Oman - Economic Insight

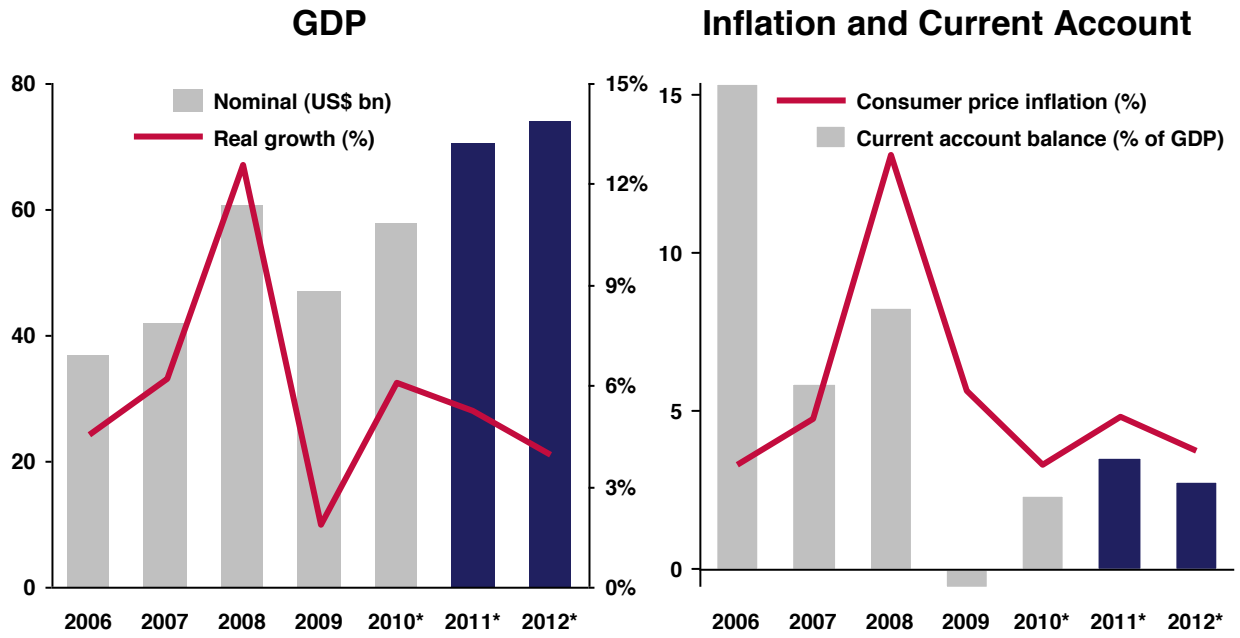
April 2011

QNB CAPITAL

* All oil and gas fields are in Petroleum Development Oman's concession area, unless indicated.

Oman outlook summary for 2011-12

- Oman has a **population of 2.7m,** of which more than a quarter are expatriate workers. A majority of the population is concentrated near the northern coast and around Salalah in the far south
- **Oman's economy is dominated by oil and gas**. However, its reserves are smaller and harder to exploit than those of its GCC neighbours
- Investment in enhanced oil recovery techniques are boosting production, after a period of decline. We forecast that **oil production will increase by an average of 3.6%** a year to reach 927,000 bpd in 2012
- **Increasing gas production is fuelling industrialisation**. We expect that gas production will rise to 3.45bn cu ft/day in 2012. LNG exports will continue at around 9m tonnes a year
- **Real GDP will grow by an average of 4.6%** in 2011-12. Nominal GDP will grow more rapidly owing to high oil prices and is forecast to reach US$74bn in 2012



Source: MONE, *QNB Capital estimates and forecasts, 2011

- We estimate that **the current account returned to surplus in 2010**. It will post an average surplus of 3.1% of GDP in 2011-12, as strong net export earnings offset deficits from corporate profit repatriation, expatriate remittances and trade in services
- We forecast **inflation will pick up slightly in 2011-12 to an average of 4.4%.** This will be due to a recovery in local demand, coupled with high global food and fuel prices
- The fall in energy prices in 2009 resulted in Oman's first fiscal deficit in a decade. Subsequently, with the recovery in oil prices, we expect **government revenue to exceed expenditure by approximately 10% of GDP** in 2011-12. Most of this will flow into the State General Reserve Fund, so the budget surplus will be nearer 1% of GDP
- Oman's **banking sector** is small and underpenetrated. Conservative oversight has kept it well insulated from the global financial crisis
- The Muscat **stock exchange** index has outperformed other indices in the GCC but market capitalisation and turnover are relatively low

