Macroeconomic outlook

Oman: Non-oil weakness to persist through 2018 on fiscal reform

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Overview and outlook

- **Our forecast remains unchanged with real GDP growth weakening to 0.1 % in 2017, before picking up to 2.2% in 2018.**
- **Fiscal deficit expected to shrink to 13% of GDP in 2017 and 8% in 2018.**
- **Inflation seen pressured upwards through 2017 and 2018.**

The economy is still expected to slow on the back of fiscal tightening. Consumer confidence is weakening, government projects are being pushed forward and market conditions have turned bearish as tax reform weighs on the short-term outlook. The persistence of low oil prices is projected to produce substantial deficits through 2018, increasing the urgency for fiscal consolidation.

The government sought to rein in spending and increase revenue collection in 2015 and 2016, though these efforts did little to dent the growing deficits. Additional measures targeting excessive spending and better revenue collection are to be introduced in 2017 and 2018. The government overhauled its corporate income tax law in 1Q17 and is poised to implement a valued-added tax in 2018. However, these steps are expected to act as a damper on domestic demand and economic growth. Nonetheless, the launch of the BP Khazzan tight gas project in 2018 is likely to provide a much-needed boost to growth. Meanwhile, liquidity in the banking sector is set to improve, on the back of recovering oil prices and future international bond issuances by the government.

At the same time, the government has been pushing structural reform and improving trade relations, which should support growth in the medium to long-term. Recent government efforts show resolve in divesting away from the public sector. Reforms supporting small and medium-sized enterprises and foreign investors seek to spark growth in the non-oil sector. Deepening ties with Iran may also be a boon for both the non-oil and financial sectors.

Growth held back by weaker consumption and investment

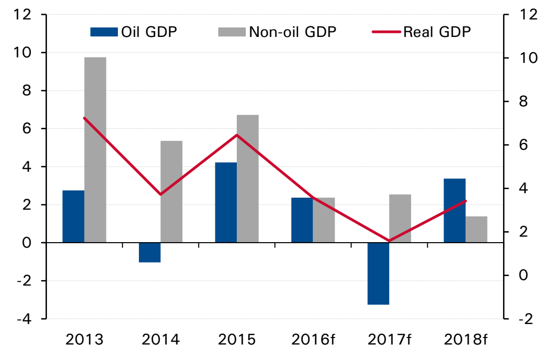
Weaker household and government consumption, coupled with delayed private and public investments is likely to lead to a slowdown in real GDP growth in 2016 and 2017. Growth is set to recover in 2018 on the back of a boost in the oil & gas sector.

Table 1: Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	US$ bn	70	66	69	73
Real GDP	% y/y	5.7	2.4	0.1	2.2
- Oil	% y/y	4.2	2.4	-3.3	3.4
- Non-oil	% y/y	6.7	2.4	2.5	1.4
CPI	% y/y	0.1	1.1	2.3	4.1
Budget balance	% GDP	-17.3	-20.4	-13.1	-8.0

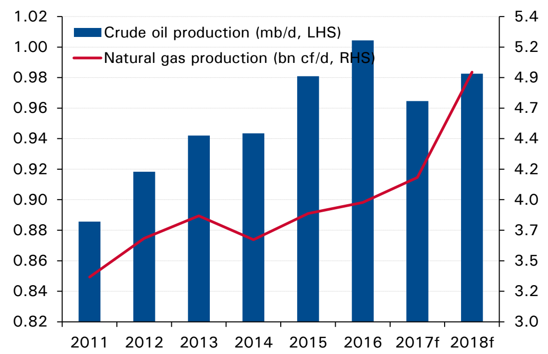
Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP
(% y/y)



