MENA Economic Outlook 2019-2020
January 2019

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Economic growth supported by expansive government investment spending

Overview and outlook

• Global growth expected at around 3.7% to 2020, but downside risks linked to deteriorating trade relations, US monetary tightening and uncertain policy-making are on the rise.

• GCC economic growth expected at 2.3% and 2.6% in 2019 and 2020, respectively, supported mainly by expansive public spending and private sector stimulus.

• With lower oil prices likely in 2019, however, the process of fiscal rebalancing will be delayed.

• Banking sector deposits recovering, but credit growth remains relatively subdued.

• GCC markets have been buoyed by inflows linked to MSCI/FTSE inclusion and a generally more bullish outlook.

Global uncertainty weighs on the outlook

This edition of the MENA Outlook occurs against a backdrop of increased global economic uncertainty and financial market volatility. The IMF, in its October 2018 WEO, revised down its global economic outlook by 0.2% to peg world output growth at roughly 3.7% over the next two years, a decent enough pace, but noted that the balance of risks is tilted to the downside. These are dominated by escalating trade protectionism, which has been sparked by the unresolved US-China trade tariff dispute and continued US monetary tightening—the US Federal Reserve hiked rates four times, by 25 bps each time, in 2018—with ramifications for emerging market economies and those with currencies pegged to the US dollar in terms of increased capital outflows and higher borrowing costs.

Policymaking uncertainty, at least in advanced economies, is further complicating the picture. From the Trump administration’s partial shutdown of the federal government and likelihood of further legislative impasse in the face of a Democrat-controlled congress to the UK’s Brexit woes and President Macron of France’s tax reversal in the face of the ‘gilet jaunes’ (yellow vests) street protests, 2018 ended on a bad note.

The financial markets plunged into bear territory during the last quarter of 2018, with the S&P 500 and MSCI EM indices closing the year down 6.2% and 12.3%, respectively. GCC stock indices, in comparison, fared relatively well, with Saudi’s Tadawul gaining 8%, Abu Dhabi’s ADX 11.7% and Qatar’s QE a region-leading 20.8% (though from a low base).

Lower oil prices expected in 2019-20 as OPEC bids to rebalance market through supply cuts

The outlook for oil prices has changed considerably over the last six months, with the balance of risks in 2019-2020 skewed to the downside. We envisage prices (Brent) averaging $65/bbl in 2019 and 2020, down from 2018’s average of $71.6/bbl. Amid a mélange of bearish catalysts, from rampant US shale production and burgeoning OPEC+ output to President Trump’s decision to offer six-month sanctions waivers to Iran’s largest customers and weakening global economic growth, Brent crude, the international benchmark, plunged almost 38% in the last three months of 2018 to $54/bbl by year’s end. Brent had been as high as $86/bbl in early October. (Chart 1.) Oil’s price drop prompted OPEC to reconvene in December and reestablish production cuts of at least 1.2 mb/d for 2019 in order to stabilize oil prices.

Chart 1: Brent crude oil futures ($/bbl)

Source: Thomson Reuters Datastream
GCC growth underpinned by ambitious public investment and business reforms

For the GCC oil producers, with the likely exception of Qatar, the softer oil price outlook for 2019-2020, coupled with production cuts, will likely delay the process of fiscal balancing and, in the process, place added pressure on the non-oil sectors to drive revenue growth and real output gains. Qatar’s decision last December to withdraw from OPEC frees it from production cut obligations, while its fiscal account was on track in 2018 to record a first surplus in three years.

Regional governments will continue with their ambitious infrastructure and development projects, backed by expansive public spending plans, with Saudi Arabia’s record SR1.1 trillion ($293bn) budget the most eye-catching.

Private sector stimulus programs and productive infrastructure investments will, by and large, support non-oil growth over the forecast period. Reforms to stimulate the business environment and incentives to attract long term foreign investment were also introduced, most notably in the UAE, which reduced fees in several sectors, including real estate and tourism (Dubai), offered mainland licenses for businesses operating in free trade zones (Abu Dhabi) and, at the federal level, approved the issuance of residency visas to skilled expatriates for up to ten years and raised foreign ownership limits of companies operating outside of free trade zones to 100% from 49%. We expect GCC non-oil growth to improve from 2.9% in 2018 to 3.3% in 2019 and 3.5% in 2020. (Chart 2.)

On the hydrocarbon side, GCC governments’ oil and gas expansion plans will continue apace, despite OPEC+ production cut obligations and the prospect of lower oil prices. The UAE is on the verge of meeting its oil production capacity target of 3.5 mb/d, having identified close to $145bn of new upstream and downstream investments over the next five years.
Bahrain

Infrastructure investments drive growth amid an improving fiscal picture

Overview and outlook

- Real GDP growth is expected to hold at around a healthy 3% over 2019-2020, supported by infrastructure spending, some of which may be financed by the recently announced GCC aid package.

- Inflation is expected to rise to 3.5% (avg.) in 2019, on the back of the introduction of the 5% VAT, before subsiding to around 2.0% in 2020, as the initial impact of the VAT ebbs away and as food and housing cost rises remain moderate.

- The budget deficit is forecast to gradually narrow from an estimated 8% of GDP in 2018 to around 4.6% of GDP by the end of 2020, on greater fiscal prudence and higher non-oil revenues.

- Credit growth is projected to continue its impressive recovery, mainly driven by heightened activity in the construction sector.

Infrastructure spending supporting economic growth

Bahrain’s economy is expected to continue being driven by the non-oil sector and underpinned by high levels of infrastructure spending, some of which will be financed by the recently announced $10bn GCC support package of loans, deposits and grants. These will be disbursed in installments over the next five years and may help finance major infrastructure projects such as the $1bn Bahrain International Airport expansion project, which will increase passenger capacity to support the tourism sector, the Bahrain national oil company modernization project and the Aluminum Bahrain (Alba) expansion project.

As part of its plans to expand the oil sector, Bahrain and Saudi Arabia inaugurated a new 350,000 b/d offshore oil pipeline connecting the two kingdoms. The pipeline replaces the existing, ageing 230,000 b/d pipeline that supplies imported crude to the kingdom’s 267,000 b/d Sitra refinery. The refinery’s capacity is also being expanded, to 400,000 b/d, which should come on line by 2022.

Oil sector activity will also benefit from the creation in 2018 of a $1bn energy fund, with capital from local and international investors. This vehicle will invest in the country’s oil and gas sectors, including its recently discovered tight oil and gas deposits. Real oil GDP could, therefore, expand by 1.4% and 1.6% in 2019 and 2020, respectively. Overall GDP growth should range around 3% in 2019-2020. (Chart 1.)

Chart 1: Real GDP (% y/y)

Source: Information & e-government Authority, NBK estimates

Furthermore, financial services, the second largest sector of the economy after oil, is expected to benefit from government initiatives and reforms, especially in the area of financial technology innovation. The cost of doing business in the sector is also low by regional standards—reportedly up to 40% lower than in Dubai—so the kingdom is well placed competitively. Real non-oil growth is forecast at 3.4% y/y on average during the next two years.

Key economic indicators

<table>
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<th>2019f</th>
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<td>-8.0</td>
<td>-5.9</td>
<td>-4.6</td>
</tr>
</tbody>
</table>

Source: Official sources, NBK estimates
Inflation to rise in 2019 on VAT introduction

Consumer price inflation is expected to rise from an estimated 2.5% in 2018 to 3.5% in 2019. This is mainly due to the rollout next year of the value-added tax (VAT). After that, inflation should subside to 2.0% in 2020 as the initial impact of the VAT ebbs away. Food price and housing cost inflation is expected to remain moderate. (Chart 2.)

Chart 2: Consumer price inflation by sector (% y/y)

Source: Thomson Reuters Datastream

Budget deficit to gradually narrow on fiscal prudence and higher non-oil revenue

The budget deficit is expected to gradually narrow, in-line with the kingdom’s ‘Fiscal Balance Program’ (FBP), a series of reforms aimed at reducing by 2022 the fiscal deficit from the current estimate of 8% of GDP to zero and the public debt from around 90% of GDP to 82% of GDP.