Table of Contents

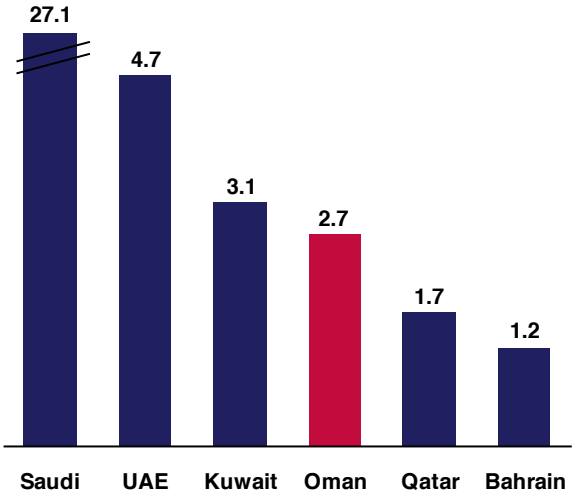
Table of Charts

1. Country Overview and Demographics

A. Country Overview

With a **population** of 2.7m, Oman accounts for about 6.6% of the total Gulf Cooperation Council (GCC) population of 41m (Fig 1.1). Oman is the second largest country in the GCC by land area. It is therefore the least densely populated.

Fig 1.1 GCC Population (2010)



Source: Bahrain, Oman, Qatar, Saudi census 2010; QNB Capital estimates for Kuwait and UAE, 2010

Oman has high hydrocarbons revenue relative to its population, but low reserves

Oman's economy is dominated by the oil and gas sector. **Oil and gas** make up around half of its nominal GDP. They also account for the vast majority of exports and government revenue. A useful measure of Oman's relative hydrocarbon wealth is the government's revenue from hydrocarbon exports, relative to the population of nationals. This was about US$7,000 in 2009, slightly higher than the US$6,200 received per national by Saudi Arabia, but well below Qatar's US$79,200 (Fig 1.2).

However, Oman's reserves—equivalent to approximately 6,200 barrels of oil per citizen—are much smaller than those of all the other GCC members (except Bahrain). In addition, they are also more expensive to extract as the rocky terrain in Oman complicates drilling.

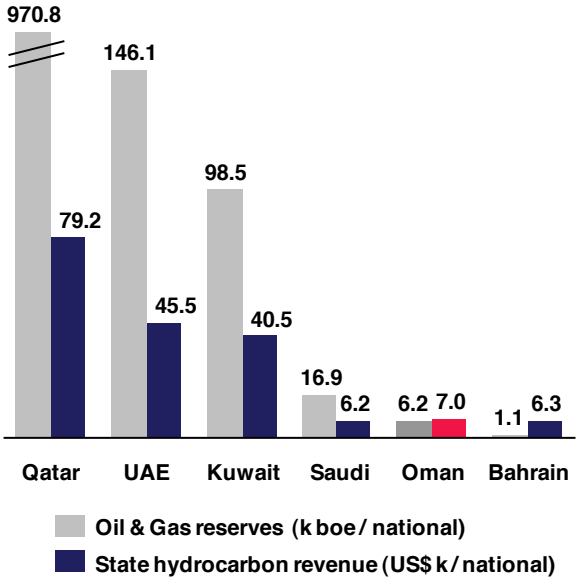
Oman's Vision 2020 looks to private sector diversification and regional development

Oman has made considerable progress in diversifying its economy[1]. Long-term **economic planning has been central to this success**. Oman's Vision 2020 was developed in 1995 with assistance from the IMF. It outlined a developmental path towards an economy that is less dependent on the oil sector. This was prepared in anticipation of a decline in oil production, which did indeed begin to happen after 2001.

One of the main aims of the vision was to create jobs for nationals, which would reduce unemployment and dependence on the expatriate labour force. This objective has been pursued through regional economic development, including the establishment of **hubs for industry and trade** at coastal cities[2]. Development was supported by rising gas production, which gave the state the opportunity to leverage its gas resources for industrial projects.

