2018-2019

July 2018

MENA Economic Outlook

National Bank of Kuwait
Economic Research Department

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Contents

MENA outlook

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Regional outlook improving amid higher oil prices and government stimulus

Overview and outlook

- **Global growth to come in at a robust 3.9% in 2018-19, but trade protectionism is a major headwind.**
- **GCC economies are recovering on oil sector output gains and continued government stimulus; GCC non-oil growth is forecast to rise to 2.7% y/y this year and 2.9% y/y in 2019.**
- **Higher oil/gas revenues and non-oil tax receipts should lead to smaller fiscal deficits.**
- **GCC fiscal deficits likely to be financed primarily by debt issuance rather than reserve drawdowns.**
- **GCC markets have been buoyed by inflows linked to MSCI/FTSE inclusion and a generally more bullish outlook.**

Robust but uneven global economic growth; trade protectionism is a major downside risk

Global economic activity continues to expand at a robust pace, spurred by domestic demand and especially investment. The IMF, in its July 2018 World Economic Outlook Update, pegged growth at 3.9% this year and in 2019. The agency noted, however, that the pace of expansion may have peaked in some large economies, while overall growth has become less synchronized, with divergences both within and between advanced and emerging economies.

The US continues to exhibit good growth momentum, benefitting from tax reform, fiscal stimulus and robust consumption (the economy is near to full employment). Activity in the Eurozone, in contrast, has been softer than expected, especially in Germany and France in the early part of the year. Emerging markets growth is generally robust but uneven; many countries have had to contend with the after-effects of US monetary policy tightening, which along with a strong dollar and trade tensions, contributed to large capital outflows ($14bn in May and June according to the IIF) toward safer markets. Weaker currencies vis-à-vis a stronger US dollar (+5% in real effective terms since February) weighs heavily on countries with dollar-denominated debt. Two more rounds of 25 bps rate rises are expected by the Federal Reserve before year-end (or only one hike depending on developments in the remainder of the year), with possibly another three hikes in 2019.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD tn	1.4	1.5	1.6	1.6
Real GDP	% y/y	2.5	-0.2	2.3	2.4
- Oil	% y/y	2.6	-3.4	1.8	1.4
- Non-oil	% y/y	2.2	2.1	2.7	3.0
Inflation	% y/y	2.1	0.7	2.7	2.4
Budget balance	% of GDP	-12.1	-8.8	-5.4	-4.3

Source: Official sources, NBK estimates

Chart 1: Brent crude oil futures

Source: Thomson Reuters Datastream

The global economy is also facing sizeable headwinds from trade protectionism, which appears to be escalating. The US and China are currently engaged in tit-for-tat tariffs, after the US recently levied 25% tariffs on $34bn worth of Chinese imports and threatened to impose a 10% rate on an additional $200 billion worth of Chinese imports.

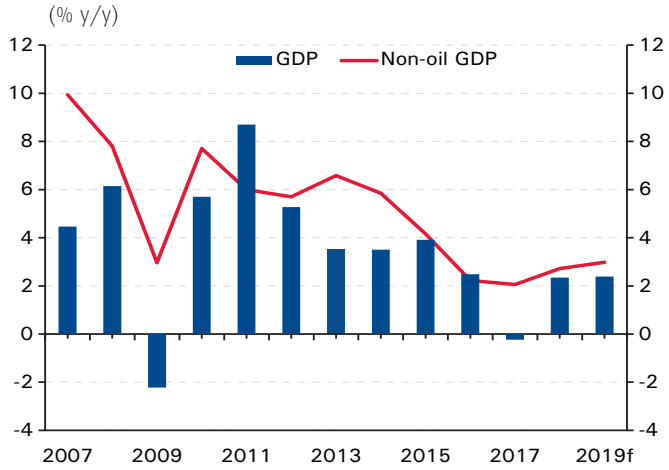
Oil prices, so central to the economic fortunes of the GCC economies, rose almost 20% to $80/bbl at one point this year on the back of the OPEC+ oil production cuts and buoyant global demand—and despite surging US shale production. However, the outlook is a little more bearish since OPEC decided in June to resupply the markets with volumes that we believe would more than compensate for any shortfalls resulting from supply outages in Venezuela and/or expected Iranian sanctions. Brent was last trading at $72/bbl, and our projection is for the price to average $65 this year and $60 in 2019. (Chart 1.)

In the GCC, the outlook has improved amid higher oil prices and regional government economic stimulus programs. We expect headline growth rising to 2.4% and 2.3% in 2018 and 2019,

respectively. GCC oil and gas exporters should benefit from an expansion in hydrocarbon sector activity, now that the OPEC production cut agreement is winding down. Saudi Arabia, the UAE and Kuwait will be the main beneficiaries, ramping up oil production by 3.5-4.0% on average by 2019 to close to pre-agreement levels.

Meanwhile, Bahrain and Qatar have both commenced projects to significantly increase their oil and gas output—Bahrain after discovering sizeable offshore tight oil and gas deposits and Qatar after deciding to expand LNG production capacity by 30%. Monetizing these gains will likely occur in the medium-to-long-term, however. GCC real oil GDP is projected to expand by 1.9% y/y and 1.4% y/y in 2018 and 2019, respectively.

Chart 2: GCC Real GDP



Source: Official sources, NBK estimates

Non-oil activity in the GCC is forecast to continue rising steadily, by 2.7% y/y this year and by 2.9% y/y in 2019, underpinned by expansive public investment projects, private sector stimulus programs and an easing in fiscal consolidation. Extra impetus has been given to governments' diversification efforts following the 2014 oil price downturn—the development of the private sector as a source of future growth and the stimulation of foreign investment. Dubai reduced various fees and charges to attract business, Abu Dhabi announced a $13.6bn, three-year stimulus package, and Saudi Arabia launched a privatization drive that it hopes will create more public-private partnerships (PPPs), private sector jobs and revenues for the treasury. Oman intends to focus on special economic zones and increase the contribution of its nascent tourism sector. Kuwait, for its part, intends to pursue implementing the project pipeline linked to its five-year development plan with renewed vigor. The authorities would have been encouraged by the approval of two major PPP projects and a new PPP guidebook.

Egypt, meanwhile, is pressing ahead with its reform agenda, helped by IMF funds. Tourism and exports are recovering, helped by a cheaper currency, remittances are increasing substantially, and the country's international reserves are rising. We peg growth at a robust 5% over 2018-2019.

Acting as a brake on regional growth, however, has been the lackluster state of loan growth amid tightening monetary conditions. And this is despite improving deposit and liquidity levels related to higher oil revenues and international sovereign debt issuances. Borrowing costs have risen as regional central banks, for the most part, raise their benchmark interest rates in line with the US Federal Reserve's rate.

Governments' finances should see marked improvement this year and next. Oil and gas revenues will rise in line with higher energy prices and non-oil revenues should be boosted by taxes and tariffs such as the value-added tax (VAT). Subsidies have been pared back and savings continue to be sought even while governments ramp up capital spending. The regional fiscal deficit is expected to narrow to 4.3% of GDP by 2019 from 8.8% of GDP last year.

Bahrain's large fiscal deficit and high public debt was in the spotlight in June after the financial markets grew concerned about the kingdom's ability to fulfill its financial obligations. The sell-off saw the Bahraini dinar fall to a 17-year low against the US dollar, the kingdom's main CDS spreads climb to a near 10-year high of 571 bps and the yields on its sovereign debt spike. Only the explicit promise of financial assistance, hitherto implicit, managed to calm anxious investors.

In general, though, the financial markets have viewed developments in the GCC more positively. In fact 2018 has seen regional equities boosted by increased domestic and international portfolio inflows, following upgrades to the Saudi and Kuwaiti bourses by MSCI and FTSE Russell.

Bahrain outlook

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Non-oil growth slowing, but activity supported by infrastructure investment

Overview and outlook

- **Non-oil growth is projected to moderate to 3.4% y/y (avg.) over 2018-2019, but will still be supported by elevated levels of infrastructure spending and a recovery in manufacturing.**
- **Inflation is expected to increase to 2.5% (avg.) in 2018, amid rising housing and food costs.**
- **The budget deficit is forecast to gradually narrow, but remain high at 8-9% of GDP; public spending levels will stay high to support infrastructure projects.**
- **Credit growth is recovering mainly on the back of heightened business credit.**

Elevated spending on infrastructure underpins economic growth

Thanks to continued output gains in the non-oil sector, real GDP growth accelerated in 2017 to 3.9% from 3.2% in 2016. The services sector—financial and social & personal services especially—and the construction sectors were major contributors to the non-oil sector's impressive growth of 5.0% last year, the highest in the GCC. (Chart 1.)

However, recent figures showed Bahrain's real GDP coming in much lower than expected in 1Q18, contracting by 1.0% quarter-on-quarter (q/q) and 1.2% year-on-year (y/y), amid a decline in oil GDP (-14.7% y/y) that was related to lingering oil field maintenance issues and Bahrain's OPEC+ quota obligations, and softer-than-expected non-oil economic activity (+1.9% y/y) linked to a decline in financial services output.

In contrast, both the manufacturing and construction sectors witnessed solid growth rates, both well above their respective 2017 annual averages. These two sectors are likely to offset some of the ongoing weakness in the financial sector and support our slightly revised estimate of 3.4% non-oil growth on average over 2018-19. Again, government infrastructure spending on a record $8bn worth of transportation, water, power and housing projects—the kingdom's largest ever pipeline—will be key.

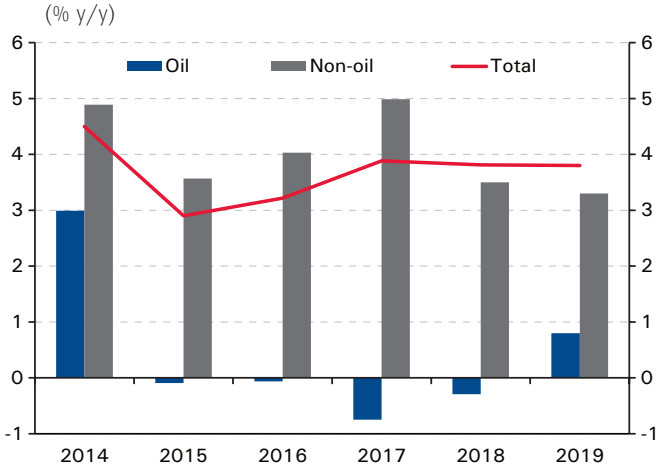
Such spending has been bolstered over the past few quarters by the allocation of funds under the Gulf Development Program—a pledge by Bahrain's neighbors in 2011 to provide $10bn in grants over 10 years to boost investment in infrastructure and housing.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD bn	32	35	37	39
Real GDP	% y/y	3.2	3.9	2.8	2.8
- Oil	% y/y	-0.1	-0.7	-0.3	0.8
- Non-oil	% y/y	4.0	5.0	3.5	3.3
Inflation	% y/y	2.8	1.4	2.5	3.5
Budget balance	% of GDP	-13.5	-11.6	-9.3	-8.6

Source: Official sources, NBK estimates

Chart 1: Real GDP



Source: Information & e-government Authority, NBK estimates

The expected winding down of the OPEC production cut agreement from mid-2018 onward should allow Bahrain to ramp up to full output capacity, likely in 2019, boosting real oil GDP by 0.8%.

The kingdom is also in the process of upgrading its oil infrastructure, including the ageing oil pipeline from Saudi Arabia and the Sitra refinery. The latter will see refining capacity increased by almost 50 percent, boosting state revenues by about $1bn, official sources reported.

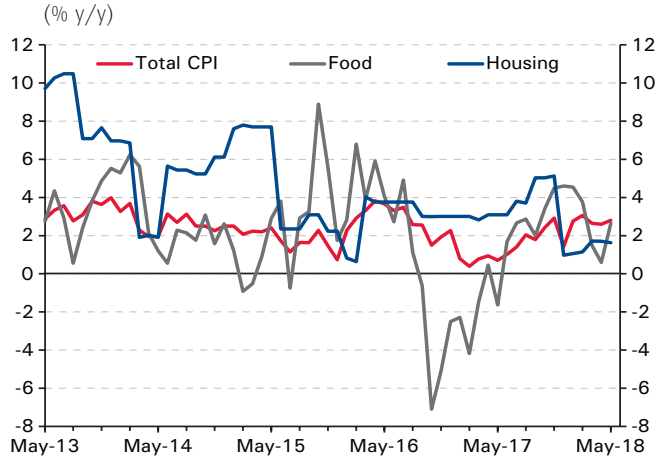
Moreover, in April, Bahrain announced that it had discovered up to 80 billion barrels of shale oil and around 20 trillion cubic feet of natural gas in offshore deposits. (The kingdom currently produces about 44,000 b/d from its own field and shares the revenues from a 300,000 b/d field owned by Saudi Arabia.) It hopes to monetize these new reserves within the next five years with the help of international oil companies. To this end, the government recently launched an energy fund

that aims to raise $1bn from local and international investors. Monetizing these new energy resources could ultimately restore investor confidence and reduce the country's fiscal deficit and high public debt levels—Bahrain is currently rated at below investment grade by major rating agencies S&P (B+), Moody's (B1) and Fitch (BB-).

Inflation to rise in 2018 and in 2019

Consumer price inflation is expected to rise from 1.4% in 2017 to 2.5% this year and then further to 3.5% in 2019 on the back of a planned value-added tax (VAT) and higher housing and food costs. (Chart 2.) Latest figures showed inflation averaging 2.8% y/y between January and May—higher than the 0.7% y/y average recorded during the same period last year—after excise duties were levied on tobacco and soft drinks.

Chart 2: Consumer price inflation by sector



Source: Thomson Reuters Datastream

The introduction of a 5% VAT, now expected in 2019, is projected to add initially around 2% to the overall inflation rate.

Budget deficit to gradually narrow but remain high

The budget deficit is expected to gradually narrow, given ongoing fiscal consolidation efforts and some improvement in revenues. While the VAT should raise around $300mn (approximately 1% of GDP) in additional tax revenue per year, the deficit will remain large at around 9.3% and 8.6% of GDP in 2018 and 2019, respectively. (Chart 3.)