The FBP outlines six major initiatives to help generate BHD 800mn ($2.1bn) in savings over the next five years: i) reducing government operational expenditures; ii) introducing a voluntary retirement scheme for government authorities; iii) balancing the Electricity and Water Authority’s expenditures and revenues by 2022 by adjusting tariffs; iv) streamlining the distribution of cash subsidies to low-to-middle income citizens; v) improving the efficiency of government spending; and vi) simplifying state processes, strengthening accountability within government departments and increasing non-oil revenues.

The program was launched immediately after the GCC announced its financial support package, so the provision of financial assistance appears to be conditional on fiscal consolidation. This should help expedite some of the previously delayed fiscal and economic reforms that had been proposed as part of the kingdom’s Economic Vision 2030. Indeed, just days after the two announcements, the Bahraini legislature approved both the draft 5% VAT law and the amended pension law.

The sign-off on the 5% VAT bill paved the way for the tax to be levied for the first time at the start of 2019. The amended pension law should lead to the paring back of pension bonuses of government ministers, members of parliament and municipal councilors.

The FBP aims to increase non-oil revenues by 2-2.5% of GDP, not least through the introduction of the VAT. However, the VAT is not expected to generate more than BHD 188.5mn ($500mn) or around 1% of GDP, so the authorities will need to find other income sources to increase non-oil revenue. Nevertheless, the budget deficit should narrow, to 5.9% of GDP in 2019 and 4.6% of GDP in 2020. (Chart 3.)

Chart 3: Budget balance & public debt (% of GDP)

Source: Bahrain Ministry of Finance, IIF, NBK estimates

Robust private credit growth driven by business lending

Business credit has been growing strongly, at a rate of 12.3% y/y, in the year to October—much higher than the 4.1% y/y average growth that was logged in 2017. Momentum is mainly driven by increased lending activity in the construction and manufacturing sectors. Total private sector credit growth in turn, which includes personal lending, came in at more-than-a-six-year high of 10.8% y/y in October. (Chart 4.)

Chart 4: Private credit & deposit growth (% y/y)

Source: Central Bank of Bahrain
Private sector deposit growth has lagged credit growth, however. Having bottomed out in August, growth reached 1.5% y/y in October. (See chart 4.) Weak deposit growth has contributed to the decline in the money supply (M1) observed during most of 2018. Growth in M2 has trended downwards.

**Foreign reserves under pressure from large twin deficits**

Large fiscal and external current account deficits continue to put downward pressure on international reserves. The current account deficit is currently estimated at around 1% of GDP for 2018. It is projected to remain in deficit in 2019, before witnessing a slight surplus in 2020 on the back of some improvement in non-oil activity. The kingdom’s reserves slid from $1.5bn in September to $1.4bn in October (1.2 months of imports). (Chart 5.) Bahrain is set to receive up to $2bn of the $10bn GCC financial support package by the end of this year, which should help replenish some of its reserves and offer some fiscal relief.

**Though risks remain, Bahrain’s economic outlook is more encouraging**

While the reforms proposed in the FBP and more broadly in the Bahrain Economic Vision 2030 are ambitious and socio-politically sensitive, indications are that the authorities are committed to forge ahead with the announced reforms. With disbursements of the GCC aid package likely to be tied to fiscal reforms and an improvement in the kingdom’s financial metrics, there is less likelihood of backsliding on its reform efforts. Serious and front-loaded progress on these reforms will send positive signals to investors. The pace of reform implementation will need to be carefully managed, however, so as not to adversely affect domestic demand.

**Chart 5: Central bank foreign reserves**

At $10bn, the support package could cover most of the kingdom’s external debt due to mature between 4Q18 and 2022, which is estimated at around $12bn. The government is, however, likely to continue to tap domestic and international bond markets to help plug the deficit. While the kingdom’s sovereign rating is classified as below investment-grade by the major rating agencies S&P (B+), Moody’s (B2) and Fitch (BB-), access to less costlier finance has improved in the months since the GCC financial package was announced as investors appear a little more confident about Bahrain’s economic outlook. Indeed, Moody’s recently upgraded its outlook on Bahrain from negative to stable on the back of the support package.

Having said that, borrowing costs are on the rise as the authorities follow the US Fed’s lead. Bahrain raised its key policy rate by 25 bps to 2.75% in December. Interbank rates have also been rising on the back of the policy rate hikes over the past year. As of mid December, the 3-month rate was up 105 bps year-to-date.
Kuwait

Non-oil growth seen at 3% in 2019, and fiscal position remains manageable

Overview and outlook

- GDP growth will moderate to 2.2% next year from 2.9% in 2018 due to oil output cuts linked to OPEC policy.
- Non-oil growth is seen improving slightly to 3.0%, but longer-term growth potential would be improved by reforms.
- Project awards could pick up after a subdued 2018, while decent employment growth will support consumer spending.
- Having hit a 15-year low in November, inflation will see a mild pick-up to average 2.0% in 2019.
- The fiscal position will end up close to balance in FY2018/19 but deteriorate slightly next year on lower oil prices.
- Credit growth has picked up from its lows partly on account of solid growth in consumer lending.
- Relatively low interest rates should also benefit growth next year.

Economic performance has steadily improved over the past two years, and the outlook for growth remains broadly encouraging. The downgrade to our oil price forecast implies a weakening fiscal outlook, but with the budget now close to balance following a period of successful consolidation and government reserves still very large, we do not expect a major change in fiscal policy that would negatively affect growth. We also look for some pick-up in project activity in 2019, delays in which weighed on growth last year – as did slow credit growth and property market weakness, both of which may now be fading. This should help offset the impact of a weaker external environment and possible rises in interest rates over the next couple of years.

Growth to remain above 2% despite crude output cuts

After rebounding to an estimated 2.9% in 2018 due in particular to recovering oil output, GDP growth is set to ease to 2.2% in 2019. (Chart 1.) The moderation is entirely due to slower growth in oil GDP reflecting changes in OPEC+ strategy. Although country-level quotas have not been announced, we assume that Kuwait’s crude production falls by around 2% in 2019 from its October reference level of 2.76 mb/d, broadly in line with the proposed aggregate cut for the group overall. However the impact on oil GDP is more than offset by the continued rise in condensate output – not part of the OPEC agreement – which is projected to reach 0.18 mb/d in 2019 from 0.1 mb/d in 2018 (a further smaller rise is projected for 2020). Overall oil GDP therefore rises 1.5% in 2019 from 3.0% in 2018. Recent news suggests that an agreement may soon be struck with Saudi Arabia to restart production in the Neutral Zone. But any rise would likely be offset by a lowering of output from other mature fields such as Burgan.

Chart 1: Real GDP (% y/y)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP</th>
<th>Non-oil</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>-2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>2010</td>
<td>-1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>2012</td>
<td>-0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>2014</td>
<td>-1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2016</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>2018f</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>2020f</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream, NBK

Over the past two years the non-oil economy has experienced a mild cyclical upswing, but upward pressures are still not very strong. Non-oil growth is estimated to have risen to 2.8% in 2018 from 2.2% in 2017, and is forecast at 3.0% in 2019. The recovery in consumer spending that helped growth through 2017 may have peaked, though with inflation still low and employment growth steady, prospects remain reasonable. Meanwhile, despite lower oil prices, fiscal policy should remain broadly supportive, with capital spending forecast to continue to rise. The pick-up in business credit growth recently also
suggests that private investment may be recovering, potentially helped by the central bank’s decision to hike interest rates more slowly than the US Fed.

In the medium term, however, growth will remain constrained by the slow pace of reforms, a lack of economic diversification and a potential slowdown in global growth. The most serious challenge facing the government is arguably the employment situation, with the private sector recently accounting for only 15% of job growth for Kuwaiti nationals which, in turn, pressuring the public sector wage bill. In addressing this, the government should focus on the skills mismatch and on measures to improve growth and the business climate, where the latest World Bank report shows that Kuwait continues to lag behind its Gulf peers. Political opposition to the government’s agenda, which includes plans for the introduction of the VAT and excise tax as well as further fuel subsidy cuts and a new debt law, are slowing reforms.

