Macroeconomic outlook

Oman: Gas output to boost GDP next year, but fiscal position still a concern

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Overview and outlook

- **We expect real GDP growth to weaken to 0.3 % in 2017 on oil output cuts and slower growth in consumption and investment, before picking up to 2.8% in 2018 thanks to a boost in gas production.**
- **The fiscal deficit will narrow this year but remain worryingly large at 14.5% of GDP. The introduction of VAT and increased hydrocarbon revenues will see it improve to 11% of GDP in 2018.**
- **Inflation will rise through 2017 and 2018 as the government implements new tax measures. Meanwhile, liquidity conditions in the banking sector should improve modestly.**
- **The economy could see a slight benefit from Qatar's discord with its regional peers, with some trade and travel diverted through Oman.**

Economic growth will slow to just 0.3% this year – its weakest since 2011 – on the back of a drop in oil output, before recovering in 2018 as gas production is expanded and the non-oil economy steadies. There remain notable downside risks, however. The government's large budget deficit could require sharper-than-forecast fiscal consolidation if the financing climate deteriorates – perhaps from the anticipated "global tapering" of monetary policy – which could also affect the government's plans for economic diversification. And inflation is set to rise following the introduction of new taxes. On the upside, Oman is benefitting from trade diversion due to the ongoing rift between Qatar and the Saudi-led bloc.

Growth to be supported by rising gas production; non-oil steady

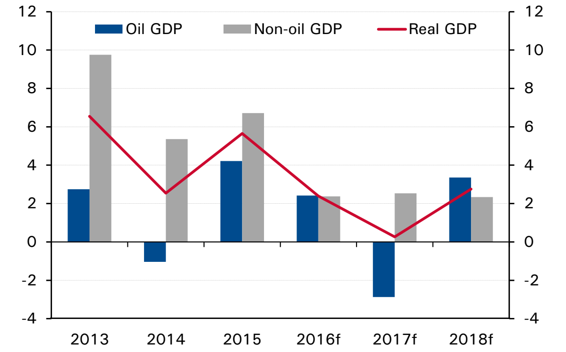
Despite the above, we have nudged up our growth forecasts to reflect both non-oil dynamics and an earlier-than-expected pick-up in gas production. Household expenditures will grow modestly even with the headwinds facing consumers, and the pursuit of business friendly laws should support non-oil growth. The launch of the BP Khazan project's first train in September 2017, with the second train to follow in 1Q18, will boost oil GDP and partially offset the extension of oil production cuts taken in accordance with the OPEC/non-OPEC agreement. Overall GDP growth is forecast at 0.3% and 2.8% for 2017 and 2018, respectively.

Table 1: Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	US$ bn	70	66	70	71
Real GDP	% y/y	5.7	2.4	0.3	2.8
- Oil	% y/y	4.2	2.4	-2.9	3.4
- Non-oil	% y/y	6.7	2.4	2.5	2.3
CPI	% y/y	0.1	1.1	1.8	4.2
Budget balance	% GDP	-17.3	-20.8	-14.5	-11.0

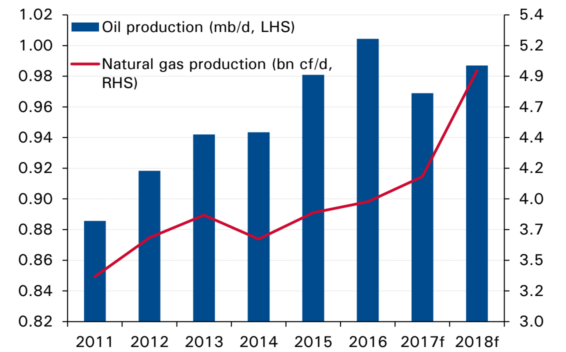
Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP
(% y/y)



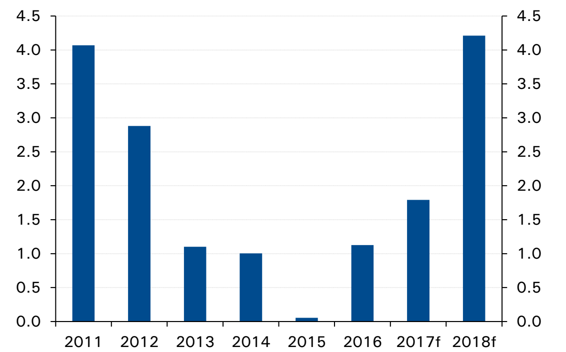
Source: National Center for Statistics and Information, NBK estimates

Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation
(% y/y, year average)



Source: National Center for Statistics and Information, NBK estimates

Latest high frequency activity indicators are mixed. Car registrations were at their lowest in five years in August, with the 12-month rolling total down 23% y/y. Hotel revenues, however, shook off a prolonged contractionary period, with July's 12-month rolling total at its highest level in almost 18 months and up 3% y/y. Meanwhile, a majority of private sector companies reported discouraging earnings in 2Q17. Companies have also slowed their hiring, with expat employment growing a mere 3% in August, compared to a monthly average of 10% in 2016. Governmental pressure to hire Omani nationals let go in the wake of the economic downturn also contributed to the slowdown in expat employment growth.

