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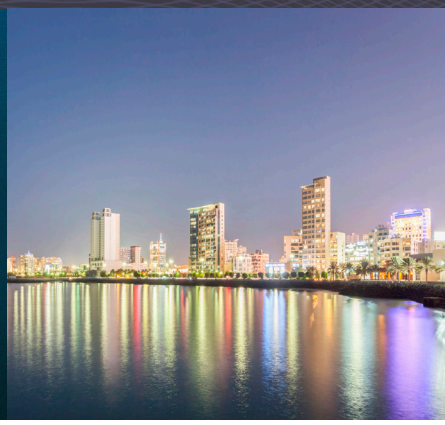
MENA Economic Outlook



1Q 2018

- GCC growth to pick up in 2018 despite oil output restraint
- Fiscal deficits to decline further as reforms gain momentum
- Oil prices rise, but market rebalancing will take time

MENA Economic Outlook
1Q 2018

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MENA outlook

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GCC growth to pick up as pace of reform accelerates; oil prices to remain steady

Overview and outlook

- **The broad-based upswing in the global economy will continue into 2018. But with inflation low, monetary policy will be tightened only gradually.**
- **The global oil market is set to rebalance only slowly, with US shale output continuing to hit modern-day highs. Oil prices are projected to remain broadly flat over the forecast period.**
- **Growth in the GCC is also strengthening. Non-oil growth will pick up to 2.4% in 2018, helped by growing momentum behind economic reform.**
- **There has been major progress on fiscal consolidation, but the GCC deficit will remain considerable at 5% of GDP in 2018, and much larger in Bahrain and Oman.**
- **Our base case is that there is no resolution to the Qatar diplomatic dispute over the forecast period, though the economic impact on the broader GCC region will remain modest.**

The current broad-based upswing in the global economy is set to continue into 2018, with growth edging up to 3.7% from 3.6% a year before. Growth in the US will be boosted by tax reform measures and, in the eurozone, by the existence of spare capacity following earlier weakness. Emerging market performance will also improve, with growth in India outpacing that in China helped by progress on reforms.

But global inflation remains subdued and, as a result, further tightening of monetary policy by key central banks will remain gradual. We forecast two 25 basis point (bp) increases in interest rates in the US in 2018, and the same in 2019. Key risks to the outlook include a slide back into protectionism, a sharp slowdown in the Chinese economy that could, in particular, affect commodity markets and financial turbulence as central banks tighten monetary policy.

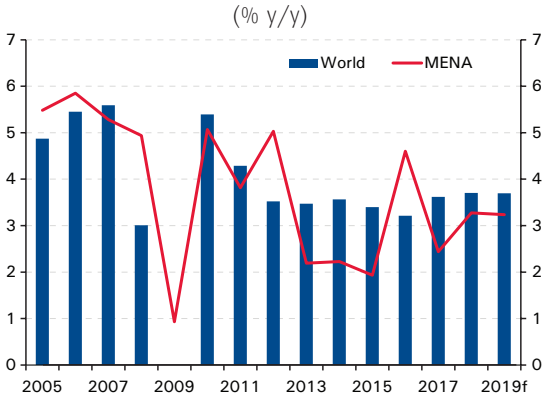
The global oil market continues to transition from a period of oversupply. The agreement among OPEC and some non-OPEC producers to limit production has succeeded in lifting oil prices well off their lows: Brent prices rallied more than 30% in 2H 2017 to stand at $63/bbl in mid-December. The expectation is that the market will continue to rebalance and global stock levels decline, but that this process will be gradual. Demand growth will be supported in 2018 by the solid global economy, but the price rally is incentivizing ever higher levels of US shale output: US oil production reached a modern-day high of 9.8 million b/d in late 2017.

GCC economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD tn	1.4	1.5	1.5	1.6
Real GDP	% y/y	2.5	0.0	2.0	2.5
Oil	% y/y	2.8	-2.7	1.2	1.0
Non-oil	% y/y	2.1	2.0	2.4	3.3
Inflation	% y/y	2.7	1.1	3.2	2.5
Budget balance	% of GDP	-12.9	-6.9	-4.9	-3.8

Source: National sources, NBK estimates

Chart 1: World/MENA GDP growth

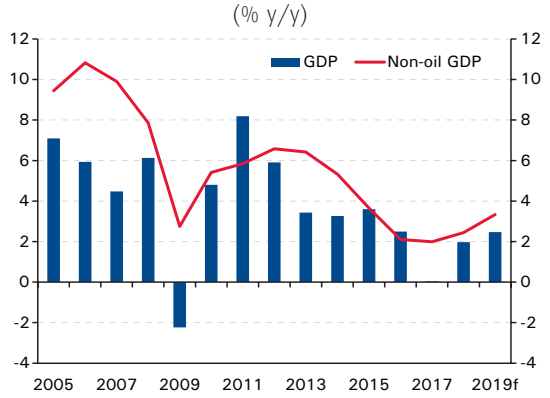


Source: International Monetary Fund, NBK estimates

Chart 2: Brent crude oil prices

Source: Thomson Reuters Datastream

Chart 3: GCC GDP



Source: NBK estimates

OPEC policy will therefore remain a delicate balancing act. The production cuts now extended to end-2018 are expected to endure, but there will be growing attention on what happens beyond 2018, with a disorderly unwinding of the current agreement risking a supply surge that would push prices lower. In our baseline, oil prices average $55/bbl in 2018 and 2019, unchanged from 2017.

In the GCC region, economic conditions are also strengthening – regional GDP will rise 2% in 2018 after stagnating a year earlier. Admittedly, much of this pick-up is linked to changes in oil output driven by OPEC policy: production is assumed to be more or less flat in 2018 after the steep cuts seen in 2017, while there is some upside in Qatar if the Barzan gas project comes on-stream. But non-oil growth is also expected to improve to 2.4% from 2% in 2017, helped by a combination of stronger world growth, an easing in the pace of fiscal consolidation, stable oil prices, only gradual tightening of monetary policy and progress on economic reforms. The UAE could see the fastest non-oil growth in the region, at 3.7%, helped by rising investment spending ahead of Expo 2020, with Kuwait and Bahrain only slightly behind.

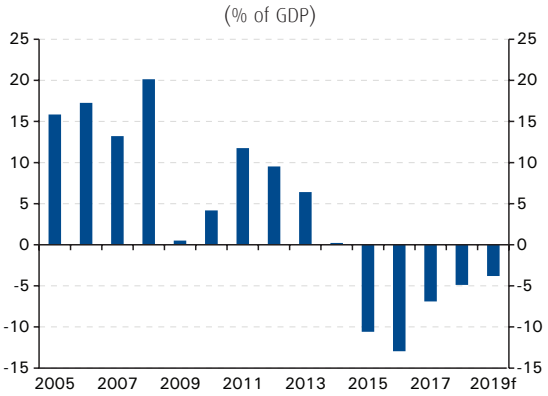
The regional fiscal deficit narrowed sharply in 2017 to 6.9% of GDP from 12.9% a year earlier, though around three-quarters of this was due to rising oil receipts. A further, albeit more modest, decline to 4.9% of GDP is forecast for 2018. Fiscal adjustment has so far focused mostly on government spending, which was cut 16% between 2014 and 2017. While spending restraint is likely to remain a feature of the policy landscape, attention is expected to shift towards increases in non-oil revenues, which will be more administratively complex to implement. The value-added tax (VAT), for example, is expected to be introduced in Saudi Arabia and the UAE early in 2018, and could net 1% of GDP in revenues. Fiscal adjustment in both Bahrain and Oman remains a major challenge and, with deficits still at 10-12% of GDP, neither looks likely to balance until well into the next decade, leaving both vulnerable to a deterioration in funding conditions.

Commensurate with improving growth performance and firmer oil prices, financial conditions also now look more stable. Although loan growth remains generally soft due to cuts in investment spending and headwinds facing consumers, liquidity conditions have improved thanks in part to the continued wave of sovereign debt issuance, with all governments barring Qatar issuing large dollar bonds and sukuk in 2017. Further issuance is expected in 2018, with investors attracted by still high credit ratings in most countries and the growing momentum of economic reform. One regional weak spot has been the equity market, with the GCC MSCI index down 5% year-to-date in mid-December.

On top of the GCC's economic challenges, the Qatar diplomatic crisis has injected political uncertainty. The Qatari economy itself appears to have weathered the initial shock from the imposition of trade and travel restrictions: import levels have recovered with the help of new trade routes; the spike in food prices was smaller than feared; and banking sector outflows have been offset by the injection of government funds. But the economic impact is also likely to accumulate over time, and the spotlight on Qatar will grow ahead of the World Cup in 2022. Our base case is that there is no resolution to the crisis over the forecast period and we expect non-oil growth in Qatar of a modest 3% in 2018 and 2019. The economic impact on the GCC more broadly will be limited, though the recent announcement that Saudi Arabia and the UAE will forge closer economic and political ties looks likely to slow any further region-wide integration efforts.

Elsewhere, growth in the MENA region overall is set to pick up to 3.3% in 2018 from a weak, base effect-influenced 2.4% in 2017. One key component is the turnaround in the Egyptian economy, where a combination of the weaker currency, capital inflows, recovering tourism and structural reforms look set to push growth back above the 5% mark.

Chart 4: GCC fiscal balance



Source: NBK estimates

Bahrain outlook

Non-oil growth supported by elevated project spending

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Overview and outlook

- **Non-oil growth will remain resilient in 2018 and 2019, with GCC investments keeping infrastructure spending levels elevated. This will help offset continued oil sector weakness and keep overall growth close to 3.0%.**
- **Inflation will rise to 2.5% in 2018 on the planned VAT as well as firmer housing and food inflation. The VAT is expected to add some 2% to the overall inflation rate.**
- **The budget deficit is forecast to gradually narrow, but remain high at 8-10% of GDP. Public spending levels will stay elevated to support infrastructure projects.**
- **Weaker foreign reserve levels are applying pressure on the long-standing currency peg to the US dollar. But we expect the government to remain committed to the peg.**

Resilient non-oil sector keeps overall growth at solid levels

Growth will continue at a decent pace of around 3% in 2018 and 2019, as resilience in the non-oil economy continues to offset weakness in the oil sector. (Chart 1.) Oil sector output is set to be flat in 2018 given Bahrain's participation in the OPEC/non-OPEC oil production cut deal, now extended to the end of 2018. With an average compliance rate of only 54% so far in 2017, Bahrain could potentially cut oil output further in 2018. However, given that its share of overall production cuts is very small, it may not be pressured to more fully comply with the deal. As a result, we see Bahrain keeping oil output levels broadly steady. In 2019, we expect oil activity to pick up and grow by 1.4% as the production deal unwinds and on the back of a new 350,000 b/d offshore oil pipeline connecting to neighboring Saudi Arabia.

The new pipeline is part of Bahrain's plans to expand its refinery capacity. It will replace the 230,000 b/d pipeline, which the government-run Bahrain Petroleum Company was forced to temporarily close in November after an explosion the government claims was carried out by terrorists. Officials say production was restored within a couple of days.

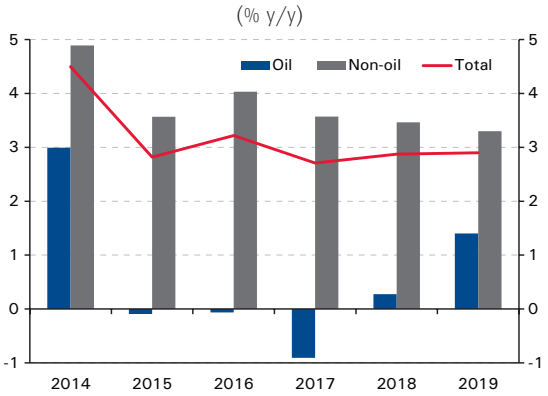
Bahrain produces around 200,000 b/d of oil, most of which is from the Abu Safa field shared with Saudi Arabia. Bahrain is looking into expanding output from its domestic field by tapping into unconventional gas.

Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	32	34	36	38
Real GDP	% y/y	3.2	2.7	2.9	2.9
- Oil	% y/y	-0.1	-0.9	0.3	1.4
- Non-oil	% y/y	4.0	3.6	3.5	3.3
Inflation	% y/y	2.8	1.0	2.5	2.5
Budget balance	% of GDP	-13.5	-12.1	-9.7	-8.0

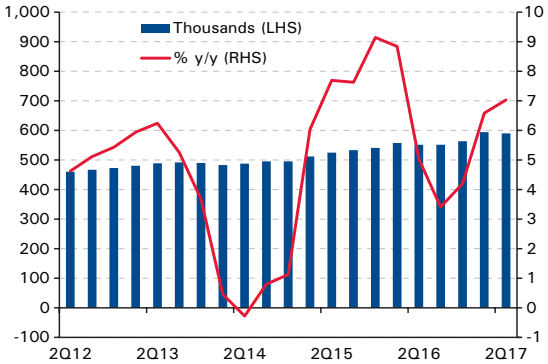
Source: Official source, NBK estimates

Chart 1: Real GDP



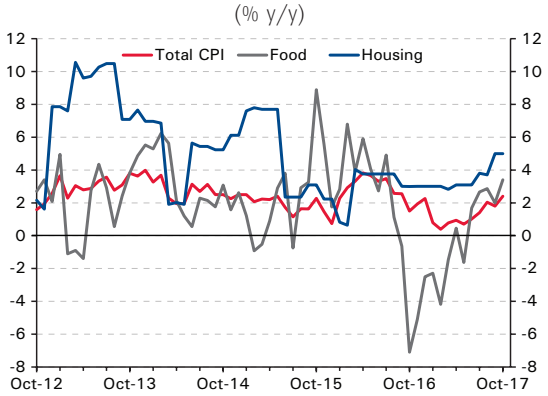
Source: Information & e-Government Authority, NBK estimates

Chart 2: Total employment



Source: Information & e-Government Authority

Chart 3: Consumer price inflation by sector



Source: Thomson Reuters Datastream

To expand its energy mix, Bahrain is building its first liquefied natural gas (LNG) terminal. It is expected to be completed in 2019 and will allow the import of up to 0.8 billion cubic feet of gas per day for domestic use. There is talk that Saudi Aramco could link up the terminal with other GCC countries. If so, this would in effect turn Bahrain into a hub for LNG imports for the region. Bahrain is also reportedly in talks with Kuwait's PIC about setting up a petrochemicals plant.

Non-oil sector growth, meanwhile, is projected to hold between a decent 3.0 and 3.5% in 2018 and 2019, mainly on the back of elevated levels of infrastructure spending.

Over the past few quarters, infrastructure spending has been bolstered 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. Data from MEED pointed to an impressive 20% y/y increase in executed projects in October. Key areas of project activity include the aluminium sector, an airport expansion, social housing, utilities, roads, renewable energy and telecoms. There are also plans for a second causeway linking Bahrain and Saudi Arabia, connecting Bahrain to the GCC rail network.

Non-oil growth has also been supported by healthier gains in the financial services sector, which was up an impressive 7.6% y/y in 2Q17, much higher than the 2.5% growth rate recorded during the same period in 2016. Similar trends are being witnessed across most other non-oil sub-sectors, including the transportation & communications and social & personal services sectors, which were up 9.6% y/y and 12.0% y/y, respectively. Growth in manufacturing activity was more muted in 2017 due to production disruptions at the Alba aluminium smelter (one of the largest in the world). With these disruptions resolved, growth in manufacturing activity should recover in the near-to-medium term.

The pace of employment growth has been strong if volatile since 2H14, helped by solid economic growth including a pickup in activity in the construction sector. (Chart 2.) In 2Q17, employment grew by a robust 7.0% y/y, up from 6.6% y/y in the previous quarter.

Inflation to rise in 2018 before steadying in 2019

Consumer price inflation is expected to rise in 2018, mainly on the back of a planned value-added tax (VAT) as well as firmer housing and food inflation. Latest figures showed inflation gaining momentum, reaching an over one-year high of 2.4% y/y in October. (Chart 3.) After falling sharply in 4Q16 as the initial impact of subsidy cuts petered out, food price inflation returned to positive territory in mid-2017 and is expected to rise further on the back of planned excise duties on tobacco and soft drinks.

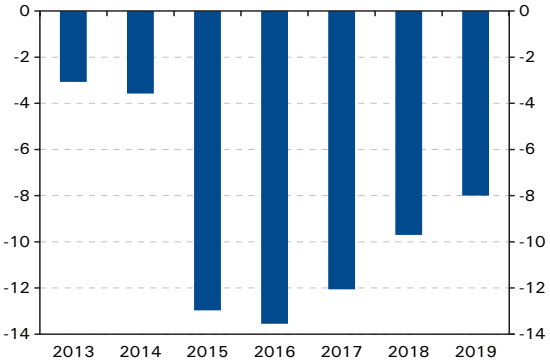
At 5%, the VAT – which we assume will be introduced in the second half of 2018 – is projected to add around 2% to the overall inflation rate for one year. We see inflation rising from around 1% in 2017 to 2.5% in 2018. We expect inflation to remain at or around that rate in 2019, given the economy's decent underlying growth performance.

Budget deficit to gradually narrow but remain very high

The budget deficit is expected to gradually narrow given ongoing fiscal consolidation efforts as well as some improvement in revenues. But the deficit will remain worryingly large at around 9.7% and 8.0% of GDP in 2018 and 2019, respectively. (Chart 4.)

Chart 4: Budget balance

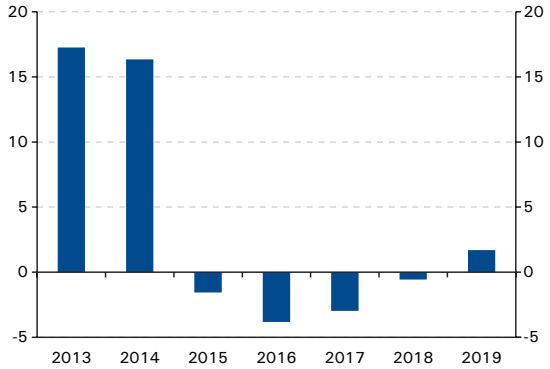
(% of GDP)



Source: Bahrain Ministry of Finance, NBK estimates

Chart 5: Current account balance

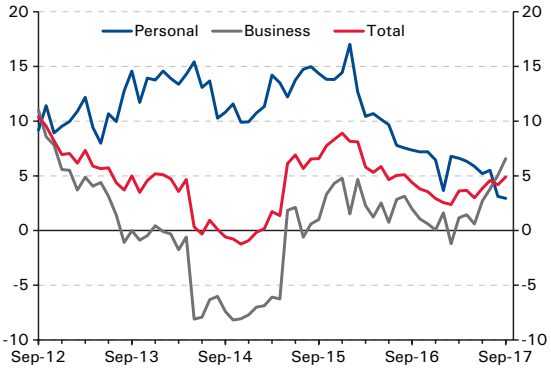
(% of GDP)



Source: Central Bank of Bahrain, NBK estimates

Chart 6: Credit growth

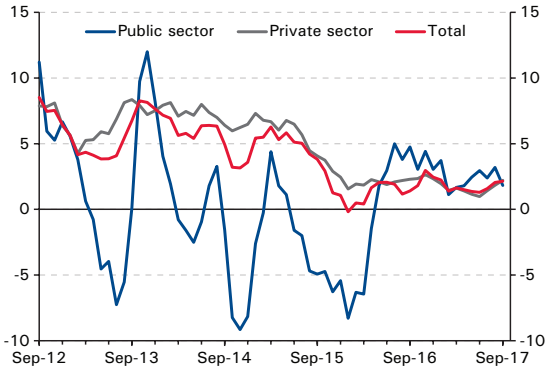
(% y/y)



Source: Central Bank of Bahrain

Chart 7: Deposit growth

(3-month moving average, % y/y)



Source: Central Bank of Bahrain

Fiscal reform has so far been centered on rationalizing subsidies. In 2015, the government lifted subsidies on meat products and approved a new pricing system for fuel to reduce subsidy costs. In 2016, it approved the removal of subsidies on housing utilities. But unlike other GCC countries, government spending in Bahrain is virtually unchanged from 2014 levels, highlighting the challenges in cutting areas such as salaries and subsidies. The VAT should raise around $0.3 billion (approximately 1% of GDP) in additional tax revenue per year.