The **private sector** is an effective job creator. Its development has been successfully encouraged by the government and the implementation of Vision 2020[3]. Investment has also been flowing into other sectors, such as tourism, transhipment and real estate developments.

Fig 1.2 GCC Oil and Gas Reserves and Revenue per National (2009)



Source: BP, IMF, QNB Capital, 2011

Oman's recent five-year plans have focused on downstream gas-based industrialisation

The Omani government implements its policies over the medium-term through a series of **five-year plans**. The 8th five-year plan began in 2011. The previous three five-year plans have focused on utilizing Oman's gas reserves:

- Oman's first liquefied natural gas (LNG) exports were shipped in 2000 from a terminal at Sur
- Gas has been used as feedstock and as a power source for a range of petrochemical and heavy industrial plants, mainly located in Sohar

Although significant progress has been made, gas production for domestic use has not grown as quickly as

[1] The non-oil sector has increased its share of GDP from 52% in 2000 to 73% in 2009 at 2000 prices

[2] Such as Sohar, Sur, Salalah, and soon at Duqm

[3] The real share of private consumption in GDP expanded from 35% in 2000 to 53% in 2008, in terms of 2000 prices

originally anticipated. This has caused Oman to scale back its industrial ambitions.

In 1970-2010, Oman achieved the world's greatest improvement in human development

The UN Development Programme (UNDP) ranked Oman as the country with the greatest improvement in its **Human Development Index** between 1970 and 2010[4]. The index measures progress against a wide range of health, education and income criteria.

In 1970, Oman's level of development was similar to that of the Democratic Republic of Congo. Since then, there has been a remarkable improvement, which is referred to locally as "The Renaissance". For example:

- Gross school enrolment and literacy rates have quadrupled
- Life expectancy has increased by 27-years

B. Demographics

The majority of the 2.7m population resides in the northern part of Oman

The latest census in December 2010 recorded a total population of 2.7m[5]. This was 15.1% higher than in the 2003 census, implying an average growth rate of about 2% a year. We forecast that this rate will pick up slightly in 2011-12 to an average of 2.4% a year. Population growth will accelerate as the economy recovers from the global recession and more expatriate workers move to Oman.

According to the census, there were about 730,000 foreigners residing in Oman in 2010, making the **expatriate share in the population 27.6%**. This is similar to the share of expatriates in Saudi Arabia, but far lower than in the smaller GCC states. In Qatar, for example, expatriates make up over 80% of the population.

About 85% of the population is **geographically concentrated** in a band about 50 miles deep along the northern coast[6]. Most of the rest of the country is sparsely populated desert[7].

The Omani population's age distribution could create a demographic dividend

The growth of the **Omani national population** is averaging just 1.3%. This compares with an average of 3.5% per year for Qatari nationals. There are two reasons for this slow growth:

- **Emigration**: Freer regional markets have made it easier for Omanis to work in other GCC states[8]
- **Declining birth rates**: family sizes have fallen rapidly as the country has developed

The reduced birth rate has contributed to the opening up of a **demographic window** for Oman's national population. This means that the working-age population will be large relative to children and retired people for a few decades.[9] This creates an opportunity for accelerated economic growth. This kind of demographic dividend has been a factor in the rapid development of many countries, for example China, in recent years.

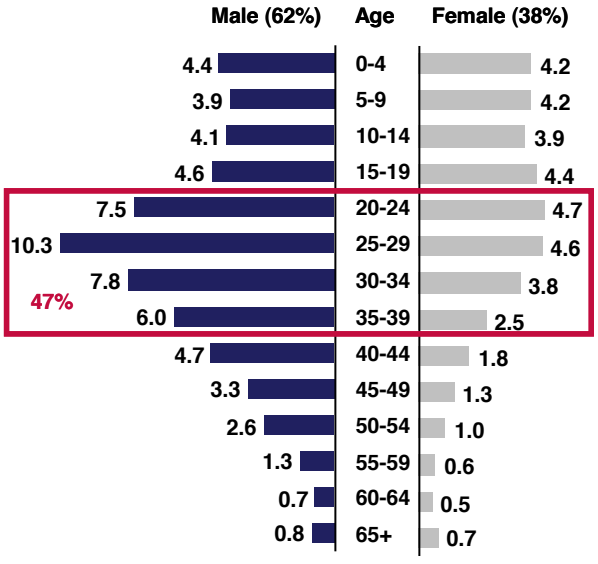
47% of the population are aged 20-39 and 62% are male, because of expatriates

The expatriate labour force has a high proportion of 20-39 year olds, boosting this age band to 47% of the total population (Fig 1.3)[10]. This further widens the demographic window, creating additional opportunity for economic growth.

