Economic Update
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Macroeconomic outlook

UAE: Real growth set to climb in 2017 and 2018 on stronger non-oil activity

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Overview and outlook

- **Real GDP growth is slated to regain momentum in 2017 and through 2018 as non-oil sector activity sees a pick-up.**
- **After moderating for two years, non-oil growth is staging a comeback in 2017 and 2018 on stronger gains in the transport, tourism and construction sectors.**
- **Inflation is projected to see some more upward pressures, on the back of tax hikes or further subsidy cuts.**
- **The fiscal balance is forecast to remain in deficit in 2017, before edging back into a surplus in 2018 on higher public revenues.**
- **Bank liquidity is set to improve in 2017 and 2018 as deposit growth picks up on stronger oil revenues.**

Real GDP growth poised to strengthen in 2017 and 2018

Following two straight years of softer growth, real GDP in the UAE is set to gather pace in 2017 and into 2018 as the non-oil sector is likely to stage a healthy recovery and offset some of the moderation in the oil sector. We foresee real GDP growth edging up from an estimated 2.5% in 2016 to a solid 3.0% in 2017 and 4.0% in 2018 (Chart 1). Whilst we may see gains in the real oil economy capped by planned oil production cuts, the healthy recovery in non-oil activity is likely to more than make up for that, as we see the hospitality and construction sectors propelled forward especially in the run-up to the Expo 2020 event in Dubai.

Growth in the oil economy is expected to be limited in at least the near-to-medium term on the back of planned production cuts. On 30 November, OPEC agreed to an oil production cut for the first time in eight years, in an attempt to prop up oil prices. The 13-member group agreed to cut output by 1.2 million barrels per day for six months starting January 2017. To that effect, we see real growth in the oil sector slowing from an estimated 2.4% in 2016 to 1.6% in 2017 before rising to around 2.8% in 2018 as production is gradually restored to its pre-production cut levels.

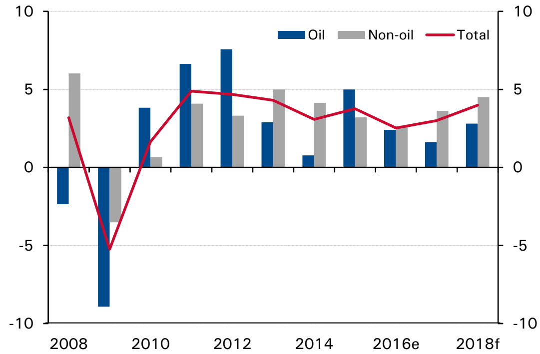
The non-oil economy is forecast to witness a healthy bounce in 2017 and maintain that stronger momentum going into 2018, as the transport, construction and tourism sectors (some of the biggest contributors to non-oil GDP growth) gather pace. Activity in the residential real estate sector is

Table 1: Key economic indicators

		2015	2016e	2017f	2018f
Nominal GDP	USD bn	370	362	398	433
Real GDP	% y/y	3.8	2.5	3.0	4.0
- Oil	% y/y	5.0	2.4	1.6	2.8
- Non-oil	% y/y	3.2	2.6	3.6	4.5
Inflation	% y/y	4.1	2.5	3.0	3.0
Budget balance	% of GDP	-2.2	-3.3	-1.1	0.5

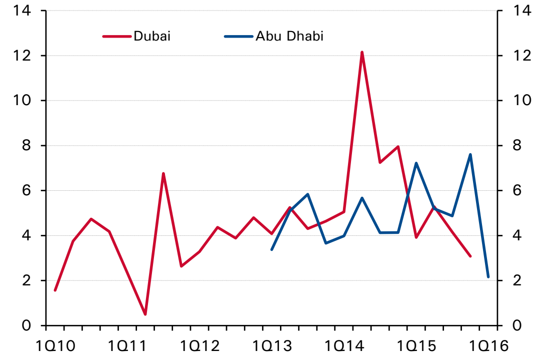
Source: Official sources, NBK estimates

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



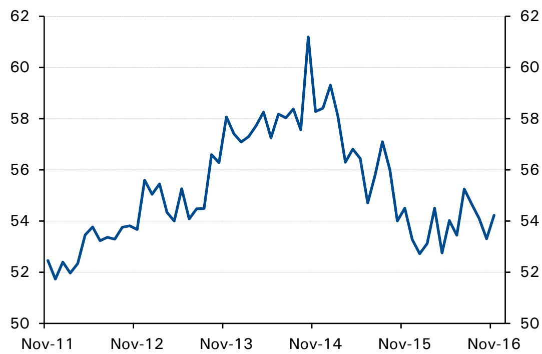
Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Dubai & Abu Dhabi real GDP
(% y/y)



