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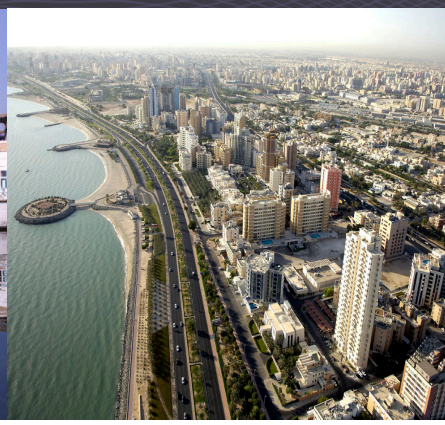
MENA Economic Outlook



1Q 2016

- Non-oil growth in GCC to stay moderate, more adjustments to low oil prices
- GCC to see first fiscal deficits in years, governments tapping bond markets
- Oil importers benefit from low oil prices, but held back by security concerns

MENA Economic Outlook
1Q 2016

Contents

MENA outlook

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GCC non-oil growth stays supported, fiscal adjustments & new sovereign debt in the pipeline

Overview and outlook

- GCC economies to grow moderately on the non-oil side in 2016 and 2017, as they further adjust to persistent lower oil prices. Adjustment to be slow and gradual and to affect initially subsidies, and project spending.
- GCC economies will see their first fiscal deficits in years, and will be issuing bonds, notwithstanding strong financial positions in many cases.
- Oil importers should benefit from lower oil prices, but are also held back by a moderate regional and world economic outlook and a problematic security situation. The IMF expects world growth at 3.6% in 2016.
- Modest global growth and abundant production should preclude significant rallies in oil prices, especially with Iranian supply in the wings.

As 2016 dawns, analysts are finally assessing quite a few potential changes, current and future, following years of steady and relatively predictable policies. Steady oil prices over $100 per barrel have given way to oil prices half of that. Interest rates that were held close to zero by major central banks, starting with the Fed in 2009, are now very likely to rise with portfolio, exchange rate, and economic implications not contemplated in the past few years. The geopolitics of the MENA region, never very predictable since the Arab Spring, have taken a new turn, with a renewed focus on the intractable Syrian conflict. The latter is now drawing attention and involvement by Russia, France, and more to come.

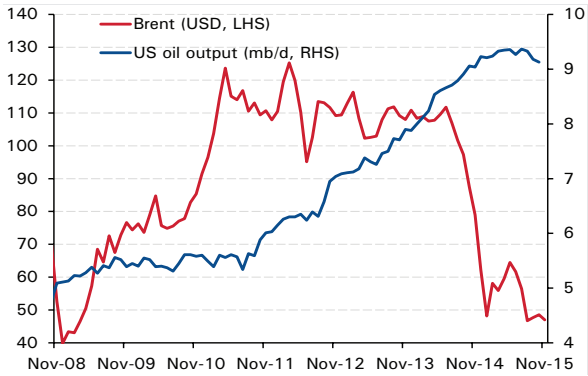
A quick look at the table below tells the GCC story: slower overall GDP growth though above 3%, sustained primarily non-oil activity. Non-oil GDP is expected to grow near 5% in 2016-17, however the numbers are skewed up by Qatar which should continue to outperform (non-oil at 9.0%). Inflation, weak worldwide, remains contained in the region. The significant change is in the budget line, where after years of strong surpluses, the GCC region should post a collective deficit in 2015 and in subsequent years, led here by Saudi Arabia. Gradual adjustments do lie ahead, however. Deficits should be expected throughout the medium term at least. Oil prices are unlikely to move above the GCC breakeven prices anytime soon. We are currently assuming oil prices average $55 bp (Brent basis) and a somewhat firmer $60 in 2017, but we recognize that the risk here is to the downside. Under this price outlook, Qatar and Kuwait are the only ones even close their break-evens.

GCC economic indicators

		2014	2015e	2016f	2017f
Nominal GDP	USD bn	1,634	1,416	1,500	1,643
Real GDP	% y/y	3.3	3.6	3.2	3.3
- Oil	% y/y	1.0	2.0	0.8	0.4
- Non-oil	% y/y	5.4	4.7	4.9	5.2
Inflation	% y/y	2.4	2.3	2.7	2.9
Budget balance	% of GDP	2.7	-12.3	-9.4	-6.7

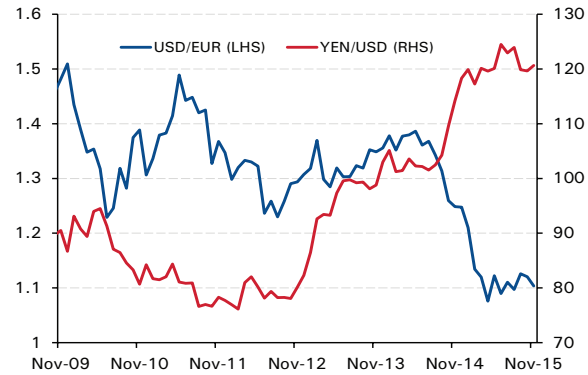
Source: National sources, NBK estimates

Chart 1: Brent oil price and US output



Source: EIA, Thomson Reuters Datastream

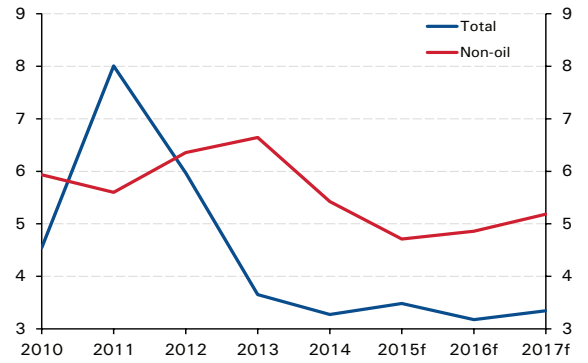
Chart 2: Exchange rates



Source: Thomson Reuters Datastream

Chart 3: GCC real GDP

(% y/y)



Source: National sources, NBK estimates

MENA oil importers should benefit from lower oil prices, and grow near 4.0%, though reforms continue to be slow and the geopolitics continue to weigh on investment, performance etc. in some cases. Others may post strong growth for special reasons (Iran with sanctions lifted, Iraq and Yemen following a period of decline).

Egypt's economy benefitted further from strong GCC financial support, has put in place some reforms, and has finished a massive landmark project in short order: the expansion of the Suez Canal. However its economy still looks tentative, and terrorism dealt its struggling tourism sector a renewed blow. We expect growth to ease to 3.5% in FY15/16 before picking up slightly to 4% in FY16/17. Financial help from the GCC remains critical. Meanwhile, growth still needs faster reforms, clearer monetary policy, and above all lower levels of threat to its security before Egypt can take off.

Internationally, the IMF and others have, true to a pattern since 2009, revised lower their projections, late in 2015. World growth is now expected at 3.6% for 2016, 3.9% for 2017. Better growth rates are anticipated for the outer 2017 year. Why? The last batch of revisions was driven primarily by concerns, confirmed, by the data, about China's economy. The latter, after years of stellar performance, appears to be slowing thereby impacting its partners, especially emerging markets and commodity economies. China is a major oil consumer, and its slower growth and its transition to a service economy both bode for softer oil/commodity demand from China. The demand factor coupled with ample oil supplies, high inventories and the reentry of Iran to the oil market, all make us believe that oil prices will stay close to their 2015 levels in 2016, and may rise a bit in 2017. The risk to prices however is on the downside.

Lower oil prices along with low interest rates are now a major source of support for oil importers and advanced economies. The EU/Eurozone is expected to grow near 1.5% in the next two years and the ECB (European Central Bank) ought to keep at, or even boost, its current quantitative easing program. On the other hand, the US Federal Reserve is readying to be the first major central bank to start hiking interest rates by the turn of the year. It will do so as unemployment is at 5.0% and GDP has been growing steadily the past few years. The Fed is now eager to "normalize" rates after years of unconventional policy. The GCC economies, pegged to the USD and thus tied to US monetary policy, are likely to follow suit soon after the Fed.

Meanwhile, the GCC countries are currently bracing for higher interest rates (albeit very gradual) at a time when they prepare raise money by issuing debt, in amounts not seen in a long time. The good news is that most have enough reserves to implement any needed reforms slowly and gradually enough, so as not to derail growth or create near-term shocks. For political and economic reasons, the GCC countries will move gradually and their reserves will allow that, while the weaker financial members should continue to benefit from the largess of the stronger members. Bahrain and non-GCC Egypt will continue to get support. Gradualism is the expectation and the key here, both for interest rates (US driven) and for GCC reforms, especially subsidies and other income support. Here, again, previous surpluses and low debt levels should allow the GCC countries to:

- Cut/control spending in a non-disruptive manner.
- Use previously accumulated funds to inject/support banking liquidity, when and if needed.
- Raise interest rates very slowly, perhaps 75 bps over 12 months.

Bahrain outlook

Soft growth ahead amid low oil prices; fiscal concerns persist

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Overview and outlook

- Real GDP growth is poised to gradually recover in 2016 and 2017 as the non-oil sector gains momentum.
- CPI inflation is forecast to see a slight uptick in 2016 and average 2.5% as the local economy gains some traction. The budget deficit is set to widen to 13-16% of GDP in 2015 and 2016.
- The budget deficit is expected to remain between 14-16% of GDP in 2016 and 2017, amid weak oil revenues and high public spending.
- Liquidity conditions in the banking sector set to tighten going into 2016 on dwindling deposits and higher interbank rates.

Real GDP growth is set to see slight uptick in 2016

Economic growth is expected to gradually recover in 2016 and 2017, as gains in the non-oil sector offset some of the weakness in the oil sector. We expect growth in real GDP to rise slightly from an estimated 2% in 2015 to around 3% year-on-year (y/y) in 2016. (Chart 1). Oil sector growth is poised to remain weak on lower oil prices. Non-oil GDP is expected to hover between 3-4% y/y in 2016 and 2017, thanks to strong fiscal spending and GCC funds targeted at housing and infrastructure developments.

The country is expected to receive a healthy boost in investment. The GCC has vowed to deliver funds amounting to about $10 billion spread over 10 years, to help prop up Bahrain's economy. Furthermore, according to the country's Economic Development Board (EDB), the country is expected to invest over $20 billion in industrial and infrastructure projects over the coming years.

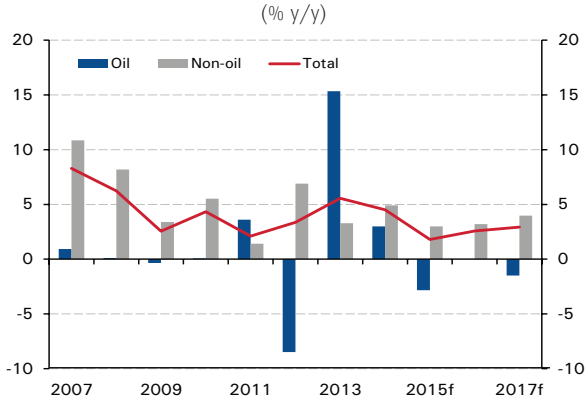
However, non-oil GDP growth remains susceptible to internal political concerns, which have weighed heavily on business optimism in the past. Whilst these concerns have mostly tapered off, they continue to quell business optimism and consequently hinder potentially higher gains in the financial services sector (the biggest contributor to the economy after oil), as well as the construction and tourism sectors.

Key economic indicators

		2014	2015f	2016f	2017f
Nominal GDP	USD bn	33.8	31.1	32.8	35.0
Real GDP	% y/y	4.5	1.8	2.6	2.9
- Oil	% y/y	3.0	-2.8	0.0	-1.5
- Non-oil	% y/y	4.9	3.0	3.2	4.0
Inflation	% y/y	2.7	2.0	2.5	2.5
Budget balance	% of GDP	-5.6	-16.2	-15.5	-14.0

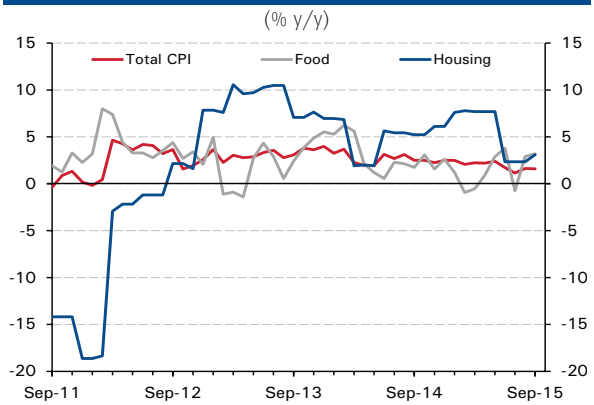
Source: Official source, NBK estimates

Chart 1: Real GDP



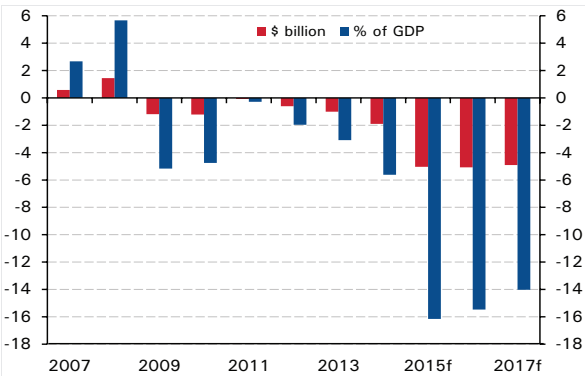
Source: Central Informatics Organization, NBK estimates

Chart 2: Consumer price inflaiton by sector



Source: Central Informatics Organization

Chart 3: Budget balance



Source: Bahrain Ministry of Finance, NBK estimates

Consumer price inflation expected to remain moderate

Headline inflation remained relatively moderate in 2015, as gains in the housing component in the first half of 2015 were offset by lower food inflation. (Chart 2). As of September, overall inflation stood at 1.6% y/y, whilst food and housing rent inflation came in at 3.2% and 3.1%, respectively. With housing inflation moderating in the second half of 2015 and softer food inflation, we expect headline inflation to slow to an annual average of 2.0% in 2015 before climbing slightly to 2.5% in 2016 as the local economy gains some traction.

Budget deficit to remain high on low oil revenues

Bahrain is forecast to pencil in one of the largest budget deficits in the GCC region. With the breakeven oil price estimated at around $120 per barrel, oil prices remaining low and government spending at high levels, we expect the budget deficit to remain between 14-16% of GDP in 2016 and 2017. (Chart 3).

Any significant curtailment in public spending is unlikely; public wages and subsidies (politically sensitive areas of spending) make up two-thirds of total government spending. Given the current political status quo, any major cuts in these two areas could add to political tensions.

Banking sector liquidity set to tighten

Credit growth, personal lending growth in particular, has remained rather resilient in 2015, in the face of lower oil prices. (Chart 5). However, lending growth is forecast to ease in 2016 on the back of tighter liquidity conditions. It is important to note that credit growth has been distorted ever since the Central Bank of Bahrain reclassified some of its financial institutions in May of 2014.

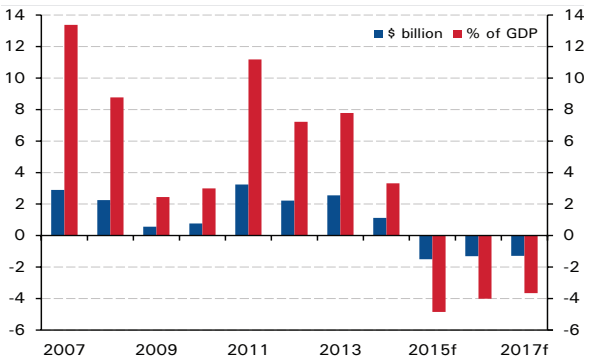
Business loan growth, relative to the growth in personal loans, was more affected by the central bank's reclassification. (Chart 5). Adjusting for the reclassification (dotted red line on chart 5) business loan growth appears to be easing of late on the back of oil price woes. As of June 2015, business loan growth and personal loan growth stood at 2.5% y/y and 13.8% y/y, respectively.

Deposit growth continued to trend lower in 2015, mainly due to a slowdown in government deposit growth. (Chart 6). After a short-lived recovery in May 2015, government deposit growth slipped back into negative territory in June, declining by 3.4% y/y. Government deposits are being sapped by high levels of fiscal spending and lower oil revenues.

Growth in the broad M2 money supply measure has been gradually trending lower since the end of 2014, on the back of lower oil prices. Recently, this has helped push interbank rates higher. In June 2015, M2 money supply growth came in at 6.5% y/y. (Chart 7). Bahrain's one-month and three-month interbank rates have risen thus far in 2015. The pick-up in both rates could be attributed to the slowdown in deposit growth. (Chart 8).

Bank asset growth remains lackluster; total commercial bank asset growth slid deeper into negative territory after declining by 2.1% y/y in June. (Chart 9). Total bank assets were shepherded lower mainly by losses in the wholesale sector. Growth in wholesale bank assets, which make up around 60% of total assets (as of 2014), contracted by almost 4% y/y in June. (Chart 10.) Asset growth

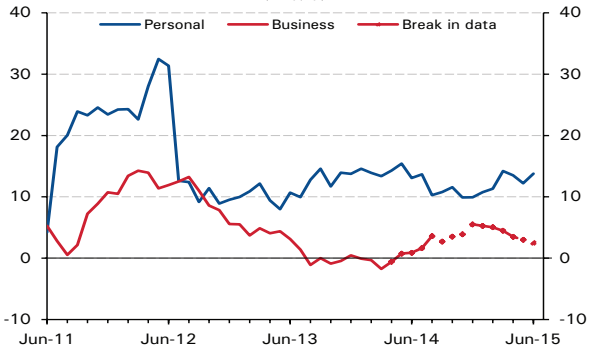
Chart 4: Current account balance



Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Private sector credit

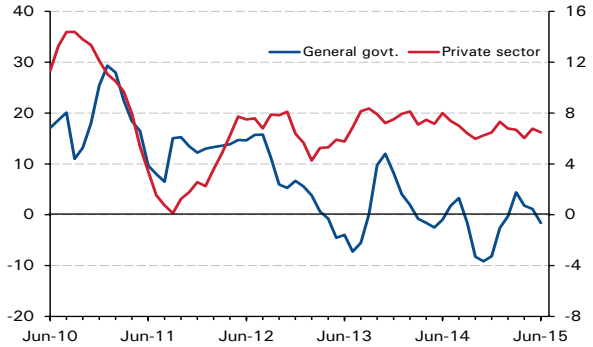
(% y/y)



Source: Central Bank of Bahrain

Chart 6: Deposits

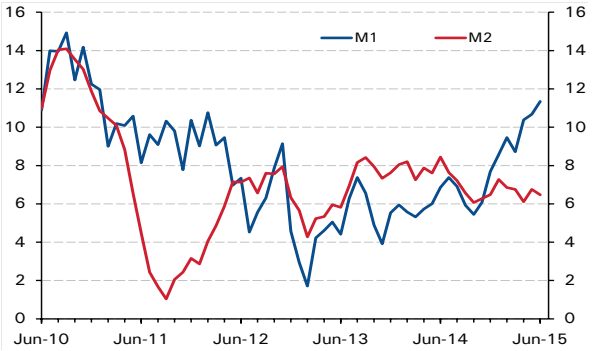
(3-month moving average % y/y)



Source: Central Bank of Bahrain

Chart 7: Money supply

(3-month moving average % y/y)



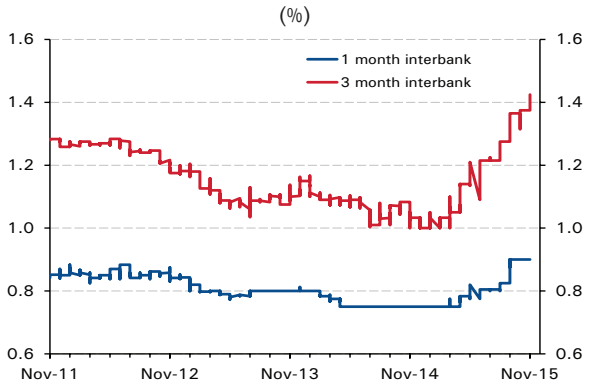
Source: Thomson Reuters DataStream

among the more domestically-focused retail banks has been on a downward trend since the beginning of this year. In June, it slowed from 2.9% y/y in May to 0.5% y/y.