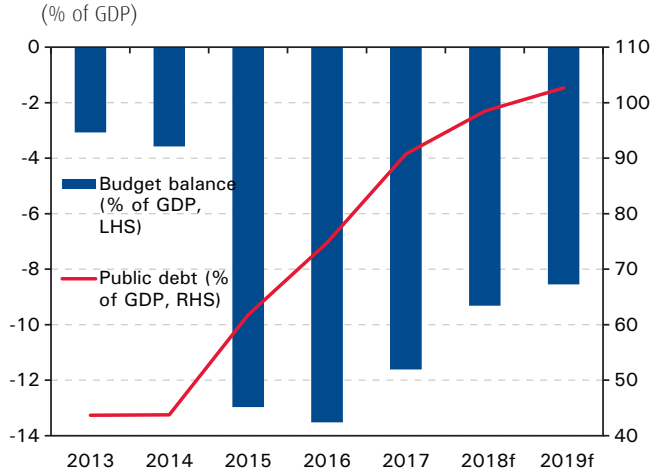
The government will therefore have to continue to look to domestic and international bond markets to plug the shortfall. The latest issue came in March 2018, a 7-year $1bn Sukuk at 6.875%, higher than the 5.25% on Sukuk issued in late 2017.

The hike in pricing reflects investors' concerns over the fiscal position and rising debt (which is expected to top 100% of GDP by 2019) as well as higher short-term rates.

Meanwhile, Saudi Arabia, Kuwait and the UAE are reportedly close to announcing a joint program to support Bahrain's economic reforms, stabilize its finances and reassure anxious financial investors after a massive sell-off toward the end of the second quarter. The sell-off was sparked by renewed concerns that the nation would not be able to tap international markets indefinitely in order to finance its large fiscal deficits.

Furthermore, Bahrain has reportedly hired investment bank Lazard for advice on how to effectively ease the strain on its public finances, the details of which have yet to be released.

Chart 3: Budget balance & public debt

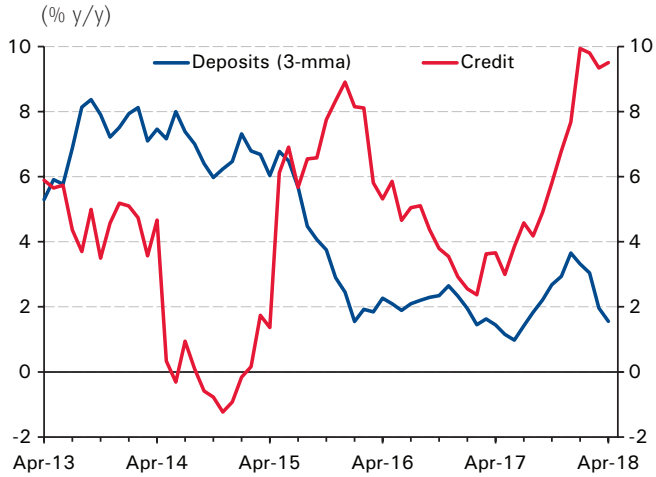


Source: Bahrain Ministry of Finance, IIF, NBK estimates

Business lending remains in recovery mode

Growth in credit to businesses continued to climb in 1Q18, thanks to the ongoing gains in lending activity in the construction sector. This has helped push total private credit growth higher, averaging an impressive 9.7% y/y in 1Q18, which is much higher than the 2.9% y/y recorded in 1Q17. (Chart 4.)

Chart 4: Private credit & deposit growth



Source: Central Bank of Bahrain

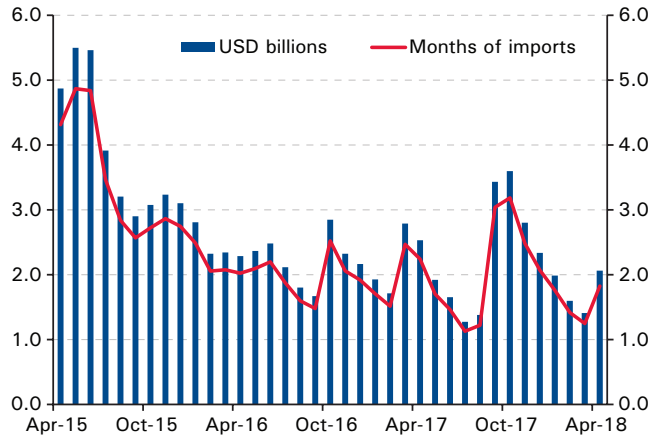
In contrast, private sector deposits grew by 2.8% y/y in 1Q18, higher than the 1.7% y/y average of 1Q17. With deposit growth subdued, M1 and M2 declined in April by 4.0% y/y and 1.4% y/y, respectively.

Following the US Fed's move in June, Bahrain raised its key policy rate by 25 bps to 2.25%. Interbank rates have been edging higher in tandem with the policy rate hikes over the past year. As of early June, the 3-month rate was up 49 bps year-to-date. While lending may come under pressure from higher rates, the business sector is expected to continue to support overall credit growth.

Foreign reserves remain under pressure

Given its large fiscal (and external deficits), Bahrain's international reserves remain under pressure. In May, the central bank's international reserves stood at $1.8bn, covering a mere one and half months' of imports. (Chart 5.) The continued weakness in foreign reserves was one of the main drivers behind the recent market sell-off in the kingdom.

Chart 5: Central bank reserves



Source: Central Bank of Bahrain

Bahrain stock market weighed down by fiscal, debt concerns

After rallying briefly towards the end of 2017 and at the start of this year, Bahrain's All Share Index moved lower in 2Q18, weighed down by fiscal and debt concerns. (Chart 6.)

Chart 6: Stock market index

(all share index)

Source: Thomson Reuters Datastream

Kuwait outlook

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Non-oil growth seen steady this year, as higher oil prices boost fiscal position

Overview and outlook

- **GDP growth is set to rebound to 2.5% this year with oil production rising due to the shift in OPEC policy.**
- **Non-oil growth is seen broadly steady at 3.5%, but reforms are needed to boost longer-term growth potential.**
- **The pipeline of scheduled project awards is decent and last year's recovery in consumer spending remains intact.**
- **Inflation is forecast at just 1.0% in 2018 on soft food and housing figures.**
- **The fiscal deficit is set to fall to 5% of GDP in FY2018/19 despite a planned increase in spending.**
- **Credit growth has been subdued on weak corporate demand and the central bank kept lending rates on hold in June.**
- **Stock market reforms have resulted in international recognition, and could trigger capital inflows later this year.**

The economy remains on an improving trend, with activity gradually expanding following the slowdown triggered by the drop in oil prices in 2014. The rise in oil prices has narrowed the fiscal deficit despite a large spending increase factored into the budget for this year, and points to a slower drawdown of the government's General Reserve fund. Total financial reserves are estimated at nearly five times' GDP – still a major cushion. The growth outlook, however, is being held back in the short term by delays in project execution and in passing the budget (approved in June). For the longer term, economic diversification and a faster pace of reform in line with some neighboring Gulf countries should improve the outlook.

GDP growth to rebound this year

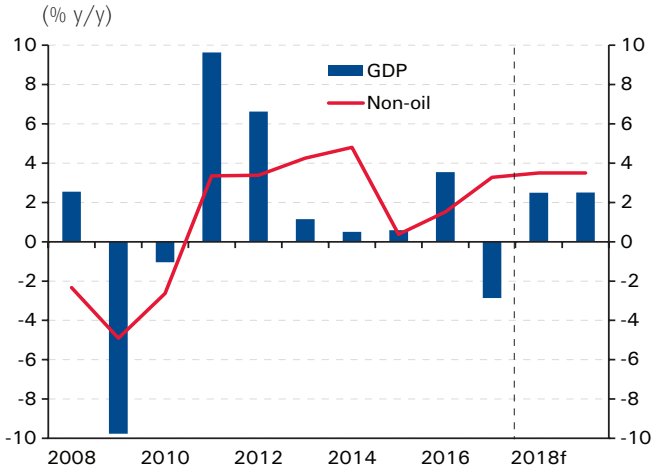
After falling 2.9% in 2017, GDP is set to rebound 2.5% this year helped in particular by higher oil output. (Chart 1.) Oil GDP fell 8.0% in 2017 as Kuwait cut its crude oil production to 2.7 million b/d in adherence with OPEC-led production goals. Output was stable in the first few months of 2018, but following OPEC's recent decision to increase output (albeit with country shares ambiguous), we forecast it to rise to 2.8 million b/d in 2H18. Oil GDP therefore rises 1.5% overall this year, and a similar amount in 2019. Work is underway to lift production capacity (excluding the neutral zone) to 3.65 million b/d from 3.15 now, which would in principle provide scope to boost output by nearly one-third in future years from current levels.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD bn	111	120	133	134
Real GDP	% y/y	3.5	-2.9	2.5	2.5
- Oil	% y/y	2.8	-8.0	1.5	1.5
- Non-oil	% y/y	1.5	3.3	3.5	3.5
Inflation	% y/y	3.5	1.5	1.0	2.5
Budget balance*	% of GDP	-13.8	-6.0	-5.0	-3.0

Source: Official sources, NBK estimates * Before RFFG transfers

Chart 1: Real GDP



Source: Thomson Reuters Datastream, NBK

Non-oil growth improved to 3.3% in 2017 from 1.5% in 2016 and is forecast at 3.5% this year – a solid performance by regional standards – with risks slightly to the downside. The recovery in consumer spending since 2016 has remained in place, helped by reasonable employment growth, low inflation, the fading impact of earlier subsidy cuts and the boost to confidence from higher oil prices. Growth will also receive help from fiscal policy, which is set to return to expansion mode in FY2018/19 for the first time in four years and capital spending remains a priority (although the boost may come late in the year). This should help offset the impact of rising interest rates, which we expect to be reasonably modest.

Although demand-side conditions look reasonable in the near term, structural measures are needed to boost the economy's longer-term growth potential. This includes the labor market, where the government continues to absorb the bulk of new Kuwaiti entrants to the labor force, as well as measures to improve the business environment, where Kuwait needs to

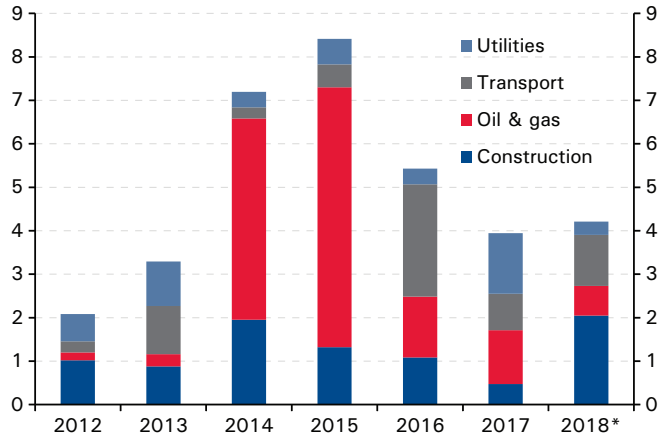
make concerted efforts to catch up at least with reforms in Gulf neighbors. The government has faced substantial opposition to reforms in parliament, resulting recently in the watering down of cuts in fuel subsidies, the postponement of VAT until at least 2021 and now a delay in passage of the debt law. While rising oil prices bolster the fiscal position and support the credit rating, the concern is that they could slow the reform effort further and delay the process of economic diversification.

Project awards steady in 2018 amid optimism on PPPs

Project activity has played an important role in supporting non-oil growth in recent years, and despite continued delays, the pipeline of awards remains decent. Around KD 4 billion in awards are scheduled for this year, similar to 2017 and boosted by a record year for construction. (Chart 2.) This is lower than in 2014 and 2015, which were lifted by large awards in the oil sector. This should underpin growth over the next few years.

Chart 2: Planned and awarded projects

(KD billion)



Source: MEED Projects, * Planned or already awarded

Implementation of the government's five-year development plan (FY2015/16-2019/20) remains a key policy goal – part of the broader aim to turn Kuwait into a regional trade and financial hub by 2035. The infrastructure sector received a boost from the approval of two major PPP projects confirmed in May, as well as the issue of a new PPP guidebook. These developments could help revitalize sentiment in a sector previously bogged down with delays and cancellations.

Improved confidence helps consumer spending

The consumer sector has also supported the growth climate, having recovered from its marked slowdown of 2016 affected by falling confidence and subsidy cuts. Consumer confidence in the first five months of the year stabilized at well above year-ago levels while card spending and withdrawals rose 8% y/y in 1Q18, faster than the 7% average of 2017. Our own NBK consumer spending index remained strong into 2Q18, while household lending is still solid.

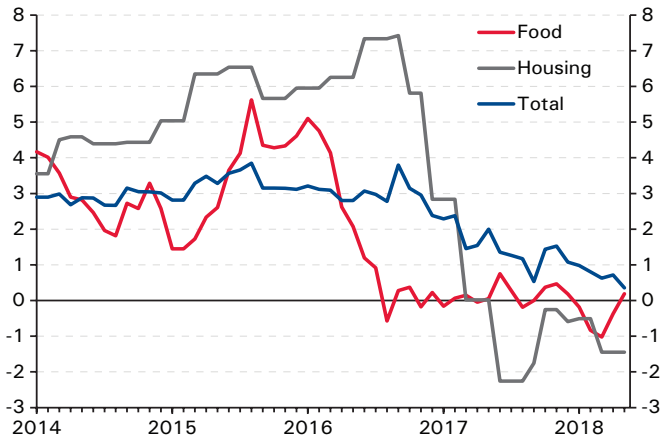
We expect consumer spending to remain supportive of growth through 2018, against a backdrop of higher oil prices, low inflation (see below), rising government spending and steady employment growth for Kuwaiti nationals. The decision to postpone the implementation of VAT until at least 2021 will also defer the hit, albeit small, to consumer incomes previously expected for next year. The main risks relate to higher interest rates – though the central bank held off on raising lending rates in June – and pressure on expat numbers as the government advances its Kuwaitization policy.