Approximately 80% of expatriate workers are male, creating a **gender imbalance**. As a result, 62% of the total population in Oman is male. This share is even higher in the working age groups.

Fig 1.3 Population by Age and Gender (2009)

(% share of total)



Source: Ministry of National Economy (MONE) pre-census estimates, 2010

[4] 2010 Human Development Report "The Real Wealth of Nations: Pathways to Human Development", UNDP

[5] This is preliminary, the full census results were not yet available at the time of publication

[6] This includes the greater Muscat conglomeration and the Batinah region. It also encompasses major inland regional centres, across the Hajar mountains, such Burami, Ibri and Nizwa. In the south, the Dhofar plateau around Salalah is also densely populated

[7] The exceptions include Musandum, which is geographically disconnected from the rest of the country on the Strait of Hormuz

[8] Oman has the highest rate of emigration amongst the GCC states

[9] More accurately, a demographic window is when the number of children under 15 are less than 30% of the population and the number over 65 years remain below 15%

[10] The breakdown by age and gender shown is based on MONE's pre-census estimates, because the full census results had not been released at the time of publication

Labour Force

Omanisation is not enough to create jobs for the 30,000 new workforce entrants each year

Oman was a pioneer within the GCC in adopting policies aiming at increasing the participation of the national population in the workforce, particularly in the private sector. **Omanisation** policies provide incentives and penalties to encourage companies to meet targets on increasing employment of Omanis. It also includes longer-term initiatives in education and vocational training.

Omanisation has had some success but more needs to be achieved. The number of Omanis working in the private sector has increased by almost 80% to 177,000 in the last four years. However, this has been partly due to the strong growth of the private sector. The proportion of Omanis to expatriates in the private sector workforce has actually declined.

Around 30,000 Omanis enter the workforce each year. **Unemployment** amongst Omani nationals therefore remains a major challenge for the government.

Most expatriate workers come from India, Pakistan, Bangladesh and the Philippines, and mainly work in the construction and services sectors. There are also some more highly skilled workers from these countries, as well as from other Arab states, Europe (particularly the UK) and North America.

The average wage in 2009 was equivalent to US$7,116 per year

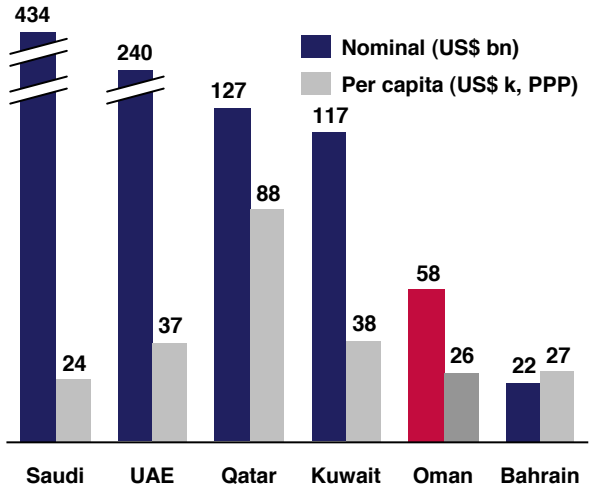
The average wage in 2009 was OR228 per month (equivalent to US$593/month and US$7,116/year), up 5% on 2008. This is only slightly higher than the new minimum wage of Omani nationals, which was raised by 43% to US$520 in February 2011. A new US$390 per month allowance for job-seekers was also announced at the same time. Wages vary considerably between workers depending on their nationalities and skills. Many low-skilled expatriates are on salaries in the region of US$100-250 per month.