Looking to 2018, increased revenue from a new VAT and recovering oil prices may see government investment spending pick up, with growth further lifted by the complete launch of the BP Khazzan tight gas project. Indeed, this may lead to stronger government consumption, gas production, and LNG exports. Household consumption will grow but at a subdued pace, as consumers grapple with higher prices (VAT) and modest jobs growth.

Oman continues to pursue diversification initiatives in a bid to divest its economy from oil. These efforts, however, are being held back by lower oil prices, which are affecting the pace of investment. A friendlier foreign investment law (due to be officiated soon) and a stronger focus on tourism and other sectors may help boost non-oil activity going forward. Nonetheless, growth in the non-oil economy will average a modest 2.4% per year in 2017 and 2018.

Oman is not participating in the blockade of the Qatari economy and could see a marginally positive economic impact, as trade and travel between Qatar and both Saudi Arabia and the UAE is diverted. Omani ports (Duqm and Salalah) have reported increased bilateral trade between the two countries, while Qatari travelers are using Muscat international as a newfound transit hub. If the dispute persists, these effects could become more deeply entrenched. New shipping lines have been opened between Oman and Qatar's recently inaugurated Hamad port.

Oil & gas sector to pick up on gas production boost

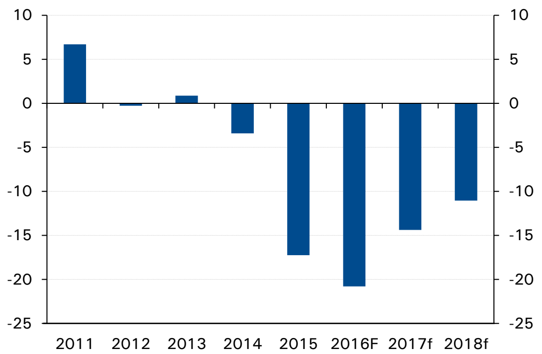
After an exceptional 2016 that saw average daily oil production breach 1 million barrels per day, oil output will contract in 2017 as Oman complies with the cuts agreed by OPEC and non-OPEC countries. However, the launch of the BP Khazzan tight gas project at end-2017 and early 2018 will deliver a strong boost to the gas sector as daily production capacity is increased by 1 billion cubic feet, or close to 25%. Oman's hydrocarbon GDP is forecast to decline 2.9% in 2017, before rising 3.4% in 2018.

Excise tax and VAT to push inflation considerably higher

Consumer price inflation has eased in recent months and stood at 1.1% y/y in August, but will pick up in 4Q17 as the government implements an excise tax. Inflation will rise further in 2018 as the government continues to liberalize prices on energy and other goods and services and introduces VAT, offsetting downward pressures from global food and energy prices. Inflation will average 1.8% in 2017 rising to 4.2% next year – though delay in implementing VAT beyond the Q1 built in to our assumptions would see the latter come in lower.

Chart 4: Budget balance

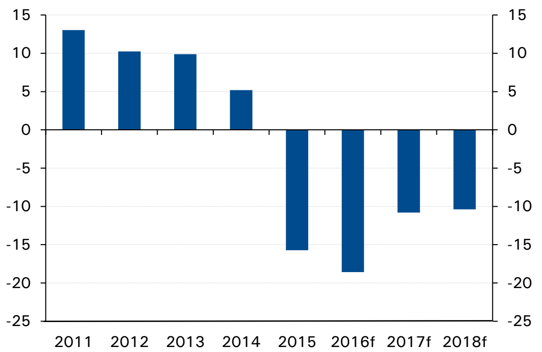
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

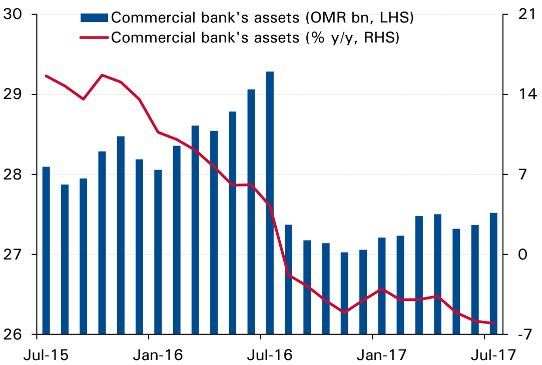
Chart 5: Current account balance

(% 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

Fiscal deficit to overshoot in 2017 and to persist into 2018

The fiscal position remains very weak. At 80% of its OMR 3 billion target just 6 months into 2017, the government is likely to overshoot its deficit projection for the second year in a row.

