Macroeconomic outlook

UAE: Oil cuts weigh on growth in 2017, but outlook remains favorable

> Dana Al-Fakir
Economist
+965 2259 5373, danafakir@nbk.com

> Daniel Kaye
Head of Macroeconomic Research
+965 2259 3136, danielkaye@nbk.com

Overview and outlook

- Growth to remain moderate at 2-3% in 2017/18 amid weak oil prices and oil production cuts. But non-oil GDP growth continues to be supported by gains in the tourism and construction sectors.
- Inflation has been mild thus far in 2017, but is expected to face renewed pressure from new taxes and higher oil prices. VAT – expected from January 2018 – could add some 2% to inflation next year.
- The fiscal balance will remain in modest deficit in 2017 and 2018 at 2-3% of GDP on the back of still-weak oil revenues and some easing in the pace of fiscal consolidation.
- Credit growth has slowed to multi-year lows on tighter lending standards, rising interest rates and weaker demand from government-linked firms and consumers. But deposit growth continues to pick up, helping an otherwise subdued liquidity climate.

GDP growth in 2017 weighed down by lower oil production

Economic growth in the UAE is expected to moderate further in 2017, before seeing a pick-up in 2018 as the non-oil sector gathers momentum and offsets continued weaknesses in the oil sector. We see GDP growth moderating from 3.0% in 2016 to 2.2% in 2017, and now expect growth in 2018 of 2.6%. The latter is below our previous projection with the extension in oil production cuts continuing to weigh on growth. (Chart 1.)

In May, OPEC and a group of non-OPEC nations agreed to extend a six-month supply cut that was scheduled to end in June of 2017, to at least the end of the first quarter of 2018, in an effort to support oil prices. The UAE's level of compliance has lagged behind its GCC peers. But state-owned oil company Adnoc, the 12th largest oil producer globally, recently announced that it will cut crude shipments by 10% starting in October. In this setting, real growth in the oil sector is poised to be negative in 2017, before improving slightly in 2018.

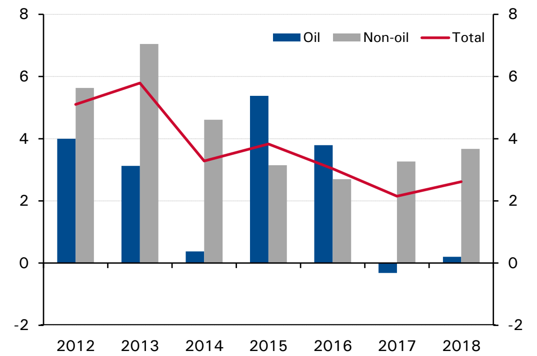
In contrast, non-oil activity is slated to recover, albeit gradually, in 2017 and over the following year, as the tourism and construction sectors (key contributors to non-oil GDP growth) gather further ground, especially in the run-up to the Expo 2020 event in Dubai. The non-oil economy is also

Table 1: Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	358	349	383	404
Real GDP	% y/y	3.8	3.0	2.2	2.6
- Oil	% y/y	5.4	3.8	-0.3	0.2
- Non-oil	% y/y	3.2	2.7	3.3	3.7
Inflation	% y/y	4.1	1.6	2.5	4.0
Budget balance	% of GDP	-3.4	-4.3	-3.1	-2.0

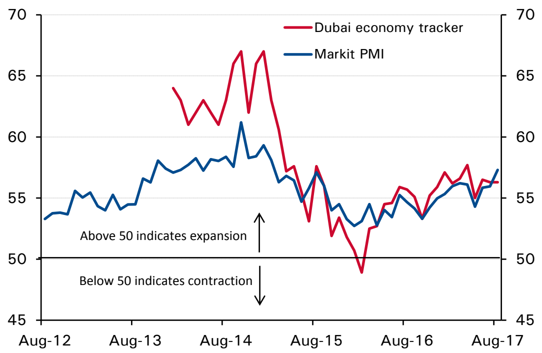
Source: Official sources, NBK estimates

Chart 1: UAE real GDP
(% y/y)



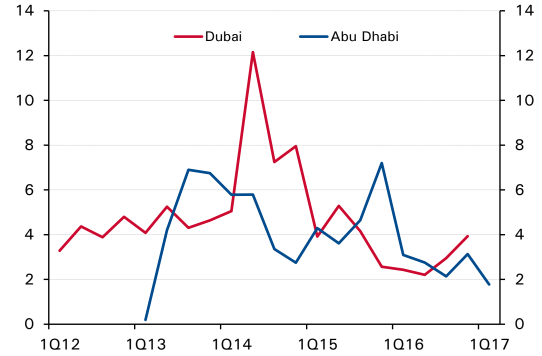
Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Non-oil sector activity
(index)



