Macroeconomic outlook

# Oman: 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.

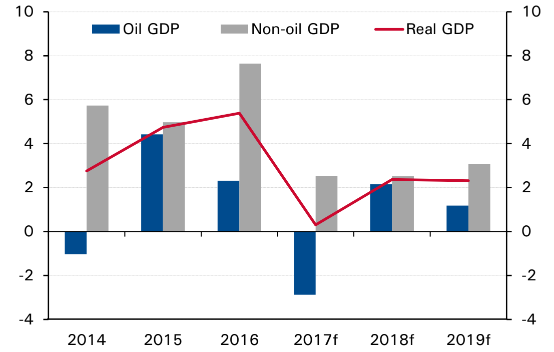
With the production cut agreement due to expire in 2019, crude oil output should return to around pre-cut levels, causing a pick-up in hydrocarbon

**Table 1: Key economic indicators**

| | | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Nominal GDP | US$ 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 | 7.6 | 2.5 | 2.5 | 3.1 |
| CPI | % y/y | 1.1 | 1.9 | 3.3 | 2.9 |
| Budget balance | % GDP | -20.6 | -13.7 | -11.6 | -10.5 |

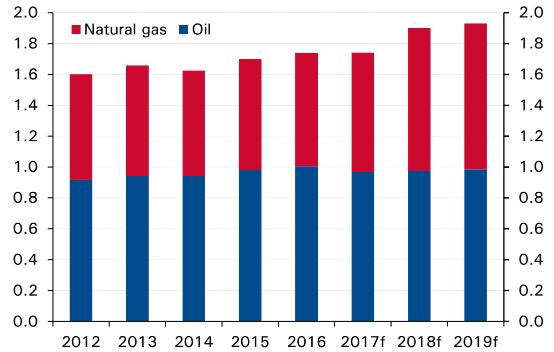
Source: National Center for Statistics and Information, NBK estimates

**Chart 1: Real GDP**
(% y/y)



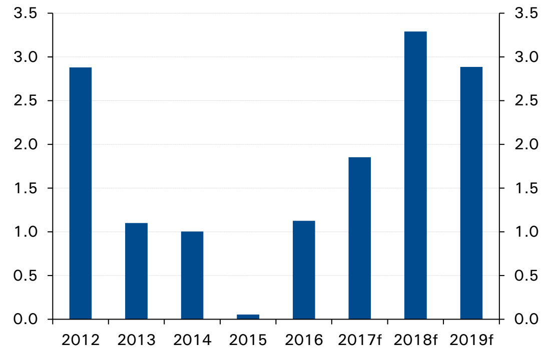

Source: National Center for Statistics and Information, NBK estimates

**Chart 2: Hydrocarbon production**
(mboe/d)




Source: National Center for Statistics and Information, NBK estimates

**Chart 3: Consumer price inflation**
(% y/y)




Source: National Center for Statistics and Information, NBK estimates 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 financial constraints, officials will continue to pursue Oman's Vision 2020, helping unclog 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 logistic 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 could 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, Qatar's diplomatic crisis 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 2H18, offsetting downward pressures from global food and energy prices. (Chart 3.) Inflation is projected to average 3% over the forecast period.

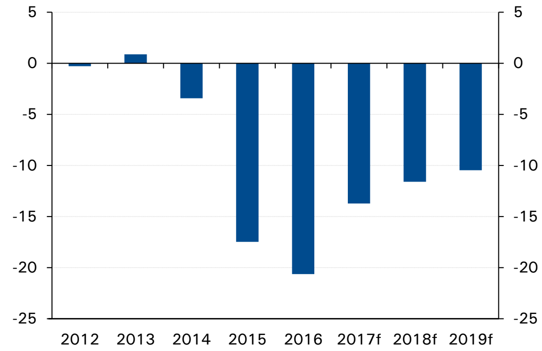
## Large fiscal deficit to persist through 2018 and 2019

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.

