Macroeconomic outlook

GCC: Non-oil growth to average 3.5% in 2016-17, as deficits spur on reform

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Overview and outlook

- **GCC economies to grow moderately on the non-oil side in 2016 and 2017, averaging 3.5% growth. Overall GDP growth to average 2.4%.**
- **Faced with the new "lower for longer" or just "lower" oil price environment, GCC policy makers have embarked on long-term changes and reforms; but adjustment is expected to be slow and gradual.**
- **GCC economies saw their first fiscal deficits in years in 2015 and have started to borrow, domestically and internationally.**
- **Oil importers are held back by a moderate regional and world outlook as well as by persistent security issues.**
- **Modest growth in global oil demand and more restrained supply are helping balance the oil market in 2016; oil prices are rising gradually. The IMF expects world economic growth at 3.1% in 2016.**
- **Major central banks to remain very accommodative, notwithstanding one possible rate hike by the Federal Reserve this year.**

Mid-year, and though our revised outlook for 2016-17 is not qualitatively different from the earlier edition of this report, the growth numbers, world and GCC, have come down. This revised expectation is the result of slightly disappointing world growth in 1H16, primarily in emerging markets, and of heightened uncertainty stemming primarily from Brexit: the momentous decision by the UK to separate from the EU. Europe, which was on track to meet or beat expectations this year, will now be subjected to Brexit winds, with the UK flirting with recession later this year.

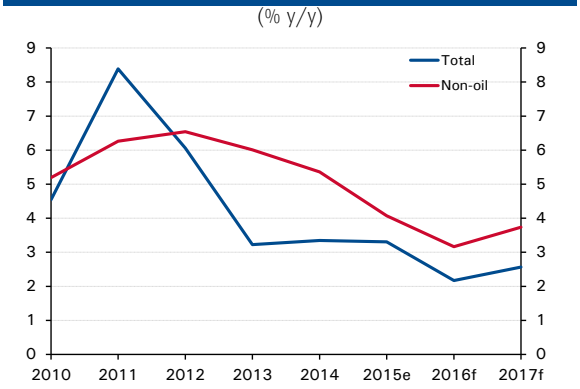
The GCC economies are expected to be marginally affected by all that; however, we revised their outlook somewhat because of more aggressive government action to reduce their fiscal deficits. Most GCC countries moved rather fast to enact spending rationalization and subsidy cuts, Kuwait being the exception. These new measures will eat into near-term growth but are otherwise good news. Though oil prices have recovered from recent January 2016 lows, they are still in the low $50s or lower (Brent basis) and are not expected by anyone to return to their heady $100 levels any time soon. The GCC governments have thus had

Table 1: Key economic indicators

		2014	2015e	2016f	2017f
Nominal GDP	USD tn	1.6	1.4	1.4	1.6
Real GDP growth	% y/y	3.3	3.3	2.2	2.6
Oil	% y/y	1.3	2.3	0.8	0.9
Non-oil	% y/y	5.4	4.1	3.2	3.7
Inflation	% y/y	2.5	2.8	3.2	3.3
Budget balance	% of GDP	2.0	-9.6	-8.6	-3.7

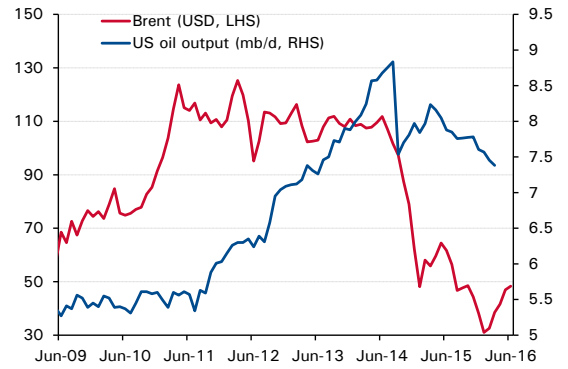
Source: National sources, NBK estimates

Chart 1: GCC Real GDP



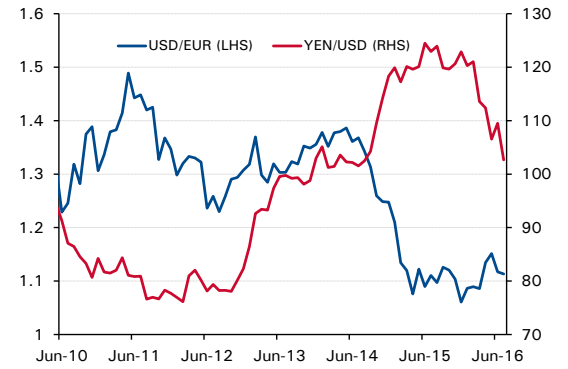
Source: National sources, NBK estimates

Chart 2: US oil production and Brent prices



Source: EIA, Thomson Reuters Datastream

Chart 3: Key exchange rates



Source: Thomson Reuters Datastream

since mid-2014 to adjust to this new reality and are moving decisively to address it, including a vast 2030 economic plan in KSA. The KSA plan aims at diversifying the economy, raising non-oil revenues, creating jobs and even privatizing part of the oil wealth/production of the country. Kuwait is also floating the idea of privatizing some downstream oil activity.