Source: Markit, Emirates NBD

Chart 3: Dubai & Abu Dhabi real GDP
(% y/y)



Source: Dubai Statistics Center, Statistics Centre - Abu Dhabi expected to be supported by a potential stabilization and eventual recovery in sales prices in the residential real estate sector. Real non-oil growth is set to rise from an estimated 2.7% in 2016, to 3.3% and 3.7% in 2017 and 2018, respectively.

The latest data on the UAE's Markit Purchasing Managers' Index (PMI), a good gauge of non-oil sector growth, also point to a steady recovery in non-oil sector activity (Chart 2). The headline PMI rose to an over two-year high of 57.3 in August mainly as new orders and output remained robust, thanks to an ongoing improvement in domestic conditions. This has more than offset the ongoing softness in new export orders.

Despite generally positive economic performance, there are a number of downside risks to the outlook. A prolonged low oil price environment has ramifications for non-oil growth, and a renewed dip in oil prices could see the government intensify its fiscal consolidation program. Furthermore, higher interest rates in the US – further hikes are expected through 2018 – will filter through to domestic rates, potentially tightening liquidity conditions and affecting investment spending.

Additional downside risks may arise if the Qatar crisis escalates or remains unresolved. Although Qatar is not a major contributor to the UAE's trade and tourism sectors, the diplomatic tensions impact investor sentiment. Another, but less likely risk, is a potential disruption to natural gas supply through the Dolphin pipeline, the main energy link between the UAE and Qatar. The pipeline supplies about a third of the UAE's natural gas, but with Abu Dhabi's government holding a 51% stake in the pipeline and foreign entities holding the remainder, the likelihood of the supply being disrupted is fairly low.

Overall non-oil economy is being supported by steady gains in Dubai

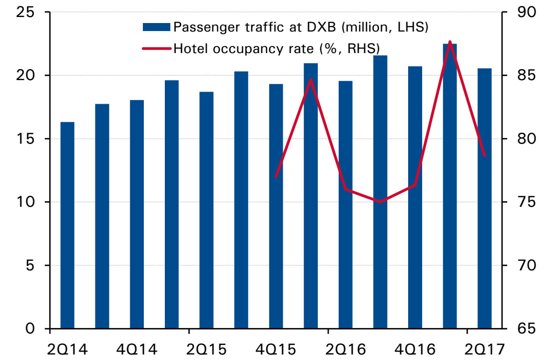
The ongoing steady recovery in the UAE's non-oil economy is largely being driven by improvements in Dubai's hospitality and construction sectors. The number of passengers passing through Dubai International Airport stood near a record high in 2Q17, at 21 million. (Chart 4.) According to Ernst & Young's latest MENA Hotel Benchmark Survey, even as average daily room rates at hotels in Dubai have declined (but remain the highest in the MENA region), demand for hotel rooms continues to hold. Occupancy rates among hotels in Dubai averaged 83% in the first half of 2017 (the highest in the MENA region).

Construction activity continues to be supported by preparations for the Expo 2020 event. At the start of 2017, Dubai Expo 2020 announced that 47 construction contracts worth $3 billion would be awarded in 2017. Projects include the construction of buildings, metro expansions, roads and bridges. One of the key contracts awarded this year was the $600 million deal with Al Futtaim Carillion for the site's three thematic districts. 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 economic diversification.

Downward pressures on Dubai's residential property prices re-emerge

After a period of stabilization in 2016 and in early 2017, following almost two years of decline amid tighter regulations, higher housing supply and risk aversion, downward pressures on Dubai's residential property prices appear to have re-emerged in 2Q17. According to Asteco's quarterly indices, prices of apartments and villas in 2Q17 were down by 4.2% y/y and 3.3% y/y, respectively. The declines in prices and the continued fall in

