UAE: Stable outlook despite global and regional risks

The UAE witnessed high growth rates after the financial crisis of 2008 but in recent years, growth has faltered. A series of structural reforms along with a fiscal stimulus package were implemented in 2018-19 to boost non-oil sector growth. These measures and the continuous drive for diversification should help raise demand and broaden the country's economic base, putting the UAE on a transitional path in the medium term. However, the country still depends on oil revenues and remains vulnerable to external shocks. A slowing global economy amid trade disputes, softer energy demand and heightened geopolitical tensions weigh on growth prospects.

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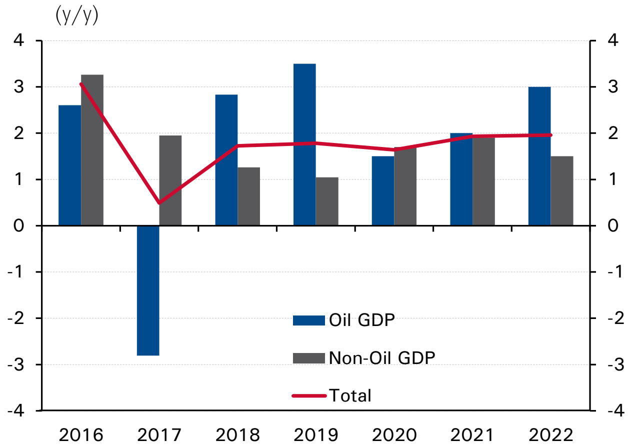
Non-oil Sector is losing momentum

The UAE witnessed robust growth after the global financial crisis, even while the global economy languished. The fast rebound in 2010-14 was broad-based, as the non-oil sector was helped by diversification policies and by the UAE's strategic location as a key international trade and business hub. After the 2014 oil-price downturn, real non-oil growth began to moderate, slowing to 1.7% in 2018 from 6.2% in 2014. A prolonged period of heightened geopolitical risk in the region adversely affected investors' sentiment, weakened trade volumes, and ultimately led to a decline in private consumption and investment. In parallel, government finances deteriorated, triggering a series of measures to rein in rising budget deficit.

More recently, rising trade tensions between the US and China and the US sanctions on Iran have undermined UAE exports and growth. Non-oil real GDP growth was barely positive at 0.3% y/y in 1Q19, but the headline growth rate stood at 3.7% y/y, almost fully due to output gains in the oil sector (+12.4% y/y). Non-oil growth was below 1% y/y for three consecutive quarters (since 2H18), reflecting more ingrained slack in the economy, despite a double-digit increase in non-oil exports in 2018 (+13.9%), suggesting continued weakness in private sector demand. There are also recent reports indicating that job creation has fallen in 2019 on account of job losses in transport and communication sectors.

Chart 1: Real GDP



Source: FCSA, NBK forecasts

Crude oil production, meanwhile, has remained relatively stable in 2019, averaging 3.06 mb/d to September, which is lower than 4Q18's average of 3.28 mb/d. This is due to the UAE's participation in the OPEC+ production cut agreement, which aims to pare back global oil supplies amid slowing energy demand growth. (Chart 1.)

Fiscal consolidation and interest rate hikes contributed to weakened demand

The decline in private consumption and investment by 0.5% and 0.7% in 2018, respectively, weighed on real growth. This weaknesses in domestic demand was reflected in lower imports of goods and services, which went down by 3.2% in 2018. Improvements in credit growth to business and the industrial sectors, by 5.8% in 2018 from 2.8% in 2017, did not quell weak sentiment as the Markit PMI declined to 55.5 on average in 2018 from 56.1 in the previous year. Prudent fiscal policies exacerbated the impact on growth as public consumption and investment contracted by 1.6% and 0.1%, respectively, in 2018. Government efforts were concentrated on consolidating the fiscal position, following the 2014 oil price drop that saw the federal government's revenues fall by about 26.1% in 2015. This has inevitably affected non-oil growth, as it softened to 1.3% in 2018 compared to 1.9% in the previous year. At the same time, public finances have improved, and budget sensitivity to oil price volatility was reduced, especially with the introduction of excise taxes in October 2017 and the Value-Added Tax (VAT) in early 2018.

