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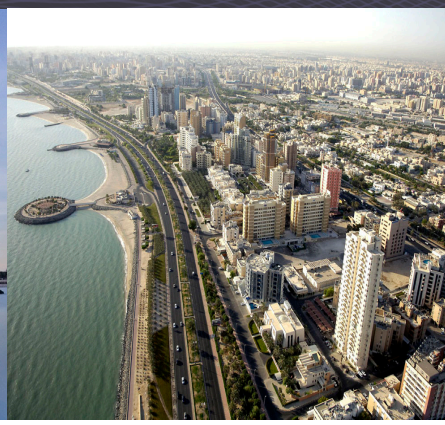
MENA Economic Outlook



3Q 2017

- GCC growth moderate but improving as austerity eases
- Reform continues to be a priority in the GCC to boost sustainability
- Oil prices remain under pressure despite extension of OPEC cuts

MENA Economic Outlook
3Q 2017

Contents

MENA outlook

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World growth steady at 3.2%; oil prices wobbly, GCC non-oil growth at 2.8%

Overview and outlook

- **Growth should be steady worldwide, in both advanced economies and emerging markets, with moderate non-oil performance by the GCC.**
- **The Fed hiked rates 25 bps in June, its second move this year; it expects one more hike this year, though markets are more cautious.**
- **Oil prices were not supported by extension of OPEC production cuts; but we still expect prices to average $55 per barrel this year.**
- **GCC countries continue to reform and rationalize their finances to cope with lower oil prices.**
- **GCC growth lower on oil production cuts, at 1.8% average for 2017-18; non-oil growth better at 2.8%, led by Qatar, UAE, Bahrain, and Kuwait.**
- **GCC fiscal deficits start shrinking in 2017; they should narrow to 5% of GDP in 2017-18, from 12% in 2016. Debt rises to finance the gap.**

It is mid-year and the world and regional growth outlooks are little changed from the start of the year. Incoming data keeps confirming this steady view. If anything, most analysts and the IMF have revised growth numbers slightly upward, especially for Europe and the MENA region. Inflation remains under control as well. One addition to this mix for the rest of this year, though, is a small rise in negative risks.

The dominant events or developments of this year are still unfolding. President Trump has taken over and is in the process of delivering on deregulation, tax reform etc. On the, perhaps bigger, questions of tax reform and infrastructure spending agenda, things are moving more slowly and could be in question, as their passage requires legislation in what is a tough contentious political environment. Nonetheless, the markets and analysts are expecting some reform to benefit the economy and help the US accelerate above 2.0% in 2018 and beyond. The Eurozone is doing relatively well, after outperforming the US in 2016. Japan is also surprising on the positive side. Both economies are poised to grow better than 1.5% this year, which may finally allow their central banks to start at least thinking about an end or reduction to their QE programs. The other large economy, China, is also doing well, expected to grow better than 6.5% this year.

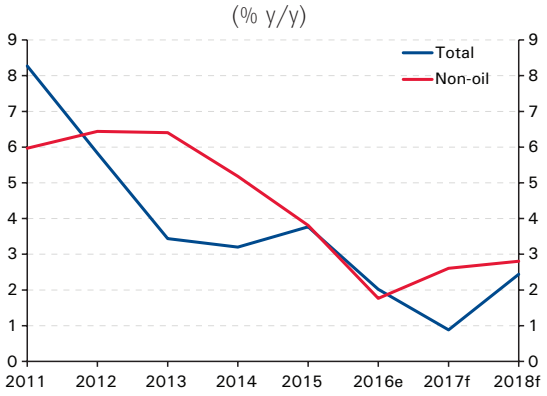
Led by these large world economies, growth is expected between 3-3.5% this year, slightly better than 3.1% in 2016, and enough to support decent, gradually rising, oil demand worldwide. The price of oil, however, is having a difficult time staying above $50 pb (Brent basis), to the dismay of OPEC and the GCC

GCC economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD tn	1.4	1.4	1.5	1.6
Real GDP	% y/y	3.8	2.0	1.1	2.4
Oil	% y/y	3.3	2.4	-1.2	2.0
Non-oil	% y/y	3.8	1.8	2.6	2.8
Inflation	% y/y	2.8	2.7	2.5	3.6
Budget balance	% of GDP	-10.4	-12.8	-6.9	-3.6

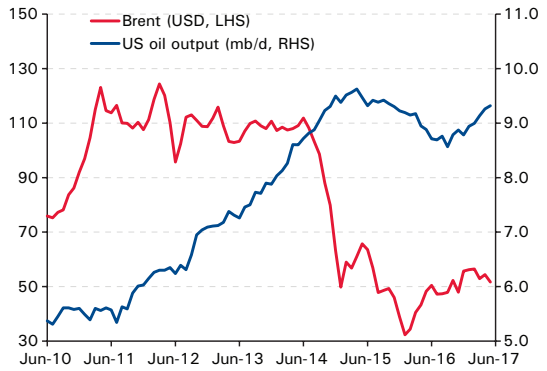
Source: National sources, NBK estimates

Chart 1: GCC real GDP



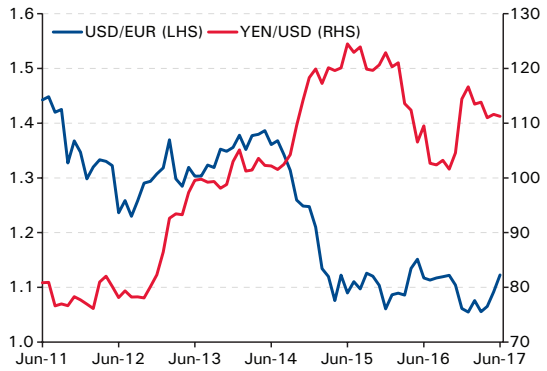
Source: National sources, NBK estimates

Chart 2: US oil production & Brent price



Source: EIA, Thomson Reuters Datastream

Chart 3: Key exchange rates



Source: Thomson Reuters Datastream

countries. OPEC and its non-OPEC partners had met with some success earlier in the year when they reduced production until June, and Brent prices averaged $53.8 in the first five months of the year. We still expect prices to recover and average $55 pb this year, notwithstanding some weakness mid-year. The OPEC announcement of an extension to the production cuts along with decent economic growth and the upcoming summer driving/travel season should slowly help the market rebalance. The rebalancing has been slow because of high inventory levels as well as rapidly rising US oil production, primarily from shale oil.

Of course, higher or "better" oil prices would come as a relief for the GCC countries. They are all expected to continue to run deficits for a while and thus to finance those via a combination of drawing down reserves and issuing debt, including international bonds. Debt issuance has been a major feature of those economies in the past few months, as many have gone to market (domestic and international) to raise debt with a good measure of success. The world is hungry for yield and good quality debt and the region definitely offers it.

The other consequence of the lower oil prices (and fiscal deficit) of late has been the need to reform fiscality via higher taxes and fees, and lower or more controlled government expenditures and benefits. These have of course contributed to slowing aggregate spending in the GCC economies and thus slowing non-oil GDP growth. On the other side of the ledger, oil growth was slowed by the OPEC production cuts. All of this is not new, and carries over from 2016. However, we do think that reforms and adjustments have taken place; though more is needed, their impact on the economies should become milder because the bulk is behind us (Saudi, UAE, Bahrain) or because countries are implementing them in a gradual studied fashion (Kuwait, Qatar)

Under our baseline, we have the GCC region growing in real terms by 1.1% this year, accelerating to 2.4% in 2018, as oil production recovers. Oil growth is expected to go from -1.6% in 2017 to 2.0% in 2018, while non-oil GDP remains less volatile, growing 2.6 and 2.8% this year and next. In most cases, the non-oil growth is coming from steady consumer growth, and sustained government capital spending, in particular in Kuwait and Qatar. We expect non-oil growth in Kuwait at 3.5% and 4.0% in 2017 and 2018. Qatar should lead with non-oil growth of 5.3% and 5.0%; however, the current diplomatic crisis could shave some of that growth. Saudi Arabia, the largest GCC economy is the one weighing on the aggregates, as it should grow by a modest 1.1% and 1.0%, held back by deeper reforms and spending cuts than the others. As mentioned earlier, all should continue to issue debt, which should be well received given the strong fiscal position in most cases. The issuance is helping with the liquidity situation, especially foreign issuance, and the authorities are chipping in when liquidity is being squeezed. Finally, the Fed raised rates in June (25 bps) and is signaling one further move this year (perhaps December); we are a bit more cautious on that front as are the markets, in part because of very tame inflation, but also as we need to see major policy decisions unfold (from Brexit negotiations to Trump's economic agenda).

Bahrain outlook

Non-oil sector continues to showcase resilience

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Overview and outlook

- **Resilience in non-oil economy expected to continue to support overall GDP growth in 2017.**
- **GCC investments set to catalyze non-oil sector activity, particularly in the construction sector.**
- **Inflation to remain subdued in the near-to-medium term.**
- **The budget deficit is poised to remain large at around 15% of GDP in 2017 on counter-cyclical spending levels.**
- **Liquidity conditions in the banking sector are forecast to improve as deposit growth gradually recovers.**

Real economy to be supported by healthy gains in the non-oil sector

Economic growth is projected to continue to gradually edge higher in 2017 thanks to a healthy pace of non-oil sector growth. Growth in real GDP is expected to rise from an estimated 3.0% in 2016 to 3.4% in 2017 (Chart 1). Whilst growth in real oil GDP is poised to come in unchanged in 2017 on the back of steady oil production levels, non-oil sector growth is forecast to continue to gather pace amid increases in investment levels, particularly in the construction sector.

According to the latest data from Bahrain's Economic Development Board (EDB), real GDP growth held steady at 3.0% year-on-year (y/y) in 2016, as the non-oil sector maintained its healthy growth pace and offset the weakness in the oil economy. (Chart 2.) Growth in real non-oil GDP held firm at 3.7% y/y in 2016. In contrast, real oil activity fell by 0.1% y/y during the same period.

Bahrain's non-oil economy is envisaged to remain the main driver of growth in 2017, thanks to the faster than expected utilization of GCC grants, which has in turn helped prop up investment. The GCC pledged $10 billion in investment over ten years and Bahrain has allocated these funds to infrastructure and housing developments.

Inflation set to remain subdued in 2017 before picking up in 2018

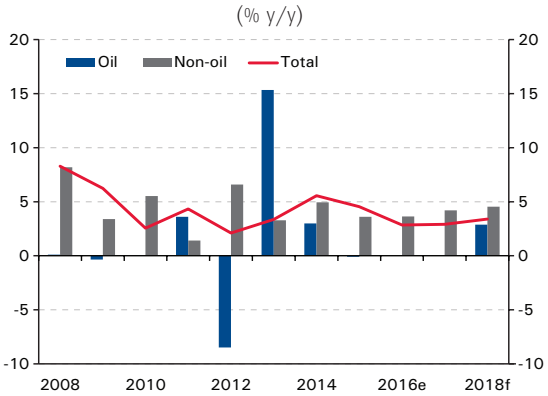
Inflation in the consumer price index (CPI) softened in the first quarter of 2017 as food prices continued to decline and housing inflation weakened. (Chart 3.) In March, it came in at a weak 0.8% y/y after food prices fell by

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	32	32	35	38
Real GDP	% y/y	2.9	3.0	3.4	4.2
- Oil	% y/y	-0.9	-0.1	0.0	2.9
- Non-oil	% y/y	3.6	3.7	4.2	4.5
Inflation	% y/y	1.8	2.8	2.5	3.0
Budget balance	% of GDP	-16.1	-18.0	-15.0	-12.6

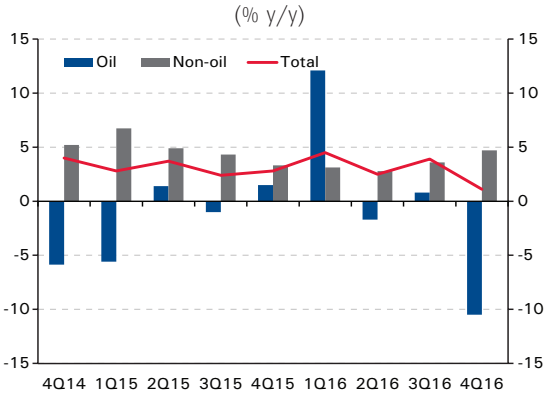
Source: Official source, NBK estimates

Chart 1: Annual real GDP



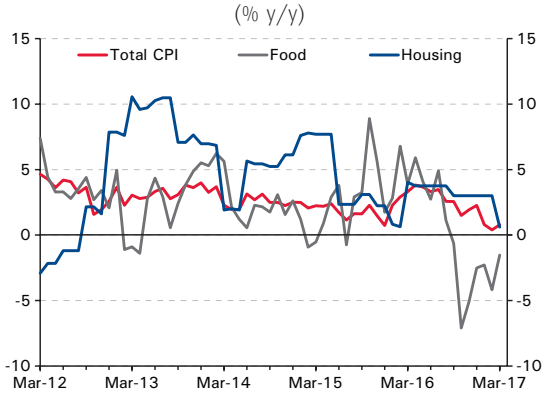
Source: Information & e-Government Authority, NBK estimates

Chart 2: Quarterly real GDP



Source: Bahrain Economic Development Board

Chart 3: Consumer price inflation by sector



Source: Thomson Reuters Datastream

1.5% y/y and housing inflation retreated to a multi-month low of 0.6% y/y.

We expect inflation to edge up, albeit modestly, in the near-to-medium term as rising activity in the non-oil sector partly offset any further hikes in the key policy rate. As a result, we expect the annual average to slightly come off the 2.8% annual average seen in 2016 to settle at or around 2.5% in 2017. In 2018, headline inflation is expected to see greater upward pressures, on the back of more solid gains in growth and especially if Bahrain becomes one of the first GCC nations to introduce a 5% value-added tax (VAT).

Budget deficit to narrow but remain high in 2017

Despite sizable fiscal consolidation measures, Bahrain is still forecast to log in 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 fairly strong, the budget deficit is forecast to narrow slightly from roughly 18% of GDP in 2016 to around 15% of GDP in 2018 (Chart 4).

Bahrain remains determined to exercise more prudent fiscal policy measures in line with the IMF's recommendations, in an effort to lower its public deficit and in turn make it more attractive in the eyes of investors. Fiscal reform has been centered on rationalizing subsidies. Meanwhile, public spending on infrastructure and development projects has remained untouched, as it is seen as an important driver of non-oil sector activity and a counterweight to the ongoing weakness in the oil economy.

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

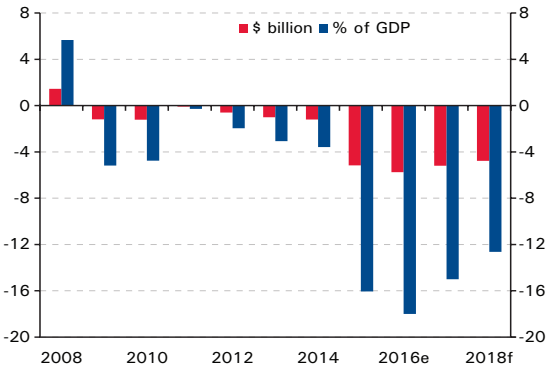
With the budget deficit expected to hover at stubbornly high levels, the nation is likely to continue to turn to domestic and international bond markets to plug its deficit. In 2015, Bahrain issued a total of $6 billion in bonds, $1.5 billion of which was in the international market. In 2016, the government issued $3.4 billion in bonds, $2 billion of which was issued internationally. As a result, public debt has edged higher and currently stands between 70-80% of GDP.

Fiscal deficit and debt concerns have led to a series of downgrades of the nation's long-term credit rating. In June 2016, 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 that same year, S&P lowered Bahrain's sovereign credit rating from BB to BB-, deeper into non-investment grade territory. The downgrades will make it more difficult for the government to negotiate better bond deals.

Lending activity to be supported by strength in non-oil sector

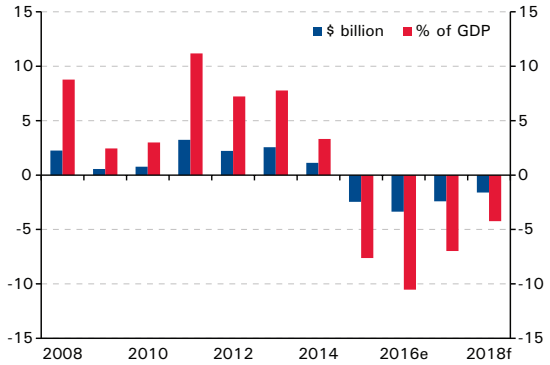
Growth in private sector borrowing decelerated sharply in recent months. In January, data from the CBB showed private sector claims falling for the first time in years. However, growth in this segment appears to have recovered in March, after it rebounded and came in at, albeit a still soft, 0.6% y/y. (Chart 6.) Whilst growth in private sector claims is expected to remain subdued in the first half of 2017, especially after the CBB took the decision to hike rates again by 25 bps in tandem with the US Fed in March (Chart 10), we expect growth in these claims to recover soon after, as higher oil prices act as a boon to consumer confidence and as credit demand in the non-oil sector, particularly in the construction sector, picks up.

Chart 4: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates

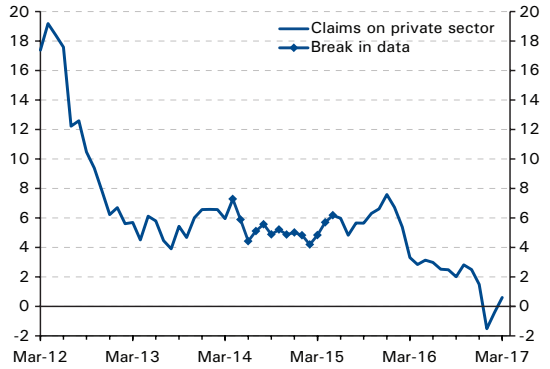
Chart 5: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 6: Private sector claims

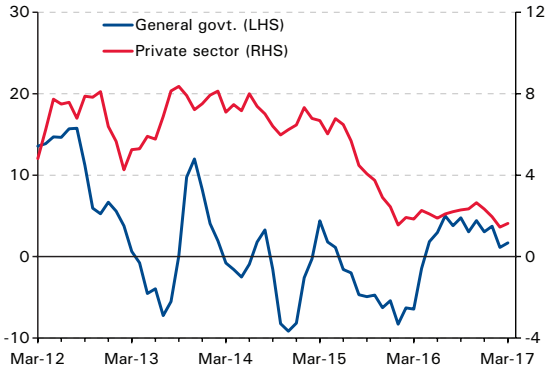
(% y/y)



Source: Thomson Reuters Datastream

Chart 7: Deposits

(3-month moving average, % y/y)



Source: Thomson Reuters Datastream

Total deposit growth is gradually gathering traction as higher oil revenues help prop up government deposit growth (Chart 7.) This should help ease liquidity constraints in the banking system. According to the latest data, growth in government deposits rose from 1.1% y/y in February to 1.7% y/y in March. Growth in private sector deposits is also witnessing a recovery, albeit a tepid one. In March it came in at 1.6% y/y, still far lower than the rates seen prior to mid-2015.