Following a 4.4% y/y estimated rise in public spending in 2017, the state budget pencils in a 2.9% y/y decline for 2018, on the back of a drop in current expenditures. Capex growth is expected to be supported by GCC grants and come in at around 2-3% y/y in 2018 and 2019. With the cumulative sum of GCC grant allocations currently standing at less than $1.3 billion year-to-date, according to the Economic Development Board, active projects are projected to continue to grow at healthy rates. Major current projects include Alba's $3 billion expansion project, a $1.1 billion airport expansion and a gas plant project worth $355 million.

With the budget deficit hovering at high levels, the government will continue to look to domestic and international bond markets to plug the shortfall. The latest issue came in late 2017 with a $3 billion three-tranche bond, at comparatively high premiums of 5-8% and maturities ranging between 7-30 years. Government debt now stands about 10% points higher at around 90% of 2017 GDP. This figure is expected to rise to above 100% of GDP by 2019. Assuming an average interest rate on government debt of around 5%, this implies debt interest payments of around 2-3% of GDP.

Fiscal deficit and debt concerns have led to a series of downgrades of the government's credit rating, the most recent being in early December, when S&P downgraded the long-term issuer rating by one notch from BB- to B+, placing it deeper in non-investment grade territory. However, despite the downgrades, yields on five-year government debt have come off the highs witnessed in early 2016 thanks partly to a recovery in oil prices. As of end of November, yields on five-year government debt were at 4.9%, around 50 basis points lower than at the start of 2016.

Business lending gains traction after prolonged period of weakness

Growth in credit to businesses is expected to offset the continued weakness in personal loans growth, thanks to an ongoing pickup in lending activity in the construction sector. Growth in personal loans has been on a downward trend since early 2016 – albeit from a strong starting point – easing to 2.9% y/y in September. (Chart 6.) However, credit to businesses – weak in recent years – has picked up of late, climbing above 6% y/y in September for the first time since 2012, thanks in part to a continued recovery in credit to the construction sector.

Deposit growth is forecast to remain limited, with government deposits capped by the low oil price environment. Growth in government and private sector deposits stood at 1.8% y/y and 2.2% y/y, respectively, in September. (Chart 7.) With deposit growth muted, both the narrower measure of the money supply (M1) and the broader measure (M2) continue to struggle to eke out gains. In September, M1 declined 3.5% y/y and M2 growth stood near a multi-year low of 2.1% y/y. (Chart 8.)

Interest rates are expected to continue to rise, reflecting in part rises in official policy rates. The policy rate, currently at 1.75%, is expected to increase by a further 25 bps in December and a further 50 bps in 2018 and in 2019, in tandem with hikes in the US federal funds rate. Interbank

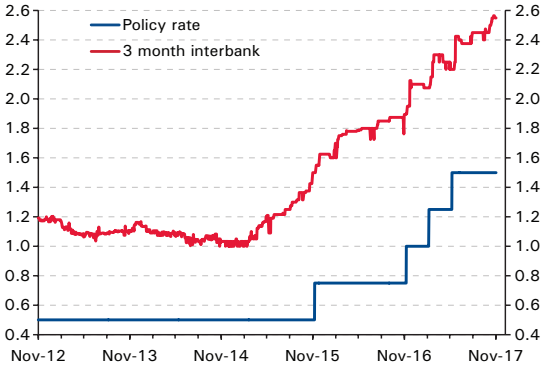
Chart 8: Money supply growth

(3-month moving average, % y/y)

Source: Thomson Reuters Datastream

Chart 9: Interest rates

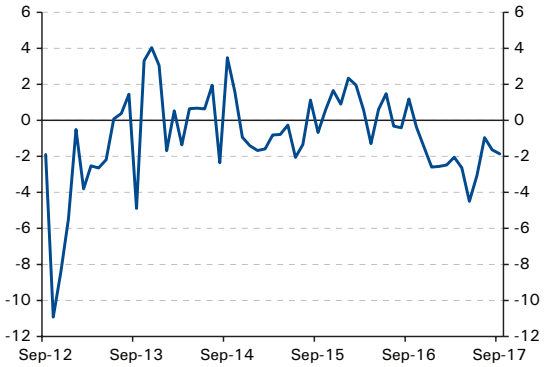
(%)



Source: Thomson Reuters Datastream

Chart 10: Total bank assets*

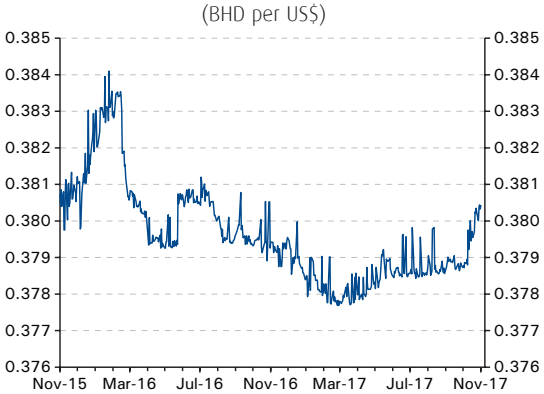
(% y/y)



Source: Central Bank of Bahrain; * Retail & wholesale bank assets

Chart 11: 12m forward FX rate

(BHD per US$)



Source: Thomson Reuters Datastream

rates jumped following the policy rate hikes of the past year. As of end-November, the 3-month rate was up 45 bps year-to-date. (Chart 9.) Whilst lending activity may come under some pressure from higher rates, the underlying strength in lending to the business sector is expected to offset some of that downward pressure and support overall credit growth.

Total commercial bank assets remained in decline in September, falling at a faster pace of 1.9% y/y mainly on the back of a continued decline in wholesale bank assets. (Chart 10.) These assets, which make up around 60% of total bank assets (as of 2016), fell by 5% y/y. In contrast, asset growth among the more domestically-centered retail banks rose for the third straight month, but still remained fairly subdued at 2.3% y/y.

Reserves and currency to remain under pressure

Given large fiscal and external deficits (charts 4 and 5), international reserves remain under pressure. The 12-month forward foreign exchange rate recently hit a one-year high (implying a new low against the US dollar), but the government has vowed to maintain the dinar's peg to the US dollar, being one of the key planks of economic and financial stability. (Chart 11.) Indeed, the proceeds from the $3 billion bond in September helped the central bank's international reserves jump to a more than two-year high of $3.4 billion from $1.4 billion in August. Furthermore, the government has reportedly asked for financial assistance from Saudi Arabia, the UAE and Kuwait to help replenish its reserves. A positive response to the request would improve the government's immediate financial position, though the prospect of such a 'bailout' may still not be viewed favorably by investors.

Bahrain stock market rally subsides in 2017

Bahrain's All Share Index moved lower through most of 2017 broadly in line with regional trends, though as of early December was actually up 3.6% year-to-date, outperforming other GCC markets. (Chart 12.) The recent climb in oil prices to above $60/bbl helped by the extension to the oil production cut deal had little visible impact, limited perhaps by continued moderate economic growth in the Gulf region, as well as geopolitical concerns including the fallout from the Qatar crisis.

Chart 12: Stock market index

(all share index)

Source: Thomson Reuters Datastream

Kuwait outlook

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Growth improving on projects and receding fiscal adjustment

Overview and outlook

- **Non-oil GDP is expected to see further recovery to 3.5-4% in 2018 and 2019 as capital spending ramps up and the consumer sector stabilizes.**
- **The fiscal deficit is seen largely steady in FY18/19 and FY19/20 with most of the fiscal adjustment behind us and oil prices stable.**
- **Inflation is expected to accelerate slightly on hikes in utility prices and dollar weakness, after easing in 2017 on cooler housing inflation.**
- **Credit growth remains robust, reflecting healthy project execution and comfortable liquidity.**
- **Stocks gained on the robust outlook and the market's upgrade by FTSE.**

The economy continues to bounce back from a 2015 slowdown, which was induced by a fiscal adjustment in the wake of the decline in oil prices. Growth in non-oil activity is expected to have improved to 3.0% in 2017, with growth seen accelerating further to 3.5-4% in 2018 and 2019. The key driver has been capital spending, bolstered by the improving implementation of the government's National Development Plan. A shift toward a more gradual fiscal adjustment should also reduce the drag on growth while ensuring continued progress on reducing the fiscal shortfall.

Substantial fiscal buffers, including large foreign reserves and a relatively low fiscal breakeven oil price, provide Kuwait with significantly more space to move gradually on fiscal adjustment than some of its GCC neighbors. As a result, authorities are keen to maintain their commitment to their capital spending plans and to continue absorbing the bulk of Kuwaiti entrants into the labor market. At the same time, the government is pushing forward with needed structural reform in an effort to encourage the private sector to play a larger role in generating new jobs in the medium-to-long term.

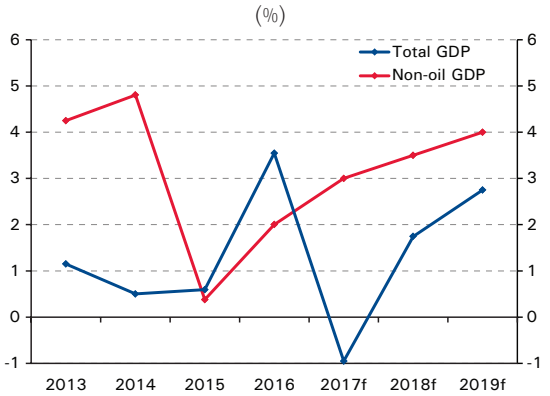
The outlook is not without its risks. Indeed, the robust growth outlook depends on a continued commitment to the projects pipeline and the ability by the various authorities to push that ahead despite bureaucratic and sometimes political resistance. Though we think this risk is low in the medium term, it could certainly materialize. Meanwhile, though the probability of oil prices moving much lower from current levels has receded for now, it remains a distinct risk. While Kuwait would be able to sustain $20 oil for some time, such a scenario is certain to alter the government's fiscal policy and hurt sentiment, with the consequent impact on non-oil activity.

Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	KD bn	33.5	37.7	39.2	41.0
Nominal GDP	USD bn	111	124	130	136
Real GDP growth	% y/y	3.5	-1.0	1.7	2.8
- Oil	% y/y	2.3	-4.5	0.0	1.5
- Non-oil	% y/y	2.0	3.0	3.5	4.0
Inflation (average)	% y/y	3.5	1.6	2.2	2.8
Budget balance*	% of GDP	-17.7	-12.5	-13.0	-12.5

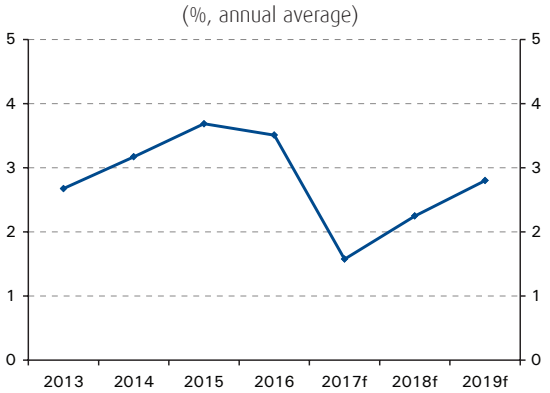
Source: CBK, MOF, CSB, NBK estimates; *after FGF

Chart 1: Real GDP growth



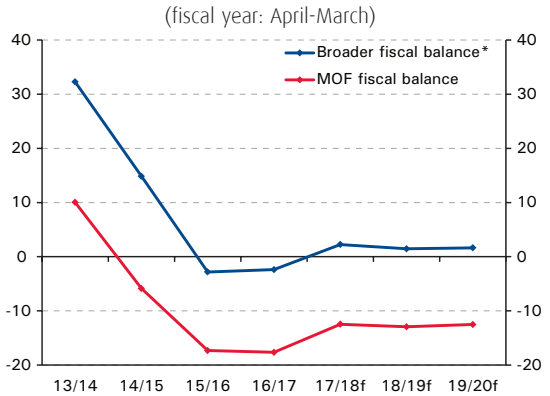
Source: Central Statistical Bureau, NBK estimates

Chart 2: Consumer price inflation



Source: Central Statistical Bureau; NBK estimates

Chart 3: Budget balance



Source: MOF, CSB, NBK estimates; * Before FGF transfer & incl. invest.inc

Non-oil growth to improve further in 2018 and 2019

After slowing in 2015, the pace of non-oil GDP growth improved to 2.0% in 2016. Non-oil growth had dropped to 0.4% in 2015, a figure which caught most analysts by surprise, including the IMF. The slowdown was largely a result of government spending cuts implemented in the wake of the mid-2014 decline in oil prices. Those cuts, which largely spared capital spending and the government wage bill, reduced spending excluding energy subsidies by 10% in FY15/16.

The fiscal adjustment has since been far smaller. There was still a decline in spending by around 2.9% in FY16/17, but outlays are expected to return to positive growth in FY17/18 and beyond. This shift to a more supportive fiscal stance should increasingly help non-oil growth in 2018 and 2019. That, combined with continued strength in project implementation and a recovering consumer sector, should help sustain non-oil growth at 3.5-4% in 2018 and in 2019.

Government project activity remains healthy

Over the last few years, an improved pace of capital spending has been a key driver of the non-oil economy. We feel that that momentum has been sustained and should continue to provide solid impetus to the economy through 2019 and possibly beyond. We estimate that over KD 28 billion worth of projects are likely to have been awarded during the last five years through the end of 2017. While the pace of project awards has slowed, the impact on growth is likely to be sustained in the medium term.

The projects pipeline remains solid, with the government still strongly committed to the ambitious capital spending program in the National Development Plan. The plan, as part of Kuwait Vision 2035, seeks to transform the country into a financial, cultural and trade leader and includes capital spending on infrastructure, housing, power and water, and the oil sector. Around a third of the spending is slated to come from public-private partnership (PPP) projects. Though progress on the PPP projects has been slow, it is expected to pick up.

Consumer sector bouncing back after slowdown

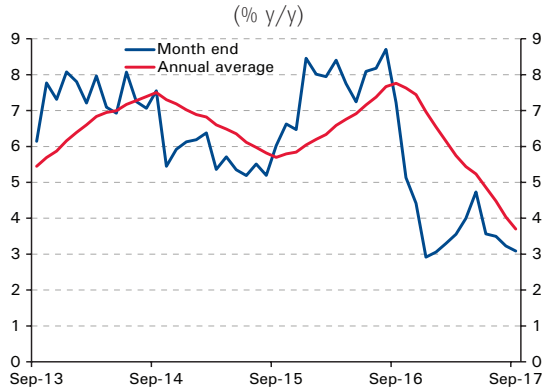
The consumer sector, long a robust and reliable source of growth, appears to be bouncing back after a period of slowdown. The sector was hit in 2015 and 2016 as a consequence of the decline in oil prices. This happened as households took a more cautious view, with the Ara consumer sentiment index falling to a low of 83 in September 2016. A year on and the index has improved significantly; the index hit 110 in September 2017. (Chart 5.)

The consumer sector continues to be well supported by steady growth in employment and salaries, particularly in the government sector and among Kuwaiti households. Employment growth among Kuwaiti nationals remains relatively solid, with public sector employment growing by around 2% y/y through June 2017. Expatriate employment has slowed but remains healthy at 3.6% y/y.

Real estate market appears to be turning a corner

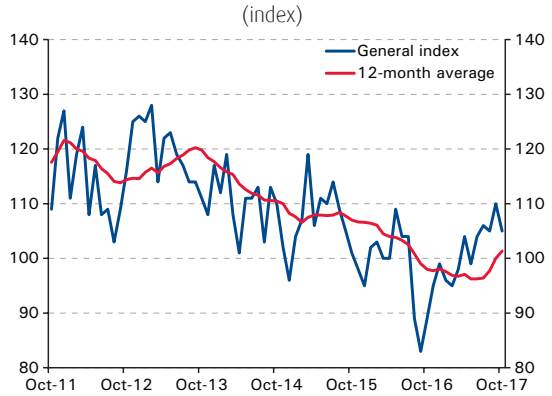
The real estate market has been showing evidence of improvement following more than two years of weakness. Sales for all sectors during the three months through October 2017 were up 33% y/y. (Chart 6.) Real estate prices also appear to have stabilized, after undergoing an orderly 15-20% correction since 2014. (Chart 7.) NBK's real estate price indices now show

Chart 4: Private credit growth



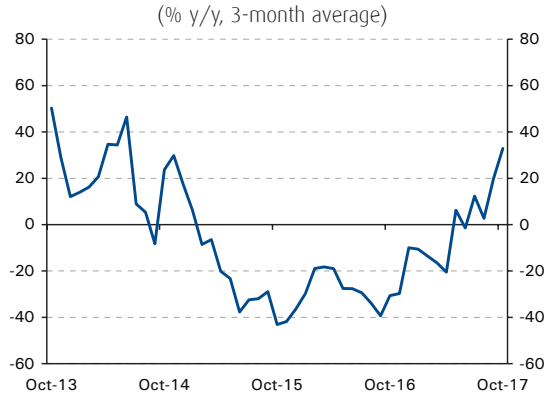
Source: Central Bank of Kuwait

Chart 5: Consumer confidence index



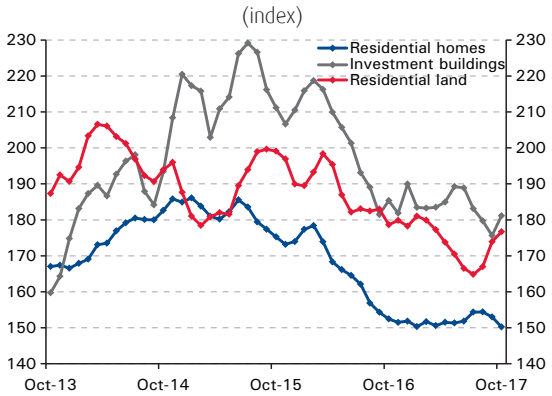
Source: Ara Research & Consultancy

Chart 6: Real estate sales



Source: Ministry of Justice

Chart 7: Real estate prices



Source: Ministry of Justice, NBK estimates

prices down 1-6% from a year ago, compared to declines of 6-13% y/y at the end of 2016.

