11). Whilst we may see loan growth ease somewhat on the back of the 25 bps policy hike in mid-December, which came on the heels of a similar increase in the US Federal funds rate, we expect growth to recover soon after as loan demand, particularly in the construction and real estate sectors, picks up.

Growth in bank deposits has been trending gradually upwards, but any significant gains have been mitigated by weaker government deposit growth, which has been weighed down by lower oil receipts. However, with oil earnings set to pick up in 2017 and 2018, this should give government deposit growth a boost. Deposit growth jumped from 3.3% y/y in August to 5.0% y/y in September before steadying at around that mark in October (Chart 11); the recent recovery in oil prices and bond issuances could be behind the improvement in growth.

Growth in the broad money supply (M2) remained soft throughout 2016. In October, it stood at 3.1% y/y (Chart 12). Growth in this segment may continue to be capped in the near term following the December hike in the policy rate. However, with deposit growth set to pick up, we should subsequently see growth in banking liquidity edge higher as well.

Both the three-month and one-month interbank rates have reached multi-year highs recently on tighter liquidity constraints and following the key policy rate hike in December (Chart 13). We should see these rates ease, at least in the medium term, as liquidity conditions improve.

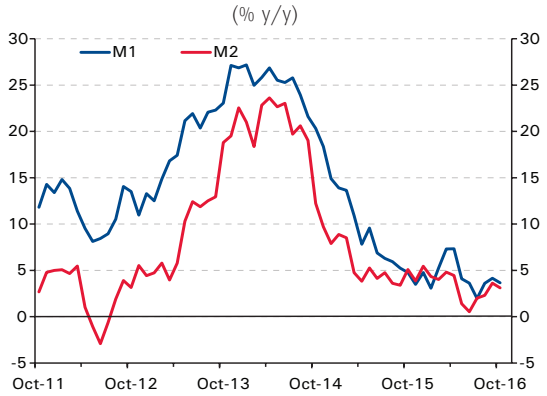
SME market reform projected to be a boon for lending and growth

Small and medium-sized enterprises (SME) account for over 95% of companies in Dubai and are a major driving force behind the emirate's economy. Yet, the SME sector was hindered by the absence of a robust and fair bankruptcy law, with knock-on effects on the banking sector. This is expected to change thanks to the introduction of a long-awaited bankruptcy law in 4Q16.

Under the previous regulatory umbrella, any unpaid debt or a bounced check would land the owner in prison and do little to help resolve arrears. The weaker external environment and a vulnerable trading sector have led to a jump in defaults and bringing the issue to attention of policymakers.

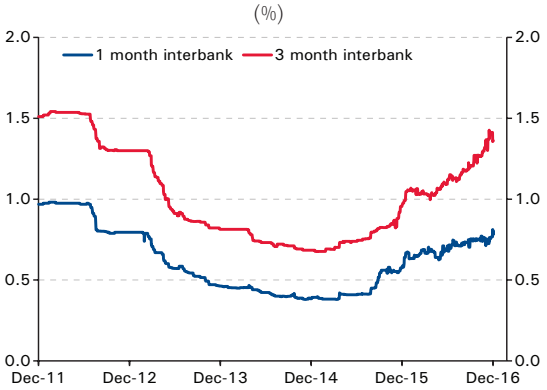
Under the new insolvency law, banks and company owners will be able to negotiate ways to restructure their debts. This should help improve banks'