Inflation to remain very low on falling housing costs

Inflation is forecast to average a 15-year low of just 1.0% this year from 1.5% in 2017. This is slightly lower than we had previously expected, thanks to softer than expected recent outturns. Inflation stood at just 0.4% y/y in May and averaged 0.7% in 2018 year-to-date. (Chart 3.) Headline inflation has been kept low by two main factors: soft food price inflation thanks to international food prices, and continued falls in housing costs. Our measure of 'core' inflation, which excludes these components, stood at a slightly firmer 1.7% y/y in May.

Chart 3: CPI inflation

(% y/y)



Source: Thomson Reuters Datastream

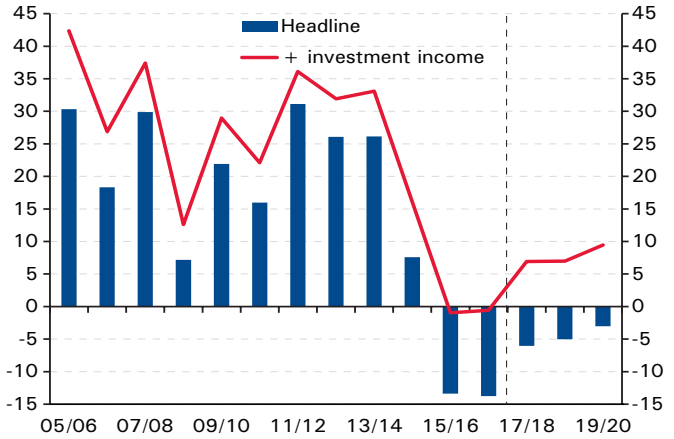
Although downward pressures from the housing and food components should ease going forward, inflationary pressures are otherwise expected to stay subdued. The US dollar, and as a result the Kuwait dinar, has strengthened slightly this year recovering some of last year's declines, and this should help reduce import cost. Core inflation should also be kept low by base effects following sizeable increases mid-last year, moderate economic growth, and – amid an improved fiscal position – the absence of planned subsidy cuts that pushed inflation higher in 2016 and 2017. Meanwhile, the delay in the implementation of VAT will no longer lift prices in 2019. Inflation next year is forecast at 2.5%.

Fiscal deficit to narrow sharply despite spending hike

Although the fiscal balance is forecast to remain in deficit over the medium term, a combination of higher oil prices and spending restraint have improved the position substantially. The deficit is estimated to have narrowed sharply to 6% of GDP in

FY2017/18 from nearly 14% of GDP a year earlier. (Chart 4.) Oil revenues – worth 90% of the total – rose 24% y/y thanks to a similar-size rise in the price of Kuwait Export Crude to $54/bbl on average. Meanwhile, spending is estimated to have risen just 3% after a cumulative cut of 17% during the previous two years.

Chart 4: Fiscal balance*



Source: Ministry of Finance, NBK * Before transfers to RFFG

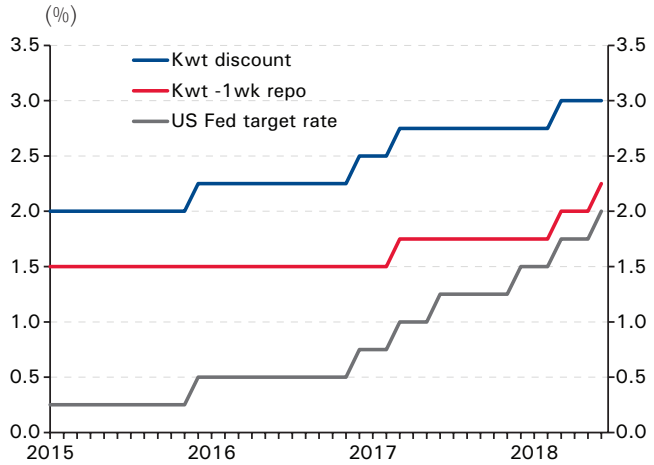
Spending under the government's draft budget for FY2018/19 was originally capped at KD20 billion, but revised up to KD21.5 billion albeit including some one-off items and higher transfer payments due to rising oil prices. The budget law was finally passed in late-June and points to a hefty 10% increase in spending this year and should provide a sizeable boost to demand in the economy. However the deficit is still forecast to narrow slightly to 5% of GDP on rising oil prices and production. Some of the one-off spending items will drop out the following year, allowing the deficit to narrow a touch further despite our forecast of slightly lower oil prices.

Despite the persistent deficits, the country's financial position remains extremely strong with accumulated savings from earlier surpluses leaving sovereign wealth fund assets estimated at $550-600 billion, or up to five times' GDP and underpinning the very strong AA credit rating. Annual returns on these assets – not included in the headline fiscal accounts – are estimated at 12-13% of GDP. Since April 2016, the government has met around half of its funding needs through debt issuance, including an inaugural $8 billion sovereign bond in March 2017. Overall government debt levels remain low at around 19% of GDP in March 2018, with the government still waiting for parliament's approval of the draft debt law that would push the borrowing limit to KD 25 billion from KD 10 billion under the previous law.

CBK lending rate left on hold in June; credit growth soft

Monetary policy remains geared towards maintaining the dinar's peg to a basket of currencies dominated by the US dollar. The central bank left its lending rate on hold at 3.0% in June following the 25bps hike by the US Federal Reserve, having raised its key rates in March following the Fed's previous move. (Chart 5.) The exchange rate system provides Kuwait with greater policy flexibility than other GCC countries that operate direct pegs to the dollar. By keeping its policy rate on hold in June, the central bank is looking to support economic growth while using other monetary policy instruments to ensure the stability of the dinar. The CBK implied that banks can raise their deposit rates without changing lending rates, which are benchmarked to the discount rate. Subsequently, it raised its repo rates by 25 basis points and banks followed and raised their deposit rates by the same amount.

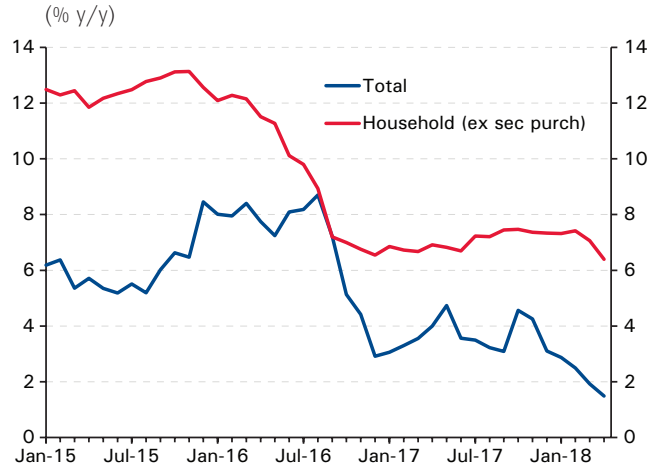
Chart 5: Policy interest rates



Source: Thomson Reuters Datastream, CBK

Credit growth has decelerated and reached a six-year low of 0.8% y/y in May, mostly reflecting weakness in business lending though affected by some exceptional one-off corporate repayments in 2017. (Chart 6.) Lending to households (normally for home purchases) has been more solid at 7-8% y/y (excluding securities lending) for most of the past year. Although likely to remain moderate overall, credit growth should be boosted later in 2018 by the expansionary budget for FY18/19, recent project awards translating into loan demand including in the important oil sector, and the base effect from last year's repayments.

Chart 6: Bank credit



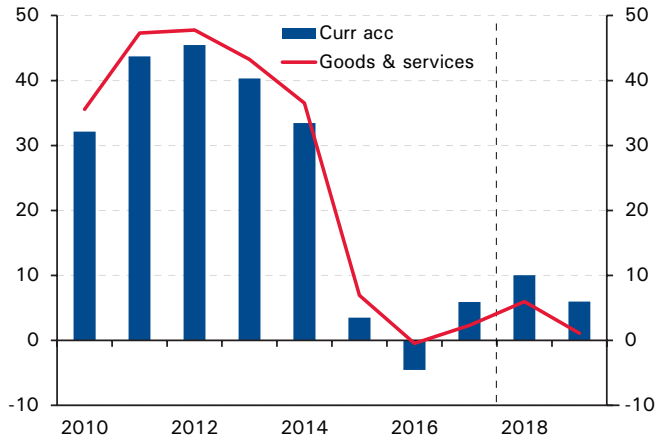
Source: Thomson Reuters Datastream, NBK

External position improving on higher oil prices

Low oil prices saw Kuwait record its first current account deficit in modern history in 2016, but the external position recovered last year, recording a surplus of 5.9% of GDP. (Chart 7.) The improvement was due to a 19% rise in oil exports driven by higher oil prices; oil receipts account for around 90% of all merchandise exports. Goods imports rose a decent 10% y/y, boosted by stronger domestic demand and imports of capital goods. A rise in the surplus to 10% of GDP is forecast for this year – modest by historic standards – as oil exports are lifted by another rise in oil prices, while import growth remains solid.

Chart 7: Current account balance

(% of GDP)

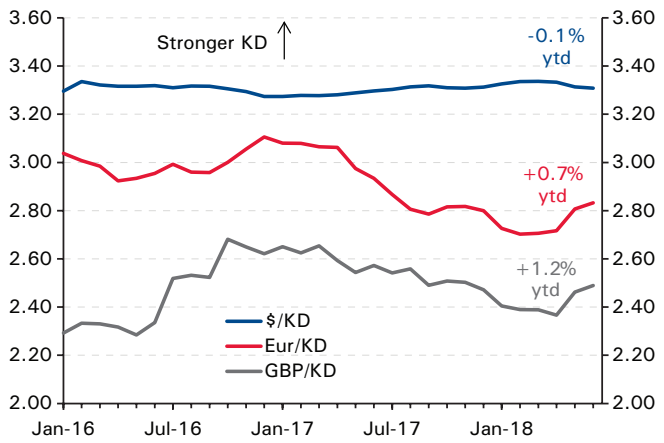


Source: Thomson Reuters Datastream, NBK

The dinar retreated in 2017 due to the slide in the US dollar, which fell 8% on a trade-weighted basis including 10% versus the euro on improving growth outside the US and the unwinding of previous dollar strength. So far in 2018, the dinar has climbed slightly against other currencies and held broadly steady against the dollar, which has been boosted by buoyant US growth and expectations of higher interest rates. (Chart 8.)

Chart 8: Kuwaiti dinar versus other currencies

(FC per dinar)



Source: Thomson Reuters Datastream

Stock market receives upgrade, but activity is thin

The stock market received a boost with news in June that global index provider MSCI will consider upgrading Kuwait to Emerging Market status in June 2019, with competitor provider FTSE Russell already committed to doing so in two phases in September and December this year. If it materializes, the MSCI upgrade could lead to even larger inflows than the $0.8 billion expected from the FTSE upgrade. The announcements follow a period of reform in the stock market with a view to improving the market's attractiveness, especially to foreign investors and ahead of a planned IPO. The latest of these occurred in April 2018, which saw listed firms allocated to one of three new market segments depending upon factors including size, liquidity and governance, as well as the introduction of new market indices.

Despite the reforms and higher oil prices, the Kuwaiti market has been flat this year, underperforming the regional average. Daily trading values have averaged around KD 11 million so far in 2018, very low compared to earlier years. One factor may be modest rates of non-oil economic growth, but investors may also be more taken with developments in larger, nearby overseas markets such as Saudi Arabia and the UAE, where the economic reform climate is more compelling. Some pick up in volumes and performance is seen later this year however, with inflows from the FTSE upgrade and the pending listing of crane and heavy equipment operator IHC possible catalysts.

Oman outlook

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Growth to pick up, but finances remain vulnerable

Overview and outlook

- **Real growth is expected to accelerate to 3.5% in 2018 from 0.3% in 2017 on increased hydrocarbon output and investment in the non-oil sector; growth will then slow to 2.6% in 2019.**
- **Although non-oil revenues remain modest, firmer oil prices will help lower the deficit from an expected 14.7% of GDP in 2017 to 7% of GDP this year; the deficit will widen a little in 2019 to 8.5% of GDP on lower oil prices.**
- **Lower domestic demand and a weaker real estate market may see inflation average 1.0% in 2018, before picking up to 3.0% in 2019 following the introduction of the VAT.**
- **In view of the government's tight finances and ambitious diversification plans, debt issuance, privatization and foreign investment will be increasingly vital; government debt is expected to rise to 47% of GDP in 2018.**

Diversification program to drive non-oil growth

The government is committed to pursuing its diversification program, where the focus will increasingly be on downstream oil products, tourism and logistics. The non-oil economy should, therefore, gain some traction, potentially expanding at an average of 3.5% per year in 2018-2019. (Chart 1.)

The opening of the new Muscat International Airport in 2018 is an important step in the government's plan to increase the contribution of the tourism sector to Oman's non-oil economy. The government intends to increase the number of tourists by more than 65% by 2020, from 3 million in 2017 to 5 million. Meanwhile, the Duqm special economic zone has attracted strong interest, mainly from small and medium enterprises that will service the tourism and logistics sectors.