Growth in the broad money supply (M2) continues to struggle to eke out healthy gains. In March it slipped to 1.5% y/y from 1.4% y/y in the previous month. The tepid growth in money supply has subsequently continued to push interbank rates to multi-year highs (Chart 8).

Bahrain's interbank rates continue to trend upwards. The one-month and three-month rates leapt in the aftermath of the 25 bps policy rate hikes in December, March and June, following similar hikes in the US federal funds rate. (Chart 10.) As of mid-June, they were up 60 bps and 33 bps year-to-date (ytd), respectively (Chart 9). With liquidity constraints set to ease in the near-to-medium term, we should see interbank rates gradually come off their multi-year highs.

Bank assets continue to see sluggish growth. Total commercial bank assets remained in decline in March after falling by 2.0% y/y mainly due to the ongoing decline in wholesale bank assets. (Charts 11 and 12.) These assets, which make up around 60% of total banks assets (as of 2016), contracted by 4.3% y/y during the same period. Asset growth among the more domestically-centered retail banks has also remained fairly subdued. In March it stood at 0.9% y/y.

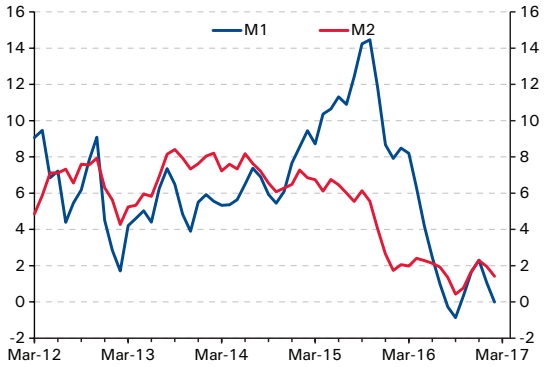
Bahrain stock market rallied in the first quarter of 2017

Bahrain's All Share Index was bouyed by better investor sentiment in early 2017, mainly thanks to positive corporate earnings. However, the rally subsided somewhat in 2Q17. (Chart 13.)

Whilst business optimisim remains vulnerable to internal political concerns, these concerns have largely subsided as reflected in the main credit default swap (CDS). The CDS, a good bellwether of the market's perception of a country's level of risk, has been trending lower. As of end of May, the CDS on five-year Bahrain debt was at 215 bps, considerably lower than the 354 bps around the same period last year. (Chart 14.)

Chart 8: Money supply

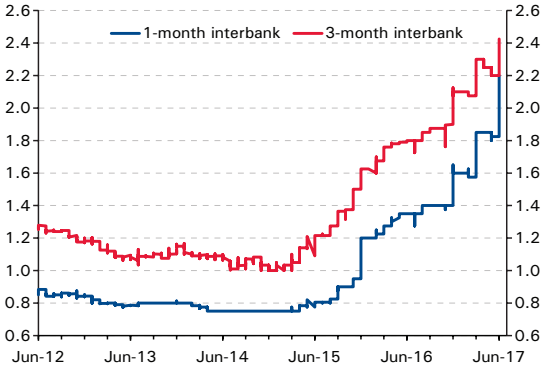
(3-month moving average, % y/y)



Source: Thomson Reuters Datastream

Chart 9: Interbank rates

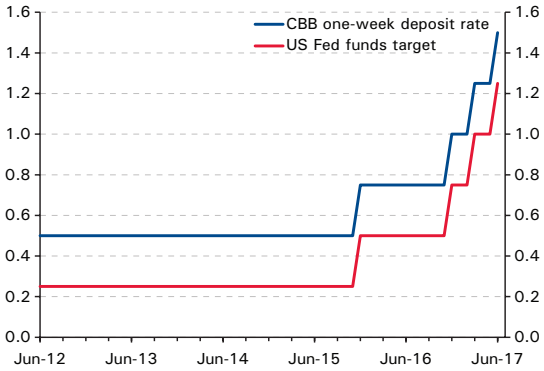
(%)



Source: Thomson Reuters Datastream

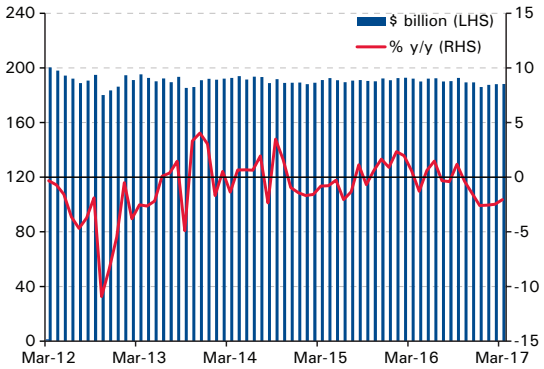
Chart 10: Policy rates

(%)



Source: Thomson Reuters Datastream

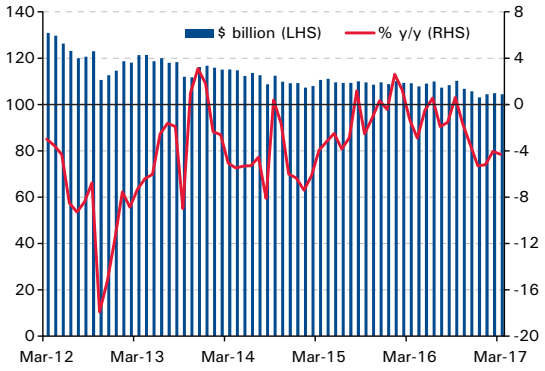
Chart 11: Commercial bank assets



Source: Central Bank of Kuwait

Chart 12: Wholesale bank assets

(3-month moving average, % y/y)



Source: Central Bank of Bahrain

Chart 13: Stock market index

(all share index)

Source: Thomson Reuters Datastream

Chart 14: 5-year credit default swap

(basis points)

Source: Thomson Reuters Datastream

Kuwait outlook

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Non-oil activity maintains solid growth amid mild fiscal adjustment

Overview and outlook

- **Non-oil GDP growth expected at 3.5-4% in 2017 and 2018 with strong projects implementation offsetting a moderating consumer sector.**
- **Fiscal deficit to narrow in 2017 and 2018 based on fiscal adjustment and improvement in the price of oil.**
- **Fiscal reforms move ahead, but large fiscal buffers support a more gradual approach to reducing the deficit.**
- **Credit growth remains robust, reflecting healthy economic growth and ample banking sector liquidity.**
- **Stock market rallied in 1Q17 but appears to be in a lull since.**

Non-oil activity has remained resilient since oil prices began retreating in 2014, thanks in large part to a strong projects pipeline and relatively limited fiscal adjustment. We expect non-oil growth to improve slightly to 3.5-4% in 2017 and 2018 (Chart 1). Inflation is also expected to remain largely in check as pressures from housing rent ease, and despite some upward pressures from subsidy cuts. Meanwhile, the fiscal deficit should narrow in 2017 and 2018 as oil prices improve and some additional fiscal adjustment is implemented.

Despite healthy non-oil activity, overall GDP growth is expected to take a hit in 2017 as Kuwait continues to apply cuts to crude oil production agreed upon in conjunction with other OPEC members. Those cuts, which are aimed at supporting oil prices, are expected to reduce Kuwait's average crude output by 4-5% in 2017. Overall GDP is likely to shrink by around 0.7% in 2017, before returning to positive growth of 3.2% in 2018 (Chart 1).

Government project activity remains healthy

Capital spending has increasingly been driving non-oil economic activity, with the implementation pace holding up relatively well after a clear pick up in 2014. Project awards were healthy in 1Q17 at KD 1.4 billion according to MEED Projects (Chart 5). The figure is similar to the quarterly average in 2016. Another KD 6.2 billion in projects are in the bidding stage and could be awarded in 2017. The projects pipeline remains solid, given the government's commitment to its development plan.

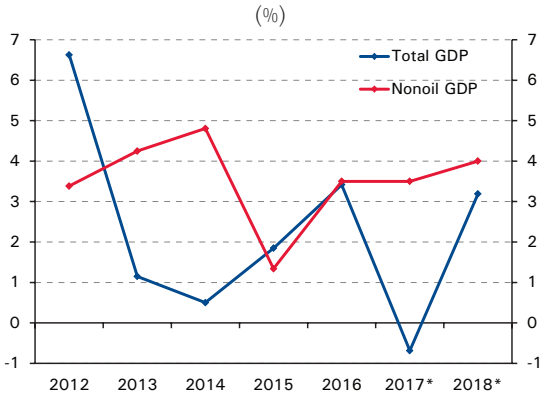
The government remains committed to an ambitious capital spending program. Indeed, the Kuwait National Development Plan (KNDP) was re-launched in 1Q17 under the "New Kuwait" slogan. The plan, also

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	KD bn	34.3	33.5	37.8	41.2
Nominal GDP	USD bn	114	111	124	135
Real GDP growth	% y/y	1.8	3.4	-0.7	3.2
- Oil	% y/y	-1.7	3.3	-4.5	2.4
- Non-oil	% y/y	1.3	3.5	3.5	4.0
Inflation	% y/y	3.3	3.2	3.0	3.5
Budget balance*	% of GDP	-17.4	-18.7	-13.8	-12.0

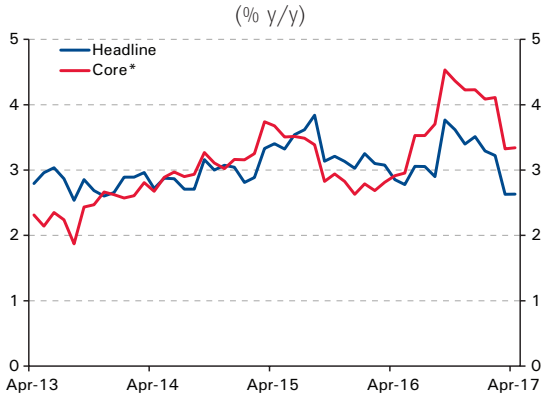
Source: CBK, MOF, CSB, NBK estimates; *after FGF

Chart 1: Real GDP growth



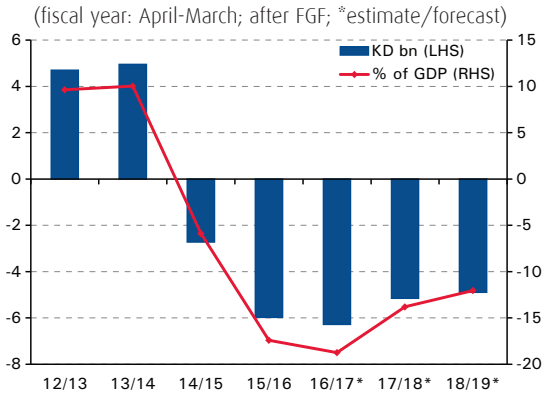
Source: Central Statistical Bureau, NBK estimates; *estimate/forecast

Chart 2: Consumer price inflation



Source: Central Statistical Bureau; *estimated by NBK

Chart 3: Budget balance



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

dubbed Kuwait Vision 2035, seeks to transform the country into a financial, cultural and trade leader. The plan brings together a number of ongoing initiatives into a renewed and more comprehensive vision for the country's development, which includes structural and fiscal reforms as well as capital spending plans.

The KNDP targets investment of KD 34 billion through 2020, about a third of which will come from the private sector. A number of schemes are being implemented as public-private partnership projects (PPP), including the Al-Zour North and Khairan integrated power generation and water desalination projects.

As a result of the infrastructure investment push, aggregate investment is expected to continue to see healthy growth. Expenditures on gross capital formation grew by 13% in 2015 and could see real growth of 8-9% on average in 2017 and 2018. This could further push up the share of investment in the economy to 23%, the highest level recorded in over 20 years, and up from 19% in 2015.

Consumer sector has slowed but remains a source of growth

The consumer 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 the economy. The sector continues to be supported by steady growth in employment and salaries, particularly in the government sector and among Kuwaiti households.

Consumer spending continued to moderate in 1Q17, but maintained a decent pace. The value of point-of-sale transactions grew by 7.1% y/y; while slower than the double-digit growth rates recorded in previous years, the pace held up relatively well thanks to steady growth in employment and wages (Chart 6). Household borrowing also moderated over the last year; growth in consumer debt eased to 6.7% y/y in March 2017 (Chart 7).

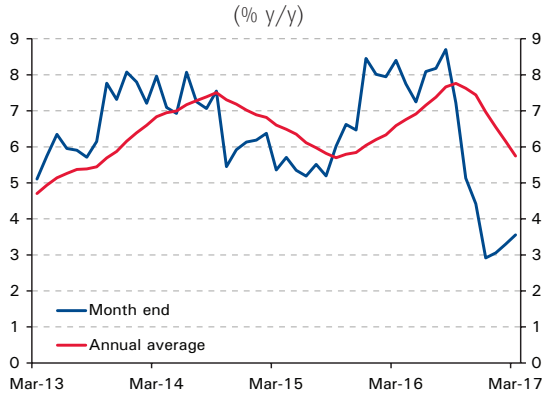
Most of the weakness in the sector has come from lower consumer confidence. Ara's index has been on a declining trend for over four years. It fell more rapidly in 2016 after the government hiked fuel prices and while it has since recovered somewhat from those levels, it remains relatively subdued (Chart 8). The index stood at 104 in April, surpassing the 100 mark for the first time in nine months.

Employment growth among Kuwaiti nationals remains relatively healthy. While there has been a slowdown in private employment, this is due to the clampdown on "phantom employment", which has resulted in a drop in reported employment numbers since mid-2015. However, employment of nationals in the public sector continued to see robust growth of around 3.5% in 2016. Meanwhile, expatriate employment maintained healthy growth of 5.6%.

Credit growth has remained healthy

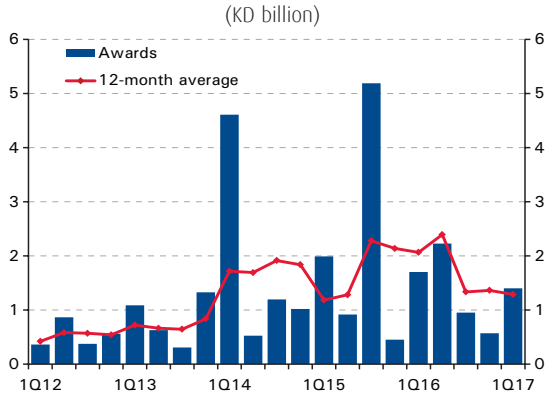
Credit growth has remained relatively healthy boosted by the resilience of non-oil GDP and the pace of capital spending, though a large corporate repayment in 4Q16 has distorted the figures (Chart 4). Credit growth in March stood at 3.6% y/y. Gains were seen across a number of sectors led by "oil & gas". Growth in "productive" sectors (excluding real estate and securities lending) accelerated to a robust 9.6% y/y reflecting progress in Kuwait's projects pipeline.

Chart 4: Private credit growth



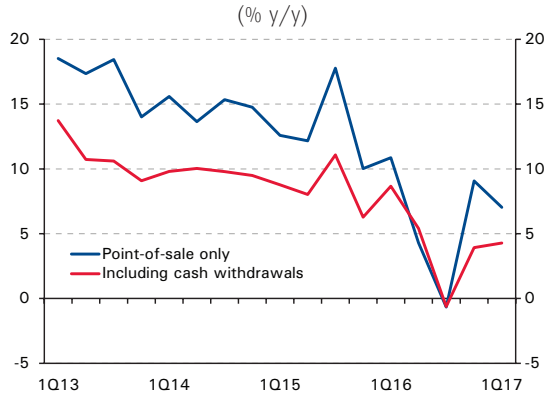
Source: Central Bank of Kuwait

Chart 5: Project awards



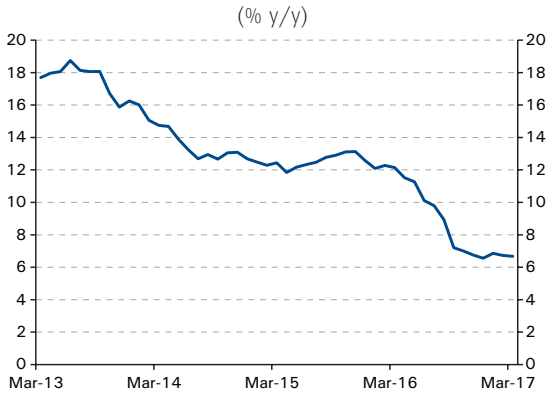
Source: MEED Projects

Chart 6: Card transactions



Source: Central Bank of Kuwait

Chart 7: Household debt growth



Source: Central Bank of Kuwait

Real estate prices appear to stabilize after orderly correction

Activity in the real estate market continued to decline year-on-year for the third consecutive year, but there are some early signs of stabilization. Sales during the 12 months through April 2017 were off by 22% y/y (Chart 9). Most of the recent weakness has come from the investment and commercial sectors. Meanwhile, activity in the residential sector has been improving. The number of transactions in the sector during the three months through April 2017 was up 22% y/y.

Prices have also been showing signs of stabilizing, as reflected in NBK's real estate price indices. Prices experienced an orderly correction during the last two years of around 18-20% from the highs in the residential and investment sectors. However, since the middle of 2016, NBK's price indices indicate that real estate values have been holding (Chart 10).

Inflation rose following the rise in fuel prices, but has since eased

Inflation eased in recent months after impact of the September 2016 hike in fuel prices faded and growth in housing rent began to moderate. Inflation eased to 2.6% y/y in March compared to its peak at 3.8% y/y in September 2016 (Chart 2). Declining housing inflation was a welcome development, and comes after four years of accelerating price growth in the sector. Weakness in the real estate market no doubt began to makes itself felt. Rent inflation went from a recent high of 7.3% y/y in mid-2016 to 4.3% this past March.

