Macroeconomic outlook

Oman: Non-oil growth held back by fiscal consolidation efforts

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Overview and outlook

- **Growth is seen weakening to 2.1% in 2016 and 1.8 % in 2017.**
- **Deficit expected at 17% of GDP in 2016, shrinking to 8% in 2017.**
- **Credit growth likely to moderate; liquidity pressures to remain.**
- **Inflation is picking up following subsidy cuts with the increase expected to be maintained through 2016 and 2017.**

The economy is showing signs of slowing. Consumer confidence is weakening, government projects are being cut, and market conditions are bearish. The persistence of low oil prices will see Oman register substantial deficits in 2016 and 2017, increasing the urgency for fiscal consolidation. Following reforms that had little impact on public finances in 2015, the government has come back with a slew of measures targeting excessive spending and better revenue collection. On the downside, these measures are expected to erode future income expectations for both consumers and investors. Credit growth is expected to slow as a result. Tightening liquidity in the banking sector, due to domestic government borrowing and declining deposits, further add to these concerns. On the upside, recent government efforts show its 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.

Real growth is weakening, but some catalysts are in sight

Oil prices continue to impact Oman's economy. While growth was healthy in 2015, at an estimated 3.5%, it is expected to slow in 2016 and 2017 to an average of 2%. Weakening consumer and investor confidence will be the primary drag. A survey by the National Center for Statistics and Information (NCSI) showed a sharp decrease in consumer confidence in 1Q16, stemming mainly from uncertainty over future income. These worries follow cost-cutting measures implemented by the Ministry of Finance in 1H16 (Chart 1).

As a result, the mood in the non-oil sector has been bearish. As of March, growth in real estate sales slowed to 6% y/y from an average of 32% in 2015; the number of newly registered vehicles retreated by 25% during the month, down for the thirteenth consecutive month; hotel revenue

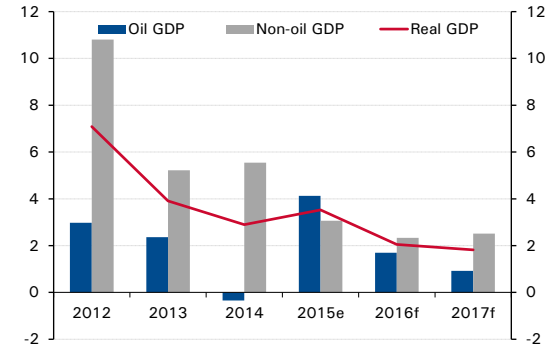
Table 1: Key economic indicators

		2014	2015e	2016f	2017f
Nominal GDP	US$ bn	83	70	69	76
Real GDP	% y/y	2.9	3.5	2.1	1.8
- Oil	% y/y	-0.2	4.1	1.7	0.9
- Non-oil	% y/y	5.5	3.1	2.3	2.5
CPI	% y/y	1.0	0.1	2.0	2.4
Budget balance	% GDP	-3.3	-17.1	-17.3	-8.4

Source: National Center for Statistics and Information, NBK estimates

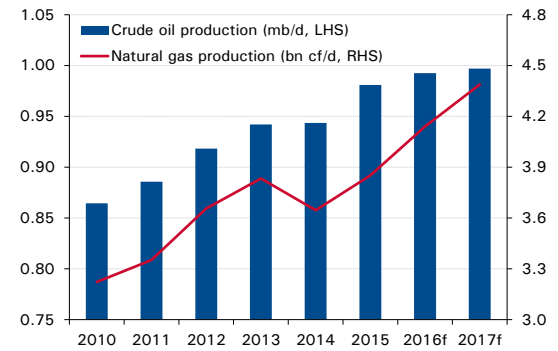
Chart 1: Real GDP

(% y/y)



Source: National Center for Statistics and Information, NBK estimates

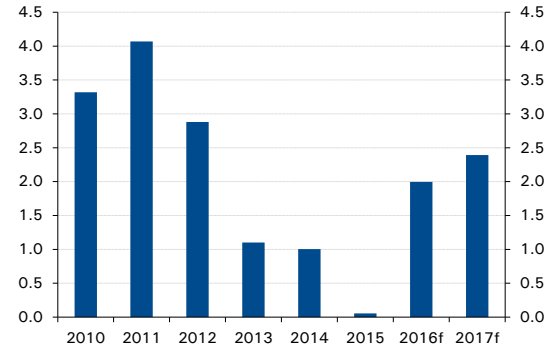
Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation

(% y/y, year average)



Source: National Center for Statistics and Information, NBK estimates

growth dropped to 4%, from a 2015 average of 15%.