Source: Dubai Statistics Center, Statistics Centre - Abu Dhabi

Chart 3: Purchasing Managers' Index
(index)



Source: Markit

also seeing signs of stabilization, after almost two years of slowing growth. We anticipate a jump in real non-oil growth from around 2.6% in 2016 to 3.6% and 4.5% 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 suggest that non-oil sector activity is set to rise in the near-to-medium term (Chart 3). The headline PMI rose from 53.3 in October to 54.2 in November, as relatively stable local economic conditions helped offset the weakness in external demand. The PMI's employment component also trekked upwards, rising to a four-month high of 51 and dispelling fears of weaker business and employment conditions.

Overall non-oil economy continues to be driven by Dubai's resilience

Much of the resilience of the non-oil economy continues to stem from Dubai's hospitality and construction sectors. The number of passengers passing through Dubai International Airport continues to hold strong. In October, this number reached 6.4 million passengers, up 2.7% year-on-year (y/y). Despite the ongoing decline in average daily room rates at hotels in Dubai over the past year, the demand for hotel rooms remained relatively solid as reflected in the average occupancy rate, which came in at a still high 75.6% in October.

Dubai's construction sector will also continue to be a key driver of non-oil growth. Construction activity is expected to remain robust, especially as Dubai prepares for the Expo 2020 event. Projects include the construction of buildings, metro expansions, roads and bridges. 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 its economic diversification.

The resilience in Dubai's non-oil economy is reflected in the Emirates NBD Dubai Economy Tracker Index (DET) (Chart 4). The DET is a forward-looking index similar to the PMI which tracks non-oil activity in Dubai. It recently witnessed a healthy pick-up thanks to buoyant levels of activity in the travel & tourism and wholesale & retail trade segments.

Dubai residential property price growth in stabilization mode

Following almost two years of slowing growth amid tighter regulations, higher housing supply and risk aversion, residential property price growth in Dubai appears to have largely stabilized. According to the latest data published by Asteco, prices of apartments fell by approximately 2.0% y/y in 3Q16 versus a decline of 2.8% y/y in 2Q16; prices of villas fell by 3.4% y/y in 3Q16 versus the 4.0% y/y decline in the previous quarter (Chart 5). We expect the stabilization period to continue at least until the end of 2017, after which we may see residential price growth pick up on the back of stronger demand.

The value of real estate transactions continued to trend lower throughout 2016, while growth in the number of transactions remained subdued but steady; the latter may be reflective of the pockets of strength in the "more affordable" housing sector (Charts 6 and 7). The recent surge in the real estate transaction value may also be indicative of a nascent recovery in the luxury housing segment.

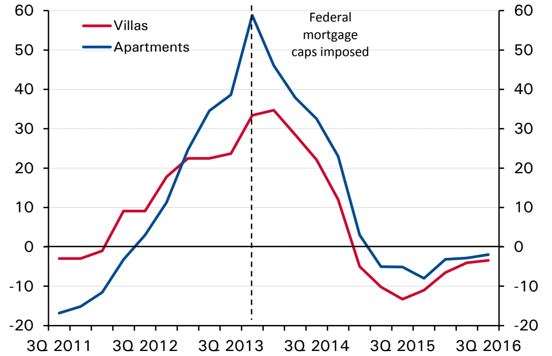
Inflation to face some upward pressure

After continuing to trend lower for most of 2016, inflation in the consumer price index (CPI) has been gaining some traction of late, as housing inflation (which weighs more heavily in the index) appears to be reversing

Chart 4: Dubai economy tracker
(index)

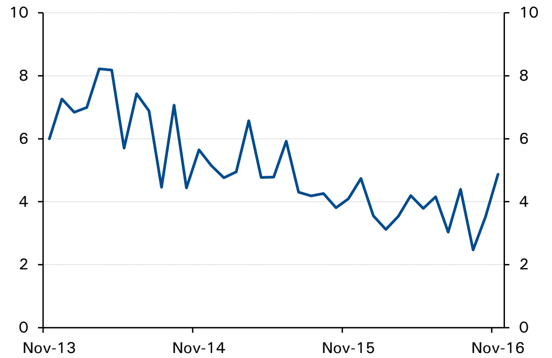
Source: Emirates NBD

Chart 5: Residential property sales prices
(% y/y)