Chart 12: Money supply



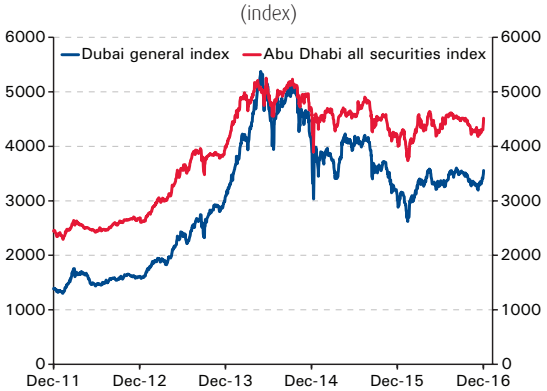
Source: Thomson Reuters Datastream

Chart 13: Interbank rates



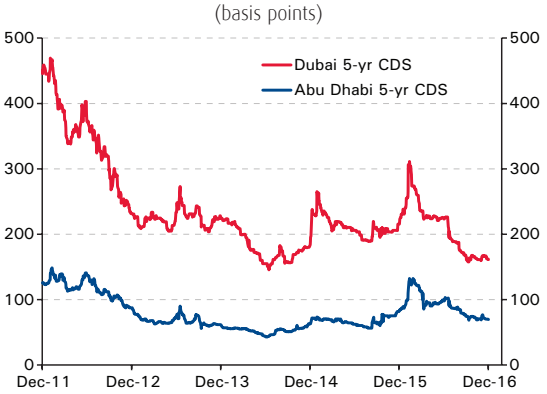
Source: Thomson Reuters Datastream

Chart 14: Stock market indices



Source: Thomson Reuters Datastream

Chart 15: Credit default swaps



Source: Thomson Reuters Datastream

credit quality and instill confidence in SMEs, and subsequently boost lending to the sector.

Markets

Both the main Abu Dhabi and Dubai markets rallied toward the end of 2016 on a recovery in oil prices and the agreed merger between the National Bank of Abu Dhabi and First Gulf Bank, which could make it the second largest bank in the Middle East. Increased enthusiasm following the US presidential elections also helped lift UAE markets, as it has global and regional markets, on the expectations that the new administration will usher in a wave of expansionary fiscal policy and boost US and global growth.

Chart 16: UAE trade-weighted exchange rate

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK estimates

Egypt outlook

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Painful reforms and IMF loan should support gradual recovery

Overview and outlook

- **Growth is expected to be steady at 2.5% in FY16/17 before it starts to improve again to 4% and 5% in FY17/18 and FY18/19.**
- **Decision to float the pound should alleviate foreign currency shortage that crimped activity, but growth will depend on foreign investment.**
- **Fiscal deficit to narrow to 10% of GDP in FY16/17 and to 6-7.5% in FY16/17 and FY17/18 if fiscal reform stays the course.**
- **Double-digit inflation should ease in 2017 and further in 2018 as monetary policy tightens, helping stabilize the pound.**

The economy slowed considerably in 2016 when a currency shortage worsened and tourism failed to recover from a collapse amid heightened security concerns. But by the end of the year, the authorities were doing the right things to help push growth back towards its potential. The government took steps to restart much needed reform, including floating the currency, hiking fuel prices, and introducing a value-added tax (VAT), as it sought to clinch a $12 billion IMF loan agreement. Once approved, the deal unlocked further funding and investment which, it is hoped, will propel the economy back towards healthy growth of 4-5% in the medium term.

The reforms being implemented are expected to see Egypt's fiscal and monetary policy tighten significantly in 2017. This will no doubt put pressure on growth, though we expect this pressure will be more than offset by an increase in foreign investment, exports and tourism. The large depreciation in the pound, following its floating, should boost the competitiveness of Egypt's exports and tourism sector. The cheaper pound will also encourage foreign investors to return, supported by the government's promise to implement much needed reforms and by large multilateral investors' pledges to increase FDI to the country.