Fiscal deficits will persist, but to remain manageable

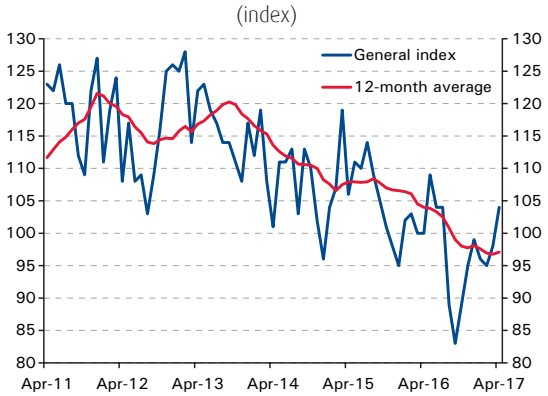
While oil prices have improved over the last year (Chart 11), the Ministry of Finance is expected to continue to register a deficit in the medium-term. With the price of oil expected to stay around $55-60 per barrel in 2017 and 2018, a deficit of 19% of GDP is expected in FY16/17 (Chart 3), after the mandatory allocation to the Future Generations Fund (FGF). The deficit is likely to narrow to around 14% of GDP in FY17/18 and to 12% in FY18/19 as oil prices improve and additional fiscal reforms are implemented.

Since oil prices began to decline in 2014, the government has taken a number of steps towards fiscal adjustment. A package of fiscal reforms was approved by the cabinet a year ago, including energy and water subsidy cuts, and the introduction of a corporate income tax and a value added tax (VAT). The National Assembly (NA) approved increases in electricity and water tariffs beginning in 2017. New taxes, including the VAT, are unlikely before 2019. We estimate that these reforms will reduce the deficit by around 5-6% of GDP by 2020, excluding the impact of higher oil prices.

The government reduced government spending by around 15% in FY15/16. Government spending is likely to have returned to positive growth in FY16/17. Spending during the first eight months of FY16/17 was above expectations at 98% of the pro-rated budget, indicating growth of 1.5%. The FY17/18 draft budget, which awaits National Assembly approval, projects expenditure growth of 5.3%; we think it will be slightly lower at around 4%.

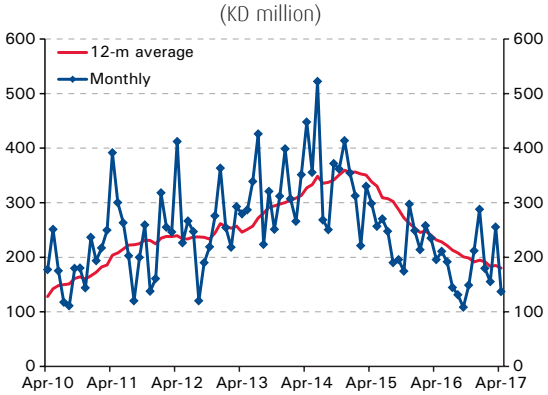
In March 2017, the government approved increases in electricity and water tariffs that were significantly lower than those mandated in legislation passed in May 2016. The subsidy cuts, to be introduced this year, will increase the electricity rates to 3-5 fils per kilowatt-hour (kWh) for the various sectors from the current 2 fils. Water tariffs will rise to KD 2 per 1,000 imperial gallons from the current KD 0.8. We estimate that the revenue increase from the new utility prices will be around KD 0.2 billion or 0.6% of GDP.

Chart 8: Consumer confidence index



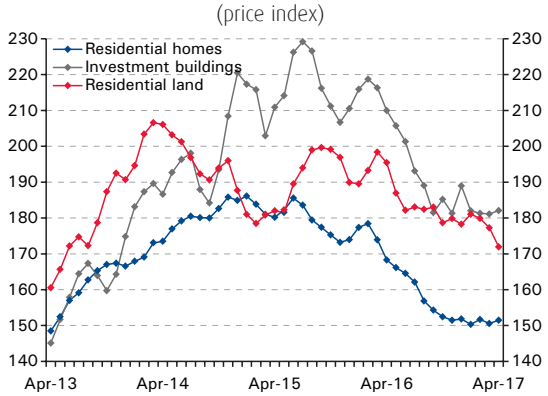
Source: ARA Research & Consultancy

Chart 9: Real estate sales



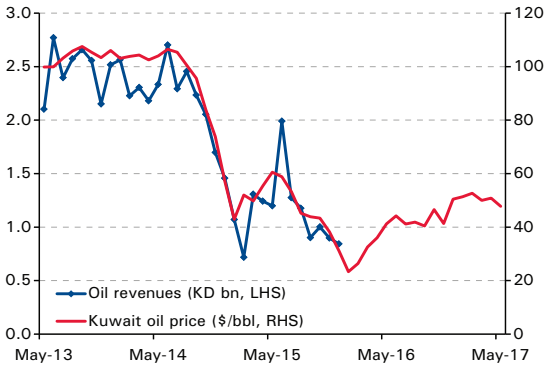
Source: Ministry of Justice

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

Sovereign wealth fund remains substantial

Kuwait continues to enjoy a relatively comfortable fiscal position thanks to a low breakeven oil price and substantial overseas assets. Sovereign wealth fund assets at the end of FY16/17 are estimated to be near $560 billion or 450% of GDP. While the bulk of the assets is in the Future Generations Fund (FGF), the General Reserve Fund (GRF), whose holdings are mostly liquid, is the one available to finance the deficit; holdings in the GRF are thought to be around KD 30 billion.

Government tapped domestic and international bonds in FY16/17

Despite a substantial sovereign wealth fund, debt issuance has been key to deficit financing. We estimate the government needed to finance around KD 6.3 billion in FY16/17 after the mandatory payment into the Future Generations Fund (FGF). Another KD 5 billion a year will be required to finance deficits in FY17/18 and FY18/19.

During FY16/17, the government issued KD 2.2 billion in debt domestically and another KD 2.4 billion ($8 billion) internationally, increasing the debt to KD 6.3 billion or 18% of GDP by the end of March 2017. Sources indicate that the Ministry of Finance could tap the domestic debt market for around KD 1 billion in FY17/18 to finance a deficit that we expect to be around KD 5 billion. This would increase the public debt to around 20% of GDP by March 2018.

Kuwait issued its first international bond, raising $8 billion at a pricing more attractive than other GCC sovereigns. Two tranches were offered, with a $3.5 billion 5-year tranche at 75 basis points (bps) over equivalent US Treasuries and a $4.5 billion 10-year tranche at 100 bps over Treasuries. The spread was below Abu Dhabi's, which until now had been considered the "gold standard" in the GCC. In the secondary market, yields on the bonds have tightened somewhat since. The pricing reflected Kuwait's solid credit rating (Moody's: Aa2, S&P: AA, Fitch: AA) and strong international appetite for GCC debt.

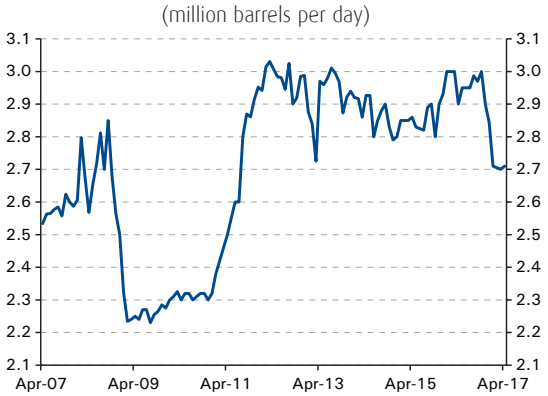
The press published details of a proposed law to double Kuwait's sovereign borrowing ceiling to KD 20 billion. The law, which should replace one expiring this fall, would also permit the state to issue longer term debt (up to 30 years from the current 10 years).

Domestic liquidity still comfortable despite some tightening

Kuwait continues to enjoy a healthy level of domestic liquidity despite the decline in oil prices. Limited fiscal adjustment and an effort to repatriate government funds have helped Kuwait avoid a liquidity squeeze similar to some of its GCC neighbors. Money supply (M2) growth has remained relatively steady at 2.7% y/y through March 2017, though it is down from double-digit growth seen before 2014 (Chart 13). Money supply (M2) to non-oil GDP was around 142% in March (Chart 15), only slightly lower than its five-year average.

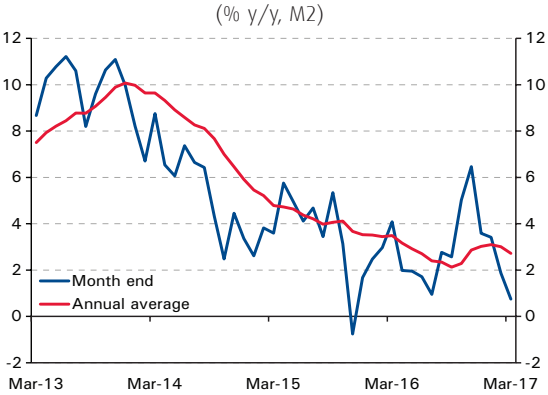
After retreating during most of 2016, domestic interbank rates have risen since the end of 2016. This was largely due to two policy rate hikes by the Central Bank of Kuwait (CBK) in December 2016 and March 2017, each by 25 bps; the discount rate now stands at 2.75%. Both hikes followed similar moves by the US Federal Reserve. Still, interbank rates did not see as large an increase. The 3-month KD interbank rate rose by only 25 bps from its low in December to 1.625%, just before the first rate hike (Chart 17).

Chart 12: Crude oil production



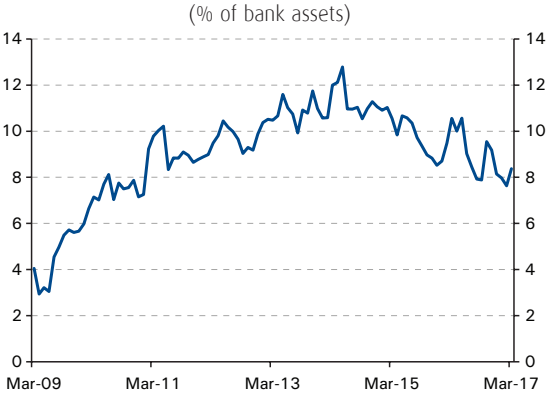
Source: OPEC

Chart 13: Money supply growth



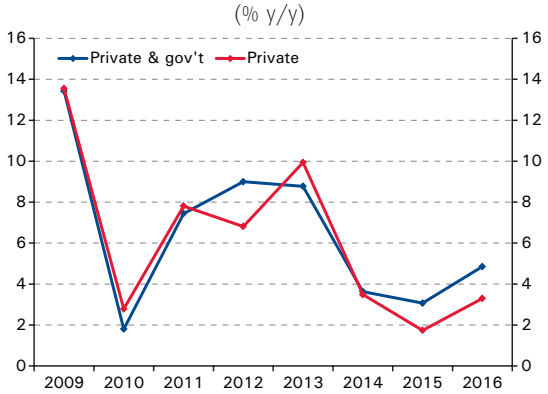
Source: Central Bank of Kuwait

Chart 14: Banks' liquid reserves



Source: Central Bank of Kuwait

Chart 15: Deposit growth



Source: Central Bank of Kuwait

Current account recorded its first deficit since liberation

The current account recorded its first deficit in over two decades in 2016, on the back of a decline in export earnings linked to lower oil prices. The current account balance registered a deficit of 4.5% of GDP compared to a 3.5% surplus in 2015 (Chart 16). To finance the deficit, there was a drawdown of liquid government assets held overseas, which resulted in the first net inflow of assets since the early 1990s. We expect the current account to return to registering a surplus of 1-2% of GDP in 2017.

Dinar has weakened thus far in 2017 on dollar retreat

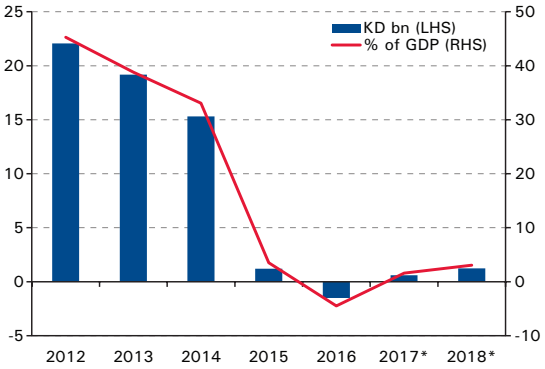
Following another strong 2016, the Kuwaiti dinar (KWD) retreated somewhat during the first five months of 2017, as the US dollar gave back some of its strong gains. The dinar index, which reflects the trade-weighted value of the currency, was off by 3.0% year-to-date (ytd) through May, reversing the entire increase seen in 2016. The trade-weighted Kuwaiti currency had seen three consecutive years of strength, gaining around 3% a year in 2014-2016. The dinar, which is pegged to a basket of major currencies with the USD having the largest weight, has increased by 0.7% against the US currency since the start of this year (Chart 18).

The 2017 rally awaits further catalysts

An equities rally in late 2016 and early 2017, after years lagging regional markets, appears to have taken a rest. In five months through January 2017, Boursa Kuwait's value-weighted index (IXW) rose 22% (Chart 19). Activity also picked up noticeably, with the daily average value of shares traded peaking in January at KD 54 million, nearly nine times what was recorded in September 2016. The weighted index has since retreated by around 5.5%. While activity has also cooled, it remains relatively elevated. The MSCI total return index is still up 8.8% ytd.

Chart 16: Current account balance

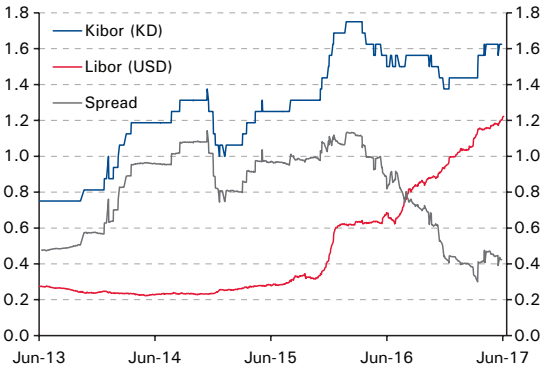
(*estimate/forecast)



Source: Central Statistical Bureau, NBK estimates

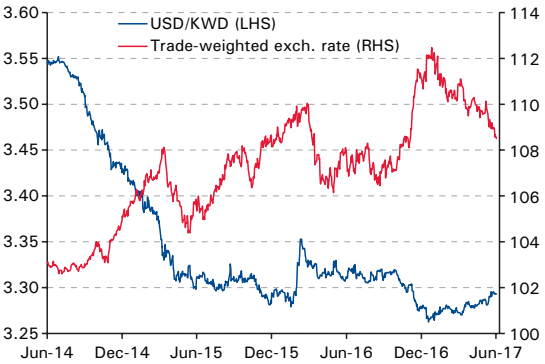
Chart 17: Interbank rates

(%, 3-month)



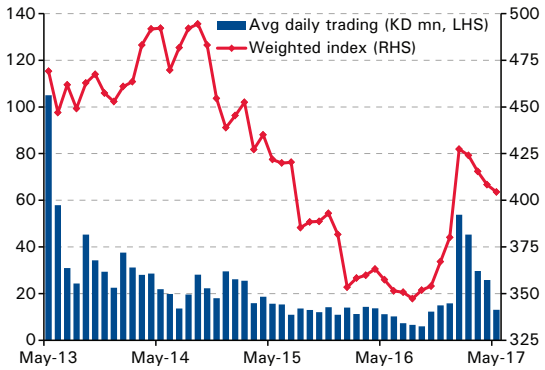
Source: Central Bank of Kuwait, Thomson Reuters Datastream

Chart 18: Exchange rate



Source: JP Morgan, Thomson Reuters Datastream

Chart 19: Stock market



Source: Boursa Kuwait, Thomson Reuters Datastream

Oman outlook

Non-oil weakness to persist through 2018 on fiscal reform

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Overview and outlook

- **Our forecast remains unchanged with real GDP growth weakening to 0.1 % in 2017, before picking up to 2.2% in 2018.**
- **Fiscal deficit expected to shrink to 13% of GDP in 2017 and 8% in 2018.**
- **Inflation seen pressured upwards through 2017 and 2018.**

The economy is still expected to slow on the back of fiscal tightening. Consumer confidence is weakening, government projects are being pushed forward and market conditions have turned bearish as tax reform weighs on the short-term outlook. The persistence of low oil prices is projected to produce substantial deficits through 2018, increasing the urgency for fiscal consolidation.

The government sought to rein in spending and increase revenue collection in 2015 and 2016, though these efforts did little to dent the growing deficits. Additional measures targeting excessive spending and better revenue collection are to be introduced in 2017 and 2018. The government overhauled its corporate income tax law in 1Q17 and is poised to implement a valued-added tax in 2018. However, these steps are 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 bond issuances by the government.

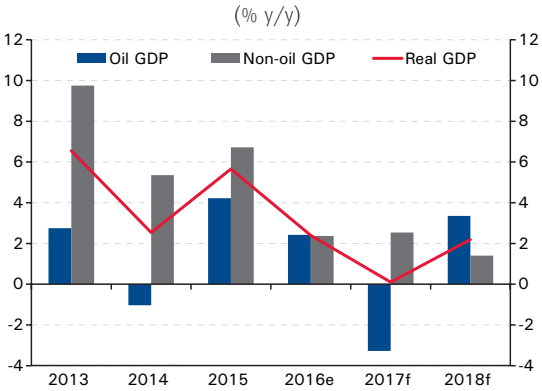
At the same time, the government has been pushing structural reform and improving trade relations, which should support growth in the medium to long-term. Recent government efforts show resolve in divesting away from the public sector. Reforms supporting small and medium-sized enterprises and foreign investors seek 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.

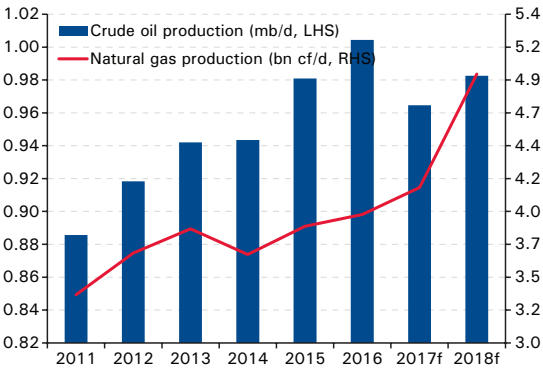
Preliminary 2016 nominal GDP numbers indicate that activity in the sultanate has slowed, with growth contracting by 5.1% , pulled down by

Chart 1: Real GDP



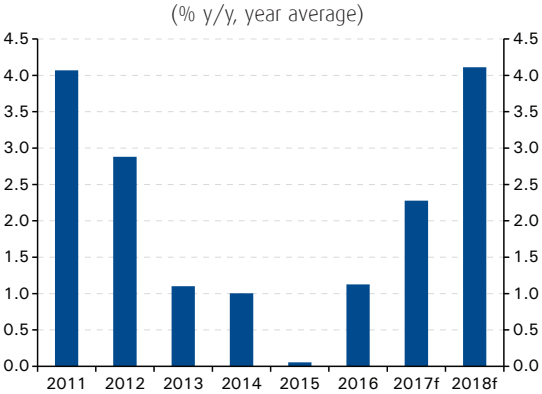
Source: National Center for Statistics and Information, NBK estimates

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

Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	70	66	69	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	1.1	2.3	4.1
Budget balance	% of GDP	-17.3	-20.4	-13.1	-8.0

Source: National Center for Statistics and Information, NBK estimates

the underperformance of petroleum activities (down 24%) and stagnant non-petroleum growth.