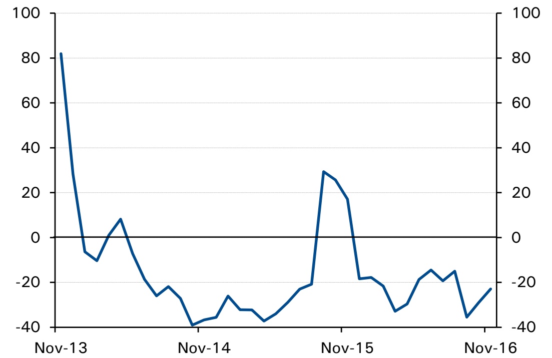
Source: Asteco, JLL

Chart 6: Value of real estate transactions
(AED billion)



Source: Dubai Land Department

Chart 7: Number of real estate transactions
(% y/y, 3-month average)



Source: Dubai Land Department

its downward trend. The latest numbers showed overall inflation rising from 1.4% y/y in September to 1.9% in October (Chart 8). As well as seeing some upward pressure from housing inflation, a mild acceleration in food inflation recently also pushed the overall inflation rate higher. However, food inflation remained soft after coming in at 2.3% y/y.

Looking ahead, we expect CPI inflation to gradually edge higher in 2017 and average at around 3% for the year, as a recovery in global oil markets pushes inflation in the transport & communications segment up and housing inflation gathers pace. With the housing market seeing some nascent signs of a recovery, we may see those gains gradually feed into housing inflation over the course of 2017 and 2018.

Fiscal balance expected to return to surplus in 2018

We expect the fiscal balance to remain in deficit, albeit a manageable one, in 2017 before returning to a surplus in 2018 on the back of higher revenues (Chart 9). The fiscal balance slipped into a deficit in 2015 for the first time in six years, after a drop in oil prices sent oil revenues tumbling. But against a backdrop of a global recovery in oil markets, together with some fiscal reforms, the deficit is seen narrowing from an estimated 3.3% of GDP in 2016 to 1.1% in 2017, before turning into a slight surplus of 0.5% of GDP in 2018.

Thanks to the UAE government's abundant financial reserves that stand at over 200% of GDP, the fiscal deficits have been manageable. This has widely helped both Dubai and Abu Dhabi maintain their high levels of public spending, particularly on infrastructure projects. In Dubai, infrastructure spending is expected to accelerate in the run-up to the Expo 2020 event.

Nonetheless, the major emirates have embarked on some fiscal adjustment and reform, including subsidy cuts and the introduction of fees on certain 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.

Furthermore, it increasingly looks like the UAE will be one of the first GCC nations to implement a VAT. The first phase of implementation, scheduled for 2018, will include UAE companies with annual revenues greater than $1 million (Dh 3.75 million). At 5%, the VAT is expected to generate around $3.3 billion (Dh 12 billion) in tax revenues or around 1% of GDP.

In an attempt to preserve foreign assets, the UAE has also tapped into international debt markets to plug its budget gap. In April, Abu Dhabi sold $5 billion in sovereign bonds, the first issuance since 2009.

Thus far, sovereign issuance has been at the level of individual emirates rather than at the federal level. This is about to change, with the UAE in the process of finalizing a federal debt law by early 2017 allowing the federal government to issue bonds. With investors globally in search for yield amid a low global rate environment, UAE bonds are likely to attract healthy demand.

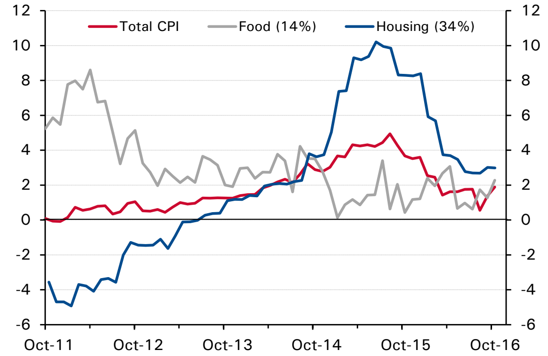
Current account surplus to expand in 2017 and 2018

The surplus in the current account balance is projected to expand for the first time in four years in 2017, as oil export earnings recover and non-oil export growth gathers steam. We foresee the current account surplus rising from a six-year low of around 4.6% of GDP in 2016 to a projected 5.7% in 2017 and 6.8% in 2018 (Chart 10).