Back to the world economy, the IMF recently revised its world outlook for 2016, down to 3.1% from 3.2%, and 3.4% earlier in the year. Advanced economies are expected to grow 1.8% and emerging markets 4.1%. MENA is expected to grow 2.9%. We anticipate outcomes close to those numbers, though the bias and risk (acknowledged by the IMF) has to be on the downside. Because of this very moderate growth outlook, oil prices are not expected to take off, though they should firm gradually ahead. The US Federal Reserve and other central banks should continue to err on the side of caution, if not outright continued non-conventional easing (ECB, BOJ), amidst negative interest rates on a wide swathe of sovereign issues.

Mid-year, Brexit was the huge event that injected volatility in financial markets and led to some growth revisions, hitting the UK outlook, the EU outlook, and the rest of the world, in that order. Of course, the aftermath of the Brexit vote saw markets stabilize after a few days, with the realization that the actual Brexit process, though raising many question marks, will play itself out over a period of 2-3 years, under the leadership of the new Prime Minister Theresa May. Compounding the already significant political uncertainty, markets and economies will have to contend later this year with a turbulent US presidential election (November, Clinton vs. Trump) and an Italian referendum on constitutional reforms (October). Both events have the potential to raise anew the anti-establishment anti-status quo temperature, as was done in the Brexit vote.

All the while, in advanced economies, as structural reform remains mired in semi-dysfunctional politics, and fiscal policy remains constrained by high levels of debt, the onus to keep things going and to avoid "accidents" lies with the central banks. Those continue to provide liquidity via unconventional means in many cases, liquidity that is contributing to support equity markets worldwide, as well as negative interest rates in Europe and Japan.

Currencies saw their share of action so far this year, with the dollar losing some ground against the euro before recovering after Brexit (down only 1% ytd), while the yen soared in 1H16 and was up some 14% against the dollar by mid-year. Many factors were at play, but the major one was the revised expectation from "several rate hikes by the Fed" this year to perhaps "only one" 25 bps hike. The US 10-year note yield dipped under 1.5% in July, making historic lows, and driven by a benign Fed and pervasive negative rates in most sectors of the yield curve (Japan, Germany, UK, etc.). For their part, oil prices recovered from their 1Q16 lows and averaged about $40 per barrel in 1H16 after an average of $47 in 2H15. We expect them to move above $50 later this year and to improve gradually into next year.

The new low oil price environment has forced structural reform and adjustment on many GCC countries in order to deal with this new reality. New taxes and revenues are being sought, and subsidy cuts have been enacted with more to come. Furthermore, all GCC countries are expected to post further deficits in 2016. The total GCC deficit was $132 billion in 2015 following a surplus of $33 billion in 2014. This was a deficit of 10%

of GDP, which we project to fall to 9% in 2016, and then to less than 4% in 2017, as governments address the problem. As mentioned above, all GCC countries are in the process of adjusting fiscally and have already acted. They are trying to keep the projects and infrastructure spending going in order to sustain the economy and to prepare for the future, while cautiously and gradually reducing some subsidies and benefits. GCC countries are also contemplating new revenues, a VAT tax has been widely discussed and could come in 2018 or 2019 (5%). Of course, the deficits have led to debt financing. Sovereigns have issued some $44 billion in bonds in 1H16 (gross) led by Saudi Arabia. The issuance started in the local domestic markets, but Abu Dhabi, Oman, and Qatar have already tapped the international market, and the others will follow.

In that context, we now expect real GDP growth of 2.2% and 2.6% for 2016 and 2017, almost 1% below our previous projections. Non-oil GDP should grow 3.2% and 3.7% in the two years, while oil GDP should grow a little under 1%. Liquidity, which tightened a bit since the Fed hiked rates 25 bps in December 2015, and since deficit financing became an issue, remains very manageable. Since we expect that the Fed will hike rates only once this year (25 bps), most GCC countries are liable to do the same with modest impact on their liquidity. And though the individual country performances are more or less in line with the GCC numbers discussed here, we expect Qatar, Kuwait and the UAE to be the better performers, especially when considering non-oil GDP growth. Those countries happen to be the ones with more flexibility thanks to their vast financial resources. Meanwhile, Egypt is struggling with a slowing economy as much delayed reforms and a challenging security environment take their toll. A more upbeat outlook will depend on the recent efforts by the government to revive a credible reform program and win back international investors, though the way forward remains challenging.

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