Gas industry to play greater role in Oman's future

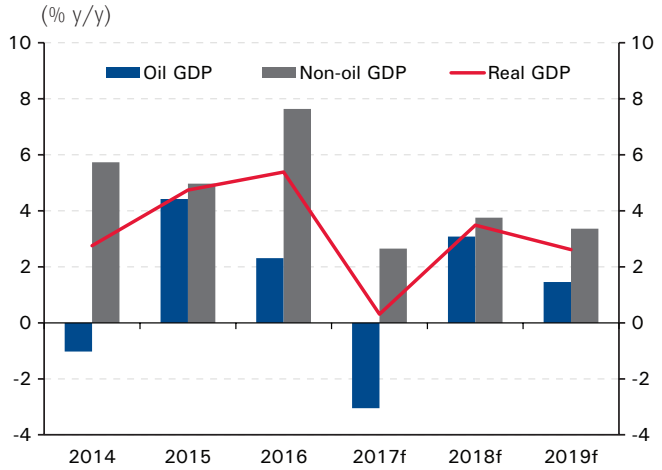
A slew of recent natural gas discoveries and new partnerships with international energy conglomerates highlights the importance of the hydrocarbon sector. Oman is committed to developing its natural gas facilities and capitalizing on its advantageous geographical location in the global LNG supply chain, all the more so in view of the fact that its oil wells are ageing. The country is also slowly diversifying its export destinations, hitherto almost exclusively Japan and South Korea. These plans should boost growth over the medium-term.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD bn	67	73	81	81
Real GDP	% y/y	5.4	0.3	3.5	2.6
- Oil	% y/y	2.3	-3.0	3.1	1.5
- Non-oil	% y/y	7.6	2.6	3.8	3.4
Inflation	% y/y	1.1	1.6	1.0	3.0
Budget balance	% of GDP	-20.6	-14.7	-7.2	-8.5

Source: Official sources, NBK estimates

Chart 1: Real GDP growth

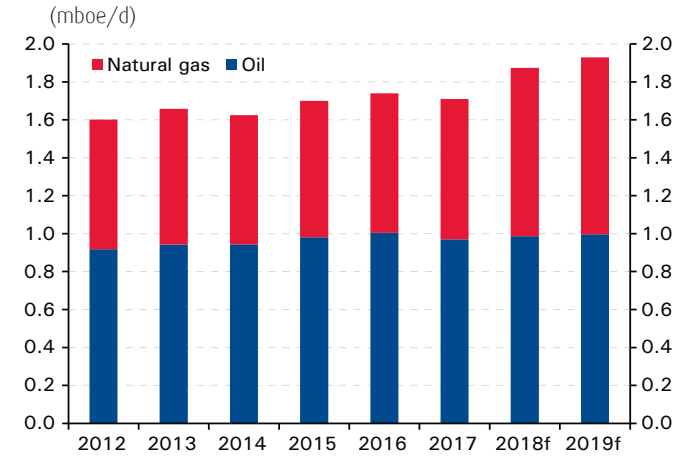


Source: Thomson Reuters Datastream, NBK estimates

In the meantime, Oman's oil output should see some increase this year from OPEC+'s decision to increase oil production (to prevent the market from over-tightening) and from the full launch of the BP Khazan tight gas project. Full production capacity will likely be reached next year. (Chart 2.) Consequently, oil sector GDP is forecast to expand by 3.1% in 2018 and 1.5% in 2019.

Risks to non-oil growth are to the downside, however. The recent extension of an expatriate employment ban has coincided with a slowdown in the real estate sector. Domestic demand may also be impacted by the departure of expatriate labor, while next year should see some downward pressures on the consumer sector with the introduction of the VAT. These effects should be temporary, though, with the pick-up in investment and government spending providing solid support for the non-oil sector.

Chart 2: Hydrocarbon production

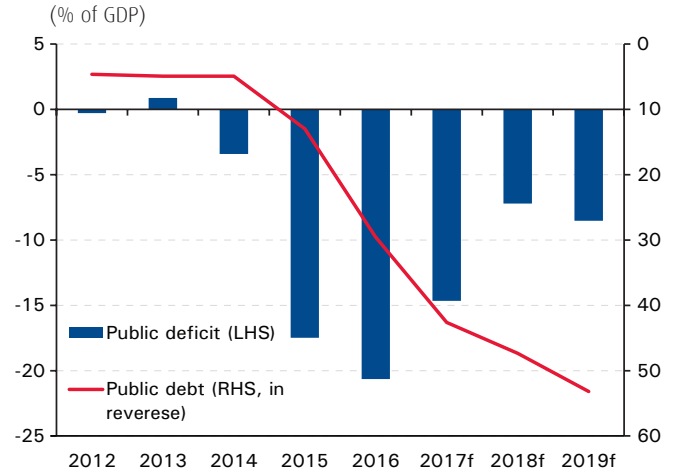


Source: Thomson Reuters Datastream, NBK estimates

Fiscal deficit to narrow on higher oil prices, but non-oil income growth continues to lag behind

Thanks to firmer oil prices—$65/bbl in 2018 and $60/bbl in 2019 as per our own projections—Oman's budget deficit should narrow to 7% of GDP in 2018 and 8.5% of GDP in 2019 from close to an expected 15% of GDP last year. (Chart 3.)

Chart 3: Fiscal balance & public debt



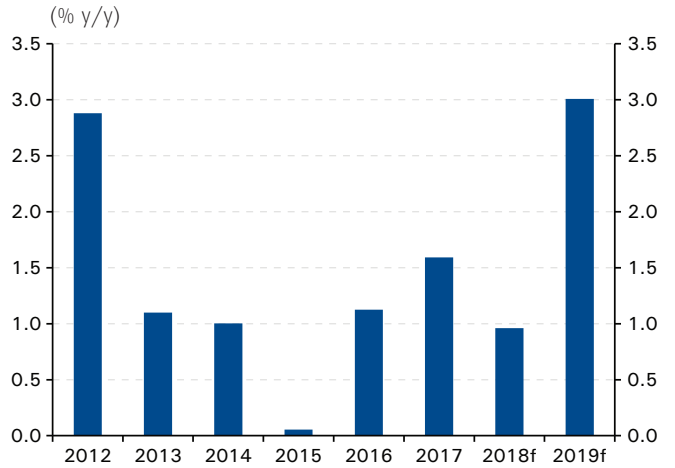
Source: Thomson Reuters Datastream, NBK estimates

Despite Oman's best efforts to increase non-hydrocarbon revenue, the sultanate continues to depend on oil and gas revenues, accounting historically for more than 80% of total revenues. The government's decision to postpone fiscal reforms such as the value added tax (VAT), to 2019, on concerns that it would negatively affect consumer spending and the non-hydrocarbon sector more broadly, did not help.

Inflation subdued in 2018 but rising in 2019

Lower domestic demand and a weaker real estate market helped contain inflation to 1.0% in 2018. It should rise initially to about 3.0% in 2019 following the introduction of the VAT. (Chart 4.)

Chart 4: Inflation



Source: Thomson Reuters Datastream, NBK estimates

Access to finance will be key to achieving the sultanate's ambition

In view of tight public finances and ambitious diversification plans, the government will need to rely increasingly on debt, privatization and foreign investment. For the time being, Oman can still count on relatively easy access to international debt markets, but this is getting more expensive due to the sultanate's low sovereign rating, and it will be much more difficult if the country loses its investment grade status. Moody's, the rating agency, recently downgraded Oman's sovereign rating to Baa3, which is only one notch above speculative grade, while S&P ranks the sultanate's credit profile as speculative.

Recognizing the risks in future public borrowing, the government has also turned to privatization as a potential source of income, with six entities slated for sale. A partial equity stake sale in the new airport and in the BP Khazan field are being considered.

However, the government and its entities will still rely primarily on debt markets for most of their required financing. Oman issued $6.5 billion earlier this year, its biggest issuance to date, while publically owned enterprises, such as Oman Gas and Oman Electricity, are seeking $1 billion and $1.2 billion, respectively, in debt financing. Government debt is expected to rise to 47% of GDP in 2018 and 52% in 2019. (See chart 3.)

The domestic banking system is also poised to help facilitate the sultanate's diversification drive, thanks to recent regulatory changes aimed at boosting domestic lending. Indeed, in addition to other reforms, the Central Bank of Oman allowed the inclusion of interbank deposits when calculating lending ratios and lowered the capital adequacy ratio to 11% from 12%. This is expected to stimulate bank lending and position Oman's interbank system as a main pillar of its financial future. As such, private sector credit growth, which averaged 4% last year, is expected to accelerate to an annual average of 7% in 2018-19.

Qatar outlook

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Economic recovery to gain traction as oil and non-oil sector output expands

Overview and outlook

- **Economic growth to rebound from 1.5% y/y in 2017 to 1.8% in 2018 and 2.2% y/y in 2019 on a pick-up in both the hydrocarbon and non-hydrocarbon sectors.**
- **The fiscal deficit should narrow to 1.2% of GDP by 2019 on increasing revenues linked to higher energy prices and tax receipts as well as continuing expenditure rationalization.**
- **Qatar has propped up the banking system with injections of liquidity; international reserves are recovering.**
- **Market sentiment is positive—the QE index is up 9.6% in 2018 and Moody's has upgraded the outlook from negative to stable.**

Growth to benefit from higher gas output and gains from the public investment program

Qatar's economic growth is expected to edge up slightly in 2018 to 1.7% y/y, following last year's growth of 1.5% y/y, before accelerating to 2.2% y/y in 2019. (Chart 1.) Economic activity will benefit from output gains in both the hydrocarbon (+0.3% y/y) and non-hydrocarbon sectors (+3.3% y/y), with the former witnessing an expansion in crude and LNG production and the latter benefitting from the government's $200 billion infrastructure spending program.

Non-oil growth is expected to taper, however, with the government's investment program reaching an advanced phase; only four years remain for many of the high-profile infrastructure projects, such as the metro, light rail system and stadia, to be completed in time for the World Cup in 2022.

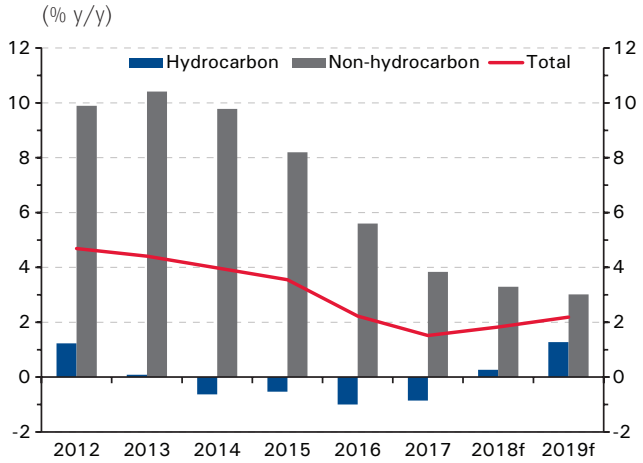
The $7.4bn Hamad Port, which Qatar plans to develop into a regional transport hub and with which the country hopes to bypass trade sanctions, was officially inaugurated at the end of 2017, leaving only a handful of projects left for the authorities to eke out future output gains. Attention, therefore, has turned back to gas/LNG production. In the short term, the delayed 1.4 billion cubic feet per day (bcf/d) Barzan gas facility should finally come on line in 4Q18, supplying additional volumes of gas and condensates, while in the medium term, the authorities' intention to expand liquefaction capacity by 30% to 100 million tonnes per annum (mtpa) will significantly boost growth in the hydrocarbon sector. Amid intensifying competition from Australia and the US, Qatar intends to maintain its position as the world's largest LNG exporter.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD bn	153	167	179	186
Real GDP	% y/y	2.2	1.5	1.8	2.2
- Oil	% y/y	-1.0	-0.9	0.3	1.3
- Non-oil	% y/y	5.6	3.8	3.3	3.0
Inflation	% y/y	2.7	0.4	0.7	2.5
Budget balance	% of GDP	-9.2	-5.8	-2.1	-1.2

Source: Official sources, NBK estimates

Chart 1: Real GDP



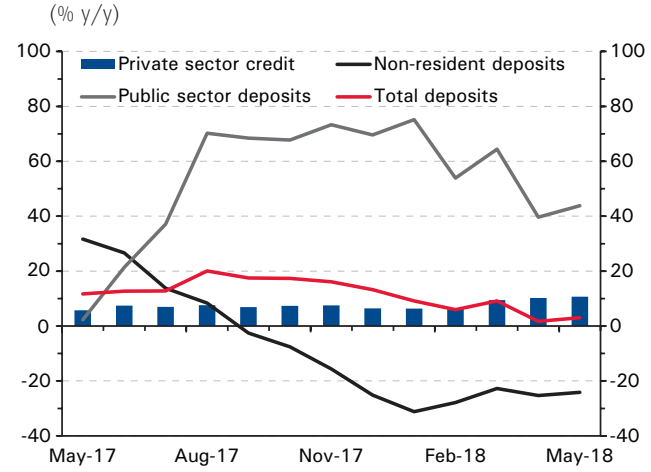
Source: General Authority for Statistics (GASTAT), NBK estimates

Qatar has been adjusting to the trade embargo but private and non-resident bank deposits growth remains low

Qatar appears to be weathering the trade embargo imposed by Saudi Arabia, the UAE and Bahrain as well as Egypt. It has rerouted passenger and trade flows and stabilized capital outflows that accelerated in the months following the severing of diplomatic ties.

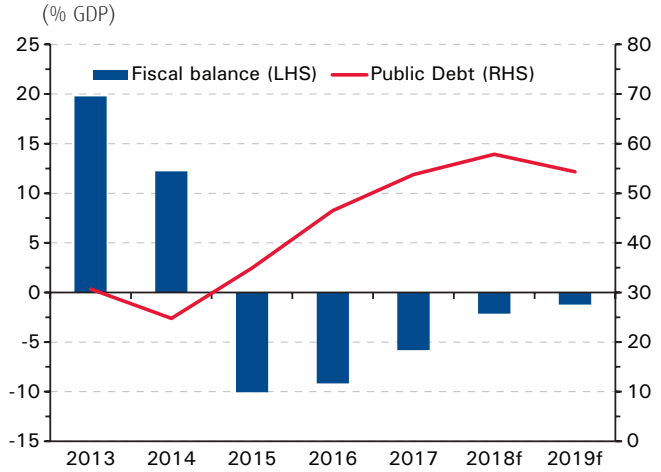
Bank deposit growth, at 3.0% y/y in May, appears to be slowly increasing, having benefitted from $30bn in public sector liquidity injections (+75% y/y at its height in January 2018) to offset the more than $21bn in private and non-resident deposits that were withdrawn from the banking system. (Chart 2.) And these have yet to recover to pre-crisis levels, remaining down y/y at -5.3% and -24.1% in May, respectively.