The slowdown is corroborated by the significant drop in consumer confidence, which registered at 78.8 in December 2016, down from 95.3 a year prior, according to the National Center for Statistics and Information.

Various other indicators also confirmed the weakness in economic activity. Car registrations slowed for a second year in a row, with the total number of registrations down 6% in 2016. Hotel revenue was down 6% for all of 2016, while the total number of real estate transactions plummeted 14% over the same period.

Early 2017 readings for most of these indicators are also showing continued weakness. This is best reflected by the pace of private sector hiring, where the employment of expats (which account for almost 90% of private sector employees) slowed to 6% in April 2017, from an average of 10% in 2016.

Real GDP growth is expected to come in at 2.4% in 2016, as the weakness in both consumer and market activity is offset by the pick-up in oil production. However, this will not carry through into 2017 due to planned oil production cuts in accordance with the OPEC/non-OPEC agreement. Growth in 2017 will also suffer from a thriftier government and early implementation of some tax reforms. For these reasons, real GDP growth in 2017 is forecast to come in flat, at an estimated 0.1%.

Increased revenue from a new VAT and recovering oil prices may see government investment spending pick up in 2018, with growth further lifted by the launch of the BP Khazzan tight gas project. 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 held back by lower oil prices, posing a drag on the non-oil economy. Private and public investment spending dried up in 2016. A friendlier foreign investment law and stronger focus on tourism and other sectors may help boost non-oil activity going forward. Nonetheless, 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

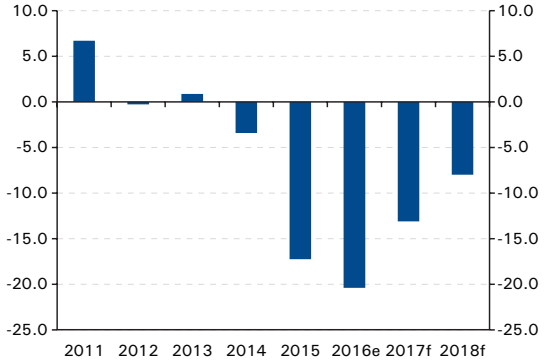
With current and expected oil prices well below the sultanate's estimated breakeven price, Oman's coffers are expected to remain under duress, with substantial deficits to be potentially registered for 2017, before recovering in 2018.

In 2016, Oman recorded a preliminary deficit of OMR 5.2 billion, overshooting the government's expectation of OMR 3.3 billion deficit, on the back of disappointing spending cuts.

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. (Note: increases from a proposed corporate income tax reform and excise taxes were not budgeted.) 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

Chart 4: Budget balance

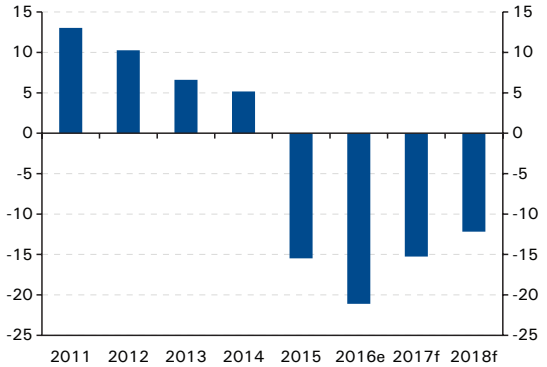
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

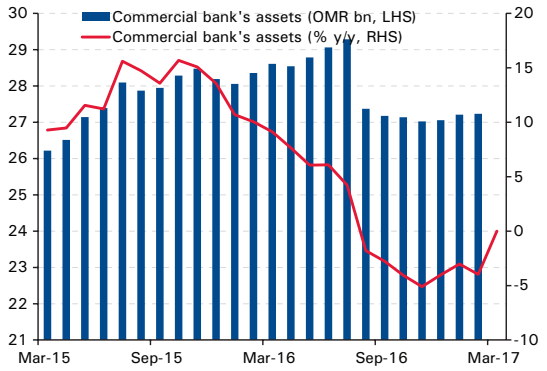
Chart 5: Current account balance

(% 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

public resistance. Indeed, domestic gasoline prices were moved back to a fixed pricing mechanism following protest earlier in the year.

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 and tax revenue, but will do little to limit expenditure growth. As such, we project a slightly larger deficit than the government's, at around OMR 3.5 billion, or 13% 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 8% of GDP in 2018.

In view of the low oil price environment, the government has adopted several measures to rein in their finances, such as fuel hikes, increases in government fees, 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. These efforts are being augmented by the overhaul of the corporate income tax (1Q17), as well as the implementation of an excise tax (2H17). Oman is also well into developing the framework that will facilitate the implementation of a VAT in early 2018.

Oman successfully raised $5 billion from international debt markets in March to finance its 2017 deficit, facilitated by its then investment grade rating. Concern over its fiscal sustainability, however, saw S&P move Oman into junk, yet both Moody's and Fitch still have the sovereign rated as investment grade, albeit with a negative outlook. In a bid to avoid borrowing at higher rates later in the year, Oman hastily issued a $2 billion sukuk in May. Oman's debt level remains low relative to its peers, though it is expected to have risen to around 30% of GDP at the end of 2016; it is seen rising further to 42% and 47% by the end of 2017 and 2018, respectively.

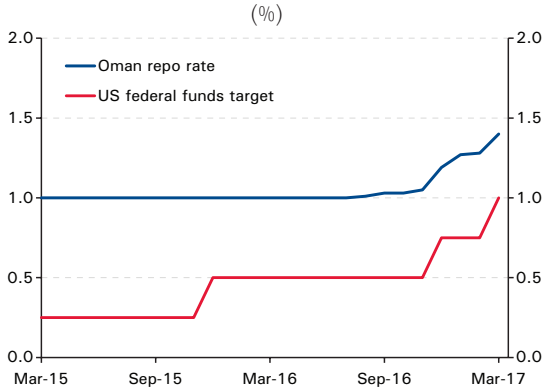
Oil & gas sector to pick up on gas production boost

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 oil production cuts agreed to by OPEC and non-OPEC countries. 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 oil output in 2018.

However, the launch of the BP Khazzan tight gas project in 2018 will see Oman's gas sector witness a strong boost as daily production capacity is increased by 1 billion cubic feet. Gas output is not affected by the OPEC agreement which only covers crude oil output. 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.

Chart 8: Policy rates



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

Source: Muscat Securities Market

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, supported by the government's international borrowing program. Government deposits were up 4% y/y in March 2017.

Credit growth 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 March 2017, private credit growth has eased to 6.3% y/y from an average 10% in 2016.

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 March US Fed rate hike. However, the CBO has been raising its overnight repurchase rate. It registered at 1.40% as of mid-March 2017.

Oman's financial sector remains well capitalized. According to the CBO's latest quarterly financial soundness statistics (September 2016), credit risk remains low in Oman with nonperforming loans (NPL) slightly higher at 2.1% of gross loans. Capitalization was also high, with a capital adequacy ratio of 15.9% in 3Q16 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 2.8% y/y in March 2017 and is expected to average 2.3% in 2017. The introduction of the VAT in 2018 may see consumer prices rise to 4.1% for that year.

Stocks weighed down by oil and increased taxes

Omani stocks were weighed down by the prevalent weakness in oil prices, as well as weaker 1Q17 earnings following the implementation of higher corporate income taxes. The MSM 30 decreased by 6.7% in May 2017.

Qatar outlook

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Growth to improve in 2017 but GCC dispute weighs heavily on outlook

Overview and outlook

- **Growth is expected to pick up to 2.5% in 2017 from 2.2% in 2016 on higher oil and gas output and further expansion in the construction, financial services and transportation sectors.**
- **A second consecutive, albeit narrowing, fiscal deficit is expected in 2017 (-5.1% of GDP), amid fiscal restraint and higher oil/gas revenues.**
- **Public debt reached 67% of GDP in 2016 as the government ramped up bond issuance and expanded its demand for credit.**
- **Private sector credit growth remains weak at 5% y/y in April.**
- **Liquidity has improved with higher energy prices and bond issuance; bank deposit growth is outpacing credit growth.**
- **The banking system is highly exposed to foreign funds (38% of total liabilities), a key concern in the current diplomatic crisis.**
- **Borrowing costs are up, CDS spreads have widened, equities are down.**
- **The currency is under pressure in the forwards market, but no de-peg.**

Headline growth slows in 2016 on a contraction in oil and gas output and government fiscal consolidation

Economic growth moderated to 2.2% in 2016 from 3.5% in 2015 on a contraction in oil and gas output (-1%) and a slowdown in non-hydrocarbon sector activity (5.6%). (Charts 1 & 2.) In the former, maturing oil fields, maintenance of LNG facilities and delays prevented the Barzan gas processing plant from reaching full capacity and stymied potential output growth. Over in the non-hydrocarbon sector, while construction (15.4% y/y), financial services (7.9% y/y) and real estate (6.8% y/y) were the major contributors to growth, the economy felt the negative effects of government fiscal consolidation, tighter liquidity and private sector credit, and generally lower consumer confidence. Last year's GDP growth rate was the slowest since 2002.

Looking ahead, we expect growth to accelerate slightly this year and next to 2.5% and 3.1%, respectively, thanks to gains in LNG, natural gas and condensates output on the hydrocarbon side. Crude output is expected to average 30,000 b/d less in 2017 as per Qatar's obligations under the terms of last November's OPEC production cut agreement. Continued growth in construction, services and transportation should contribute on the non-hydrocarbon side. The government's $200 billion public infrastructure

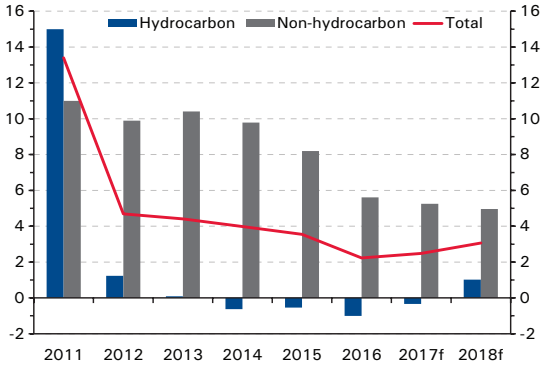
Key economic indicators

		2015	2016	2017f	2018f
Nominal GDP	USD bn	164.6	152.4	169.9	183.9
Real GDP	% y/y	3.5	2.2	2.5	3.1
- Oil	% y/y	-0.5	-1.0	-0.3	1.0
- Non-oil	% y/y	8.2	5.6	5.3	5.0
Inflation	% y/y	1.8	2.7	1.5	3.0
Budget balance	% of GDP	-1.9	-9.0	-5.1	-3.5

Source: Official sources, NBK estimates

Chart 1: Real GDP

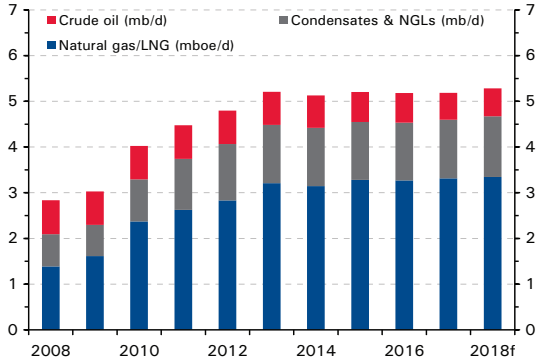
(% y/y, base year 2013)



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

Chart 2: Oil and gas production

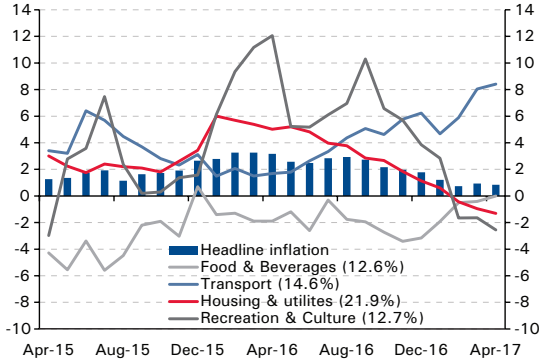
(million barrels of oil/oil equivalent per day)



Source: JODI, BP, OPEC, NBK estimates

Chart 3: Consumer price inflation

(% y/y, weights in brackets)



Source: MDP&S

program, which it is executing as part of its Vision 2030 diversification strategy and FIFA World Cup 2022 plan, will underpin growth in this sector, even while the government continues to keep a tight rein on current expenditures.

Of course, the recent diplomatic rift between Qatar and its neighbors, in which air, transport and even financial links have been severed or limited, does have the potential to significantly alter the equation and affect the outlook. Depending on how long the crisis lasts—two weeks and counting so far—the impact on the flow of goods and services, people and capital could be substantial, with negative repercussions for Qatari trade, tourism, labor and banking sector liquidity. These are all key components of Qatar's diversification strategy; limitations imposed on any one of these would cause headline growth to suffer. Inflation would almost certainly spike, as consumer goods and materials are rerouted, while the banking system, with its elevated share of foreign liabilities, could experience outflows and rising costs.

Headline inflation to ease in 2017 on moderating rental costs and as the impact of 2016's fuel/utility price hikes recedes

Inflation averaged 2.7% in 2016, increasing from 2015's headline figure of 1.8% due to price hikes which were associated with the removal of energy and utility subsidies. This also came despite a 2% decline in food prices that year. As of April 2017, inflation was 0.8% y/y, brought lower by declining rental prices (-1.3% y/y) and falling costs in the recreation and culture category (-2.6% y/y). (Chart 3.) Rent inflation, which feeds into the largest CPI contributor—the housing and utilities category—turned negative in February for the first time in 5 years. The supply of properties exceeds demand, and real estate prices, as measured by the real estate price index, were down almost 10% y/y in March. (Chart 4.) We expect inflation to ease to 1.5% in 2017 before rising to 3% next year on slowly rebounding international food prices and improving economic growth. Of course, were the diplomatic dispute to drag on for several months, with the supply of food and goods entering Qatar either affected or subjected to costlier reroutes, then the impact on consumer prices could be profound.

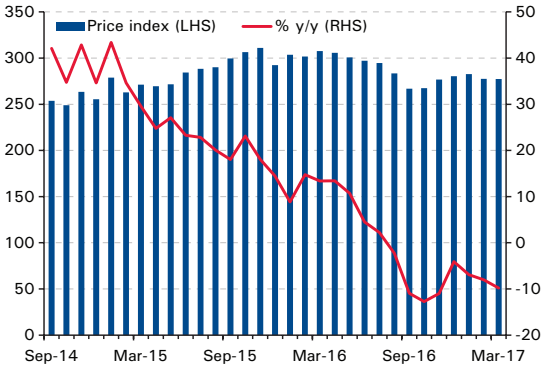
Fiscal restraint to continue this year but the deficit should narrow on higher oil and gas revenues

Qatar recorded its second consecutive fiscal deficit in 2016, at -9% of GDP. (Chart 5.) Lower oil and gas revenues as a result of the oil price downturn have significantly affected the government's finances. In response, the authorities embarked on fiscal consolidation, cutting current expenditures through freezes in public sector pay, reductions in expatriate employees and in the number of ministries. Fuel and utility subsidies were cut, and non-essential infrastructure scaled back, as in other GCC states. This year should see further fiscal restraint, but with spending targeted to a greater extent at infrastructure projects, many of which need to be completed in time for the FIFA World Cup in 2022. The deficit is expected to narrow to -5.1% of GDP in 2017 and to -3.5% of GDP in 2018, thanks largely to an expected improvement in energy prices.

The government has increasingly tapped the debt markets to finance the deficit, leading to a sharp rise in public debt

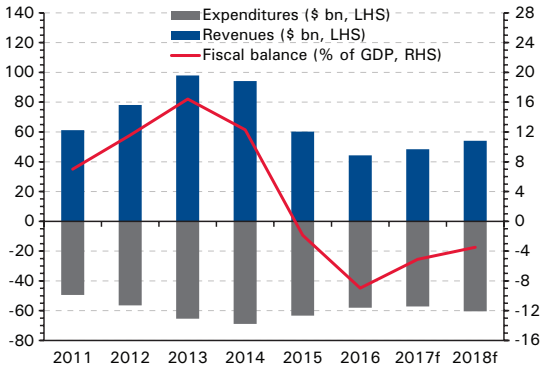
Qatar sold more than $17 billion in bonds and sukuk in 2016, $14.5 billion of which was raised from international investors. This included a $9.0 billion triple-tranche USD-denominated international bond last May. Consequently, central government debt (gross) increased significantly in 2016 to 67.2%

Chart 4: Real estate price index



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

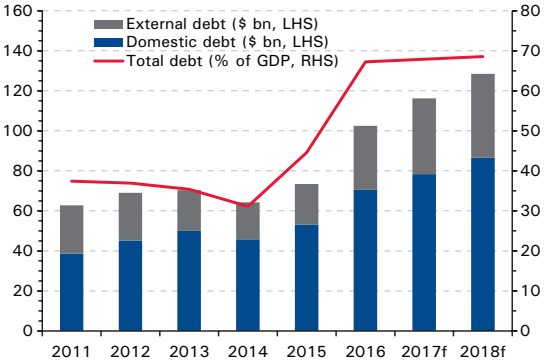
Chart 5: Fiscal balance



Source: QCB, NBK estimates

Chart 6: Central government debt (gross)

($ billion)



Source: QCB, NBK estimates

Chart 7: International reserves

($ billion)

Source: QCB, NBK estimates

of GDP from 44.6% in 2015. (Chart 6.) Recourse to the debt markets has helped Qatar's finances and injected much-needed liquidity into the banking system.

Increasing debt issuance has not stemmed the decline in the country's international reserves, however, which fell to $34.4 billion in April, a y/y decline of 3.6%. (Chart 7.) April's figure also represents a fall of $11.6 billion, or 25%, from the country's all-time high reserve level of $46 billion in November 2014. Import cover is still around 6.6 months, however, which is more than twice the 3 months recommended by the IMF for fixed exchange-rate regimes.

Increased government borrowing driving credit growth, but lending to the private sector remains soft

In 2016, total credit growth rebounded from the single digit lows of early 2015 to come in at a robust 12.1%, driven by public sector lending. By the end of April, credit growth was ranging around 9% y/y, with public and private sector lending growth at 15.9% y/y and 5.1% y/y, respectively. (Chart 8.) Private credit growth is below where it needs to be to get the private sector fully engaged in the country's development plan. Real estate lending is especially lackluster, while demand from industry, contractors and retail consumers remains soft.