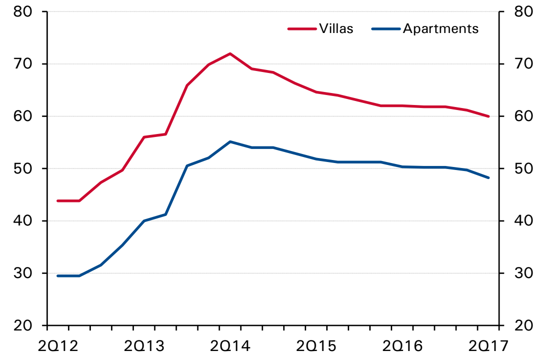
Chart 4: Dubai tourism



Source: Dubai airports, Dubai Statistics Center

Chart 5: Dubai residential property sales prices

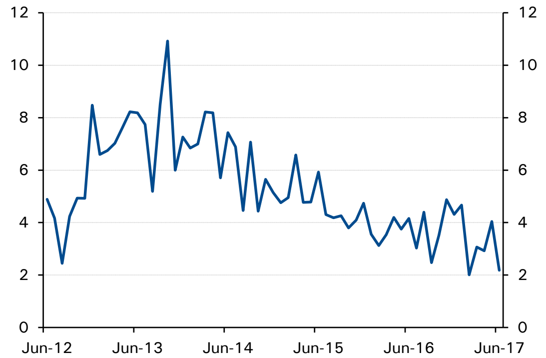
(index)



Source: Asteco

Chart 6: Value of real estate transactions

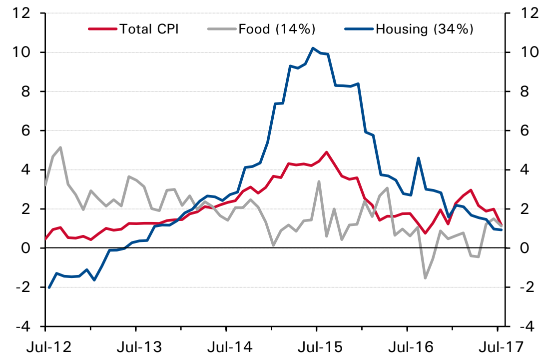
(AED billion)



Source: Dubai Land Department

Chart 7: Consumer price inflation by sector

(% y/y, weights in brackets)



Source: Thomson Reuters Datastream

the value of real estate transactions were attributed to increased housing supply and to a shift in demand towards the more affordable housing sector. (Charts 5 and 6.)

Inflation to face some upward pressure

Consumer price inflation has so far trended downwards in 2017 against a backdrop of soft food inflation and slowing housing inflation (which weighs heavily in the index). Latest figures showed inflation easing from 2.0% y/y in June to 1.2% y/y in July. (Chart 7.)

We expect CPI inflation to edge higher in the near-to-medium term and average close to 2.5% for the year, as higher oil prices push inflation in the transport segment up, housing inflation gathers pace and amid tax hikes planned for selected consumer goods in October. In 2018, inflation is expected to climb further, especially on the back of a planned 5% value-added tax (VAT) on selected companies. Scheduled for the beginning of 2018, it is expected to add 2% to inflation next year.

Fiscal balance to remain in small deficit in 2017 and 2018

The fiscal balance will remain in manageable deficit in 2017 and 2018 amid weak oil revenues and an easing in fiscal consolidation, as Dubai's government gradually ramps up spending on construction projects in the run-up to the Expo 2020 event. We foresee a deficit of 3.1% and 2.0% of GDP in 2017 and 2018, respectively. (Chart 8.)

Nonetheless, fiscal adjustment and reform is proceeding, with 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.

In a bid to raise more public revenues, in August the newly established FTA published a law on an excise tax. The tax will be levied on selected goods – tobacco, energy drinks and soft drinks – from the beginning of October. With the excise tax set at 100% on tobacco and energy drinks and 50% on fizzy drinks, it is expected to raise around $2 billion (0.5% of GDP) in annual fiscal revenue.

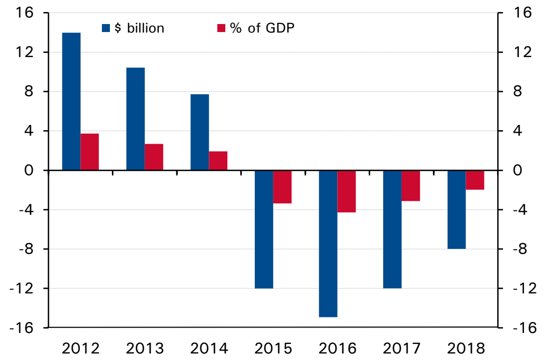
Furthermore, the UAE will be one of the first GCC nations to implement a VAT. The tax will be imposed on UAE companies from January with annual revenues greater than $1 million. At 5%, the VAT is expected to generate around $5 billion in tax revenues or 1% of GDP.