Project awards to rise after disappointing 2018

A further reason for modest growth in 2018 was a reduced pace of project activity. This has been important in supporting growth in earlier years. Project awards had reached a disappointing KD 1.6 billion by early December 2018, less than half of the KD 4 billion expected at the beginning of the year, and significantly below the average of the last five years. (Chart 2.) The low level of awards was due to delays in the implementation of megaprojects such as the KAPP Al-Zour North IWPP and the KIPIC petrochemical complex. Further setbacks came from cancelled roadworks that were scheduled to take place in the 1st half of 2018. Restructuring of relevant government agencies (PART, KAPP) may have been at the root of the delays, among other factors.

Chart 2: Planned and awarded projects

With pressure increasing from parliament and the State Audit Bureau arising from the setbacks, and given the critical role key projects play in Kuwait’s five-year (FY2015/16-2019/20) development plan and Vision 2035, awards are expected to pick up in 2019. The bulk of awards is expected to come from the power and water, oil and gas, and construction sectors, and will include rescheduled projects from 2018.

Consumer spending growth strong but easing

Accelerating consumer spending growth has played an important role in the recovery in the broader economy over the past two years, but there are signs that the improvement may be tapering off. Growth in ATM and POS transactions eased to 8.6% y/y in 3Q18, while growth in the NBK consumer spending index slowed to a one-year low of 4.1% y/y. However, inflation is low, and other fundamentals, such as employment and credit growth, remain reasonably strong, so any slowdown in spending seems unlikely to be sharp.

Encouragingly, employment growth appears to be gradually picking up, reaching 3.3% y/y in 2Q18 from 2.4% y/y in 4Q17. The shedding of expatriate jobs in the public sector, down 14% y/y in 2Q18 mainly due Kuwaitization initiatives, has been more than offset by stronger growth in the private sector. But for Kuwaiti nationals, much of the rise in employment (around 85%) continues to come in the public sector, which will be difficult to sustain longer term. Another softer spot for the spending outlook is wage growth, which for Kuwaiti nationals (for whom data is available) has been anemic in recent quarters. This could in part reflect the low inflation environment, but also potentially poor productivity growth.

Inflation to pick up in 2019, but remain low

Inflation has come in even softer than expected in 2H18, and reached a 15-year low of just 0.1% y/y in November. (Chart 3.) Weakness continues to be driven by deflation in housing services (mostly rents), where price falls have intensified this year due to ongoing softness in the real estate market. Low rates of food price inflation – reflecting international food price trends – have also been a factor. But one measure of ‘core’ inflation, which excludes both of these items, also decelerated to 1.3% in November, half its rate of the end of last year.
We expect inflation to pick up next year to an average of 2.0% from a downwardly-revised 0.6% in 2018. But much of this rise reflects a rise in food and housing inflation after pronounced weakness in 2018. By contrast, core inflation will accelerate more modestly, to 2.2% from 1.9% in 2018, with most of the factors containing price pressures recently remaining in place. These include only moderate economic growth, the strong Kuwaiti dinar (reflecting the partial tie to the strong US dollar) bearing down on import prices, and the absence of planned subsidy cuts that pushed inflation higher in 2016 and 2017. We also do not expect the VAT to be introduced until 2021 at the earliest, while the impact of a proposed excise duty on tobacco and selected drinks would be modest.

Fiscal position to finish close to balance in FY18/19

The past two years have seen a major improvement in the fiscal position, thanks to a combination of higher oil prices and spending restraint. The deficit narrowed to 9% of GDP in FY17/18 from nearly 14% of GDP a year earlier; this year a further narrowing to just 0.5% of GDP is forecast and a balanced budget, which would be the first in four years, cannot be ruled out. (Chart 4.) Despite a recent fall, oil revenues – worth 90% of the total – are projected to rise 27% in FY18/19 based upon an average price of Kuwait Export Crude of $68/bbl, before slipping next year as oil prices fall back. Non-oil revenues are projected to see notable rises due to the resumption in 2018 of UNCC compensation payments.

Thanks to surpluses accumulated in previous years, the government’s broader financial position remains very strong, with sovereign wealth fund assets estimated at nearly $600 billion. Moreover, annual returns on these assets are worth up to 12% of GDP and not included in the headline fiscal accounts. These assets also underpin the government’s very strong AA credit rating, which has been maintained in recent years. Nevertheless, the government’s room for maneuver on fiscal policy in the near term is slightly more limited than these figures imply. General Reserve Fund assets, which are used to finance deficit shortfalls, had declined to $88 billion at end-FY17/18, and could be depleted in a few years if the oil price weakens and if non-oil revenue-generating reforms are absent. Also, the government is unable to issue any further debt until the new debt law has been passed by parliament.

CBK maintains low interest rates to support growth

Monetary policy remains geared towards maintaining the dinar’s peg to a basket of currencies dominated by the US dollar. Unlike some other GCC countries whose currencies are fixed to the dollar, the Central Bank of Kuwait (CBK) left its lending rate on hold at 3.0% in December following the 25 bps hike by the US Fed. (Chart 5.) The bank has now followed four out of the Fed’s nine rate hikes during the current tightening cycle which began in 2015, though the repo rate, a benchmark for deposits, has risen more frequently. In keeping rates low, the bank is taking advantage of the flexibility provided by the peg to an exchange rate basket 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.

The reduction in the deficit over the past two years has seen the government switch tack and boost spending to support the economy. After rising 9% last year, spending is projected to see another solid rise of 5% in FY18/19, boosted by some one-off factors but also higher transfer payments due to rising oil prices. This still leaves spending 6% below its FY14/15 peak due to large cuts in the intervening years. Expenditures are projected to fall back slightly in FY19/20 as the drop in oil prices reduces transfer payments and as some of the one-off spending items drop out. This limits the impact of lower oil revenues on the deficit, which climbs to 1% of GDP.
picked up, and remains comparatively strong at 6.4% y/y. We expect credit growth to end 2018 at 4-5% y/y and to maintain that pace in 2019, supported by a pick-up in project awards. The CBK’s relaxation of lending restrictions late in 2018 should boost household borrowing in 2019.

The dinar had, by mid-December, edged lower year-to-date against the US dollar (USD), but risen 5% versus the euro and 6% against the British pound. These changes reflect movements in the USD, which has appreciated by more than 5% on a trade-weighted basis due to a combination of strong US economic growth and rising US interest rates. It also reflects some reversal of USD weakness from 2017, when it had fallen by 8%. On a five-year basis, the dinar is still up more than 10% against the euro due to the longer-term rise in the dollar.

**Stock market sees heightened foreign interest in 2018**

Boursa Kuwait performed relatively well in 2018, supported by improved sentiment linked to continued market development efforts and inclusion in the FTSE Emerging Market index. Despite a drop in monthly trading volumes relative to previous years, 2018 saw a record KD277 million of net capital inflows, helping the All Share price index gain 5.2% – the GCC region’s third best performer. Market capitalization stands at KD 29.6 billion. While volatile global markets, rising interest rates and the drop in oil prices in 4Q18 may weigh on market sentiment, foreign interest was helped by the second phase of inclusion in the FTSE EM index in late December and going forward by a possible upgrade by MSCI in 2020 to be announced in June 2019. Moreover, the Ministry of Commerce in December proposed to remove the current 49% limit on foreign ownership of banks.

**External position improving on higher oil prices**

The current account has recovered after falling into deficit for the first time in modern history in 2016, and is forecast to record a surplus of 15% of GDP in 2018. (Chart 7.) The improvement was due to a 32% rise in oil exports driven by higher oil prices (oil receipts account for around 90% of all merchandise exports). Data for 1Q-3Q18 show goods imports up 10% y/y, boosted by imports of intermediate goods, but imports of capital goods were weak at 2%. In 2019, the surplus is forecast to dip to 10% of GDP as the fall in oil prices lowers export revenues, but import growth is expected to remain reasonably solid. We note also that income from investment (mostly government) was worth a huge 16% of GDP in 2017, more than double the level of five years earlier.