Non-oil exports may continue to face some headwinds going forward due

Chart 8: Consumer price inflation by sector

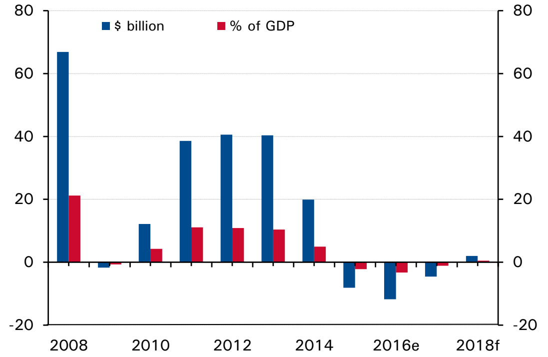
(% y/y, weights in brackets)



Source: Thomson Reuters Datastream

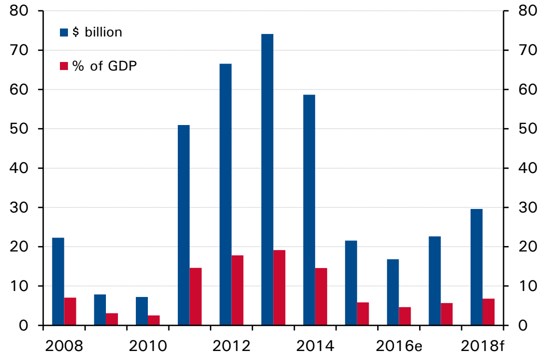
Chart 9: Budget balance

(revenues include ADNOC profits & investment income)



Source: UAE National Bureau of Statistics, NBK estimates

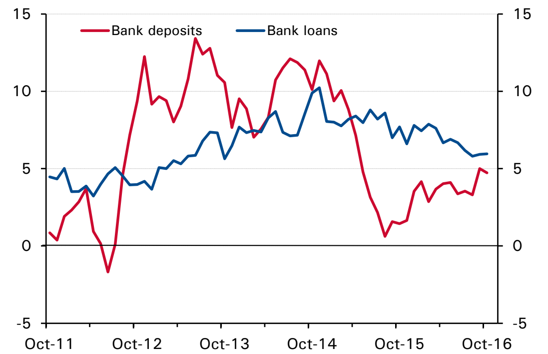
Chart 10: Current account balance



Source: UAE National Bureau of Statistics, NBK estimates

Chart 11: Bank loan and deposit growth

(% y/y)



Source: Central Bank of the UAE

to the stronger dirham. The stronger dollar has led to an appreciation in the dirham's trade-weighted index, increasing the cost of exports and making it a more expensive place to visit and invest in (Chart 16). Trade with Asian markets has been most affected by the stronger dirham, which has seen their currencies weaken against a stronger US dollar. Tourism, however, has been less affected, given that a majority of tourists are from the GCC, and so has investment in real estate, which depends far more on UAE nationals. The gains in the tourism and real estate sectors are expected to more than offset the costs of a stronger dollar. This should help non-oil exports continue to log in a decent performance.

Banking liquidity to improve as oil revenues trek upwards

Following almost two years of moderation, we expect lending activity to gradually rise in 2017 and 2018 as growth in the real estate and construction sectors improves. The latest data is pointing to early signs of stabilization in lending activity. In October, lending growth remained modest and relatively stable at around the 6.0% mark for the third straight month (Chart 11). Whilst we may see loan growth ease somewhat on the back of the 25 bps policy hike in mid-December, which came on the heels of a similar increase in the US Federal funds rate, we expect growth to recover soon after as loan demand, particularly in the construction and real estate sectors, picks up.

Growth in bank deposits has been trending gradually upwards, but any significant gains have been mitigated by weaker government deposit growth, which has been weighed down by lower oil receipts. However, with oil earnings set to pick up in 2017 and 2018, this should give government deposit growth a boost. Deposit growth jumped from 3.3% y/y in August to 5.0% y/y in September before steadying at around that mark in October (Chart 11); the recent recovery in oil prices and bond issuances could be behind the improvement in growth.

Growth in the broad money supply (M2) remained soft throughout 2016. In October, it stood at 3.1% y/y (Chart 12). Growth in this segment may continue to be capped in the near term following the December hike in the policy rate. However, with deposit growth set to pick up, we should subsequently see growth in banking liquidity edge higher as well.