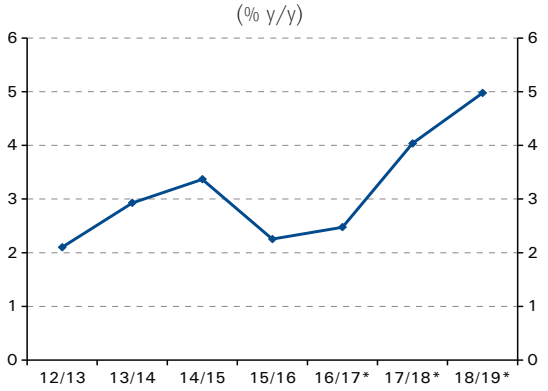
Of course, whenever major reforms are promised there are risks that authorities will fail to deliver. Indeed, the authorities will be tempted to limit the tightening of fiscal and monetary policy to minimize the short-term economic and social pain, which could be severe. However, the massive fiscal and investment support currently pledged to Egypt by the IMF and others is largely conditional on the progress of reforms. Any slippage could hold up those funds, reduce growth and put renewed pressure on the pound; it would also hurt sentiment among private investors. It is thus critical that the government be seen to be moving decisively to reduce the sizeable fiscal deficit, even if the reduction is gradual. This would in turn

Key economic indicators

		FY15/16	FY16/17f	FY17/18f	FY18/19f
Nominal GDP	EGP bn	2,708	3,147	3,612	4,094
Nominal GDP	USD bn	326	221	195	216
Real GDP growth	% y/y	2.3	2.5	4.0	5.0
Inflation	% y/y	14.0	18.0	10.0	8.0
Budget balance	% of GDP	-11.0	-10.0	-7.5	-6.0

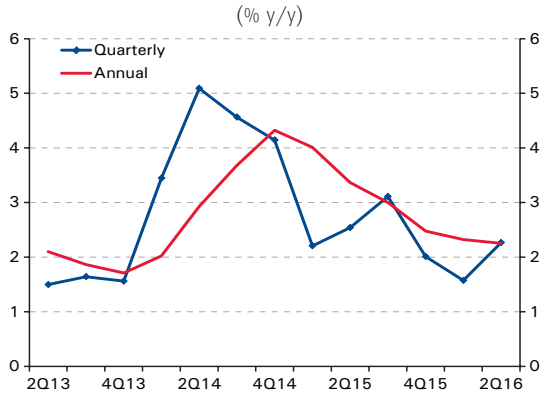
Source: Central Bank of Egypt, Ministry of Planning, NBK estimates

Chart 1: Real GDP growth



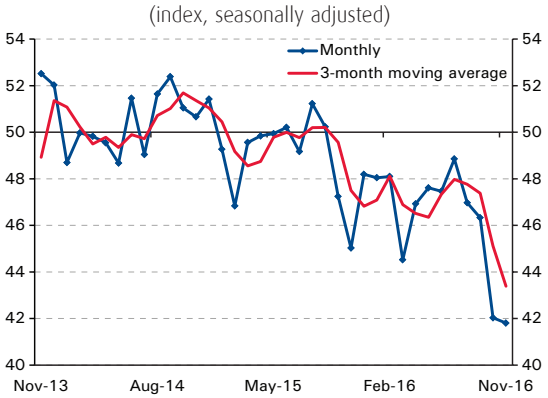
Source: MOP, TR Datastream, NBK estimates; *estimate/forecast

Chart 2: Quarterly GDP growth



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index



Source: Markit

reduce the need for domestic deficit financing and thus allow monetary policy to tighten and help stabilize the pound.

Economy slowed in 2016 on FX shortage and collapse in tourism

Economic growth is expected to have slowed significantly during 2016 following a more modest slowdown in 2015. Real GDP growth retreated to 2.3% year-on-year (y/y) in 2Q16 (Chart 2), down from average growth of 3.4% the year before. All indications are growth has remained subdued since, averaging around 2%. The economy should improve gradually in 2017 following the floatation of the currency, which should help competitiveness and business sentiment. Growth should thus improve slightly to 2.5% this fiscal year (FY16/17), before accelerating to 4% and 5% in FY17/18 and FY18/19, respectively (Chart 1).

Growth had been deteriorating gradually since the middle of 2015 and into 2016. The Ministry of Planning's production index had been in decline for most of that period. In October 2016, the index was down by 12% y/y (Chart 5). The slump came mostly from a decline in tourism and the related transportation sector, as well as construction. We should expect production to start improving in 4Q16, after the liberalization of the exchange rate and the approval of the IMF loan agreement. The production index will also benefit from a basis effect as the 4Q15 collapse in tourism fades.