Inflation eased significantly in 2017 on weak housing rent

New revised statistics revealed significantly lower inflation in 2017. Inflation in October eased to 1.4% y/y, down from 2.6% y/y at the end of 2016. (Chart 4.) The main source of softer price growth has been housing rent, which is now in deflationary territory with prices down 0.3% y/y. Base effects also explain the decline in inflation, especially as the fuel price hikes of September 2016 faded.

Going forward, inflation is expected to pick up pace. A moderately weaker US dollar, which implies a weaker dinar, is expected to put some upward pressure on prices in 2018. Also, the hike in utility prices taking place in stages in 2017 and early 2018 are expected to filter into the rest of consumer prices gradually in the coming year. Finally, we expect the value-added tax (VAT) to be introduced in 2019, impacting prices moderately then. As a result, average annual inflation is seen picking up from 1.6% in 2017 to 2.2% in 2018 and 2.8% in 2019.

Fiscal deficits will persist, but to remain manageable

The Ministry of Finance is expected to continue to register a deficit in the medium term, even though oil prices have improved and despite some fiscal consolidation. We expect the price of Brent crude to average around $55 per barrel in 2018 and 2019, little changed from 2017. As a result, the fiscal balance is expected to register a deficit of 12-13% of GDP in FY18/19 and FY19/20 (chart 3), after the mandatory allocation to the Future Generations Fund (FGF), a level that is largely in line with what we expect for FY17/18.

There was some good progress on fiscal consolidation during the first two years after the decline in oil prices, though we expect the pace will slow in the coming two years. The bulk of the progress came in the form of spending cuts. Expenditures were reduced by 15% and 3% in FY15/16 and FY16/17. Cuts in spending came from general belt-tightening in areas outside the wage bill and capital spending. They have also included cuts in subsidies, with fuel prices and utility rates seeing hikes.

Spending is expected to return to positive growth in FY17/18 and beyond, with the government's focus shifting to the revenue side. Fiscal reforms include the introduction of a corporate income tax and a value added tax (VAT), though both are in early stages and have yet to receive legislative approval by the National Assembly. There is a good chance that the VAT will be introduced in 2019, with the corporate earnings tax not likely before 2020. We estimate that these reforms together will boost non-oil revenues by around 2-3% of GDP by 2020.

Sovereign wealth fund remains substantial

A relatively prudent fiscal policy over the years has allowed Kuwait to amass one of the largest sovereign wealth funds (SWF) in the region. Kuwait's SWF is estimated to be worth around $560 billion or 450% of GDP as at the end of 2017, with the bulk of the assets held overseas. The assets are split between the Future Generations Fund (FGF) and the General Reserve Fund (GRF). The latter, whose holdings are mostly in liquid assets, is generally available to finance the deficit. Kuwait has continued to add to the FGF even as oil prices declined, at the expense of the GRF or increasing public debt.

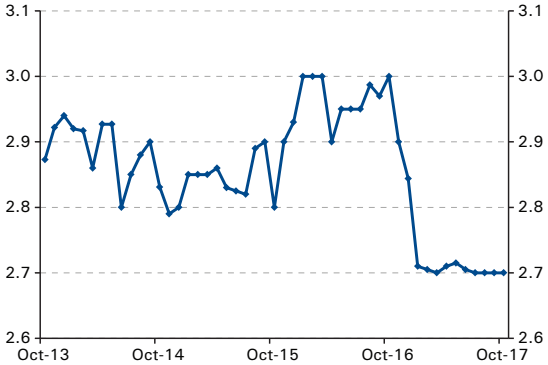
Chart 8: Oil prices

(USD per barrel, Kuwait export crude)

Source: Kuwait Petroleum Corporation

Chart 9: Crude oil production

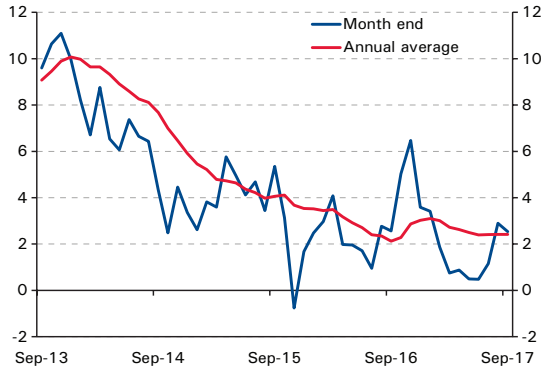
(million barrels per day)



Source: OPEC

Chart 10: Money supply growth

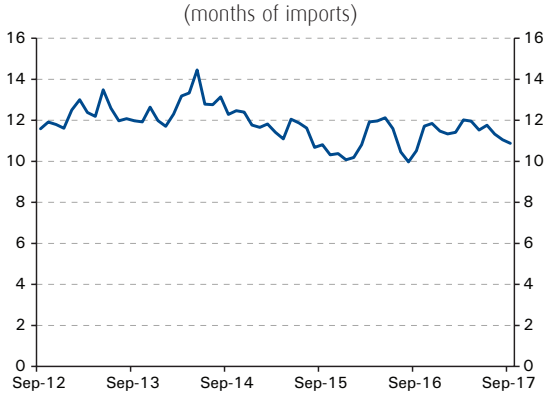
(% y/y, M2)



Source: Central Bank of Kuwait

Chart 11: Central bank foreign reserves

(months of imports)



Source: Central Bank of Kuwait, NBK estimates

Government tapped domestic and international bonds in FY16/17

Despite a large SWF, Kuwait has opted to also rely on debt to finance its deficit. Since April 2016, the government issued KD 3.6 billion in debt domestically and another KD 2.4 billion ($8 billion) internationally. This increased total debt to KD 7.1 billion or 20% of GDP as of the end of October 2017. Debt issuance has financed around two-thirds of the deficit since the April 2016.

Debt issuance has been on hold since September 2017 following the expiration of the law that allows the Ministry of Finance to issue debt. New legislation is being considered by the National Assembly which would renew the issuance mandate, double the sovereign borrowing ceiling to KD 20 billion and permit, for the first time, the issuance of 30 year debt. In the past, issuance was limited to tenors of up to 10 years.

Current account recorded its first deficit since liberation

After recording its first deficit in over two decades during 2016, the current account is expected to have swung back to surplus in 2017. A surplus of KD 0.6 billion was recorded in 2Q17, up from KD 0.4 billion in 1Q17. We expect a surplus in 2017 as a whole of around KD 1.9 billion or 5% of GDP after recording a deficit of 4.5% of GDP in 2016. The improvement has come largely on the back of a higher oil price, with the Kuwait crude oil price expected to have increased by more than 30% between 2016 and 2017.

However, after improving in 2017, the current account is expected to deteriorate slightly in 2018 and 2019. With oil prices expected to remain largely steady and continued growth in imports and worker remittances in tandem with growth in the non-oil economy, the current account surplus is seen shrinking to under 1% of GDP by 2019. (Chart 12.)

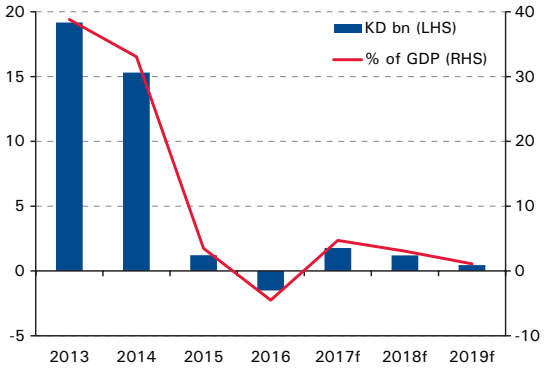
Dinar down in 2017 on dollar weakness

Following three years of gains, the Kuwaiti dinar retreated during most of 2017. A weaker US dollar has seen the dinar decline by 3.7% in trade-weighted terms year-to-date (ytd) through October 2017. The Kuwaiti currency had gained around 3% a year in the three years between 2014 and 2016. The dinar, which is pegged to a basket dominated by the US dollar, has increased by 1.1% against the US currency since the start of this year. (Chart 14.)

Already good year for equities boosted further by FTSE upgrade

After rallying in late 2016 and early 2017, equities were again boosted in 3Q17 after FTSE Russell upgraded Kuwait's market to emerging market status. Recent catalysts also included interest by Omantel to acquire a sizeable stake in Kuwait's largest telecom provider Zain. Boursa Kuwait's value-weighted index (IXW) soared by 9.1% in 3Q17. (Chart 15.) The index was up 10.5% year-to-date through October. Activity is also up in 2017, though the daily average value of shares traded has eased from peaks in January 2017.

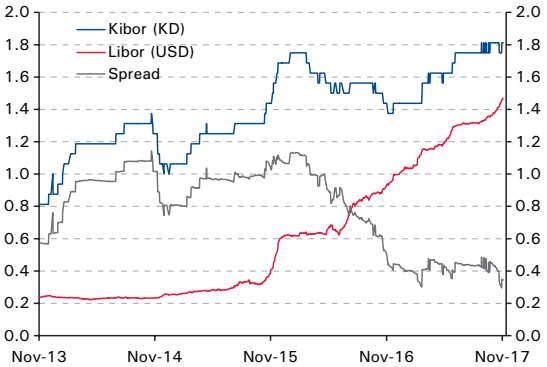
Chart 12: Current account balance



Source: Central Statistical Bureau, NBK estimates

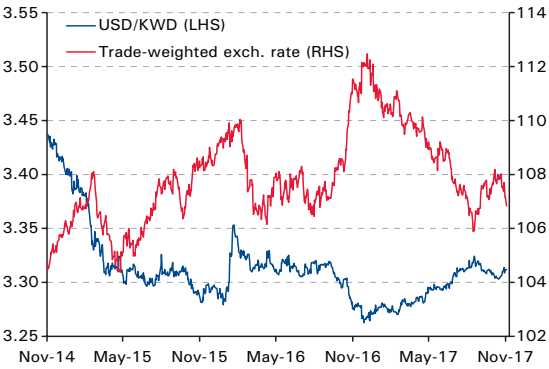
Chart 13: Interbank rates

(%, 3-month)



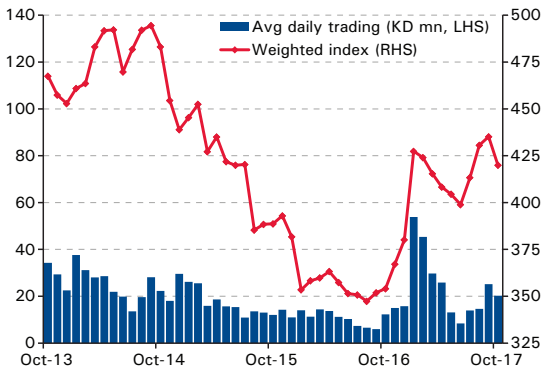
Source: Central Bank of Kuwait, Thomson Reuters Datastream

Chart 14: Exchange rate



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock market



Source: Boursa Kuwait, Thomson Reuters Datastream

Oman outlook

Rising gas output to boost GDP, but fiscal position still a concern

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Overview and outlook

- **We expect real GDP growth to pick up to 2.4 % in 2018 on a boost from gas exports and modest growth in consumption and investment, then to hold steady at 2.3% in 2019.**
- **The fiscal deficit will narrow over 2018 and 2019 but remain worryingly large at 11.6% and 10.5% of GDP, despite the introduction of VAT and increased hydrocarbon revenues.**
- **Inflation will rise in 2018 as the government implements new tax measures, with some carry-through into 2019. Meanwhile, bank lending may weaken amid an environment of rising interest rates and modest growth.**
- **The government is trying to implement Vision 2020, but weak public finances place increasing importance on foreign investment.**

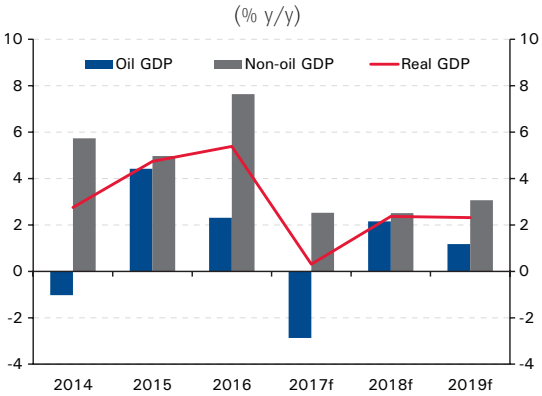
The economy is set to grow modestly in 2018 and 2019, but there are considerable vulnerabilities. Activity is still dependent on the hydrocarbon sector given the lack of progress on diversification, and low oil prices have hit growth and present a major financial challenge. The government will record several further years of large fiscal deficits, with revenues insufficient to cover current expenditures, while rising debt will increase the interest burden. Domestic concerns, regional tensions and tightening global monetary policy could lead to a weakening of the external funding climate, leaving the sovereign's reserves open to depletion.

Growth to be supported by rising gas production

We have revised our growth forecast for 2018 lower to 2.4%, from 2.9%, reflecting the recent extension to the OPEC/non-OPEC production cut deal (to which Oman is a contributor) beyond March 2018, while private and public consumption growth remain modest. (Chart 1.) The launch of BP's Khazzan project will lend a much-needed boost to the economy, in addition to the pursuit of Vision 2020, but both consumption and investment will be held back with oil prices steady and as fiscal consolidation efforts continue.

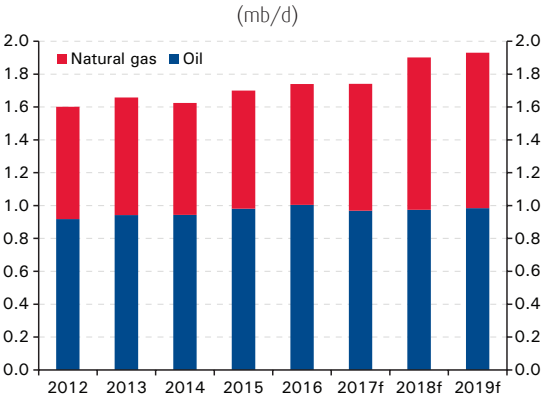
With the production cut agreement due to expire in 2019, crude oil output should return to around pre-cut levels, supporting hydrocarbon sector growth. Gas production's steady expansion towards its increased capacity of close to 5 billion cubic feet per day will further support the sector. Once fully online, BP Khazzan's new capacity will account for 10% of hydrocarbon output. (Chart 2.) Meanwhile, as the initial impact of VAT begins to dissipate, household consumption will pick-up, albeit at a modest pace. Despite the

Chart 1: Real GDP



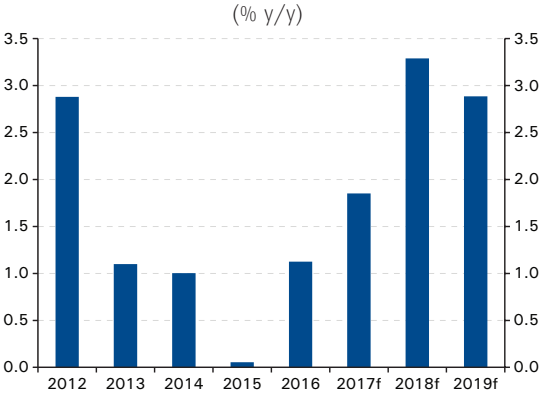
Source: National Center for Statistics and Information, NBK estimates

Chart 2: Hydrocarbon production



Source: National Center for Statistics and Information, NBK estimates

Chart 3: Consumer price inflation



Source: National Center for Statistics and Information, NBK estimates

Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	67	74	76	80
Real GDP	% y/y	5.4	0.3	2.4	2.3
- Oil	% y/y	2.4	-2.9	2.2	1.2
- Non-oil	% y/y	7.5	2.5	2.5	3.1
Inflation	% y/y	1.1	1.9	3.3	2.9
Budget balance	% of GDP	-20.6	-13.7	-11.6	-10.5

Source: National Center for Statistics and Information, NBK estimates

financial constraints, officials will continue to pursue Oman's Vision 2020, helping unclogg the pipeline of megaprojects needed to diversify the economy away from oil.

According to MEED, Oman is set to award $149 billion in projects between 2018 and 2022 (equivalent to 190% of GDP), with the bulk ($125 billion) expected in the first two years. The planned projects will focus on developing Oman's downstream, tourism, and logistics sectors, key components of the country's diversification plan, with a strong emphasis on the Duqm special economic zone.

The government's constrained financial position adds uncertainty to the vision's execution, with much riding on favorable oil prices and a friendly foreign investor environment. To that end, the government has pursued some pro-business initiatives, such as its soon-to-be revamped foreign investment law, and sourced large foreign investment partnerships and funding. A consortium of Chinese firms is set to help develop a large part of Duqm, with close to $11 billion budgeted to be invested over 15 years. In August 2017, Oman partnered with Kuwait to develop the Duqm refinery. At a capacity of 230,000 barrels per day, the refinery will be at the heart of Duqm's petrochemical complex, which is expected to be awarded in 2020. Furthermore, state-owned entities have secured external funding for core development projects, such as Oman Oil Company's $1 billion loan.

So far, the Saudi-led embargo on Qatar has been mildly beneficial for Oman, but could have negative longer-term effects if it prompts a reassessment of the region's attractiveness by foreign investors – much needed in Oman. Indeed, yields on Omani debt have risen in tandem with their Saudi counterparts, following the latter's anti-corruption crackdown.

VAT to push inflation higher in 2018 and 2019

Inflation stood at 1.6% y/y in September, on the back of a pick-up in food and transport prices. Inflation will rise further in 2018, before steadying in 2019, as the government continues to liberalize prices on energy and other goods and services and introduces VAT, late in 2H17, offsetting downward pressures from global food and energy prices. (Chart 3.) Inflation is projected to average 3% over the forecast period.

Large fiscal deficit to persist through 2018 and 2019

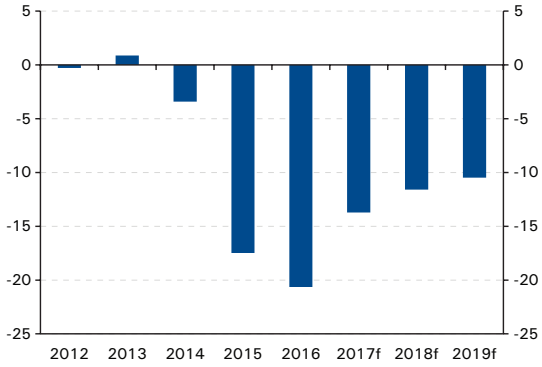
The average oil price is expected to hold steady at $55 per barrel in 2018 through 2019. Yet with Oman's estimated breakeven price averaging $92 dollars for the same period, the fiscal balance will remain in deficit indefinitely. The deficit will edge lower over the forecast period, but remain alarmingly large at 12% of GDP for 2018 and 11% for 2019. (Chart 4.) Financing these shortfalls will also be increasingly challenging.

Government revenue growth should be decent in 2018 and 2019, helped by a projected average OMR 200 million per year in receipts following the launch of Khazzan. While the implementation of the VAT is not expected until the second half of next year, it should eventually add some OMR 0.6 billion in annual receipts. As such, government revenue growth is seen averaging 6% over the next two years.