Both the three-month and one-month interbank rates have reached multi-year highs recently on tighter liquidity constraints and following the key policy rate hike in December (Chart 13). We should see these rates ease, at least in the medium term, as liquidity conditions improve.

SME market reform projected to be a boon for lending and growth

Small and medium-sized enterprises (SME) account for over 95% of companies in Dubai and are a major driving force behind the emirate's economy. Yet, the SME sector was hindered by the absence of a robust and fair bankruptcy law, with knock-on effects on the banking sector. This is expected to change thanks to the introduction of a long-awaited bankruptcy law in 4Q16.

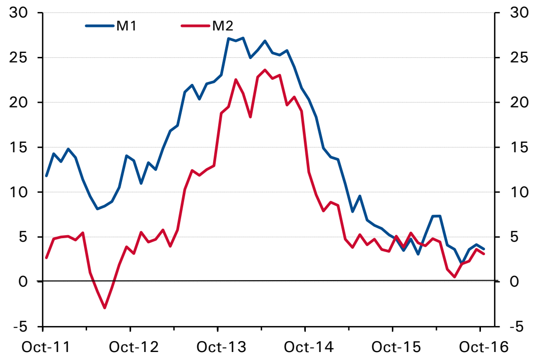
Under the previous regulatory umbrella, any unpaid debt or a bounced check would land the owner in prison and do little to help resolve arrears. The weaker external environment and a vulnerable trading sector have led to a jump in defaults and bringing the issue to attention of policymakers.

Under the new insolvency law, banks and company owners will be able to negotiate ways to restructure their debts. This should help improve banks' credit quality and instill confidence in SMEs, and subsequently boost lending to the sector.

Markets

Chart 12: Money supply

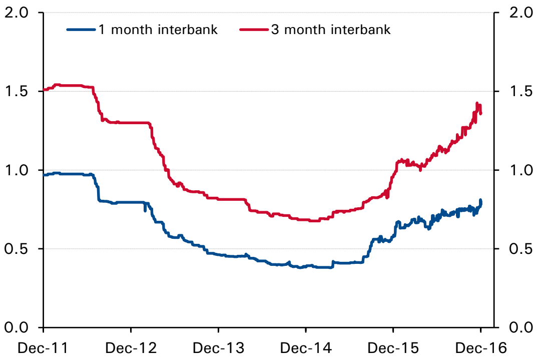
(% y/y)



Source: Thomson Reuters Datastream

Chart 13: Interbank rates

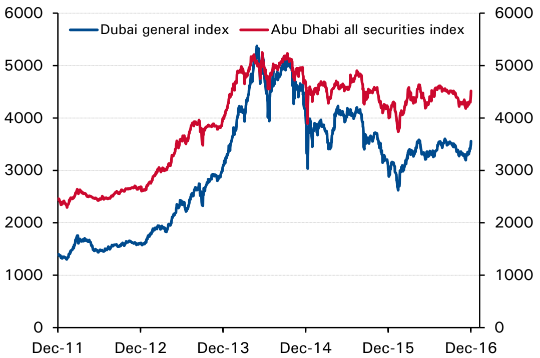
(%)



Source: Thomson Reuters Datastream

Chart 14: Stock market indices

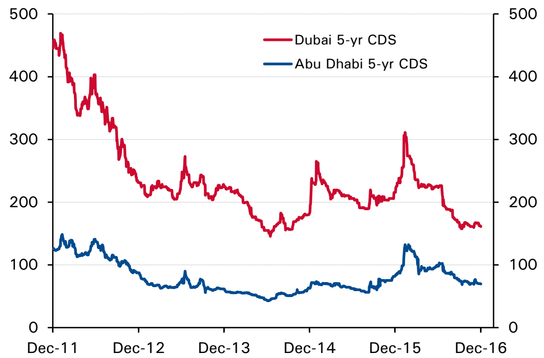
(index)



Source: Thomson Reuters Datastream

Chart 15: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

Both the main Abu Dhabi and Dubai markets rallied toward the end of 2016 on a recovery in oil prices and the agreed merger between the National Bank of Abu Dhabi and First Gulf Bank, which could make it the second largest bank in the Middle East. Increased enthusiasm following the US presidential elections also helped lift UAE markets, as it has global and regional markets, on the expectations that the new administration will usher in a wave of expansionary fiscal policy and boost US and global growth.

Chart 16: UAE trade-weighted exchange rate

(index, Jan 2000 = 100)

Source: Thomson Reuters Datastream, NBK estimates

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