Markit's Purchasing Managers' Index (PMI) has also reflected the weak growth, staying below 50 for over a year since late 2015 (Chart 3). The index averaged 46.4 during the last twelve months, a level consistent with GDP growth below 2%. The November 2016 PMI figure remained depressed at 41.8, indicating activity had yet to benefit from the pound's free floatation and from the approval of the IMF loan agreement.

Tourism remained weak in 2016 on security concerns

Tourism has been a key source of slowdown over the last year. The tragic terrorist attack in October 2015 that downed a Russian plane shortly after takeoff in Sharm El-Sheikh had a devastating effect on the tourist industry. The attack came at a time when Egyptian tourism was struggling to recover from years of political instability and security threats. September 2016 data show that tourist numbers had yet to recover. The number of visitors was off by 41% y/y, and the number of "nights stayed" was 45% lower y/y (Chart 6).

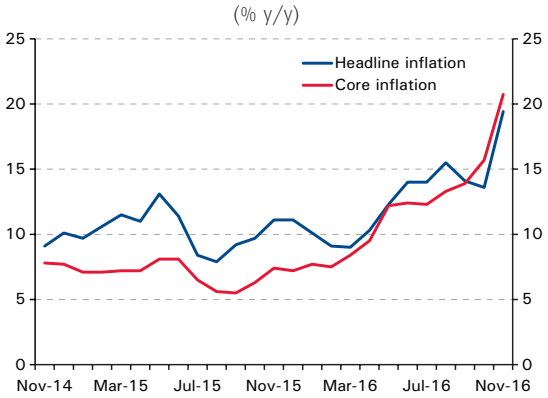
Currency float sees capital controls scrapped and pound down 50%

In November, Egypt chose to float its currency, after a 6-year struggle to maintain a peg to the US dollar. Capital controls, in place in various forms since 2011, and more strictly since early 2013, were gradually scrapped, and the Central Bank of Egypt (CBE) finally allowed banks to trade the currency freely starting 3 November. The Egyptian pound (EGP) has declined by over 50% against the dollar since, to settle at around 19.2 EGP/USD by 19 December (Chart 14); it was down by 59% ytd in 2016.

Inflation jumped following pound floatation and fuel price hike

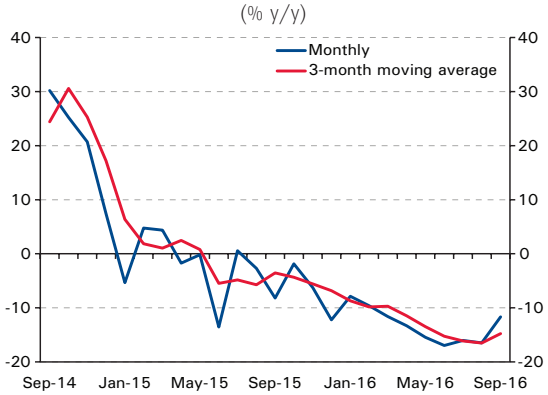
The floating of the pound was followed by a 30-50% increase in controlled fuel prices. The move helped cushion the impact of the pound's depreciation on the budget; but it also added to the rise in consumer prices. Inflation was already on the rise in 2016, having accelerated to around 14% by October 2016 (Chart 4). In November it jumped to 19.4% and is expected to remain at those levels through most of 2017, before cooling off in late 2017 and easing further in 2018.