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**Source:** Thomson Reuters Datastream, NBK
Oman

Diversification efforts to proceed; public spending to remain high

Overview and outlook

- Real growth is expected to rise from an estimated 2.4% in 2018 to 3.6% in 2020 on continued gains in hydrocarbon output and non-oil activity, supported by the government’s diversification and infrastructure spending program.
- Continued high spending levels amid a slightly softer oil price environment is likely to see the fiscal deficit widen to around 7% of GDP in 2019; non-oil revenues (e.g. from VAT) should, however, begin to increase going forward.
- Inflation is expected to climb to 2.9% in 2019 from an estimated 0.9% in 2018 if the VAT is rolled out as planned.
- Public debt is likely to continue rising, to just above 50% of GDP by 2020, as the authorities pursue further debt issuances to finance the deficit, but privatization and foreign investments are also being explored.

Pro-growth reforms set to persist in 2019 and 2020

The government’s development and diversification drive will continue to support the oil and non-oil sectors, respectively. In the energy sector, the authorities are committed to developing the country’s downstream oil processes and further expanding gas production capacity. In the non-oil economy, the government will continue to realize plans for a multi-billion-dollar special economic zone in Duqm and an infrastructure development project that will connect Oman’s three major ports Salalah, Sohar and Duqm, which is likely to be a boon for trade and investment prospects in the sultanate. The non-oil economy is also likely to get a further boost from the tourism sector, which the government hopes will increase by a minimum 65% in the number of tourists by 2020. To this end, we potentially see economic growth averaging around 3.4% over 2019 and 2020, on the back of a recovery in both oil (3.3% y/y on avg.) and non-oil sector activity (3.5% y/y on avg.). (Chart 1.)

Key economic indicators

<table>
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<th>2018e</th>
<th>2019f</th>
<th>2020f</th>
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<td>-14.7</td>
<td>-5.3</td>
<td>-6.8</td>
</tr>
</tbody>
</table>

Source: Official sources, NBK estimates

Oil and gas sector outlook looks promising

Notwithstanding Oman’s participation in the OPEC+ production cut agreement, which had called for a 45 kb/d cut in Omani crude output (Oman averaged 92% compliance in 2018, according to the IEA), it is Oman’s gas sector that is increasingly driving hydrocarbon sector growth and revenues, especially following recent non-associated natural gas discoveries and new project partnerships with international energy firms. Indeed, Omani gas supplies set new records in 2018, mainly on the back of an increase in production at the BP-operated 1 billion cubic feet per day Khazzan gas field.

Earlier this year BP initiated the development of Phase 2 (Ghazeer), which is expected to add by 2021 a further 500 million cubic feet per day to its production capacity. Furthermore, state-led Petroleum Development Oman (PDO) announced that it had discovered about 4.4-4.7 trillion cubic feet and 112 million barrels, respectively, of recoverable gas and condensate reserves at Mabrouk North East. Production at this site is likely to begin in three to four years’ time.

Non-oil growth anchored on diversification strategy

In tandem with Oman’s Vision 2020 plan, the Omani government’s steadfast commitment to its diversification strategy, which sees the development of key sectors including manufacturing, transport, logistics and tourism, is likely to support non-oil GDP growth going forward. The potential gains in these respective sectors are expected to temper the
expected moderation in consumer demand within the next two years, triggered by the possible introduction of the value-added tax (VAT) in 2019. We therefore expect real non-oil GDP growth to continue to gather momentum and rise from an estimated 3.0% in 2018 to 3.3% in 2019 and 3.6% in 2020.

**Inflation to gradually rise as economy recovers**

Inflation is expected to pick up over the next two years in tandem with an economic recovery. In the event that the VAT is introduced as planned in 2H19, we expect annual inflation to rise from an estimated 0.9% in 2018 to around 3.0% in 2019. The initial impact will fade away, however, and inflation will moderate to around 1.4% in 2020. (Chart 2.)

**Fiscal deficit to widen in 2019 on higher spending**

Oman’s budget deficit is expected to rise to around 7% of GDP in 2019 as the government pursues an expansionary fiscal policy to support economic growth. The deficit should narrow to around 6.0% of GDP in 2020 as revenues are driven up by higher real oil and non-oil output. (Chart 3.)

A planned excise tax on sugary beverages and tobacco products and the possible introduction of VAT in 2019, should give non-oil revenues a further boost.

**Authorities to finance deficits via further debt issuances and the privatization of state-owned firms**

Oman’s persistently high spending has caused public debt levels to rise to almost 50% of GDP from a mere 13% of GDP in 2015. This has led to a series of credit rating downgrades, with Oman currently being rated below investment grade territory by S&P and Fitch. Nonetheless, the authorities have been successful at issuing sovereign debt, albeit at elevated cost premiums, to plug the fiscal deficit, against a backdrop of relatively modest sovereign wealth assets. Indeed, Oman sold a $1.5bn seven-year sukuk at the start of 4Q18, its second debt issuance this year after the sale of a $6.5bn conventional bond in January 2018.

In addition, the government is also looking to attract foreign investment. It plans to privatize two electricity companies, Oman Electricity Transmission and Muscat Electricity Distribution ($3.2bn in total assets), which would also help lower subsidy costs.

**Economic outlook encouraging despite downside risks**

Downside risks to Oman’s outlook stem mainly from continued budget deficits and the accumulation of public debt, which could further affect its credit rating. The planned introduction of the VAT and excise taxes next year should raise non-oil revenues and improve the fiscal balance within the next two years. In case Oman participates in a potential further round of OPEC+ production cuts in 2019, this will have a small impact on public finances and growth. However, further gains in gas output and non-oil sector activity are likely to more than offset those risks going forward.
Qatar

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

Overview and outlook

- Economic growth is expected to gradually rise to 3.0% by 2020, supported by continued infrastructure investment, regulatory reforms and output gains in the gas sector.
- Public finances are on a firmer footing thanks to higher energy prices and restrained expenditures; both the fiscal and current accounts are expected to record a surplus in 2018, of 3.1% of GDP and 9% of GDP, respectively.
- Non-resident deposit growth has recovered, while private sector credit growth should remain robust.
- Market sentiment is more positive, with the Qatar Exchange index’s 21% rise in 2018 the region’s best performance.

Economic outlook positive as confidence returns

Qatar’s economy has been performing well, with output expected to increase by an annual average of 2.7% over 2018-2020 from 1.6% in 2017 on the back of gains in the non-hydrocarbon sector, especially in manufacturing and construction, and in the gas sector, where the authorities are intent on expanding LNG capacity by 43% by 2024. Underpinning economic activity is the government’s expansive public investment program, which is now reaching an advanced stage with the FIFA World Cup only three years away. Qatar’s public finances are also on a firmer footing, with the country’s first fiscal surplus in three years expected in 2018, at 3.1% of GDP, and its foreign reserves back on the rise, thanks to higher oil and gas prices and restrained public expenditure growth.

Moreover, businesses and investors appear to have regained their confidence in Qatar’s economy: non-resident deposits are returning, private sector credit growth, led by corporates, is in the double digits, and the stock market just ended 2018 posting the highest yearly gains in the region at 21%.

Nevertheless, challenges remain, including continued dependence on the hydrocarbon sector, which is at the mercy of volatile energy prices, rising borrowing costs linked to tightening US monetary policy and regional geopolitical risks, with no sign yet of a resolution to the GCC boycott.

Growth driven by continued infrastructure investment

The non-hydrocarbon sector will continue to spearhead economic growth, rising by 4.1% y/y and 4.8% y/y in 2019 and 2020, respectively, and supported by the government’s $200bn infrastructure investment program under the auspices of the Qatar National Vision 2030. (Chart 1.)

Activity in 2018 was dominated by output gains in the manufacturing and construction sectors, with the Laffan refinery ramping up production and further progress made in relation to transportation, entertainment and real estate infrastructure projects ahead of the World Cup in 2022. The benefits resulting from regulatory reforms introduced over the last two years, such as allowing 100% foreign ownership across all sectors, accelerating the issuances of commercial and industrial licenses and offering long-term expatriates permanent residency in Qatar, should also accrue over the forecast period.