Bahrain stock market gains constrained by lower oil prices

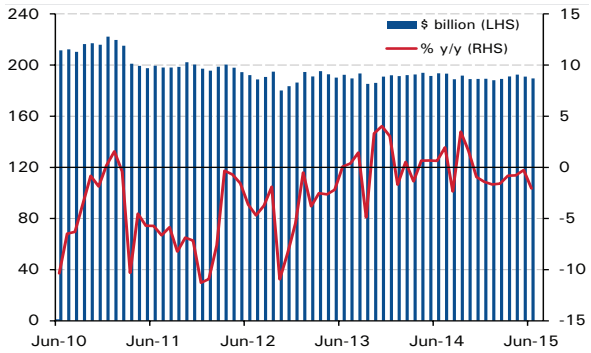
The Bahrain All Share Index like other GCC markets has been under pressure for most of 2015 amid a sustained slump in oil prices. The low oil price environment is expected to continue to weigh on investor sentiment in 2016.

Chart 8: Interbank rates



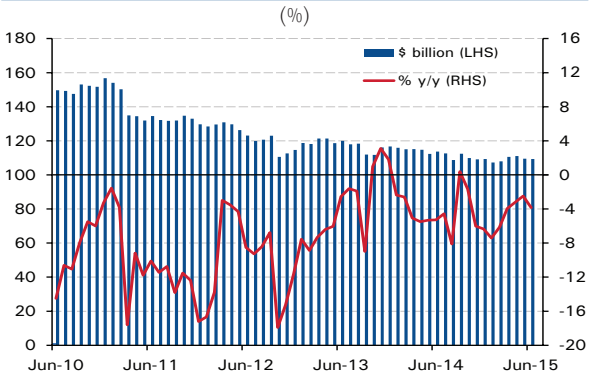
Source: Thomson Reuters DataStream

Chart 9: Commercial bank assets



Source: Central Bank of Bahrain

Chart 10: Wholesale bank assets



Source: Central Bank of Bahrain

Chart 11: Stock market index

Source: Thomson Reuters DataStream

Kuwait outlook

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Non-oil growth seen at 4-5% as fiscal stance remains supportive

Overview and outlook

- **Non-oil growth to pick up pace despite pressure from lower oil prices; non-oil growth expected at 4-5% in 2016 and 2017.**
- **Government's capital spending plans to remain on track, with recent pickup in execution expected to be sustained.**
- **Relatively moderate fiscal deficits are expected in the medium term, with large buffers more than adequate.**
- **Inflation is expected to ease in 2016 and 2017 thanks to a stronger dinar and low global inflation.**

Economic activity is expected to improve in 2016 and 2017, boosted by an increase in public investment and steady growth in consumption. This is happening despite the large decline in oil prices seen since the middle of 2014, and which has put some pressure on the government's fiscal position. While the government has already taken some measures to rationalize current spending, some of which are incorporated in the current budget, the impact on the domestic economy is expected to be limited. We have revised our growth outlook slightly downwards, though we still see growth improving.

The pressure on the country's fiscal and external positions remains contained and manageable. The fiscal deficit should not exceed 6.2% of GDP in FY15/16 and is seen narrowing to under 4% in the following two years. Thanks to large fiscal and external buffers, the government is expected to maintain a relatively supportive fiscal stance despite the decline in oil revenues. The sovereign wealth fund is estimated at over 400% of GDP ($550 billion).

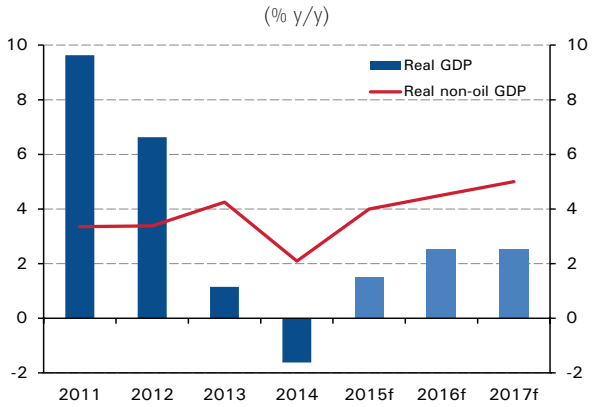
The main downside risk to this outlook is if oil prices remain lower for longer or if they see further declines from current levels. Our baseline view is that Brent will gradually improve towards an average of $55 a barrel in 2016 and perhaps $60 in 2017. A weaker oil price scenario would put added pressure on the fiscal and external positions of Kuwait and could result in more significant expenditure cuts and possibly even some reductions or delays in capital spending. Nonetheless, we think this is a risk and not our baseline at this point.

Key economic indicators

		2014	2015	2016f	2017f
Nominal GDP	KD bn	46.6	40.9	43.5	47.3
Nominal GDP	USD bn	164	136	145	158
Real GDP growth	% y/y	-1.6	1.6	2.4	2.5
- Oil	% y/y	-1.7	-0.5	0.6	0.2
- Non-oil	% y/y	2.1	4.0	4.5	5.0
Inflation	% y/y	3.0	3.4	3.0	3.0
Budget balance	% of GDP	7.5	-6.2	-3.8	-3.6

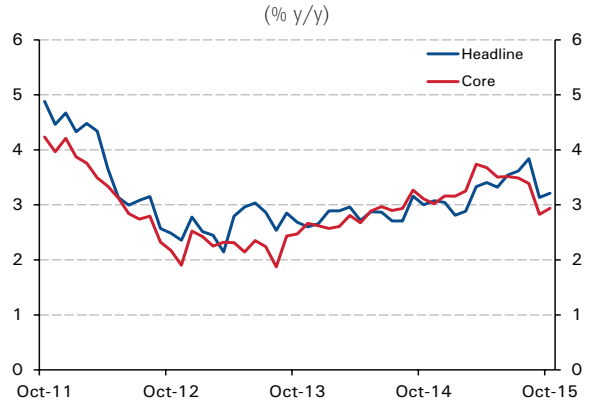
Source: Central Bank of Kuwait, Ministry of Finance, Central Statistical Bureau, NBK estimates

Chart 1: Real GDP growth



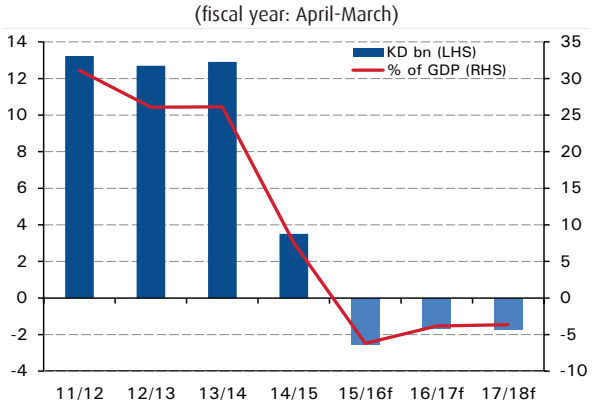
Source: Central Statistical Bureau, NBK estimates

Chart 2: Consumer price inflaiton



Source: Central Statistical Bureau, NBK estimates

Chart 3: Budget balance



Source: Ministry of Finance, Central Statistical Bureau, NBK estimates

Non-oil growth to accelerate bolstered by public investment

Activity in the non-oil sector has remained resilient, with growth accelerating to 4% in 2015 in our view. (Chart 1.) We also see growth accelerating further towards 4.5-5% in 2016 and 2017. And, though the most recent available official data on non-oil GDP growth shows slower growth of 2.1% in 2014, we think this will be revised upwards towards 3-3.5%. In our view, the pace of growth started to show some pick up back in 2014, supported by accelerating project implementation and a robust consumer sector. This momentum is expected to have carried over into 2015.

While growth is expected to accelerate, there are signs that non-oil activity is cooler than it would have been, had oil prices remained above $100. Private credit growth eased to around 6% by the end of 2014 and is expected to remain relatively steady at that pace at the close of 2015. However, a large part of this slowdown in credit growth was due to a slowdown in lending to the real estate sector. Also, the credit figures have been dampened by a number of corporates resolving legacy debts predating the financial crisis.

Government capital spending key to growth outlook

The somewhat robust outlook for the non-oil sector is being driven in large part by the outlook for government capital spending. Plans involve spending around KD 34 billion between 2015 and 2020. (Chart 5.) Since late 2013, there has been a marked improvement in the implementation of the government development plan. The plan calls for both government and private investment in a host of large infrastructure projects (PPPs in some cases). Following some delay in prior years, we have seen a pickup in the pace of implementation. More than KD 7.5 billion in projects were awarded in 2014 and another KD 12 billion during 2015.

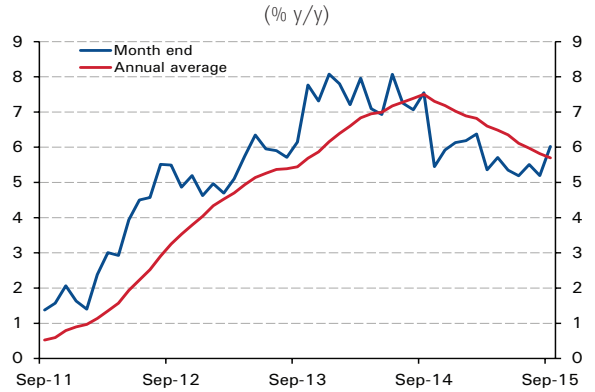
Consumer is healthy, though spending on durables has softened

The consumer sector has been a solid source of growth in non-oil activity and is expected to remain so in 2016 and 2017. This is supported by steady growth in employment and salaries, particularly in the government sector and among Kuwaiti households. As a result, growth in consumer spending and household borrowing has been robust. With no expectations of cuts in government wages and salaries and with subsidy reforms expected to be delayed and gradual, we see support for this sector remaining strong.

A number of consumer indicators show that the sector remains relatively resilient. Estimates of household income growth based on data from the Public Institute for Social Security have shown resilience, growing by 4.4% y/y through June 2015. Data on consumer's spending using credit and debit cards shows that growth has remained relatively robust, at 17.8% y/y in 3Q15. (Chart 6.) Household borrowing has also been healthy growing by 12.9% y/y in September 2015. (Chart 7.)

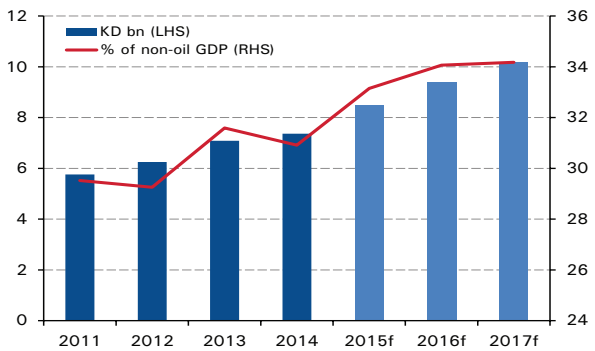
Nonetheless, there have been signs that consumers have not been unscathed by the current low oil price environment. Consumer confidence has taken a hit. The average ARA general consumer confidence index has retreated by around 3% between 2014 and 2015 year-to-date through October 2015. (Chart 8.) Most of this decline was in the durable goods component, which dropped by 11%. Indeed, car sales retreated significantly in 2015. Data on the number of car registrations through October 2015 show that new car sales have fallen by 13% y/y in 3Q15.

Chart 4: Private credit growth



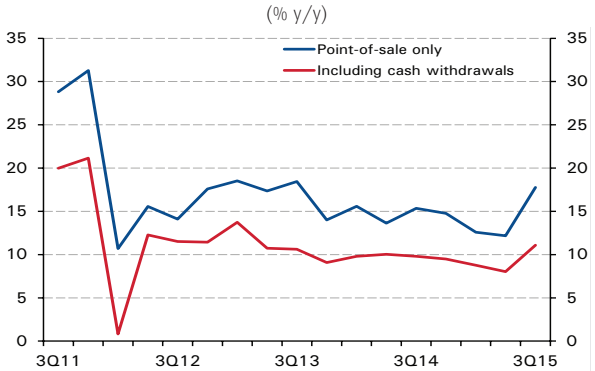
Source: Central Bank of Kuwait

Chart 5: Aggregate investment



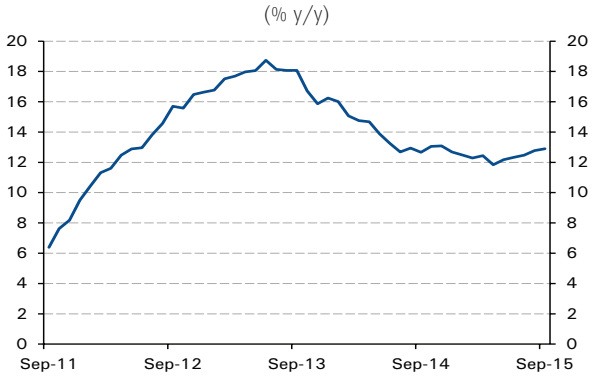
Source: Central Statistical Bureau, NBK estimates

Chart 6: Card transactions



Source: Central Bank of Kuwait

Chart 7: Household debt



Source: Ministry of Justice

Real estate market cools off, putting downward pressure on prices

The real estate market cooled significantly in 2015 following a strong showing in 2014. Total sales during the first ten months of 2015 decreased by 29% compared to the previous year. Growth in 2014 had topped 21%. (Chart 9.) Sales activity in all sectors was down in 2015, including residential, investment and commercial. The impact on prices has been mixed. According to NBK estimates, prices of investment buildings continue to see positive growth, though that pace has eased significantly from a 43% y/y in early 2014 to about 8% in 3Q2015. Meanwhile, prices of residential plots and homes are little changed or have retreated y/y.

Inflation picked up on domestic pressures, but seen easing in 2016

Inflation picked up in 2015 on higher inflation in housing rent and food prices. Average (12-month) inflation reached 3.2% y/y in October 2015, up from 2.8% a year before. (Chart 2.) Most of the inflationary pressures have come from domestic sources, with our own estimate of core inflation (excluding food) showing a similar trend. Offsetting these pressures have been a stronger dinar and weak international inflation. We expect inflation to average around 3.4% by the end of 2015 and to cool off in 2016 and 2017 to around 3%.

Deficits are expected in the medium term

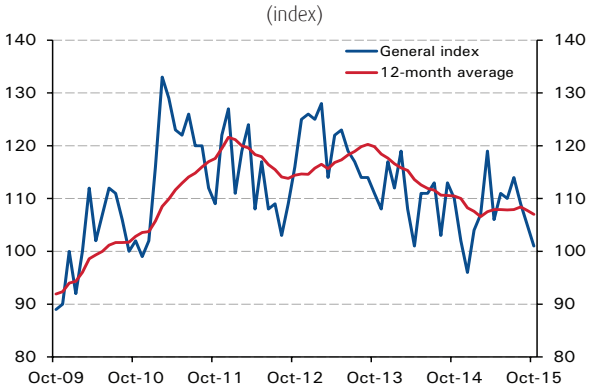
With the Brent oil price likely to remain in the $40-50 range and to improve only gradually in the coming two years, Kuwait is expected to post moderate sized deficits at least through 2017. Substantial fiscal buffers, in the form of a sovereign wealth fund estimated at over 400% of GDP, should help Kuwait pull through relatively easily, without making deep spending cuts. While the government is expected to tap into its liquid assets to finance part of the deficit, debt issuance is also expected.

Even with the government already taking some measures to rationalize spending, revenues are expected to fall short to the tune of 6.2% of GDP in FY15/16. (Chart 3.) This could narrow to 3.8% of GDP in FY16/17 on some improvement in oil prices. In FY17/18, we expect oil prices to recover further towards $60, which should help narrow the deficit to around 3.6% of GDP.

The government's first response to lower oil prices was to rationalize spending. This initiative started late in 2014 and was reflected in the FY15/16 budget. The latter sought to reduce government expenditures by 17%. Around half of these cuts came from the reduced cost of fuel subsidies due to lower oil prices and were little more than an accounting change; the rest came from cuts in non-essential spending and reducing inefficiencies and waste. Importantly, there were no reductions in wages and salaries or in capital expenditures.

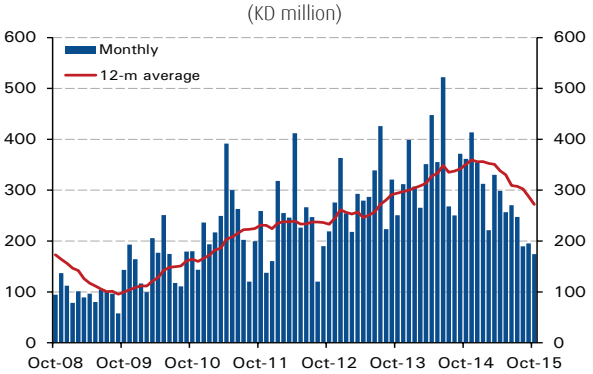
In the medium term, the government is keen on tackling subsidy reform, starting with fuel subsidies, in an effort to further rationalize spending and reduce economic inefficiencies. Subsidies in Kuwait amount to 9% of GDP according to the IMF. The cabinet is expected to issue a petrol subsidy reform package in the coming months. This is expected to include a phase-out of subsidies on petrol in 2016. It is thought that this will include a cash transfer to low income Kuwaiti households. The cabinet will likely make a similar proposal for electricity and water subsidies sometime in 2016 but this will require legislative changes.

Chart 8: Consumer confidence index



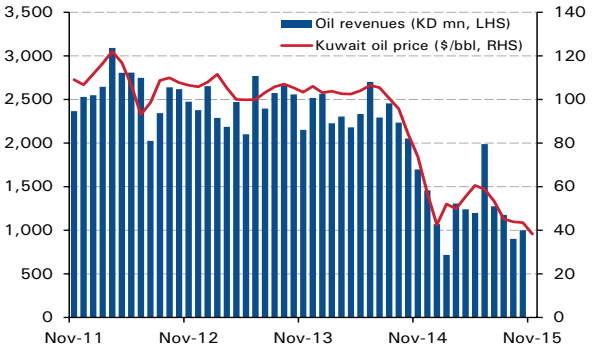
Source: ARA Research & Consultancy

Chart 9: Real estate sales



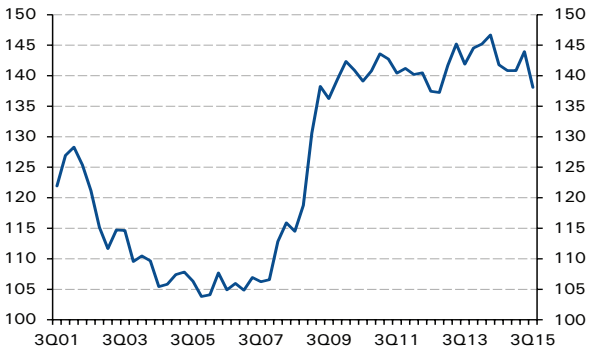
Source: Ministry of Justice

Chart 10: Oil price and government oil revenues



Source: Ministry of Finance, Kuwait Petroleum Corporation

Chart 11: Liquidity



Source: Central Bank of Kuwait, Central Statistical Bureau, NBK estimates

The parliament is also currently deliberating on an ambitious wage bill reform initiative, which could result in substantial savings for the government on its wage bill. The legislation aims to standardize pay across the public sector and to increase control over the government's wage bill. It will also put limits on wage and salary growth in the public sector by streamlining the process of salary increases.

Beyond efforts to reduce spending, the government is taking some steps to address the long term sustainability challenges facing Kuwait by bolstering non-oil revenues. Steps include efforts to introduce a comprehensive corporate income tax at a proposed rate of 10%. This would replace existing taxes imposed on foreign corporates and a number of smaller levies on domestic companies. Another measure being proposed is a value added tax (VAT), which is being tackled in a coordinated fashion with other GCC countries. Neither of the two tax initiatives is expected to take effect before 2019 at the earliest.