Deposit growth rebounds in 1Q17 but increased foreign liabilities amid Qatar's diplomatic dispute prompts a ratings downgrade

Meanwhile, the banking system has witnessed double-digit deposit growth since last December as oil prices firmed over that period. Total deposits rose by 16.4% y/y by the end of April. (Chart 9.) Both public and private sector deposits have led the way, rising by 0.3% y/y and 12.1% y/y, respectively. Meanwhile, non-resident deposits, though still increasing at the rate of 56% y/y, are not doubling as they were last year.

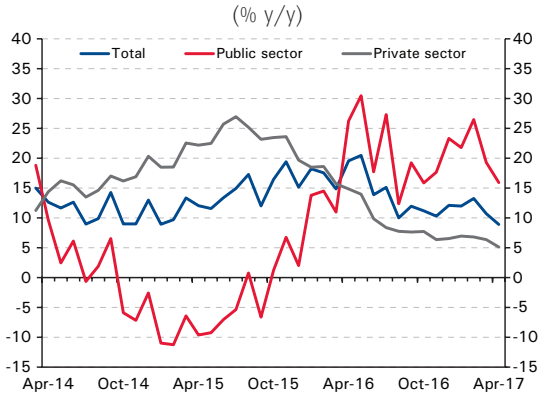
The improvement in liquidity is reflected in the banking sector's loan-to-deposit ratio (LDR), which has fallen since the start of the year as deposit growth has outpaced credit growth. As of April, it stood at 111.6%, having been as high as 119.9% in February 2016.

The decline in government deposits (-11.1%) last year and anemic private deposit growth (0.9%) hastened commercial banks reliance on foreign funds and led to an increase in overseas liabilities. Net foreign liabilities reached QR 182.5 billion ($50.1 billion) in April, up 28% y/y. (Chart 10.) Almost all of the liabilities are non-resident deposits, interbank funds and debt securities. They are also largely short-term in nature i.e. less than 12 months.

Most of the funds raised from overseas have been directed towards local lending, a significant portion of which is financing for the government's infrastructure projects, which tend to be long term. This large foreign currency mismatch plus the extent of the banking system's reliance on foreign funds—38% of total bank liabilities and 167% of foreign assets as of April—are part of the reason that Qatar found its long term sovereign rating lowered. S&P cut it by one notch to AA- recently, following the country's diplomatic isolation by Saudi Arabia and its other neighbors.

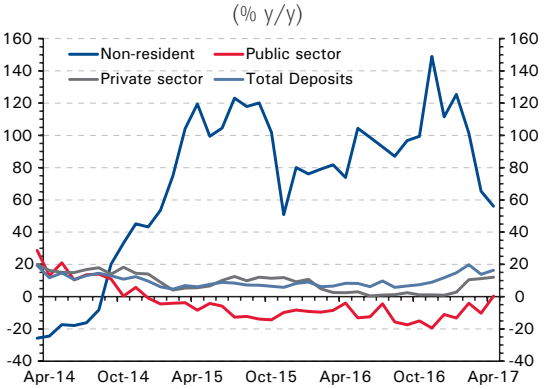
All its ratings (including the country's four largest banks) were placed on negative credit watch, a move that was also echoed by Fitch. The key concern is the potential for outflows of external funds should the crisis continue unresolved.

Chart 8: Credit growth



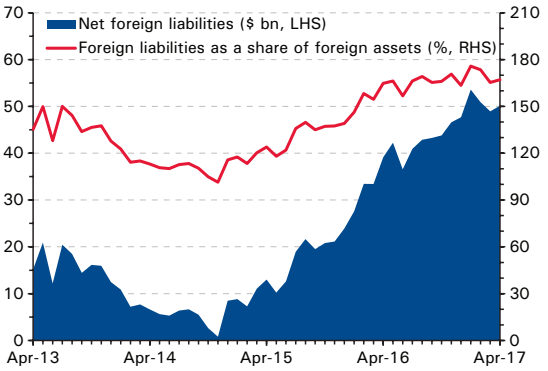
Source: QCB

Chart 9: Deposit growth



Source: QCB

Chart 10: Banks' net foreign liabilities



Source: QCB

Chart 11: Interbank rates

Source: Thomson Reuters Datastream

The UAE central bank, for example, is reportedly already preparing instructions for UAE entities to unwind their exposure to Qatar, while SAMA, the Saudi central bank, has told banks not to process Qatari riyal-denominated payments and to limit exposure to Qatar.

And while Qatari banks' exposure to GCC-sourced funds is no more than 8% of total foreign liabilities (QR 75 billion or $26 billion), the potential for non-GCC funds to depart in the event of a crisis escalation is acute; foreign entities may decide that exposure to Qatar is just not worth the risk. Recognizing this, Qatari banks are reportedly raising their deposit rates in response by as much as 100 bps over LIBOR. This compares with an average differential of 20 bps before the crisis.

Markets moved immediately to re-price Qatari risk, with borrowing costs up, spreads widening and equities falling.

The impact on the markets has been pronounced, with strong re-pricing of Qatari risk: borrowing costs have already spiked, with interbank rates rising 29 bps to 2.21% over the last week; CDS spreads have widened from 58 bps before the crisis to 92.5 bps as of 12 June; yields on Qatari bonds (2021) are up 35 bps; and the QE index, the main equities index, is down 7% ytd at 9,135, having been in positive territory in early June. (Charts 11-13.)

The riyal is also under pressure in the forwards market, with speculation increasing that a total financial boycott by Qatar's neighbors would lead to financial outflows and tighter credit conditions and force the Qataris to abandon the US dollar peg. (Chart 14.) We view this as highly unlikely, however. The authorities are steadfast in their commitment to the peg with more than enough resources to defend it.

The authorities, with $335 billion in sovereign wealth fund assets with the Qatar Investment Authority (QIA), as well as $34 billion in central bank international reserves, would have ample financial resources to weather a financial dislocation of this sort (asset coverage of Qatari banks' GCC exposure would stand at 14 times).

Furthermore, the political and economic costs of a de-peg would dwarf any potential benefit to Qatar.

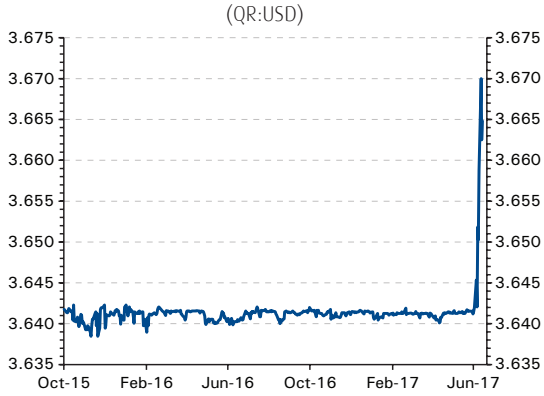
Chart 12: Credit default swap (5-year)

Source: Thomson Reuters Datastream

Chart 13: Qatar Exchange (QE)

Source: Thomson Reuters Datastream

Chart 14: 12-month forward exchange rate



Source: Thomson Reuters Datastream

Saudi Arabia outlook

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Government spending and reforms to stimulate non-oil activity

Overview and outlook

- **Growth is forecast to slow from 1.4% in 2016 to 0.5% in 2017 due primarily to a contraction in oil sector activity (-0.3% y/y) as the kingdom complies with its OPEC crude production cut agreement.**
- **Non-oil growth to accelerate from -0.1% y/y in 2016 to 1.1% y/y in 2017 as the government adopts a moderately expansive fiscal stance and rolls out its Vision 2030 reform agenda.**
- **The fiscal deficit should halve to -8.0% of GDP in 2017 on higher oil/non-oil revenues and relative fiscal restraint.**
- **The fiscal deficit will continue to be financed by a combination of debt issuance and reserve drawdowns; public debt should peak in 2018 at around 24% of GDP.**

Responding to the oil price downturn, the Saudi government has embarked on a radical and ambitious plan to transform the kingdom's entire economy, restructure its finances and ultimately wean it off its oil dependency. The Saudi Vision 2030 and its associated tactical programs, now provide the basis upon which economic growth and development will be benchmarked. Public expenditures and investment will be redirected towards localizing industries, training Saudis and raising economic competitiveness. Fiscal reform is taking place through expenditure rationalization, non-oil revenue enhancements and privatization of state entities, so that by 2020 the kingdom would achieve a balanced budget. Fuel and utility prices have been hiked, taxes are about to be introduced, including a VAT in 2018, while the authorities unveil a private sector stimulus package. That package is to include a housing and household allowance program to mitigate the burden on low income families.

The risks and challenges are immense; the most pressing is the need to stabilize the oil price at a level high enough to kick-start growth in the non-oil economy directly, through government spending and investment in SR 1.4 trillion ($373 billion) worth of outstanding capital projects, and indirectly, through enhanced banking sector liquidity and lending. Consumer activity and confidence should rebound.

Real GDP growth to slow in 2017 on oil sector contraction, but non-oil sector activity expected to rebound

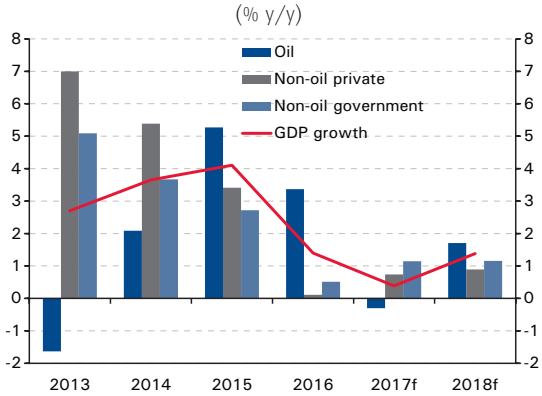
Saudi economic growth is projected to slow further from last year's 1.4% to 0.5% y/y in 2017. (Chart 1.) Behind the outlook are a contraction in oil sector

Key economic indicators

		2015	2016	2017f	2018f
Real GDP growth	% y/y	4.1	1.4	0.5	1.3
Oil	% y/y	5.3	3.4	-0.3	1.7
Non-oil	% y/y	3.2	-0.1	1.1	1.0
Inflation	% y/y	2.2	3.5	1.4	2.1
Fiscal balance	% of GDP	-15.0	-16.8	-8.0	-3.7
Public debt	% of GDP	5.8	13.2	17.7	24.3

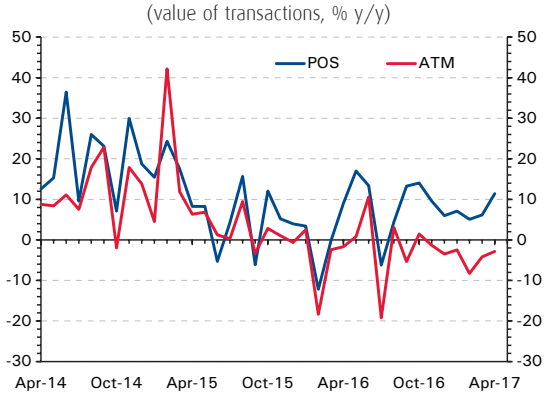
Source: Official sources, NBK estimates

Chart 1: Real GDP



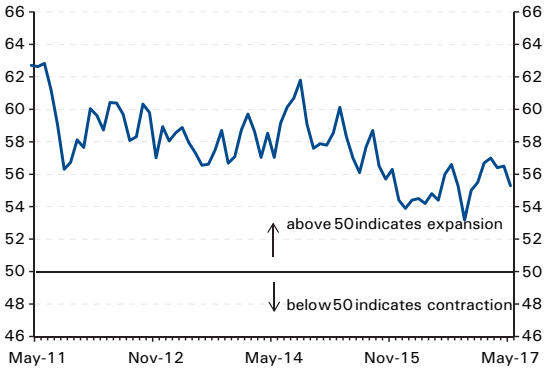
Source: General Authority for Statistics (GASTAT), NBK estimates

Chart 2: ATM and POS transactions growth



Source: Saudi Arabian Monetary Agency (SAMA)

Chart 3: Purchasing Managers' Index (PMI)



Source: Emirates NBD/Markit

activity, by -0.3% y/y, in line with Saudi Arabia's commitment to OPEC's cuts, and continued weakness in the non-oil private sector. Private sector growth fell to a 26-year low of 0.1% last year, following two years of relative fiscal austerity and low business confidence triggered by the oil price downturn.

This year, however, non-oil activity is expected to rise by 1.1% y/y, thanks to moderately expansive government fiscal policy, including the launch of specific housing and private sector stimulus packages, and a rebound in consumer, manufacturing and construction activity. The consumer sector should get a welcome boost from the recent reinstatement of public sector bonuses and allowances.

The private sector stimulus package, which is worth SR 200 billion ($53.3 billion), aims to boost private sector GDP by 2020 through efficiency enhancements to high energy and labor-intensive industries. The government is also committed to improving the localization of industries such as oil/gas and defence.

Moreover, the non-oil manufacturing sector is expected to benefit from the full operation of major petrochemical projects such as the $20 billion Sadara petrochemical complex and the $500 million Rabigh expansion project. The direct effects of these and ancillary projects should lead to the creation of thousands of jobs, providing a welcome boost to Saudi employment levels.

Nevertheless, the retail and consumer sector remains a weak spot. The latest metrics, such as point of sale (POS) and ATM transactions, private sector credit growth and the Purchasing Managers' Index (PMI) show improving but subdued activity. (Charts 2, 3 and 10.). The roll out of the second round of the government's subsidy cuts this year, along with the implementation of excise taxes on tobacco and sugary products, and the VAT in 2018, will undoubtedly squeeze consumer finances, although the government has moved to mitigate the adverse effects on lower income families via the introduction of the Household Allowance Program.

Deflation unlikely to last beyond 1H17, after which energy price hikes, excise taxes and VAT (in 2018) will push prices up

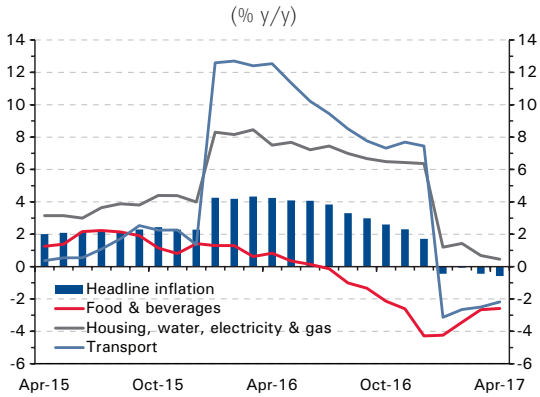
Inflation has been in negative territory since the start of the year, falling to -0.6% y/y in April. (Chart 4.) The downward trend is due to a combination of weak consumer demand, still soft international food prices and lingering base effects relating to last year's subsidy cuts. As a further reflection of anemic demand, real estate prices have also been trending downwards, falling by around 10% y/y. (Chart 5.) Going forward, however, it is more likely that inflation will pick up once the government's second round of energy subsidy cuts are instituted and after the authorities roll out their planned excise taxes on tobacco and sugary products by the middle of the year. The introduction of the VAT in 2018, at a rate of 5%, will also impact consumer prices, and propel the headline inflation rate towards 2.1% in 2018 from a projected 1.4% in 2017.

Fiscal deficit to narrow in 2017-2018 on higher oil prices and fiscal reforms...

Saudi Arabia's 2-year-old budget deficit is likely to extend into 2017 and 2018. The deficit should narrow, however, from last year's high of -16.8% of GDP to -8% of GDP in 2017, and to -3.7% of GDP in 2018. (Chart 6.)

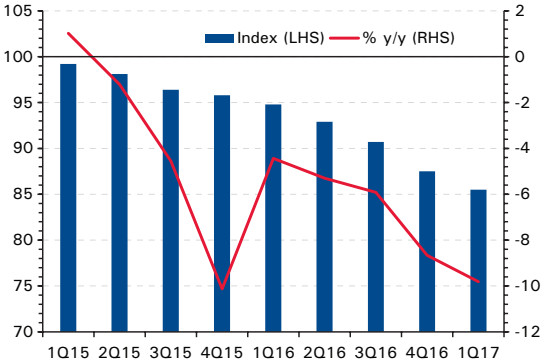
The expectation of higher oil prices during the next two years (Brent to average $55/bbl in 2017 and $60/bbl in 2018) and continued fiscal restraint as well new reforms stipulated in the National Transformation Program (NTP) and Vision 2030 documents are behind the improved outlook.

Chart 4: Consumer price inflation



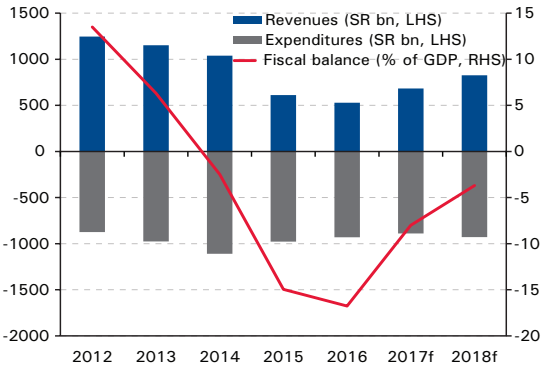
Source: GASTAT

Chart 5: Real estate price index



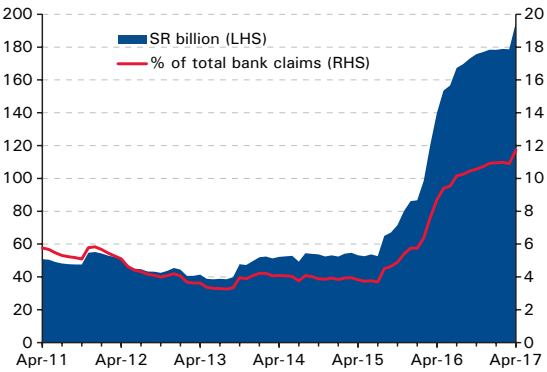
Source: GASTAT

Chart 6: Fiscal balance



Source: SAMA, NBK estimates

Chart 7: Banks' holdings of government bonds



Source: SAMA

Indeed, judging by recent data for 1Q17, which showed the fiscal deficit halving to SR -26.2 billion ($7 billion) from the pro-rata 1Q17 budget estimate of SR 50 billion ($13 billion), the government appears to have carried through into 2017 some of the fiscal restraint and spending rationalization programs it introduced in 2016. In 1Q17, revenues increased by 72% y/y while expenditures contracted by -3% y/y.

