Macroeconomic outlook

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

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

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<thead>
<tr>
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<th>2015</th>
<th>2016e</th>
<th>2017f</th>
<th>2018f</th>
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<tbody>
<tr>
<td>Nominal GDP (USD bn)</td>
<td></td>
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<tr>
<td>Real GDP % y/y</td>
<td>3.8</td>
<td>3.0</td>
<td>2.2</td>
<td>2.6</td>
</tr>
<tr>
<td>- Oil % y/y</td>
<td>5.4</td>
<td>3.8</td>
<td>-0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>- Non-oil % y/y</td>
<td>3.2</td>
<td>2.7</td>
<td>3.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Inflation % y/y</td>
<td>4.1</td>
<td>1.6</td>
<td>2.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Budget balance % of GDP</td>
<td>-3.4</td>
<td>-4.3</td>
<td>-3.1</td>
<td>-2.0</td>
</tr>
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</table>

Source: Official sources, NBK estimates
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, 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 $53 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 2017. 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
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).
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.)