Our base case sees government expenditures expanding modestly by 1-3% per year in 2018 and 2019, as fiscal consolidation efforts become more politically challenging and economic growth eases. Sharp spending cuts, however, are possible if downside risks prevail. Regional tensions will deter the government from large cuts in defense spending, while the

Chart 4: Budget balance

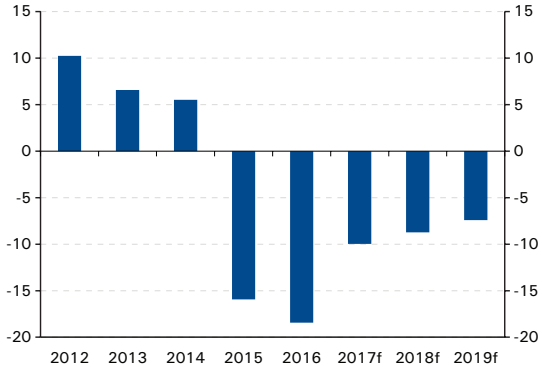
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

Chart 5: Current account balance

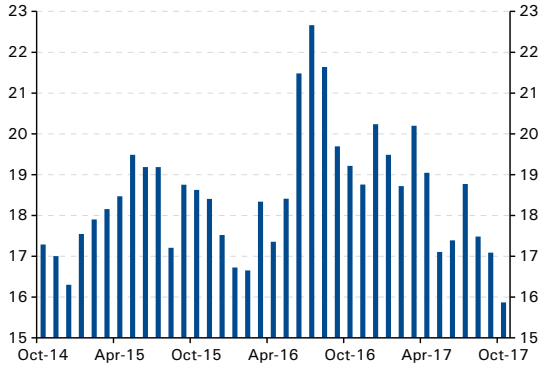
(% of GDP)



Source: National Center for Statistics and Information, NBK estimates

Chart 6: Central bank foreign assets

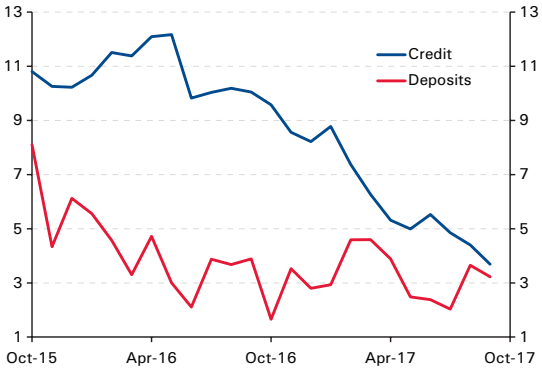
(USD billion)



Source: Central Bank of Oman

Chart 7: Private sector credit and deposits

(% y/y)



Source: Central Bank of Oman

wage bill may be protected to offset the slowdown in economic growth and the impact of VAT. Increased debt will also push the interest bill higher. Meanwhile, investment expenditure will be constrained, with the government foregoing unnecessary spending.

At the expected pace of revenue growth, expenditures would have to decline by 3% each year between 2018 and 2022 to balance the fiscal accounts – well below our base case.

More debt issuance likely given large financing challenge

Our fiscal forecasts imply a funding requirement of $9 billion in 2018 and $8 billion in 2019, which is lower than the average $12 billion per year in 2015-17. Some of this is likely to come from the further drawdown of government assets, including both the estimated $24 billion in sovereign wealth fund assets and the central bank's $16 billion in FX reserves. (Chart 6.) But the government will also utilize domestic and international borrowing markets. It borrowed $10 billion internationally in 2017 and, if previous financing patterns are maintained, it could borrow $7 billion per year in 2018 and 2019. This will see the stock of government debt grow to 47% and 52% of GDP, respectively, from 30% in 2016. As a result, the interest burden could increase to 6% of total spending in 2019, compared to 1.5% in 2016.

Funding conditions could deteriorate in an environment of rising interest rates and concerns over the government's fiscal position. Both S&P and Moody's recently downgraded Oman over such worries.

Current account deficit to shrink on a rise in LNG exports

Oman will remain a net borrower in its external accounts. The current account deficit will persist in 2018 and 2019, albeit shrinking as a share of GDP on the back of a rising trade surplus. Steady oil prices and higher LNG exports should help offset a mild expansion in the import bill. Remittances will be broadly steady thanks to a weaker labor market, while a stronger focus on tourism and the ease of doing business are expected to keep the service deficit in check. The current account deficit is seen at single digits for the first time in 3 years, averaging 8% of GDP over the two years. (Chart 5.) This will leave the economy needing to attract $13 billion in capital per year to avoid a further drawdown in official reserves.

Banking system sees liquidity conditions tighten slightly

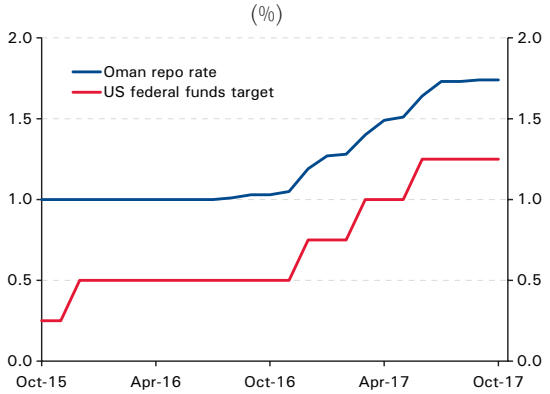
Monetary conditions are projected to tighten as private lending increases at modest single digit levels to compensate for the higher cost of living and deposit growth continues to ease due to weaker economic activity. (Chart 7.)

Lending growth is forecast to weaken to 7% in 2018 and 2019, compared to 9% between 2014 and 2017. Households and non-financial companies, the biggest drivers of credit, are seen turning to banks to accommodate VAT and to cope with slower economic growth.

We expect the currency peg to be maintained, though it has experienced some pressure in offshore markets. The 12-month forward rate jumped to 84 swap points over the spot rate in July 2017 following the Saudi-led blockade on Qatar. It has since dropped, but increased again following the Saudi corruption crackdown. As of early December the 12-month forward rate stood at 63 swap points over the spot rate. (Chart 9.)

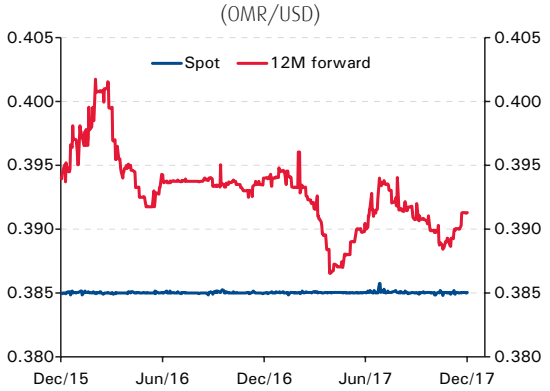
Meanwhile, the prospect of rising US interest rates may compound pressures, which due to the peg may see domestic rates rise in tandem. (Chart 8.)

Chart 8: Policy rates



Source: Central Bank of Oman

Chart 9: Exchange rate



Source: Thomson Reuters Datastream

Chart 10: Muscat Securities Market

Source: Muscat Securities Market

Nonetheless, the banking sector remains well capitalized. According to the CBO's latest quarterly financial soundness statistics (June 2017), credit risk remains low with nonperforming loans at 1.9% of gross loans. Capitalization was also high, with a capital adequacy ratio of 16.6% in 2Q17.

Stocks weighed down by weaker economy

The weaker operating environment continues to weigh on Omani corporates, with most still reporting weaker earnings. The MSM 30 decreased by 6.9% y/y in November 2017 to reach 5110, hovering near 7-year lows. (Chart 10.) This leaves Oman as the second worst performing market in the GCC, down 12% YTD, trailing Qatar's 24% contraction and well below Abu Dhabi's 5% drop.

Qatar outlook

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Non-oil growth to slip further as diplomatic row persists

Overview and outlook

- **GDP growth is expected to pick up to 3.5% in 2018 from 1.2% in 2017, but this improvement is contingent on the startup of the much-delayed Barzan gas project, which would add 20% to total gas output.**
- **Non-oil growth, by contrast, will remain under pressure as the GCC diplomatic rift disrupts investment, trade and the business climate. While the initial shock to the economy has passed, an intensification of the dispute presents a downside risk to growth.**
- **Financial sector flows have stabilized after government cash injections pushed up deposit growth. Further interest rate hikes will be needed to support the exchange rate peg, but risk tightening credit conditions at a time when the economy requires support.**
- **The 2018 budget allocates funds for food security schemes and sports stadia, but will not provide a large fresh stimulus to the economy. The fiscal deficit will narrow to a manageable 3% of GDP.**

Growth to pickup in 2018, but risks skewed to the downside

Our forecast for GDP growth in 2018 has been revised down to 3.5% from 4.0% before, driven by the continued fallout from the GCC diplomatic rift which shows few signs of resolution. (Chart 1.) This will still be a pickup from the 1.2% expected for 2017, with the rebound driven by the startup of the long-delayed Barzan gas project, which could boost real hydrocarbon sector GDP by 4%. (Chart 2.) Given the scope for further delay at Barzan and the potential for an intensification of the diplomatic dispute, the risks to our growth forecast are on the downside.

Non-oil growth in 2018 has been downgraded to 3.0% from 4.0% before, and is weaker than the 3.5% now expected for 2017. The initial shock to the economy from the dispute which started in June has passed, with imports returning close to pre-crisis levels, new trade routes established and capital flows more stable. But the economy remains under pressure. Corporate earnings have been hit, equity and real estate prices have slumped (chart 3), and the more difficult funding climate has put strain on banks and the currency peg.

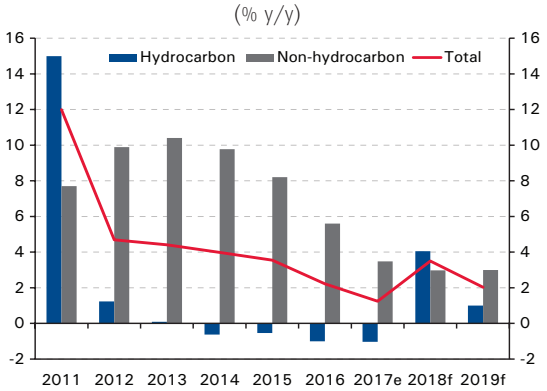
Although trends are obscured by data issues, our view is that the flow of people and tourists into Qatar has also been significantly affected. The resident population was up 3% year-to-date in November, compared to 7-11% in the equivalent period in the previous five years. Population growth

Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	152.5	161.4	169.4	176.3
Real GDP	% y/y	2.2	1.2	3.5	2.0
- Oil	% y/y	-1.0	-1.0	4.0	1.0
- Non-oil	% y/y	5.6	3.5	3.0	3.0
Inflation	% y/y	2.7	0.5	2.5	2.5
Budget balance	% of GDP	-9.0	-5.0	-3.0	-2.0

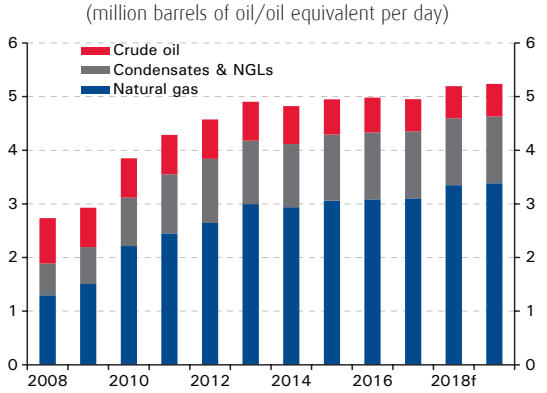
Source: Official sources, NBK estimates

Chart 1: Real GDP growth



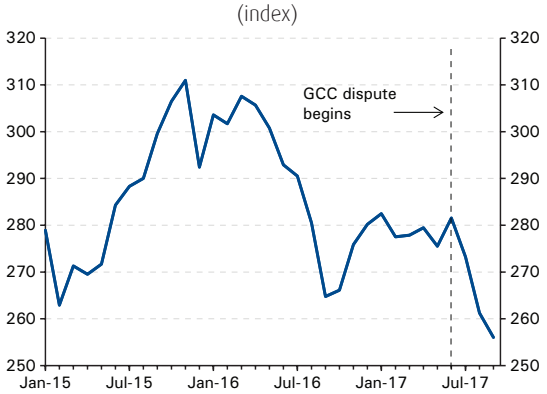
Source: Thomson Reuters Datastream, NBK estimates

Chart 2: Oil and gas production



Source: JODI, BP, OPEC, NBK estimates

Chart 3: Real estate price index



Source: Qatar Central Bank

slipped to just 1.7% y/y, the slowest since 2011, though has been trending down for the past few years. (Chart 4.) Visitor arrivals were down 32% y/y in October, and down 74% y/y from the GCC. This weakness is likely to persist unless a resolution to the crisis is found.

More positively, the government's main source of revenues – oil and gas receipts – has been largely unaffected by the dispute (including the gas delivered via the Dolphin pipeline to the UAE), and it has recently bolstered its finances by the sale of stakes in various overseas firms. Activity is also cushioned by the long pipeline of infrastructure projects to which the authorities are committed both for the World Cup in 2022 and Vision 2030, including the metro (due 2019), Lusail Light Rail system (2020) and World Cup stadia. Meanwhile, there are plans to restart development of North Field gas deposits following the lifting of the 12-year moratorium, though the impact will likely fall beyond our forecast range. The latest 5-year development plan (2017-22) is being finalized.

Inflation very low, outlook clouded by possible VAT

Inflation – already low in 1H 2017 – fell in to negative territory in August and September for the first time since 2011 and is estimated at 0.4% for 2017 as a whole. (Chart 5.) Key to weak price pressures has been the slump in the housing component, at -5.4% y/y in October, driven by the broader correction in house prices which has arguably intensified since the summer. But 'core' inflation is also low, estimated at 0.8% for 2017 due to the still-strong currency (linked to the dollar peg) and weaker growth climate. Although food prices have risen due to the diplomatic dispute, the rise has not been as severe as feared.

A VAT was intended to be implemented (likely late) in 2018, which would add around 2% to the annual rate of inflation for one year. This is factored in to our forecast, but given the absence of preparations so far, the current need to support the economy and the manageable fiscal deficit, there is a good chance that implementation will be postponed. With base effects likely to push food inflation higher, the fading of downward prices pressures from the exchange rate and possibly VAT in 2H, we forecast inflation to pick up to 2.5% in 2018.

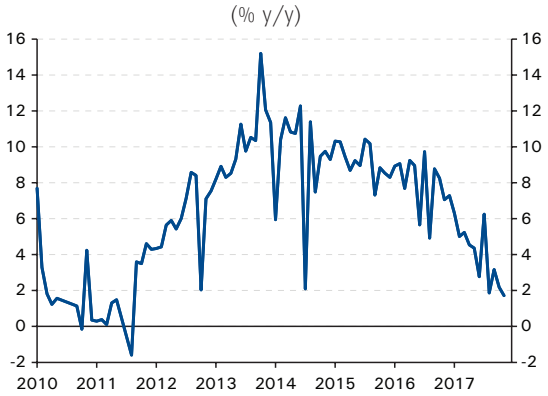
Budget outlines modest spending rise in 2018, deficit to narrow

The fiscal deficit has been at manageable levels – and much lower than in some other GCC countries. The deficit is estimated to have narrowed to 5% of GDP in 2017 from 9% a year earlier, with higher revenues due to a y/y rise in oil and gas prices more than offsetting a modest increase in government spending. (Chart 6.) Hydrocarbon exports were unaffected by the diplomatic row, and accounted for around 85% of budget revenues. We estimate that spending had been cut by around 17% in 2016 which helped limit the deficit but also contributed to the slowing economy.

The government's budget for 2018 signals a 2% rise in spending, including a focus on food security projects in light of the trade embargo and a rising wage bill that reflects the launch of new schools and hospitals. But we think spending will overshoot, as it did in the previous two years. As has been typical, capital spending will account for nearly half of all outlays, with some QAR11 billion allocated to sports projects primarily stadia for the 2022 World Cup.

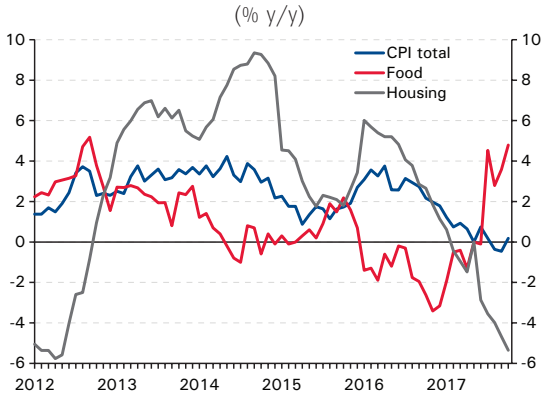
On the revenue side, we have also penciled in the introduction of excise duties and VAT later in the year, which combined could add just over 1% of GDP to receipts. But given the authorities' desire to support the economy, there is a good chance that these measures will be postponed. The net

Chart 4: Population growth



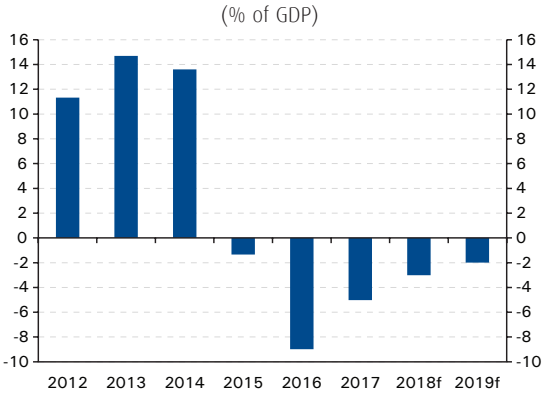
Source: MDPS

Chart 5: Consumer price inflation



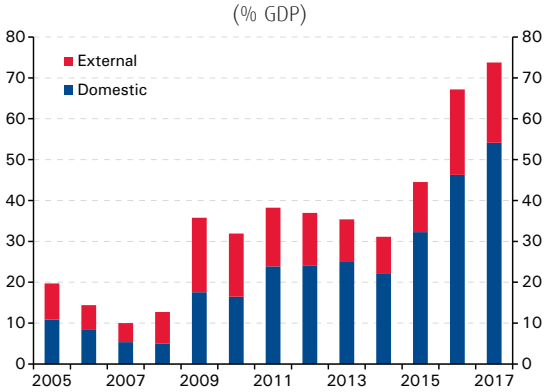
Source: Thomson Reuters Datastream

Chart 6: Fiscal balance



Source: Thomson Reuters Datastream, NBK estimates

Chart 7: Central government debt



Source: QCB, Thomson Reuters Datastream, NBK estimates

result is that the deficit is forecast to narrow to 3% of GDP in 2018 then to 2% in 2019, with oil and gas prices broadly steady.

Government debt levels continue to rise but bond yields still low

Despite talk of a sovereign bond issue in late 2017, the government has avoided tapping international markets since the giant $9 billion bond issue of May 2016. It has, however, increased its borrowing direct from local banks, which reached $87 billion in October from $71 billion at end-2016. Total government debt will stand at around $120 billion by end-2017, or 74% of GDP (see chart 7), which is high compared to many of its Gulf peers.