To avoid relying solely on foreign reserves to finance the country's public deficit, Abu Dhabi issued $5 billion in sovereign bonds in April 2016, its first issuance since 2009. But there has been no new sovereign debt issued since. The UAE is in the process of finalizing a federal debt law, which will allow the federal government to issue bonds as well.

Yields on debts maturing in 2021 for Dubai and Abu Dhabi have remained fairly low and steady, relative to their GCC peers, on the back of stable economic conditions. Indeed, the main credit default swaps (CDS's), which are typically good bellwethers of a sovereign's level of risk, remain close to multi-year lows. As of end of August, the CDS on five-year Dubai and Abu Dhabi government debt stood at 122 and 55 basis points (bps), respectively (Chart 9).

Chart 8: Budget balance

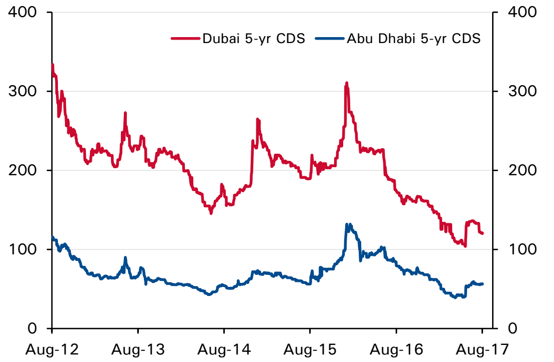
(revenues include ADNOC profits & investment income)



Source: UAE National Bureau of Statistics, NBK estimates

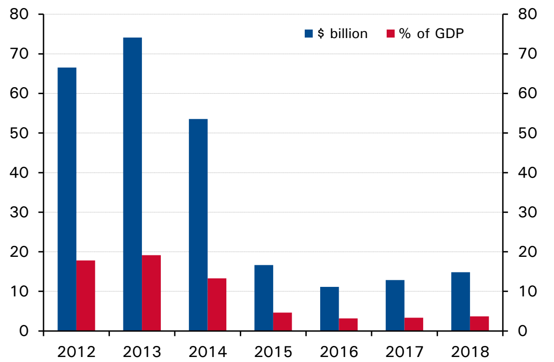
Chart 9: Credit default swaps

(basis points)



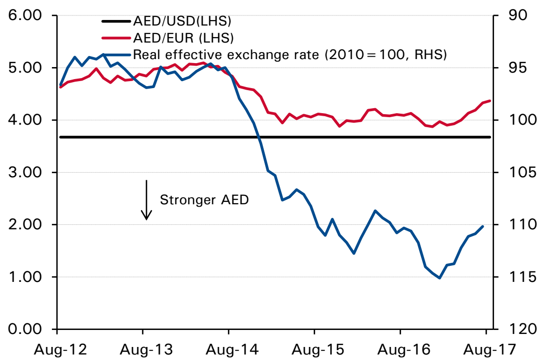
Source: Thomson Reuters Datastream

Chart 10: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 11: UAE exchange rate



Source: Thomson Reuters Datastream, Bank for International Settlements

Current account surplus to expand slightly in 2017 and 2018

The surplus in the current account balance is projected to marginally expand in 2017, on the back of a slight pick-up in oil export receipts and as non-oil export growth gathers pace. We foresee the current account surplus edging up from a six-year low of 3.2% of GDP in 2016 to 3.4% in 2017 and 3.7% in 2018 (Chart 10).

Non-oil export growth remains susceptible to a stronger dirham. Until recently, the stronger dollar led to an appreciation in the dirham's real effective exchange rate, increasing the cost of exports and making it a more expensive place to visit and invest in (Chart 11). Trade with Asian markets was most affected by the stronger dirham, as their currencies weakened against a stronger US dollar. Tourism, however, was less affected, given that a majority of tourists are from the GCC, and so was investment in real estate, which depends far more on UAE nationals.

Banking liquidity showing some signs of improvement in 2017

Credit growth has eased further in 2017 on the back of rate hikes and tighter lending rules. In July, lending growth stood near a multi-year low of 3.5% y/y (Chart 12), predominantly due to the ongoing weakness in private sector credit growth as well as the ongoing decline in lending to government-related entities.

Deposit growth, by contrast, has accelerated further over the past year, as higher oil export receipts have helped replenish government deposits. In July, it came in at 7.1% y/y on the heels of an impressive 12.7% y/y rise in government deposits. To that effect, the loan-to-deposit ratio held at 100.1% during the same period.