Chart 2: Credit and deposit growth



Source: Qatar Central Bank

Chart 3: Fiscal balance and public debt



Source: Qatar Central Bank, NBK estimates

Private sector credit growth, in contrast, is proving robust. Growth has accelerated every month this year, reaching 10.7% y/y in May, led by a broad-based uptick in demand for credit from the consumption, general trade, services and real estate sectors. (See Chart 2.) And this is despite a general rise in the cost of borrowing, although the QCB has only raised its benchmark QMR lending and repo rates once, by 25 bps, to 2.5% and 5%, respectively, since the beginning of 2017. Interbank rates are around 2.6%.

Inflation slowing on real estate weakness

Inflation fell to 0.1% y/y in June, weighed down by continued weakness in the real estate sector, with housing and utility costs (22% of the CPI basket) declining 4.3% y/y in the same month. June's headline rate came down despite the authorities hiking domestic fuel prices in May. The moderation in population growth, a trend which appeared to quicken in the wake of the diplomatic dispute, (+1.4% y/y in June), has also been a factor in the slowdown in demand. Inflation is not likely to exceed 0.7% in 2018 (avg.).

Fiscal deficit to narrow on higher oil/non-oil revenues

Qatar's public finances appear to be on a sounder footing following the government's fiscal consolidation efforts (cuts to subsidies, merging of ministries etc.), which brought public expenditures down by 12% in 2017, and the rise in oil and gas prices. The fiscal deficit should continue to narrow to 1.2% of GDP by 2019, helped by firmer energy prices and additional non-hydrocarbon revenue streams, such as VAT, which should be implemented next year. (Chart 3.)

The deficit has been financed primarily by domestic debt, although Qatar returned to the international bond markets in April with a successful $12bn bond sale. Meanwhile, QCB international reserves appear to have recovered to $24.7bn in May; around $20bn was tapped in 2017 to stem the capital outflows. Public debt is expected to peak at 57.8% of GDP this year, before falling to 54.3% of GDP in 2019.

Financial market sentiment generally positive

The benchmark Qatar Exchange (QE) index has performed well so far in 2018, up by 9.6% at 9,341 by 13 July. The market has been buoyed by FTSE inflows and MSCI flows as well as generally positive sentiment linked to higher energy prices and Qatar's ability to withstand the GCC boycott. Indeed, this resilience was recently echoed by Moody's, which changed the outlook on the government's long-term issuer ratings from negative to stable and affirmed its rating at Aa3. Moody's cited Qatar's strong net foreign asset position, its high per capita income and large natural gas reserves as supporting factors.

Saudi Arabia outlook

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Growth recovers led by oil sector rebound

Overview and outlook

- **Economic growth is expected to accelerate to 2.2% y/y this year as oil output increases and domestic demand recovers.**
- **Non-oil growth, expected at 1.9% y/y in 2018, is underpinned by the government's expansionary budget, private sector stimulus programs and general easing in fiscal austerity measures.**
- **Inflation to trend lower to 1.8% by 2019 as the effects of January's VAT and energy price hikes wear off.**
- **The fiscal deficit is projected to narrow from 9% of GDP last year to 4.6% of GDP by 2019; government debt is expected to reach 24.5% of GDP in 2019.**
- **Saudi equities boosted by MSCI and FTSE Russell EM inclusion; higher oil prices helping to lift sentiment.**

Growth recovering on oil and non-oil sector output gains

The Saudi economy looks poised to rebound this year from 2017's contraction, with oil production expected to increase following OPEC's decision to boost output from July and non-oil activity likely to benefit from elevated government spending after the authorities unveiled their most expansionary budget to date. The improved outlook occurs against a backdrop of continuing structural reforms under the ambitious Vision 2030 umbrella but at a pace that is less likely to impinge on consumer demand and private sector activity. Growth prospects will, however, be contingent on higher oil prices.

The reforms have been broadly two-pronged, aimed at both fiscal sustainability—through a combination of lower fuel/utility subsidies and higher taxes e.g. on tobacco, expatriate residents and consumption (VAT)—and economic diversification. This the authorities intend to pursue through private sector stimulus packages, privatization of state assets and regulatory measures designed to attract more foreign investment and technology know-how to Saudi Arabia. We expect real GDP growth to accelerate from last year's decline of -0.9 y/y to reach 2.2% y/y in 2018 and 1.9% y/y in 2019. (Chart 1.)

Key economic indicators

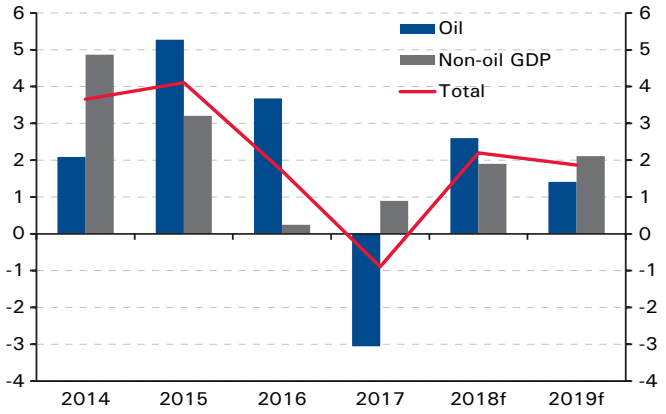
		2016	2017	2018f	2019f
Nominal GDP	USD bn	648	683	748	755
Real GDP	% y/y	1.7	-0.9	2.2	1.9
- Oil	% y/y	3.7	-3.1	2.6	1.4
- Non-oil	% y/y	0.2	0.9	1.9	2.1
Inflation	% y/y	2.1	-0.8	2.9	1.8
Budget balance	% of GDP	-12.6	-9.0	-6.1	-4.6

Source: Official sources, NBK estimates

Just-released quarterly GDP data for 1Q18 supports the view of an economy slowly rebounding from recession. Real output expanded by 1.2% y/y, ending a run of four consecutive quarters of negative growth.

Chart 1: Real GDP

(% y/y)



Source: General Authority for Statistics (GASTAT), NBK estimates

In the same quarter, the non-oil sector posted growth of 1.6% y/y, driven by gains in both the private and the government sectors, while oil GDP expanded by 0.6% y/y, helped by an increase in oil production, which the kingdom was able to achieve while still fulfilling its obligations to the OPEC production cut agreement.

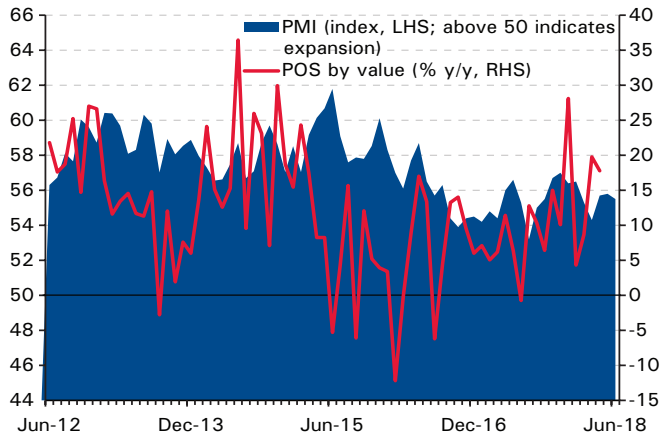
Saudi crude production, which averaged 9.95 mb/d in 2017 (achieving a OPEC compliance rate of 122%), is expected to increase significantly during the second half of 2018 now that OPEC+ has announced its intention to boost aggregate output by a nominal 1 mb/d to relieve a tightening oil market and restrain oil prices from spiking higher. Without knowing the kingdom's share of this figure, we estimate conservatively that output could be 260,000 b/d higher on average at 10.2 mb/d compared to 2017. 2019 would see production rise further.

Meanwhile, the uptick in the performance of the non-oil sector in 1Q18 compared to 4Q17 was largely a reflection of output gains in the manufacturing, financial and real estate services

sectors as well as in the government sector. Government spending is the lynchpin of the Saudi non-oil economy, with its expansive 2018 budget (SR978bn), private sector stimulus package (SR72bn over 5 years) and privatization drive as well as citizens and household account programs, which aim to mitigate the burden on low income families of the pull-back in energy and utility subsidies. The recently launched privatization program will sell state assets (utilities, hospitals etc.) and encourage the formation of more public private partnerships (PPP). In the process, the government hopes to net SR35-40bn in direct sales revenues and achieve savings of SR25-35bn, while creating 10,000-12,000 jobs in the private sector.

Recent POS and PMI data tend to confirm the rebound, albeit a moderate one, in non-oil activity. The value of POS transactions grew by 18% y/y in April, while the PMI, which indicates the level of business activity in the non-oil private sector, reached a 2018-high of 55.0 on higher output and new orders. (Chart 2.)

Chart 2: Point of sale (POS) and PMI data



Source: SAMA, Markit, Emirates NBD

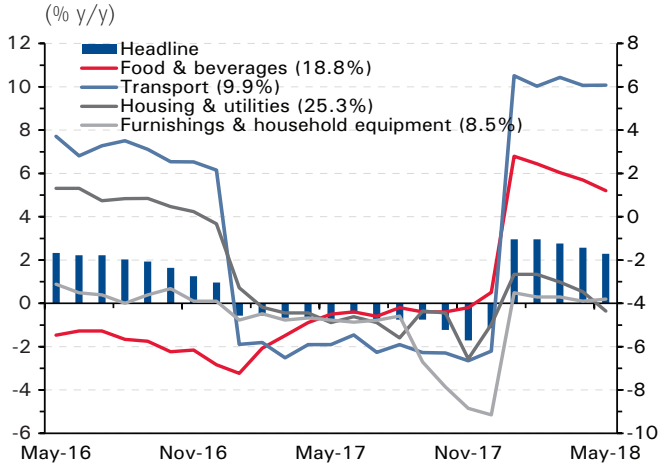
Bank credit growth to the private sector, however, continues to lag. At a lackluster 0.7% y/y in April, it is far below levels that would be commensurate with a deep-rooted and sustainable private sector recovery. (See Chart 5.)

Furthermore, Saudi unemployment continues to pose a challenge, more than two years into the government's Vision 2030 reform drive. The authorities intend to bring the unemployment rate down from 11.6% in 2015 to 7.0% by 2030. However, the rate keeps going up, reaching 12.9% in 1Q18—the fourth consecutive quarterly rise—as the labor force expands at almost twice the rate of employment. And this is despite an acceleration in the government's Saudization policy, (by penalizing employers that hire expatriates, for example) which has seen almost 700,000 expats leave the kingdom since the beginning of 2017.

Inflation slowing as effects of VAT wear off

Inflation has been moderating since the authorities rolled out the 5% value added tax (VAT) and instituted the second round of energy price hikes in January. Consumer prices surged 5.6% m/m and 6.8% y/y, with prices in the transport, food and restaurant & hotel categories in the CPI especially affected. (Chart 3.)

Chart 3: Inflation



Source: Thomson Reuters Datastream, NBK

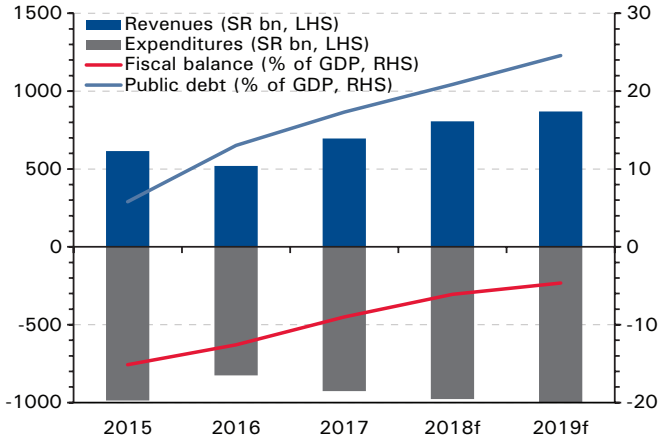
Nevertheless, we expect inflation to continue to ease to 2.9% (avg.) in 2018 as the one-off effects of January's price hikes wear off and given that housing and rental costs, which continue to fall due to a combination of weaker demand and government efforts to make housing more affordable, carry the largest weight in the consumer basket. As a corollary, growth in the Saudi real estate price index was -1.5% y/y in 1Q18.

Fiscal deficit to narrow on higher oil/non-oil revenues

The kingdom's public finances should continue to improve as the authorities realize some of the gains targeted in the Fiscal Balance Program (FBP). While the government's objective of a balanced budget has shifted to 2023 in order to lessen the impact of austerity policies on demand, the fiscal deficit is expected to continue to narrow from 9.0% of GDP last year to 6.1 and 4.6% of GDP in 2018 and 2019, respectively. The realization of higher oil revenues through higher oil prices is key, given that oil proceeds account for 63% of all treasury receipts and especially since the authorities intend to boost spending by 5.6% y/y with their largest ever budget, an estimated 20% of which is expected to be spent on infrastructure projects.

The contribution of non-oil revenues, however, will continue to increase as the authorities capitalize on recently-added taxes such as the VAT, excise tax and the expat/expat dependents levy, which will increase again this year. Non-oil revenues have doubled since 2014 to SR256bn in 2017, equivalent to 36.7% of all revenues and 10% of GDP. Investment returns accrued to the treasury through the Public Investment Fund (PIF) should also rise, helped by higher US and global interest rates.