The government's credit rating has been downgraded once by each of the main rating agencies through 2017, one of which occurred before the crisis began. But the overall rating still stands at high investment grade – of AA- or equivalent – reflecting the relatively manageable fiscal deficit and strong asset position. The yield on the government's 2026 bond – previously one of the lowest among comparable maturity bonds in the region – stood at around 3.6% in early December, a 10-30 bps premium against Kuwait, Saudi and Abu Dhabi and up from around 3.2% pre-crisis. (Chart 8.)

Deposit flows now more stable after initial crisis-related shock

After an initial shock triggered by the diplomatic crisis, flows within the banking system have stabilized somewhat. Deposits of non-residents – including from the GCC – fell $13 billion (25%) between May and October, while private sector deposits also dipped. But this was more than offset by an inflow of $27 billion in public sector deposits, as the government looked to cushion the impact on the banking sector. The net impact of these flows has been to push overall deposit growth up to a very strong 17% y/y in October. (Chart 9.) Encouragingly, private sector deposits had returned to growth in September, while the pace of non-resident outflows has eased. But further government funding is likely should the need arise.

Credit growth accelerates, albeit driven by the public sector

Despite the weaker operating environment, credit growth has remained robust, reaching a more than 1-year high of 16% y/y in October. (Chart 10.) But much of this strength relates to lending to the government, which surged 61% y/y in October and accounted for 22% of all lending compared to 16% a year earlier. Lending to the private sector has been softer, though stable, at around 7% y/y since the crisis began. Increased exposure to the government will likely reduce any rise in problem loans, but could eventually limit funds available to the private sector.

Market interest rates also edging higher as liquidity tightens

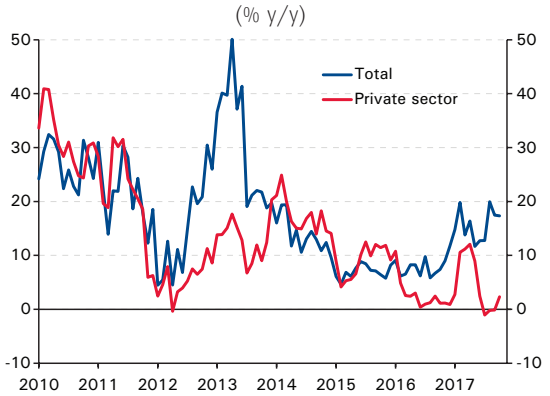
Government and central bank (QCB) deposit injections have helped to ease liquidity pressures in the banking system resulting from the exodus of foreign funds. Admittedly, 3-month interbank rates have risen more than 50 bps to 2.5% since 1H17. But much of this was related to the rise in policy interest rates in June, following the hike by the US Federal Reserve – though the rise since May was around 20-50 bps more than in other GCC countries. (Chart 11.)

The QCB hiked its repo rate by 25 bps to 2.5% in December following the latest Fed hike, but left its other policy rates on hold. We expect 2 further US interest rate rises in both 2018 and 2019. In the current climate, the QCB is likely to follow suit, in order to avoid inviting pressure on the riyal currency peg. But rate hikes risk tightening credit conditions at a time when the economy requires additional support.

Chart 8: Yeild on government 2026 bond

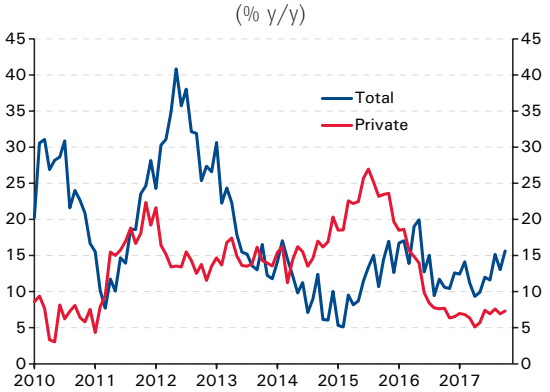
Source: Thomson Reuters Datasteam

Chart 9: Deposit growth



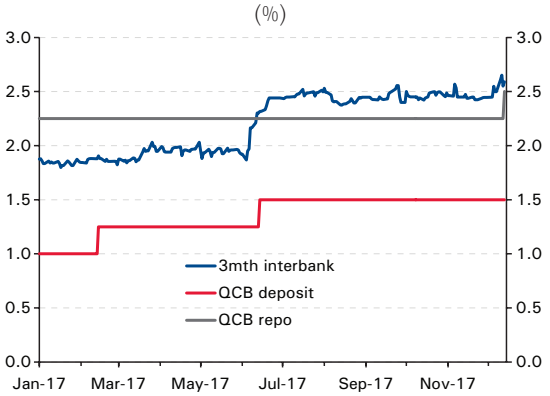
Source: Qatar Central Bank

Chart 10: Credit growth



Source: Qatar Central Bank

Chart 11: Interbank and policy interest rates



Source: Thomson Reuters Datastream

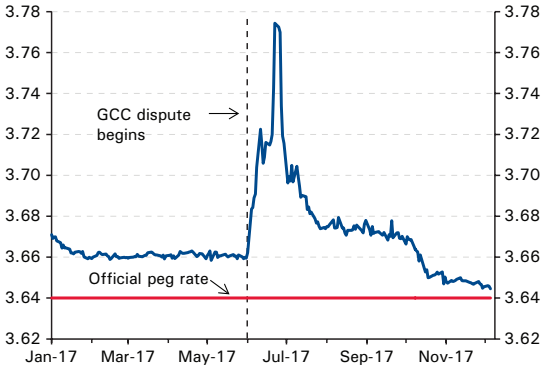
The currency market continues to see some pressure. Some investors were said to be having difficulty obtaining US dollars at the official pegged rate of QAR3.64/$1 in the onshore market, with the QCB subsequently guaranteeing that investors in the stock market would be able to exchange riyals at the official rate. Liquidity in the market has since improved, with the gap between the onshore and offshore riyal rates narrowing and the 1-year forward rate back trading very close to the official rate, having been as much as 3.6% weaker in June. (Chart 12.)

Given the costs and disruption that would follow, a change in the currency peg regime remains very unlikely. The authorities also have plenty of financial firepower at their disposal. The central bank's international reserves have fallen from $46 billion in May to $36 billion in October (under the new definition), but now appear more stable and still equate to 7 months of imports, which is well above levels traditionally considered adequate. (Chart 13.) Moreover, this does not include an estimated $300 billion plus in assets held by the Qatar Investment Authority – the sovereign wealth fund.

Stock market edges up from 7-year low

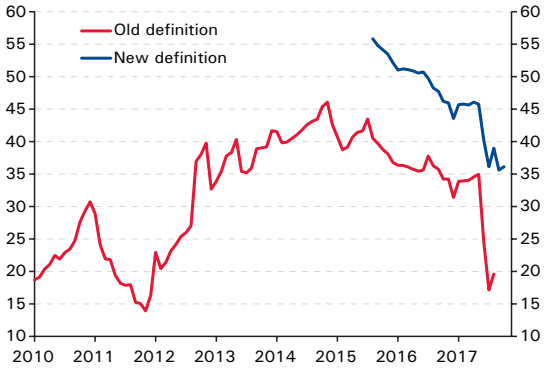
The main Qatar stock index has continued to lose ground in recent months, and by mid-December was down 23% year-to-date (ytd) and 19% since the diplomatic crisis began in June. (Chart 14.) This compares to ytd changes of +4% to -12% in other Gulf markets and also leaves the market near a 7-year low recorded in November. Poor performance reflects outflows of capital by overseas investors, the impact of the crisis on the economic outlook and corporate earnings, and broader regional concerns about geopolitics and low oil prices.

Chart 12: 12-month forward exchange rate



Source: Thomson Reuters Datastream

Chart 13: Qatar net foreign reserves



Source: Thomson Reuters Datastream, Qatar Central Bank

Chart 14: QE stock market

Source: Thomson Reuters Datastream

Saudi Arabia outlook

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Non-oil growth recovering on stronger demand and government stimulus

Overview and outlook

- **Saudi economic growth is rebounding thanks to stronger domestic demand and government stimulus; it could reach 2.0% by 2019.**
- **The government is on a firmer fiscal footing after rationalizing its expenditures and tapping new sources of non-oil revenues.**
- **The fiscal deficit is expected to narrow to 2.8% of GDP by 2019, having likely halved to 7% of GDP in 2017.**
- **The authorities will continue issuing bonds/sukuk and drawing down reserves to finance the fiscal deficit but at a slower pace.**
- **Credit growth (-1.8% y/y) and deposit growth (-0.5% y/y) in October, are not yet at levels sufficient to stimulate a robust economic recovery.**
- **Markets are generally more optimistic about the economic outlook, however; 2018 could see MSCI inclusion and the Saudi Aramco listing.**

The Saudi economy appeared to turn a corner in 2017. After more than two years of subdued demand and negative sentiment associated with the decline in oil prices, consumer and private sector activity began to tick up. Cautious optimism has begun to pervade the Saudi market, not least helped by the recovery in oil prices and the government's loosening of the purse strings. Public sector allowances have been reinstated, capital spending projects have resumed and economic stimulus programs have been announced after two years of relative fiscal austerity. An ambitious program of non-oil revenue generation and economic diversification has been unveiled in the Saudi Vision 2030, the implementation of which will be the driving force of Saudi Arabia's growth and development.

Non-oil growth to improve over the medium term thanks to supportive fiscal policy and government reforms...

The non-oil sector rebounded slightly in 2017 (+0.5% y/y), following the weakest growth in twenty years in 2016 (+0.2% y/y). (Chart 1.) Consumer spending and private sector activity, two linked but key barometers of the economic recovery, began to improve in 2017, especially after oil prices started rising from the middle of the year. Retail point of sale (POS) activity, for example, grew at the fastest rate in more than a year in October (+15% y/y by value), no doubt helped by the reinstatement and backdating of public sector allowances. (Chart 3.)

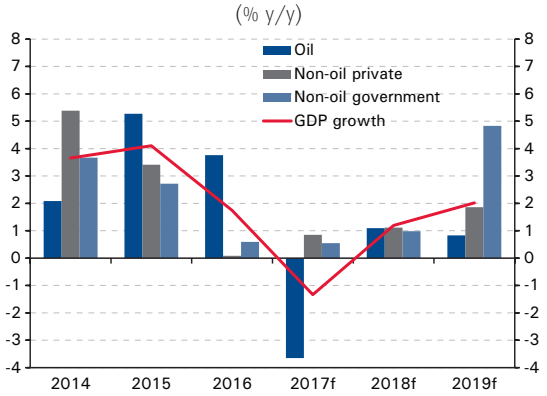
Meanwhile, November's reading of the Saudi Purchasing Managers' Index (PMI), at 57.5, was the highest in more than two years, helped by output

Key economic indicators

		2016	2017f	2018f	2019f
Real GDP growth	% y/y	1.7	-1.3	1.2	2.0
Oil	% y/y	3.8	-3.7	1.1	0.8
Non-oil	% y/y	0.2	0.5	1.3	2.9
Inflation	% y/y	3.5	-0.2	2.9	2.0
Fiscal balance	% of GDP	-16.9	-7.3	-4.5	-2.8
Public debt	% of GDP	13.1	17.1	19.7	21.3

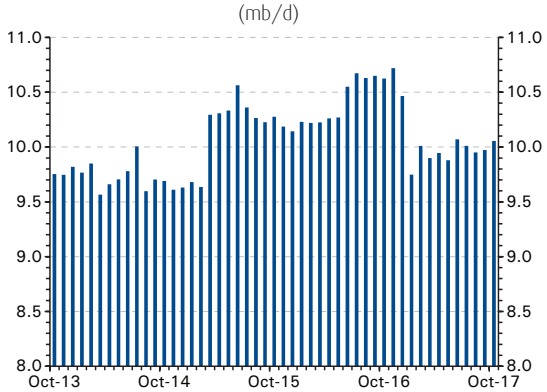
Source: Official sources, NBK estimates

Chart 1: Real GDP growth



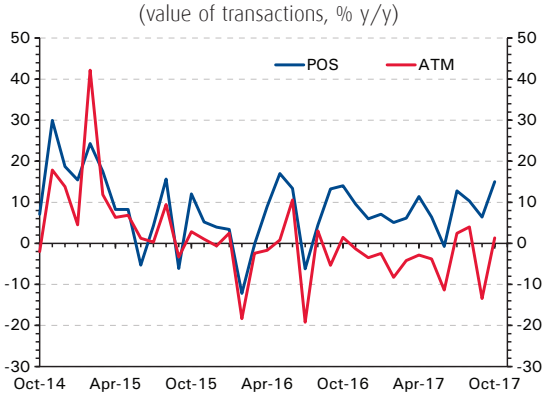
Source: General Authority for Statistics (GASTAT), NBK estimates

Chart 2: Crude oil production



Source: Joint Organizations Data Initiative (JODI)

Chart 3: Point of Sale (POS) & ATM transactions



Source: Saudi Arabian Monetary Agency (SAMA)

and new orders rising at the fastest pace in 2017. (Charts 4.) The PMI provides a snapshot of business activity in the kingdom's private sector.

To be sure, weaknesses persist. Construction activity, which is a proxy for infrastructure spending, remains lackluster, as evidenced by continued decline in cement sales (-5%). Private sector credit growth is also still negative (-1.5% y/y in October), and too weak at this stage to facilitate a more robust economic recovery. Unemployment, meanwhile, increased to 12.8% in 2Q17 from 12.4% at the end of 2016. (Charts 5 and 6.)

Moreover, the imposition of excise taxes on tobacco and soft drinks and levies on expatriate dependents, both of which came into effect in mid-2017, would be expected to have a dampening effect on demand. The introduction of a value-added tax (VAT), scheduled for early 2018, could also affect discretionary spending.

But a recovery is on the cards, nonetheless. We see non-oil growth rising to 1.3% and 2.9% in 2018 and 2019, respectively, with momentum improving as the government moves to a moderately expansive fiscal stance and as it proceeds with implementing structural and regulatory reforms as stipulated in the Fiscal Balance Program (FBP). Large-scale infrastructure projects, such as the King Khaled/King Abdul-Aziz international airports, the Riyadh light railway and the Jizan and Tabuk economic cities will continue as planned; the $500 billion cutting-edge and self-sustaining NEOM project is also on the horizon, with the main contract scheduled to be awarded in 2019 for completion in 2030. All in all, there are more than $1.45 trillion worth of infrastructure projects currently underway or planned, according to MEED.

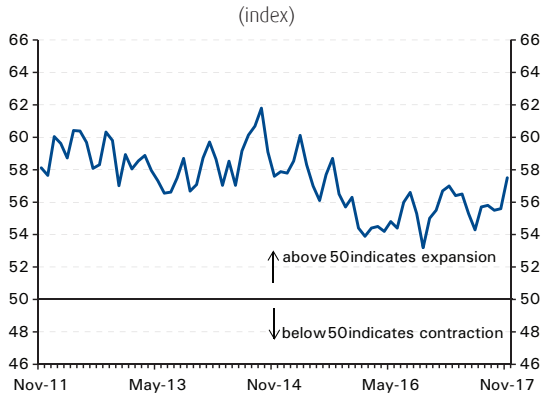
The realization of new economic support and incentive programs, as per the FBP and soon-to-be released National Transformation Program (NTP) 2.0, will also be crucial to the outlook. Under the "My House" program, 120,000 housing units will be constructed over the next three years to help plug the shortfall in affordable housing, while the Housing Allowance program will aim to offset some of the loss in discretionary spending that low-income households have experienced following the reduction in energy and utility subsidies. Here, the government is looking at up to SR50-60 billion in disbursements by the end of 2019.

Then there is the highly anticipated SR200 billion ($53.3 billion) 5-year private sector stimulus program, which came into effect in 2017. While the authorities have already indicated that the private sector will be expected to participate in an increasing number of public-private partnerships (PPP), this fund is specifically targeted at high energy, high labor and high water intensity firms, to help them enhance their efficiency and competitiveness. The government hopes to realize the Vision 2030 target of increasing the private sector's share of GDP from 40% to 65%.

...but oil sector output gains will remain limited due to OPEC production cut obligations

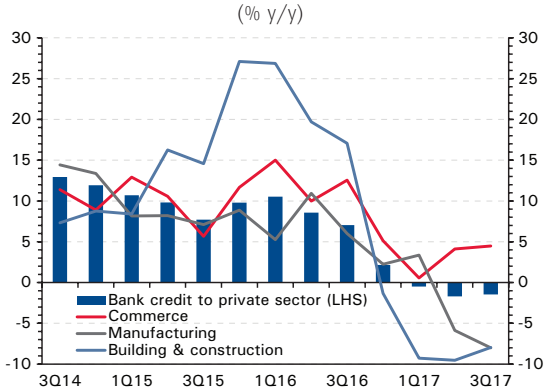
The Saudi oil sector contracted in 2017 by an estimated 3.7% y/y. This is entirely a reflection of Saudi Arabia cutting its oil production (by 4.7% to 9.97 mb/d) in line with its OPEC obligations. (See Chart 2.) The OPEC agreement itself was extended on 30 November for a further nine months, from March 2018 until the end of 2018, effectively capping the kingdom's crude output for at least another year. However, given that Saudi Arabia serially overachieved in meeting its compliance targets, it has room to maneuver to expand its output and still adhere to its quota. Therefore, we are penciling in real oil growth of 1.1% in 2018 and 0.8% in 2019 after the agreement expires. Headline GDP is projected to expand by 1.2% and 2.0% in 2018 and 2019, respectively. (See Chart 1.)

Chart 4: Purchasing Managers' Index (PMI)



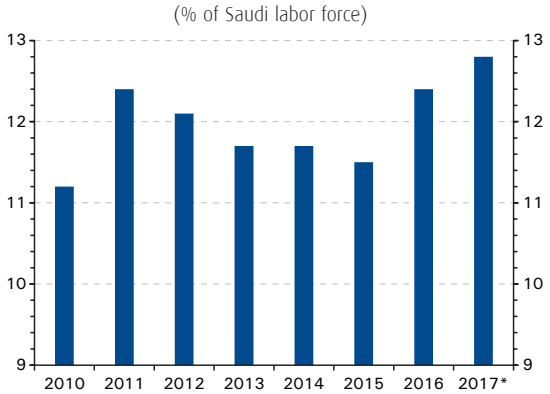
Source: Emirates NBK, Markit

Chart 5: Pvt. sector credit/consumer loan growth



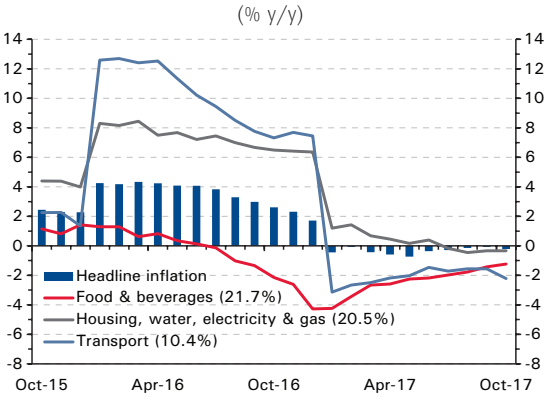
Source: SAMA

Chart 6: Saudi unemployment rate



Source: GASTAT; * as of 2Q17

Chart 7: Consumer price inflation



Source: GASTAT

Slow economic growth in 2017 reflected in consumer price deflation, but prices will rise in 2018 with the introduction of a VAT

Deflation has been a feature of the Saudi consumption basket since the start of 2017. Prices were still falling by 0.2% y/y in October, with food, housing and transportation, the three largest components in the Saudi cost of living index, still in negative territory. (Chart 7.) With demand expected to pick up in 2018 and the government due to impose a new value-added tax (VAT) of 5% on goods and services in January, inflation will likely spike, potentially reaching 2.9% on average by the end of the year. It should then fall to 2.0% in 2019 as the VAT's effect subsides.