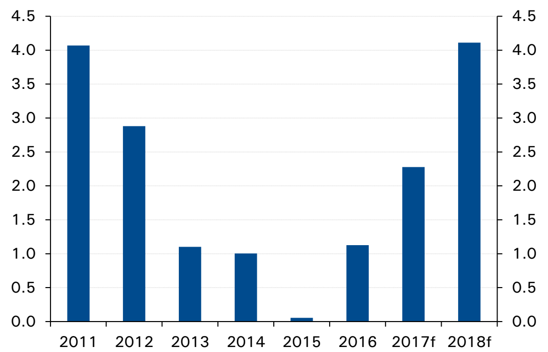
Source: National Center for Statistics and Information, NBK estimates

Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation
(% y/y, year average)



Source: National Center for Statistics and Information, NBK estimates

Preliminary 2016 nominal GDP numbers indicate that activity in the sultanate has slowed, with growth contracting by 5.1% , pulled down by the underperformance of petroleum activities (down 24%) and stagnant non-petroleum growth.

The slowdown is corroborated by the significant drop in consumer confidence, which registered at 78.8 in December 2016, down from 95.3 a year prior, according to the National Center for Statistics and Information.

Various other indicators also confirmed the weakness in economic activity. Car registrations slowed for a second year in a row, with the total number of registrations down 6% in 2016. Hotel revenue was down 6% for all of 2016, while the total number of real estate transactions plummeted 14% over the same period.

Early 2017 readings for most of these indicators are also showing continued weakness. This is best reflected by the pace of private sector hiring, where the employment of expats (which account for almost 90% of private sector employees) slowed to 6% in March 2017, from an average of 10% in 2016.

Real GDP growth is expected to come in at 2.4% in 2016, as the weakness in both consumer and market activity is offset by the pick-up in oil production. However, this will not carry through into 2017 due to planned oil production cuts in accordance with the OPEC/non-OPEC agreement. Growth in 2017 will also suffer from a thriftier government and early implementation of some tax reforms. For these reasons, real GDP growth in 2017 is forecast to come in flat, at an estimated 0.1%.

Increased revenue from a new VAT and recovering oil prices may see government investment spending pick up in 2018, with growth further lifted by the launch of the BP Khazzan tight gas project. Indeed, this may lead to stronger government consumption, gas production, and LNG exports. Nonetheless, household consumption is expected to remain subdued in 2018, with total GDP growth estimated at 2.2%.

Oman continues to pursue diversification initiatives in a bid to divest its economy from oil. Efforts, however, are held back by lower oil prices, posing a drag on the non-oil economy. Private and public investment spending dried up in 2016. A friendlier foreign investment law and stronger focus on tourism and other sectors may help boost non-oil activity going forward. Nonetheless, the non-oil economy is expected to see real growth average 2% from 2017 through 2018.

High breakeven price sees fiscal deficit persisting into 2018

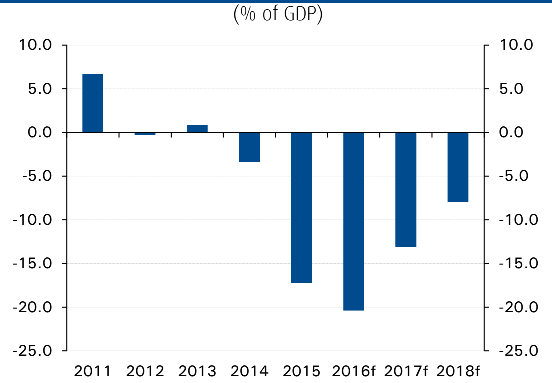
With current and expected oil prices well below the sultanate's estimated breakeven price, Oman's coffers are expected to remain under duress, with substantial deficits to be potentially registered for 2017, before recovering in 2018.

In 2016, Oman recorded a preliminary deficit of OMR 5.2 billion, overshooting the government's expectation of OMR 3.3 billion deficit, on the back of disappointing spending cuts.