The implementation of the excise and VAT taxes coupled with higher domestic fuel prices pushed the inflation rate to 3.1% in 2018, offsetting the impact of weak demand. With the fading effect of the excise taxes in 4Q18, core inflation entered deflation territory. In 2019, weaker private domestic demand, low credit to businesses and the industrial sectors (2.6% ytd in August) and the decline in rental prices—which fell by more than 5% during the first eight months of 2019 mainly on account of oversupply and shrinking expat numbers—had a greater bearing on domestic prices. As the impact of VAT began to wane, the UAE slipped into deflationary mode with prices down by 2.0% y/y as of last August.

The increase in UAE interest rates that began in 2016 in tandem with the rise in US rates—in view of the UAE Dirham peg to the US dollar—contributed to tightening liquidity and further weakening of private sector demand. The real estate sector was also affected by the rise in borrowing costs as well as by the higher sales transaction fees, while the supply side suffered from a glut, causing prices to fall since 2015. The decline in real estate prices was more evident in Dubai, falling by 7.3% in 2018. The Dubai government formed a new committee to curb the fall in prices through regulating the pace of projects to achieve balance between supply and demand. The oversupply in the real estate sector continued to weigh on property prices in 2019, with prices in Dubai and Abu Dhabi falling by 10% and 7.7% y/y in July, respectively.

How did the authorities react to slowing growth?

In a bid to stimulate non-oil sector growth, the authorities adopted a series of structural measures and an expansionary fiscal policy. The structural reforms aimed mainly at reducing the cost of doing business and improving the investment climate. The government reduced or canceled around 1,500 service fees related to the issuance and renewal of working permits and industrial licensing services, and granted residency visas to foreign experts in the medical, research and technical fields. The government launched a credit guarantee scheme of AED 100 million through Emirates Development bank to provide strategic financing solutions to SMEs. More importantly, a new investment law was issued recently to loosen foreign ownership requirements outside of the designated free zones and to allow foreign shareholders to own up to 100% of UAE companies in 122 business activities in 13 sectors. Dubai also supported SMEs by updating regulations for business accelerators and incubators by offering 100% ownership, reducing the cost in the aviation, real estate, and tourism sectors and lowering business charges.

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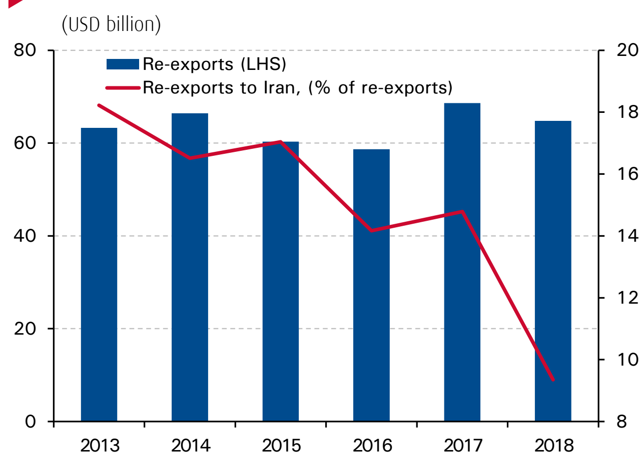
Abu Dhabi, on the other hand, adopted a $13.6 billion (AED 50 billion) three-year fiscal stimulus package in 2018 to support the government accelerators program. This includes around 50 initiatives that target SMEs, startups, the industrial, tourism and technology sectors through attracting investments and introducing new licenses in technology businesses. Abu Dhabi also implemented an instant licensing system, an accelerated approval process. In addition, Abu Dhabi National Oil Company (ADNOC) launched an In-Country Value (ICV) program in 2018 to support the government's growth agenda through awarding procurement contracts to ADNOC's suppliers based on Emiratization and their supply chains under which they were encouraged to increase their domestic content. In addition, ADNOC, embarked on new downstream investments for 2018-21 of USD 45.0 billion (AED 165 billion) in LNG, LPG and petrochemical products to raise the value-added of the hydrocarbon industries.