Iran's resurgence on the global economic stage may help offset the slowdown, with Oman set to benefit from Iran's potential growth, while Iran will look to Oman as a conduit for trade. Oman's neutral stance towards neighboring Iran has allowed it to deepen its relationship following the nuclear deal. Bilateral investments are expected to increase, as Iran vowed to repay Oman for its "allegiance" throughout the negotiations. Several deals have been lined up since. An Iranian car manufacturer will be setting up shop in Oman, while talks of building a $1.5 billion hospital complex, financed by Iran, are underway. Iran's close proximity will also help prop up Oman's tourism sector.

Domestically, Oman is looking to jump start its economy by pursuing its development plan, which will emphasize the role of the private sector in funding more than half of the OMR 41 billion to be spent on the plan. To that aim, Oman has passed legislation allowing for 100% foreign ownership and has abolished minimum capital requirements for firms. The small and medium-sized enterprise sector, a pillar in Oman's diversification strategy, is set to benefit greatly from these developments.

Government project spending will remain instrumental to Oman's non-oil sector, but spending will be reserved to necessary projects, dampening its lift on growth. As of 1H16, the value of awarded projects has decreased by 12% compared to the same period in 2015. Focus will be given to infrastructure and power projects. Oman is faced with an electricity supply gap, threatening its future growth prospects. Energy consumption has also grown rapidly, rising by 14% y/y in March .

Fiscal pressures are expected to persist

Fiscal pressures are expected to persist in 2016, but may soften in 2017. Low oil prices are expected to offset gains from the gradual implementation of reforms during 2016. A recovery in oil prices, coupled with increased compliance with reforms, may see greater fiscal consolidation in 2017.

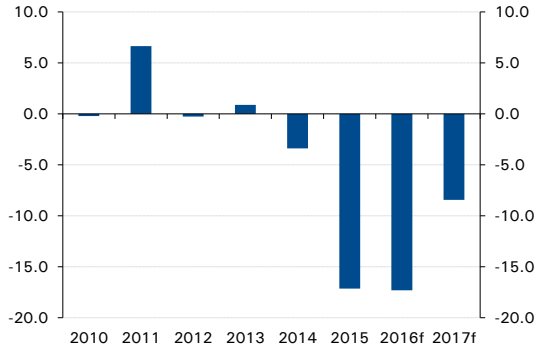
Official data shows the deficit at 17.1% of GDP (OMR 4.7 billion) in 2015, surpassing official expectations. A similar deficit is expected in 2016; though oil prices are seen to be weaker, spending restraint will start to be felt on the gradual implementation of fiscal reforms. In 2017, the deficit is expected to narrow, dropping to 8.4% of GDP, as additional spending cuts and revenue measures are realized and oil prices begin to recover; a potential increase in gas production will also help (Chart 4).

The government has enacted a number of spending and revenue reforms in a bid to reign in on a widening deficit. Benefits, bonuses, and scholarships have been halted at all ministries and quasi-sovereign institutions. Spending restrictions have been implemented as well. Sovereign and quasi-sovereign entities are now required to receive government approval prior to any new ventures, projects, or spending initiative. They are also required to decrease operational expenses by 10% year-on-year in 2016. The government is also looking to halt subsidizing electricity for commercial, industrial, and government users. This comes on the heels of rapidly growing electricity consumption.