We estimate that the government will require around KD 10-15 billion in deficit financing in the coming five years. The government has sufficient liquid funds to easily finance the deficits in the medium term without resorting to debt, including KD 34 billion in mostly liquid overseas assets in the General Reserve Fund (managed by KIA, the Kuwait Investment Authority). Nonetheless, the Ministry of Finance has indicated an intention to finance some of this requirement through bond issuance in an effort to reduce the burden on KIA assets, to take advantage of low interest rates and to deepen domestic capital markets.

Liquidity sees some tightening, but remains comfortable

With the government running a deficit and the current account seeing its surplus narrow considerably, there is a concern that system liquidity could be under pressure. Indeed, we have already seen a slowdown in M2 growth, which has fallen from around 8% in the middle of 2014 to 5.3% in September 2015. Still, levels of liquidity remain relatively healthy. For example, M2 to non-oil GDP stood at 138% in 3Q15, compared to an average of 140% since the financial crisis. (Chart 11.) However, banks have seen some tightening in liquidity, with interbank rate spreads to Libor starting to climb. (Chart 12.)

The dinar has strengthened along with the stronger dollar

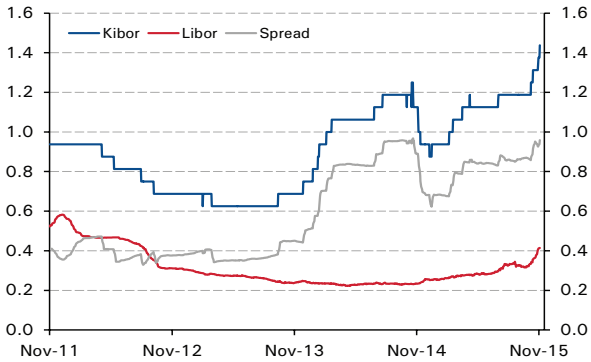
The Kuwaiti dinar (KWD) continued to appreciate in 2015, pulled up by a stronger US dollar; the currency rose by 2.7% in trade-weighted-terms through the end of November 2015 following an increase of 3.2% in 2014. The dinar, which is pegged to a basket of major currencies, with the US dollar having the largest weight, depreciated against the US currency by 3.9% year-to-date (ytd) through November 2015 following a similar decline in 2014. (Chart 13.)

2015 has been a tough year for equities

Kuwait's stock market retreated during 2015, as low oil prices continued to weigh on investor sentiment but also pulled down by a large correction in emerging market equities. Following an initial but short-lived recovery earlier in 2015, the Kuwait Stock Exchange's value-weighted index (IXW) was down by 10.5% ytd through November. The MSCI total return index was down by 10.6% ytd.

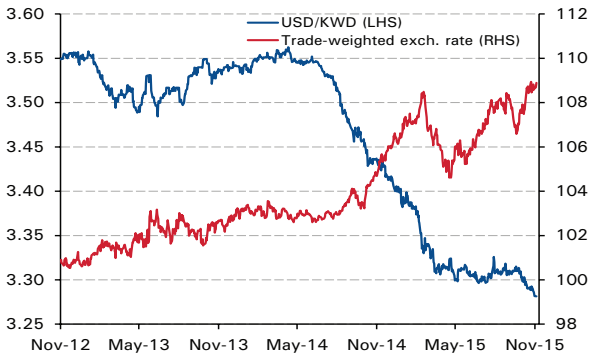
Chart 12: Interest rates

(%, 3-month)



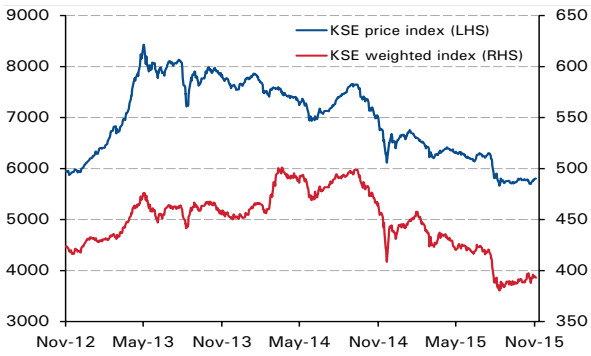
Source: Central Bank of Kuwait, Thomson Reuters Datastream

Chart 13: Exchange rate



Source: JP Morgan, Thomson Reuters Datasream

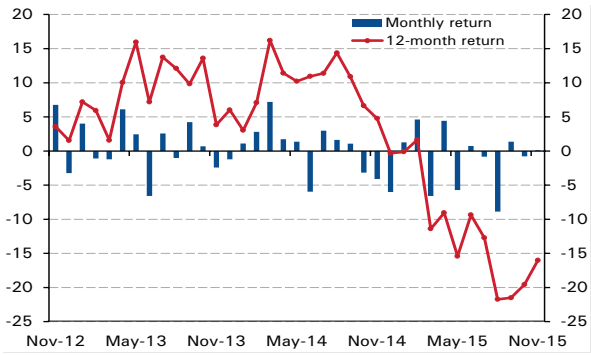
Chart 14: Stock market indices



Source: Kuwait Stock Exchange, Thomson Reuters Datastream

Chart 15: Stock market total returns

(MSCI total return index, %)



Source: MSCI, Thomson Reuters Datastream

Oman outlook

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Fiscal deficit to exceed target; growth moderates

Overview and outlook

- GDP is forecast to grow by 4.0% in 2015 before moderating to 2.9% in 2016 and 3.2% in 2017; non-oil growth expected to slow to an average 4.5% over 2015-2017.
- Fiscal deficit is expected at 21% of GDP in 2015, but to narrow in 2016 and 2017.
- Currency likely to maintain US dollar peg.
- Banking sector prepared for any slowdown; credit growth to moderate but will remain healthy.
- CPI inflation expected to remain below 1% in 2015.
- Equities remain vulnerable to external shocks.

Last year's sharp decline in oil prices has exposed the vulnerability of Oman's economy. With one of the highest breakeven oil prices in the GCC, Oman is likely to see a sizeable fiscal deficit in 2015 and 2016. Despite this, Oman is expected to avoid deep cuts in spending in the near term, choosing instead to maintain a supportive fiscal stance. The government can comfortably finance deficits in the near term thanks to its sovereign wealth fund, strong credit standing, and low debt levels.

Real GDP growth expectations for 2015 and 2016 have been revised downwards to 4.0% and 2.9%, respectively, on the back of a weaker non-oil sector. (Chart 1.) Most of 2015's non-oil decline will be offset by a pick-up in oil production as Oman pushes to maximize revenue (but short-term production capacity is fast approaching). Increased production following the launch of the BP tight gas project, coupled with increased trade prospects with a sanctions free Iran and an expected small recovery in energy prices in 2017, may lead to a soft uptick in real growth, to 3.2%.

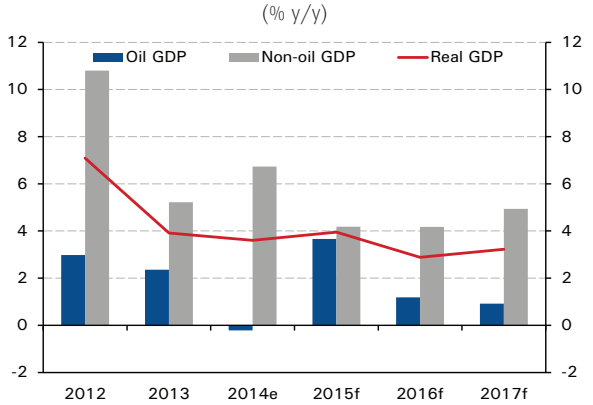
With lower oil prices highlighting the need to diversify the economy, authorities are keen to stick to their ambitious projects pipeline, but will cut back on unnecessary expenditures if the lull continues. Oman's next five year plan (2016-2020) aims to increase the role of the private sector in helping develop its logistics, manufacturing, and tourism sectors, supported by a new investment law. As a result, project spending is expected to remain accommodative and supportive of non-oil growth in the near term.

Key economic indicators

		2014	2015	2016f	2017f
Nominal GDP	USD bn	81	68	71	76
Real GDP	% y/y	3.6	4.0	2.9	3.2
- Oil	% y/y	-0.2	3.7	1.2	0.9
- Non-oil	% y/y	6.7	4.2	4.2	4.9
Inflation	% y/y	1.0	0.5	2.0	2.5
Budget balance	% of GDP	-3.4	-21	-17	-14

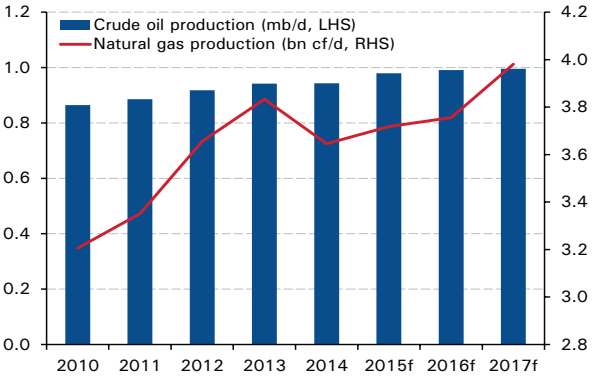
Source: National Center for Statistics and Information, NBK estimates

Chart 1: Real GDP



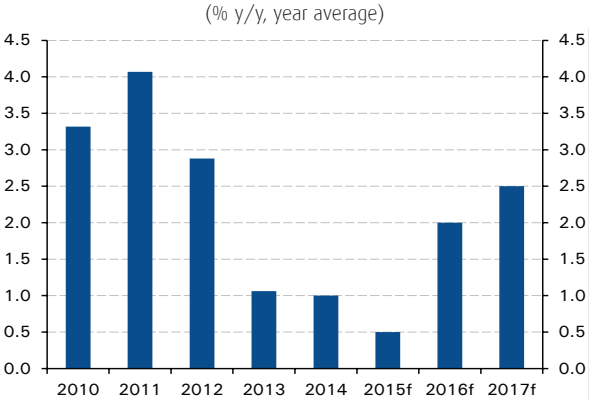
Source: National Center for Statistics and Information, NBK estimates

Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation



Source: National Center of Statistics and Information, NBK estimates

Fiscal pressures persist but in-line with expectations

Oman sunk into fiscal deficit in 2014 and is expected to record a larger one in 2015. Recent preliminary public finance data from the National Center for Statistics and Information estimated Oman's deficit to have reached OMR 1.8 billion (post transfers) in 1H15 – almost 70% of its full year 2015 target of OMR 2.5 billion. At this pace, the deficit is expected to exceed the official target. Our expectations are for a deficit closer to OMR 5 billion, or 21% of GDP, in 2015. The deficit is expected to narrow in 2016 and 2017 following explicit intentions to curb spending, a small recovery in oil prices, and a potential increase in gas production. (Chart 4.)

Oil and gas revenue, which roughly accounts for 85% of total revenue, came in 36.3% lower year-on-year in 1H15. Omani crude averaged $53.8 per barrel for the first ten months of 2015, according to the Dubai mercantile exchange, which is almost half its value for the same period a year ago. It has yet to recover from its decline in late 2014 and remains well below its estimated breakeven price of $107 and the official budget projection of $75 for 2015. We expect the Omani oil price to continue to average $55 per barrel for 2015 and in 2016 and $60 for 2017.

Current expenditures were little changed in 1H15, reflecting the stickiness of government spending, notably the difficulty of cutting popular spending items such as wages and salaries or household transfers. Civil ministry expenses, which include wages paid to the public sector – the largest employer of Oman's 2.2 million nationals – have seen rapid growth lately, growing by a compounded annual rate of 13% for the past four years, and accounting for more than 50% of current expenditures. Efforts to offset the layoffs of nationals at foreign owned oil companies could see this expense grow in the near future.

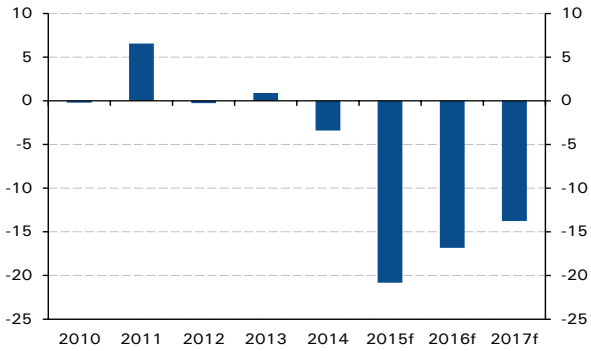
Investment spending was down 6.8% y/y in 1H15 mainly due to a drop in oil production expenditure as the low oil price environment may have streamlined some projects, evident by the recent lay-offs at foreign owned oil companies. Future investment behavior may weaken but is expected to remain accommodative, with the need for government-led diversification highlighted by deflated energy prices. The minister of oil and the central bank governor both reaffirmed the sultanate's determination to continue investment spending, which is expected to be encouraged by a new investment law that introduces the public private partnerships (PPP) model. As of 3Q15, OMR 2.7 billion worth of projects have been awarded in Oman compared to OMR 3.7 billion for the same period last year.

Oman is well equipped to handle the strain on its budget and is easily capable of financing its current and investment needs. The Central Bank of Oman has already tapped debt markets for OMR 750 million, taking advantage of Oman's low debt levels and healthy credit rating. A sovereign sukuk, Oman's first, was successfully offered in October 2015, helping to deepen the country's debt markets. The CBO planned to borrow OMR 600 million in 2015 on behalf of the treasury in addition to drawing on reserves and utilizing donor grants. The CBO's borrowing is expected to remain robust in 2016 and potentially in 2017 as well (if oil prices do not recover by then).

The government may also take other steps to ease the burden on its purse. Oman cut natural gas subsidies to some industrial producers earlier in 2015. Further subsidy cuts are also being considered with the focus on consumer goods and energy. Preliminary figures show subsidies down 33% in 1H15 year-on-year. The government is also looking to privatize

Chart 4: Budget balance

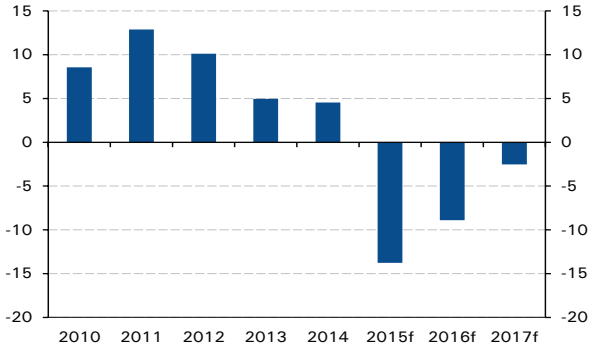
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

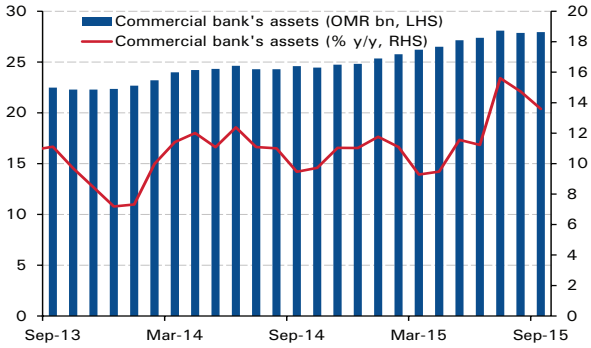
Chart 5: Current account balance

(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

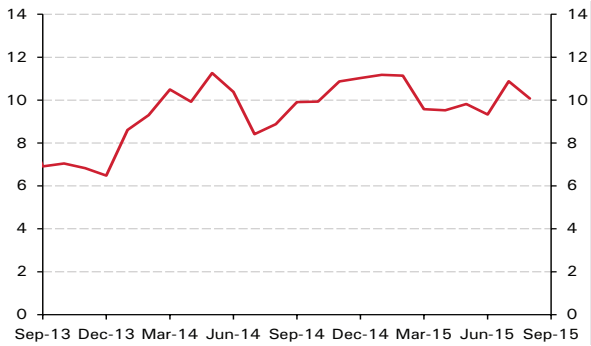
Chart 6: Commercial bank assets



Source: Central Bank of Oman

Chart 7: Credit to private sector

(% y/y)



Source: Central Bank of Oman

some public sector companies in the oil sector, while the GCC as a whole is mulling alternative taxation schemes.

Currency to remain pegged to USD

Following the rise of the US dollar and persistence of low oil prices, speculative talk of Oman abandoning its peg to the US dollar has surfaced as an alternative for fiscal relief. We believe that such an occurrence is unlikely. Floating the currency will invite external volatility, erasing the prevalent steady monetary environment and increasing the sensitivity of the economy to future global economic downturns and commodity price swings. The energy-dominated import bill, which is being driven by rapidly growing domestic demand, will also grow, putting further pressure on expenditures, notably subsidies, at a time when discretionary spending is warranted. Finally, the non-oil sector, which may benefit from an increase in domestic demand, is still nascent and may be inadequately prepared to comprehensively offer domestic substitutes for imports.

Oil production picks up, nearing target

To offset the drop in oil prices, the government of Oman has ramped up oil production, pushing its output to record levels. (Chart 2.) Given this pick-up, we have revised our oil sector growth expectations upwards, to 3.7% for 2015, 1.2% for 2016, and moderating to 0.9% in 2017. (See Chart 1.)

As of September 2015, oil output has averaged 978,000 barrels per day, 2,000 barrels short of the production target set earlier this year. July also saw Oman top its monthly crude oil production at a record average of 1 million barrels per day, an extraction rate it hopes to maintain in the short term. Petroleum Development Oman, the state's largest producer, is expected to shoulder the bulk of the production growth. However, a long term lull in oil prices may hinder such efforts, since complex geology and aging wells have seen Oman's extraction costs require constant investment to remain low. For now, producers' breakeven prices remain profitable, ranging between $7 and $12 per barrel.

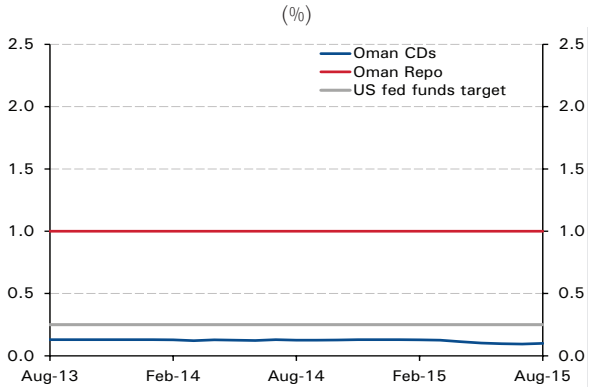
Gas production has also been picking up. During the past nine months, output averaged 109 million cubic meters per day (mcm/d), up 5.5% from a year ago as domestic demand continues to strongly grow. In fact, some gas export commitments had to be rescheduled to quell domestic pressures. Gas exports are nearly all committed to Japan and South Korea. Supply should see a boost once the BP Khazan tight gas project comes into operation in 2017. A gas pipeline with Iran will also help meet growing domestic demand, with imports set to flow in 2018. Meanwhile, talks of jointly developing oil and gas fields with Iran are underway.

Banking system healthy and well capitalized

Weaker non-oil prospects could see credit growth slow, while delinquencies may rise as individuals and companies adapt to the weaker growth. Low oil prices have had a mild impact on Oman's banking system so far. Private credit growth remains resilient, maintaining healthy growth of 10.3% over the first nine months of 2015. (Chart 7.) Meanwhile, government deposits continued to see weakening growth following the tumble in oil prices, but showed no pressure on liquidity. Primarily deposit funded, Omani banks may increasingly rely on market funding to offset any disturbances from the latter. Government deposits account for 30% of total deposits.

According to the CBO's latest financial stability report (May 2015), credit risk remains low in Oman with nonperforming loans (NPL) at 1.9% of gross

Chart 8: Policy rates



Source: Central Bank of Oman

Chart 9: Muscat Securities Market

Source: Muscat Securities Market

loans and a coverage ratio (provisions to NPL) of 72% as of the end of 2014. Capitalization was high as well, with a tier-1 capital ratio of 13%, making Oman's financial sector well prepared for any slowdown.