Saudi Arabia's finances are on a firmer footing, with the deficit narrowing thanks to higher revenues and rationalized expenditures

The government appears on track to halve its fiscal deficit in 2017 to within range of our forecast of 7% of GDP (SR186.6 billion or $49.8 billion). (Chart 8.) For 2018 and 2019, we see the fiscal deficit narrowing even further, to 4.5% and 2.8% of GDP, respectively.

The improved outlook is due to the expectation that revenues, both oil and non-oil, will increase over the forecast period, and that expenditures will continue to be rationalized as the government proceeds with its FBP-mandated reform and restructuring program.

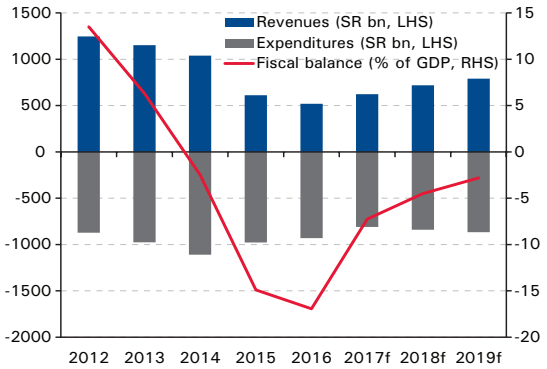
On the revenue side, while the Saudi treasury will continue to depend on oil receipts for more than half of its income in the short-to-medium term — oil revenues were up 27% y/y in 2017 thanks to higher oil prices — the real story going forward will be the activation by the authorities of so-called additional revenue 'levers'. Some of these, such as the Public Investment Fund's (PIF) new asset expansion program and the authorities' imposition of a new regime of excise duties and expatriate taxes, already bore fruit in 2017. Returns from the PIF (and SAMA) rose by 150% y/y in 3Q17 after the kingdom's new sovereign wealth fund (SWF) increased the size of its assets under management by 47%, from SR 570 billion in 2015 to SR 840 billion (the PIF is expected to return 4-5% per annum by 2020).

Meanwhile, the so-called 'sin' tax on tobacco/soft drinks (100% on tobacco and energy drinks, 50% on soft drinks) and the levy on expatriate dependents (starting at SR100 per dependent per month) as well as the tax on undeveloped 'white' land (2.5%) brought additional revenues to the government. With more than two million expatriate dependents registered, the expatriate levy could net the treasury around SR1.3 billion in 2017 (1.4% of non-oil revenues) and up to SR5.7 billion in 2019 as the fees are scheduled to have tripled by then (assuming that the expatriate dependent population does not change during this time).

Revenues are expected to increase further in 2018 with the introduction of a 5% VAT (worth an estimated SR22 billion or 1.5% of non-oil GDP in 2018) and the doubling of the expatriate dependents levy. Moreover, as the government attempts to promote Saudization, additional charges will be imposed on companies employing expatriates at a level equal to or greater than the number of Saudis on their books.

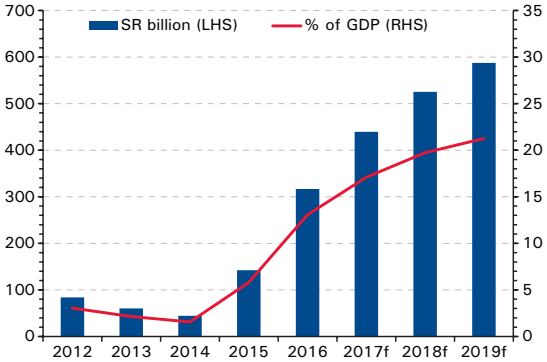
On the expenditure front, the government was relatively frugal in 2017, notwithstanding the reinstatement and backdated payment of public sector allowances. Fiscal consolidation saw the government cut back quite aggressively on procurements and projects, with total spending estimated to have fallen by 1.8% compared to 2016 (if 2016's accrued contractor payments are excluded). This is well within the government's budget for

Chart 8: Fiscal balance



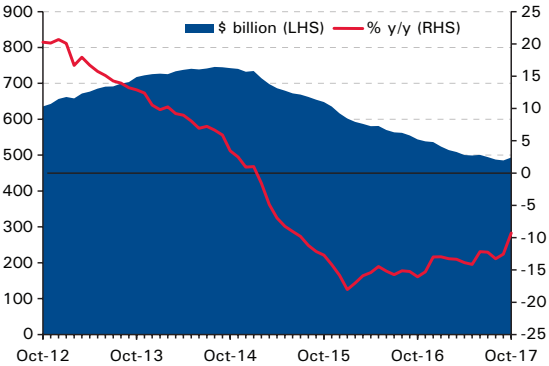
Source: Ministry of Finance, NBK estimates

Chart 9: Government debt



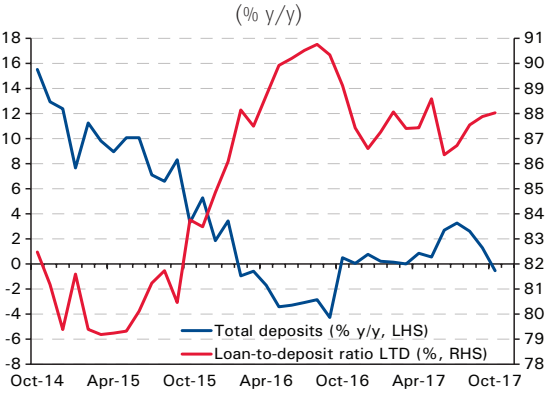
Source: SAMA, NBK estimates

Chart 10: Official foreign reserves (SAMA)



Source: SAMA

Chart 11: Deposit growth & loan-to-deposit ratio



Source: SAMA

the year, a not insignificant achievement. Balancing the budget by 2020 is a realistic prospect.

Public debt rising as the government continues to finance the deficit through bond sales and reserve drawdowns

With the authorities proceeding with their bond issuance program, selling at least SR134 billion ($35.7 billion) worth of domestic and international bonds and sukuk in 2017 to finance the deficit (and develop the domestic debt market), Saudi public debt is projected to rise to 17.1% of GDP in 2017. The debt level in 2016 was 13.1% of GDP. It should peak at 21.3% of GDP in 2019, which is still very low by global standards. (Chart 9.)

In tandem, foreign reserve assets were tapped to the tune of $43 billion in the year to October 2017 (-9.3% y/y); Saudi Arabia's total reserves fell to $493.4 billion in that month. (Chart 10.) This is an improvement on the $73 billion that was drawn down over the same period in 2016. The rate of reserve depletion should slow considerably over the next two years as the fiscal deficit narrows.

Contracting private sector deposits could portend liquidity pressures

Deposit growth was negative in 2017 (-1% in the year to October), despite the injection of liquidity that the government's bond sales provided. (Chart 11.) Indeed, government infusions, some of which were derived from higher oil revenues, took up some of the slack from a contracting private sector deposit base (-2.9% ytd in October). This was largely due to a decline in time and savings deposits (M2).

Liquidity pressures, though minimal at present, might be expected to increase in the event that there is no expansion in the deposit and money supply base. Interbank bank rates have been slowly trending upwards since March, with the 3-month SAIBOR rising 15 bps to reach 1.876% on 13 December. (Chart 12.) Borrowing costs rose in 2017 following three successive interest rate hikes of 25 bps in SAMA's benchmark reverse repo rate during the year; the third rate hike took effect recently on the 13 December, bringing the benchmark rate up to 1.5%. This was in line with the US Fed's monetary tightening program, which envisages further hikes in 2018. SAMA will likely follow suit but also raise its repo rate, which has been at 2.0% for more than ten years, to restore the spread.

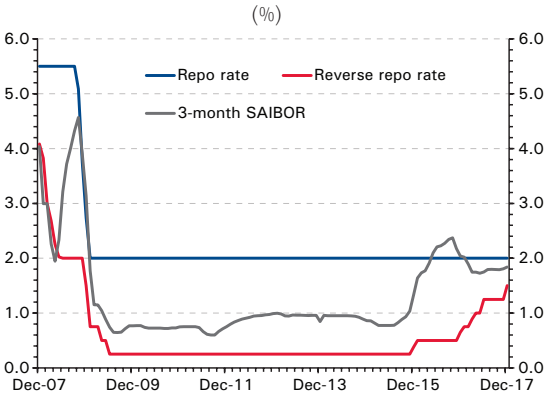
Markets generally optimistic about the economic outlook

Markets are generally optimistic about the kingdom's economic trajectory. The fiscal accounts appear to be under control, oil prices are holding steady above $60/bbl and listed company results look to have improved in 3Q17 (on an annual and quarterly basis). As a result, pressure on the exchange rate has largely abated and sovereign CDS spreads were still below 100 bps in December. (Charts 13 & 14.)

On the equity front, as of mid-December, the Tadawul All-Share Index (TASI) had slowly recovered ground (-2.0% ytd), seemingly shrugging off the anti-corruption commission's arrest of high profile ministers and businessmen in early November and continuing regional geopolitical troubles. (Chart 15.)

Looking ahead, 2018 should see further liberalizing reforms being unveiled as the Saudi Capital Markets Authority (CMA) moves to attract investors. The potential inclusion of the Saudi bourse in the MSCI/FTSE emerging markets index and the listing of 5% of Saudi Aramco, arguably the showpiece of the Saudi Vision 2030 plan, will be very positive for liquidity and valuations more broadly.

Chart 12: Interest rates

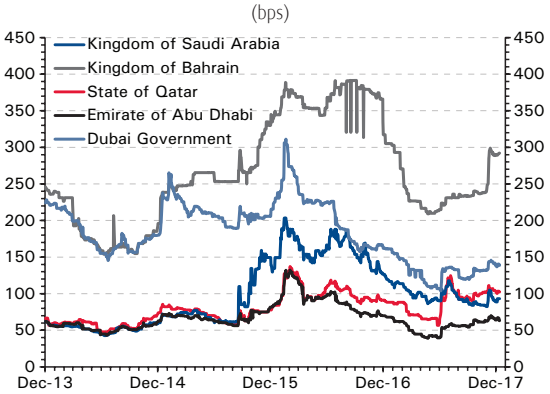


Source: SAMA, Thomson Reuters Datastream

Chart 13: Saudi riyal forward exchange rate

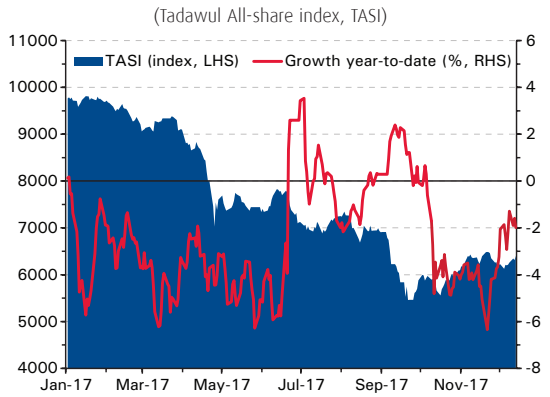
Source: Thomson Reuters Datastream

Chart 14: Sovereign credit default swap spreads (CDS)



Source: Thomson Reuters Datastream

Chart 15: Saudi stock exchange index



Source: Thomson Reuters Datastream

UAE outlook

Non-oil growth to be fastest in the Gulf region in 2018, at 3.7%

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Overview and outlook

- **A pickup in the pace of preparations for the Dubai Expo 2020 event will support non-oil growth in 2018 and 2019. This should help offset continued weakness in the oil sector and deliver growth of around 3% in the overall economy.**
- **Prices will face upward pressures from the introduction of VAT in 1Q18, which is expected to add some 2% to inflation for one year. We see inflation picking up from 2.5% in 2017 to 4.0% in 2018.**
- **The fiscal position will gradually improve, but stay in modest deficit at around 2% of GDP in 2018 and 2019 with oil revenues weak and as fiscal tightening is eased to support Expo spending.**
- **Credit growth is projected to remain soft against a backdrop of tighter lending standards, higher interest rates, pressure on real estate and reasonable economic growth.**

GDP growth to be supported by solid gains in the non-oil economy

The economy continues to perform better than many of its Gulf peers, with relatively high levels of diversification benefitting its capacity to cope with lower oil prices, alongside continued political stability. We see GDP growth picking up from 2.2% in 2017 to around 2.6% and 3.4% in 2018 and 2019, respectively, well above the regional average. (Chart 1.)

Growth in the oil sector will remain capped in 2018 by the extension in OPEC production cuts and possibly stricter compliance with the agreement. The UAE has so far lagged its GCC peers in terms of compliance and has vowed to continue to cut oil output to meet its commitment. Crude output stood at 2.92 million b/d in October, a compliance level of 67% against a target of 2.87 million b/d under the agreement.

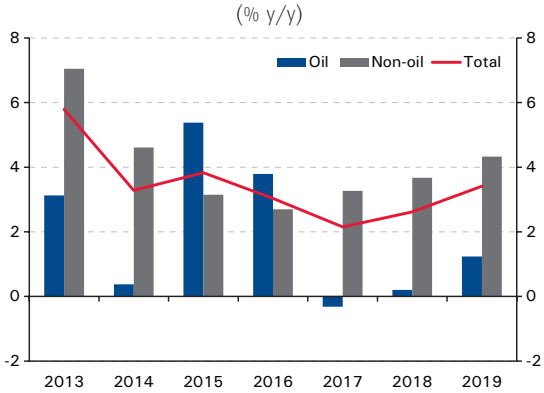
Oil sector activity is projected to gradually rise from 2019 onwards. Despite the output cuts, the UAE continues to invest in expanding its oil production capacity in anticipation of higher demand. ADNOC, the state-owned oil firm, recently extended concessions at the Upper Zakum offshore field, its biggest oil field, to expand its output capacity by around 350,000 b/d to 1 million b/d by the year 2024. This is projected to increase the UAE's overall production capacity from around 3.2 million b/d currently to 3.5 million b/d. Furthermore, in a bid to diversify further from pure crude production, ADNOC has pledged to invest around $110 billion over the next

Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	349	383	407	435
Real GDP	% y/y	3.0	2.2	2.6	3.4
Oil	% y/y	3.8	-0.3	0.2	1.2
Non-oil	% y/y	2.7	3.3	3.7	4.0
Inflation	% y/y	1.6	2.5	4.0	3.0
Budget balance	% of GDP	-4.3	-3.4	-2.0	-1.8

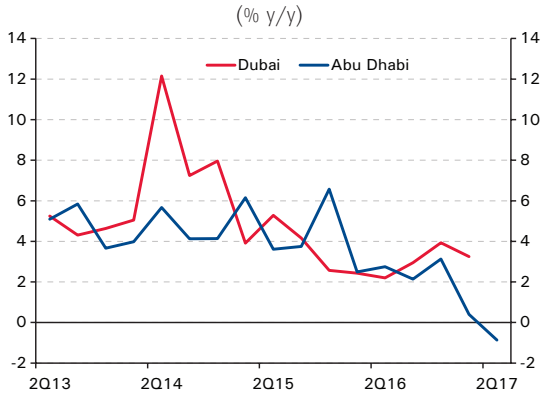
Source: Official sources, NBK estimates

Chart 1: UAE real GDP



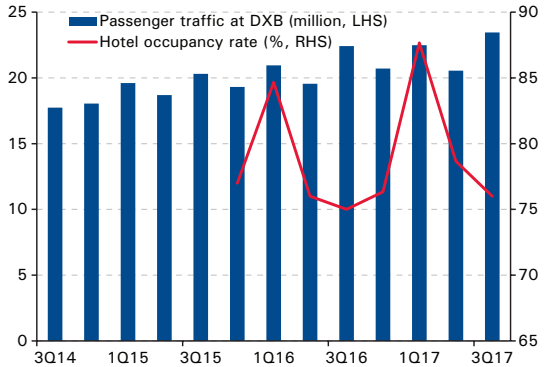
Source: UAE Federal Competitiveness & Statistics Authority, NBK

Chart 2: Dubai & Abu Dhabi real GDP



Source: Dubai Statistics Center, Stastics Center - Abu Dhabi

Chart 3: Dubai tourism



Source: Dubai airports, Dubai Statistics Center

five years in international downstream projects and to develop Abu Dhabi's unconventional gas infrastructure. It aims to start producing unconventional gas by 2030. ADNOC has also recently sold 10% of its fuel-retailing unit to help finance its expansion projects, raising around $0.9 billion.

In neighboring Dubai, the Emirates National Oil Company (ENOC) is also eyeing a $1.1 billion expansion of its refinery in Jebel Ali. The expansion is scheduled to be ready by the fourth quarter of 2019 and increase production from 140,000 b/d to 210,000 b/d.

Meanwhile, non-oil activity is on track to perform reasonably well in 2018 and 2019, thanks to further gains in the tourism and construction sectors, especially with the Expo 2020 event in Dubai drawing nearer. The latter should help offset the continued weakness in the real estate sector, where prices remain under pressure. We expect non-oil growth to rise from 3.3% in 2017 to 3.7% next year and 4.0% in 2019.

There are still a number of downside risks. A further dip in oil prices could lead to the government pursuing more aggressive fiscal consolidation. Furthermore, interest rates are likely to rise, potentially squeezing liquidity and dampening growth in investment spending. An escalation of the Qatar crisis may also affect growth. Qatar is not a major contributor to the UAE's trade and tourism sectors, but tensions could affect investor sentiment.

Growth in Dubai remains reasonably robust

Real GDP in Abu Dhabi fell 0.9% y/y in 2Q17, mainly on the back of a 1.9% y/y drop in oil output. (Chart 2.) Non-oil GDP was flat during the same period, weighed down by fiscal consolidation efforts. However, with consolidation set to ease and infrastructure projects gathering steam in 2H17, non-oil growth is expected to gradually improve into 2018. GDP growth in Dubai has so far fared better, at 3.2% y/y in 1Q17.

Dubai's important hospitality and construction sectors are performing well. The number of passengers passing through Dubai International Airport came in at a record high of 23 million in 3Q17. (Chart 3.) Construction activity continues to be supported by preparations for the Expo 2020 event. Over $8 billion has been allocated to Expo-related projects, including for buildings, metro expansions, roads and bridges and Dubai has reportedly already invested up to half of that total amount so far. As of November 2017, the total level of awarded projects in Dubai was up 17% y/y at $302 billion. Over 2018 and 2019 an additional $107 billion worth of projects are expected to be awarded.