The 2017 budget may fare better, with the government expecting a OMR 3 billion deficit for that year. Their budgetary strategy will focus on cutting expenditures and keeping revenues unchanged, with the average barrel of oil priced at $45. (Note: increases from a proposed corporate income tax reform and excise taxes were not budgeted.) Given the government's current fiscal expenditure performance, such an outlook would imply

Chart 4: Budget balance

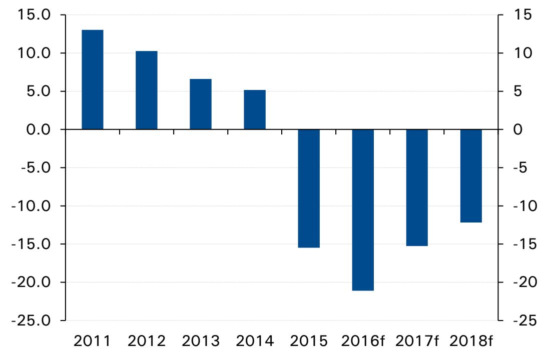
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

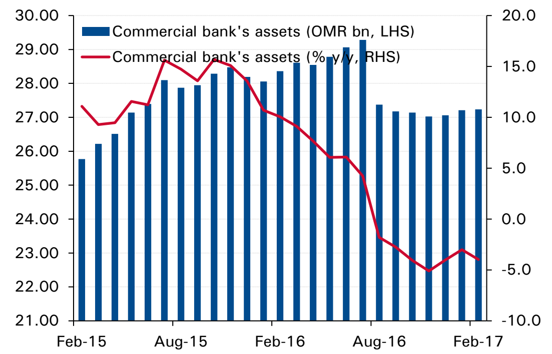
Chart 5: Current account balance

(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

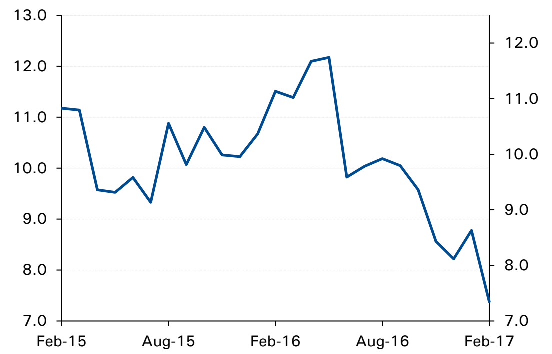
Chart 6: Commercial bank assets



Source: Central Bank of Oman

Chart 7: Credit to private sector

(% y/y)



Source: Central Bank of Oman

further aggressive cuts in subsidies and a large cut in current expenditures. The likelihood of that happening, however, is slim, since such cuts may face public resistance. Indeed, domestic gasoline prices were moved back to a fixed pricing mechanism following protest earlier in the year.

On the bright side, revenues, both oil and non-oil, are expected to come in higher on the back of higher expected oil prices ($55 per barrel) and better fee collection and tax revenue, but will do little to limit expenditure growth. As such, we project a slightly larger deficit than the government's, at around OMR 3.5 billion, or 13% of GDP, for 2017.

Implementation of the VAT in 2018, in addition to a pick-up in oil prices, will see revenues increase that year, helping improve the budget deficit. Current and investment expenditures are expected to pick-up, however, encouraged by the stronger revenue streams. Indeed, the government may offset the impact of the tax through wage increases and a more aggressive pursuit of its development plan. The deficit is expected to come in at 8% of GDP in 2018.

In view of the low oil price environment, the government has adopted several measures to rein in their finances, such as fuel hikes, increases in government fees, and spending cuts at government institutions. In recent months, the government also moved ahead with cuts in electricity subsidies, visa fee increases, and a privatization program. These efforts are being augmented by the overhaul of the corporate income tax (1Q17), as well as the implementation of an excise tax (2H17). Oman is also well into developing the framework that will facilitate the implementation of a VAT in early 2018.