Recent public finance data showed little progress in significantly reducing spending, which was virtually unchanged in 1H17 from 1H16. Current expenditures increased by a small 1.3%, at the expense of investment expenditures (down 6%), on the back of higher defense spending and interest payments. Efforts to curb public sector wage growth, however, did materialize somewhat, with civil ministry spending (which includes wages) decreasing by 2.4%.

On the bright side, revenues, both oil and non-oil, rose on the back of higher oil prices and better fee collection and tax revenue. The government has adopted several measures to strengthen its finances and recently overhauled the corporate income tax (1Q17), while the implementation of an excise tax scheduled for 4Q17 will lend further support. However, we still forecast a large deficit of 14.5% of GDP for 2017.

Implementation of the VAT in 2018, which could add OMR 0.4 billion, in addition to a pick-up in oil prices, will see revenues increase next year. However, in our baseline scenario, current and investment expenditures pick up, 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. We forecast the deficit narrowing to 11% of GDP in 2018. Nevertheless, we would not rule out more aggressive spending cuts should the funding climate weaken or should oil prices come in much lower than expected.

Public debt levels low, but rising

The government 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 sub-investment grade in May (BB+). Both Moody's (Baa2) and Fitch (BBB) still have the sovereign rated as investment grade, albeit at a lower rating (Moody's) 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. It also borrowed $3.5 billion from Chinese banks through a syndicated loan in August. Oman's public debt level remains low relative to similarly-rated sovereigns, though it rose to around 30% of GDP at the end of 2016 and is seen rising further to 44% and 52% by the end of 2017 and 2018, respectively.

Banking system sees liquidity conditions improving

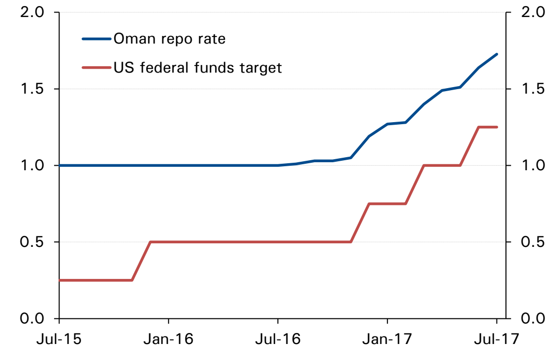
In light of the rise in oil prices, the banking sector is projected to see liquidity pressures ease gradually as government deposits recover, supported by the government's international borrowing program. Government deposits were up 3% y/y in July 2017.

Credit growth is slowing in 2017, possibly on the back of weaker household spending, and is expected to pick up in 2018, as individuals cope with the higher cost of living brought forth by the implementation of the VAT. In July 2017, private credit growth eased to 4.9% y/y from an average 10% in 2016.

Despite Oman's currency peg to the dollar, the Central Bank of Oman

Chart 8: Policy rates

(%)



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

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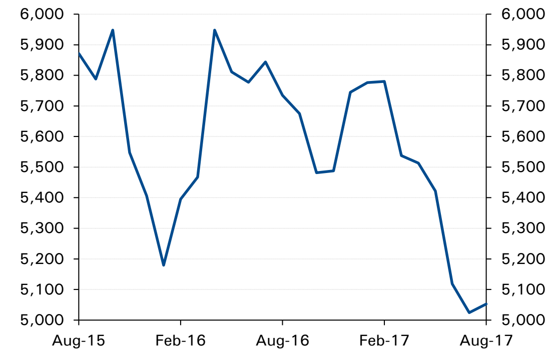

Source: : Muscat Securities Market

(CBO) refrained from increasing its main policy rate after the June US Fed rate hike. However, the CBO has been raising its overnight repurchase rate. It registered at 1.72% as of July 2017.

The banking sector remains well capitalized. According to the CBO's latest quarterly financial soundness statistics (June 2017), credit risk remains low with nonperforming loans (NPL) at 1.9% of gross loans. Capitalization was also high, with a capital adequacy ratio of 16.6% in 2Q17.

Stocks weighed down by weaker economy

The weaker operating environment has started to take a toll on Omani corporates, with most reporting weaker earnings in 1H17. The MSM 30 decreased by 11.9% y/y in August 2017 to reach 5053, hovering near 7-year lows. This leaves Oman as the second worst performing market in the GCC, down 13% YTD, trailing Qatar's 20% contraction and well below Abu Dhabi's mild 2% drop.

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