Based on full year figures for 2016, total expenditures were cut by 16% from 2014's historically high level of SR 1,110 billion ($296 billion) to SR 930 billion ($248 billion). Capital expenditures were curtailed by scrapping or deprioritizing non-essential infrastructure projects. Fuel and utility subsidies were cut. Public sector bonuses and allowances were cancelled. (The latter were reinstated in April by royal decree, however).

The second round of fuel and utility subsidy cuts is expected this year as the government pushes ahead with its phased plan to link all fuel, water and electricity prices to international market-based prices by 2020. The estimated savings to the government are in the region of SR 209 billion ($55 billion) by 2020, or around 8.7% of 2016 GDP, as detailed in the government's Fiscal Balance Program (FBP).

The FBP targets a balanced budget by 2020. This it aims to do by improving the efficiency of spending, under the auspices of the newly-established Bureau of Spending Rationalization (BOSP), and by broadening the non-oil revenue base. In the former, the adoption of best practice across government ministries in terms of improving contracting and procurement practices, for example, should lead to cumulative savings of around SR 70 billion ($18 billion) by 2020 and SR 21.4 billion ($4.8 billion) in recurrent annual savings after that. The introduction of a VAT in 2018 plus a host of other taxes and fees (expat levy, 'sin taxes'...) should net the Saudi treasury an additional SR 152 billion ($40 billion) in revenues by 2020. The introduction of VAT could generate about SR 22 billion ($5.8 billion) next year, or 1.5% of non-oil GDP. The authorities hope that by 2020 more than 50% of the kingdom's total revenues will be generated independently of oil—up from 37.7% in 2016.

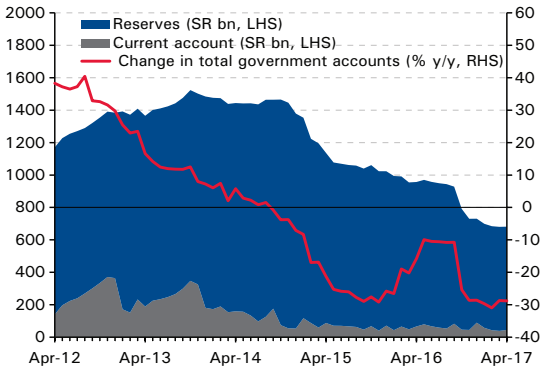
...but government spending expected to increase after 2 years of fiscal restraint

With the above in mind, the government has, nevertheless, adopted an expansionary budget this year (notwithstanding the SR 105 billion in back payments to contractors in late 2016), raising its spending by an estimated 8% as it attempts to soften the impact of continued austerity on consumer spending and to stimulate the non-oil economy. Indeed, this partly explains the reinstatement of previously cancelled state allowances and bonus payments in April 2017.

Fiscal deficit to continue to be financed by a combination of debt issuance and reserve drawdowns

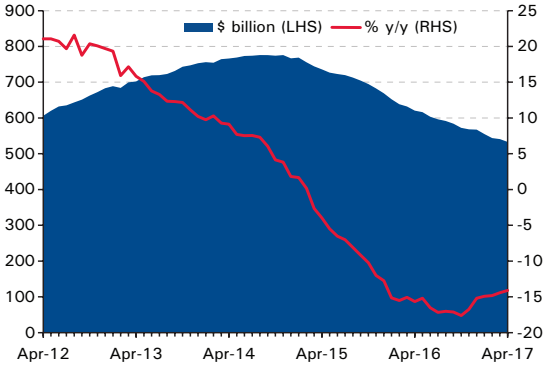
According to the authorities, at least SR 120 billion ($32 billion) in debt will be issued in 2017, equating to about 60% of 2017's deficit. More than half of that will be domestic debt sales (SR 70 billion) and the remainder international issuance. The authorities hope to capitalize on the highly successful sale in October 2016 of $17.5 billion in sovereign bonds, a record for an emerging market, as well as the more recent sovereign sukuk issuance of $9 billion. Banks' holdings of government bonds have, consequently, skyrocketed from a low of SR 38.5 billion ($10.3 billion) in 2013 to almost SR 190 billion ($52 billion) in April of this year; bonds account for almost 11.7% of total banks' claims. (Chart 7.)

Chart 8: Government accounts at SAMA



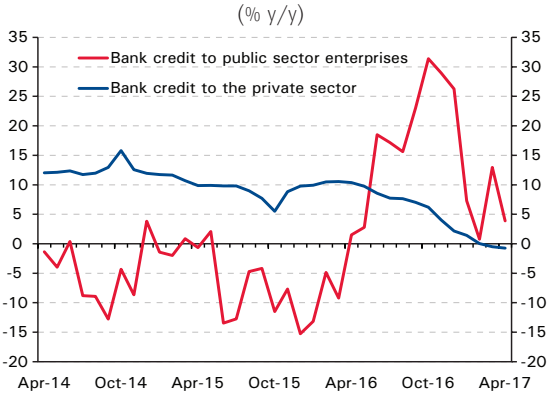
Source: SAMA, NBK estimates

Chart 9: Net foreign assets



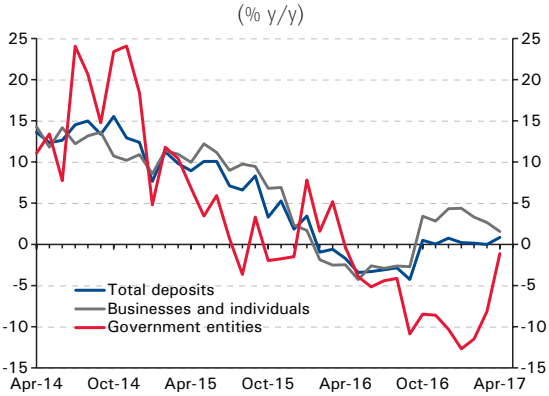
Source: SAMA

Chart 10: Bank credit growth



Source: SAMA

Chart 11: Bank deposit growth



Source: SAMA

Debt issuance should ease the pressure on the government's accounts at SAMA (current account and government reserves), which declined by SR 293 billion, or 28.6%, in 2016—an average monthly drawdown of around SR 24.4 billion ($6.5 billion). According to SAMA's April bulletin, SR 44.6 billion ($11.9 billion) was withdrawn from the government's current account in the first 4 months of 2017, SR 26.2 billion of which was required to cover the government's first quarter fiscal deficit. (Charts 8 & 9.) The remainder appears to have been placed in the banking system, perhaps to improve liquidity or in anticipation of further spending outlays.

Public debt (gross) is forecast to rise from last year's 13.2% of GDP to an estimated 17.7% of GDP this year and peak at around 24.3% of GDP in 2018. (Chart 9.) These levels are low by international standards and the authorities' own stated objective of a maximum permissible debt-to-GDP ceiling of 30% by 2020.

Credit and deposit growth remain lackluster, acting as a brake on economic growth

Both total and private sector bank credit growth turned negative in March, for the first time since December 2009. (Chart 10.) The contraction in credit to the private sector, by -0.8% y/y in April, is particularly worrisome, given how important the sector is to the success of the Saudi Vision 2030. Lending to the construction, commercial and services sectors remains especially weak, and consumer loan growth in 1Q17, at -0.3% y/y, was the lowest since the financial crisis.

Bank deposit growth is also struggling at the moment, even though it has rebounded slightly from last September's low of -4.3% y/y. Growth was 0.9% y/y April. (Chart 11.) We are yet to see, however, evidence of an improvement in the deposit base of banks resulting from higher oil prices, the government's repayments to contractors, or even last October's sovereign bond sale. 6 months on and deposit levels are barely any higher. Commercial banks' deposits with SAMA, on the other hand, have increased to SR 235 billion ($62.6 billion), suggesting perhaps that banks have been shuttling off some of their excess deposits into reserves at the central bank. (Chart 12.)

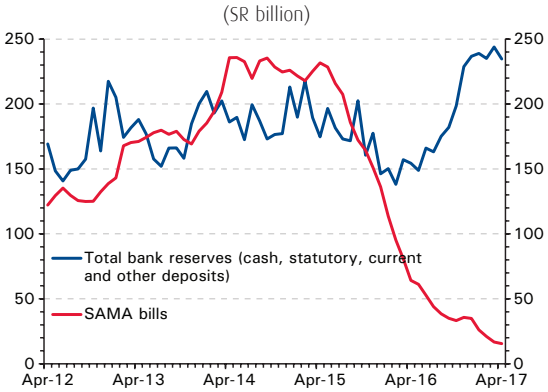
Further monetary tightening on the cards, but improved liquidity affords the authorities room for maneuver

Following the US Fed's lead, SAMA raised its key interest rate, the reverse repo, for the second time this year, by 25 bps from 1.0% to 1.25% in June. The repo rate, however, remains at 2.0%. (Chart 13.) One further 25 bps rate hike may be on the cards during the second half of the year. This would further raise the cost of borrowing in the kingdom at a time of subdued consumer activity, anemic credit growth and low inflation, and should thus require the authorities to take a more considered approach.

Nevertheless, the authorities would seem to have room for maneuver: interbank rates (3-month SIBOR) have fallen by a sizeable 66 bps from their October 2016 high of 2.38% to around 1.72% as liquidity constraints have eased following the sovereign international bond sale. (Chart 14.) Also, pressure on the Saudi riyal in the forwards markets has dropped significantly. (Chart 15.)

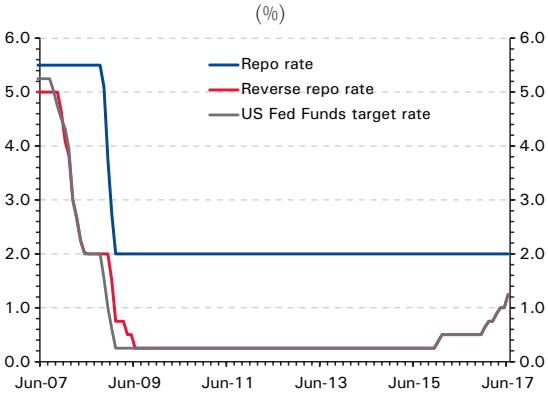
Market perceptions of Saudi sovereign risk also seem to be moderating—and this comes despite Fitch's recent ratings downgrade of Saudi's long term foreign and local currency ratings to A+ from AA-.

Chart 12: Bank reserves & holdings of SAMA bills



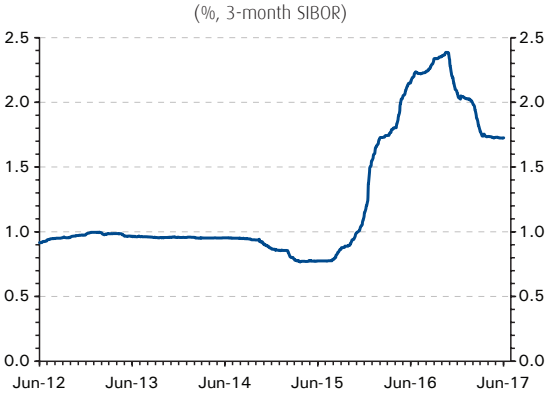
Source: SAMA

Chart 13: Key interest rates



Source: Thomson Reuters Datastream

Chart 14: Interbank rates



Source: Thomson Reuters Datastream

Chart 15: Saudi riyal 12-month forward rate

Source: SAMA

Oil price weakness and a spate of downward revisions to Saudi economic prospects continue to weigh on market sentiment

Halfway into the year and the main Saudi stock index, the Tadawul All-Share Index (TASI), remains down by more than 5% year-to-date at around 6,822. (Chart 17.) The bourse continues to suffer from weak sentiment despite better-than-expected corporate and bank profits in 1Q17 and despite the king's reinstatement of state allowances in late April. The retreat in oil prices, the IMF's downward revision to Saudi growth and Fitch's debt rating downgrade all appear to have cast a long shadow over the index.

Nevertheless, the Saudi bourse, in conjunction with the regulatory authorities (CMA), continues to press ahead with reforming and modernizing the stock market in order to bring it up to international standards and increase its appeal to foreign investors. New measures introduced recently include: short selling, a first for the middle east; a two-day trade settlement cycle (T+2); new regulations for REITs; and less stringent restrictions on investments by qualified foreign investors (QFI), whereby the AUM requirement has been reduced from $5 billion to $1 billion and the single stock ownership limit of QFIs raised from 5% to 10%. The authorities hope that such measures will help the bourse gain inclusion in emerging market indices such as the MSCI EM Index and the FTSE Global Equity Index. The MSCI is expected to decide on whether the kingdom is on its review list next month, while the FTSE decision is expected in September.

Then there are the preparations for arguably the showpiece event in the realization of the Saudi Vision 2030: the part-privatization of Saudi Aramco. Up to 5% of the energy giant is expected to be publicly listed either next year or in 2019, generating at least $45 billion in proceeds (based on an Aramco valuation of $900 billion) for the kingdom's newly designated SWF, the Public Investment Fund (PIF). According to Prince Mohammed Bin Salman, 50-70% of the proceeds of the Aramco sale will be invested in local industries such as mining, entertainment and defense; a total of SR 500 billion ($133 billion) will be invested within 3 years of the Aramco IPO.

Chart 16: Stock exchange index

(Tadawul All-Share Index, TASI)

Source: Thomson Reuters Datastream

UAE outlook

Growth set to moderate slightly in 2017 amid crude oil cuts

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Overview and outlook

- **Real GDP growth is expected to moderate in 2017 on the back of oil sector cuts.**
- **Non-oil growth is forecasted to remain resilient on stronger gains in the tourism and construction sectors.**
- **Inflation is projected to see renewed upward pressures from further taxes or subsidy cuts.**
- **The fiscal deficit is set to narrow in 2017 and return to a surplus in 2018, on prudent reforms and higher public revenues.**
- **Bank liquidity is expected to continue to see improvements in 2017 and 2018 as higher oil revenues prop up deposit growth.**

Real GDP growth to moderate in 2017 on lower crude production

Real GDP in the UAE is expected to moderate for a third straight year in 2017 as crude production is lowered, in compliance with the agreement among OPEC members to cut crude supply. Whilst the oil sector is projected to act as a laggard on overall growth, the non-oil sector is set to continue to propel forward and offset a contracting oil sector. Subsequently, we foresee real GDP moderating from an estimated 2.4% in 2016 to 2.2% in 2017 (Chart 1).

Growth in the oil economy is expected to be limited in the medium-to-long term on the back of planned production cuts. In May, OPEC and a group of non-OPEC nations agreed to extend a six-month output cut that was scheduled to end in June, to at least the end of the first quarter of 2018, in a bid to prop up oil prices. As a result, real oil GDP is expected to decline by around 1% in 2017, before rising by 2.6% in 2018 as production is gradually restored to its pre-production cut levels.

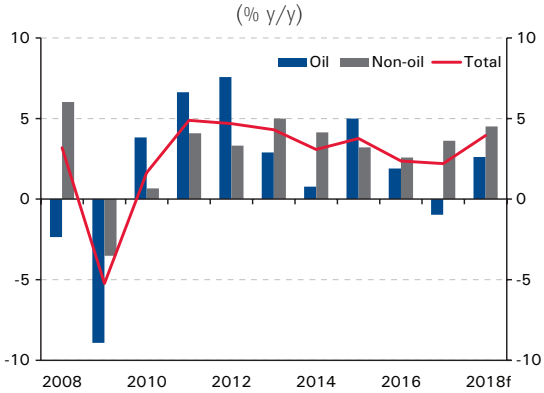
The non-oil economy is forecast to gain some ground in 2017 and maintain that strong momentum in 2018, as the construction and tourism sectors (some of the biggest contributors to non-oil GDP growth) remain buoyant. The construction sector will be supported by easing fiscal consolidation as well as higher Dubai Expo 2020 related infrastructure investments. The non-oil economy is also set to be supported by the residential real estate sector, which after witnessing almost two years of slowing growth is showings signs of stabilization. We 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.

Key economic indicators

		2015	2016	2017f	2018f
Nominal GDP	USD bn	370	360	391	425
Real GDP	% y/y	3.8	2.4	2.2	3.9
Oil	% y/y	5.0	1.9	-1.0	2.6
Non-oil	% y/y	3.2	2.6	3.6	4.5
Inflation	% y/y	4.1	1.6	2.5	3.0
Budget balance	% of GDP	-2.3	-3.6	-1.8	0.6

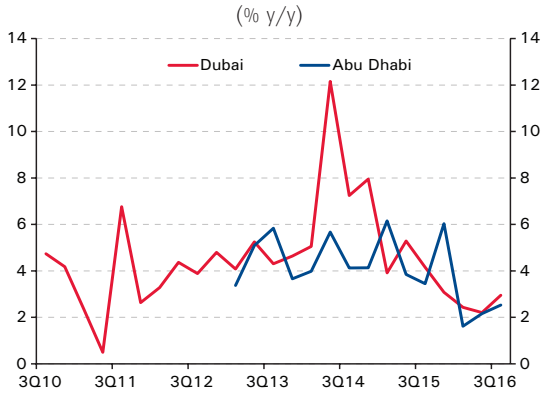
Source: Official sources, NBK estimates

Chart 1: UAE real GDP



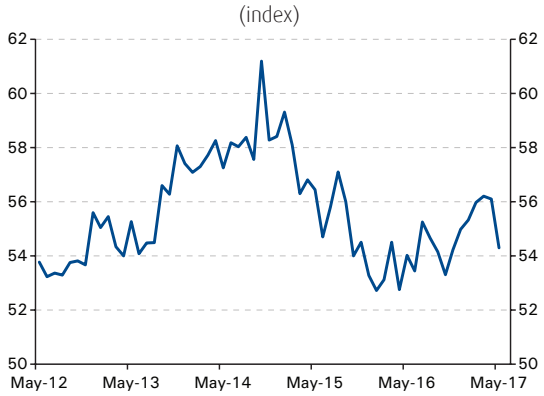
Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Dubai & Abu Dhabi real GDP



Source: Dubai Statistics Center, Stastics Center - Abu Dhabi

Chart 3: Purchasing Managers' index



Source: Markit

The latest data on the UAE's Markit Purchasing Managers' Index (PMI), a good gauge of non-oil sector growth, also show that non-oil sector activity is set to remain solid in the near-to-medium term (Chart 3). The headline PMI slipped in May, but still remained fairly solid at 54.3, as stable local economic conditions helped offset some of the softness in global demand.

Overall non-oil economy propped up by Dubai's resilience

Much of the non-oil economy's momentum continued to be fuelled by Dubai's hospitality and construction sectors. The number of passengers passing through Dubai International Airport remains near record highs. In April, this number stood at 7.6 million passengers, up a healthy 9.2% year-on-year (y/y). Despite an ongoing decline in average daily room rates at hotels in Dubai over the past year, demand for hotel rooms remains solid as reflected in the average occupancy rate. According to Ernst & Young's latest MENA Hotel Benchmark Survey, occupancy rates among hotels in Dubai averaged 88% in April (the highest in the MENA region).

