United Arab Emirates

In search of a second wind

Economic growth has slowed for the past three years. OPEC+'s restrictive policy is curbing oil production. Non-oil GDP has been hit by sluggish tourist traffic, which has eroded domestic demand, notably in Dubai. In the short term, in the midst of a slowdown in world trade, the only factor that is boosting growth is the current preparations for Expo 2020. In this environment, consumer price inflation is negative, pulled down by the persistent slump in house prices. Fiscal policy remains cautious and offers little support for growth.

The feeble rebound in real GDP growth in 2018 (+1.7% compared to +0.5% in 2017) confirmed the sluggishness of the UAE economy. All of the components of domestic demand declined, both consumption and investment. This meagre GDP growth was due solely to a decline in imports and a slight upturn in exports at a time when hydrocarbon production was on the rise. In 2019, with OPEC+ renewing its restrictive policy [1] and with the non-oil economy showing no signs of a recovery, prospects are still looking morose.

Oil GDP growth faces headwinds

In the midst of the slowdown in global economic growth, and given the dynamic momentum of US oil production, OPEC policy is likely to remain restrictive in the quarters ahead. In early July, the group of OPEC+ countries decided to renew the production levels adopted at year-end 2018. As a result, UAE oil production is expected to remain unchanged in 2019 at about 3.05 million barrels a day (mb/d). On average, this represents a 2.4% increase in production compared to 2018.

In 2020, our central scenario calls for the stability of oil GDP in the UAE (equivalent to about 30% of total GDP). World oil supply will continue to be influenced by US production, which is unlikely to encourage the OPEC+ countries to ease significantly their restrictive policy. Looking beyond factors pertaining to the oil market, the main risk to oil GDP is geopolitical. Rising tensions in the Strait of Hormuz since the beginning of the year have led to low-intensity attacks on maritime shipping routes. These incidents highlight the vulnerability of the Emirate's oil outlets. Production is essentially located in Abu Dhabi (96% of total production) and is shipped via the Strait of Hormuz. In case of a blockade, the pipeline between Abu Dhabi and the port of Fujairah can transport 50% of production. These two alternatives for transporting oil products were hit by attacks that caused minor damage. Although a complete blockade of transport channels is unlikely, the risk of a temporary rupture has increased.

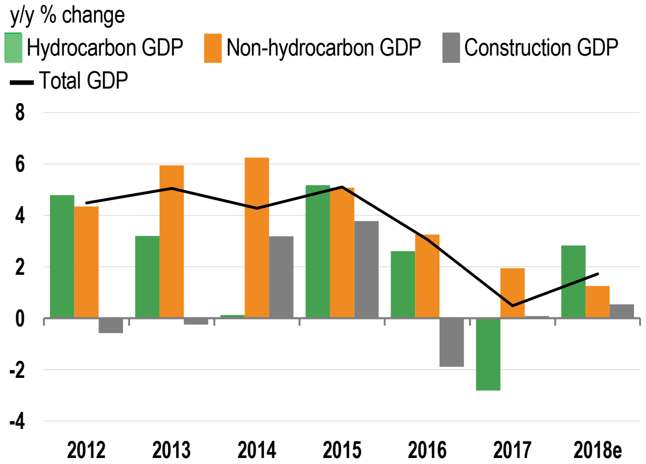
In the medium term, assuming OPEC's policy eventually changes, the national oil company ADNOC has ambitious targets: to boost daily production to 5 mb/d by 2030, develop the petrochemical industry, and increase natural gas production in order to achieve self-sufficiency.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	0.5	1.7	2.4	3.2
Inflation (CPI, year average, %)	2.0	3.1	-1.8	1.0
Gen. Gov. balance / GDP (%)	-1.7	1.8	0.2	0.9
Gen. Gov. debt / GDP (%)	20	17	17	16
Current account balance / GDP (%)	7.0	12.0	11.0	11.0
External debt / GDP (%)	67	64	66	66
Forex reserves (USD bn)	95	100	105	107
Forex reserves, in months of imports	6.8	6.6	6.5	6.5
Exchange rate USDAED (year end)	3.67	3.67	3.67	3.67

e: BNP Paribas Group Economic Research estimates and forecasts

2- Slow economic growth



Source: Federal Competitiveness and Statistics Authority, BNP Paribas

Mixed outlook for the non-oil sector

Growth in the non-oil sector was unusually weak in 2018 at 1.3%, the lowest growth rate since the 2009 crisis. The slowdown can be attributed to several factors, notably the lacklustre regional environment, the introduction of VAT on consumption, the negative indirect effects of the Qatar embargo and the dollar's appreciation,

[1] OPEC+ is mainly comprised of OPEC members + Russia.

which might have had an unfavourable impact on tourism. Short-term prospects are still uncertain, and economic signals are contradictory.