Chart 4: Consumer price inflation



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

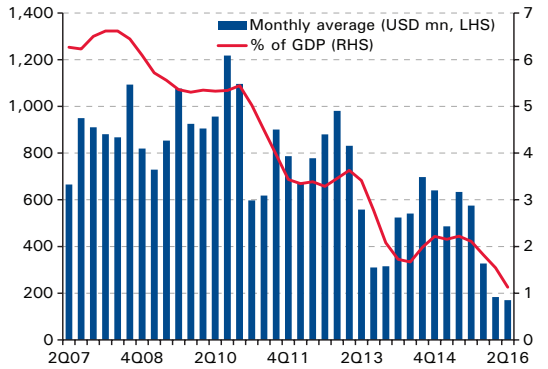


Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism

Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, NBK estimates

The CBE also moved to hike policy rates in November, in an effort to quell inflation and support the newly floated pound. The CBE increased rates by 300 basis points (bps), raising the CBE deposit and lending rates to 14.75% and 15.75%, respectively (Chart 11). The central bank had already raised rates by 300 bps in three moves over the previous 12 months. The CBE is likely to maintain a tighter monetary policy in the months ahead just as the government moves ahead with the tighter fiscal stance promised in its reform agenda.

Tighter fiscal stance is key to the government agenda and outlook

Egypt's fiscal deficit remains relatively large and a key source of imbalance for the economy. In its effort to kick-start reforms and gain approval for the IMF loan agreement, the government pledged to bring the deficit under control. In this effort, the government fast tracked legislation for a value-added tax (VAT) in August 2016. Other efforts include reining in spending by controlling the wage bill and reducing government subsidies. These reforms should help reduce the deficit to around 10% of GDP in FY16/17 from around 11% the prior year (Chart 9). Further improvements in the deficit to 7.5% and 6% of GDP are expected in FY17/18 and FY18/19, respectively.

Pressure on domestic financing to diminish

In recent years, the government has largely resorted to domestic debt issuance to finance its deficit and most of this debt has been absorbed by banks. This has come at a cost of crowding-out lending to the private sector and of boosting money supply. Over the last six years, claims to the government have risen, from 25% of assets to 56% in August 2016. By contrast, lending to the private sector dipped below 25% of bank assets.

The pressure on domestic financing is likely to diminish in the medium term, as the government reduces the deficit and relies more on international funding. Some of the financing will come from over $20 billion in funding pledged by various multilateral institutions and states. Debt markets will also play an important role, with Egypt planning to issue $3-5 billion in international bonds in the near future.

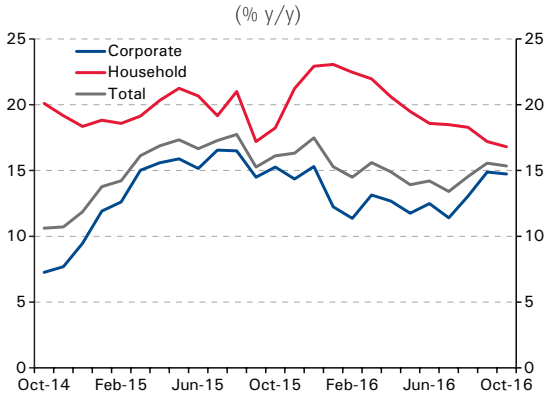
The positive news of the IMF loan deal has helped ease Egypt's sovereign yields. Egypt's USD 2040 bond yielded 8.5% in mid-December (Chart 10); while the spread to the 20-year US Treasury bond was mostly unchanged at around 540 bps from just before the IMF deal's approval. This was well below spreads in excess of 600 bps that were seen prior to the approval of the IMF deal.

Current account deficit widened in 2016

The current account deteriorated further in 2016, with the deficit widening to $9.7 billion during the first half of the year. The 12-month trailing deficit rose to 5.8% of GDP compared to 3.7% a year before. The deterioration was due largely to a collapse in tourism revenues, and declines in worker remittances and foreign grants. By contrast, the trade deficit narrowed by 13% thanks largely to a drop in imports. Foreign direct investment (FDI) also continued to provide support (Chart 12), accounting for around 2.1% of GDP during the 12 months through 2Q16.