Lower global inflation weighs on consumer prices

Oman's consumer prices have been subdued by declining global food and energy prices. This has led us to revise our inflation expectations downwards to 0.5% for 2015 and 2.0% for 2016, picking up further to 2.5% in 2017. (Chart 3.) At -0.1% y/y, September's reading marked the third time in 2015 that Oman's consumer price index slipped into deflation. The index has been pressured by reduced food and clothing prices and nearly flat transportation prices. Meanwhile, mild inflation was witnessed in housing, utilities, and furnishing prices, which has benefited from strong growth in Oman's real estate market, which in turn has been driven by rapid population growth. Price growth is expected to remain modest, pressured by global factors, but will be supported by domestic forces as real estate demand remains solid and subsidy reforms are implemented.

Current account to shift into deficit on weaker oil revenue

The current account balance is projected to shift into deficit in 2015 following the sharp drop in oil prices, and remain there in 2016 and 2017. (Chart 5.) Weaker oil prices will more than offset the decline in import prices, driving the trade balance into deficit. The removal of international trade sanctions on Iran is expected to provide some support to the trade balance, however. The services deficit will continue to expand, albeit at a slower pace as projects aimed at boosting tourism and transport come to fruition. Meanwhile, further growth in the expatriate population will see remittances grow, thus widening the transfers deficit.

The stock market remains vulnerable to external shocks

Omani stocks, along with equities across the GCC, continue to be heavily affected by the decline in global oil prices. (Chart 9.) The perceived slowdown of the Chinese economy, Oman's largest energy importer, affected investor confidence, as did concerns about the sustainability of the government's fiscal situation. As of the end of October 2015, the MSM 30 declined by 6.2% year-to-date, with the bulk of the drop occurring in August. The stock market has yet to recover. The IPO of Phoenix Power in June, Oman's largest power plant in operation, barely catalyzed positive sentiment before China rattled international markets. Oman's regular market cap stood at OMR 7.8 billion in October, down from OMR 8.5 billion in July.

Qatar outlook

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Strong public investment drives growth amid low energy prices

Overview and outlook

- Growth is forecast to average 5.1% during 2015-17, boosted by output gains in the gas sector and public investment; the latter will drive average non-hydrocarbon growth of 9.1% y/y.
- Government spending to be rationalized amid low energy prices, but a small fiscal deficit of 0.5% of GDP is expected in 2016.
- Inflation is likely to rise gradually from 1.7% in 2015 to 3.0% in 2017.
- Private sector credit growth is robust at around 20.0% y/y.
- Slowing deposit growth and continuing debt issuance have raised liquidity concerns.
- Bearish oil market sentiment saw the QE index pressured in 2015.

Despite lower oil prices, high public investment in the country's $200 billion development plan and gas output gains linked to the launch of the Barzan production facility should see Qatar's economic performance remain relatively strong through 2016 and 2017. Inflation is expected to edge up slowly, once the deflationary effect of soft international food and commodity prices begins to ease and once rental costs resume their upward trajectory. A stronger dollar should keep imported inflation in check, however.

With oil and gas revenues down by 40%, Qatar is expected to record in 2016 its first fiscal deficit since 1999. Consequently, non-essential capital projects are likely to be scaled back amid a drive to rationalize spending and stimulate the private sector. As low energy prices feed through to the banking sector in the form of slowing deposit, credit and asset growth, liquidity has tightened and rates have risen. CDS spreads have also widened. Nevertheless, with strong fiscal and external buffers, including net external assets equivalent to 132% of GDP, Qatar is better placed than most of its peers to negotiate the current downturn.

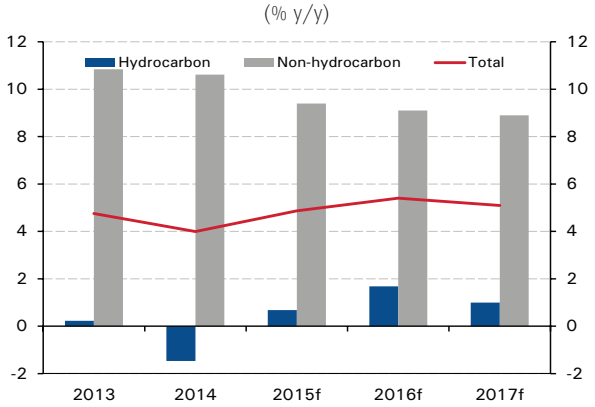
Risks to the outlook center on the trajectory of energy prices, the performance of the global economy, volatility in financial markets and delivery of the authorities' domestic infrastructure program ahead of the World Cup in 2022. Qatar's position as the leading LNG exporter in the world is also likely to come under pressure by the arrival of Australia and the US as major LNG competitors in 2016.

Key economic indicators

		2014	2015f	2016f	2017f
Nominal GDP	USD bn	210.1	174.7	189.3	211.0
Real GDP	% y/y	4.0	4.9	5.4	5.1
- Oil	% y/y	-1.5	0.7	1.7	1.0
- Non-oil	% y/y	10.6	9.4	9.1	8.9
Inflation	% y/y	3.0	1.7	2.4	3.0
Budget balance	% of GDP	16.1	2.5	-0.5	0.1

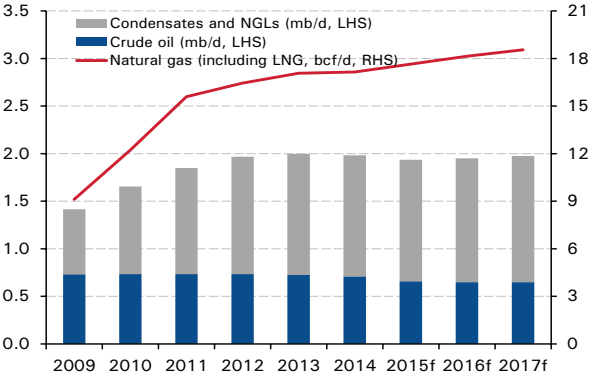
Source: Ministry of Development Planning & Stats (MDP&S), Qatar Central Bank, NBK estimates

Chart 1: Real GDP



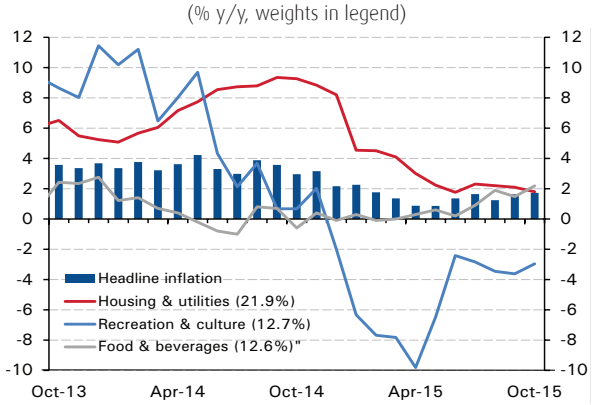
Source: MDP&S, NBK estimates; note: series rebased to 2013

Chart 2: Oil and gas production



Source: JODI, BP, OPEC, NBK estimates

Chart 3: Consumer price inflation



Source: MDP&S

Real economic growth boosted by hydrocarbon sector gains and government investment spending

Real GDP is forecast to grow by 5.4% in 2016 and 5.1% in 2017, from an expected increase of 4.9% in 2015. (Chart 1.) This figure, while down from the 9.2% annual average witnessed during 2010-2014, still puts Qatar among the most dynamic economies in the GCC.

Hydrocarbon sector output, having plateaued with the attainment of maximum LNG capacity in 2012, is expected to receive a boost from the commissioning of Barzan in late 2015, which should reach full production of 1.4 billion cubic feet per day (bcf/d) in 2016. Consequently, real hydrocarbon growth is expected to clock in at 0.7% in 2015 and 1.7% in 2016, before falling to 1.0% in 2017.

Barzan was the last project sanctioned before the 2005 moratorium on gas extraction from the country's giant North Field was put in place. Once fully operational, the facility should supply additional volumes of gas by-products such as condensates and natural gas liquids (NGLs). These took over from crude oil as the dominant liquid fuel products once crude output from Qatar's maturing oil fields began to decline in 2007. Crude output averaged 0.66 mb/d 2015. (Chart 2.) Output had been as high as 0.85 mb/d in 2007.

In contrast, the non-hydrocarbon sector remains the main determinant of Qatar's economic growth. Underpinned by government spending, output is forecast to expand by 9.1 % y/y on average between 2015 and 2017. Financial services, construction and trade and hospitality will continue to drive Qatar's non-hydrocarbon sector. Economic expansion is also being propelled by burgeoning population growth of 8.8% y/y, which is helping to boost domestic consumption.

The authorities have indicated that they remain committed to executing the country's $200 billion development and diversification plan regardless of the decline in oil prices. The need to roll out World Cup and related infrastructure by 2022 imparts a measure of urgency to government efforts. High profile projects such as the Qatar Integrated Railway ($40 billion), Hamad Port ($7 billion), the Lusail Mixed-Use Development ($45 billion) and the local roads and drainage program ($14.6 billion) look set to proceed apace. Non-essential capital projects, however, will be downgraded and scaled back in the current cost-conscious environment.

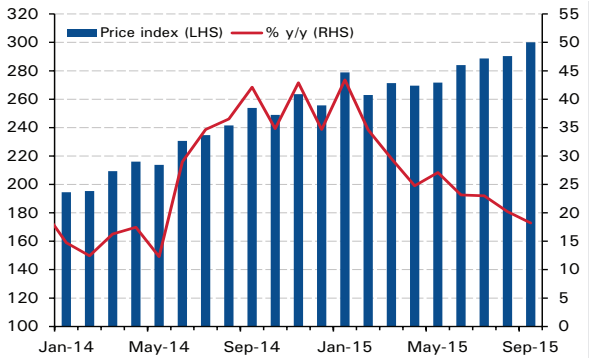
Inflation likely to rise gradually in 2016-2017 on higher rental and food and commodity prices

Headline inflation is projected to rise gradually over the next two years, from an expected 1.7% in 2015 to 3.0% in 2017 (on an annual average basis). Rising rental costs and slowly rebounding global food and commodity prices are likely to be the predominant inflationary impulses. While rental inflation slowed to 1.8% y/y in October (Chart 3.), rapid population growth owing to the influx of expatriate workers is expected to continue exerting pressure on the country's limited residential housing stock. The price of land and buildings, as measured by the real estate price index (REPI), was up 18.2% y/y last September, although it has been moderating over the last year. (Chart 4.) A strengthening US dollar-to which the Qatari riyal is pegged-has helped restrain imported inflation.

Fiscal and current account surpluses to narrow on lower energy prices

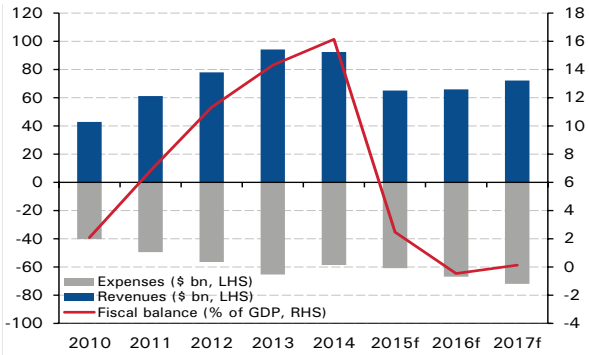
Qatar's fiscal balance is likely to swing into deficit in 2016, for the first time since 1999. With spending levels remaining relatively elevated amid a 40% decline in hydrocarbon revenues, the fiscal surplus is forecast to

Chart 4: Real estate price index



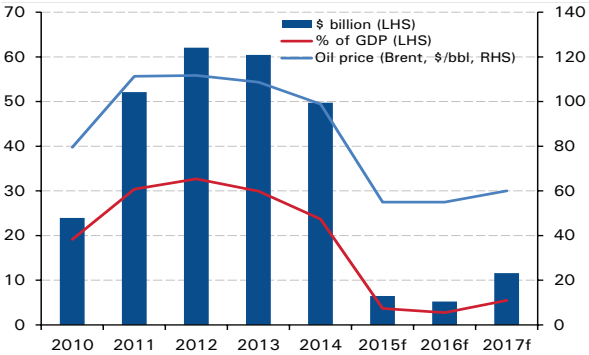
Source: Qatar Central Bank (QCB), Qatar Ministry of Justice (MOJ)

Chart 5: Fiscal balance



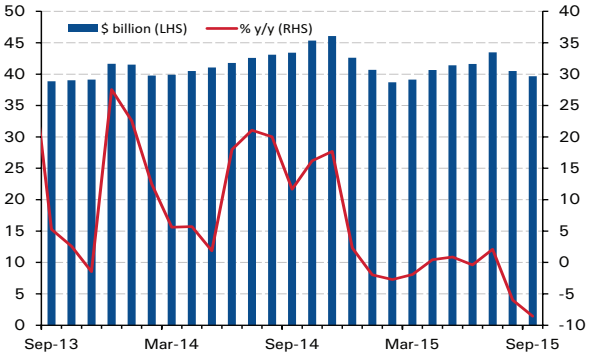
Source: QCB, NBK estimates

Chart 6: Current account balance



Source: QCB, NBK estimates

Chart 7: International reserves (net)



Source: QCB

narrow from 16.1% of GDP in 2014 to -0.5% of GDP in 2016. In 2017, the fiscal account should just about balance. (Chart 5.) Similarly, the current account surplus is likely to narrow considerably. (Chart 6.)

On the fiscal side, future spending is likely to be rationalized. While current spending will be restrained, capital spending will need to rise as the authorities make up for previous below-budget outlays, due to delays and capacity constraints, and push ahead with implementing their development plan ahead of the World Cup in 2022. As mentioned, however, non-essential projects will be scaled back.

The prospect of a sustained period of low energy prices has prompted the government to proceed with reforming the state's finances. New measures include: the introduction of a QAR 600 billion ($165 billion) 10-year spending cap on new investment projects; the creation of a macro-fiscal unit and public investment management department (PIM); the shift to a calendar rather than a fiscal year budget (effective in 2016); the withdrawal of subsidies to certain state institutions; and the privatization of semi-government institutions. The last two measures were announced by the Amir in November 2015 and form part of an effort to shrink state monopolies and boost the economic contribution of the private sector.

Sufficient fiscal buffers to weather the downturn, but low public debt may rise in the event of sustained fiscal deficits

With $39.6 billion in international reserves (excluding the $256 billion SWF)-equivalent to 7.4 months of imports-and strong credit ratings, however, Qatar has sufficient assets to finance capital spending and weather the fall in energy prices-certainly over the forecast period. (Chart 7.) Were oil prices (and gas prices by extension) to remain in the $40-50 range for longer, then, like Saudi Arabia, the authorities would probably envisage stepping up bond issuance, perhaps with a view to attract international investors, given domestic liquidity concerns. Gross central government debt had dropped to 31.0% of GDP in 2014 from a high of 42.0% of GDP in 2010 after the authorities paid back maturing public debt. (Chart 8.) This trend could reverse, however.

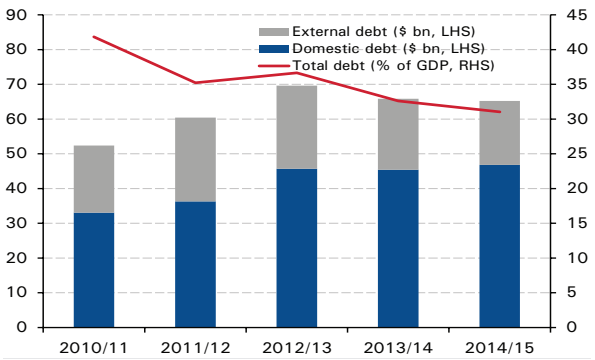
Banking sector beginning to feel the effects of low oil prices

Credit growth has been moderating over the last year owing to a slowdown and contraction in public sector borrowing. The most recent data showed overall bank credit growing by 12.0% y/y in September, with credit to the public sector contracting by -6.6% y/y. (Chart 9.) In contrast, credit growth to the private sector has averaged 22.0% y/y for most of the year (compared to 15.6% in 2014), as banks continue expanding credit lines to the real estate, industrial and retail sectors of the economy. Foreign lending has also proceeded apace, with growth averaging 45.2% y/y in 2015. In view of the government's commitment to continue spending on infrastructure and expand private sector participation in the development plan, the outlook for credit growth remains positive.

Lower deposit flows raise funding and liquidity pressures

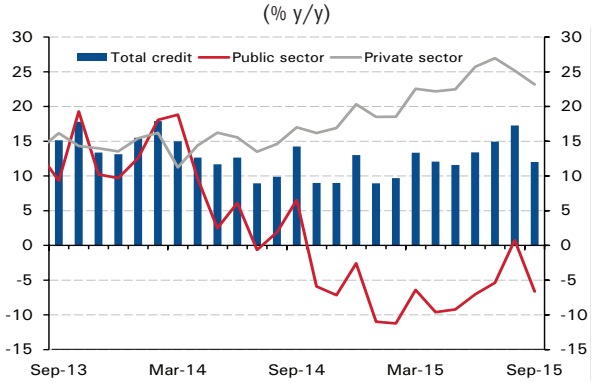
Reduced government deposits in the banking system resulting from lower oil and gas prices have slowed overall deposit growth considerably over the previous year. Total banking sector deposits grew by 7.1% y/y as of end-September, down from the average annual growth rates of 13.8% and 30.6% in 2014 and 2013, respectively. Public sector deposits were down by -13.9% y/y last September-the steepest contraction since the financial crisis. (Chart 10.) Public sector deposits, as a share of total bank deposits,

Chart 8: Central government debt (gross)



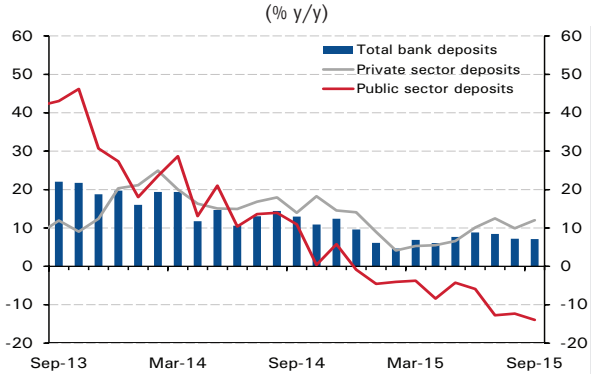
Source: QCB

Chart 9: Bank credit



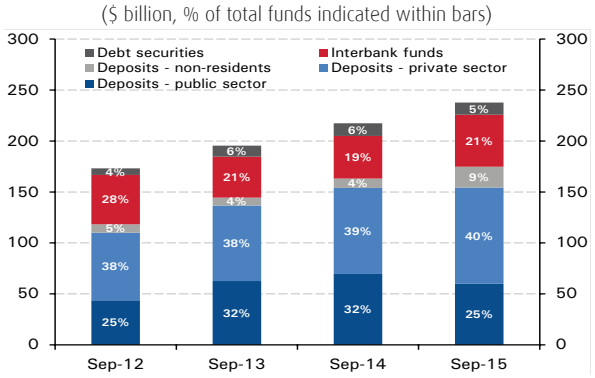
Source: QCB

Chart 10: Bank deposits



Source: QCB

Chart 11: Banks' source of funds



Source: QCB

stood at 25.0%, which is a decline from their high of 32.0% in 2013 and 2014. (Chart 11.) Private sector deposit growth has remained in double digits, however.

With deposit growth slowing and trailing credit growth-the loan-to-deposit ratio (LDR) remained elevated at 111.4% last September-banks are increasingly facing funding pressures. In response, banks are increasing their exposure to the costlier and more volatile interbank funds as well as to the debt markets; interbank funds as a share of total funds was back up to 21.4% in September 2015. (See Chart 11.)

