Macroeconomic outlook

UAE: Growth in non-oil sector to remain moderate, support overall economy

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Overview and outlook

- **Overall real GDP growth is expected to moderate further in 2016 on weaker oil GDP growth.**
- **Non-oil growth is poised to slow but remain moderate, as gains in the hospitality, transport and construction sectors continue to hold.**
- **CPI inflation is expected to come off the highs seen in 2015 as the initial impact of the tariff hikes/subsidy cuts subside.**
- **A higher but still manageable fiscal deficit is projected in 2016, on the back of high public expenditure levels.**
- **The banking sector is expected to swing towards tighter liquidity conditions in 2016, as credit growth outweighs weaker deposit growth. Deposit growth is being undermined by lower oil revenues.**

Real GDP growth in non-oil economy to remain modest

Real economic growth in the UAE is forecast to moderate to 2.5% year-on-year (y/y) in 2016, as real oil GDP growth remains tepid against a backdrop of low international energy prices. (Chart 1.) Growth in the non-oil sector is poised to slow but still experience some decent gains.

The weakness in the real oil GDP sector is expected to persist in the near-to-medium term amid an oversupplied global oil market. Real oil GDP growth is projected to slow further and come in "flat" in 2016, before seeing a slight recovery in 2017 on higher production levels.

Non-oil sector growth is expected to lose some steam in 2016 but still remain moderate as the tourism and construction sectors continue to churn out gains. The number of passengers at Dubai's International Airport recently retained its position as the world's busiest airport for the second straight year in 2015, as the number of total passengers came in north of 78 million. Construction activity is set to remain strong especially as preparations for the Dubai Expo 2020 continue. These include the construction of buildings, metro expansions, roads and bridges... In its 2016 budget, Dubai announced that it would allocate Dh16.6 billion for infrastructure projects, Dh1.8 billion higher than in 2015.

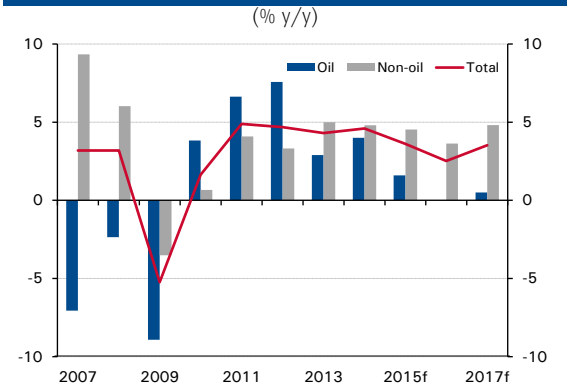
According to the Minister of State, the infrastructure being built for the

Table 1: Key economic indicators

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

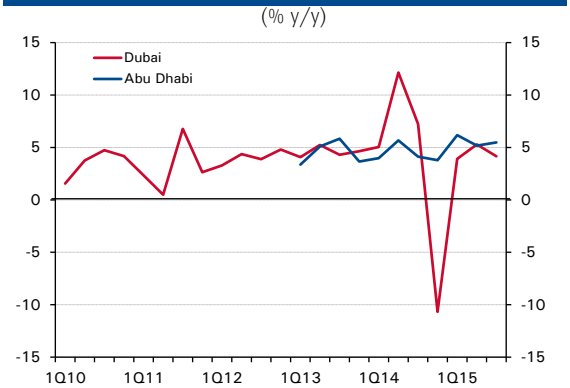
Source: Official sources, NBK estimates

Chart 1: UAE real GDP



Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Dubai & Abu Dhabi real GDP



Source: Dubai Statistics Center, Abu Dhabi Statistics Center

Chart 3: Purchasing Managers' index

Source: Markit

Expo will be permanent, as part of the emirate's 'vision of growth'. In addition, at the end of 2015 President Sheikh Khalifa announced that the federal authorities plan to invest more than Dh300 billion ($82 billion) domestically to foster a post-oil "knowledge economy". The plans also include tripling the labor force in the "knowledge economy" by 2021.