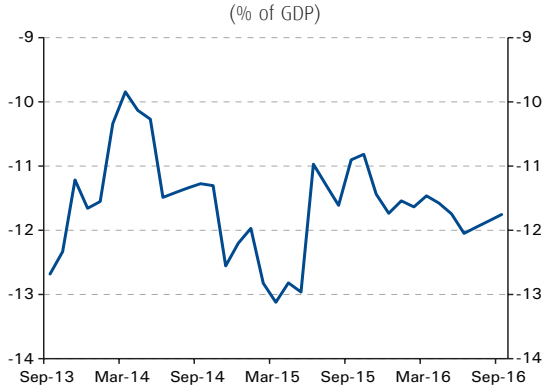
Foreign reserves saw a notable improvement towards the end of 2016 as Egypt agreed to an IMF-supported economic reform program and began implementation. The $12 billion IMF loan agreement, which was approved in November, was supplemented by a number of additional bilateral and multilateral pledges. This has helped push reserves to $23.1 billion by

Chart 8: Private credit



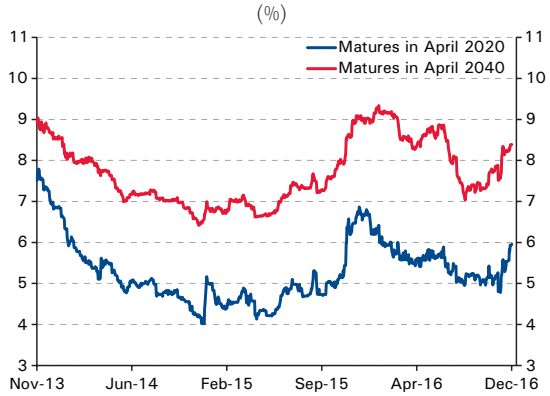
Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 9: Fiscal balance



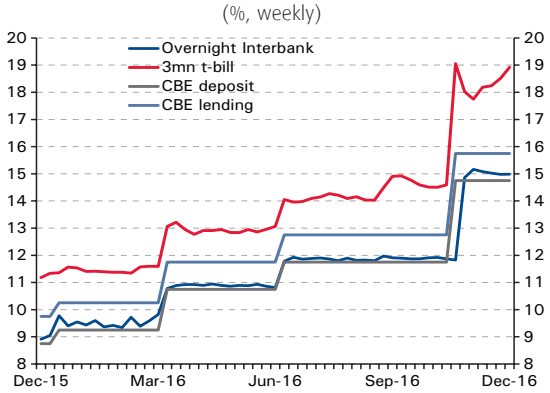
Source: MOF, TR Datastream, NBK estimates, *estimate/forecast

Chart 10: USD sovereign bond yeilds



Source: Thomson Reuters Datastream

Chart 11: Interest rates



Source: Central Bank of Egypt, Thomson Reuters Datastream

the end of November 2016, equivalent to 4.5 months of imports and the highest figure in over five years (Chart 13).

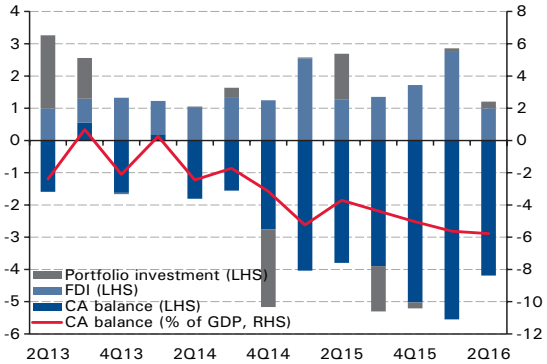
The decision to float the currency in early November should help relieve much of the pressure on reserves. With the CBE no longer supporting the EGP, the depletion of reserves should be reduced significantly. The currency has already fallen by more than 50%; tighter fiscal and monetary policy going forward should help stabilize the pound, as inflation is brought down and foreign investment returns to the country.