In the gas sector, the authorities’ intention to expand LNG production capacity by 43% to 110 million tonnes per annum (mtpa) by 2024 could see real output gains appear as early as

Key economic indicators

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018e</th>
<th>2019f</th>
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<td>190</td>
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<td>Real GDP % y/y</td>
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<td>- Oil % y/y</td>
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<td>- Non-oil % y/y</td>
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<td>Budget balance % of GDP</td>
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<td>3.1</td>
<td>1.3</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: Official sources, NBK estimates
2020—Qatar Petroleum (QP) has already issued its first tender for drilling rigs. Hydrocarbon sector real GDP growth should, therefore, rise from 0.3% in 2018 to 0.9% by 2020.

**Inflation subdued on continued real estate weakness**

Inflation, which is expected to average 0.3% in 2018, has been weighed down by continued weakness in the real estate sector (due to oversupply and the moderation in population growth) and by base effects relating to the spike in food prices in 2017 in the aftermath of the GCC trade boycott. Both CPI components were in negative growth territory in November 2018, falling by 2.6% y/y and 2.4%, respectively. Inflation (avg.) should pick up slowly to 2.3% in 2020 (but to more than 3.5% if the VAT is introduced in 2020).

**First fiscal surplus expected since 2015**

Qatar’s fiscal balance is expected to shift into a surplus of 3.1% of GDP in 2018, following three consecutive years of deficits. While this is due primarily to higher oil and gas revenues following the increase in energy prices, restrained expenditures (cuts to subsidies, merging of ministries etc.) and some increase in non-oil revenues are also responsible. (Chart 2.) The fiscal deficit has been financed primarily by domestic debt, although Qatar returned to the international bond markets in April 2018 with a successful $12bn sale. There was no shortage of takers.

The external current account balance, which moved into a surplus in 2017, also improved. Looking ahead, while energy prices are expected to be softer in 2019-20, it is unlikely that either account will slip back into a deficit.

**Chart 2: Fiscal and current account balance**

<table>
<thead>
<tr>
<th>Fiscal balance</th>
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<tbody>
<tr>
<td>2016</td>
<td>2017</td>
</tr>
<tr>
<td>20</td>
<td>15</td>
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</table>

Source: QCB, NBK estimates

Meanwhile, official QCB reserves (gross) in October 2018, were at $28.2bn, not far off pre-blockade levels.

**Banking sector has recovered from post-blockade capital flight, while credit growth continues to be robust**

Furthermore, thanks to timely injections of liquidity by the Qatari sovereign wealth fund, the QIA, the government was able to offset the outflows of non-resident deposits that followed the dispute. Overall, foreign bank liabilities—deposits from overseas banks, non-residents and debt securities—have increased by about 20%, as of October 2018, with non-resident inflows in particular recovering after bottoming out at QR135bn in November 2017, a drop of 27% from pre-embargo levels. Growth in the overall and private sector deposit base has been weak, though, running at 1.5% y/y and 0.5% y/y in October 2018, respectively. Base effects relating to 2017’s sizeable government deposit placements are also at play, though.

**Chart 3: Credit and deposit growth**

<table>
<thead>
<tr>
<th>Private sector credit</th>
<th>Public sector deposits</th>
<th>Private sector deposits</th>
<th>Non-resident deposits</th>
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<tr>
<td>160</td>
<td>140</td>
<td>120</td>
<td>100</td>
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<tr>
<td>Oct-16</td>
<td>Apr-17</td>
<td>Oct-17</td>
<td>Apr-18</td>
</tr>
</tbody>
</table>

Source: Qatar Central Bank

Private sector credit growth, on the other hand, has outpaced deposit growth (+11.4% y/y), thanks to increased demand from the services, general trade and real estate sectors. This is positive for the broader economy, coming against a backdrop of rising borrowing costs—the Qatar Central Bank (QCB) raised its benchmark QMR deposit rates four times in 2018 (25 bps each time) in line with the US Fed’s monetary tightening schedule.

**Qatari equities outperformed regional peers in 2018**

The benchmark Qatar Exchange (QE) index rose 21% in 2018, outperforming regional stock indices. Starting from a lower base compared to its GCC neighbors following 2017’s negative performance, Qatari equities benefitted from sizeable portfolio inflows linked to the MSCI rebalancing and generally positive sentiment linked to higher energy prices. The authorities’ relaxation of foreign ownership limits and the rating agency Moody’s affirmation of the sovereign’s Aa3 rating and its revision of the outlook on the government’s long-term issuer ratings from negative to stable also helped to instill confidence in Qatar’s economy.
Saudi Arabia

Economic growth improving amid record government spending

Overview and outlook

- Saudi economic growth is expected to increase from 2.3% in 2018 to 2.5% by 2020, with the government supporting non-oil activity through record public spending, investment and private sector stimulus programs.

- Public finances are on a more sustainable footing thanks to higher oil and non-oil revenues as well as more targeted spending; the fiscal deficit has narrowed to 4.6% of GDP in 2018 but may widen in 2019 on expected lower oil revenues.

- Government debt to reach 23.7% of GDP by 2020 due to continued deficit financing via bond and sukuk issuances.

- With private credit growth still weak (1.7% y/y in Oct 2018), rising cost of funds (as well as softer oil prices) could present a downside risk to the growth outlook.

Positive growth outlook amid record government spending

The Saudi economy has recovered after last year’s contraction, and is forecast to expand by 2.3% in 2018 on the back of record high oil production since mid-2018 and increases in non-oil sector activity. However, domestic and private sector demand has been sub-optimal, having been adversely affected by lackluster credit growth and rising costs such as the VAT, expatriate levies and higher cost of funds in the context of rising interest rates, as well as by the net loss of almost a million expatriate workers since 2017. At the same time, the Saudi unemployment rate has crept up, to 12.9% in 2018. But fiscal reform has, however, proceeded broadly in line with the government’s Fiscal Balance Program, accruing savings and generating greater non-oil revenues. The fiscal deficit, has consequently, narrowed to 4.6% of GDP in 2018; public debt, though, has edged up to 19.4% of GDP.

Looking ahead to 2020, in view of Saudi Arabia’s participation in a further round of OPEC+ production cuts, which will cap oil GDP growth, the non-oil sector will increasingly take the lead, with annual average gains of 3.2% expected thanks to elevated government spending, private sector stimulus and ongoing Vision 2030 business reforms. But the economy is likely to have to operate in an environment of softer oil prices, which could cause the fiscal deficit to widen in 2019.

Oil output rebounds but non-oil activity to drive growth

Saudi oil sector output in 2018 benefitted greatly from the OPEC+ decision in mid-2018 to boost crude production to offset falling Venezuelan and Iranian supplies, the latter due to US President Trump’s decision to reinstate stringent energy sanctions on the Islamic Republic. Saudi crude production hit an all-time high of 11.09 mb/d in November, helping to realize real oil growth of around 2.8% in 2018. (Chart. 1)

However, with Saudi Arabia signing up to another round of OPEC+ production cuts for the duration of 1H19 in order to stabilize oil prices that had dropped by more than 30% since October, crude output is not expected to increase above 10.2-10.3 mb/d. Consequently, oil GDP gains in 2019 and 2020, at 0.2% and 1.2%, respectively, will be limited, and reflect primarily increased gas production and crude flows to feed expanding refinery operations, namely the 400,000 b/d jazan refinery, which went on line in 2018.

Nevertheless, it is on the non-oil sector that the kingdom’s economic fortunes will ultimately rest.
Saudi non-oil activity has been increasing amid record budget outlays of SR1 trillion-plus and a renewed government focus on the private sector—the second phase of the SR72 billion ($19bn), four-year private sector stimulus plan was launched in November—and on capital intensive projects. Billions have been pledged on housing, tourism, transportation, power and education projects.

Sectoral data released during the year confirmed the improvement in non-oil activity, with the manufacturing component of the industrial production index, up 16.4% y/y in 2Q18, and real manufacturing GDP growth increasing to 3.2% y/y. Real estate and financial services were also positive contributors, rising by 4.2% y/y. In terms of business and consumer activity, the value of point-of-sale (POS) transactions in October had increased by 17.3% y/y and the headline figure in the Saudi Purchasing Managers’ Index (PMI) was up at a 2018-high of 55.2 in November. (Chart 2.)

Despite the gains, consumer activity remains below potential. The average PMI for 2018, at 53.7, is the lowest in the history of the survey—and well below 2011’s avg. of 60—and private sector credit growth, though rising last October to a twenty-two month high of 1.7% y/y, is still a long way off the double digit growth rates of 2011-2015. (Chart 3.)