Ministries are also encouraged to look for new sources of non-oil revenue and improving revenue collection. So far, the Sultanate has seen an increase in the cost of vehicle license plates, air traffic fees, and its airport departure tax. Oman may also consider implementing a VAT in 2017, one

Chart 4: Budget balance

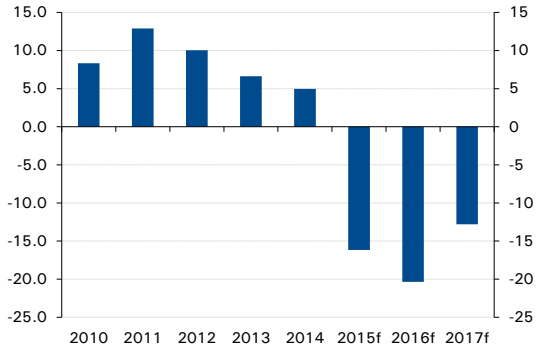
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

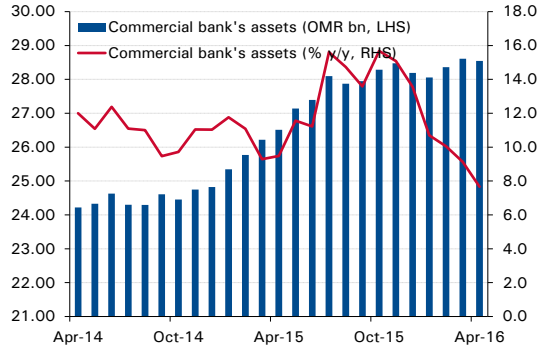
Chart 5: Current account balance

(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

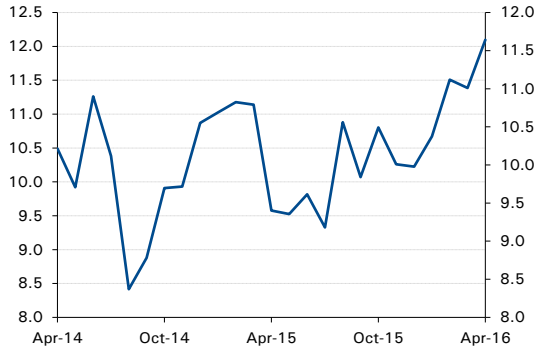
Chart 6: Commercial bank assets



Source: Central Bank of Oman

Chart 7: Credit to private sector

(% y/y)



Source: Central Bank of Oman

year ahead of other GCC countries, given the difficult condition of its finances. These measures follow some less impactful reforms, such as the liberalization of petrol prices and a subsidy adjustment for industrial power usage that have done little to reign in the deficit.

The government's low debt level, estimated at 10% of GDP in 2015, and its relatively healthy credit rating, gives it some space to withstand the strain on its budget under lower oil prices. Despite recent downgrades by rating agencies, Oman maintains an investment grade rating and strong appetite for its debt. This was reflected by the Central Bank of Oman's (CBO) latest foray into international debt markets, on behalf of the treasury, as it comfortably raised $2.5 billion. A $1 billion international syndicated loan was also arranged earlier in 2016. The government is looking to capitalize on this momentum and plans to access international markets again with a $2.5 billion sukuk offering. To help finance the 2016 deficit, the CBO plans to borrow more from international markets in addition to drawing down reserves and utilizing donor grants.

Oil production stays strong, needs investment

To offset the drop in oil prices, the government continued to ramp up oil production, but is fast approaching its production limit (Chart 2). Furthermore, decreased investment in enhanced oil recovery will see output plateau close to current levels. As such, growth is expected to moderate to 1.7% in 2016 and 0.9% in 2017 (Chart 1).

Oil output was steady at 994,000 barrels per day in April, averaging 998,000 barrels per day since January 2016. Petroleum Development Oman, the state's largest producer, has been shouldering the bulk of the production growth. The lull in oil prices may hinder this growth, since complex geology and aging wells require constant investment in enhanced oil recovery (EOR) techniques to remain sustainable over the medium term. However, the government, in search of a short-term boost to production, has favored investing in new fields. This sudden shift in production strategy may see the gains from newly developed oil fields offset by decreases in output from older wells over the next few years.

Gas production has remained strong, picking up in April by 15% year-on-year (y/y), with output of 114 million cubic meters per day, on the back of increasing domestic demand. To keep up with domestic consumption, Oman has rescheduled 5% of its LNG exports. Gas exports are nearly all committed to Japan and South Korea. Supply should see a boost once the BP Khazan tight gas project comes into operation late in 2017, which recently received approval for an expansion. A gas pipeline with Iran will also help meet growing domestic demand, with imports set to flow in 2018. There is also talk of jointly developing oil and gas fields with Iran.