Equities market has outperformed region thus far in 2016

The stock market outperformed the MENA region in 2016, especially after the decision to float the currency. The market first rallied in March following a devaluation; it rose strongly again after the pound fell by more than 50% in November 2016 in the wake of the currency's floating. The EGX30 index was up 68% through 19 December (Chart 15); still, the market has not kept up with the drop in the currency, with the MSCI total return USD index off by 21% ytd.

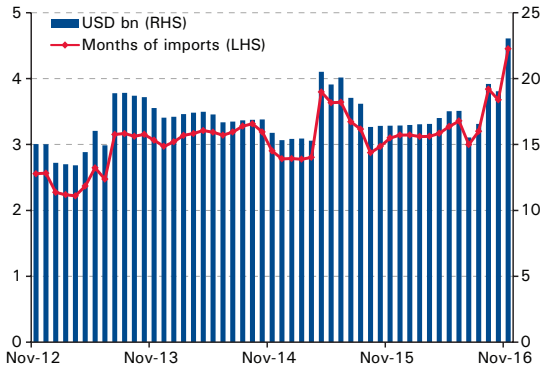
Chart 12: Balance of payments

(LHS: USD billion; RHS: % of GDP)



Source: Central Bank of Egypt, Thomson Reuters Datastream

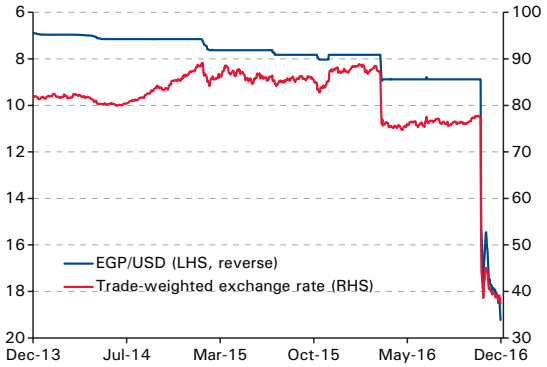
Chart 13: Official reserves



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30, thousand))