Interbank rates tacked sharply upward since July, reflecting once again concerns over tightening liquidity. (Chart 12.) In order to alleviate potential liquidity constraints, the International Monetary Fund (IMF), in its Article IV Consultation, suggested that the authorities reallocate deposits from government and related institutions, including from the overseas SWF, and reduce the size of the central bank's T-bill and bond auctions.

Government securities form the bulk of commercial banks' liquid assets, and, along with deposits at the central bank, provide some measure of liquidity cover. While liquid banking assets accounted for 27.0% of total tangible assets in December 2015, this figure looks likely to fall to between 22.0-25.0% by the end of 2015.

An expected US rate rise by 2016 will likely add further pressure to domestic rates

With the Qatari riyal pegged to the US dollar, domestic interest rates tend to be closely aligned with US interest rates. The US Federal Reserve is expected to raise its benchmark Federal Funds rate by the turn of 2016, which will likely mean that Qatar's key lending and deposit rates will follow suit, possibly with some lag. (Chart 13.)

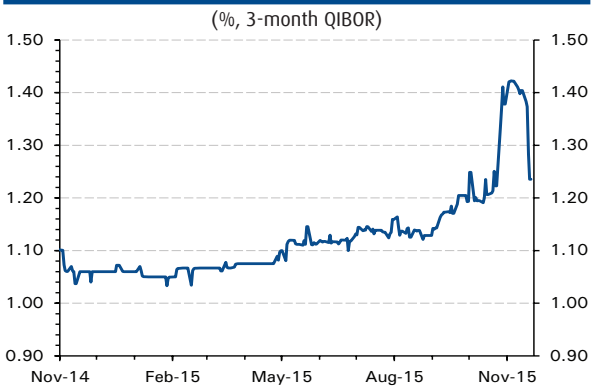
Qatari equities roiled by oil price slump despite market profitability

With the oil price slump continuing to negatively affect market sentiment, the benchmark Qatar Exchange Index (QE) had been in negative territory (year-to-date) for close to 7 months by mid-November 2015. This is despite the fact that Qatari corporates had posted the highest earnings growth in the GCC, of 13%, during the first 6 months of 2015. As of 20 November, the index was down -8.1% to 10,860. (Chart 14.) Low trading volumes have reflected weak buyer interest. Investors have also been concerned that the government would be forced to rein in spending, including cutting subsidies, and consider corporate tax increases in a bid to boost state coffers.

The trajectory of energy prices is the central risk to the outlook

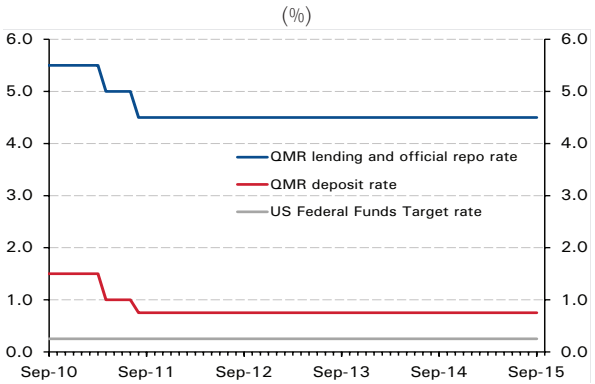
With its sizeable fiscal buffers and AA credit rating, Qatar remains well positioned to weather the current period of low energy prices. Nevertheless, the longer oil and gas prices remain depressed, the more pressure Qatar will face on its finances and banking sector. Growth will undoubtedly be affected. In a sign of rising pressures, along with a rise in the forward currency curve, the 5-year sovereign credit default swap spread widened significantly, by 14 bps, during the second half of the year. (Chart 15.) The likely arrival in 2016 of Australia and the US as LNG exporters is another concern, as it will challenge Qatar's position as the world's largest LNG exporter. Qatar's low gas production cost base, however, should enable it to compete effectively in this new environment.

Chart 12: Interbank rates



Source: Thomson Reuters Datastream

Chart 13: Key interest rates



Source: QCB

Chart 14: Qatar Exchange index (QE)

Source: Thomson Reuters Datastream

Chart 15: Sovereign credit default swaps (CDS)

Source: Thomson Reuters Datastream

Saudi Arabia outlook

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Economy resilient but growth slowing amid the oil price slump

Overview and outlook

- The real economy should receive a boost from record oil output, to grow by 3.5% in 2015, before slowing to 2.5% in 2016 and 2.3% in 2017; non-oil growth is forecast to average 3.7% over 2015-17, underpinned by firm but more disciplined government spending.
- Inflation should remain muted at 2.1% in 2015 before gradually rising to 2.9% in 2017.
- A sizeable fiscal deficit of -22.9% of GDP is expected in 2015, but this is likely to narrow to a still large -12.6% of GDP by 2017. Government reserves are likely to be drawn down to finance the deficit; domestic debt issuance is also an option.
- The authorities started issuing $5 bn in sovereign bonds per month to help finance the fiscal deficit and lessen the pressure on the kingdom's foreign reserves.

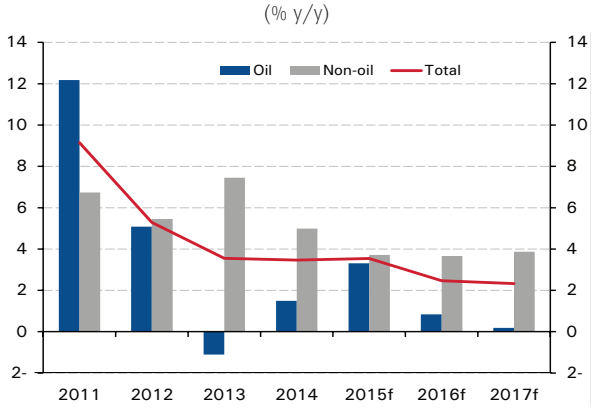
Saudi Arabia's economy has begun to feel the effects of the decline in oil prices: non-oil activity has moderated, the fiscal account has fallen into deficit and the flow of deposits into the banking system, especially government-sourced, has slowed. Faced with a sizeable fiscal deficit, a consequence of lower oil revenues and record high spending, and the prospect of increased drawdowns of the kingdom's foreign reserves, the authorities in 2015 started issuing sovereign bonds for the first time since 2007. Concerns over fiscal sustainability, tightening banking sector liquidity in the context of bond issuance, and slowing deposit growth all weighed heavily on the markets during the latter half of 2015. The result was: interbank rates spiked, CDS spreads widened and the performance of the benchmark TASI stock index swung into double-digit negative territory on the year. The subsequent downgrade of Saudi Arabia's credit rating, from AA- to A+, by S&P added to markets' anxieties. Nevertheless, consumer activity remains buoyant, supported by government spending, and oil output has expanded. Moreover, with substantial government deposits at Saudi Arabian Monetary Agency (SAMA) and foreign reserve assets, the kingdom has ample resources to help it negotiate the economic downturn, at least over the medium term. Clearly, however, prudent fiscal policies will need to be the way forward for Saudi Arabia.

Key economic indicators

		2014	2015e	2016f	2017f
Nominal GDP	USD bn	3.5	3.5	2.5	2.3
Real GDP growth	% y/y	1.5	3.3	0.8	0.2
- Oil	% y/y	5.0	3.7	3.7	3.9
- Non-oil	% y/y	2.7	2.1	2.6	2.9
Inflation	% y/y	-2.3	-22.9	-16.4	-12.6
Budget balance	% of GDP	1.6	6.0	12.3	16.3

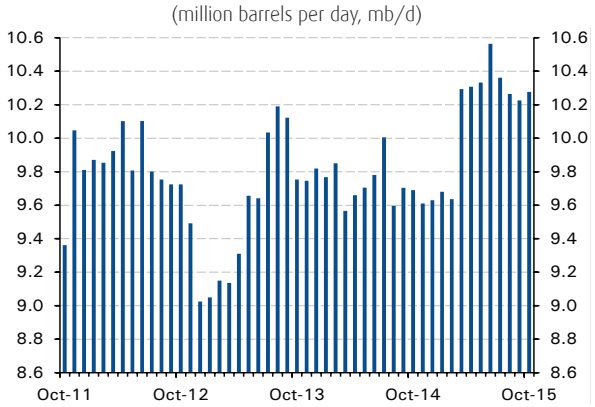
Source: Official sources; NBK estimates

Chart 1: Real GDP



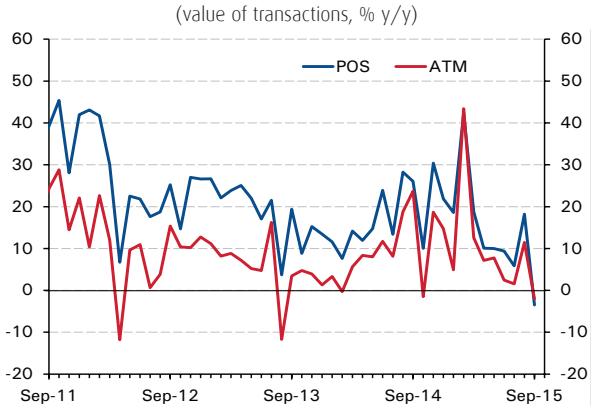
Source: Central Department of Statistics and Information; NBK estimates

Chart 2: Crude oil production



Source: OPEC

Chart 3: ATM and point of sale transactions



Source: Saudi Arabian Monetary Agency (SAMA)

Oil output has surprised to the upside in 2015 as Saudi Arabia stuck to its 'market share over price' strategy

Real oil output is expected to expand by 3.3% in 2015 after a year in which oil production surged to a record high of over 10.0 million barrels per day (mb/d) on average. (Charts 1 & 2.) Elevated oil production has come about as Saudi Arabia's looks to retain and increase export market share amid plunging oil prices, and as it attempts to move up the hydrocarbon value-chain by increasing production of refined products. The latter has been boosted by increases in refinery capacity. Crude for direct burn i.e. power generation has also been a factor, especially over the energy-intensive hot summer months. Moving into 2016 and 2017, we forecast real oil GDP growth to slow to 0.8% and 0.2% year-on-year (y/y), respectively.

Non-oil activity buoyant, supported by government spending, but key consumer metrics point to slowing economic growth

Non-oil activity is likely to remain relatively buoyant, supported by government spending. However, there are signs that the economy is cooling: GDP growth in 2Q15 slowed for the third successive quarter and key metrics of consumer and business activity such as point of sale (POS) and ATM transactions, business confidence and private sector credit growth, have all been slipping. (Charts 3-5.) October's reading of the Saudi Purchasing Managers' Index (PMI), which tracks business conditions in the non-oil sector, fell for the second consecutive month, to 55.7 on slower output and new orders. (Chart 4.) This is the lowest figure in the survey's 6-year history. The pace of job creation also seemed to be slowing. Having said that, both business activity and employment growth remained healthy-indeed payroll numbers increased for 19 months in a row. Taking this into consideration, annual non-oil growth is projected to slow, from 5.0% in 2014 to an average of 3.7% during 2015-2017.

Headline GDP growth is, therefore, forecast to expand by 3.5% in 2015 before slowing to 2.5% and 2.3% in 2016 and 2017, respectively. (See Chart 1.)

Solid but slowing employment growth as output moderates

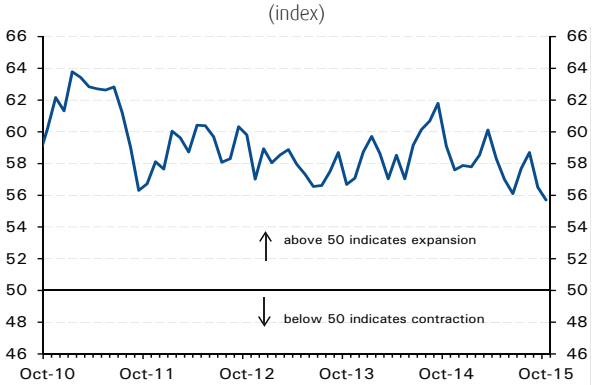
Looking at Saudi employment trends, the recent PMI survey chimed with employment data provided by the central statistical office that showed the number of Saudis taking up employment, for example, increasing by 56,000, or 1.1%, to 4.9 million over the last year (1H14-1H15). (Chart 6.) Again, though, this is a notable slowdown from the 5.6% and 8.9% growth rates witnessed in 1H14 and 1H13, respectively. Also, this is slower than both the 4.5% y/y increase in the rate of expatriate employment growth recorded in 1H15 and the 4.0% y/y increase in the pace of overall economic growth over the same period; up until June 2015, Saudi job creation had been proceeding at a faster rate than overall GDP growth.

Nevertheless, the proportion of Saudis employed in the private sector, the Saudization ratio, which is a key metric of the government's Nitaqat program, has steadily improved. The ratio increased from 9.9% in 2009 to 15.2% in 2013 (the last year for which data is available). Moreover, the Saudi unemployment rate has also fallen steadily and gradually since 2011, from 12.4 % to 11.6% as of mid-2015. (Chart 7.)

Inflation remains subdued but is expected to rise gradually

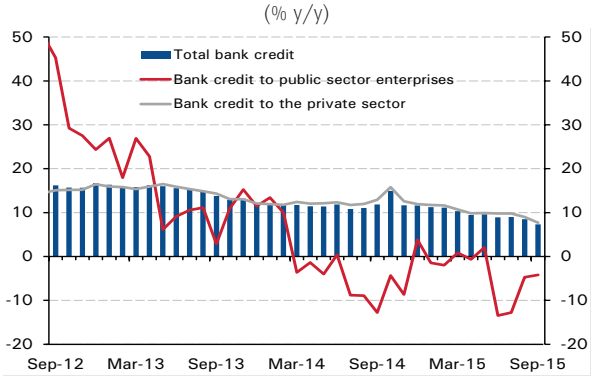
Consumer price inflation in Saudi Arabia remained muted at 2.3% last September. (Chart 8.) This largely reflected depressed international food

Chart 4: Purchasing Managers' Index (PMI)



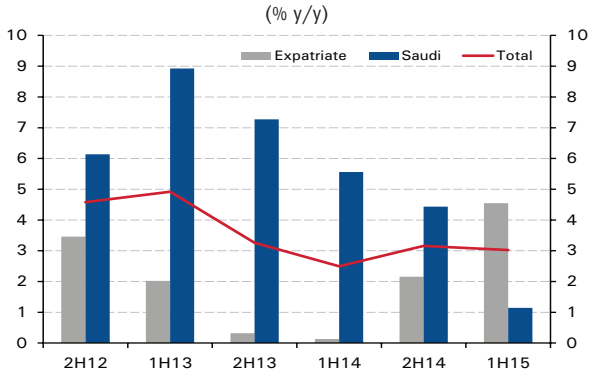
Source: Emirates NBD/Markit

Chart 5: Bank credit



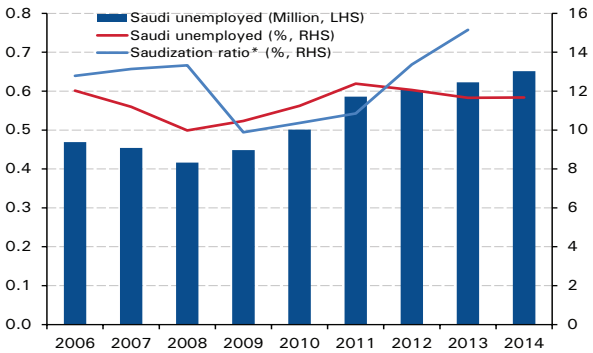
Source: SAMA

Chart 6: Employment growth



Source: CDSI

Chart 7: Saudi unemployment



Source: CDSI, SAMA, * refers to % of Saudi labor force in private sector

and commodity prices as well as a stronger dollar, to which the riyal is pegged. The dollar's rise against a basket of currencies over the last year has rendered the kingdom's non-dollar-denominated imports less costly, effectively raising the purchasing power of Saudi consumers. Nevertheless, there are tentative signs that inflation in the largest constituents of Saudi Arabia's CPI-housing, food and transport-is beginning to pick up. Housing and utility costs increased by 3.8% y/y in September, while prices in the food and transport categories increased by 1.9% y/y and 2.5% y/y, respectively. Inflation is expected to rise gradually over the next year or so, bringing the average annual rate to 2.6% in 2016 and 2.9% in 2017, respectively.

Fiscal deficits expected while oil prices remain depressed

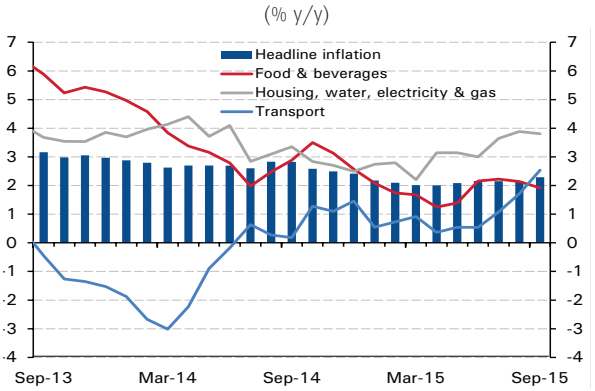
The kingdom's fiscal account, having swung into deficit of -2.3% of GDP in 2014-for the first time since the financial crisis-looks likely to widen markedly by end-2015, to an estimated -22.9% of GDP. (Chart 9.) This is due to a combination of burgeoning expenditures, including King Salman's $32.0 billion accession bonus, and lower oil revenues. Recognizing the need for fiscal consolidation, the authorities have scaled back some of their capital spending on non-essential infrastructure, such as new stadia, for example. They have also, according to the IMF, lowered the threshold for approval for new projects from SAR 300 million to SAR 100 million. On the revenue side, apart from the move up the value chain i.e. selling increasing volumes of refined petroleum products rather than solely crude oil, a 2.5% tax on undeveloped urban land has been announced. Energy subsidy cuts for commercial and industrial users as well as a new VAT law have also been mooted. Pending the possible rollout of these measures, we expect the authorities to exercise greater restraint over spending, which should help narrow the kingdom's fiscal deficit to -16.4% of GDP in 2016 and -12.6% of GDP in 2017.

Government deposits at SAMA drawn down; falling foreign reserves spurred the issuance of Saudi Arabia's first sovereign bonds since 2007

By September 2015, the funds in the central government's deposit accounts at SAMA had fallen by -28.0% y/y, or $112 billion. (Chart 10.) The kingdom's foreign reserve assets, meanwhile, had dropped by -12.1% y/y, or $90 billion, over the same period. (Chart 11.) While reserves still provide close to a healthy 30 months of import cover, the quickening pace of reserve depletion in 2015, equating to $6.5 billion per month, has unsettled markets and encouraged speculation that Saudi Arabia could be forced to abandon its peg to the dollar.

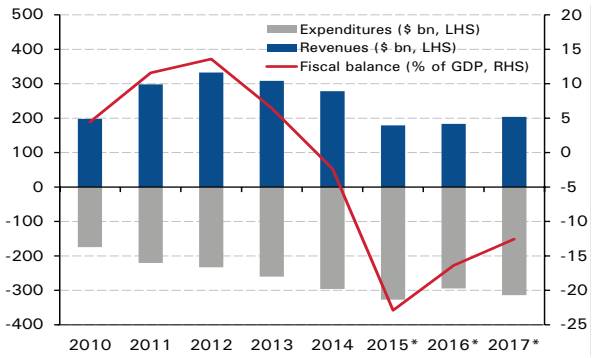
Falling reserves also prompted the authorities to announce, in August, their first local currency bond issuance program since 2007. SAR 20 billion ($5.3 billion) worth of bonds was sold to public institutions and local banks across three tranches of 5-year, (1.92% yield), 7-year (2.34% yield) and 10-year (2.65% yield) maturities. Approximately SAR 100 billion ($27 billion) will be sold in 2015, over five monthly issuances of SAR 20 billion ($5.3 billion). This should help finance around 18% of the $148 billion fiscal deficit expected this year. The program is expected to continue at a similar pace in 2016, with the possibility of up to 40% of the projected deficit in 2016 being covered through debt issuance. The remaining shortfall will be financed by drawing down the kingdom's still sizeable reserves and assets. (Chart 14 shows the consequent increase in bank holdings of government bonds.)