Annual growth in the broad money supply (M2) saw healthy gains in 1H17 in line with rising deposit growth. Latest data showed growth coming off slightly in July, but at 6.1% y/y it still remained close to multi-year highs (Chart 13).

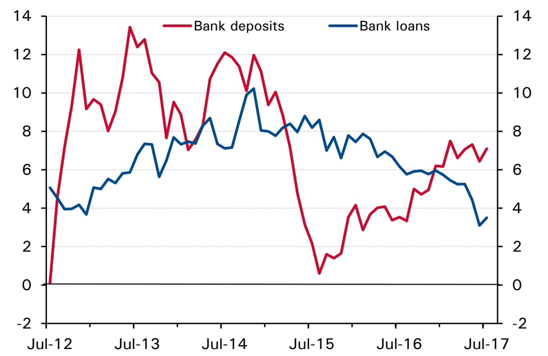
The three-month and one-month interbank rates have risen sharply thus far in 2017, following two additional 25 bps hikes in the policy rate. (Chart 14.) In June, the UAE central bank hiked its key policy rate by 25 bps for the second time in 2017 to 1.50%, in tandem with a 25 bps hike in the US Fed rate.

Market performance has been mostly steady in 2017

The Abu Dhabi Securities Exchange (ADX) and Dubai Financial Markets (DFM), the key equity markets in the UAE, maintained their sideways trend for the most part of 2017, mainly as oil prices remained subdued despite the supply cut extension by OPEC. (Chart 15.)

Chart 12: Bank loan and deposit growth

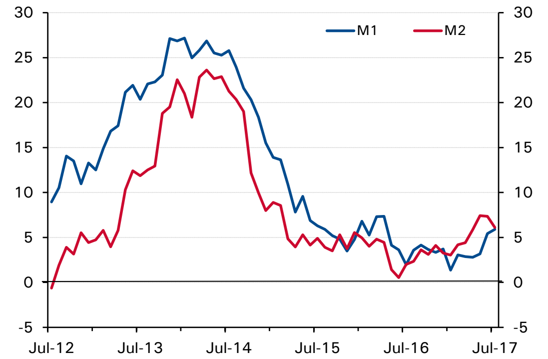
(% y/y)



Source: Central Bank of the UAE

Chart 13: Money supply growth

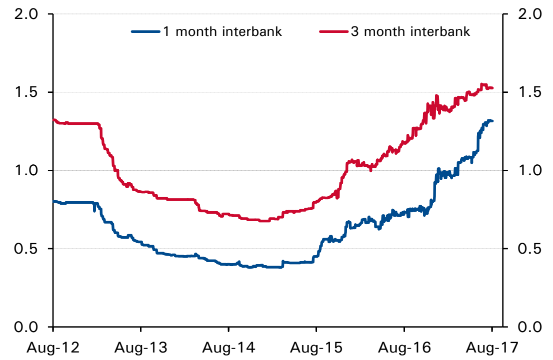
(% y/y)



Source: Thomson Reuters Datastream

Chart 14: Interbank rates

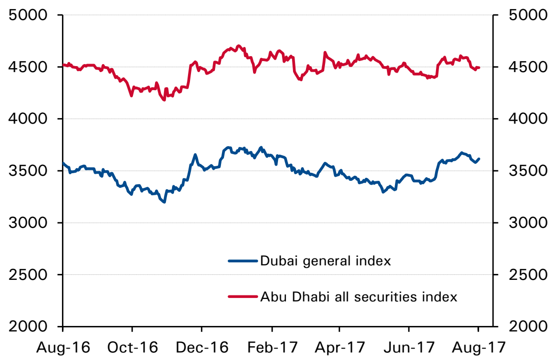
(%)



Source: Thomson Reuters Datastream

Chart 15: Main stock markets

(index)



Source: Thomson Reuters Datastream

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Representative Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

© Copyright Notice. The Economic Brief is a publication of the National Bank of Kuwait. No part of this publication may be reproduced or duplicated without the prior consent of NBK.
While every care has been taken in preparing this publication, National Bank of Kuwait accepts no liability whatsoever for any direct or consequential losses arising from its use. GCC Research Note is distributed on a complimentary and discretionary basis to NBK clients and associates. This report and other NBK research can be found in the "Reports" section of the National Bank of Kuwait's web site. Please visit our web site, www.nbk.com, for other bank publications. For further information please contact: NBK Economic Research, Tel: (965) 2259 5500, Fax: (965) 2224 6973, Email: econ@nbk.com