Dubai's real non-oil GDP growth continues to hold

According to the latest data, Dubai's economy slowed from 5.3% y/y in 2Q15 to a still decent 4.2% y/y in 3Q15, as growth in the non-oil sector moderated from 5.4% y/y to 4.1% y/y during the same period. (Chart 2.) The data is more or less in-line with the Emirates NBD Dubai Economy Tracker Index (DET), which trended down in 2015. The DET is a forward–looking private survey that tracks the performance of economic activity in Dubai's non-oil private sector. In February, the DET slipped into contractionary territory for the first time on record after falling to 48.9, (any reading below 50 denotes a contraction, while any reading above 50 denotes an expansion). However, the contraction in non-oil sector activity was short-lived after the DET rose to 52.5 in March, thanks to solid improvements across most of its sub-components, including business optimism. (Chart 4.)

Abu Dhabi

Latest figures show that Abu Dhabi's economy grew by an impressive 5.5% y/y, in real terms, in 3Q15, after non-oil sector growth jumped from 4.5% y/y to 7.1% y/y during the same period. (Chart 2.) The jump was fuelled by the public administration & defense sector. Abu Dhabi is expected to continue to log in moderate rates of growth in the coming quarters as government expenditures continue to gain some traction. Recently, the undersecretary of Abu Dhabi's Department of Economic development said that Abu Dhabi is targeting a real non-oil GDP growth rate of up to 8% over the next 20 years.

PMI gained some more ground in early 2016

The Markit Purchasing Managers' Index (PMI) is gradually edging back up after trending lower throughout 2015, thanks to healthy gains in new orders and output. (Chart 3). In March, the UAE's headline PMI (a leading economic indicator) rose to 54.5 from 53.1 in February. (A reading above 50 indicates an expansion in activity; a reading below 50 indicates a contraction.)

Inflationary pressures subsided during the same period after staff costs contracted for the first time since December 2011. Overall input prices remained moderate. Employment conditions continued to remain decent in early 2016, even amid softer oil prices, keeping fears of a major oil-induced disruption to domestic consumption and the overall economy at bay.

Residential property price growth in Dubai expected to stabilize in 2016

After continuing to trend lower for the most part of 2015, growth in Dubai's residential sales prices showed some nascent signs of stabilization in the latter part of the year. According to Asteco, a major real estate services company, prices of apartments in Dubai fell by approximately -5.1% y/y in 3Q15 and -3.4% y/y in 4Q15. Villa prices fell by -13.3% y/y and -10.3% y/y in 3Q15 and 4Q15, respectively. (Chart 5.)

The imposition of higher transaction fees in 4Q13 and federal mortgage caps in early 2014 (before the drop in oil prices) undoubtedly delivered the outcomes the authorities desired: cooling off the property market and

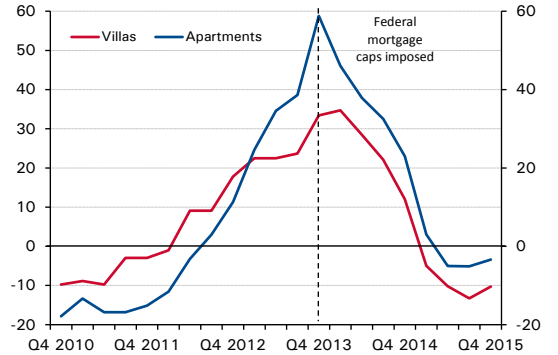
Chart 4: Dubai Economy Tracker

(index)

Source: Emirates NBD

Chart 5: Residential property sales prices

(% y/y)



Source: Asteco, JLL

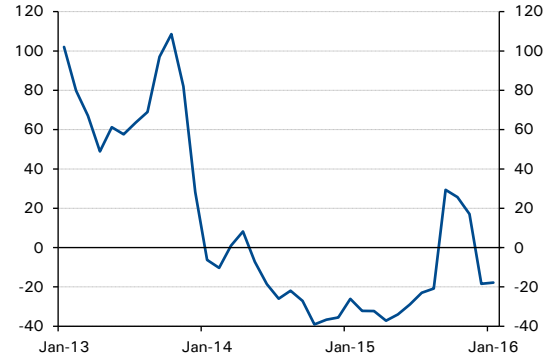
Chart 6: Value of transactions

(AED billion)

Source: Dubai Land Department

Chart 7: Number of transactions

(% y/y, 3mm average)



Source: Dubai Land Department

curbing speculation. These measures have also been recently accompanied by an on-going rise in housing supply and a change in preferences and risk appetite within the residential property market.