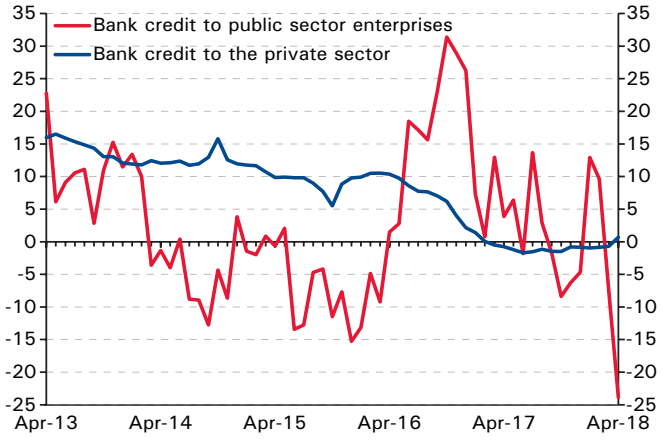
Chart 4: Fiscal balance and government debt



Source: Ministry of Finance, NBK estimates

Chart 5: Bank credit and deposits

(% y/y)



Source: Thomson Reuters Datastream

Government debt rises, but foreign reserves recover

Central government debt is expected to rise from 17.3% of GDP last year to 24.6% of GDP by the end of 2019 amid continued local and international debt issuance. (See Chart 4.) The authorities have already sold $11bn worth of bonds this year, a figure that is expected to rise to around $37bn by year-end—similar to last year's volume which financed 61% of the deficit, with the remainder covered by reserves. We expect the authorities will increasingly try to minimize reserve drawdowns and rely more on debt issuance to take advantage of the still relatively low global interest rates. But while foreign reserve assets declined by 7.5% ($40bn) in 2017, as of April, they were actually up 10% at $506bn.

Tighter monetary conditions could weigh on growth

Saudi monetary policy is focused on preserving the peg to the dollar and keeping in step with US interest rates in order to minimize capital outflows. SAMA has already raised its benchmark repo and reverse repo rates twice this year, by 25 bps each time, to 2.5% and 2.0%, respectively. In March the repo was raised, preemptively, for the first time since 2009 after interbank rates fell below their USD Libor equivalent, sparking concerns about dollarization and capital flight.

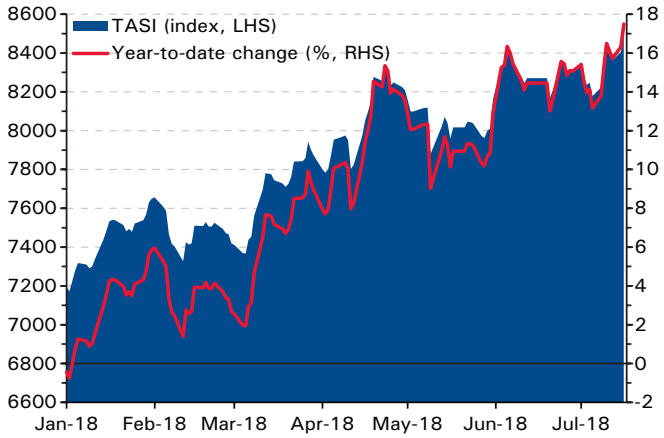
The rise in the cost of funds comes at a particularly sensitive time for the authorities. Private sector credit, but also deposits, are barely increasing, which is weighing on economic activity. (Chart 5.)

Equities boosted by MSCI/FTSE inclusion

Outperforming its GCC peers by a considerable margin, the main Saudi stock index (TASI) is up 17.5% at 8,490 so far in 2018, having been boosted by the bourse's recent inclusion in the MSCI and FTSE Russell emerging market indices. At least $10bn in passive foreign inflows are expected following the MSCI decision. Higher oil prices and affirmation of the sovereign's credit ratings by the likes of Moody's (A1) and Fitch (A+) have helped lift sentiments. Markets will be looking to the 5% IPO of Aramco, possibly in 2019, and further delivery by the regulator of financial reforms to spur positive sentiment.

Chart 6: Stock market

(Tadawul All-share Index, TASI)



Source: Thomson Reuters Datastream

UAE outlook

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Growth to accelerate in 2018 as non-oil activity recovers and oil output increases

Overview and outlook

- **We see headline growth edging up from 0.8% in 2017 to around 2.5% in 2018, as preparations for the Dubai Expo 2020 event remain supportive of non-oil growth and as oil production increases.**
- **Consumer price inflation is expected to rise to 3.5% this year on average from 2.1% in 2017, mainly on the back of the introduction of VAT in January.**
- **The fiscal position should recover in 2018, registering a small surplus of 0.4% of GDP thanks to higher oil revenues and despite an easing in the pace of fiscal consolidation.**
- **Credit growth is expected to remain subdued over 2018-19 due to tighter lending standards, higher interest rates and weakness in the real estate market; infrastructure financing should provide some opportunities though.**

Growth to pick up on gains in the non-oil sector and as oil growth recovers

After moderating for two straight years, real GDP growth in the UAE is set to accelerate over the forecast period, edging up from 0.8% in 2017 to around 2.5% in 2018 and 3.3% in 2019. (Chart 1.) Growth will be driven by ongoing infrastructure investment in the non-oil economy and increasing output in the oil sector, as the OPEC production cut agreement is wound down.

With oil production expected to increase from mid-2018, we think real oil GDP growth will recover from 2017's decline of 3.0% and rise to 0.6% and 1.5% in 2018 and 2019, respectively. According to the latest official data, UAE crude production averaged 2.87 million barrels per day (mb/d) in May, having experienced its first increase in March (+1.6% m/m) in more than a year.

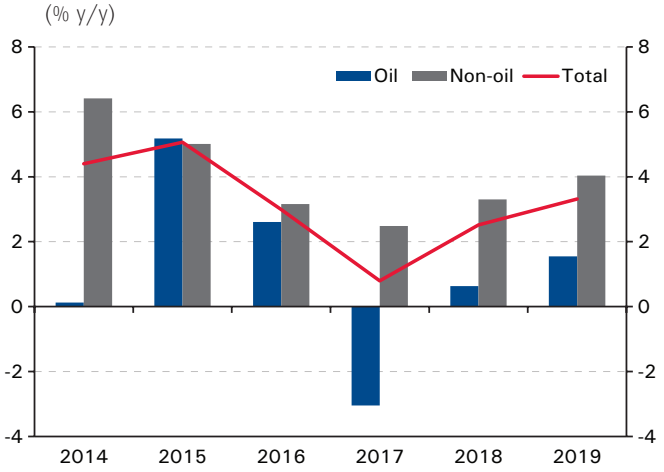
The UAE continues to invest in expanding its oil production capacity in anticipation of higher demand. ADNOC, the state-owned oil firm, recently announced plans to double its refining capacity and triple its petrochemical output by 2025. To support its plan of attracting strategic investors, it intends to privatize parts of its businesses and offer six competitive oil and gas concessions for the first time. Bids are due by October, with the winner granted exploration and development rights.

Key economic indicators

		2016	2017	2018f	2019f
Nominal GDP	USD bn	357	382	409	425
Real GDP	% y/y	3.0	0.8	2.5	3.3
- Oil	% y/y	2.6	-3.0	0.6	1.5
- Non-oil	% y/y	3.2	2.5	3.3	4.0
Inflation	% y/y	1.6	2.1	3.5	3.0
Budget balance	% of GDP	-4.3	-2.6	0.4	1.2

Source: Official sources, NBK estimates

Chart 1: Real GDP



Source: UAE Federal Competitiveness & Statistics Authority, NBK estimates

The non-oil economy, meanwhile, is forecast to maintain its healthy growth momentum and expand by 3.3% this year from 2.5% in 2017, supported by further gains in the tourism and construction sectors, especially with the Expo 2020 event in Dubai drawing nearer. 2019 should see the non-oil economy grow by a further 4.0%.

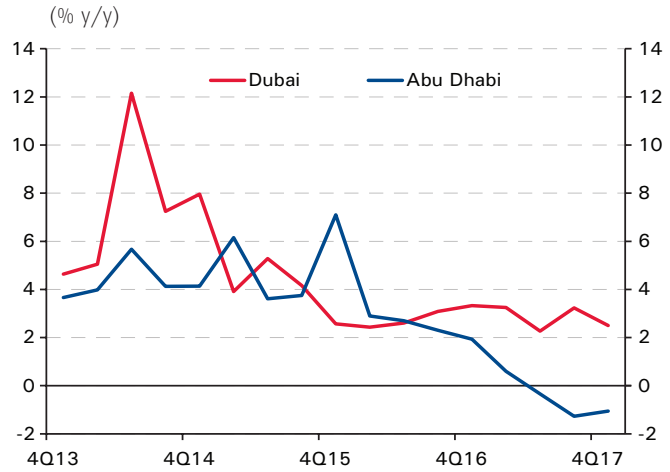
Growth in Dubai and Abu Dhabi to benefit from a new package of economic reforms

Moreover, in a further effort to support the non-oil economy, the federal authorities and the governments of Dubai and Abu Dhabi have unveiled a series of growth-enhancing measures in recent months. At the federal level, the UAE has raised the share of local businesses outside of designated "free zone" areas that foreigners are permitted to own from 49% to 100%.

The move is part of a wider plan that includes residency visas of up to 10 years to investors and highly skilled expats, such as specialists in the scientific, technical, medical and research fields. The new ownership and residency rules are expected to stimulate FDI inflows and help boost the domestic real estate market.

Abu Dhabi, meanwhile, recently approved a three-year Dh50 billion ($13.6bn) economic stimulus program. The authorities intend to make it easier to do business in the emirate, spur employment growth and increase tourism activity. Government spending has been key to the emirate notching up a third consecutive quarter of accelerating non-oil growth—3.0% in 4Q17. Headline growth, however, managed only 1.1% y/y in the same quarter, given the dominance of the oil sector (which is subject to oil production cuts) in Abu Dhabi's economy. (Chart 2.)

Chart 2: Dubai & Abu Dhabi real GDP



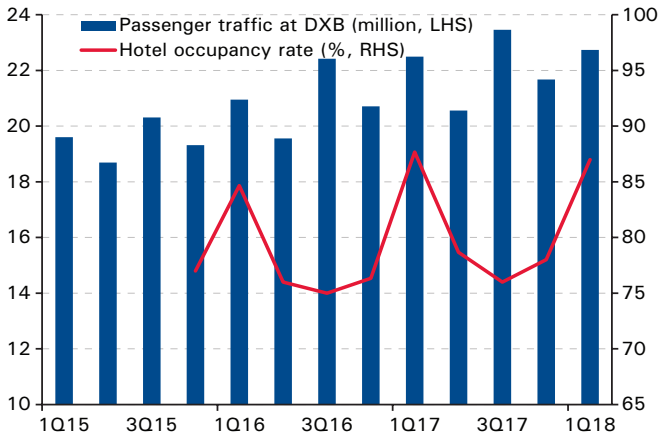
Source: Dubai Statistics Center, Statistics Centre - Abu Dhabi

Dubai has also announced its own plans to improve the business climate and stimulate foreign investment. As a start, the authorities plan to waive some fees on aviation, real estate and school and reduce those on business. Furthermore, Dubai's Department of Economic Development (DED) launched a package that will help businesses clear fines and renew licenses in monthly instalments. Businesses will also be able to freeze their trade licenses for a year and also seek favorable settlements with the DED for any commercial violations. In May, both Dubai and Abu Dhabi agreed to exempt businesses from any administrative fines until the end of the year, all in a bid to bolster foreign investment and business activity.

Meanwhile, economic growth in Dubai continues to fare better, thanks to its more diversified economy. Output expanded by 2.5% y/y in 4Q17. (See Chart 2.) Dubai's important hospitality and construction sectors continue to perform well, and the measures unveiled above will undoubtedly act as a further boost to these respective sectors.

The number of passengers passing through Dubai International Airport came in at a record high of 23 million in 1Q18, just above the average 22 million recorded in 2017. (Chart 3.) Construction activity continues to be supported by preparations for the Expo 2020 event. Over $8bn has been allocated to Expo-related projects, including for buildings, metro expansions, roads and bridges; Dubai has reportedly already invested up to half of that total amount so far.

Chart 3: Dubai tourism



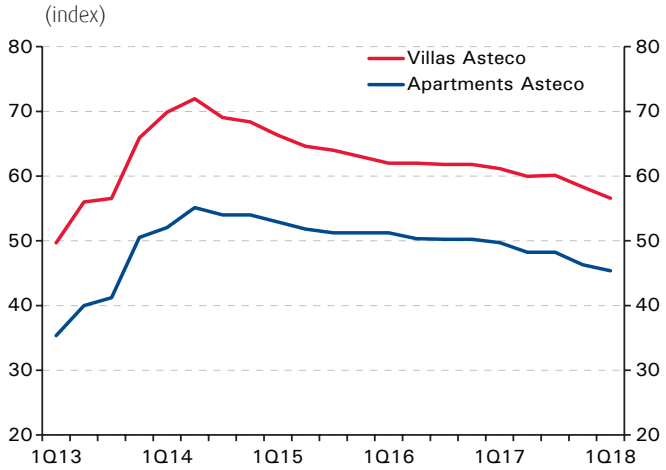
Source: Dubai Airports, Dubai Statistics Center

A number of downside risks persist, however. If downward pressures on oil prices re-emerge, this could lead the government to adopt stricter fiscal consolidative measures again, quelling economic growth. Also, with interest rates likely to rise further, this could eventually lead to tighter liquidity and a slowdown in investment spending. A potential escalation of the Qatar crisis may also affect growth. While Qatar is not a major contributor to the UAE's trade and tourism sectors, regional tensions typically affect investor sentiment.

Dubai's residential property prices continued to ease in 1Q18

The impact of more stringent loan-to-value regulations (introduced back in 2013) on Dubai's residential property market continues to be compounded by the effects of increased supply and higher interest rates. According to Asteco, the prices of both apartments and villas fell at a faster rate (-9% y/y) in 1Q18 than in the previous quarter; prices are expected to continue to fall this year due to still higher supply and further shifts in the composition of demand, away from luxury housing to more affordable housing units. (Chart 4.)

