Growth to pick up, but finances remain vulnerable

Highlights

- Real growth is expected to accelerate to 3.5% in 2018 from 0.3% in 2017 on increased hydrocarbon output and investment in the non-oil sector; growth will then slow to 2.6% in 2019.
- Although non-oil revenues remain modest, firmer oil prices will help lower the deficit from an expected 14.7% of GDP in 2017 to 7% of GDP this year; the deficit will widen a little in 2019 to 8.5% of GDP on lower oil prices.
- Lower domestic demand and a weaker real estate market may see inflation average 1.0% in 2018, before picking up to 3.0% in 2019 following the introduction of the VAT.
- In view of the government’s tight finances and ambitious diversification plans, debt issuance, privatization and foreign investment will be increasingly vital; government debt is expected to rise to 47% of GDP in 2018.

Diversification program to drive non-oil growth

The government is committed to pursuing its diversification program, where the focus will increasingly be on downstream oil products, tourism and logistics. The non-oil economy should, therefore, gain some traction, potentially expanding at an average of 3.5% per year in 2018-2019. (Chart 1.)

The opening of the new Muscat International Airport in 2018 is an important step in the government’s plan to increase the contribution of the tourism sector to Oman’s non-oil economy. The government intends to increase the number of tourists by more than 65% by 2020, from 3 million in 2017 to 5 million. Meanwhile, the Duqm special economic zone has attracted strong interest, mainly from small and medium enterprises that will service the tourism and logistics sectors.

Gas industry to play greater role in Oman’s future

A slew of recent natural gas discoveries and new partnerships with international energy conglomerates highlights the importance of the hydrocarbon sector. Oman is committed to developing its natural gas facilities and capitalizing on its advantageous geographical location in the global LNG supply chain, all the more so in view of the fact that its oil wells are ageing. The country is also slowly diversifying its export destinations, hitherto almost exclusively Japan and South Korea. These plans should boost growth over the medium-term.

<table>
<thead>
<tr>
<th>Table 1: Key economic indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2016</strong></td>
</tr>
<tr>
<td>Nominal GDP</td>
</tr>
<tr>
<td>Real GDP</td>
</tr>
<tr>
<td>- Oil</td>
</tr>
<tr>
<td>- Non-oil</td>
</tr>
<tr>
<td>Inflation</td>
</tr>
<tr>
<td>Budget balance</td>
</tr>
</tbody>
</table>

Source: Official sources, NBK estimates

In the meantime, Oman’s oil output should see some increase this year from OPEC+’s likely decision soon to increase oil production (to prevent the market from over-tightening) and from the full launch of the BP Khazan tight gas project. Full production capacity will likely be reached next year. (Chart 2.) Consequently, oil sector GDP is forecast to expand by 3.1% in 2018 and 1.5% in 2019.
revenues. The government’s decision to postpone fiscal reforms such as the value added tax (VAT), to 2019, on concerns that it would negatively affect consumer spending and the non-hydrocarbon sector more broadly, did not help.

**Inflation subdued in 2018 but rising in 2019**

Lower domestic demand and a weaker real estate market helped contain inflation to 1.0% in 2018. It should rise initially to about 3.0% in 2019 following the introduction of the VAT. (Chart 4.)

**Access to finance will be key to achieving the sultanate’s ambition**

In view of tight public finances and ambitious diversification plans, the government will need to rely increasingly on debt, privatization and foreign investment. For the time being, Oman can still count on relatively easy access to international debt markets, but this is getting more expensive due to the sultanate’s low sovereign rating and the higher interest rate environment. And it will be much more difficult if the country loses its investment grade status; Moody’s, the rating agency, recently downgraded Oman’s sovereign rating to Baa3, which is only one notch above speculative grade, while S&P ranks the sultanate’s credit profile as speculative.

Recognizing the risks in future public borrowing, the government has also turned to privatization as a potential source of income, with six entities slated for sale. A partial equity stake sale in the new airport and in the BP Khazan field are being considered.

However, the government and its entities will still rely primarily on debt markets for most of their required financing. Oman issued $6.5 billion earlier this year, its biggest issuance to date, while publically owned enterprises, such as Oman Gas and Oman Electricity, are seeking $1 billion and $1.2 billion, respectively, in debt financing. Government debt is expected to

---

Chart 2: Hydrocarbon production (mboe/d)

![Chart 2: Hydrocarbon production](chart2)

**Source:** Thomson Reuters Datastream, NBK estimates

Risks to non-oil growth are to the downside, however. The recent extension of an expatriate employment ban has coincided with a slowdown in the real estate sector. Domestic demand may also be impacted by the departure of expatriate labor, while next year should see some downward pressures on the consumer sector with the introduction of the VAT. These effects should be temporary, though, with the pick-up in investment and government spending providing solid support for the non-oil sector.

**Fiscal deficit to narrow on higher oil prices, but non-oil income growth continues to lag behind**

Thanks to firmer oil prices—$65/bbl in 2018 and $60/bbl in 2019 as per our own projections—Oman’s budget deficit should narrow to 7% of GDP in 2018 and 8.5% of GDP in 2019 from close to an expected 15% of GDP last year. (Chart 3.)

**Chart 3: Fiscal balance (% of GDP)**

![Chart 3: Fiscal balance](chart3)

**Source:** Thomson Reuters Datastream, NBK estimates

Despite Oman’s best efforts to increase non-hydrocarbon revenue, the sultanate continues to depend on oil and gas revenues, accounting historically for more than 80% of total revenues.
rise to 47% of GDP in 2018 and 52% in 2019.

The domestic banking system is also poised to help facilitate the sultanate’s diversification drive, thanks to recent regulatory changes aimed at boosting domestic lending. Indeed, in addition to other reforms, the Central Bank of Oman allowed the inclusion of interbank deposits when calculating lending ratios and lowered the capital adequacy ratio to 11% from 12%. This is expected to stimulate bank lending and position Oman’s interbank system as a main pillar of its financial future. As such, private sector credit growth, which averaged 4% last year, is expected to accelerate to an annual average of 7% in 2018-19.