Economic Update
12 February 2017

Macroeconomic outlook

Oman: Real growth seen slowing in 2017 as fiscal stance tightens

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Overview and outlook

- **We see real GDP growth 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

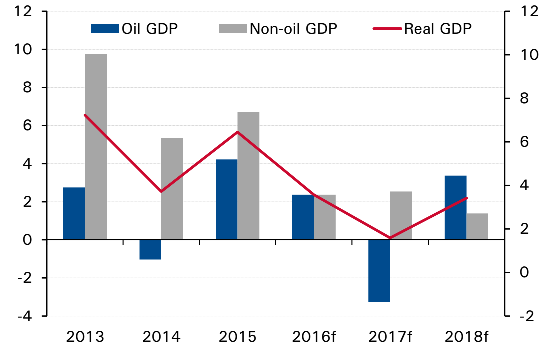
Weaker household and government consumption, coupled with delayed private and public investments is likely to lead to a slowdown in real GDP

Table 1: Key economic indicators

		2015	2016f	2017f	2018f
Nominal GDP	US$ 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
CPI	% y/y	0.1	1.2	2.0	4.1
Budget balance	% GDP	-17.3	-19.1	-13.9	-8.8

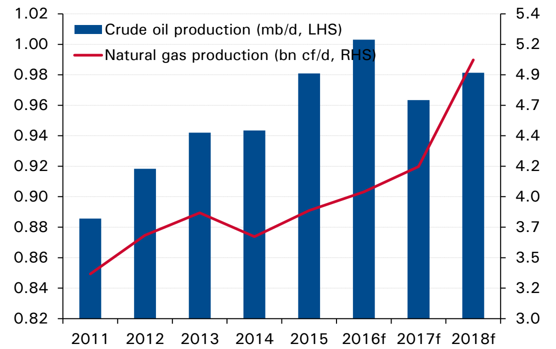
Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP
(% y/y)



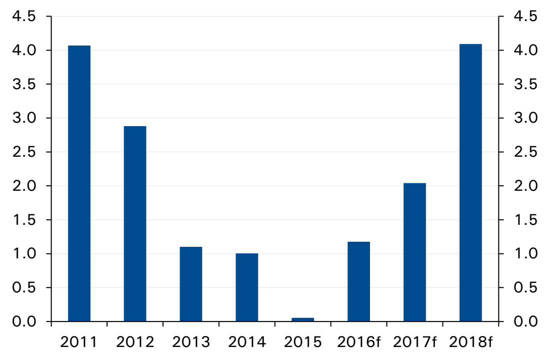
Source: National Center for Statistics and Information, NBK estimates

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 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 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.

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.

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.

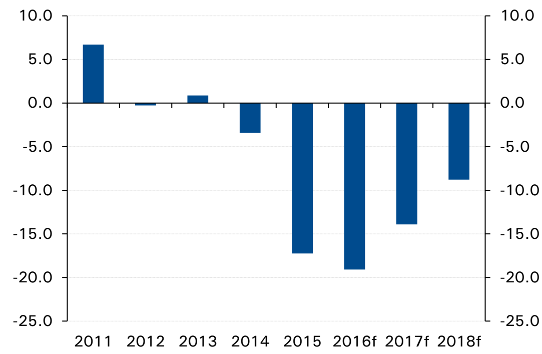
The 2017 budget may fare better, with the government expecting a OMR 3 billion deficit for that year. Their budgetary strategy will focus on cutting expenditures and keeping revenues unchanged, with the average barrel of oil priced at $45. Given the government's current fiscal expenditure performance,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

Chart 4: Budget balance

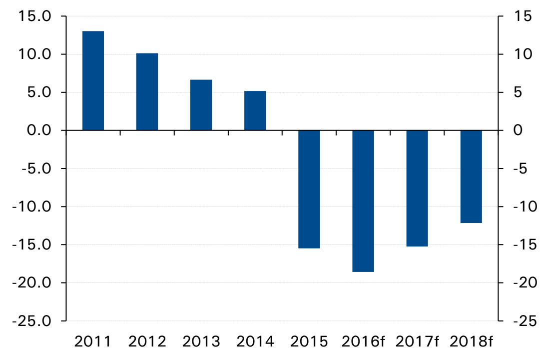
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