Against a backdrop of greater housing supply, sellers have been forced to lower prices. Also, more and more buyers are favoring affordable (mid-range) and/or end-use housing. While transaction values continue to trend lower, the growth in transaction volumes has been gradually recovering recently due to rising activity in the "more affordable" housing segment. (Charts 6 and 7.) We expect to see more of this shift towards mid-range housing, especially amid a low oil price environment and tighter lending restrictions.

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

It is safe to conclude that Dubai's property market is going through a significant correction and that the measures that were put in place have helped lead the market in the right direction.

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

Headline inflation began to ease in early 2H15 after housing inflation (rent, which weighs heavily in the index) peaked. Food inflation has also remained relatively soft. As a result, inflation in the consumer price index (CPI) continued to slow in February, falling to 2.2% y/y from 2.5% in January.

The rise in housing costs peaked at 10.2% y/y in June 2015. It had been accelerating since 2013 on the back of a recovery in the residential property sector. (Chart 8.) The steep rise in housing costs in 1H15 mainly came on the back of the one-off hike in electricity and water tariffs (for both nationals and expatriates) and the removal of the rental cap in Abu Dhabi. But with more housing entering the market and the effect of the one-off hike in utility tariffs on the wane, we should see inflation in the housing segment correct further over the medium-term.

A stronger US dollar and lower commodity prices will also help limit upward inflationary pressures from any further subsidy cuts. Consequently, we forecast inflation to slow from an annual average of 4.1% in 2015 to 3.5% in 2016.

A manageable fiscal deficit is expected in 2016 amid steady spending levels and lower revenues

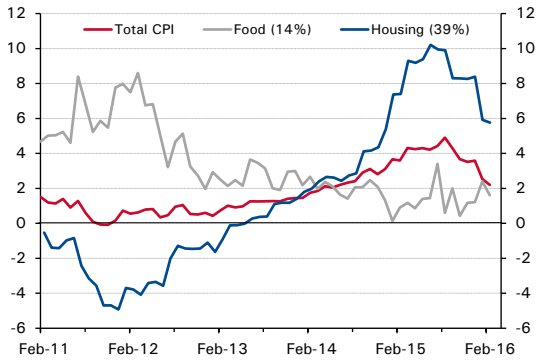
The UAE's fiscal balance (breakeven oil price is $70/b) is expected to log in a deficit of 3.2% of GDP in 2016, on steady spending levels and lower oil earnings. (Chart 9.)

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

Nonetheless, the major emirates have embarked on some fiscal prudence and reforms. According to official reports, Abu Dhabi has curtailed and/or delayed spending on a number of projects designated as low-priority. In November 2015, Dubai passed a law covering public-private partnerships

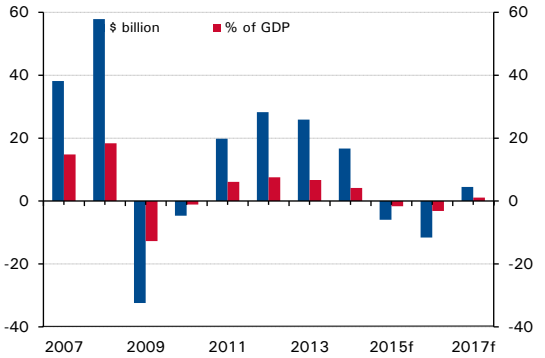
Chart 8: Consumer price inflation by sector

(% y/y, weights in brackets)



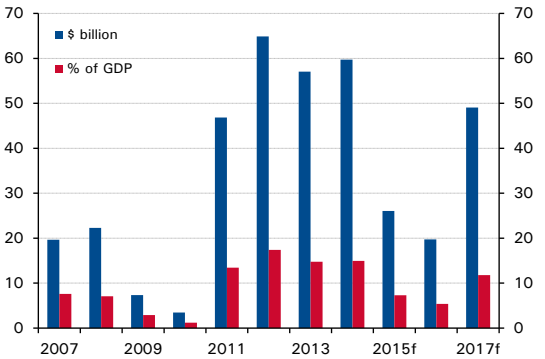
Source: Thomson Reuters Datastream

Chart 9: Budget balance



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

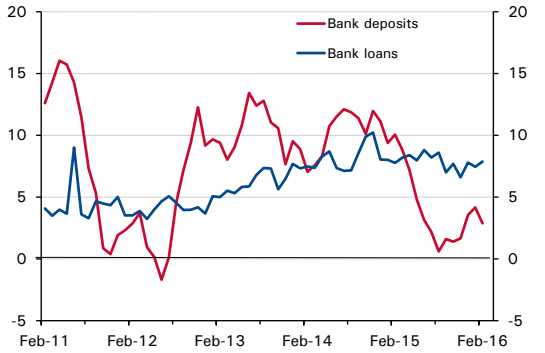
Chart 10: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 11: Bank loan and deposit growth