Chart 8: Consumer price inflation



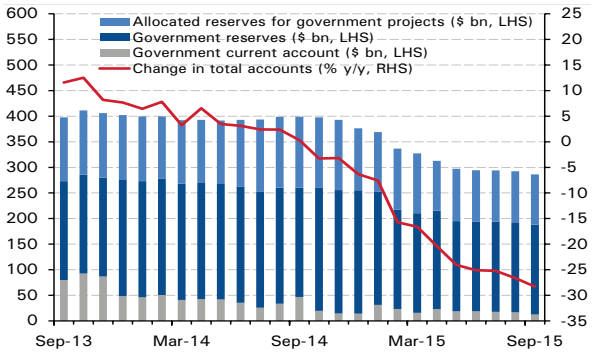
Source: SAMA

Chart 9: Fiscal balance



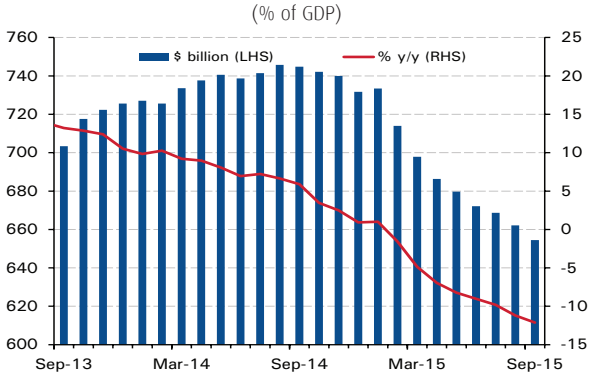
Source: SAMA, NBK estimates

Chart 10: Government accounts at SAMA



Source: SAMA

Chart 11: SAMA foreign reserve assets



Source: SAMA, NBK estimates

At 2016's projected spending rate, Saudi Arabia could, therefore, through a combination of debt issuance and reserve drawdown, weather a period of low oil prices (in the $50-55.0 per barrel range) for at least two years before even half of the kingdom's foreign reserves are depleted. Moreover, the authorities would seem to have ample fiscal space with central government gross domestic debt a very low 1.6% of GDP ($11.6 billion) in 2014. Even if debt issuance proceeds as discussed, gross outstanding public debt would still only rise to $38.8 billion, or 6.0% of GDP in 2015, and to $83.3 billion, or 12.3% of GDP, in 2016. These are still very low levels of public debt by international standards. (Chart 12.)

While banks' interest margins should improve through participation in the bond issuance program, banking sector liquidity will need to be monitored

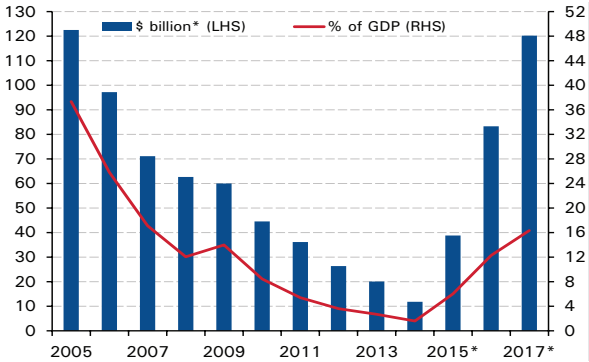
Issuing debt of up to $45 billion over the course of a year or two, or even several years, would nevertheless have implications for the domestic banking system. On the positive side, banks' net interest margins and revenues should improve as banks shift from lower-yielding, short-term liquid assets to higher-yielding, longer term government securities. As of July 2015, short term liquid assets such as cash, deposits with banks and the central bank, as well as treasury bills, accounted for only $106 billion, or 18% of the Saudi banking system's balance sheet. So there is plenty of scope to accommodate bond issuance by the government in the short term without unduly constraining liquidity. Things would get trickier, however, were low oil prices to persist for several years and liquidity conditions tighten further both locally and internationally.

Deposit growth, especially on the government side, has already begun to slow down. Total banking deposit growth slowed to 6.6% y/y in August 2015, which is the slowest rate of growth since late 2010. Growth did pick up slightly, to 8.3% y/y, in September, though. (Chart 13.) And the 3-month interbank rate, the Saudi Arabia Interbank Offered Rate (SAIBOR), tacked sharply upwards during 2H15, by 28 bps, to 1.05% in late November, to reflect both slowing deposit growth and the recent sovereign bond issuances. (Chart 15.) Moreover, there is always the risk that the sovereign debt issuance program could crowd out the private sector, with obvious negative effects for non-oil economic growth.

Concerns mount that Saudi Arabia would be forced to abandon its peg to the US dollar

In August, financial markets grew concerned over the prospect of Saudi Arabia recording large fiscal deficits, the increasing rate of its international reserve drawdown in 2015 and its decision to tap the bond markets. Attention focused on the sustainability of the kingdom's fixed exchange rate to the US dollar. With echoes of previous oil price crashes that put pressure on its fixed exchange rate, the Saudi riyal one-year dollar forward rate spiked to SAR 3.792 per US dollar on 24 August, and the 5-year credit default swap spread (CDS) widened significantly, almost doubling to 110 bps on the same day. Both have remained elevated, but the forward rate broke new ground in November with a rise above SAR 3.801 per US dollar. (Charts 16 & 17.) The authorities are unlikely, however, to shift away from an exchange rate regime that has served them well in the past, anchoring the economy and inflation. The dollar peg provides stability to trade and income flows, especially given the fact that oil, which is priced in dollars, continues to dominate the Saudi economy, accounting for more than 80% of the kingdom's export and fiscal revenues.

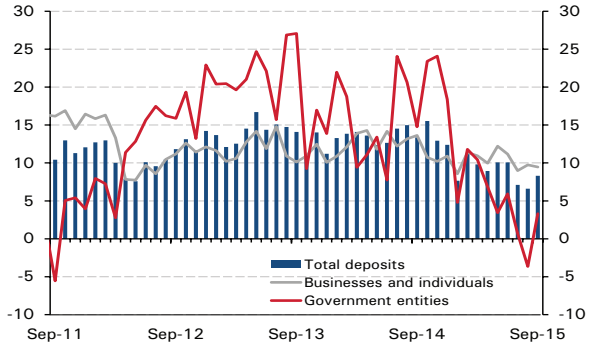
Chart 12: Public debt (gross)



Source: SAMA, NBK estimates; *note: forecasts assume 40% of deficit financed by debt

Chart 13: Bank deposits

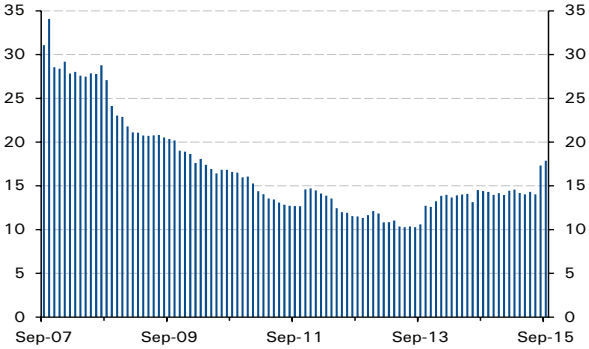
(% y/y)



Source: SAMA

Chart 14: Bank holdings of government bonds

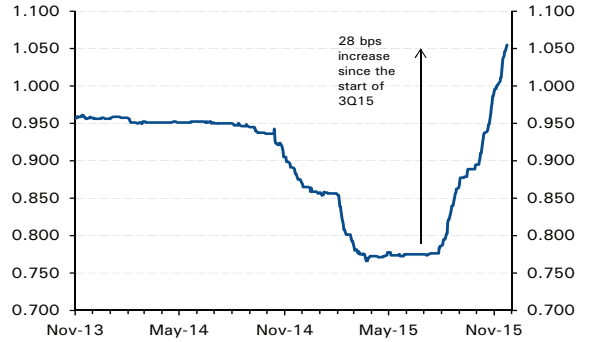
($ billion)



Source: SAMA

Chart 15: Interbank rates

(%, 3-month SAIBOR)



Source: Thomson Reuters Datastream

Monetary policy remains accommodative, but interest rates likely to increase in line with a US rate rise expected by end-2015

Monetary policy has remained accommodative in the context of the currency peg to the US dollar. Mirroring the path of the US federal funds rate, currently at 0.0%-0.25%, SAMA's key interest rates, the reverse repo and repo, have remained unchanged at 0.25% and 2.0%, respectively, since late 2009. (Chart 18.) SAMA is expected to follow the Federal Reserve's lead and raise its policy rates sometime in early 2016.

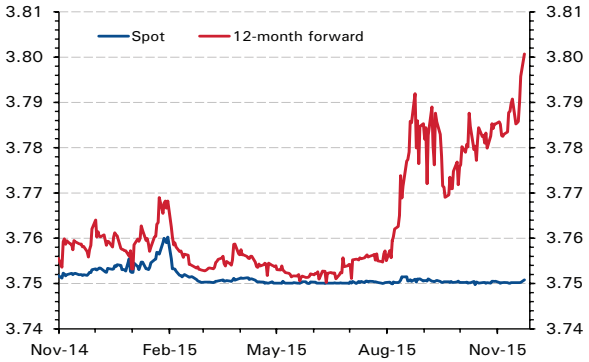
Bearish sentiment weighed on Saudi equities despite the market opening up to foreign investment in June 2015

Meanwhile, the local equity market continued to be roiled by low oil prices and weaker sentiment. As of 23 November, the Saudi Tadawul All-Share Index (TASI) was down by -14.2% year-to-date (ytd) at 7,149. (Chart 19.) Up until mid-August 2015, TASI had largely been in positive territory, boosted by the opening of the stock market to foreign investors in June. But a spate of 'negative outlook' assessments and a one notch downgrade (AA- to A+) by the ratings agency Standard & Poor's (S&P), compounded the market's anxieties, weighing heavily on the index.

Worth watching in 2016 will be whether foreign portfolio inflows pick up, following a lackluster performance in 2015 and the market's reaction to the announcement that the kingdom will ease restrictions on foreign ownership in retail and wholesale business, from the current maximum of up to 75% to 100%. While domestic firms would be expected to come under pressure with the added competition, overall, the effect should be positive for the economy, with foreign direct investment (FDI), private sector employment of Saudi nationals and, ultimately, Saudi consumers benefiting.

Chart 16: Saudi riyal spot and forward exchange rates

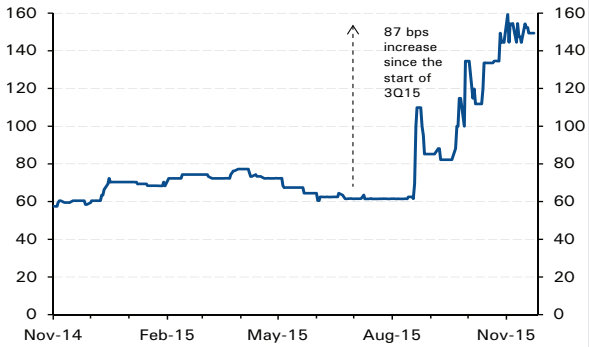
(Saudi riyal per US dollar, SAR:USD)



Source: Thomson Reuters Datastream

Chart 17: Soverign credit default swaps (CDS)

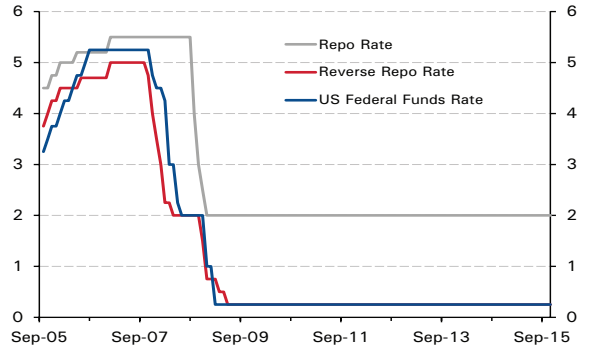
(bps, 5-year CDS)



Source: Thomson Reuters Datastream

Chart 18: Key interest rates

(%)



Source: Thomson Reuters Datastream

Chart 19: Stock Market

(Tadawul All-Share Index, TASI)

Source: Thomson Reuters Datastream

UAE outlook

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Non-oil sector seen improving in 2016 and 2017

Overview and outlook

- Real GDP growth is expected to moderate in 2015 on weaker oil GDP growth; it should improve in 2016 and 2017 as non-oil sector activity gains momentum to around 5-6% on buoyant hospitality, transport and construction sectors.
- CPI inflation expected to increase by 4.0% in 2015 on firmer housing inflation, before moderating to 3.5% in 2016 and 2017.
- A modest fiscal deficit is projected in 2015 and 2016, near balance in 2017.
- The banking sector may experience some tightness in liquidity as credit growth outpaces falling deposits. Deposit growth remains weak as oil revenues continue to be sapped.

Real GDP growth in non-oil sector to remain resilient

Real economic growth in the UAE is estimated at 3.9% year-on-year (y/y) for 2015, as real oil GDP growth continued to be affected by conditions in international energy markets. (Chart 1.) A resilient non-oil sector and a recovery in oil GDP are expected to drive overall GDP growth higher in 2017.

Real oil GDP growth is expected to be weak in the near-to-medium term amid low global demand. Real oil GDP growth is estimated to slow down from 4.0% y/y in 2014 to 1.6% y/y in 2015. Growth is likely to be flat in 2016, before picking up in 2017 thanks to rising oil production.

Non-oil sector growth is likely to accelerate to around 5.5% and 6.0% y/y for 2016 and 2017. This sector should be led higher by firmer activity in tourism, financial services and construction. Construction activity is set to accelerate as the Dubai Expo 2020 draws closer. Furthermore, the President, Sheikh Khalifa, recently announced that the federal authorities plan to invest more than Dh300 billion ($82 billion) domestically to foster a post-oil "knowledge economy". The plans also envisage tripling the labor force in the knowledge economy by 2021.

PMI trends lower in 2015

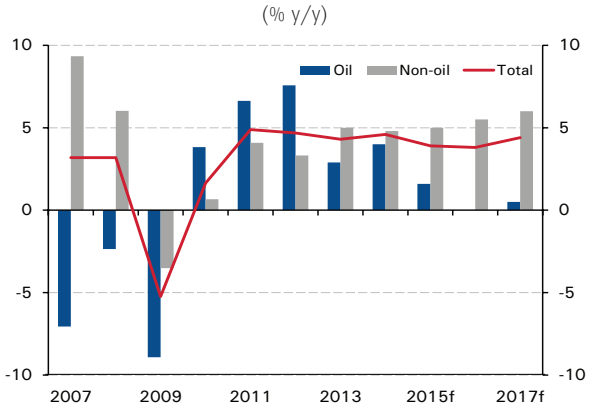
The Markit Purchasing Managers' Index (PMI) trended lower throughout 2015, against a backdrop of a stronger US dollar (and thereby UAE dirham) and weak global demand. (Chart 2). The UAE's headline PMI (a forward-looking economic indicator) slipped from 56.0 in September to a more-

Key economic indicators

		2014	2015e	2016f	2017f
Nominal GDP	USD bn	399.4	361.4	387.1	427.9
Real GDP	% y/y	4.6	3.9	3.8	4.4
- Oil	% y/y	4.0	1.6	0.0	0.5
- Non-oil	% y/y	4.8	5.0	5.5	6.0
Inflation	% y/y	2.0	4.0	3.5	3.5
Budget balance	% of GDP	4.2	-1.2	-1.5	0.3

Source: Official source, NBK estimates

Chart 1: Real GDP

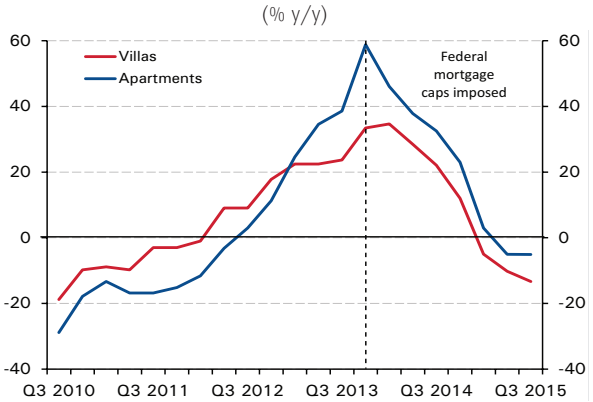


Source: UAE National Bureau of Statistics, NBK estimates

Chart 2: Markit Purchasing Managers' Index

Source: Markit

Chart 3: Residential property sales prices



Source: Asteco, JLL

than-two-year low of 54.0 in October, mainly due to a drop in new orders and output. (A reading above 50 indicates an expansion in activity; a reading below 50 indicates a contraction in activity.)

Inflationary pressures appeared to be rather subdued as input costs and staff costs remained steady. It is also worthwhile to note that employment conditions have remained stable, even while oil prices trend lower, with the employment sub-index consistently around 52 over the past six months. This should help allay fears of a major oil-induced disruption to domestic consumption and the overall economy.

Residential property price growth in Dubai maintained its downward trend in 2015

Growth in sales prices in Dubai's residential property sector continued to trend lower in 2015. However, data for the latter part of 2015 pointed to signs of stabilization, particularly in the case of apartment sales prices. According to Asteco, a major real estate services company, prices of apartments in Dubai fell by around 5.0% y/y in 3Q15 for the second consecutive quarter. Villa prices, meanwhile, had fallen by 10.2% y/y and 13.3% y/y in 2Q15 and 3Q15, respectively. (Chart 3.)

The imposition of higher transaction fees in 4Q13 and federal mortgage caps in early 2014 (before oil prices fell) undoubtedly delivered the results the authorities were looking for: cooling off the property market and curbing speculative buying. These measures have also been recently compounded by an on-going rise in housing supply and a change in preferences and risk appetite within the residential property market.

Against a backdrop of greater supply, sellers have been forced to lower prices. Also, more and more buyers are favoring affordable (mid-range) and/or end-use housing. While transaction values continue to fall, growth in the number of transactions has recovered of late thanks to rising activity in the "more affordable" housing segment. (Charts 4 and 5.) Looking ahead, we expect to see more of this shift towards mid-range housing, especially amid a low oil price environment and tighter lending restrictions.

The property market has also been hampered by a stronger dirham (higher US dollar) currency relative to key emerging market currencies. This has dented sales to Russian and Asian buyers. But for the majority of buyers, hailing from the UAE or GCC region (dollar-based), the impact is expected to be more muted.

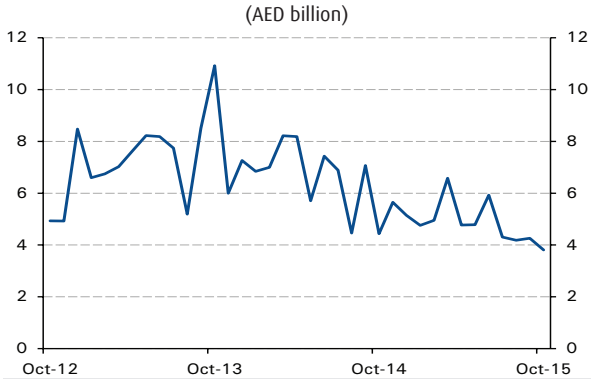
It is safe to conclude that Dubai's property market is going through a significant correction and that the measures that were put in place have so far shepherded the market in the right direction, with perhaps further correction ahead.

Consumer price inflation expected to moderate in the near-to-medium term

After accelerating throughout 1H15, headline inflation is expected to moderate over the coming months as housing inflation (rent, which weighs heavily in the index) stabilizes. September data showed inflation in the CPI slowing to 4.3% y/y as inflation in housing costs eased and food inflation remained subdued.