Source: Thomson Reuters Datastream

Regional economic data and forecasts

GCC	Unit	2012	2013	2014	2015	2016e	2017f	2018f
Bahrain								
Nominal GDP	$ bn	30.7	32.8	33.8	32.2	31.9	34.6	37.7
Real GDP	% y/y	3.4	5.6	4.5	2.8	2.9	3.4	4.2
Oil sector	% y/y	-8.5	15.3	3.0	-0.1	0.0	0.0	2.9
Non-oil sector	% y/y	6.9	3.3	4.9	3.6	3.6	4.2	4.5
Budget balance	% of GDP	-2.0	-3.1	-3.6	-16.1	-18.0	-15.0	-12.6
Current account balance	% of GDP	7.2	7.8	3.3	-7.6	-10.5	-7.0	-4.2
Inflation	% y/y	2.8	3.2	2.7	1.8	2.5	2.5	3.0
Kuwait								
Nominal GDP	$ bn	174.2	174.3	162.7	114.1	110.4	124.2	134.1
Real GDP	% y/y	6.6	1.1	0.5	1.8	3.6	1.7	2.7
Oil sector	% y/y	10.3	-1.8	-2.1	-1.7	3.6	0.0	1.5
Non-oil sector	% y/y	3.4	4.2	4.8	1.3	3.5	3.5	4.0
Budget balance	% of GDP	9.6	10.0	-5.9	-17.4	-18.3	-9.5	-8.4
Current account balance	% of GDP	45.3	40.9	33.4	5.2	0.3	5.5	6.9
Inflation	% y/y	3.3	2.7	2.9	3.3	3.4	4.0	3.0
Oman								
Nominal GDP	$ bn	76.3	78.9	81.0	69.8	67.9	69.7	73.3
Real GDP	% y/y	7.1	6.6	2.5	5.7	2.4	0.1	2.2
Oil sector	% y/y	3.0	2.7	-1.0	4.2	2.4	-3.3	3.4
Non-oil sector	% y/y	10.8	9.8	5.4	6.7	2.4	2.5	1.4
Budget balance	% of GDP	-0.3	0.9	-3.4	-17.2	-19.1	-13.9	-8.8
Current account balance	% of GDP	10.1	6.6	5.2	-15.5	-18.6	-15.2	-12.2
Inflation	% y/y	2.9	1.1	1.0	0.1	1.2	2.0	4.1
Qatar								
Nominal GDP	$ bn	186.8	198.7	206.2	164.6	161.1	183.1	199.7
Real GDP	% y/y	4.7	4.6	4.0	3.5	2.9	3.7	3.7
Oil sector	% y/y	1.2	0.1	-0.6	-0.5	-0.2	1.6	2.1
Non-oil sector	% y/y	9.9	10.6	9.8	8.2	6.0	5.8	5.2
Budget balance	% of GDP	11.5	14.7	12.4	1.3	-5.0	-2.6	-1.7
Current account balance	% of GDP	33.2	30.4	24.4	6.5	-4.1	1.5	2.4
Inflation	% y/y	1.9	3.1	3.3	1.6	2.9	2.3	3.4
Saudi Arabia								
Nominal GDP	$ bn	733.9	744.3	753.8	646.0	632.6	689.1	739.7
Real GDP	% y/y	5.4	2.7	3.6	3.5	1.1	0.7	1.3
Oil sector	% y/y	5.1	-1.6	2.1	4.0	2.4	0.5	0.4
Non-oil sector	% y/y	5.6	6.2	4.8	3.1	0.2	0.8	1.9
Budget balance	% of GDP	13.6	6.5	-2.3	-15.0	-12.1	-7.5	-6.7
Current account balance	% of GDP	22.5	18.2	9.8	-8.1	-5.6	-0.6	1.3
Inflation	% y/y	2.9	3.5	2.7	2.2	3.6	2.5	4.3
UAE								
Nominal GDP	$ bn	373.4	388.6	401.9	370.3	361.6	397.7	432.7
Real GDP	% y/y	6.9	4.6	3.1	3.8	2.5	3.0	4.0
Oil sector	% y/y	7.6	2.9	0.8	5.0	2.4	1.6	2.8
Non-oil sector	% y/y	6.6	5.5	4.1	3.2	2.6	3.6	4.5
Budget balance	% of GDP	10.9	10.4	5.0	-2.2	-3.3	-1.1	0.5
Current account balance	% of GDP	17.8	19.1	14.6	5.8	4.6	5.7	6.8
Inflation	% y/y	0.7	1.1	2.3	4.1	2.5	3.0	3.0
Egypt (fiscal year)								
Nominal GDP	$ bn	284.4	304.9	331.5	326.1	226.9	204.7	227.2
Real GDP	% y/y	2.1	2.9	3.4	2.3	2.5	4.0	5.0
Budget balance	% of GDP	31.6	32.9	30.0	27.1	29.6	29.1	28.4
Current account balance	% of GDP	-2.2	-0.9	-3.7	-5.7	NA	NA	NA
Inflation	% y/y	9.8	8.2	11.4	14.0	18.0	10.0	8.0

International data

	Unit	2012	2013	2014	2015	2016e	2017f	2018f
Brent crude oil spot price (year average)	$ p/b	111.6	108.7	99.0	52.4	45.5*	55.0	60.0
CRB commodity price index	Index	484.1	457.3	437.8	374.78	419.93*	-	-
Eur/USD	1$ = €	0.758	0.736	0.827	0.921	0.945*	-	-
US Fed Fund Rate	%	0.25	0.25	0.25	0.5	0.75*	-	-
MSCI World stock market index	Index	1,339	1,661	1,730	1,663	1,712*	-	-
MENA real GDP (IMF, year average)	% y/y	3.5	3.3	3.4	3.2	3.1	3.4	3.6
World real GDP (IMF, year average)	% y/y	5.1	2.2	2.6	2.1	3.2	3.2	3.4

Source: Thomson Reuters Datastream, official sources, NBK estimates

* As at 23 December 2016.

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