(% y/y)



Source: Central Bank of the UAE

(PPPs) to tap into private sector funding for key projects. Furthermore, the UAE government is expected to impose new reductions in subsidies. At the start of 2015, it took the decision to hike utility tariffs. Later, in August, it deregulated petrol prices.

The Ministry of Energy released more pricing details in March 2016 which showed that petrol prices will rise by more than 10% in April, as it maintains its new system of adjusting prices monthly in response to the conditions in global energy markets.

An imposition of a departure-tax at the Dubai International Airport starting on July 1st of 2016 may also increase non-oil revenues. The departure tax, which will be valued at Dh35 ($9.54) will be introduced to help finance the emirate's development projects. Given that the Dubai International airport was the world's busiest in 2015, with 78 million passengers passing through the airport that year, the tax is forecast to raise $500 million annually.

Also, in an attempt to preserve foreign assets, the UAE is also looking to raise debt on international markets to help finance their fiscal deficit. With a relatively low level of external debt (estimated at around 30% of GDP) the UAE has ample room to raise further debt.

The fiscal balance is expected to return to a surplus in 2017 on the back of an expected (delayed) oil price recovery and a planned increase in oil production.

Current account surplus to narrow on lower oil export earnings

The surplus in the current account is expected to continue to narrow in 2016, on the back of a fall in oil export receipts and higher imports. Non-oil export revenues are expected to hold thanks to the modest gains in the trade and tourism sectors. (Chart 10.)

The UAE's non-oil exports may be slightly under pressure, however, by the strength of the dirham. The stronger dollar has led to an appreciation in the UAE's trade-weighted index increasing the costs of its exports and making it a more expensive place to visit and invest in for expatriates from outside the GCC region and the US. (Chart 16.) The UAE's major trading partners are in Asia, and those countries saw further depreciation in their currencies vis-à-vis the dirham. However, given that the majority of tourists visiting the UAE are from the GCC region and that UAE nationals are the predominant investors in the country's real estate sector, the non-oil economy should continue to perform well in the current low oil price environment.

Furthermore, the removal of sanctions on Iran by the West is expected to be a boon for UAE trade, particularly in the non-oil sector. The UAE is Iran's biggest non-oil trading partner and its biggest source of imported goods.

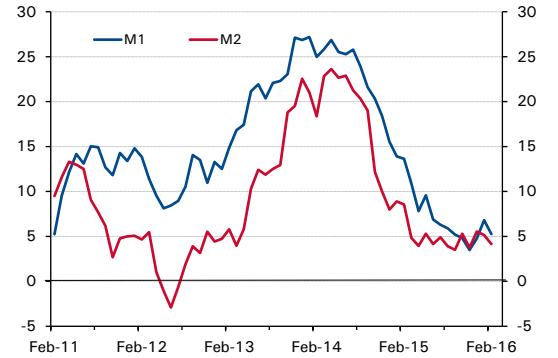
Banking sector to see some liquidity tightness on weaker deposit growth

Credit growth continues to post healthy gains, even amid a softer oil price environment and a slowing real estate market, as lending to the construction sector continues to hold. Loan growth rose from 7.4% y/y in January to 7.9% y/y in February. With capital spending expected to increase further in the run-up to the Expo 2020 in Dubai, we should continue to see healthy gains in loan growth. (Chart 11.)

However, bank deposit growth continues to remain relatively subdued due to softer government deposit growth, which is closely correlated with oil revenues. As of February, total deposit growth stood at 2.9% y/y.