**Chart 4: Budget balance**

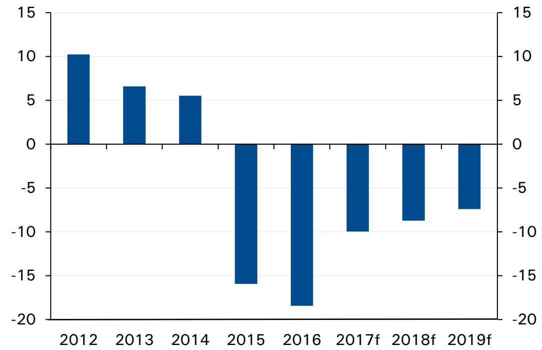
(% of GDP)




Source: National Center for Statistics and Information, NBK estimates

**Chart 5: Current account balance**

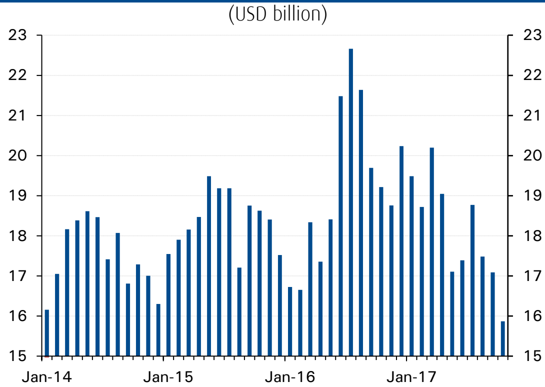
(% of GDP)




Source: National Center for Statistics and Information, NBK estimates

**Chart 6: Central bank foreign assets**

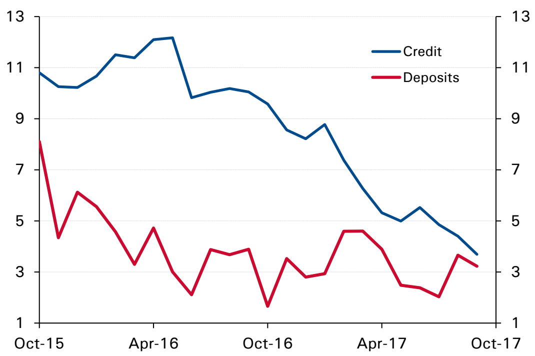
(USD billion)




Source: Central Bank of Oman

**Chart 7: Private sector credit and deposits**

(% y/y)




Source: Central Bank of Oman

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 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 issues 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 pick-up 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 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 services and income deficits 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 slightly tightening

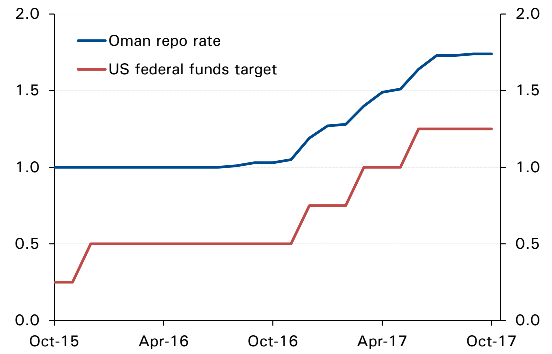
Monetary conditions are projected to tighten as private lending increases at modest single digit levels to compensate for the higher cost of living and deposit growth continues to ease due to weaker economic activity. (Chart 7.)

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

**Chart 8: Policy rates**

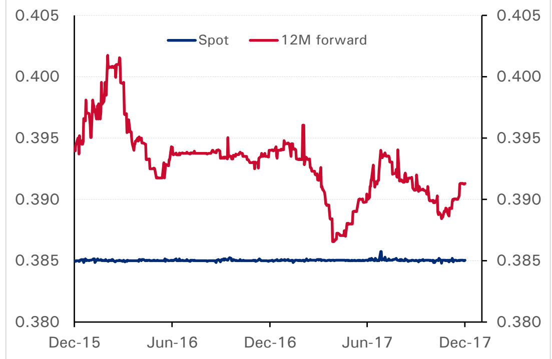
(%)




Source: Central Bank of Oman

**Chart 9: Exchange rate**

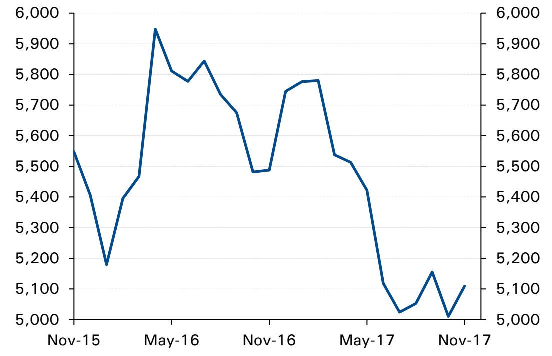
(OMR/USD)




Source: Thomson Reuters Datastream

**Chart 10: Muscat Securities Market**

(index)




Source: Muscat Securities Market

blockade on Qatar. It has since dropped, but increased again following the Saudi corruption crackdown. As of 4 Dec 2017 the 12-month forward rate stands 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.) 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 (NPL) 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.

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