2. Gross Domestic Product

A. Nominal GDP

In 2010, nominal GDP recovered by 24% to US$58bn, about 6% of the GCC total

Fig 2.1: GDP in the GCC (2010)

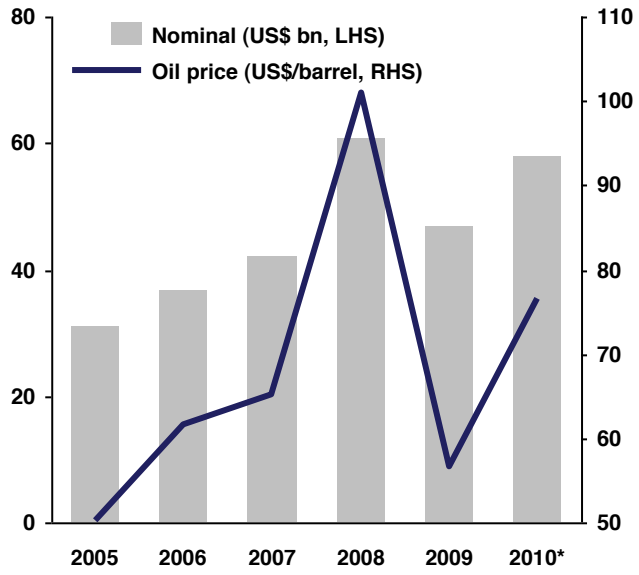


Source: IMF and QNB Capital estimates, 2011; Note: Purchasing power parity (PPP) adjusts GDP relative to prices in each country

Oman's nominal GDP reached an estimated US$58bn in 2010. Oman is the second smallest economy in the GCC, after Bahrain, and represents about 6% of the regional GDP (Fig 2.1). However, it has grown rapidly in recent years, particularly as a result of energy price rises in 2005-08. Its compound annual growth rate (CAGR) during this period was 25%. About two-thirds of this growth was due to increases in prices.

A temporary decline in oil prices pushed GDP down by 22.6% in 2009, but quarterly data until September 2010 shows that it has risen strongly since then, as oil prices have also recovered.

Fig 2.2: Nominal GDP and Oil Prices (2005-10)



Source: MONE, *QNB Capital estimate for GDP, 2011

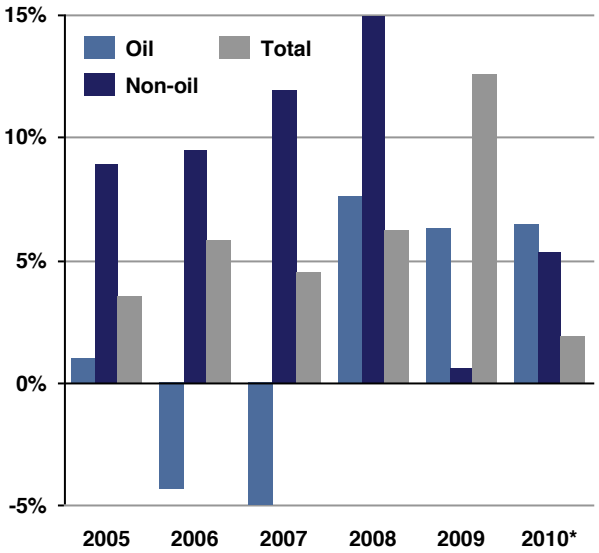
B. Real GDP

Real growth in 2005-08 came from the non-oil sector, whereas oil led the way in 2009

Aside from price increases, the underlying growth in the real economy was also strong. Real GDP grew at an impressive **CAGR of 7.2%** in 2005-08, peaking at 12.6% in 2008.

This real growth actually came from the **non-oil sector**, which experienced a CAGR of 11% during 2005-08 (Fig 2.3). Meanwhile the oil sector was flat in real terms over this period. Oil production volumes declined steadily until 2007, before recovering in 2008 (see Section 3A).

Fig 2.3 Real GDP Growth (2005-10)



Source: MONE, *QNB Capital estimate, 2011

In 2009, the **global recession** had an impact on large parts of Oman's real economy, both directly and indirectly:

- Directly through a fall in demand, and hence in production
- Indirectly through a decline in government spending because of reduced government oil revenue (see Section 5B). The government has long been a key driver of the non-oil economy

Nonetheless, the non-oil sector managed to achieve 0.5% real growth in 2009. Meanwhile, the oil sector grew by 6.2%. This was possible because Oman is not a member of OPEC, and so was not obliged to reduce its oil output in response to the fall in prices. The overall result was that Oman recorded 1.9% real growth in 2009, a challenging year in which some of its neighbours experienced a recession.