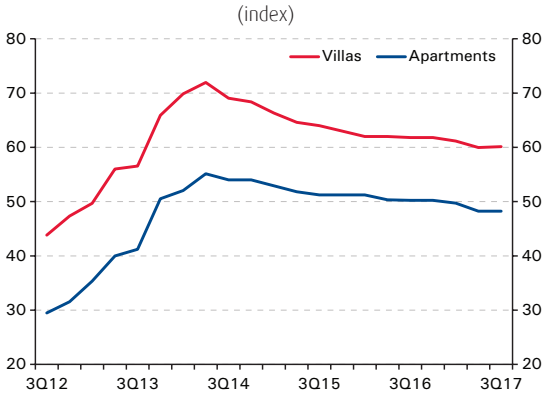
Dubai's residential property prices appear to have stabilized in 2017

Following almost two years of falling prices amid tighter regulations, rising housing supply and risk aversion, residential property prices in Dubai appear to have largely stabilized in 2017. (Chart 4.) According to Asteco, the prices of both apartments and villas were unchanged in Q3, though still down by 4% y/y and 3% y/y, respectively. However, downward pressures on prices are projected to persist in the near-to-medium term due to higher housing supply and further shifts in demand toward the more affordable housing sector. The value of real estate transactions has continued to trend lower in 2017. (Chart 5.)

Inflation to trend upwards in 2018

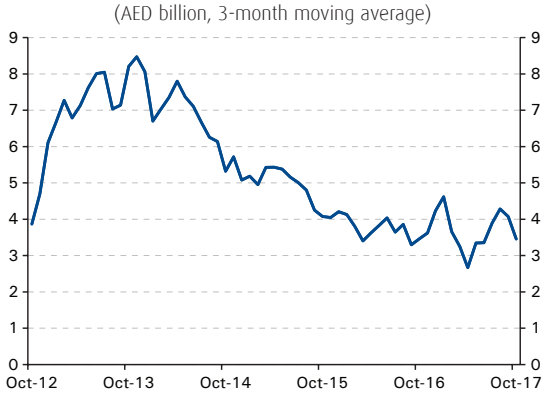
After trending downwards for most of 2017, consumer price inflation is forecast to rise in 2018. Latest figures showed inflation edging up from 0.8% y/y in August to 1.1% y/y in September as inflation in the food and housing

Chart 4: Dubai residential property sales prices



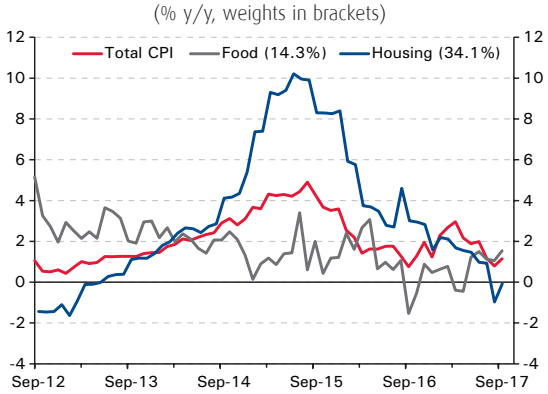
Source: Asteco

Chart 5: Dubai real estate transactions



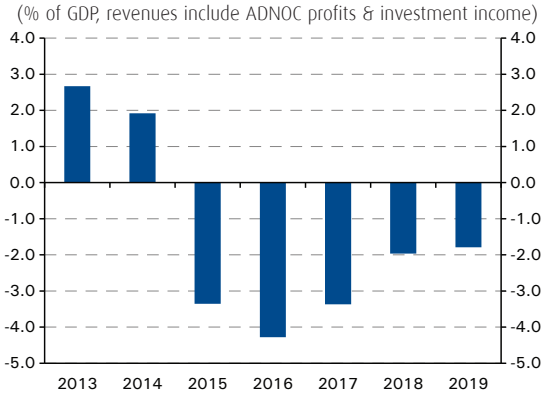
Source: Dubai Land Department

Chart 6: Consumer price inflation by sector



Source: Thomson Reuters Datastream

Chart 7: Budget balance



Source: UAE Ministry of Finance, NBK estimates

components both gained some traction. (Chart 6.)

We see inflation climbing from 2.5% in 2017 to 4.0% in 2018 on the back of new taxes including the 5% VAT. The VAT, which is due to be levied from 1Q18, is expected to add some 2% to inflation for one year. Given the relatively decent growth outlook, we see inflation moderating only to around 3.0% in 2019, as the initial impact of the VAT wears off.

Fiscal balance to narrow but remain in modest deficit

The fiscal balance will gradually improve, but stay in modest deficit at around 2% of GDP in 2018 and 2019. (Chart 7.) Oil revenues remain relatively weak and the pace of fiscal consolidation is easing, as Dubai's government gradually increases spending on construction projects in the run-up to Expo 2020.

Nonetheless, fiscal adjustment and reform is proceeding, with the establishment of the Federal Tax Authority, subsidy cuts and the introduction of various fees and taxes. Efforts have also been made to rely more heavily on the private sector for implementation of some projects.

October saw the introduction of an excise tax levied on tobacco, energy drinks (both 100%) and fizzy drinks (50%). It is expected to raise around $2 billion (0.5% of GDP) in annual fiscal revenue and follows a similar move in Saudi Arabia in June. Furthermore, the UAE will be one of the first GCC nations to implement VAT. At 5%, the tax is expected to generate $5 billion in revenues, or 1% of GDP.

To avoid relying solely on foreign reserves to finance the country's public deficit, Abu Dhabi issued $5 billion in sovereign bonds in April 2016 and 10 billion in October 2017. The UAE is in the process of finalizing a federal debt law, which will allow the federal government to issue bonds as well. Supported by the relatively stable economic and political environment, yields on Dubai and Abu Dhabi five-year government debt have remained fairly low and steady over the past year, tracking US Treasuries. As of end-November, yields on Abu-Dhabi's 2021 bond were little changed year-to-date at 2.54%, while yields on Dubai's debt were down 28 bps at 3.05%. (Chart 8.) Alongside Kuwait, the Abu Dhabi government enjoys the strongest long-term credit ratings in the GCC.

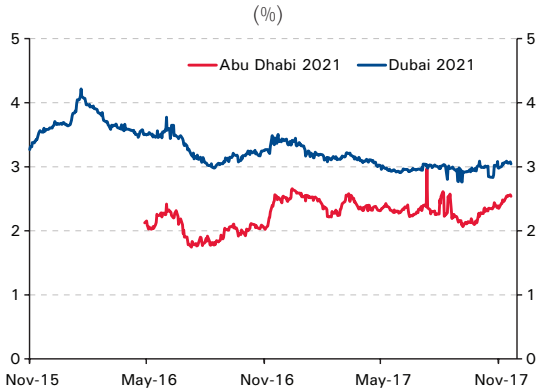
Current account surplus to expand slightly in 2018 and 2019

The current account surplus is projected to marginally expand in 2018 and 2019, on the back of more stable oil export receipts and as non-oil export growth gathers pace, thanks to a gradual improvement in external demand. We expect the current account surplus to rise from an estimated 3.4% of GDP in 2017 to 3.9% by 2019. (Chart 9).

Loan growth remains weak, but liquidity has improved

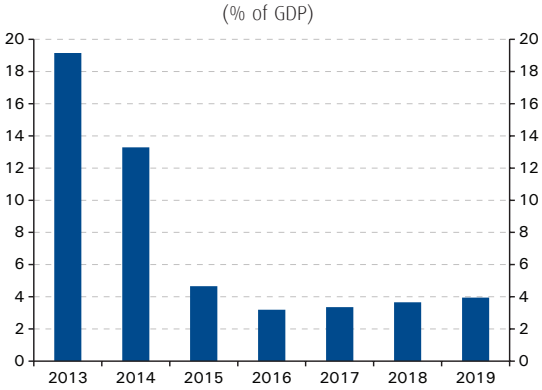
Loan growth has fallen to multi-year lows against a backdrop of moderate economic growth, interest rate hikes, higher risk aversion in the climate of lower oil prices and tighter lending rules. In October, lending growth stood at just 0.9% y/y (Chart 10), weighed down by ongoing weakness in private sector credit growth and a continued decline in lending to government-related entities. The central bank's latest credit sentiment survey (3Q) showed a continued tightening in lending standards, especially for small to medium enterprises, but also points to an improvement in credit growth in the near-to-medium term.

Chart 8: Government bond yields



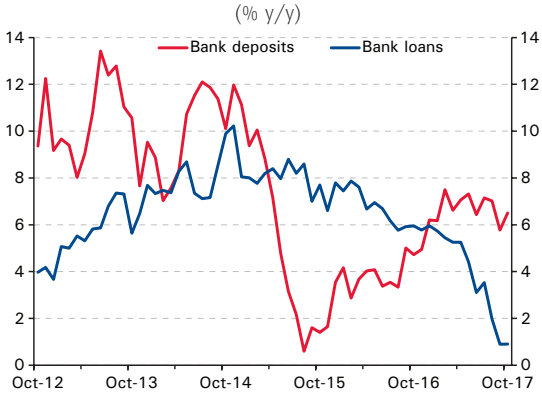
Source: Thomson Reuters Datastream

Chart 9: Current account balance



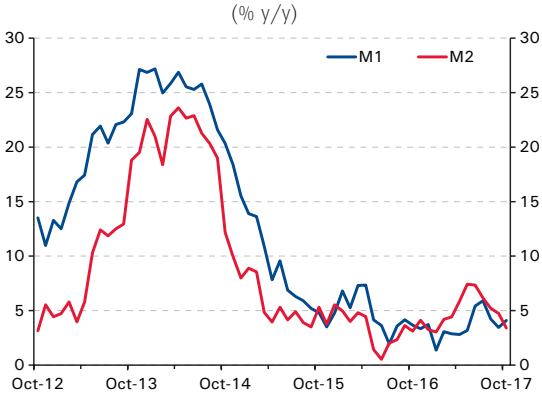
Source: Central Bank of the UAE, NBK estimates

Chart 10: Bank loan & deposit growth



Source: Central Bank of UAE

Chart 11: Money supply growth



Source: Thomson Reuters Datastream

In contrast, deposit growth was a solid 6-7% y/y through 2017, as higher oil revenues have helped prop up government deposits. Consequently, broad money (M2) growth has eased slightly, but remains reasonable. (Chart 11.) Given the recent trends in credit and deposit growth, the loan-to-deposit ratio stood at 99% in October, versus 104.5% a year earlier. After injecting about $9 billion into the banking system earlier this year to ease liquidity constraints, the central bank began withdrawing liquidity from the banking system in July, following improvements in deposit growth. Some $6 billion (around 0.8% of gross bank assets) in excess liquidity was removed from the system between July and September.

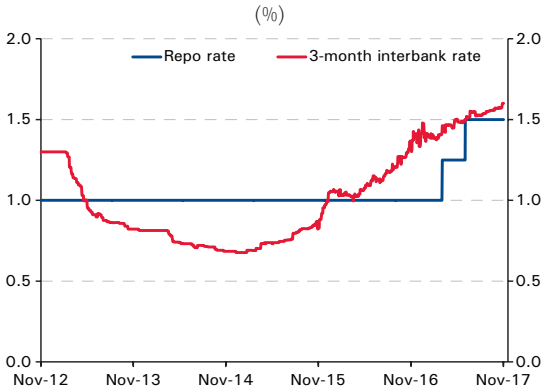
Interbank rates continued to trend upwards in 2017, following three additional 25 bps hikes in the policy rate following hikes in the US federal fund rate. (Chart 12.) With the US policy rate scheduled to rise by 0.25% twice in both 2018 and in 2019 and UAE rates expected to follow suit, interbank rates are expected to climb higher still.

Major UAE banks have gradually returned to modest levels of profitability in 2017. Indeed during the first nine months, net profits among major banks were up a solid 6.5% y/y, a major improvement compared to the 7.5% y/y decline witnessed a year earlier. The merger of First Gulf Bank and the National Bank of Abu Dhabi earlier in 2017 spurred talks of further mergers in the still-crowded banking industry. According to recent reports, two of the UAE's smallest banks, the Bank of Sharjah and Invest Bank, are currently in merger talks.

Stock markets edge lower in 2017, though outperform the region

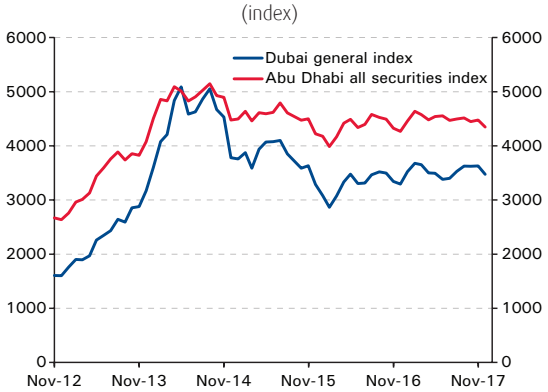
The Abu Dhabi Exchange (ADX) and Dubai Financial Markets (DFM), the key equity markets in the UAE, both moved lower year-to-date by early December, though have outperformed the region overall. (Chart 13.) The continued weakness in the consumer and real estate sectors, as well as low oil prices, has weighed on market performance.

Chart 12: Interest rates



Source: Thomson Reuters Datastream

Chart 13: Main stock markets



Source: Thomson Reuters Datastream

Egypt outlook

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Economy continues to recover as reforms boost sentiment and exports

Overview and outlook

- **Growth is set to continue to improve to 4.7% in FY17/18, and to 5% and 5.5% in FY18/19 and FY19/20.**
- **There has been significant progress on reforms, with a positive impact on external flows, fiscal resilience, and activity.**
- **The fiscal deficit is set to narrow further in the coming years, after declining to under 11% of GDP in FY16/17.**
- **Double-digit inflation is set to ease as the central bank has kept policy rates high and the pound has been stable.**

Economic activity continued to bounce back in 3Q17 after showing a healthy recovery during the first half of 2017. The economy has generally benefited from the floating of the pound, which has helped renew optimism and made the economy more competitive. Other fiscal and structural reforms have also made significant progress. As a result, the economy has benefited from strong export growth, a recovery in tourism and higher investment. The country's foreign reserves have also improved significantly, returning to levels not seen since before the political unrest in 2011.

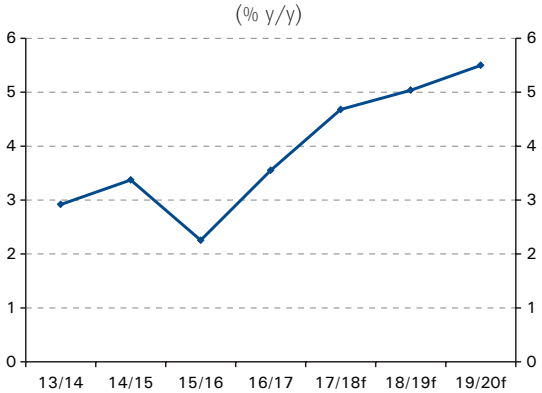
Growth is set to accelerate to 5.5% by FY19/20

The economy continued to see robust growth in 3Q17, as real GDP growth accelerated to 5.2% year-on-year (y/y). (Chart 2.) This compares to just 2.3% average growth in 2016. The private sector has been a key source of growth, expanding by 5% y/y in 1Q17, according to the most recent data available, while the public sector grew by just 2.4% y/y.

The Purchasing Managers' Index (PMI) continued to improve in 4Q17, suggesting further acceleration in GDP growth. The index rose to 50.7 in November, its best level in over two years. Exports have been particularly strong in the PMI data, with the new export orders component rising to 55.5. The latest trade data also shows exports (in US dollar terms) up 14% y/y in 3Q17. The drop in the value of the pound after last year's currency float has clearly made exports more competitive.

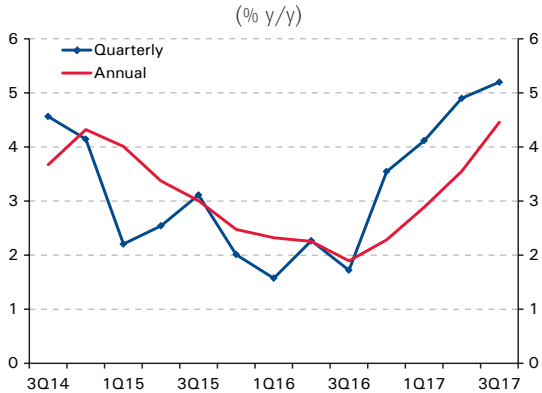
The improving growth has also been supported by a recovery in tourism. The number of visitors to Egypt jumped by 55% y/y in 3Q17. The tourism component of the production index rose by 15% y/y in 2Q17. Despite the improvement, the potential for growth in the sector remains massive,

Chart 1: Real GDP growth



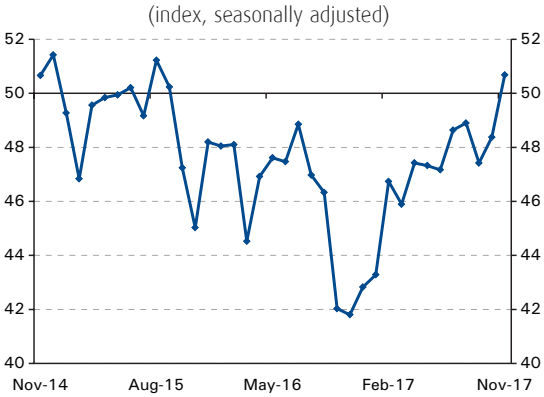
Source: MOP, Thomson Reuters Datastream, NBK estimates

Chart 2: Quarterly GDP growth



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index



Source: IHS Markit

Key economic indicators

		FY16/17	FY17/18f	FY18/19f	FY19/20f
Nominal GDP	EGP bn	3,481	4,366	5,028	5,771
Nominal GDP	USD bn	251	237	267	299
Real GDP growth	% y/y	3.6	4.7	5.0	5.5
Inflation (average)	% y/y	30.0	14.0	10.0	9.0
Budget balance	% of GDP	-10.9	-8.5	-7.5	-6.5

Source: CBE, MOF, MOP, NBK estimates

with tourism still well below pre-2011 levels. The political unrest and the heightened threat of terror attacks have continued to put significant pressure on the sector. The number of visitors to Egypt in 1Q17 remained 36% below the 3Q10 level.

The economy is expected to continue to improve in the years ahead. While we see growth cooling slightly in the coming quarters as some base effects fade, average growth in FY17/18 is still expected to improve to 4.7% from the prior year's 3.6%. Beyond that, growth is seen accelerating to 5% and 5.5% in FY18/19 and FY19/20, respectively. (Chart 1.) The economy will continue to face some headwinds from tighter fiscal and monetary stances in the coming 2-3 years, but this is expected to be countered by strong investment activity, export growth and a recovery in tourism.

Fiscal deficit narrowing as reforms take effect

The government has been undertaking an ambitious reform program including tackling its large fiscal deficit. Last year, the existing sales tax was replaced by a value-added tax (VAT), which promised to increase tax revenues by up to 1% of GDP. The government also cut subsidies, raising the retail price of fuel, electricity and water. Fiscal reform also included an effort to bring wage bill growth under control.