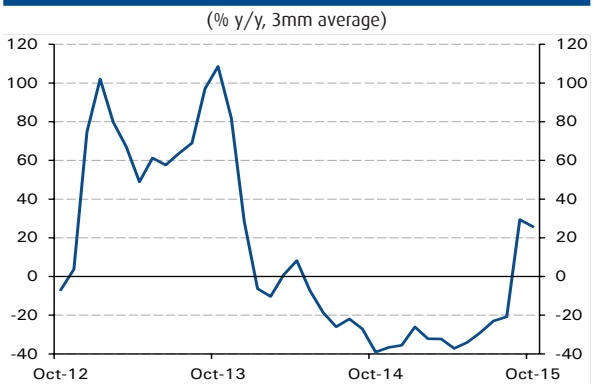
The rise in housing costs appears to have peaked at 10.2% y/y last June. It had been on an upward trajectory since the end of 2013 on the back

Chart 4: Value of transactions



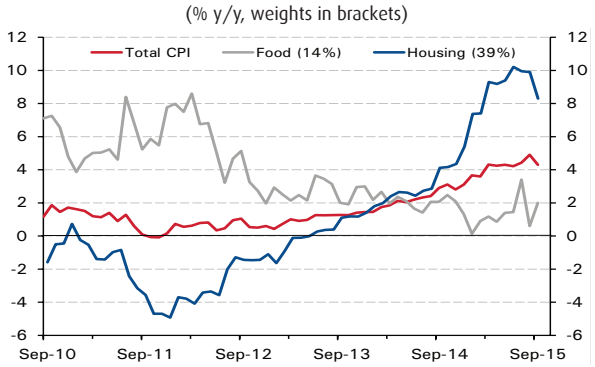
Source: Dubai Land Department

Chart 5: Number of transactions



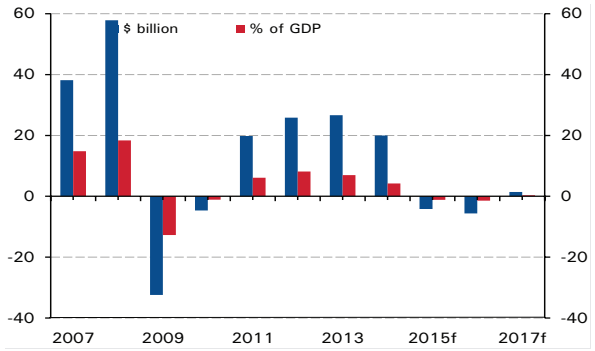
Source: Dubai Land Department

Chart 6: Consumer price inflation by sector



Source: Thomson Reuters Datastream

Chart 7: Budget balance



Source: UAE National Bureau of Statistics, NBK estimates
Note: Budget balance includes ADNOC profits & investment income.

of a recovery in the residential property sector. (Chart 6.) The steep rise in housing costs in 1H15 mainly came on the back of the one-off hike in electricity and water tariffs (for both nationals and expatriates) and the removal of the rental cap in Abu Dhabi. But with more housing set to enter the market and the effect of the one-off hike in utility tariffs set to wane, we should see inflation in the housing segment steady over the medium-term.

A stronger US dollar and lower commodity prices will also help limit any further gains in the headline rate. Consequently, we forecast inflation to average 4.0% in 2015 and 3.5% in 2016 and 2017.

Modest fiscal deficits in 2015 and 2016 on high spending levels and lower oil revenues

Amid steady spending and lower revenues, the UAE's fiscal balance (breakeven oil price is $70 per barrel) is expected to swing from an estimated surplus of 4.2% of GDP in 2014 to a deficit of 1.2% and 1.5% of GDP in 2015 and 2016, respectively. (Chart 7.)

With abundant financial reserves (a staggering 200% of GDP) to help finance these deficits, however, it is unlikely that the UAE economy will need to carry out any significant fiscal consolidation in the medium-term. Both Dubai and Abu Dhabi are scheduled to maintain their high levels of public spending on infrastructure projects. In Dubai, infrastructure spending is expected to accelerate in the run-up to the Expo 2020 event.

That is not to say that the major emirates have not exercised some fiscal prudence and reforms recently. According to official reports, Abu Dhabi has curtailed and/or delayed spending on a number of projects designated as low-priority. Dubai is poised to pass a law covering public-private partnerships (PPP) late in 2015, to tap into private sector funding for key projects. Furthermore, the UAE government is expected to impose further reductions in subsidies. At the start of 2015, it took the decision to hike utility tariffs. Later, in August, it deregulated petrol prices. This will help lower subsidy costs. The fiscal balance is expected to return to a surplus in 2017 on the back of an expected oil price recovery and a planned increase in oil production.

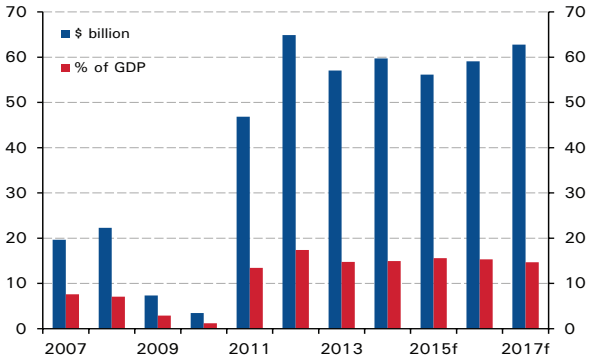
Current account surplus to remain resilient on strong non-oil earnings

The current account is expected to continue to post a surplus, of 14-15.0% of GDP in 2016 and 2017, on the back of strong non-oil export revenues. Downward pressures on the surplus from lower oil export earnings and higher imports are being partly offset by robust non-oil export revenues, especially from the tourism, trade and financial services sectors. (Chart 8.)

The UAE's non-oil exports may be slightly affected by the strength of the dirham. The stronger dollar has led to an appreciation in the UAE's trade-weighted index increasing the costs of its exports and making it a more expensive place to visit and invest in for expatriates outside the GCC region and the US. (Chart 14.) The UAE's major trading partners are in Asia, and those countries that are not pegged to the dollar could see further depreciations in their currencies vis-à-vis the dirham. However, given that the majority of tourists visiting the UAE are from the GCC region and that UAE nationals are the predominant investors in the country's real estate sector, the non-oil economy should continue to perform well in the current low oil price environment.

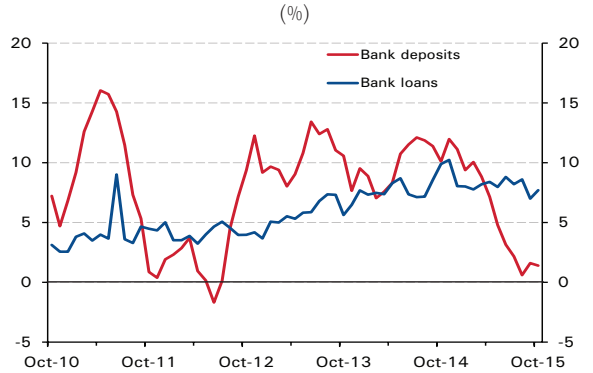
Furthermore, a potential removal of sanctions on Iran by the West in

Chart 8: Current account balance



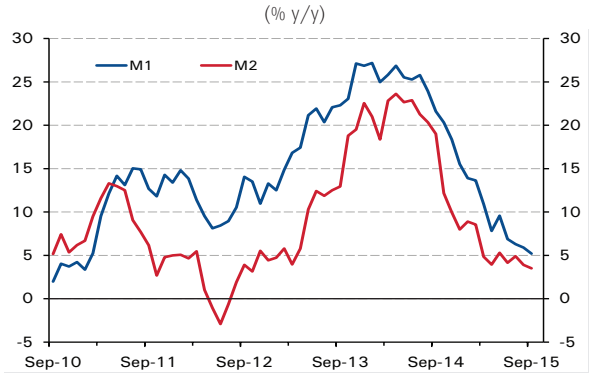
Source: UAE National Bureau of Statistics, NBK estimates

Chart 9: Bank lending



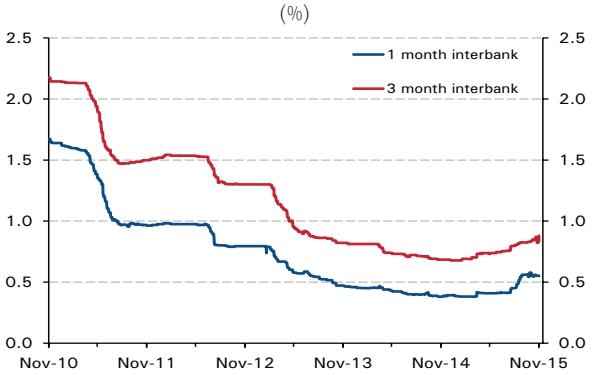
Source: Central Bank of the UAE

Chart 10: Money supply



Source: Thomson Reuters Datastream

Chart 11: Interbank rates



Source: Thomson Reuters Datastream

early 2016 could be a huge boost for UAE trade, particularly in the non-oil sector. The UAE is Iran's biggest non-oil trading partner and its biggest source of imported goods.

Banking sector poised to undergo some liquidity tightness as deposit growth weakens

Growth in bank loans continues to hold on to its recent moderate pace, even amid softer oil prices and a slowing real estate market. Within the non-oil sector, lending to the construction sector has proven robust. In October 2015, loan growth was hovering at 7.7% y/y. With capital spending expected to increase further in the run-up to the Expo 2020 in Dubai, we should continue to see healthy gains in loan growth. (Chart 9.)

Bank deposit growth has, however, been trending lower in 2015 as a result of a slowdown in government deposit growth. As of October 2015, total deposit growth stood at 1.4% y/y. (See Chart 9.) Growth in government deposits, which is closely correlated with oil revenues, has slowed. With deposit growth trailing credit growth, the loan-to-deposit ratio has consequently edged higher in recent months. In October 2015 it climbed to a three-year high of 103.2%.

Slowing deposit growth is also evident in the slowdown in annual broad money supply (M2) growth. This has been trending downwards since mid-2014. (Chart 10.)

Monetary policy remains accommodative, and there is room for monetary tightening if need be. The UAE's three-month and one-month interbank rates both saw a slight uptick in 2H15, but they both remain low and below 1.0%. (Chart 11.) A rise in the US Fed rate is expected to further tighten liquidity conditions in the banking sector.

Small and medium-sized enterprises (SME) in Dubai have been struggling of late due to delayed payments by their customers. Since the summer of 2015, there have been anectodal reports of defaults or late payments.

According to the Dubai SME report (2013), SMEs account for about 95% of the enterprise population in Dubai, 43% of the workforce and 40% of the total value-added to the Dubai economy. Thus, they are one of the main driving forces behind the economy. The trading sector accounts for the majority (around 57%) of SME businesses in Dubai. Given that the trading sector is dominated by commodity trading, it has been hurt by the on-going weakness in commodity prices. Also, with around 51% of the SME businesses heavily dependent on trade/exports, they have been hit by the appreciation in the dirham against most major currencies (with the exception of the US dollar).

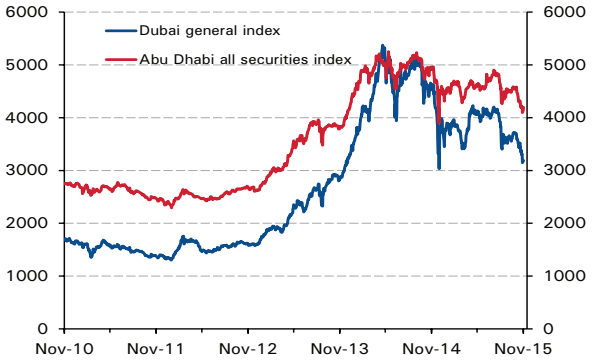
The UAE Banks Federation estimates that among SMEs, loans amounting to between Dh5 billion and Dh7 billion ($1.36 billion-$1.9 billion) are at risk of default. While provisions for non-performing loans (NPL) have remained steady in 2015, loan defaults among SMEs would ultimately lead to a pick up in NPL provisions. The government has vowed to step up its efforts in formulating a new bankruptcy law to help support SMEs and reduce the risk of default. However, with gross credit valued at Dh1.4 trillion and SME loans at risk of a default valued at Dh7 billion, the impact on the banking sector should be limited.

Markets and interest rates

The main Abu Dhabi and Dubai markets were under pressure in the second

Chart 12: Stock market indices

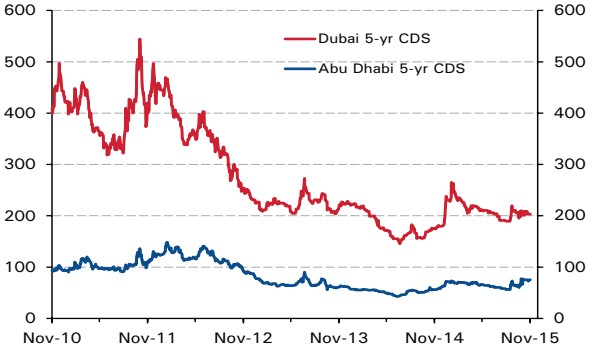
(index)



Source: Thomson Reuters Datastream

Chart 13: Credit default swaps

(basis points)



Source: Thomson Reuters Datastream

Chart 14: UAE trade-weighted index

(index, Jan 100 = 2000)

Source: Thomson Reuters Datastream

half of 2015, in sync with international and other GCC markets, and amid a softer oil price environment.

The main credit default swaps (CDS), good indications of the level of risk within an economy, have stabilized recently. (Chart 13.) In mid-November, the CDS on five-year Dubai and Abu Dhabi government debt stood at 206 and 75 basis points, respectively.

In the near-to-medium term we may see the nascent effects of the long-awaited changes in the UAE's companies' law. One of the changes includes lowering the minimum percentage of equity that a company needs to float, from 55% to 30%. This should lead to an increase in initial public offering (IPO) activity; the 55% requirement was deemed too high by entrepreneurs, many of whom were reluctant to divest too much from their own businesses.

US dollar-dirham peg is here to stay even amid on-going appreciation

The dirham has been pegged to the US dollar at a rate of $1 = 3.673 Dhs since 1997. The current exchange rate policy has thus far helped the UAE economy instil macroeconomic stability, keep the rate of inflation in check and maintain investor confidence. However, the peg has come under pressure of late against a backdrop of falling oil prices and a stronger US dollar against most other currencies. Nonetheless, thanks to the country's abundant foreign reserves, the UAE has enough ammunition to defend its peg to the US dollar.

Egypt outlook

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Growth slowed in 2015 as activity hurt by bottlenecks

Overview and outlook

- Growth slowed in 2015, with the pace expected to decline to 3.5% in FY15/16 before improving to 4-4.5% in FY16/17 and FY17/18.
- Economic activity hit by foreign currency shortages, energy bottlenecks, and weak tourism hurt by challenging security.
- Inflation has eased and is expected to maintain current levels.
- The fiscal deficit is expected to narrow gradually from 13% of GDP in FY14/15 to 11% in FY16/17.
- Pressure on the external position remains a challenge, with GCC official support critical.

Economic growth slowed in 2015 after a strong pickup in 2014. Economic activity was hurt by foreign exchange shortages and further expectations of currency devaluation. Exports have also been weighed down by worsening security conditions in the region and sluggish global growth. While the economy benefited from a strong recovery in tourism during 2014 and early 2015, and a healthy boost to public capital spending, both factors appeared to fade during the second half of 2015.

Several indicators have pointed to slower activity in the economy since the start of 2015. Real GDP growth began slowing in 1Q15 and continued to ease in 2Q15. The production index began to retreat around the middle of the year against the year before. The Purchasing Managers' Index (PMI) dipped significantly below 50 early in the year and again later in 2015. Private credit growth, which had held up most of 2015, slowed towards the end of the summer, reflecting slowing economic activity.

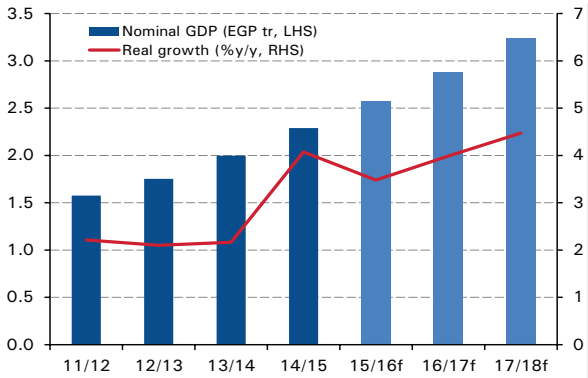
Egypt's fiscal and external positions continued to face significant pressures, with conditions appearing to deteriorate in 2015. The country continues to record a large fiscal deficit after foreign government grants declined. Reforms to address the deficit have not moved quickly enough. The external position also worsened in 2015, with the current account deficit widening and foreign reserves remaining relatively tight despite generous GCC deposits. Several devaluations helped reduce the pressure on the pound, but expectations of further declines in the currency and difficulties obtaining foreign currency have kept investors in wait-and-see mode.

Key economic indicators

		FY14/15	FY15/16f	FY16/17f	FY17/18f
Nominal GDP	EGP bn	2,289	2,576	2,885	3,245
Nominal GDP	USD bn	310	331	361	396
Real GDP growth	% y/y	4.1	3.5	4.0	4.5
Inflation	% y/y	11.4	9.0	8.0	8.0
Budget balance	% of GDP	-13.1	-12.0	-10.7	-9.8

Source: Central Bank of Egypt, Ministry of Finance, Ministry of Planning, NBK estimates

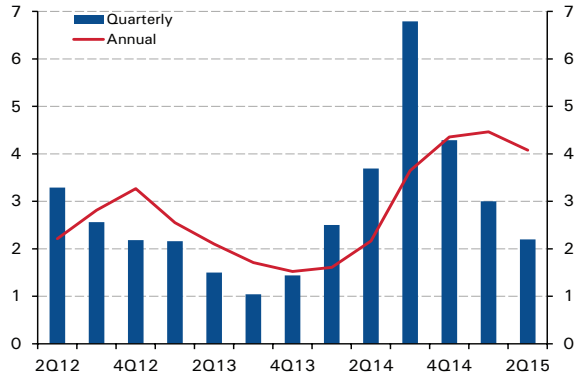
Chart 1: GDP



Source: Ministry of Planning, NBK estimates

Chart 2: Real GDP

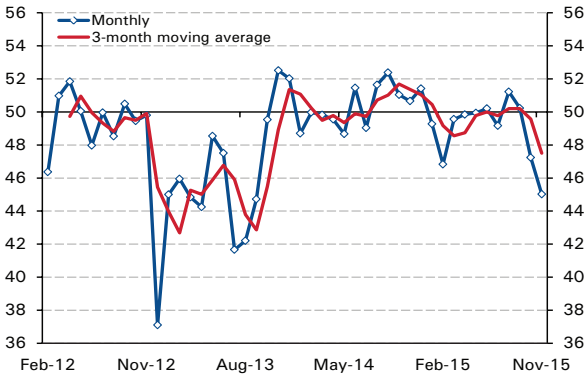
(% y/y)



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index

(index, seasonally adjusted)



Source: Markit

Recovery lost steam in 2015

Following a robust recovery in 2014, economic growth began to lose steam in 2015. Real GDP growth slowed to 2.1% year-on-year (y/y) in 2Q15. (Chart 2). Economic growth still managed to average a relatively strong 4.1% in FY14/15, though this was largely due to strong growth in 3Q14 and 4Q14, when output benefited from basis effects. In FY15/16, we expect growth to slow to around 3.5% before accelerating once again to 4% in FY16/17 and 4.5% in FY17/18. (Chart 1).

One of the key indicators of the slowdown has come from the Ministry of Planning's production index, which has been solidly in negative territory since June 2015. (Chart 5). In August 2015, the 3-month moving average was down 4.5% y/y. The main source of the slowdown has been a contraction in manufacturing activity, which accounts for as much as 38% of the index. The slowdown has been largely in the petrochemicals sector and was due to reduced availability of gas feedstock as authorities prioritized gas for power generation during the peak summer months.