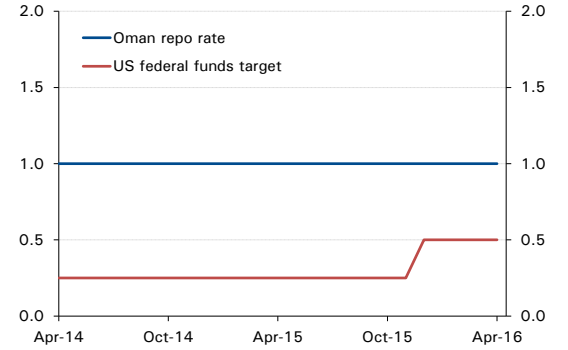
Banking system sees tightening conditions

Banking conditions have tightened following the prolonged decline in oil prices, with credit growth expected to slow this year and next. Government deposits may suffer as well, following net withdrawals to finance the deficit. Continued domestic borrowing by the government and the expectation of a rate hike may strain liquidity conditions.

Private credit growth remains resilient at 12% y/y in April 2016, but may see a slowdown as consumer confidence weakens because of the planned cuts in government spending. Meanwhile, both private and government deposits have seen growth decline. Government deposits were down 1% in April 2016 y/y, its fifth consecutive contraction. As a

Chart 8: Policy rates

(%)



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

(index)

Source: : Muscat Securities Market

result, the loan-to-deposit ratio rose to 105% from a 2015 average of 99%. In a bid to shore up deposits, Omani banks have turned to international debt markets for funding.

Liquidity conditions have deteriorated on the back of declining deposits and increased domestic government borrowing. The Omani overnight interbank rate was up 21 basis points from January 2016 through April 2016, while 3-month treasury bills were up 64 basis points in June 2016 from a year ago. To cope, the CBO has allowed commercial banks to treat government debt as part of their eligible reserves, up to a maximum of 2% of deposits at the CBO. The measure is expected to ease liquidity constraints and encourage the purchase of government paper.

External economic risk factors may hamper Oman's efforts to ease banking system pressures through international debt offerings. Further US policy rate hikes in 2016 and 2017 and increased global market volatility could see appetite for emerging markets diminish. Upward pressure on the US dollar, and in turn the Omani rial, may discourage investment in Omani debt if its offerings are mispriced.

Oman is the only GCC member not to move its policy rate following the first federal funds rate hike in December 2015, making a move in the policy rate more likely this year.

Oman's financial sector is well capitalized. According to the CBO's latest quarterly financial soundness statistics (Sep. 2015), credit risk remains low in Oman with nonperforming loans (NPL) at 2.0% of gross loans. Capitalization was also high, with a capital adequacy ratio of 15.8% in 3Q15 and a tier-1 capital ratio of 13% at the end of 2015.

Inflation lifted following subsidy cuts

Inflation picked up following recent subsidy cuts. The increase is expected to be maintained in the following years as the government liberalizes prices on energy and goods and services, offsetting downward pressures from global food and energy prices. Oman's CPI is seen rising by 2.0% in 2016 and 2.4% in 2017. April's inflation reading came in strong at 2.2% y/y, its highest pace in three years, on the back of increased housing and transportation costs. In the coming months, we expect the slowdown in the real estate market to see housing costs subside.

Current account in deficit on weaker oil revenue

The current account balance is projected to remain in deficit, picking up in 2016 before narrowing in 2017 (Chart 5). Weaker oil prices will more than offset the decline in import prices, keeping the trade balance in deficit into 2016. The removal of international trade sanctions on Iran 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 April 2016, Oman's foreign reserves stood at OMR 6.7 billion, or an estimated 5.6 months of 2015 imports.

The stock market rides the oil price recovery wave

Omani stocks, along with equities across the GCC, continue to be strongly correlated with global oil prices (Chart 9). The MSM 30 increased by 7% year-to-date following the rebound in global oil prices during the first half of 2016, outperforming regional peers. Market volatility could see some IPOs delayed in 2016, robbing the market of much needed catalysts.

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