Still-subdued consumer confidence amid rising household costs—fuel and utilities, expatriate levies, tobacco and soft drinks and the 5% VAT—have undoubtedly played a part. Consumption was also affected by the net loss of almost a million expatriate workers since the start of 2017 in the face of rising expatriate fees and an acceleration in the government’s Saudization policy.

Recognizing the adverse effect on demand, the government created the citizens’ and household allowance programs to mitigate some of the additional cost burdens and augmented citizen’s take home with SR1000 ($266) in monthly allowances and, from 2019, bonus payments for public sector workers independent of performance. The government is also reportedly considering slowing down the scheduled rate of increase in expatriate fees to ease the cost burden on both expatriates (currently SR200 per expatriate dependent per month but due to double to SR400 by 2020) and firms (currently SR400 per month for every expat worker that exceeds a Saudi employee and due to rise to SR700-800 per month by 2020). Of course, firms also face the reality of hiring costlier Saudi workers, given their higher salary expectations.

Moreover, the Saudi unemployment rate continues to creep up. The government’s Vision 2030 reform drive sought to reduce the rate to 7.0% from 11.6% in 2015. As of 2Q18, the figure had reached 12.9%—the fifth consecutive quarterly rise—as the Saudi labor force growth outpaces employment growth.

Inflation easing after the VAT-related spike in 2018

Inflation has moderated since the authorities rolled out the 5% value added tax (VAT) and instituted the second round of energy price hikes in January. Having been as high as 4.0% y/y in February, headline inflation slowed to 2.8% y/y in October 2018 on falling housing/utilities costs (25% of the CPI basket). We are not expecting inflation to increase much above 2% on average in 2019, from 2.5% in 2018, with inflationary impulses coming mainly from higher food, restaurant and transportation costs and in line with a pick-up in economic activity underpinned by the government’s expansionary fiscal stance.

Fiscal deficit to narrow by 2020

The kingdom has made considerable improvement over the last few years in rationalizing public spending, creating viable non-oil revenue streams and, ultimately, bringing down the
fiscal deficit from a peak of 15.1% of GDP in 2015 to an estimated 4.6% of GDP in 2018. (Chart 4.)

The narrower fiscal deficit of 2018 was the result of revenue growth (+29% y/y to SR895bn) significantly outpacing expenditure growth (+11% y/y to SR1,029bn). Not only did the kingdom capitalize on higher oil prices (+35% y/y at an avg. of $71/bbl) and greater export volumes, it was also able to substantially raise non-oil revenues (+12% y/y) from excise duties (tobacco etc.), expatriate levies and of course the VAT. Non-oil revenues as a share of GDP reached a high of 10%.

The authorities, recently announcing another record budget, of SR1,106bn ($295bn), for 2019 are committed to supporting the non-oil economy through austerity-mitigating social allowances and through more productive infrastructure investments. They plan to increase spending by 7.4% over actual 2018 outlays. While the government is broadly on track to achieve its balanced budget objective by 2023, 2019 could see the deficit widen, to 6.4% of GDP, rather than narrow. This is because we expect oil prices to be softer than in 2018—and indeed lower than the government’s own price forecast—and the government to continue with its expansionary fiscal policy. We believe that the authorities will be obliged to pare back some of its intended expenditure outlays to keep the deficit in check.

Public debt to rise on further bond/sukuk issuances

The government continues to finance the deficit through a combination of debt issuance (e.g. bonds, sukuk, loans) and reserve drawdowns. Public debt reached an estimated 19.4% of GDP (SR563bn) at the end of 2018, and is forecast to rise to 22.2% of GDP in 2019 and to 23.7% of GDP by 2020 (See Chart 4.) We put the government’s financing requirement at around SR188bn ($50.3bn) in 2019, higher than the government’s own forecast of SR118bn ($31.5bn), due to our lower oil price estimate. Saudi debt is still low by international standards. Meanwhile, central government deposits and reserves are estimated to have fallen to SR523bn at end-2018, a drop of SR66bn y/y (-11%), equal to half of 2018’s fiscal deficit.

Deposit growth picking up pace but rising cost of funds presents a downside risk

Total bank deposit growth rose by 1.2% y/y in October, while deposits of businesses and individuals grew by 1.9% y/y. (See Chart 3.) While weak by pre-2014 standards, it is an improvement on the negative deposit growth seen in 2017.

Funding costs, however, are on the rise, which could stifle still-weak consumer/business borrowing. SAMA just raised, for the fourth time in 2018 following the US Fed’s lead, its key policy rates, the repo and reverse repo, by 25 bps to 3.0% and 2.5%, respectively. Two further hikes are now expected in 2019.

Interbank rates (SAIBOR) have also trended upwards in 2018, by about 100 bps to 2.91% as of 19 December 2019, as the Saudi central bank (SAMA) works to maintain a positive spread with US Libor in order to stem capital outflows. (Chart 5.)

Outlook is positive, spearheaded by public investment

Government investment is expected to continue spearheading the kingdom’s development and diversification plan. While visible improvements have been made in the fiscal, economic and regulatory spheres, the outlook is still very dependent on the trajectory of oil prices. Retaining the confidence of businesses and foreign investors is paramount. Feeding into that, however, the authorities are sure to have recognized the value of managing expectations and perceptions.
Overview and outlook

- Real GDP growth should continue to trend upwards, rising from an estimated 2.2% in 2018 to 2.7% in 2020, supported by the non-oil economy and especially by gains in the construction sector.

- We see inflation slowing from an estimated 3.5% in 2018 to 1.5% in 2020, amid continued downward pressures, particularly from the housing component, and as the initial impact of the tax/fuel hikes wears off.

- The fiscal position is expected to improve over the forecast period on a pick-up in non-oil revenues; the deficit should narrow to 0.7% of GDP in 2019 before the balance shifts to a surplus of 1.2% of GDP in 2020.

- Credit growth is expected to gradually recover as lending to the business sector continues to gain traction.

- Lower oil prices and rising borrowing costs represent the main risks to the outlook in 2019-2020, although announced economic reforms and elevated public investment, especially in Dubai ahead of Expo 2020, are growth-positive.

Growth to rise as non-oil sector gathers momentum

Real GDP growth in the UAE is projected to continue to trend upwards over the next two years, rising from an estimated 2.2% in 2018 to 2.4% and 2.7% in 2019 and 2020, respectively. (Chart 1.) While headline growth will see only a moderate contribution from the oil sector, on account of the UAE's participation in another round of OPEC+ production cuts in 2019 in order to balance oil supply (and thus support oil prices), it will, nevertheless, benefit from elevated construction activity and government spending ahead of the Expo 2020 on the non-oil side. The UAE cabinet, in October, approved a record federal budget of Dh60.3bn for the 2019 fiscal year. Credit growth will likely continue to recover as gains in business lending activity offset some of the monetary tightness stemming from higher interest rates. Further falls in oil prices represent the greatest risk to the outlook, in terms of lower government revenues, which could possibly force the government to scale back spending, and in terms of business confidence and banking sector liquidity.

Key economic indicators

<table>
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<tr>
<th>Indicator</th>
<th>2017</th>
<th>2018</th>
<th>2019e</th>
<th>2020f</th>
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<td>Nominal GDP (USD bn)</td>
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<td>405</td>
<td>416</td>
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<tr>
<td>Real GDP % y/y</td>
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<td>Oil % y/y</td>
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<td>Non-oil % y/y</td>
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<td>2.8</td>
<td>3.0</td>
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<tr>
<td>Inflation % y/y</td>
<td>2.1</td>
<td>3.5</td>
<td>2.0</td>
<td>1.5</td>
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<td>Budget balance % of GDP</td>
<td>-3.8</td>
<td>-1.2</td>
<td>-0.7</td>
<td>1.2</td>
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</table>

Source: Official sources, NBK estimates

Only a marginal boost in oil GDP expected in 2019-20...