Difficult external environment persists

Reforms, however, are facing headwinds from a global slowdown and regional geopolitical tensions. The US-China trade war and the ensuing uncertainty facing global investors have adversely affected global growth, reduced demand and disrupted regional supply chains. The imposition of tariffs by the US administration directly affected the UAE steel and aluminum industry (with latter growing by 1.8% in 2018 compared to 20.8% in 2017) whose products constitute around 15.2% of UAE's non-oil exports in 2018. This global backdrop has dimmed the UAE's non-oil exports prospects and contained the impact of the authorities' growth-boosting measures. However, the negative global trading environment has provided an opportunity for the UAE to redirect its trade closer to home. Trade ties between the UAE and other GCC countries have consequently increased, with GCC countries' share of UAE non-oil exports rising from 23.2% in 2017 to 34.1% 2018. Saudi Arabia tops the list, taking in 16% of the UAE non-oil exports.

The geopolitical tensions and the sanctions imposed by the US on Iran have also had an adverse impact on the UAE's re-exporting sector. Banks have become more reluctant to finance commercial operations with Iran lest they open themselves up to possible legal actions by the US. Dubai, as one of Iran's main links to the outside world, was impacted by the re-imposition of sanctions, causing UAE re-exports to Iran—which constitutes around 15% of the UAE's total re-exports—to drop by 40.2% in 2018 (Chart 2.)

Chart 2: Re-exports to Iran



Source: FCSA, NBK calculations

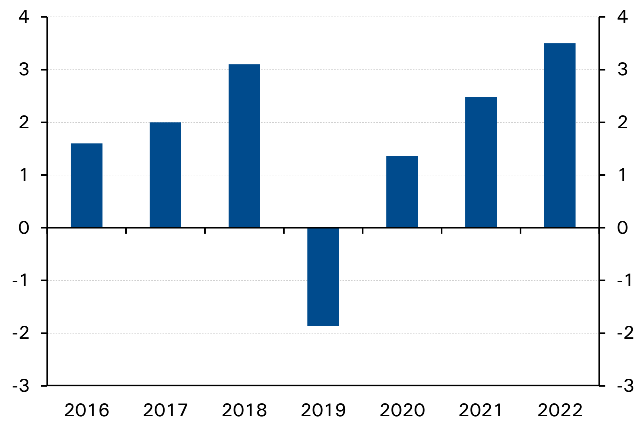
Looking Forward

Growth prospects in the UAE remain relatively solid, supported by the oil sector, which is expected to grow by 3.5% in 2019. However, the extension of the OPEC+ agreement into 2020, coupled with weaker global demand will put downward pressure on the sector going into 2020, such that it is only expected to grow by an average of 2.2% during 2020-22. On the other hand, the non-oil sector is expected to grow moderately by 1.0% in 2019 before trending up to around 1.8% during 2020-21 as the impact of structural reforms, the fiscal stimulus package and the EXPO 2020 begin to be realized. Going into 2022, growth is expected to ease to 1.5% as the impact of the Abu Dhabi stimulus and EXPO 2020 fades.

Headline inflation is expected to rebound starting in 2020. Deflation is expected at -1.9% in 2019 on the back of an expected 5.5% contraction in rental prices. In 2020 and beyond, with the pick-up in demand, inflation is likely to gain more momentum and average 2.4% in 2020-22. Transportation prices will remain subdued in the medium term due to weak oil prices, while tourism-related items are expected to rise, coinciding with EXPO 2020. (Chart 3.)

Chart 3: Headline Inflation

(y/y)