Chart 4: Dubai residential property sales prices



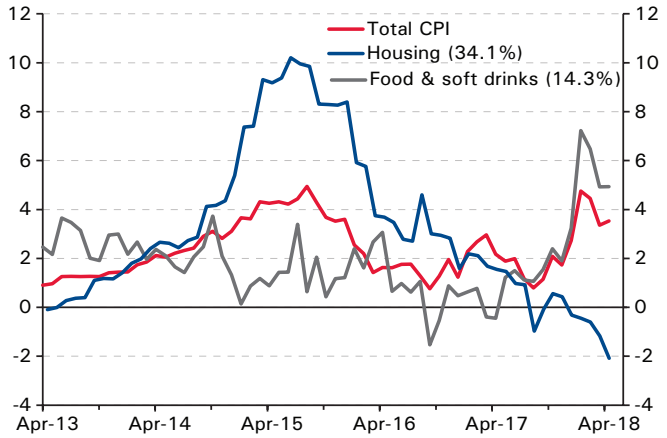
Source: Asteco

Inflation set to come in higher in 2018

After trending downwards for most of 2017, consumer prices increased in January following the introduction of a 5% VAT and the paring of fuel subsidies. Inflation jumped to 4.8% y/y in January from 2.7% y/y in December. However, the inflationary trend for the remainder of the year is expected to be downward—in May it stood at 3.5% y/y—as the initial impact of the tax/fuel hikes wear off and as housing costs, which have been experiencing deflation, continue to move lower. (Chart 5.)

Chart 5: Consumer price inflation by sector

(% y/y, weights in brackets)



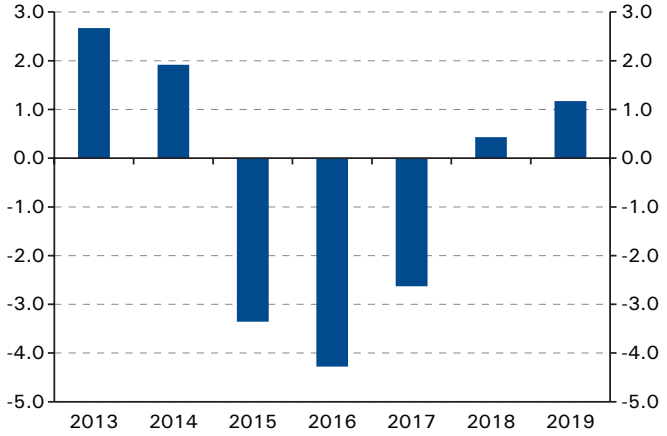
Source: Thomson Reuters Datastream

Also, anecdotal evidence points to some companies lowering prices in an attempt to maintain market share and prop up household consumption. We see average inflation settling at 3.5% in 2018 before easing to 3.0% in 2019.

Fiscal balance to improve in 2018

Chart 6: Budget balance

(% of GDP, revenues include ADNOC profits & investment income)



Source: Thomson Reuters Datastream

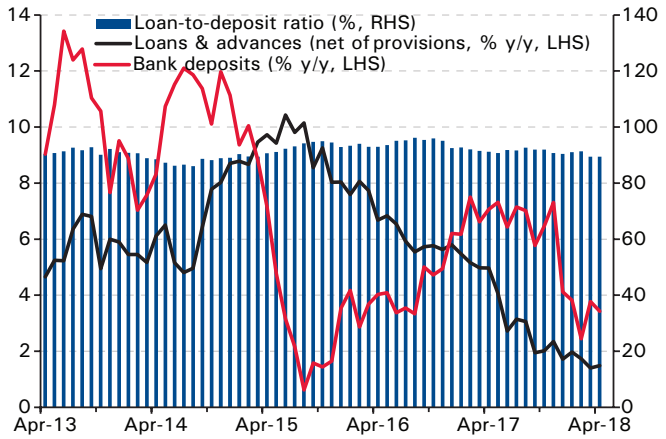
After registering a deficit for three consecutive years, the fiscal balance is expected to return to a surplus in 2018, albeit a small one, of 0.4% of GDP, as higher oil prices more than offset the loosening of the government's purse strings as the pace of fiscal consolidation is eased. (Chart 6.) Meanwhile, non-oil revenues might increase amid a continued improvement in general business conditions. As a result, the balance is expected to improve to 1.2% of GDP in 2019.

Improvement in economic activity being reflected in latest credit data; loan and deposit growth seen recovering

Latest gross credit growth data showed signs of recovery in May, after rising from 2.1% y/y in April to 2.5% y/y, mainly thanks to an improvement in lending activity to the corporate sector. (Chart 7.) Indeed, lending to the business and industrial sector jumped from 3.3% y/y to 5.3% y/y during the same period. While the central bank's latest credit sentiment survey (1Q18) showed that lending standards continued to tighten moderately, especially for small to medium enterprises, it pointed to an improvement in credit growth in the near-to-medium term, particularly among businesses. Indeed, credit growth is likely to continue to be supported by a rise in lending activity in the construction sector, as infrastructure spending is ramped up in preparation for the Expo 2020 event in Dubai.

Chart 7: Bank loan and deposit growth

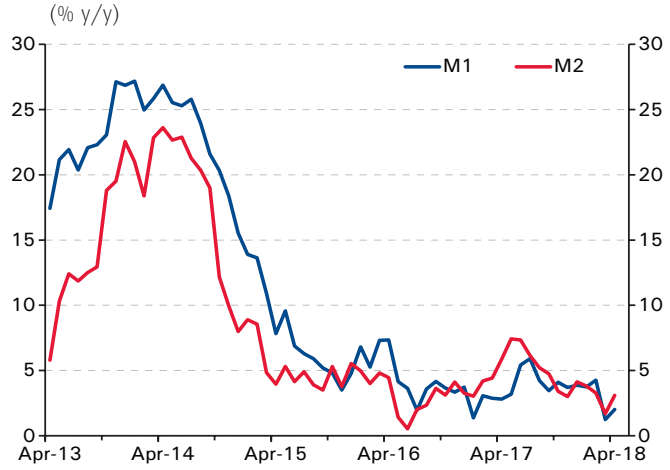
(% y/y)



Source: Thomson Reuters Datastream

Deposit growth also witnessed a pick-up, rising slightly from 3.4% y/y in April to 3.5% y/y in May, as higher oil prices pushed growth in government deposits up from 6.2% y/y to 8.5% during the same period. However, despite the rise in deposits, broad money (M2) eased and, at 2.4% y/y in May, stood near multi-year lows. (Chart 8.) Given the recent trends in credit and deposit growth, the loan-to-deposit ratio fell to 96.7% in May, compared to 97.9% at the start of the year.

Chart 8: Money supply growth

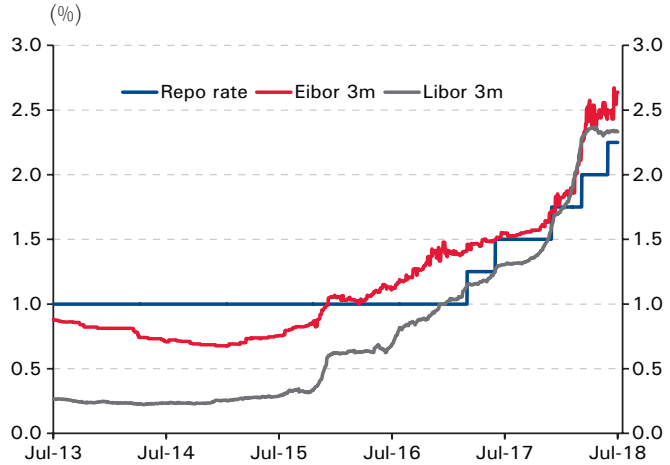


Source: Thomson Reuters Datastream

Meanwhile, reflecting the slowdown in deposit growth, the cost of funding in the UAE has been rising; interbank rates were also lifted by the introduction of a new EIBOR system in April and in response to the general tightening in monetary policy that has been occurring since the US Federal Reserve began raising rates in late 2015.

The most recent federal funds rate hike, of 25 bps on 14 June—the second rate increase this year—was followed immediately by a 25 bps increase in the UAE's benchmark rate to 2.25%. (Chart 9.) At least one, possibly two more rate hikes are expected before year-end, but the increase in borrowing costs comes amid slowing deposit and credit growth, so will need to be monitored.

Chart 9: Interest rates

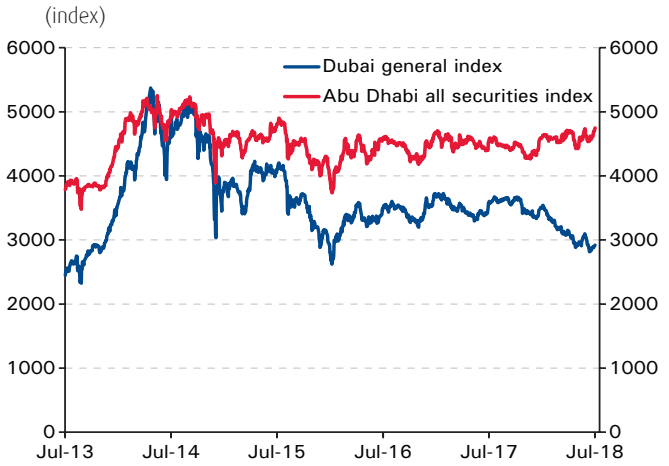


Source: Thomson Reuters Datastream

Dubai's main stock market remains weighed down by the weakness in the property sector

Equities on the Abu Dhabi Exchange (ADX) and Dubai Financial Markets (DFM) have been on opposite trajectories in 2018. While the ADX is up almost 8% year-to-date (as of 16 July), thanks to the improvement in oil prices, the DFM is down nearly 14%, as the ongoing weakness in the property sector continues to sour the mood. The planned liquidation of Abraaj, the region's largest private equity firm, has also weighed on investor sentiment. The Dubai-based firm has been under international investor scrutiny over how it used money in a $1bn healthcare fund. (Chart 10.) Nonetheless, the recently announced economic reforms are expected to help lift sentiment and ultimately improve market performance going forward.

Chart 10: Main stock markets



Source: Thomson Reuters Datastream

Egypt outlook

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Growth outlook solid as government pushes on with reforms

Overview and outlook

- **Economic growth should remain at a robust 5% as the government presses on with its reform agenda.**
- **The cheaper pound has seen exports grow strongly and tourism continue to recover, while unemployment has fallen.**
- **Inflation softer at a still-high 14% but could rise further in 2H18 following fresh subsidy cuts.**
- **The prospect of higher inflation has seen the central bank pause in its interest rate cutting cycle.**
- **The fiscal deficit should narrow to below 9% of GDP in FY18/19 amid further revenue measures and spending restraint.**
- **The current account deficit widened in 1Q18, but the external position overall is much stronger thanks to capital inflows.**

The economy has continued to recover from the crisis of late 2016, which saw the currency devalued and a three-year IMF support package worth $12 billion predicated on a package of macroeconomic policies and structural reforms. Following the re-election of President Sisi for a second four-year term in April 2018, the government looks set to press ahead with the reform agenda, which aims at cutting subsidies, reducing the still-large fiscal deficit, while boosting long-run growth and job creation. Although the economy faces a number of long-term challenges including persistently high inflation and unemployment, poverty and low levels of investment, near-term prospects remain bright, with growth supported by the more competitive currency, recovering tourism, falling domestic interest rates and more orthodox policymaking than in pre-crisis years.

Growth to remain robust at close to 5%

GDP growth came in strong in the second half of 2017 (1H FY2017/18), averaging 5.2% y/y. This compares to growth of 3.6% in FY2016/17 and 2.3% a year earlier. Growth in 2H17 was boosted by a strong pick-up in both exports and investment, while growth in the private sector outpaced that in the public sector, at a healthy 5.4%. Reflecting the improving conditions, unemployment fell to 10.5% in 1Q18 from 12% a year earlier, its lowest in eight years.

The Purchasing Managers Index (PMI) has confirmed the pick-up in activity seen over the past year, averaging close to 50 in January-May (+8% y/y) and peaking above the 50 mark in April for only the second time since 2015. Strength has been seen in both the output and new orders components. The export orders component has eased back to around 50, having recovered strongly last year, but remains well above the low of just 36 recorded before the currency float.

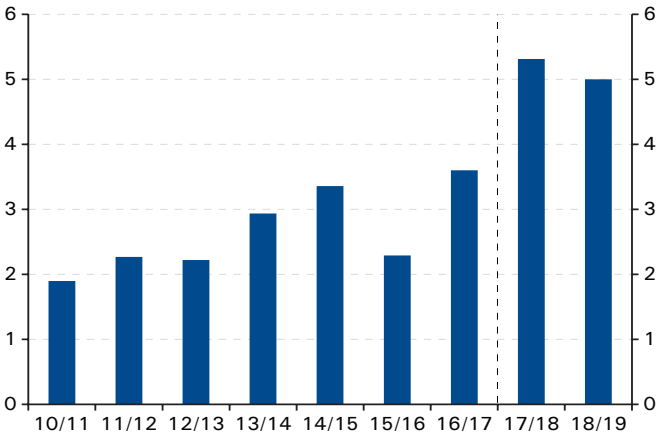
Key economic indicators

		FY16/17	FY17/18f	FY18/19f	FY19/20f
Nominal GDP	EGP bn	3,470	4,387	5,089	5,853
Nominal GDP	USD bn	251	248	288	331
Real GDP	% y/y	3.6	5.3	5.0	5.0
Inflation	% y/y	23.5	20.6	10.0	9.0
Budget balance	% of GDP	-10.9	-10.0	-8.5	-7.0

Source: Official sources, NBK estimates

Chart 1: Real GDP

(% y/y)



Source: Thomson Reuters Datastream, NBK

Growth is also supported by improved trade, which has been helped by a more competitive pound. Export receipts were up strongly at 14% y/y in the first four months of 2018, though slightly off the 20%+ rate recorded at the end of last year. Tourism numbers have also strengthened, with arrivals up 54% y/y in 4Q17, albeit remaining well below pre-"Arab Spring" levels.