In 2019, according to the OPEC+ production agreement, the UAE is expected to pare back crude production by 2.5% (from October 2018’s reference level) to 3.10 million barrels per day, starting January. Despite the cut, output in January will still be 8.2% higher y/y, and as such, we think real oil GDP growth is still likely to rise next year, from an estimated 0.6% in 2018 to 0.8% in 2019. It should accelerate further to 1.0% in 2020 as the UAE expands its oil production capacity in anticipation of higher demand.

...but non-oil activity to benefit from 2018’s economic reforms

Meanwhile, the non-oil sector is expected to remain supportive of overall growth, expanding by a healthy 3.0% and 3.4% in 2019 and 2020, respectively, mainly due to increasing construction activity ahead of Dubai’s Expo 2020 event.

In an effort to prop up growth, the federal authorities and the governments of Dubai and Abu Dhabi announced a raft of pro-growth reforms throughout 2018. At the federal level, the authorities approved the issuance of residency visas of up to 10
years to investors and highly skilled expats, such as specialists in the scientific, technical, medical and research fields, and will allow expatriates to seek extended residency visas after retirement. The authorities also raised the share that foreigners are permitted to own of local businesses (based outside of designated “free zone” areas) from 49% to 100%.

Moreover, in further support of foreign direct investment (FDI), the UAE president issued a new law to establish a Foreign Direct Investment Unit in the Ministry of Economy. The unit will be responsible for promoting initiatives that help create a more attractive investment environment. The UAE is determined to boost inward investment and diversify its financing options away from public funding. According to the finance minister, FDI is expected to increase by almost 6% y/y in 2018 to reach $11-11.5bn, which is by far the largest in the region. The authorities are eyeing a further 15-20% increase by end-2020.

Meanwhile, Abu Dhabi recently revealed further details of its new three-year, Dh50 billion stimulus plan, which will be called ‘Tomorrow 21’ and directed at four main sectors: business and investment; society; knowledge and innovation; and lifestyle. Additionally, companies based in the capital’s free zones will be allowed to operate on the mainland under a dual license. This should help reduce the cost of doing business, improve competitiveness and boost foreign investments.

The most recent figures showed real growth in Abu Dhabi rising from a mere 0.1% in 1Q18 to 1.5% y/y in 2Q18, thanks to increased crude output and non-oil activity. (Chart 2.)

Dubai’s economic growth registered 2.5% y/y in 4Q17, driven by the emirates’ construction and hospitality sectors. The measures announced above are likely to give these sectors a further boost. Indeed, the Dubai Economy Tracker index leapt from 52.5 in October to a five-month high of 55.3 in November, as growth in the construction sector accelerated ahead of the Expo 2020.

Tourism was also a major contributor, with the number of passengers passing through Dubai International Airport coming in at a record high of 24 million in 3Q18, above the average of 22 million recorded in 2017.

Dubai’s residential property prices maintained their downward trend in 2018

The impact of more stringent loan-to-value regulations on Dubai’s residential property market continues to be compounded by the effects of increased supply, higher interest rates and changing demand patterns—tenants are increasingly opting for more affordable housing units. According to Asteco, the average prices of apartments and villas fell at a faster rate (-13.6% y/y) in 3Q18 than in 2Q18 (-9.3% y/y). (Chart 3.)

Inflation higher in 2018 but should slow in 2019-2020

After rising in January following the introduction of a 5% VAT and the paring back of fuel subsidies, inflation trended downwards in 2018 as the initial impact of the tax/fuel hikes wore off, food price rises moderated and housing costs fell deeper into deflationary territory. Latest data showed inflation easing from 1.6% y/y in October to just over a one-year low of 1.3% y/y in November. We see inflation (avg.) slowing from an estimated 3.5% in 2018 to 1.5% in 2020.

Fiscal balance to gradually improve over 2019 and 2020

The fiscal deficit is expected to gradually narrow to 0.7% of GDP in 2019 from an estimated 1.2% of GDP in 2018, on mainly higher non-oil revenues, in-line with an improvement in the business climate. (Chart 4.) A surplus of 1.2% of GDP
should be on the cards for 2020. In October, the UAE cabinet approved a balanced budget of Dhs 60.3 billion ($16.4bn) for the 2019 fiscal year, 17.3% higher than 2018's expected outlay. This is the highest budgeted spending on record.

**Chart 4: Budget balance**

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

<table>
<thead>
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<th>Year</th>
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<tr>
<td>2018</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2019</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2020</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: UAE Ministry of Finance, IMF, NBK estimates

**Lending activity but also cost of funding on the rise**

Having bottomed out at the end of 2017, total credit growth has since trended upwards, reaching 3.7% y/y in November 2018 on increased corporate lending. (Chart 5.)

**Chart 5: Bank loan and deposit growth**

(% y/y)

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan-to-deposit ratio</th>
<th>Bank loans</th>
<th>Bank deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>Dec-13</td>
<td>Dec-14</td>
<td>Dec-15</td>
</tr>
<tr>
<td>2014</td>
<td>Dec-14</td>
<td>Dec-15</td>
<td>Dec-16</td>
</tr>
<tr>
<td>2015</td>
<td>Dec-15</td>
<td>Dec-16</td>
<td>Dec-17</td>
</tr>
<tr>
<td>2016</td>
<td>Dec-16</td>
<td>Dec-17</td>
<td>Dec-18</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream

Lending to the business and industrial sectors increased by a strong 6.5% y/y in November. With construction activity expected to continue apace ahead of Expo 2022, credit growth should continue to gain traction.

Despite slowing from 7.5% y/y in October to 6.5% y/y in November, deposit growth has also been on an upward trend in 2018. The recent slowdown was attributed to an easing in both government and private sector deposit growth. Broad money supply (M2) growth, however, continues to hover in the low single digits, near multi-year lows.

Meanwhile, in response to the tightening in monetary policy in the US, the cost of funding in the UAE has been on the rise. The most recent federal funds rate hike, of 25 bps in December—the fourth rate increase this year—was followed immediately by a 25 bps increase in the UAE's benchmark rate to 2.75%. At least one, possibly two more rate hikes are expected in 2019. Also, the 3-month interbank rate (EIBOR) was up 109 bps year-to-date (ytd) as of mid-December.

**Real estate sector woes weigh on Dubai’s stock market**

Equities on the Abu Dhabi Exchange (ADX) and Dubai Financial Markets (DFM) were on opposite trajectories in 2018. While the ADX was up almost 10% ytd (as of mid-December), thanks to the improvement in oil prices, the DFM was down 26% on continued weakness in the property sector. (Chart 6.) Indeed, real estate stocks were down almost 40% ytd.

**Chart 6: Main UAE stock indices**

(index; rebased, 20 December 100 =2013)

<table>
<thead>
<tr>
<th>Index</th>
<th>December 13</th>
<th>December 14</th>
<th>December 15</th>
<th>December 16</th>
<th>December 17</th>
<th>December 18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dubai general</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Abu Dhabi all</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream

**Downside risks to the outlook center on oil prices**

As ever, oil prices are central to the outlook. Government spending and hence non-oil activity is largely determined by it. Oil also has knock-on effects in terms of banking sector liquidity and broader consumer confidence. Moreover, with the US Fed expected to tighten interest rates further in 2019, borrowing costs are rising, potentially dampening business activity. However, Dubai’s Expo 2020 expansive public investment program and the UAE’s broader economic reforms should prove to be positive for economic growth.
Egypt

Economic outlook promising as government reforms continue apace

Overview and outlook

- Economic growth will remain robust at 5.2% in FY2018/19 as Egypt’s economic reform program continues.
- Given the current and expected inflation rates, the central bank may remain cautious about easing monetary policy.
- The fiscal position has improved, driven mainly by higher tax revenues, cuts in subsidies and containment of the wage bill.
- The external account is expected to narrow to about 2% of GDP in 2018/19 due to improved external competitiveness.

The Egyptian economy has been recovering nicely since the adoption of a strong and ambitious economic reform program in late 2016, supported by $12bn from the IMF. The significant progress made so far won the praise of all and ushers in a new era for Egypt. Indeed, growth has been strong, the budget deficit has contracted, the unemployment rate has started to drop and the public debt dynamics have improved. Egypt is still facing a number of risks, though, including high exposure to external shocks, persistently high inflation, and high debt servicing costs. However, with steadfast implementation of reforms, a more competitive currency, a stronger fiscal position and a lower debt level, as well as an improved regulatory environment, the outlook for the next two years is favorable.