The results have already born fruit, though some fiscal targets were missed due to the significant increase in oil prices. The fiscal deficit declined to 10.9% of GDP in FY16/17 from 12.1% the prior fiscal year. Data through May 2017 shows the deficit declining to 10.2% of GDP during the first eleven months of the fiscal year. The primary deficit, which excludes interest payments on the debt, narrowed to 1.3% of GDP year-to-date through May 2017, from 3.7% a year ago.

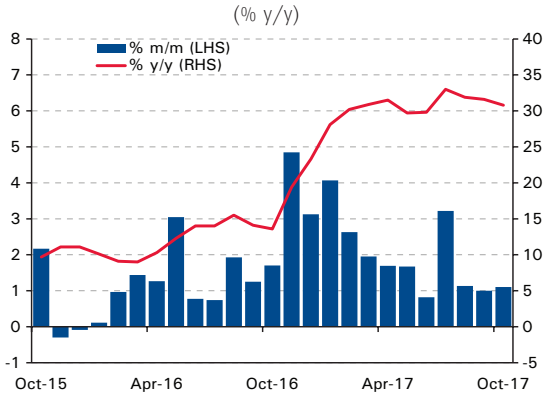
Increased control of the wage bill and healthy tax revenue growth from the VAT were responsible for most of the improvement in the primary deficit. Indeed, the wage bill grew by just 3% (in nominal terms); this compares to 18% average annual growth during the previous five years. As a result, total spending fell to 25.3% of GDP to-date in FY16/17, its lowest level in six years. At the same time, tax revenues grew by 33% y/y, which helped push total revenues to 15.1% of GDP.

We expect this improving trend to continue in the coming two fiscal years as spending is brought under control and the government improves revenue collection. The deficit should narrow to 8.5% of GDP for the full FY17/18 before improving further to 7.5% and 6.5% in the following two fiscal years. The gains are expected to come from continued measures to reduce the subsidy bill. Higher revenues are also expected to be an important source, as tax collection methods improve and the government's hiking of the VAT rate from 13% to 14% this fiscal year is felt.

Structural reforms also moved forward in 2017

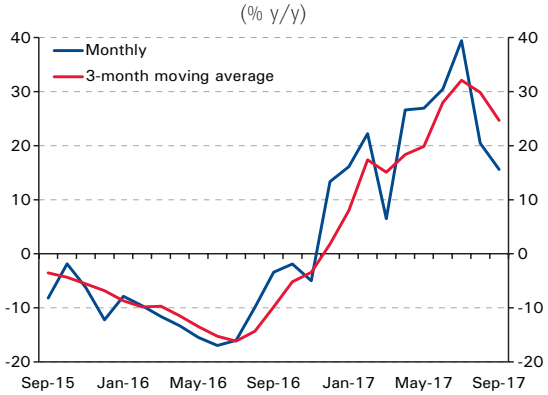
The reform agenda also includes structural reforms to boost investment, growth and job creation. Measures include steps to improve the business environment and streamline laws governing investment, industrial registration and insolvency. Significant progress has already been made in implementing these. New regulations overhauling the investment environment were enacted during 2017. The new law provides broad guarantees and incentives to foreign investors and simplifies the investment process. The year also saw the passing of a new industrial permits law, which will streamline the process and reduce waiting times.

Chart 4: Consumer price inflation



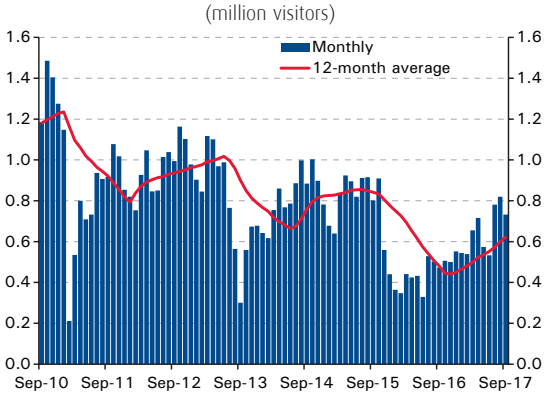
Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index



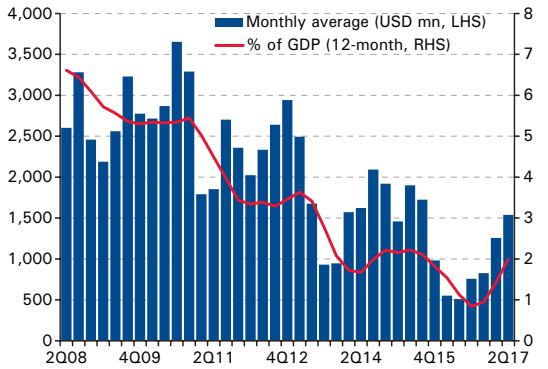
Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism



Source: CAPMAS

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, press, NBK estimates

Elevated inflation is set to ease with tough CBE approach

Last year's floating of the currency, cuts in subsidies and the introduction of the VAT all contributed to higher inflation over the past year. CBE policy rate hikes have helped bring inflation under control, though it remains relatively elevated. Inflation stood at 31% y/y in October, though monthly price growth continued to ease. (Chart 4.) The rate is expected to end 2017 at around 23% before easing further to 10% by the end of 2018 and 8% by the end of 2019.

The central bank's policy rates have remained elevated in an effort to combat the high level of inflation. Three hikes since the currency float have seen rates rise by 700 basis points over the past twelve months. The bank's overnight deposit and lending rates now stand at 18.75% and 19.75%, respectively. (Chart 11.) Expectations are for the central bank to begin cutting rates in the coming months, as soon as the CBE is convinced that inflation has come under control.

Current account improved in 1Q17 after the deficit widened in 2016

The current account deficit shrank to its lowest level in nearly three years in 2Q17, to $2.4 billion or 4.8% of GDP. The current account benefited from strong export growth, which topped 7.4% y/y in 2Q17. The quarter also saw strong growth in tourism receipts and remittances.

In 2Q17, tourism receipts and worker remittances continued to improve, benefiting from the floating of the pound and from improved security conditions. Tourism receipts tripled to $1.5 billion in 2Q17 from a year ago, growing by 17% during the full FY16/17. Despite the improvement, receipts remain well below pre-"Arab Spring" levels. Worker remittances were up 10% y/y in 2Q17 to $4.8 billion.

At the same time, portfolio inflows skyrocketed following the pound float, providing further support to the external position. Net investment portfolio inflows shot up to $8.2 billion during the quarter, possibly the largest such inflow ever recorded. This came on the heels of a $7.6 billion net inflow in 1Q17.

Foreign reserves are holding at improved levels

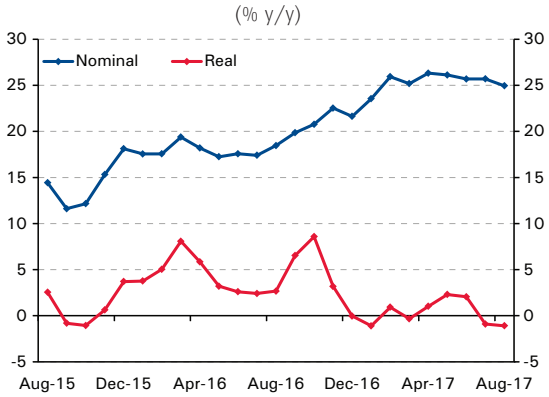
As a result, foreign reserves have risen significantly. By July, reserves had shot up past their pre-"Arab Spring" level for the first time. Since then, reserves have been largely steady, coming in at $36.7 billion or an estimated 8.1 months of imports at the end of November 2017. (Chart 13.)

The strong recovery in foreign reserves over the past year has seen the CBE remove restrictions imposed on foreign currency activity after 2011. The CBE recently scrapped caps on deposits and withdrawals by importers. It also imposed a 1% entry charge for use of the CBE repatriation mechanism by foreign investors, presumably in an effort to discourage its use and possibly with an eye toward eventually phasing it out entirely.

Multilateral commitments, including from the IMF, have been an important source of foreign reserves. However, the more important source has been private investment and other private flows. Higher interest rates have made domestic bonds more attractive while equities have drawn investors hoping to profit from the economic recovery.

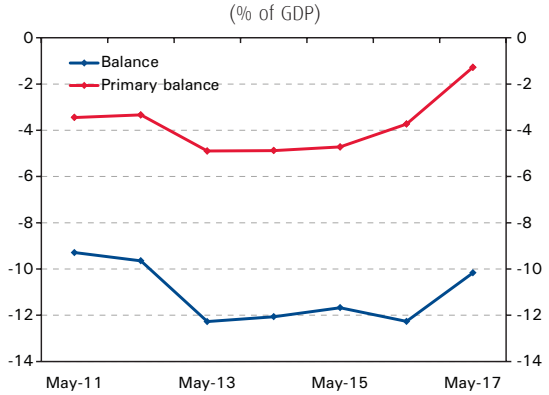
Despite the improved outlook and investment sentiment, rating agencies have yet to upgrade the country's sovereign credit rating to reflect that. Moody's affirmed the sovereign rating at B3 with a stable outlook in August.

Chart 8: Private credit in local currency



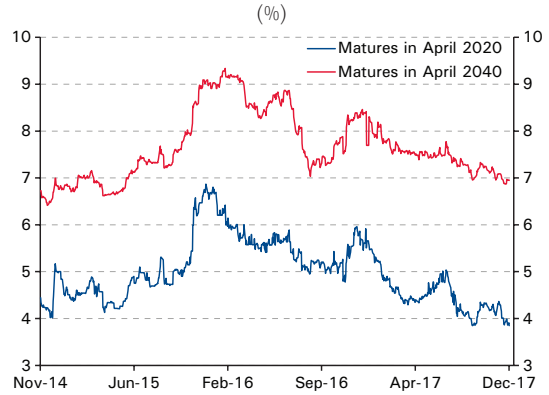
Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 9: Fiscal balance



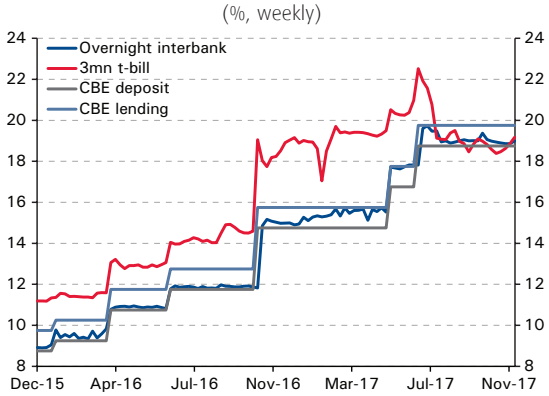
Source: MOF, NBK estimates

Chart 10: USD sovereign bond yeilds



Source: Thomson Reuters Datastream

Chart 11: Interest rates



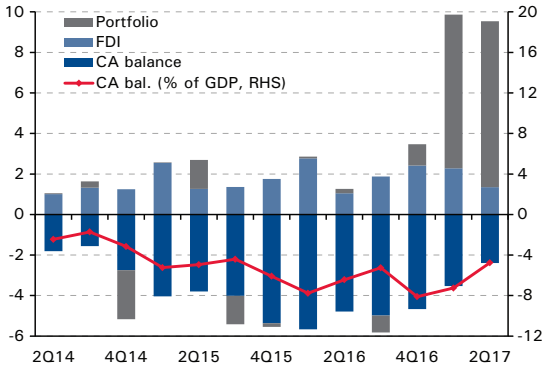
Source: Central Bank of Egypt, Thomson Reuters Datastream

The agency pointed to continued weakness in the country's fiscal position and large financing needs, while noting the "strong" commitment to reforms. The country's sovereign rating by the three major rating agencies remains 4-5 notches below 2010. Indeed, 2018 might be the year when rating agencies begin to take a more positive view as risks recede and economic reforms picks up pace.

Equities continued to do well on the positive outlook

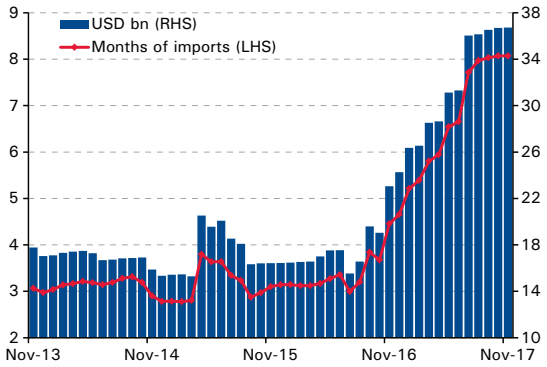
After seeing a strong rally in the wake of the pound's float, equities continued to do well in 2017. The EGX30 was up 17% year-to-date through 5 December. However, despite the strong 72% rise in the EGX30 index to-date following the currency float, the gains have not been enough to counter the decline in the pound. The index valued in US dollars is down 15% to-date from the end of October 2016.

Chart 12: Balance of payments



Source: CBE, Thomson Reuters Datastream, NBK estimates

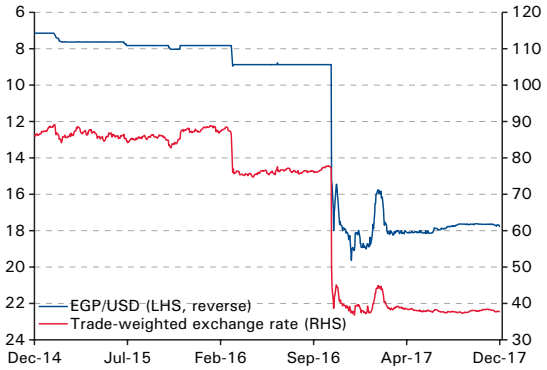
Chart 13: Official reserves



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30, thousand)

Source: Thomson Reuters Datastream

Regional economic data and forecasts

	Unit	2013	2014	2015	2016	2017f	2018f	2019f
Bahrain								
Nominal GDP	USD bn	32.8	33.8	31.0	32.1	33.8	36.0	38.2
Real GDP	% y/y	5.6	4.5	2.8	3.2	2.7	2.9	2.9
Oil sector	% y/y	15.3	3.0	-0.1	-0.1	-0.9	0.3	1.4
Non-oil sector	% y/y	3.3	4.9	3.6	4.0	3.6	3.5	3.3
Budget balance	% of GDP	-3.1	-3.6	-13.0	-13.5	-12.1	-9.9	-8.4
Current account balance	% of GDP	17.3	16.4	-1.6	-3.8	-3.0	-0.6	1.6
Inflation	% y/y	3.2	2.7	1.8	2.8	1.0	2.5	2.5
Kuwait								
Nominal GDP	USD bn	174.3	162.7	114.7	111.0	124.3	130.2	136.3
Real GDP	% y/y	1.1	0.5	0.6	3.5	-1.0	1.7	2.8
Oil sector	% y/y	-1.8	-2.1	-1.7	2.3	-4.5	0.0	1.5
Non-oil sector	% y/y	4.2	4.8	0.4	2.0	3.0	3.5	4.0
Budget balance	% of GDP	10.0	-5.9	-17.3	-17.7	-12.5	-13.0	-12.5
Current account balance	% of GDP	38.8	33.1	3.5	-4.5	4.7	3.1	1.1
Inflation	% y/y	2.7	3.2	3.7	3.5	1.6	2.2	2.8
Oman								
Nominal GDP	USD bn	78.9	81.0	68.8	66.7	73.8	76.3	79.5
Real GDP	% y/y	6.6	2.8	4.7	5.4	0.3	2.4	2.3
Oil sector	% y/y	2.7	-1.0	4.4	2.3	-2.9	2.2	1.2
Non-oil sector	% y/y	9.8	5.7	5.0	7.6	2.5	2.5	3.1
Budget balance	% of GDP	0.9	-3.4	-17.5	-20.6	-13.7	-11.6	-10.5
Current account balance	% of GDP	6.6	5.5	-15.9	-18.4	-10.0	-8.7	-7.4
Inflation	% y/y	1.1	1.0	0.1	1.1	1.9	3.3	2.9
Qatar								
Nominal GDP	USD bn	198.7	206.2	164.6	152.4	161.4	169.4	176.3
Real GDP	% y/y	4.4	4.0	3.6	2.2	1.2	3.5	2.0
Oil sector	% y/y	0.1	-0.6	-0.5	-1.0	-1.0	4.0	1.0
Non-oil sector	% y/y	10.4	9.8	8.2	5.6	3.5	3.0	3.0
Budget balance	% of GDP	14.7	13.6	-1.0	-9.0	-5.0	-3.0	-2.0
Current account balance	% of GDP	30.4	24.0	8.4	-5.5	2.0	3.0	3.0
Inflation	% y/y	3.1	3.3	1.8	2.7	0.5	2.5	2.5
Saudi Arabia								
Nominal GDP	USD bn	746.6	756.4	651.8	646.4	685.4	709.8	736.9
Real GDP	% y/y	2.7	3.7	4.1	1.7	-1.3	1.2	2.0
Oil sector	% y/y	-1.6	2.1	5.3	3.8	-3.7	1.1	0.8
Non-oil sector	% y/y	6.3	4.9	3.2	0.2	0.5	1.3	2.9
Budget balance	% of GDP	6.3	-2.5	-15.0	-16.9	-7.3	-4.5	-2.8
Current account balance	% of GDP	18.1	9.8	-8.7	-4.3	-0.3	0.5	0.7
Inflation	% y/y	3.5	2.7	2.2	3.5	-0.2	2.9	2.0
UAE								
Nominal GDP	USD bn	390.4	403.2	357.9	348.7	383.3	407.0	434.7
Real GDP	% y/y	4.7	3.3	3.8	3.0	2.2	2.6	3.4
Oil sector	% y/y	2.9	0.4	5.4	3.8	-0.3	0.2	1.2
Non-oil sector	% y/y	5.6	4.6	3.2	2.7	3.3	3.7	4.0
Budget balance	% of GDP	2.7	1.9	-3.4	-4.3	-3.4	-2.0	-1.8
Current account balance	% of GDP	19.0	13.3	4.7	3.2	3.4	3.7	3.9
Inflation	% y/y	1.1	2.3	4.1	1.6	2.5	4.0	3.0
Egypt (fiscal year)								
Nominal GDP	USD bn	304.9	331.5	326.1	251.2	237.4	266.7	298.7
Real GDP	% y/y	2.9	3.4	2.3	3.6	4.7	5.0	5.5
Budget balance	% of GDP	-11.5	-11.0	-12.1	-10.9	-8.5	-7.5	-6.5
Current account balance	% of GDP	-0.9	-3.7	-6.1	-6.1	NA	NA	NA
Inflation	% y/y	8.2	11.4	14.0	29.8	13.6	10.0	8.8

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	55.0	55.0	55.0
CRB commodity price index	Index	457.3	437.8	374.8	423.1	-	-	-
Eur/USD	1$ = €	0.736	0.827	0.921	0.951	-	-	-
US Fed Fund Rate	%	0.25	0.25	0.5	0.75	-	-	-
MSCI World stock market index	Index	1,661	1,730	1,663	1,751	-	-	-
MENA real GDP (IMF/NBK)	% y/y	2.5	2.6	2.6	5.1	2.4	3.3	3.2
World real GDP (IMF)	% y/y	3.5	3.6	3.4	3.2	3.6	3.7	3.7

Source: Thomson Reuters Datastream, official sources, IMF, NBK estimates

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