Dubai's construction sector is also a major contributor to non-oil growth. Construction activity is expected to hold strong, 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 has gradually been regaining its momentum amid improvements in the travel & tourism and wholesale & retail trade segments.

Dubai residential property price growth stabilizing

Dubai's residential property prices continued to stabilize, following almost two years of decline amid tighter regulations, higher housing supply and risk aversion. According to Asteco's quarterly indexes, prices of apartments and villas in 1Q17 appeared steady, though they are down by 3.0% y/y and 1.3% y/y, respectively. (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.

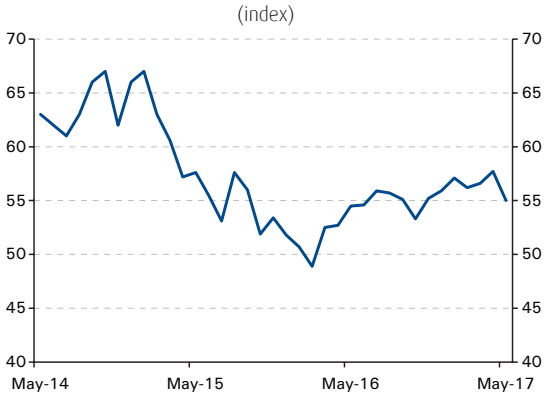
The value of real estate transactions continues to trend lower (Chart 6), while growth in the number of transactions accelerated somewhat recently, which may be indicative of signs of strength in the "more affordable" housing segment.

Inflation to face some upward pressure

Inflation in the consumer price index (CPI) softened recently, after retreating from 3.0% y/y in March to 2.2% y/y in April, as housing inflation (which weighs more heavily in the index) continued to trend lower and as food costs declined. (Chart 7.)

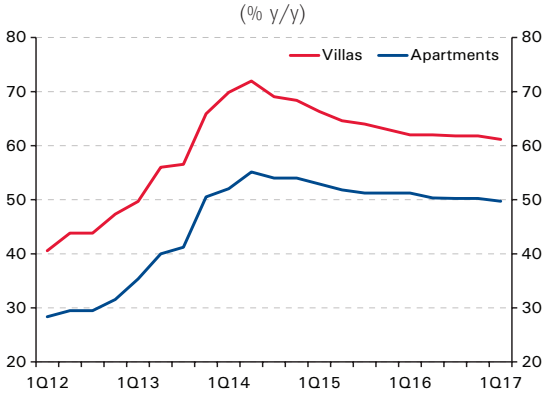
We expect CPI inflation to gradually edge higher in the second half of 2017 and average around 2.5% for the year, as a recovery in oil prices pushes inflation in the transport segment up, as housing inflation gathers pace and amid tax hikes planned for selected consumer goods in 4Q17.

Chart 4: Dubai economy tracker



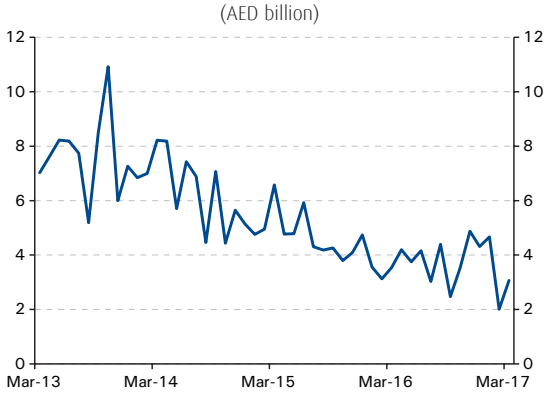
Source: Emirates NBD

Chart 5: Residential property sales prices



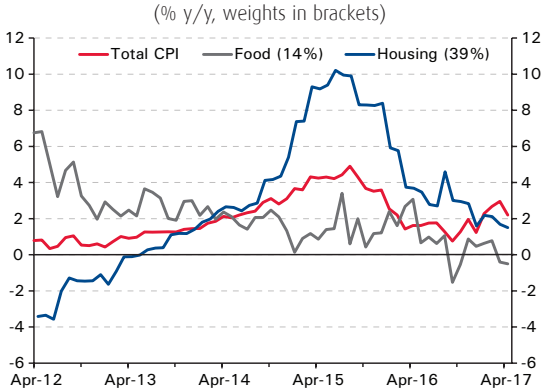
Source: Asteco, JLL

Chart 6: Value of real estate transactions



Source: Dubai Land Department

Chart 7: Consumer price inflation by sector



Source: Thomson Reuters Datastream

Fiscal deficit forecast to narrow in 2017 and return to a surplus in 2018

We expect the fiscal deficit to narrow in 2017 thanks to more prudent public spending and higher revenues. We estimate the fiscal deficit widened to 3.6% of GDP in 2016 after having slipped into a deficit for the first time in six years in 2015 on the drop in oil prices. But with global oil markets recovering and a more prudent fiscal policy in place, the deficit is seen narrowing to 1.8% in 2017 and returning to a slight surplus of 0.6% in 2018. (Chart 8.)

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

Nonetheless, the major emirates have embarked on some fiscal adjustment and reform, including the establishment of the Federal Tax Authority (FTA), subsidy cuts and the introduction of fees and taxes on selected goods and 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.

The newly established FTA recently announced that it would impose a 100% tax on tobacco and energy drinks and a 50% levy on carbonated drinks from 4Q17. Furthermore, it increasingly looks like the UAE will be one of the first GCC nations to implement a value-added tax (VAT). The first phase of implementation, scheduled for the beginning of 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 2016, Abu Dhabi issued $5 billion in sovereign bonds, the first issuance since 2009.

Moody's recently affirmed the UAE's Aa2 credit rating and upgraded its outlook from negative to stable, citing an effective public policy response to the lower oil price environment and improved economic growth prospects.

The main credit default swaps (CDS), which are deemed to be good bellwethers of a sovereign's level of risk, fell to new lows following Moody's announcement. As of mid-June, the CDS on five-year Dubai and Abu Dhabi government debt stood at 130 and 52 basis points, respectively (Chart 14).

With investors globally in search for yield amid a low global rate environment, the recent credit affirmation and outlook upgrade should be a further boon to the UAE bond market.

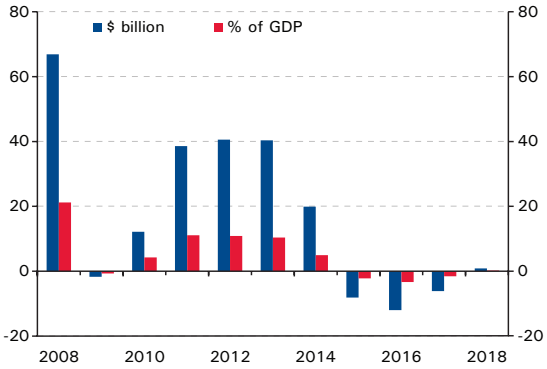
Current account surplus to expand in 2017 and 2018

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 pace. We foresee the current account surplus rising from a six-year low of around 4.8% of GDP in 2016 to a projected 5.1% in 2017 (Chart 9).

Non-oil export growth may continue to be affected by a 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 15). Trade with Asian markets has been most

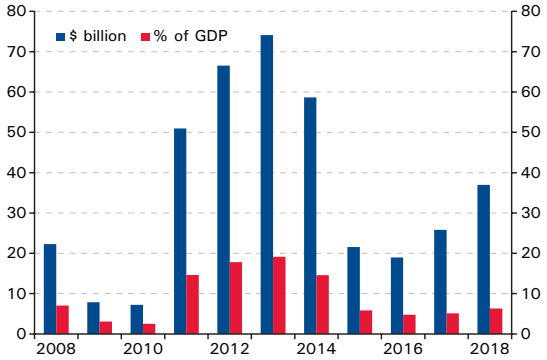
Chart 8: Budget balance

(revenues include ADNOC profits & investment income)



Source: UAE National Bureau of Statistics, NBK estimates

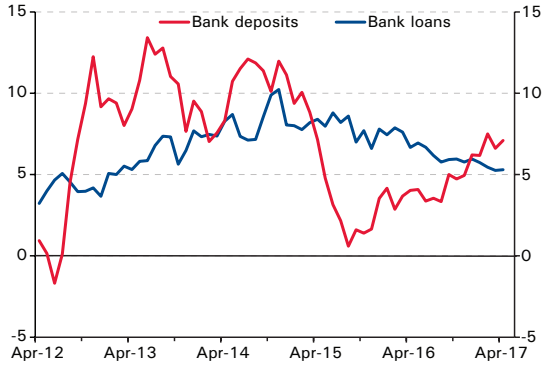
Chart 9: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 10: Bank loan & deposit growth

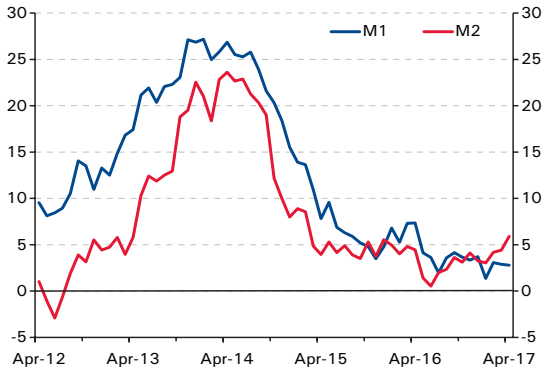
(% y/y)



Source: Central Bank of UAE

Chart 11: Money supply

(% y/y)



Source: Thomson Reuters Datastream

affected by the stronger dirham, which have 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. As a result, the gains in the tourism and real estate sectors are expected to more than offset the costs of a stronger dollar. This should help keep non-oil export growth ebullient.

Banking liquidity recovers on stronger oil revenues

Following almost two years of moderation, lending activity appears to have plateaued in early 2Q17 on the back of improvements in the real estate and construction sectors. In April, lending growth came in at a modest 5.3% y/y (Chart 10).

Growth in bank deposits continues to trend upward. At the end of 2016, it surpassed lending growth for the first time in almost two years, thanks to higher oil export receipts, which have helped replenish government deposits. After deposit growth logged in a healthy pace of 7.1% y/y in April, the loan-to-deposit ratio subsequently eased further to 99.4% during the same period.

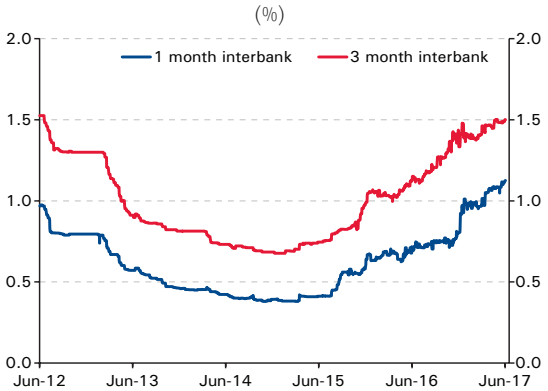
Growth in the broad money supply (M2) is gradually edging higher, mainly in tandem with stronger deposit growth. Latest data showed growth in this segment jumping from 4.4% y/y in March to an over-two-year high of 5.9% y/y in April (Chart 11).

The three-month and one-month interbank rates have continued to rise amid key policy rate hikes. (Chart 12.) In June, the UAE Central Bank hiked its key policy rate, the repo rate, by 25 bps for the second time this year to 1.50%, in tandem with a 25 bps hike in the US Fed rate.

Equities have been mostly steady in 2017

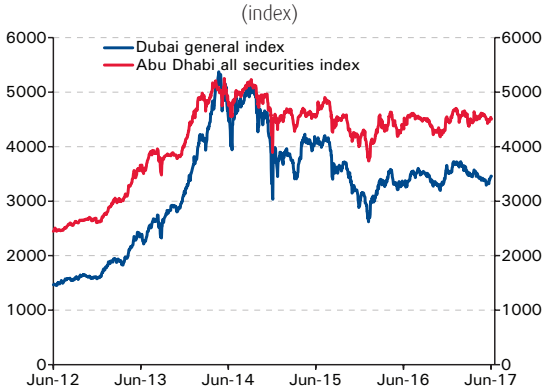
The key equity markets in Abu Dhabi and Dubai have been trending sideways for the most part of 2017. Lacking any major catalysts of their own, the markets will continue to be led by international markets and oil prices. (Chart 13.)

Chart 12: Interbank rates



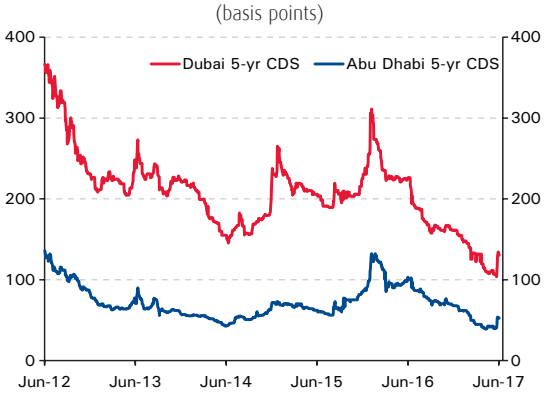
Source: Thomson Reuters Datastream

Chart 13: Stock market indices



Source: Thomson Reuters Datastream

Chart 14: Credit default swaps



Source: Thomson Reuters Datastream

Chart 15: UAE trade-weighted exchange rate

Source: Thomson Reuters Datastream

Egypt outlook

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Economic recovery has been slow but reforms proceed on track

Overview and outlook

- **Growth should improve to 3% in FY16/17, before it accelerates to 4% and 5% in FY17/18 and FY18/19.**
- **The floating of the pound alleviated foreign currency shortages, but GDP growth recovery has been gradual.**
- **Fiscal deficit to narrow to 11% of GDP in FY16/17 and to 8-9% in FY17/18 and FY18/19 as fiscal reform stays the course.**
- **Double-digit inflation should ease in late 2017, and further in 2018, as monetary policy tightens, stabilizing the pound.**

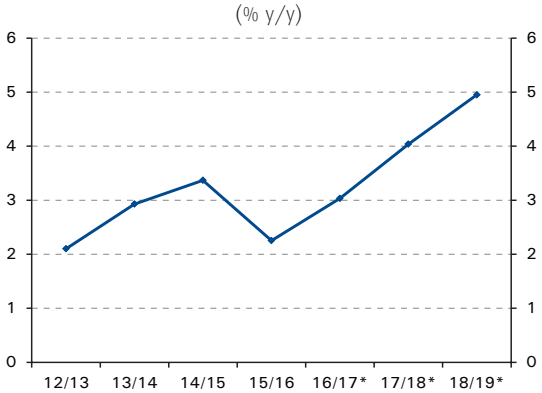
Egypt's economy has been in recovery mode following a considerable slowdown in 2016. A currency shortage that crimped activity last year was relieved with the decision to float the currency and the launch of comprehensive reform. A number of fiscal reforms implemented in 2016 are already having a positive impact on the deficit. A $12 billion IMF loan agreement also helped inject a degree of confidence among investors. As a result, the country's foreign reserves have improved significantly over the last seven months.

With reforms expected to see fiscal and monetary policy tighten, growth will be largely driven by foreign investment, exports and tourism all supported by a more competitive currency, and by the prospects of an improved operating environment. This is already being felt, with exports and tourism improving in 4Q16 and 1Q17. Foreign investment is also up, in part benefiting from large pledges by multilateral institutions.

The key risk to the outlook is a lack of progress on reforms, though progress has been relatively good so far. Indeed, during its regular review in May, the IMF provided a positive assessment as it recommended the disbursement of the second tranche of its loan agreement. The IMF felt that authorities had taken important measures that are likely to "place public debt on a declining path to sustainable levels". The latest fiscal figures also indicate that progress is being made.

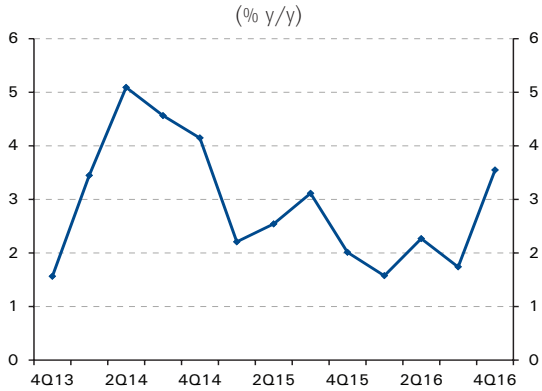
Egypt's decision to join its GCC allies in cutting ties with Qatar is not likely to have a material impact on the Egyptian economy. Over 250,000 Egyptians living in Qatar (accounting for 4-5% of remittances), have not been asked to leave. While Qatar accounted for over 60% of LNG imports in 2016, these shipments remain untouched. Meanwhile, authorities in Egypt indicated that

Chart 1: Real GDP growth



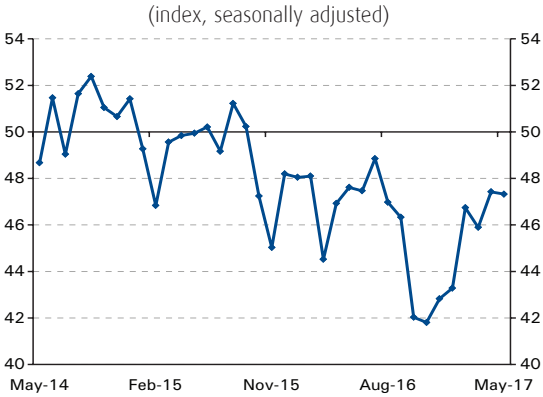
Source: MOP, TR Datastream; *estimate/forecast

Chart 2: Quarterly GDP growth



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index



Source: Markit

Key economic indicators

		FY15/16	FY16/17f	FY17/18f	FY18/19f
Nominal GDP	EGP bn	2,708	3,424	4,181	4,792
Nominal GDP	USD bn	326	247	227	254
Real GDP growth	% y/y	2.3	3.0	4.0	5.0
Inflation	% y/y	14.0	30.0	11.0	9.0
Budget balance	% of GDP	-12.1	-10.5	-8.8	-7.7

Source: CBE, MOF, MOP, NBK estimates

private Qatari investments will not be affected though Qatar accounts for only 1-2% of FDI inflows.

Economy showed signs of bouncing back in 4Q16 and 1Q17

After slowing significantly during 2016, economic growth began bouncing back late in the year. Real GDP growth rose to 3.5% year-on-year (y/y) in 4Q16 (Chart 2), compared to average growth below 2% during the first nine months of 2016. The improvement came largely from the manufacturing sector, which grew 6.4% y/y in 4Q16. Growth in other sectors remained weak.