Chart 12: Money supply

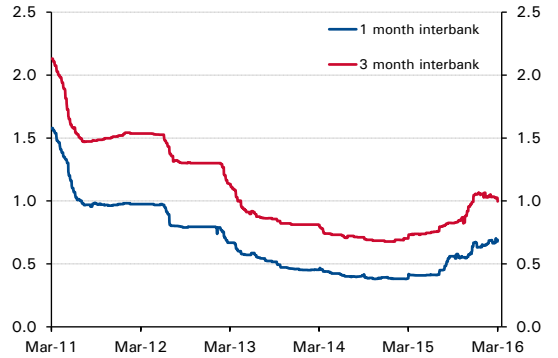
(% y/y)



Source: Thomson Reuters Datastream

Chart 13: Interbank rates

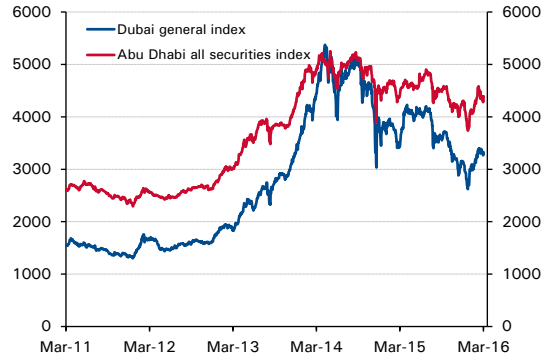
(%)



Source: Thomson Reuters Datastream

Chart 14: Stock market indices

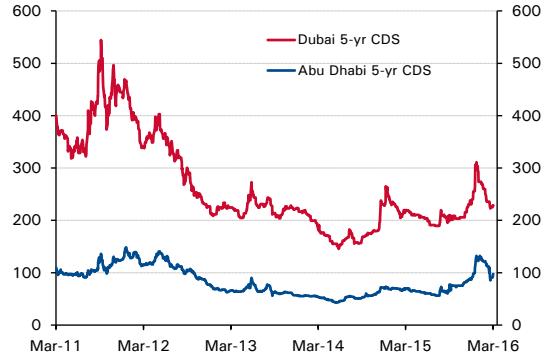
(index)



Source: Thomson Reuters Datastream

Chart 15: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

(Chart 11.) With deposit growth coming in below credit growth, the loan-to-deposit ratio has been relatively higher in recent months. In February it was at 102.2%.

Slowing deposit growth is also evident in the tepid annual gains in broad money supply (M2). M2 growth slowed from 5.1% y/y in January to 4.2% y/y in February. (Chart 12.)

Both the UAE's three-month and one-month interbank rates have been edging higher since 2H15, but they still remain relatively low. (Chart 13.) Additional hikes in the US federal funds rate, possible this year, would further pressure liquidity conditions.

The struggling small and medium-sized enterprises (SME) sector in Dubai has been offered some relief with a 'mini-insolvency law'. The sector has been struggling due to delayed payments by customers and there have been anecdotal reports of defaults or late payments since mid-2015. These sparked concerns about the possible negative repercussions on the banking sector. Having said that however, the number of SMEs was up by a still strong 18% y/y in 2015.

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

The UAE Banks Federation (UBF) estimates that among SMEs, loans amounting to between Dh5 billion and Dh7 billion ($1.4 billion-$1.9 billion) are at risk of default. While growth in provisions for non-performing loans (NPL) still remains low, loan defaults among SMEs would ultimately lead to a pickup in NPL provisions. However, with total credit valued at Dh1.4 trillion and SME loans at risk of a default valued at Dh7 billion (0.5% share), the impact on the banking sector should be limited. Nevertheless, the government stepped up its efforts to come up with a much-needed loan-restructuring scheme in March 2016 or what the chairman of the UBF described as a 'mini-insolvency law' to help support SMEs, reduce the risk of default and retain confidence in the sector.

Markets and interest rates

The main Abu Dhabi and Dubai markets remain under pressure, taking a cue from international and other GCC markets, and as oil prices remain subdued.

The main credit default swaps (CDS), good gauges of the level of risk within an economy, came off their recent highs towards the end of March. (Chart 15.) At the end of 1Q16, the CDS on five-year Dubai and Abu Dhabi government debt stood at 229 and 98 basis points, respectively.

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

Chart 16: UAE trade-weighted index

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK

their own businesses.

US dollar-dirham peg is here to stay

The dirham has been pegged to the US dollar at a rate of $1 = Dh 3.673 since 1997. The current exchange rate policy has thus far helped the UAE economy instil macroeconomic stability, keep the rate of inflation in check and maintain investor confidence. Although the peg has come under pressure against a backdrop of falling oil prices and a stronger US dollar against most other currencies, the UAE has certainly ample reserves to defend its peg to the US dollar.

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