In June 2019 the PMI index reached 57.7, confirming its rebound since end-2018. This was the exception, however, and the other economic indicators are all trending downwards, notably in Dubai, which is by far the Federation's most diversified economy. Passenger traffic at the Dubai airport has slowed continuously since 2016. In Q1 2019, full-year growth was virtually nil (+0.2%). The sharp slowdown in the tourism sector confirms the trend observed since 2016. We can also see a significant decline in spending by tourists. According to the central bank, revenue per overnight stay declined by 7.6% in 2018, resulting in feeble retail sales growth. This is the Emirate's biggest economic sector (12%) after the extractive industries (30%). Growth was the slowest in the past two years (0.1% and 0.5%, respectively).

Activity in the construction sector is still trending upwards, notably as projects are completed for the World Expo 2020. This is likely to be the main growth engine in 2019. Construction sector lending remains the most dynamic segment of bank lending to the private sector (+8% y/y in March 2019). Excluding projects pertaining to Expo 2020, however, the property sector has been hit by ongoing price declines since 2016, due to a chronic over supply.

At the same time, external factors are likely to place a negative strain on activity in the short term. The Emirates are a major logistical base for regional trade (essentially with Asia and the Middle East). Re-export activities account for about 60% of total non-oil exports. Even though the US-China trade war will not have a direct impact on UAE growth, the decline in world trade will reduce the Emirate's logistics activities. In volume terms, world trade rose at an average monthly rate of only 0.5% in Q1 2019, compared to 3.6% in Q1 2018. Rising political tensions in the region is another factor that will continue to strain growth. The Dubai economy is dependent on the services sector and foreign investment, notably in the property market, which makes it especially vulnerable to the deterioration in the regional political environment.

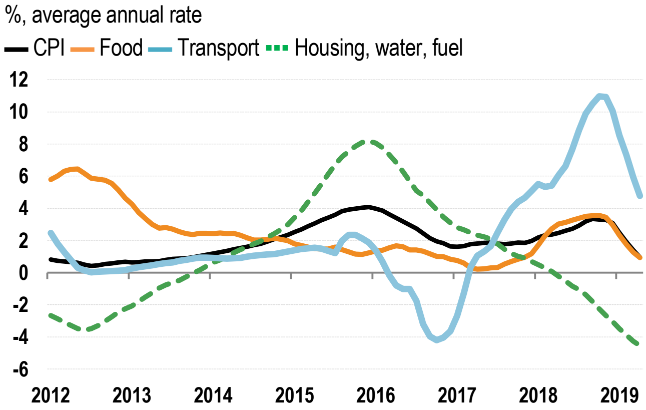
Economic policy provides little support

In the midst of a morose economy, economic policy measures are unlikely to be significant support factors. The 2019 budget is expected to support growth, but without triggering a major recovery in public expenditures. The main government measures target improvements in the business environment, notably for foreign investment. In terms of monetary policy, the growth of bank lending could get a boost from the decline in central bank rates. With the dirham pegged to the US dollar, the slight decline expected in US rates in 2019 should reduce the cost of financing.

Deflationary environment

Feeble activity in the non-oil sectors and a depressed property market have created deflationary pressures. Inflation was still positive at 3% in 2018, mainly due to the introduction of VAT at the beginning of the year. In 2019, we are looking for a decline in overall consumer price inflation to an average annual rate of about 1.8%.

3- Broad decline in consumer prices



Source: Federal Competitiveness and Statistics Authority, BNP Paribas

The housing and energy component, which accounts for a third of the composition of the consumer price index, declined 4.5% y/y in April 2019. Similarly, transport and food prices have been trending downwards since the beginning of the year. The decline in housing prices should continue to negatively weigh on the overall index at least through the end of the year.

It is hard to determine whether the Emirate's sluggish economic activity is due more to structural factors (decline in attractiveness for tourists and investors) or to cyclical ones (economic slowdown in the Gulf region, geopolitical tensions). Growth seems to be in the process of normalising, notably in Dubai. The current situation could strain the quality of bank assets, due notably to their exposure to the construction and housing sectors (25% of private sector loans). Moreover, if growth continues to slow over the long term it could strain the performance of government-related entities, which are very active in the sector and heavily leveraged.

Nonetheless, the UAE economy continues to benefit from solid fundamentals, both in terms of public finances and external accounts. Recent consolidation movements at various levels (banking, sovereign funds) and a cautious economic policy have bolstered the country's medium-term prospects.

Pascal Devaux
pascal.devaux@bnpparibas.com