Oman successfully raised $5 billion from international debt markets to finance its 2017 deficit; its investment grade rating facilitated this. Oman's debt level remains low relative to its peers, though it is expected to have risen to around 30% of GDP at the end of 2016; it is seen rising further to 39% and 44% by the end of 2017 and 2018, respectively.

Oil & gas sector to pick up on gas production boost

After an exceptional year that saw average daily production breach 1 million barrels per day, Oman is expected to see its oil sector contract in 2017, as it complies with oil production cuts agreed to by OPEC and non-OPEC countries. The recovery of oil prices over the forecast period, however, will offset the drop in crude oil production. The higher revenue potential may also imply a more modest uptick in oil output in 2018.

However, the launch of the BP Khazzan tight gas project in 2018 will see Oman's gas sector witness a strong boost as daily production capacity is increased by 1 billion cubic feet. Gas output is not affected by the OPEC agreement which only covers crude oil output. As such, Oman's real oil GDP growth is seen at 2.4% in 2016, -3.3% in 2017, and 3.4% in 2018.

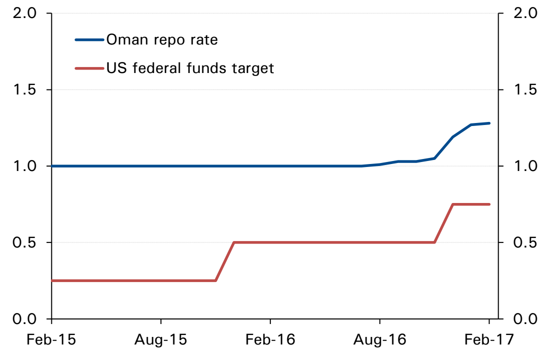
With domestic gas demand still outstripping supply, and the bulk of gas output going towards Oman's LNG exports, the need for gas imports continues to grow. As such, an Iranian gas pipeline is proposed that will import 1 billion cubic feet per day from 2018. This could help Oman avoid disruptions to its LNG exports and even consider expanding them. Progress on the pipeline, however, has been slow.

Banking system sees liquidity conditions improving

In light of the rise in oil prices, Oman's banking sector is projected to see

Chart 8: Policy rates

(%)



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

(index)

Source: : Muscat Securities Market

liquidity pressures ease as government deposits recover, supported by the government's international borrowing program. Government deposits were up 2% y/y in February 2017.

Credit growth is expected to slow in 2017, on the back of weaker household spending, only to pick up in 2018, as individuals cope with the higher cost of living brought forth by the implementation of the VAT. As of February 2017, private credit growth has eased to 7.4% y/y from an average 10% in 2016.

Despite Oman's currency peg to the dollar, the Central Bank of Oman (CBO) refrained from increasing its main policy rate after the widely expected March US Fed rate hike. However, the CBO has been raising its overnight repurchase rate. It registered at 1.28% as of mid-February 2017.

Oman's financial sector remains well capitalized. According to the CBO's latest quarterly financial soundness statistics (September 2016), credit risk remains low in Oman with nonperforming loans (NPL) slightly higher at 2.1% of gross loans. Capitalization was also high, with a capital adequacy ratio of 15.9% in 3Q16 and a tier-1 capital ratio of 13% at the end of 2015.

More subsidy cuts and a VAT see inflation on an upward path

Inflation picked up following recent subsidy cuts. The increase is expected to be sustained in 2017 and 2018 as the government liberalizes prices on energy and other goods and services, offsetting downward pressures from global food and energy prices. Inflation in Oman's consumer price index (CPI) came in at 2.8% y/y in March 2017 and is expected to average 2.3% in 2017. The introduction of the VAT in 2018 may see consumer prices rise to 4.1% for that year.

Stocks weighed down by oil and increased taxes

Omani stocks were weighed down by the prevalent weakness in oil prices, as well as weaker 1Q17 earnings following the implementation of higher corporate income taxes. The MSM 30 decreased by 7.3% in April 2017.

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