There are good signs that GDP growth in 1Q17 will continue to improve. The quarter has seen a much awaited rebound in tourism. The number of tourist arrivals rose to a monthly average of 580,000 during the first three months of 2017 (Chart 6). While this figure is well below potential, it is up 49% y/y. The improvement is reflected in a healthy bounce in Egypt's production index, which was up 81% y/y in March.

The sector continues to be weighed down by security concerns following the downing of a Russian commercial airline in October 2015 by terrorists. Indeed, a number of European countries maintain travel restrictions to the country as a result. Tourism, which has suffered since the Arab Spring in 2011, remains well below its full potential. Arrivals in 1Q17 were half their 1Q10 level.

Markit's Purchasing Managers' Index (PMI) also indicated growth may be returning, though by that measure the recovery appears to be relatively slow. The index rose from a low of 42 in November 2016 to 47 in May (Chart 3). Despite the improvement in the index, it remains at levels consistent with GDP growth of only 2%. Nonetheless, the index does indicate particular strength in exports; the new export orders component rose to a survey-high of 54.8 in May.

The economy is expected to continue to improve in 2017, despite headwinds from a tighter fiscal and monetary stance. Growth in FY16/17 is expected to average 3.0%, up from 2.3% the previous fiscal year. The pace is expected to accelerate further to 4% and 5% in FY17/18 and FY18/19, respectively (Chart 1).

Reform agenda boosts optimism and the long term outlook

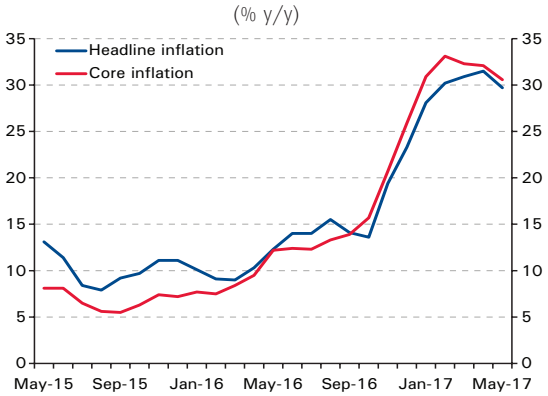
In January, the IMF published details of the reform program that was the basis of a $12 billion loan approved in November 2016. It includes steps already taken, like the VAT and floating the currency, as well as measures to further reduce energy subsidies and to improve the business environment. Tighter monetary and fiscal policy is a key element of the program, which will coincide with deep structural reforms to boost job creation, foreign investment and exports.

Floating the currency was one of the conditions for the IMF loan agreement and was seen as necessary to address the large external imbalances. The 50% decline in the value of the pound improved Egypt's competitiveness, which in turn helped boost non-oil exports by more than 29% y/y in 4Q16. The pound has since been relatively stable at around 18 EGP to the USD.

Inflation has remained elevated following floatation of the pound

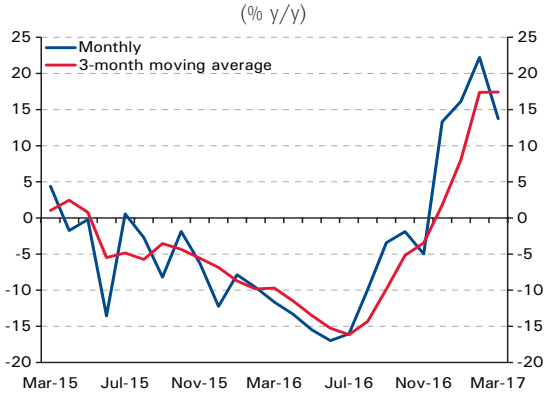
However, the large decline in the value of the EGP has fueled inflation as the higher price of imported goods pushes domestic prices higher. Inflation accelerated to 30% by May 2017 (Chart 4). The rate is expected to remain at

Chart 4: Consumer price inflation



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

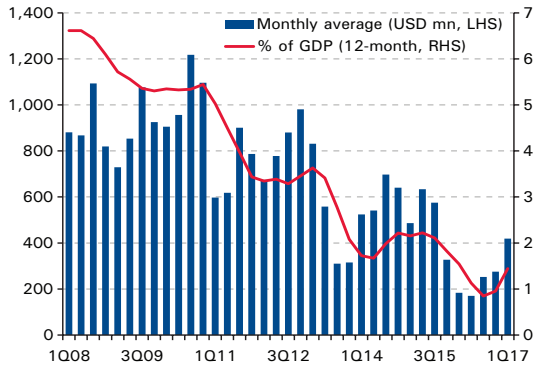


Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism

Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, NBK estimates

those elevated levels through most of 2017, before cooling off in late 2017 and easing further in 2018. We expect inflation to ease to around 20% by the end of 2017 and to 10% by the end of 2018.

Policy rates have been hiked twice in an effort to quell inflation

In an effort to fight inflation, the CBE hiked its policy rates twice since the currency float. The first time, in November, the central bank lifted rates by 300 basis points (bps) (Chart 11). Authorities had already raised rates by 300 bps in three moves over the previous 12 months. The CBE raised rates again in May, this time in a widely unexpected move, hiking them by 200 bps. Authorities felt that, with "data pointing to strengthening demand-side pressures", risks to the inflation outlook had "tilted more strongly to the upside".

Fiscal deficit has narrowed as reforms begin to take effect

The key priority for the government has been addressing the large fiscal deficit, which is a key source of imbalance for the economy. Some progress has already been made in that regard. The government replaced its sales tax with a value-added tax (VAT) in 2016. There have also been efforts to control the wage bill and to reduce government subsidies. A financial stamp tax was also introduced, though its fiscal impact is expected to be limited.

The impact of these measures on the fiscal picture has already been felt. The deficit narrowed during the first nine months of FY16/17 through March 2017 to 11% of GDP. The improvement, around 1.1 percentage points, came largely from increased control of the wage bill and healthy tax revenue growth. Tax revenues increased by 27% y/y thanks to the new VAT. During this period, the primary deficit (excluding interest payments) more than halved to 1.5% of GDP.

This improving trend is expected to continue over the next two years. The deficit should narrow to around 10% of GDP in FY16/17 from around 12% the prior year (Chart 9), and further to around 9% and 8% in FY17/18 and FY18/19, respectively.

Government taps international debt market

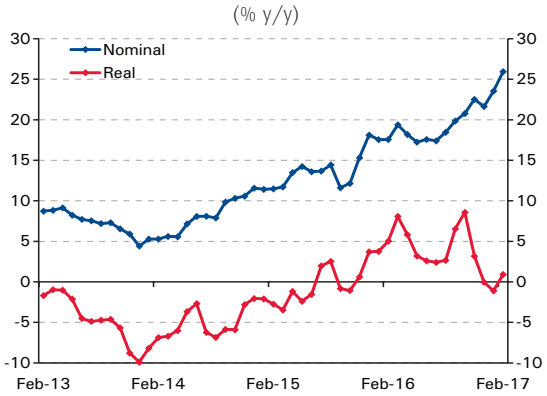
In an effort to reduce reliance on domestic financing of the deficit, the government has tapped international markets. The government raised $4 billion in USD bonds in January, an issuance that was more than 3.5 times oversubscribed. Pricing also came in more favorably than anticipated. The debt sale, which was Africa's largest ever, included 5-year, 10-year and 30-year tranches. Another $3 billion was raised in May with similar maturities. Once again, appetite for the issuance was strong, with the size double what the government had targeted initially.

Current account deficit widened in 2016

The current account deteriorated in 2016 largely as a result of the collapse in tourism and lower remittances, but has since improved in 1Q17. Tourism receipts were more than halved to $2.6 billion, as tourists stayed away following the bombing of a Russian passenger airplane. Meanwhile, remittances fell by 9% to $16 billion; an unfavorable official exchange rate had seen overseas workers increasingly use unofficial channels to repatriate their savings, which hurt remittances.

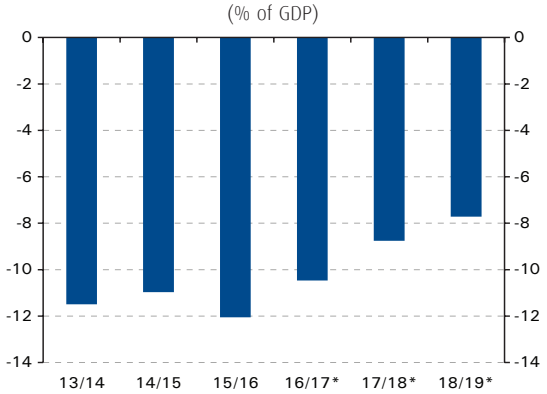
These negative trends, both of which we expect will begin to abate in 2017, were countered by more positive trends in the goods balance. The trade deficit actually narrowed by 5% thanks to strong export growth. Non-oil

Chart 8: Private credit in local currency



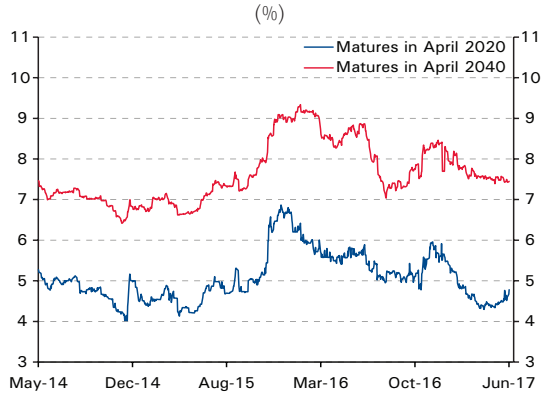
Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 9: Fiscal balance



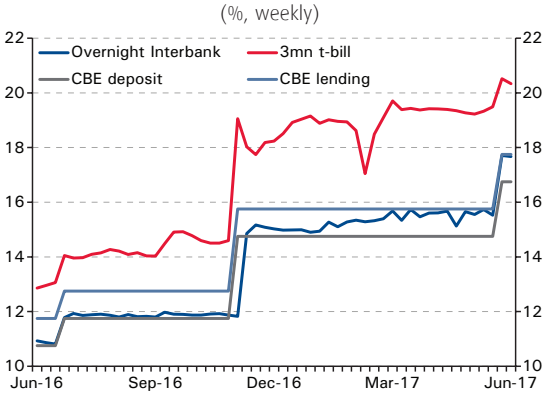
Source: MOF, TR Datastream, NBK estimates, *estimate/forecast

Chart 10: USD sovereign bond yeilds



Source: Thomson Reuters Datastream

Chart 11: Interest rates



Source: Central Bank of Egypt, Thomson Reuters Datastream

exports received a strong boost in 2016, increasing by 17% to $14.5 billion. At the same time, import growth was flat in part thanks to a 17% drop in the oil import bill.

Egypt continued to benefit from healthy levels of foreign direct investment (FDI), which continued to provide support to the balance of payments (Chart 12). FDI rose by 17% in 2016 and accounted for around 2.9% of GDP. FDI in 4Q16 alone saw a healthy jump to an annualized 4.2% of GDP, recording one of the best quarters in more than six years.

The balance of payments saw trends improve strongly in 1Q17; the current account deficit shrank to its lowest level in over two years (to $3.5 billion or 7.3% of GDP) and portfolio inflows skyrocketed, as the decline in the pound made Egypt an attractive destination. The current account continued to benefit from strong export growth, which topped 30% y/y in 1Q17. The quarter also saw tourism receipts and remittances bounce back. Meanwhile, net investment portfolio inflows shot up to $7.6 billion during the quarter, possibly the largest such inflow ever recorded.

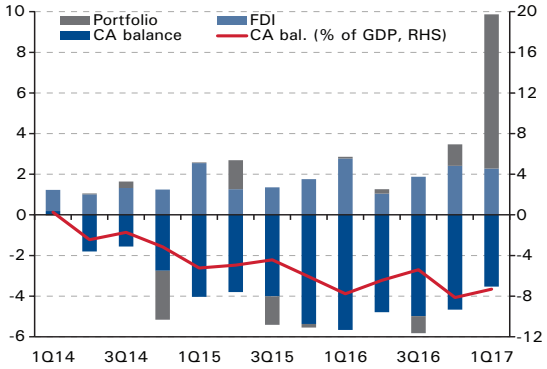
Foreign reserves have improved significantly since October 2016

Foreign reserves have risen significantly since the decision to float the pound. CBE reserves rose to their highest level in over six years in May to $31.1 billion or an estimated 7.7 months of imports (Chart 13). This is more than 60% higher than their level on the eve of the decision and before the IMF finalized its $12 billion loan to Egypt. The decision to float the currency relieved much of the pressure on reserves; these also benefited from inflows from a number of multi-lateral organizations, including the IMF.

Equities rallied since the decision to float the currency

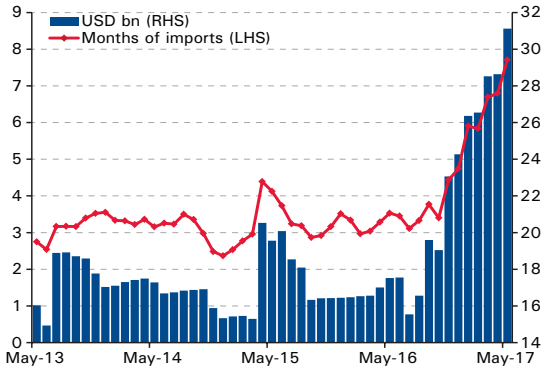
The stock market has outperformed most markets since October 2016. The EGX30 index was up 10% thus far in 2017 through 6 June. This followed a gain of 57% in 4Q16, with most of that taking place in November. Despite the rally, gains have not been enough to counter the drop in the currency; the MSCI total return index in USD remains down by 16% from its level before the currency float.

Chart 12: Balance of payments



Source: CBE, Thomson Reuters Datastream, NBK estimates

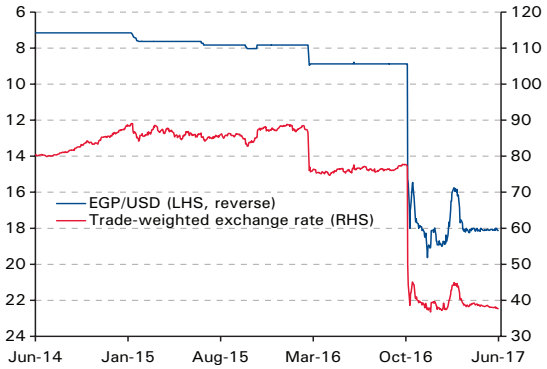
Chart 13: Official reserves



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

	Unit	2012	2013	2014	2015	2016e	2017f	2018f
Bahrain								
Nominal GDP	USD 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	3.0	3.5
Kuwait								
Nominal GDP	USD bn	174.2	174.3	162.7	114.1	111.0	124.3	135.2
Real GDP	% y/y	6.6	1.1	0.5	1.8	3.4	-0.7	3.2
Oil sector	% y/y	10.3	-1.8	-2.1	-1.7	3.3	-4.5	2.4
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	-18.7	-13.8	-12.0
Current account balance	% of GDP	45.3	38.8	33.1	3.5	-4.5	1.6	3.0
Inflation	% y/y	3.3	2.7	2.9	3.3	3.2	2.9	3.5
Oman								
Nominal GDP	USD bn	76.3	78.9	80.9	69.7	66.2	69.4	73.0
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	-17.3	-20.4	-13.1	-8.0
Current account balance	% of GDP	10.1	6.6	5.2	-15.5	-21.1	-15.3	-12.2
Inflation	% y/y	2.9	1.1	1.0	0.1	1.1	2.3	4.1
Qatar								
Nominal GDP	USD bn	186.8	198.7	206.2	164.6	152.4	169.9	183.9
Real GDP	% y/y	4.7	4.6	4.0	3.5	2.2	2.5	3.1
Oil sector	% y/y	1.2	0.1	-0.6	-0.5	-1.0	-0.3	1.0
Non-oil sector	% y/y	9.9	10.6	9.8	8.2	5.6	5.3	5.0
Budget balance	% of GDP	11.6	16.4	12.3	-1.9	-9.0	-5.1	-3.5
Current account balance	% of GDP	33.2	30.4	24.4	8.4	-5.0	1.2	2.3
Inflation	% y/y	1.9	3.1	3.3	1.8	2.7	1.5	3.0
Saudi Arabia								
Nominal GDP	USD bn	735.9	746.6	756.4	651.8	639.6	689.5	727.5
Real GDP	% y/y	5.4	2.7	3.7	4.1	1.4	0.5	1.3
Oil sector	% y/y	5.1	-1.6	2.1	5.3	3.4	-0.3	1.7
Non-oil sector	% y/y	5.7	6.3	4.9	3.2	-0.1	1.1	1.0
Budget balance	% of GDP	13.5	6.3	-2.5	-15.0	-16.8	-8.0	-3.7
Current account balance	% of GDP	22.4	18.1	9.8	-8.0	-5.2	-0.1	2.3
Inflation	% y/y	2.9	3.5	2.7	2.2	3.6	2.5	4.3
UAE								
Nominal GDP	USD bn	373.4	388.6	401.9	370.3	360.0	390.8	425.3
Real GDP	% y/y	6.9	4.6	3.1	3.8	2.4	2.2	3.9
Oil sector	% y/y	7.6	2.9	0.8	5.0	1.9	-1.0	2.6
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	-3.6	-1.8	0.6
Current account balance	% of GDP	17.8	19.1	14.6	5.8	4.8	5.1	6.3
Inflation	% y/y	0.7	1.1	2.3	4.1	1.6	2.5	3.0
Egypt (fiscal year)								
Nominal GDP	USD bn	284.4	304.9	331.5	326.1	246.6	227.4	254.2
Real GDP	% y/y	2.1	2.9	3.4	2.3	3.0	4.0	5.0
Budget balance	% of GDP	-12.8	-11.5	-11.0	-12.1	-10.5	-8.8	-7.7
Current account balance	% of GDP	-2.2	-0.9	-3.7	-6.7	NA	NA	NA
Inflation	% y/y	9.8	8.2	11.4	14.0	30.0	11.0	9.0

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	45.7	55.0	60.0
CRB commodity price index	Index	484.1	457.3	437.8	374.8	423.1	-	-
Eur/USD	1$ = €	0.758	0.736	0.827	0.921	0.951	-	-
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	1,751	-	-
MENA real GDP (IMF)	% y/y	5.5	2.1	2.7	2.6	3.8	2.3	3.2
World real GDP (IMF)	% y/y	3.5	3.4	3.5	3.4	3.1	3.5	3.6

Source: Thomson Reuters Datastream, official sources, IMF, NBK estimates

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