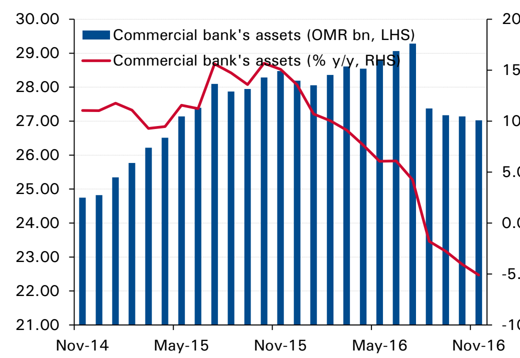
Chart 5: Current account balance

(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

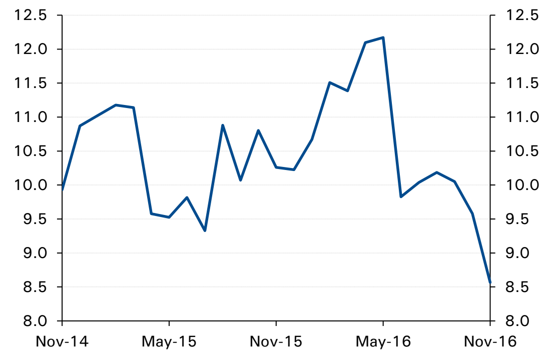
Chart 6: Commercial bank assets



Source: Central Bank of Oman

Chart 7: Credit to private sector

(% y/y)



Source: Central Bank of Oman

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.

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.

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.

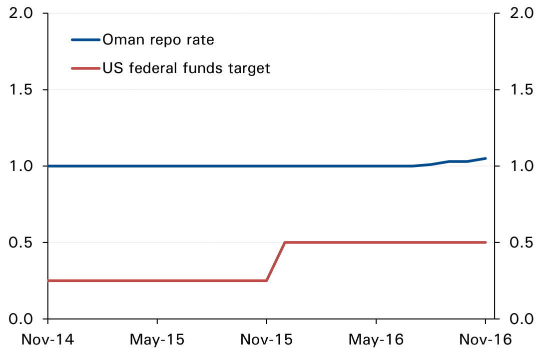
Banking system sees liquidity conditions improving

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 at 0.46% in December 2016, lower than the 0.57% recorded in March 2016 before Oman issued its international bond. It was still up, however, from December 2015's reading of 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 4% y/y in November 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 November 2016, private credit growth

Chart 8: Policy rates

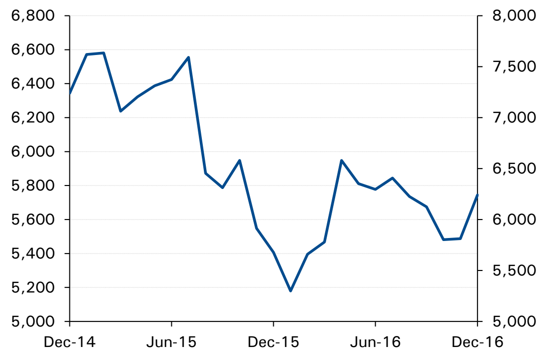
(%)



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

(index)



Source: : Muscat Securities Market

has eased, but remained resilient at 8.6% year-on-year (y/y), and is set to finish the year on a similar note.

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

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) came in at 1.1% in 2016 and is expected at 2% in 2017. The introduction of the VAT in 2018 may see consumer prices rise to 4.1% for that year. December's inflation reading came in at 1.1% y/y, on the back of increased housing, furnishing, and transportation costs, offsetting the sustained decreases in food prices.

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 are 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 6.3% in 2016; outperforming most of its regional peers.

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