Slower growth in transportation and tourism has also been a source of slowdown, according to the production index data. Indeed, growth in tourist numbers slowed during 3Q15 following strong growth in the previous four quarters. The sector had benefited from strong basis effects in 3Q14 and 4Q14; those began to fade earlier this year. By 3Q15, tourist numbers began to decline. The number of visitors fell by 5% y/y during 3Q15, while the cumulative number of "nights stayed by tourists" fell by 9% y/y. (Chart 6). Further deterioration can now be expected following the tragic downing of a Russian commercial aircraft carrying largely Russian tourists back home from Sharm El-Sheikh; evidence now points to an act of terrorism.

Markit's Purchasing Managers' Index (PMI) has also indicated a slowdown in 2015, though until 4Q15 there was still some hope that the slowdown may only be temporary. (Chart 3). The index first fell below the critical 50 mark in January and hit a 17 month low in February of 46.8 before improving somewhat. The index appeared to improve in 2Q15 and 3Q15, but sank back down to 47.2 in October and 45.0 in November. The index has averaged 49.0 during the first eleven months of 2015, down from 50.3 during the same period in 2014.

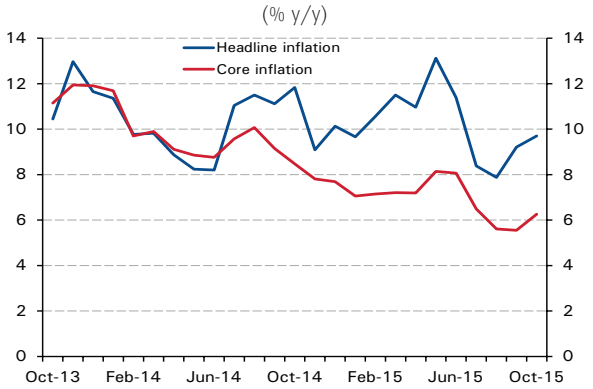
Credit growth has also eased in recent months, following a strong run. The pace began to slow during the summer, with annualized growth falling to 4.7% during 3Q15 compared to growth topping 27% during the first half of 2015. Despite the slowdown in 3Q15, growth from a year ago remained relatively robust at 16.1% y/y in October 2015. (Chart 8).

Inflation has eased in recent months

Inflation has eased during 2015, with core inflation falling to its lowest level since early 2013. Core inflation fell to 6.3% in October 2015. Headline inflation was somewhat higher at 9.7% but remains below the average of the previous fiscal year ending June 2015. One of the factors is a basis effect; a year ago in June 2014, price levels were pushed higher due to a government hike in fuel prices.

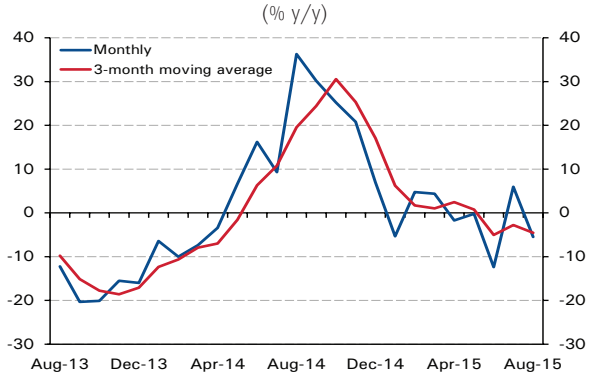
With inflation easing, the Central Bank of Egypt (CBE) moved to reduce its policy rates by 50 basis points earlier in 2015. Rates have been steady since, with the CBE deposit rate at 8.75% and the CBE lending rate at 9.75%. Treasury bill rates have been largely steady as well, at around

Chart 4: Consumer price inflation



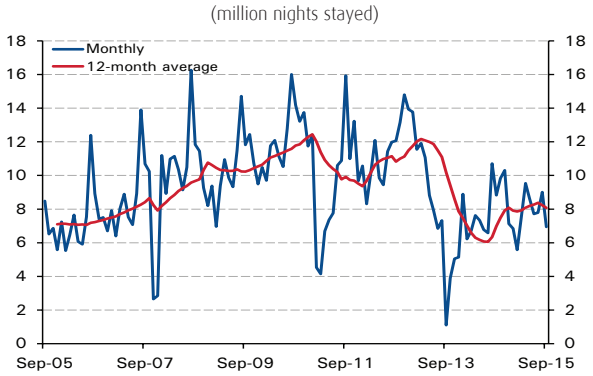
Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index



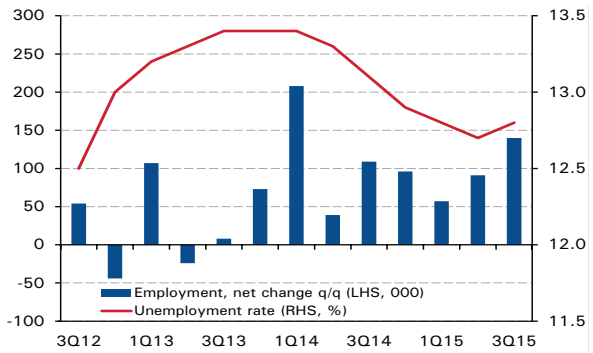
Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism



Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Employment



Source: CAPMAS, Thomson Reuters Datastream

11-11.5% for the 3-month bills. The exception was a brief period in June 2015 when rates rose slightly towards 12.25% before settling back down again. (Chart 11).

Fiscal deficit remains high despite reform hopes

Egypt's large fiscal deficit remains a key concern for the country's outlook. The fiscal position has deteriorated over the last year, in large part due to a decline in official grants. The deficit reached 13.9% of GDP for the 12 months ending in May 2015. This compares to 10.9% a year before. The Ministry of Finance has yet to publish full FY14/15 figures on the budget. (Chart 9.)

Spending growth has continued to outpace revenue growth. Spending grew by 24% during the 12 months ending in May 2015 compared to the year before; revenue growth was half that at 13%. As a result, spending has risen to over 34% of GDP, up as much as six percentage points since 2010. Meanwhile, revenues (excluding grants) have been largely steady at around 20% of GDP.

External pressures have deepened as current account deficit widened

The current account deficit deteriorated through 2Q15 largely on a decline in official transfers, though weaker oil exports and strong imports were also to blame. While Egypt continues to benefit from GCC deposits at the central bank, grants to the government have declined. The deficit widened to 4% of GDP on a 12-month trailing basis through 2Q15, its worst level in three years. (Chart 12.)

The trade balance widened by 14% during the 12 months through 2Q15. Lower oil export receipts, largely from a decline in the price of oil, were the main culprit. Oil exports fell by 30% between the 12 months ending in June 2014 and the same period in 2015. Higher imports have also been a source of deterioration, though the pace of growth has clearly eased.

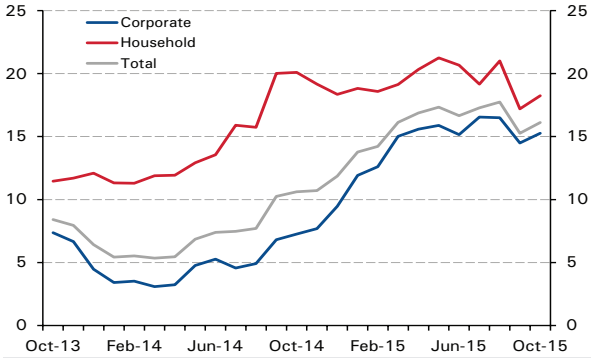
At the same time, official transfers (i.e. grants) have virtually gone to zero after they accounted for 3.6% of GDP in 2014. This has cost the balance of payments around $3 billion in the 12 months ending in 2Q15, double the size of the loss coming from the deteriorating trade balance. Private transfers, which are almost entirely from worker remittances, remain an important source of foreign currency for Egypt (they amount to around 9% of GDP) their growth has been more modest recently, slowing to 4.1% y/y during the last 12 months.

While growth in service receipts (which include tourism revenues) has been healthy, they only offset some of the deterioration in the trade balance. Tourism receipts grew by as much as 45% during the 12 months through 2Q15; this large increase was due to a weak base during the second half of 2013 when receipts had collapsed following the June 2013 removal of President Morsi. But 2Q15 still saw healthy growth of 17% y/y even without this basis effect.

Foreign direct investment (FDI) improved somewhat in 2015, which has helped finance a growing current account deficit. FDI rose to 2.1% of GDP during the 12 months ending in 2Q15, compared to 1.4% a year before. The amount of FDI during the period rose to $2.1 billion, up from $1.4 billion the year before.

Chart 8: Private credit

(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 9: Fiscal balance

(% of GDP, 12-month trailing)

Source: Ministry of Finance, Thomson Reuters Datastream

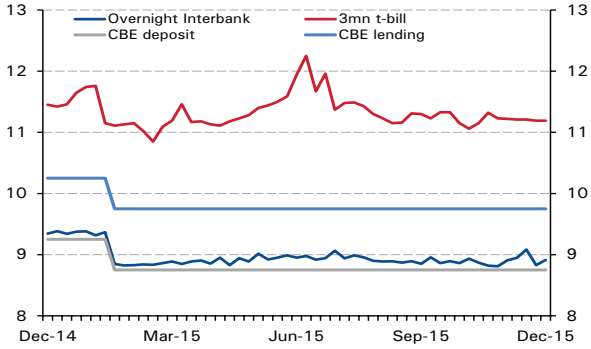
Chart 10: USD sovereign bond yeilds

(%)

Source: Thomson Reuters Datastream

Chart 11: Interest rates

(%, weekly)



Source: Central bank of Egypt, Thomson Reuters Datastream

USD-denominated bond yields have risen on expectations of Fed hikes

Yields on sovereign bonds denominated in US dollars have been rising in recent months. The increase has generally coincided with rising yields in advanced markets and to a greater extent in emerging markets, all driven by expectations of higher interest rates by the US Federal Reserve. However, Egypt has seen yields rise somewhat more rapidly, which could reflect a deteriorating risk profile, given heightened growth and security concerns. Yields on USD denominated sovereign debt due in 2020 and 2040 have risen by 177 and 157 basis points (bps) since July 2015 to 6.5% and 8.9%, respectively. (Chart 10). The country's credit default swap (CDS) has also been on the rise; it has risen from around 270 bps in late in 2014 to 425 bps in early December 2015.

Official reserves are stable, supporting the pound

Official foreign currency reserves held by the CBE have come under pressure recently, despite a $6 billion deposit made by GCC allies in April 2015. Reserves stood at $16.4 billion at the end of November 2015. (Chart 13.) At around 3.2 months of imports, reserves are near the minimum level recommended by the IMF.

The central bank has sought to devalue the pound several times in 2015 in an effort to stem the pressure and improve access to foreign currency in the market. (Chart 14.) The CBE allowed the Egyptian pound (EGP) to depreciate against the US dollar in February, July and again in October 2015. The last move was reversed a few weeks later in what appeared to be an attempt to limit expectations of further currency declines. Through November, the EGP was down by 8.7% ytd against the USD and by 0.3% in trade-weighted terms. The pound continues to have an active unofficial market, where the currency trades at a 4-5% premium to the official rate (or 8.15-8.25 EGP/USD) according to press sources.

The main challenge for the central bank has been managing the external pressures on the pound without allowing the currency to devalue too rapidly. CBE policy under the former governor, Hisham Ramez, was to maintain capital controls and ration access to foreign currency through an auction system in place since early 2013. This set of policies has been criticized for creating a severe foreign currency shortage and for negatively impacting economic activity. It is not clear if Tarek Amer, the new governor who took office in November 2015, will change policy in any major way.

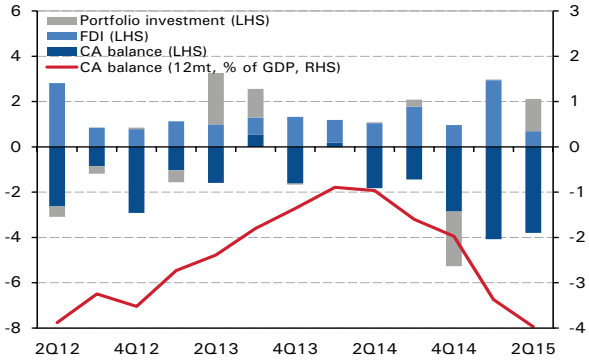
Equities recorded sharp declines in 2015

Egypt's stock market has declined significantly since it peaked in February 2015, mostly in line with similar declines in other emerging markets. Egypt's EGX30 index was down by nearly 29% through November 2015 (Chart 15); the Egypt MSCI total return index was down by over 25% ytd. This followed three years of robust gains, when the market largely outperformed markets in the region.

In a positive step for investors, authorities recently announced that they paid all pending foreign portfolio fund repatriation requests. The last batch of pending requests, according to the central bank, amounted to $547 million. It should be noted that these requests were for investors opting not to use the CBE's repatriation mechanism or where investments predated its introduction in 2013. The mechanism remains an option for foreign portfolio investors wishing to repatriate proceeds from their trading activity.

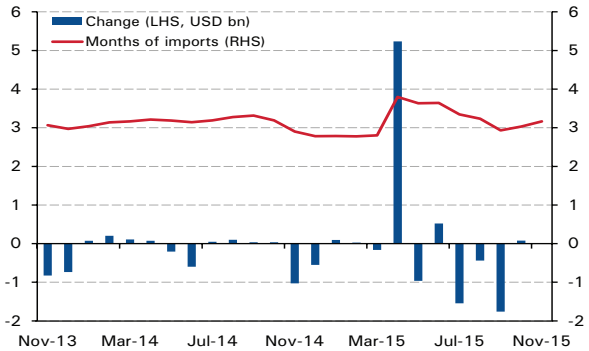
Chart 12: Balance of payments

(LHS: USD billion; RHS: % of GDP)



Source: Central Bank of Egypt, Thomson Reuters Datastream

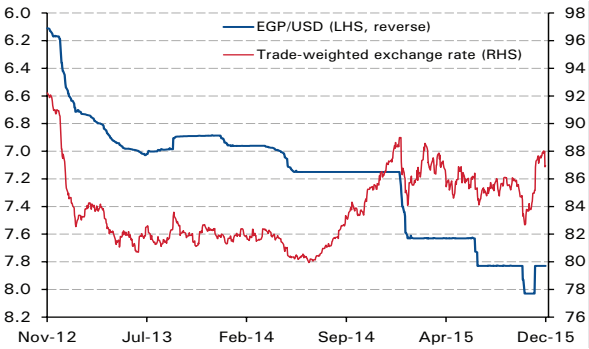
Chart 13: Official reserves



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30)

Source: Thomson Reuters Datastream

Regional economic data and forecasts

	Unit	2011	2012	2013	2014	2015f	2016f	2017f
Bahrain								
Nominal GDP	USD bn	29.1	30.6	32.8	33.8	31.1	32.8	35.0
Real GDP	% y/y	2.1	3.4	5.6	4.5	1.8	2.6	2.9
Oil sector	% y/y	3.6	-8.5	15.3	3.0	-2.8	0.0	-1.5
Non-oil sector	% y/y	1.4	6.9	3.3	4.9	3.0	3.2	4.0
Budget balance	% of GDP	-0.3	-2.0	-3.1	-5.6	-16.2	-15.5	-14.0
Current account balance	% of GDP	11.1	7.2	7.8	3.3	-4.8	-4.0	-3.7
Inflation	% y/y	-0.4	2.8	3.2	2.7	2.0	2.5	2.5
Kuwait								
Nominal GDP	USD bn	154.0	174.2	174.3	163.7	134.9	145.1	157.5
Real GDP	% y/y	9.6	6.6	1.1	-1.6	1.5	2.5	2.5
Oil sector	% y/y	15.6	10.3	-1.8	-1.7	-0.7	0.7	0.2
Non-oil sector	% y/y	3.4	3.4	4.2	2.1	4.0	4.5	5.0
Budget balance	% of GDP	31.1	26.0	26.1	7.4	-6.2	-3.8	-3.6
Current account balance	% of GDP	43.6	45.3	40.9	32.5	5.9	5.9	6.6
Inflation	% y/y	4.7	2.8	2.7	3.0	3.5	3.0	3.0
Oman								
Nominal GDP	USD bn	69.4	77.4	78.2	81.1	67.6	70.5	76.1
Real GDP	% y/y	-1.1	7.1	3.9	3.6	4.0	2.9	3.2
Oil sector	% y/y	2.0	3.0	2.4	-0.2	3.7	1.2	0.9
Non-oil sector	% y/y	-3.7	10.8	5.2	6.7	4.2	4.2	4.9
Budget balance	% of GDP	7.4	0.5	1.6	0.4	-18.6	-14.7	-11.6
Current account balance	% of GDP	12.9	10.1	5.0	4.5	-13.8	-8.9	-2.5
Inflation	% y/y	4.0	2.9	1.1	1.1	0.5	2.0	2.5
Qatar								
Nominal GDP	USD bn	171.4	189.8	201.9	210.1	174.7	189.3	211.0
Real GDP	% y/y	13.0	6.2	4.6	4.0	4.9	5.4	5.1
Oil sector	% y/y	15.6	1.3	0.2	-1.5	0.7	1.7	1.0
Non-oil sector	% y/y	10.9	10.1	10.6	10.6	9.4	9.1	8.9
Budget balance	% of GDP	6.8	11.3	14.3	16.1	2.5	-0.5	0.1
Current account balance	% of GDP	30.4	32.7	29.9	23.1	3.7	2.8	5.5
Inflation	% y/y	1.9	1.9	3.1	3.0	1.7	2.4	3.0
Saudi Arabia								
Nominal GDP	USD bn	669.5	733.9	744.3	746.2	646.3	678.5	735.9
Real GDP	% y/y	9.2	5.3	3.6	3.5	3.5	2.5	2.3
Oil sector	% y/y	12.2	5.1	-1.1	1.5	3.3	0.8	0.2
Non-oil sector	% y/y	6.7	5.5	7.5	5.0	3.7	3.7	3.9
Budget balance	% of GDP	11.6	13.6	6.5	-2.3	-22.9	-16.4	-12.6
Current account balance	% of GDP	21.9	20.6	18.2	10.3	-8.9	-8.4	-3.8
Inflation	% y/y	3.7	2.9	3.5	2.7	2.1	2.6	2.9
UAE								
Nominal GDP	USD bn	348.5	373.4	387.2	399.4	361.4	387.1	427.9
Real GDP	% y/y	5.2	6.9	4.3	4.6	3.9	3.8	4.4
Oil sector	% y/y	6.6	7.6	2.9	4.0	1.6	0.0	0.5
Non-oil sector	% y/y	4.5	6.6	5.0	4.8	5.0	5.5	6.0
Budget balance	% of GDP	5.7	7.6	6.7	4.2	-1.2	-1.5	0.3
Current account balance	% of GDP	14.6	17.8	14.7	15.0	15.5	15.3	14.7
Inflation	% y/y	0.8	0.7	1.1	2.0	4.0	3.5	3.5
Egypt (fiscal year)								
Nominal GDP	USD bn	261.7	267.9	285.9	310.0	330.7	361.3	396.4
Real GDP	% y/y	2.2	2.1	2.2	4.1	3.5	4.0	4.5
Budget balance	% of GDP	-10.6	-13.6	-12.3	-13.1	-12.0	-10.7	-9.8
Current account balance	% of GDP	-3.9	-2.4	-1.0	-3.9	NA	NA	NA
Inflation	% y/y	7.3	9.8	8.2	11.4	9.0	8.0	8.0

International data

	Unit	2011	2012	2013	2014	2015f	2016f	2017f
Brent crude oil spot price (year average)	USD p/b	111.2	111.6	108.7	99.0	55.0	55.0	60.0
CRB commodity price index	Index	482.0	484.1	457.3	437.8	-	-	-
Eur/USD	1$ = €	0.773	0.758	0.736	0.827	-	-	-
US Fed Fund Rate	%	0.25	0.25	0.25	0.25	-	-	-
MSCI World stock market index	Index	1,183	1,339	1,661	1,730	-	-	-
MENA real GDP (IMF, yr avg)	% y/y	4.6	5.0	2.1	2.6	2.3	3.8	4.1
World real GDP (IMF, yr avg)	% y/y	4.2	3.4	3.3	3.4	3.1	3.6	3.8

Source: Thomson Reuters Datastream, official sources, NBK estimates

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