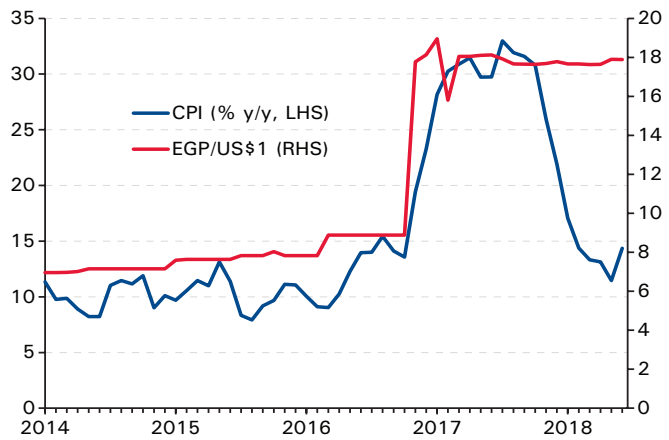
Based upon improved policy-setting, the more competitive currency, rising tourism, falling inflation and interest rates (see below) and progress on reforms, we expect growth to remain solid over the short-to-medium term, at around 5% in both FY2017/18 and FY2018/19. Growth will also benefit from a rise in natural gas output including from the offshore Zohr gas field, where production could reach 2.7 billion cubic feet per

day by end-2019 and add 2% to the level of GDP.

Inflation has returned to more moderate levels

Inflation surged in the months following the currency float in November 2016, with higher import prices, domestic supply shortages, subsidy cuts and the introduction of (and then increase in) VAT pushing it to a peak of 33% in July 2017. (Chart 2.) It has since come down sharply, thanks in part to the fading impact of the currency depreciation but also tighter monetary policy by the central bank (CBE). The inflation rate had fallen to 11.5% y/y in May 2018 (core 11.1% y/y) – still high but a level similar to its average in the years before the currency float.

Chart 2: Consumer price inflation and the exch. rate



Source: Thomson Reuters Datastream

However, recent fresh cuts in utility subsidies pushed the inflation rate higher to 14.4% in June, and are expected to keep pushing inflation up over coming months, before it resumes its downward path in the autumn. We expect inflation to average 21% in FY2017/18, falling to 10% in FY2018/19. The decline in inflation has given the central bank space to cut interest rates by 200 bps in the first half of 2018, leaving its overnight deposit and lending rates at 16.75% and 17.75%, respectively, though it held off from further cuts at its policy meeting in June. The CBE is targeting inflation at 13% +/- 3% in 4Q18 and falling to single digits thereafter. It views the main upside risks to this outlook as rising oil prices, demand-side pressures and the inflationary impact of fiscal reforms and is seen maintaining a cautious approach to policy loosening going forward.

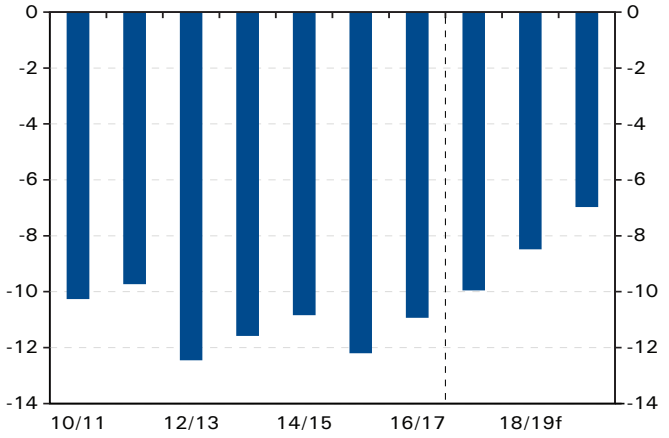
Budget deficit narrowing gradually, but still large

The government has made good headway implementing the fiscal reforms agreed under the IMF program and, as a result, the fiscal balance has seen some improvement. VAT was introduced in September 2016 at 13% then raised to 14% in July 2017; electricity and fuel prices have risen multiple times – the latter four times since 2014 with subsidies due to be eliminated by end-2019; and excise duties were raised on tobacco last year. There has also been more stringent control of the wage bill and improvements in revenue collection.

The budget deficit narrowed to 10.9% of GDP in FY2016/17 from 12.2% a year earlier, and figures for the first eight months of FY2017/18 point to further improvement. Spending was up 29% y/y in July-February on higher interest payments and social payouts, but revenues rose a stronger 39% y/y, reflecting increases in tax revenues. Despite an increase in expenditures, including on wages and pensions to compensate for some of the impact of lifting subsides, the official budget for FY2018/19 still targets a deficit of 8.4% of GDP as revenues are expected to increase as well. Given recent trends, strong economic growth and the apparent commitment to reform, we think this target is achievable.

Chart 3: Fiscal balance

(% of GDP)



Source: Thomson Reuters Datastream, NBK

The improved picture is also reflected in better financing conditions. Yields on the government's short and long-term domestic debt – the bulk of total debt – have declined this year due to lower policy rates and inflation, but the 10-year yield remained high at 15% in May. Yields on external debt however have risen alongside international rates. Public debt rose to around 100% of GDP in 2017, but given high inflation and the narrowing fiscal deficit, is forecast to decline to around 90% of GDP by 2019. However, the government's credit rating has barely improved at well below investment grade (Moody's at B3; S&P the exception, having upgraded to B from B- in May), with rating agencies waiting to see further progress on reducing the deficit given still large funding needs and the potential for reform fatigue.

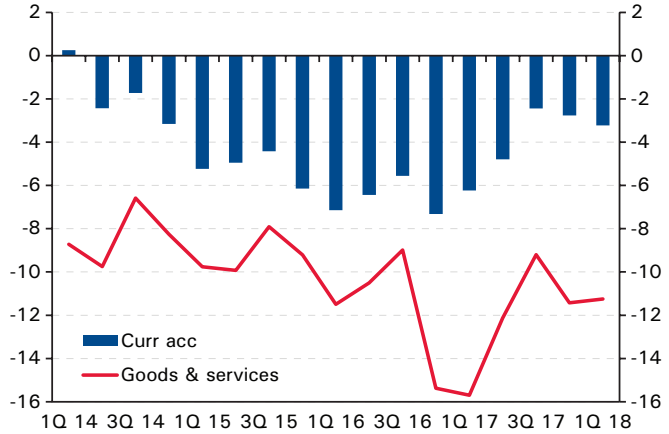
Current account still in deficit, but reserves stronger

The current account deficit widened to 3.2% of GDP, or $1.9 billion in 1Q18 from 2.8% in 4Q17 and a three-year low of 2.4% in 3Q17. (Chart 4.) But this is still well below the 7.3% of GDP peak recorded in 4Q16 just after the currency float. The widening in 1Q18 was due to a rise in the deficit on investment income, which has climbed in the past two years helped by rising interest payments and dividend payments from Egypt-based international oil companies. The goods and services deficit meanwhile narrowed slightly to 11.2% of GDP on strong growth in exports. Transfer payments stood at a very large

surplus of 10.8% of GDP and was more than double its levels of two years ago due to the impact of the cheaper pound on remittance payments from overseas – traditionally an important source of support for the external position.

Chart 4: Current account balance

(% GDP)



Source: Thomson Reuters Datastream, NBK

Meanwhile the overall balance of payments swung further into surplus in 1Q18 at 9.0% of GDP, or $5.4 billion, its best figure since 2005. Key to the improvement have been rising capital inflows notably portfolio investment, at $6.9 billion in 1Q18. Investors have taken advantage of higher domestic interest rates and the cheaper currency, and foreigners now hold nearly one-third of all treasury bills outstanding versus almost none before the currency float. The improvement has also resulted in a sharp recovery in the central bank's foreign reserves, which rose to $44 billion in June 2018, up 41% y/y and from a low of $16 billion nearly two years earlier. (Chart 5.)

The government has received a $2 billion installment from the IMF in July at the completion of the third review under the program, taking the total received to $8 billion so far and boosting reserves further.

Chart 5: International reserves

($ billion)

Source: Thomson Reuters Datastream

Equity market sees further gains in 2018

The main stock market index jumped nearly 50% in the two months after the currency float, then followed this with a further 22% rally in 2017. (Chart 6.) In the first half of 2018, the index has outperformed most regional markets, rose 9%, helped by strong economic growth prospects, the more stable external climate, lower domestic interest rates and positive news on financial support from the IMF. However, this increase has not been enough to keep pace with the decline in the pound's value, and the index is still below November 2016 levels in US dollar terms.

Chart 6: EGX 30 stock market index

(index)

Source: Thomson Reuters Datastream

Regional economic data and forecasts

	Unit	2013	2014	2015	2016	2017	2018f	2019f
Bahrain								
Nominal GDP	USD bn	32.8	33.8	31.0	32.1	35.2	37.3	39.4
Real GDP	% y/y	5.6	4.5	2.8	3.2	3.9	2.8	2.8
Oil sector	% y/y	15.3	3.0	-0.1	-0.1	-0.7	-0.3	0.8
Non-oil sector	% y/y	3.3	4.9	3.6	4.0	5.0	3.5	3.3
Budget balance	% of GDP	-3.1	-3.6	-13.0	-13.6	-11.6	-9.3	-8.6
Current account balance	% of GDP	7.3	4.5	-2.4	-4.6	-3.9	-2.1	-0.7
Inflation	% y/y	3.2	2.7	1.8	2.8	1.4	2.5	3.5
Kuwait								
Nominal GDP	USD bn	174.2	162.7	114.6	110.9	120.1	132.9	134.0
Real GDP	% y/y	1.1	0.5	0.6	3.5	-2.9	2.5	2.5
Oil sector	% y/y	-1.8	-2.1	-1.7	2.8	-8.0	1.5	1.5
Non-oil sector	% y/y	4.2	4.8	0.4	1.5	3.3	3.5	3.5
Budget balance	% of GDP	26.1	7.6	-13.4	-13.8	-6.0	-5.0	-3.0
Current account balance	% of GDP	40.3	33.4	3.5	-4.6	5.9	10.0	6.0
Inflation	% y/y	2.7	3.2	3.7	3.5	1.5	1.0	2.5
Oman								
Nominal GDP	USD bn	78.9	81.0	68.8	66.7	72.5	81.4	80.9
Real GDP	% y/y	6.6	2.8	4.7	5.4	0.3	3.5	2.6
Oil sector	% y/y	2.7	-1.0	4.4	2.3	-3.0	3.1	1.5
Non-oil sector	% y/y	9.8	5.7	5.0	7.6	2.6	3.8	3.4
Budget balance	% of GDP	0.9	-3.4	-17.5	-20.6	-14.7	-7.2	-8.5
Current account balance	% of GDP	6.6	5.5	-15.9	-18.4	-12.7	-5.0	-5.6
Inflation	% y/y	1.1	1.0	0.1	1.1	1.6	1.0	3.0
Qatar								
Nominal GDP	USD bn	198.7	206.2	164.6	152.4	166.9	179.4	185.5
Real GDP	% y/y	4.4	4.0	3.6	2.2	1.5	1.8	2.2
Oil sector	% y/y	0.1	-0.6	-0.5	-1.0	-0.8	0.3	1.3
Non-oil sector	% y/y	10.4	9.8	8.2	5.6	3.8	3.3	3.0
Budget balance	% of GDP	19.9	10.2	-10.1	-9.2	-5.8	-2.1	-1.2
Current account balance	% of GDP	30.4	24.0	8.4	-5.5	1.9	2.8	2.9
Inflation	% y/y	3.1	3.3	1.8	2.7	0.4	0.7	2.5
Saudi Arabia								
Nominal GDP	USD bn	746.6	756.3	654.2	647.6	683.0	747.5	754.5
Real GDP	% y/y	2.7	3.7	4.1	1.7	-0.9	2.2	1.9
Oil sector	% y/y	-1.6	2.1	5.3	3.7	-3.1	2.6	1.4
Non-oil sector	% y/y	6.4	4.9	3.2	0.2	0.9	1.9	2.1
Budget balance	% of GDP	6.3	-2.5	-15.1	-12.6	-9.0	-6.1	-4.6
Current account balance	% of GDP	18.1	9.8	-8.7	-3.7	2.2	6.5	3.8
Inflation	% y/y	3.5	2.2	1.2	2.1	-0.8	2.9	1.8
UAE								
Nominal GDP	USD bn	390.1	403.1	358.1	357.0	382.5	410.6	427.9
Real GDP	% y/y	5.1	4.4	5.1	3.0	0.8	2.5	3.3
Oil sector	% y/y	3.2	0.1	5.2	2.6	-3.0	0.6	1.5
Non-oil sector	% y/y	5.9	6.4	5.0	3.2	2.5	3.3	4.0
Budget balance	% of GDP	2.7	1.9	-3.4	-4.2	-2.6	0.4	1.2
Current account balance	% of GDP	19.0	13.5	4.9	3.7	6.9	7.1	7.4
Inflation	% y/y	1.1	2.3	4.1	1.6	2.1	3.5	3.0
Egypt (fiscal year)								
Nominal GDP	USD bn	305.2	331.6	331.8	251.0	248.0	287.5	330.7
Real GDP	% y/y	2.9	3.4	2.3	3.6	5.3	5.0	5.0
Budget balance	% of GDP	-11.6	-10.8	-12.2	-10.9	-10.0	-8.5	-7.0
Current account balance	% of GDP	-0.9	-3.8	-6.0	-6.0	NA	NA	NA
Inflation	% y/y	8.2	11.4	14.0	23.5	20.9	10.0	9.0

International data

	Unit	2013	2014	2015	2016	2017f	2018f	2019f
Brent crude oil spot price (year average)*	$ p/b	108.7	99.0	52.4	45.7	54.9	65.0	60.0
CRB commodity price index*	Index	457.3	437.8	374.8	423.1	432.45	-	-
Eur/USD*	1$ = €	0.736	0.827	0.921	0.951	0.833	-	-
US Fed Fund Rate	%	0.25	0.25	0.5	0.75	1.5	-	-
MSCI World stock market index*	Index	1,661	1,730	1,663	1,751	2,103	-	-
MENA real GDP (IMF/NBK)	% y/y	2.5	2.6	2.6	5.1	2.2	3.5	3.9
World real GDP (IMF)	% y/y	3.5	3.6	3.4	3.2	3.6	3.9	3.9

Source: Thomson Reuters Datastream, official sources, IMF, NBK estimates; * Lastest available data

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