Growth continues its momentum

GDP growth reached 5.3% in the fiscal year 2017/18, the fastest pace in a decade, and continued at the same rate in the first quarter of the FY2018/19 (3Q18). Growth was supported mainly by a strong pick-up in government investment spending, a continued increase in natural gas production and a recovery in the tourism sector. As a result, the unemployment rate fell to 10% in 3Q18 from 11.9% a year earlier.

However, the Purchasing Managers Index (PMI), while showing a pick-up in activity over the first quarter of the FY2018/19 (avg. of 50.5 in July-September), fell again into contraction territory in the second quarter (October-December), reaching an average of 48.2. This suggests some weakness in the recovery of the non-oil private sector, on account of some challenging economic conditions that continued to weigh on demand.

Inflation remains higher than expected

Although the fading impact of the currency depreciation has led inflation to fall sharply from a peak of 33% in July 2017, the latest fuel and power subsidy cuts in mid-2018 has pushed up inflation, from 11.4% in May to 17.7% in October 2018, above the CBE target inflation rate of 13% (± 3%). This reflected mainly larger-than-expected successive monthly increases in the prices of fruits and vegetables (Chart 2). The headline rate has since decelerated to 12.0% in December, as the price of food and beverages fell by 6.7% compared to the previous
month. Core inflation, however, slowed from 8.86% in October to 8.3% in December, providing relative comfort to the Central Bank of Egypt (CBE).

**Chart 2: Consumer price inflation**

(\% y/y)

Source: Thomson Reuters Datastream

The recent increase in the custom dollar for non-essential goods from EGP16/$ to the market exchange rate of close to EGP17.9/$ could push inflation somewhat higher over the coming months or at least moderate its decline. The recent changes to the foreign exchange repatriation mechanism, whereby foreign investors will need to secure their foreign exchange in the interbank market rather than from the CBE, will likely lead to more flexibility in, and possibly some pressures on the exchange rate.

Moreover, prices will likely remain susceptible to upward pressures in most of 2019, especially if the fuel subsidies are fully eliminated and the indexation mechanism is introduced as planned. We expect inflation to average 14% in FY2018/19, down from 20.9% in FY2017/18, but there is a lot of uncertainty on how domestic prices will evolve depending on what will happen to oil and import prices, and on exchange rate movements, among others.

**Monetary Policy will likely remain tight**

With inflation remaining relatively high, the CBE will likely be more cautious about easing monetary policy; it may keep its interest rates unchanged during this fiscal year at 16.75% for its overnight deposit and 17.75% for its lending rate.

In this context, monetary policy faces a difficult dilemma. On one hand, it needs to maintain high interest rates to attract foreign capital to serve its financing needs in foreign currencies. But on the other hand, it wants to reduce the cost of borrowing to encourage investment and boost economic growth, as well as reduce debt service to reach the budget deficit target. However, it would be prudent to maintain and entrench macroeconomic stability first by keeping inflation under control and this would open the door for a later reduction in interest rates and a pick-up in private sector activity.

**Budget deficit narrowing gradually, but still large**

Egypt’s fiscal position has improved, driven mainly by higher tax revenues, cuts in energy subsidies and containment of the wage bill. The budget deficit narrowed from 10.7% of GDP in FY2016/17 to 9.7% of GDP in FY2017/18, and the recent figures still point to further improvement. (Chart 3.) Indeed, the fiscal deficit narrowed slightly to 1.9% during the first quarter of FY2018/19, down from 2% during the same period in the last fiscal year. This gives the government more room to meet its budget deficit target of 8.4% of GDP for the current fiscal year and 7% for the FY2019/20.

Given recent trends, we think these targets are achievable, especially after the recent plunge in the price of oil from a high of $80/bbl to around $60, which has given Egypt considerable fiscal space. But there are also risks to the downside and Egypt could miss its fiscal targets if oil prices increase above the benchmark oil price set in the budget (between USD 65/b and USD 67/b), or if government debt service costs continue to increase in line with the global increase in interest rates, absent other compensatory measures. In fact, back in September, the CBE had to cancel a number of bond auctions as banks and investors required higher interest rates than the government was willing to pay, in view of the negative impact on their fiscal deficit targets.

**Chart 3: Fiscal balance**

(\% of GDP)

Source: Thomson Reuters Datastream, NBK

As per debt dynamics, the public debt ratio has declined from 108% of GDP in FY2016/17 to an estimated 98% during FY2017/18, driven mainly by the gradual fiscal consolidation underway and combined with a further pick-up in real GDP growth. We expect government debt to reach 94% of GDP in the FY2018/19 and 88% next fiscal year, while recent state budget guidelines for FY2019-20 released in October had set a public debt target of 79.3% of GDP by FY2021/22.

However, in this context, Egypt has planned to diversify its debt instruments (promoting its international bonds in Asia and issuing green bonds and sovereign Sukuk), as part of its efforts to improve its debt structure and reduce borrowing...
costs. Therefore, given that the domestic interest rate will remain more expensive than planned by the budget, the ratio of external debt to total debt will likely increase in the coming year.

**Current account deficit keeps narrowing**

The external sector has gained considerable strength since the depreciation of the EGP, supported by some export growth due to improved competitiveness as well as lower imports. The current account deficit in fiscal year 2017/18 narrowed by 58.6% to $6bn, falling to 2.5% of GDP from 6.1% of GDP ($14bn) a year ago. (Chart 4.) We expect the current account deficit to narrow further to about 2% of GDP in 2018/19, helped by decreasing energy imports and continued recovery in the tourism sector.

**Chart 4: Current account balance**

(\(\%\) GDP)

Source: Thomson Reuters Datastream, NBK

Meanwhile, the overall balance of payments registered a surplus of $12.8bn compared with a surplus of $13.7bn in the same period a year earlier, aided by large capital inflows. FDI inflows were strong at $7.7bn (3.2% of GDP) in the fiscal year 2017/18, driven by hydrocarbon investments, while portfolio investment declined recently, as emerging markets witnessed capital flight with some countries experiencing currency crisis (Turkey and Argentina). This improvement in Egypt’s external position has led foreign reserves to rise to record levels of USD 44.26bn in FY2017/18, covering about eight months of Egypt’s commodity imports. (Chart 5.)
### Regional economic data and forecasts

<table>
<thead>
<tr>
<th>Country</th>
<th>Nominal GDP</th>
<th>Real GDP</th>
<th>Oil sector</th>
<th>Non-oil sector</th>
<th>Budget balance</th>
<th>Current account balance</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>USD bn</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
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<tr>
<td>Kuwait</td>
<td>USD bn</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
<td>% y/y</td>
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<tr>
<td>Oman</td>
<td>USD bn</td>
<td>% y/y</td>
<td>% y/y</td>
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<tr>
<td>Saudi Arabia</td>
<td>USD bn</td>
<td>% y/y</td>
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<td>% y/y</td>
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### International data

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<th>2017</th>
<th>2018e</th>
<th>2019f</th>
<th>2020f</th>
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<tbody>
<tr>
<td>Brent crude oil spot price (year average)</td>
<td>$/b</td>
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<td>53.5</td>
<td>45.7</td>
<td>54.9</td>
<td>71.5</td>
<td>65.0</td>
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<td>CRB commodity price index*</td>
<td>Index</td>
<td>437.8</td>
<td>374.8</td>
<td>423.1</td>
<td>432.5</td>
<td>409.2</td>
<td>-</td>
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<tr>
<td>Eur/USD*</td>
<td>1$ = €</td>
<td>0.827</td>
<td>0.921</td>
<td>0.951</td>
<td>0.833</td>
<td>0.872</td>
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<td>US Fed Fund Rate</td>
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<td>0.75</td>
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<td>Index</td>
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<td>1,761</td>
<td>2,103</td>
<td>1,884</td>
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<td>MENA real GDP (IMF/NBK)</td>
<td>% y/y</td>
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<td>5.2</td>
<td>1.8</td>
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<tr>
<td>World real GDP (IMF)</td>
<td>% y/y</td>
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<td>3.3</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
</tr>
</tbody>
</table>

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