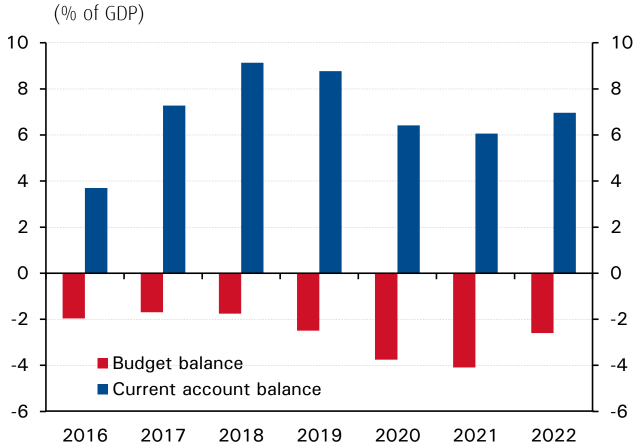


Source: FCSA, NBK forecasts

Weakening oil prices will weigh on government revenues, which could decline from 29.2% of GDP in 2019 to average around 28.0% of GDP in 2020-22. On the other hand, expenditures will rise in 2019 and 2020 due to the government's plans to boost economic growth. As a result, we expect the budget deficit to be about 2.5% of GDP in 2019 and widen to 3.6% of GDP in 2020-22. However, the fiscal position remains strong as the UAE can afford a modestly expansionary fiscal stance in the next few years given its large financial buffers and fiscal space. (Chart 4.)

Chart 4: Current Account and Budget Balance

(% of GDP)



Source: CBUAE, IMF, NBK forecasts

Exports and re-exports growth may soften in the medium term, because of slow global demand growth and the sanctions on Iran. The decline in oil prices as well as in oil production will narrow the current account surplus, but it will remain sizable at 8.8% in 2019, before falling to around 6.5% in 2020-2022. The UAE will remain a hub for attracting FDI, supported by strong fundamentals, government reforms and a supportive investment climate.

Sovereign Wealth Funds (SWFs) and foreign reserves provide cushions against exogenous shocks. The accumulated SWFs assets of Abu Dhabi Investment corporation, Investment Corporation of Dubai, and Mubadala Development Company is estimated at more than USD 1,100 billion in addition to the CBUAE official reserves of USD 102 billion. These funds provide large buffers and sufficient fiscal space that can be used to support the non-oil sector and boost growth when the need arises.

Downside risks continue to weigh on the medium-term outlook. The UAE economy is the most vulnerable among GCC countries to a global economic slowdown given its high openness. Headwinds from the uncertain global and regional geopolitical situation could hamper growth and slow diversification efforts. US sanctions on Iran will continue to affect re-exports, especially for Dubai. The vulnerability of the economy to oil prices remains an important risk factor, and the concentration of the non-oil economy on a few sectors such as construction, tourism and logistics could be limiting as these sectors cannot continue to grow at the same high rates as before.

Furthermore, fragile growth in MENA region economies will further weaken external demand. Domestic risks also exist and relate to continued weakness in the real estate sector, while the prospect of lower interest rates could adversely affect banks' performance through lower collateral quality, high provisioning and lower net interest income. However, with the recent central bank efforts to limit bank exposures to the real estate sector, these risks seem manageable at this time.

The UAE economy is facing downside risks but these could be balanced by some upside risks going forward. The upside risks stem from important structural reforms and from an investment-friendly business environment. The UAE continues to lead the Arab region in the World Bank's Ease of Doing Business rankings, where it is ranked 16th globally in 2019 and in the World Economic Forum's competitiveness index. The favorable regulatory environment, along with good infrastructure, makes the UAE the most desirable destination for FDI in the region. Recent reform efforts aimed at boosting growth, simplifying further the regulatory framework, relaxing foreign ownership and protecting minority investors as well as the inception of a credit guarantee scheme for SMEs will have an additional benefit for the business environment. In the short term, the upcoming EXPO 2020 will bolster non-oil sector growth in 2020 with some ripple effects in the following few years.

UAE key economic indicators

UAE	Unit	2016	2017	2018	2019e	2020f	2021f	2022f
Nominal GDP	$ bn	357	378	414	409	419	440	466
Real GDP	%y/y	3.1	0.5	1.7	1.8	1.6	1.9	2.0
- Oil sector	%y/y	2.6	-2.8	2.8	3.5	1.5	2.0	3.0
- Non-oil sector	%y/y	3.3	1.9	1.3	1.0	1.7	1.9	1.5
Budget balance	% GDP	-2.0	-1.7	-1.8	-2.5	-3.8	-4.1	-2.6
Current account balance	% GDP	3.7	7.3	9.1	8.8	6.4	6.1	7.0
Headline Inflation	% y/y	1.6	2.0	3.1	-1.9	1.4	2.5	3.5

Source: FCSA, NBK forecasts

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