Diversification efforts to proceed; public finances should improve

Highlights

- Real growth is expected to rise from an estimated 2.4% in 2018 to 3.6% in 2020 on continued gains in hydrocarbon output and non-oil activity, supported by the government’s diversification and infrastructure spending program.
- Continued high spending levels amid a slightly softer oil price environment is likely to see the fiscal deficit widen to around 7% of GDP in 2019; non-oil revenues (e.g. from VAT) should, however, begin to increase going forward.
- Inflation is expected to climb to 2.9% in 2019 from an estimated 0.9% in 2018 if the VAT is rolled out as planned.
- Public debt is likely to continue rising, to just above 50% of GDP by 2020, as the authorities pursue further debt issuances to finance the deficit, but privatization and foreign investments are also being explored.

Pro-growth reforms set to persist in 2019 and 2020

The government’s development and diversification drive will continue to support the oil and non-oil sectors, respectively. In the energy sector, the authorities are committed to developing the country’s downstream oil processes and further expanding gas production capacity. In the non-oil economy, the government will continue to realize plans for a multi-billion-dollar special economic zone in Duqm and an infrastructure development project that will connect Oman’s three major ports Salalah, Sohar and Duqm, which is likely to be a boon for trade and investment prospects in the sultanate. The non-oil economy is also likely to get a further boost from the tourism sector, which the government hopes will increase by a minimum 65% in the number of tourists by 2020. To this end, we potentially see economic growth averaging around 3.4% over 2019 and 2020, on the back of a recovery in both oil (3.3% y/y on avg.) and non-oil sector activity (3.5% y/y on avg.). (Chart 1.)

<table>
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<tr>
<th>Table 1: Key economic indicators</th>
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<tr>
<td><strong>2017</strong></td>
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<tr>
<td>Nominal GDP</td>
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<td>Real GDP</td>
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<td>- Oil</td>
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<td>- Non-oil</td>
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<td>Inflation</td>
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<td>Budget balance</td>
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Source: Official sources, NBK estimates

Oil and gas sector outlook looks promising

Notwithstanding Oman’s participation in the OPEC+ production cut agreement, which had called for a 45 kb/d cut in Omani crude output (Oman averaged 92% compliance in 2018, according to the IEA), it is Oman’s gas sector that is increasingly driving hydrocarbon sector growth and revenues, especially following recent non-associated natural gas discoveries and new project partnerships with international energy firms. Indeed, Omani gas supplies set new records in 2018, mainly on the back of an increase in production at the BP-operated 1 billion cubic feet per day Khazzan gas field. Earlier this year BP initiated the development of Phase 2 (Ghazeer), which is expected to add by 2021 a further 500 million cubic feet per day to its production capacity.
Furthermore, state-led Petroleum Development Oman (PDO) announced that it had discovered about 4.4-4.7 trillion cubic feet and 112 million barrels, respectively, of recoverable gas and condensate reserves at Mabrouk North East. Production at this site is likely to begin in three to four years’ time.

**Non-oil growth anchored on diversification strategy**

In tandem with Oman’s Vision 2020 plan, the Omani government’s steadfast commitment to its diversification strategy, which sees the development of key sectors including manufacturing, transport, logistics and tourism, is likely to support non-oil GDP growth going forward. The potential gains in these respective sectors are expected to temper the expected moderation in consumer demand within the next two years, triggered by the possible introduction of the value-added tax (VAT) in 2019. We therefore expect real non-oil GDP growth to continue to gather momentum and rise from an estimated 3.0% in 2018 to 3.3% in 2019 and 3.6% in 2020.

**Inflation to gradually rise as economy recovers**

Inflation is expected to pick up over the next two years in tandem with an economic recovery. In the event that the VAT is introduced as planned in 2H19, we expect annual inflation to rise from an estimated 0.9% in 2018 to around 3.0% in 2019. The initial impact will fade away, however, and inflation will moderate to around 1.4% in 2020. (Chart 2.)

**Fiscal deficit to widen in 2019 on higher spending**

Oman’s budget deficit is expected to rise to around 7% of GDP in 2019 as the government pursues an expansionary fiscal policy to support economic growth. The deficit should narrow to around 6.0% of GDP in 2020 as revenues are driven up by higher real oil and non-oil output. (Chart 3.) A planned excise tax on sugary beverages and tobacco products and the possible introduction of VAT in 2019, should give non-oil revenues a further boost.

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**Authorities to finance deficits via further debt issuances and the privatization of state-owned firms**

Oman’s persistently high spending has caused public debt levels to rise to almost 50% of GDP from a mere 13% of GDP in 2015. This has led to a series of credit rating downgrades, with Oman currently being rated below investment grade territory by S&P and one notch above non-investment grade by both Fitch and Moody’s. Nonetheless, the authorities have been successful at issuing sovereign debt, albeit at elevated cost premiums, to plug the fiscal deficit, against a backdrop of relatively modest sovereign wealth assets. Indeed, Oman sold a $1.5bn seven-year sukuk at the start of 4Q18, its second debt issuance this year after the sale of a $6.5bn conventional bond in January 2018.

In addition, the government is also looking to attract foreign investment. It plans to privatize two electricity companies, Oman Electricity Transmission and Muscat Electricity Distribution ($3.2bn in total assets), which would also help lower subsidy costs.

**Economic outlook encouraging despite downside risks**

Downside risks to Oman’s outlook stem mainly from continued budget deficits and the accumulation of public debt, which could further affect its credit rating. The planned introduction of the VAT and excise taxes next year should raise non-oil revenues and improve the fiscal balance within the next two years. In case Oman participates in a potential further round of OPEC+ production cuts in 2019, this will have a small impact on public finances and growth. However, further gains in gas output and non-oil sector activity are likely to more than offset those risks going forward.