In 2010, as the non-oil sector recovered, we estimate that the rate of real growth picked up to 6.1%.

C. GDP by Economic Sector

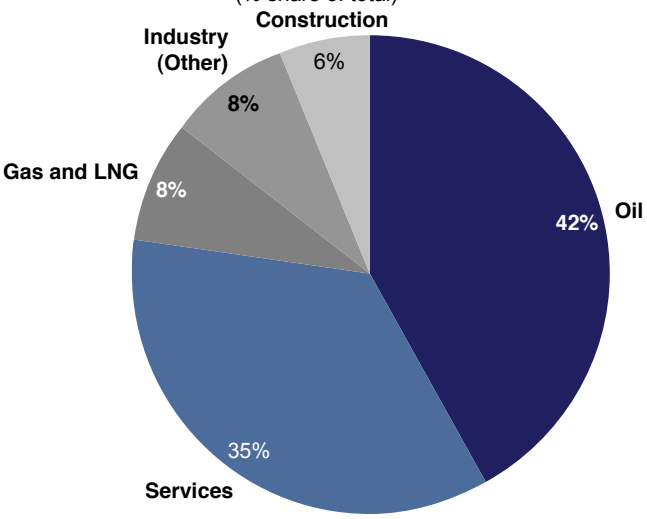
Oil and gas comprises over 50% of the economy

We estimate that the **oil and gas** sector accounted for around 50% of nominal GDP in 2010[11] (Fig 2.4). There is an additional indirect contribution of oil and gas to the overall economy. This is because the government's spending of its oil and gas revenue drives much of the rest of the economy.

The **services sector** is the second largest component of the economy. However, its share in nominal GDP has been declining in recent years. It fell to an estimated 35% of GDP in 2010, compared to an average of 42% in 2000-04. This has occurred despite a real CAGR of 8% in 2005-10. More buoyant prices in other sectors have driven down the share of the services sector in nominal GDP.

The **construction** sector has experienced the most substantial growth over the last decade. Its share of GDP more than tripled from 2.1% of GDP in 2000 to 6.5% in 2009. This growth was a result of a mix of industrial, commercial and residential developments, part of a regional construction boom.

Fig 2.4: GDP by Economic Sector (2010)
(% share of total)[12]



Source: QNB Capital estimates, 2011

The **industry sector** has grown strongly since 2005 after the launch of new petrochemical and metals plants in Sohar. Its contribution increased from 5% of GDP in 2005 to an estimated 8% in 2010, assisted by the government's efforts at diversification.

The growth of the industrial sector has reduced the relative importance of **agriculture's** contribution to the economy. Agriculture's share in GDP declined from 2.1% of GDP to just 1.4% over the last decade.

D. GDP by Consumption

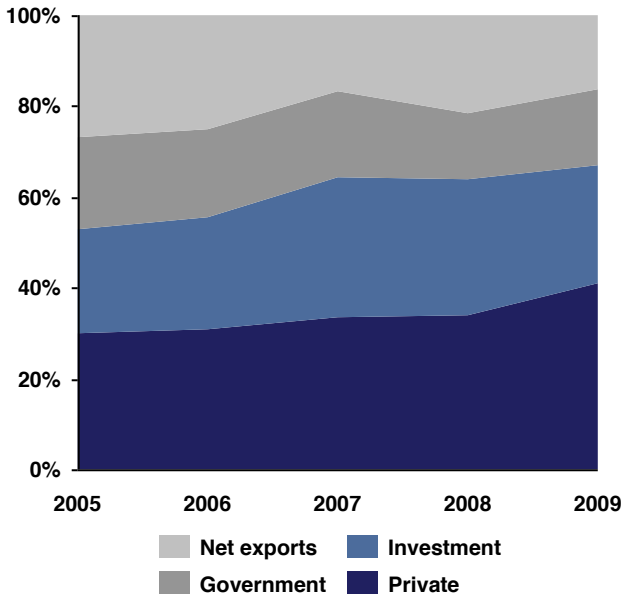
Investment has been making up an increasingly large share of GDP by consumption. Its share doubled from 15% of GDP in 2000 to 30% in 2008[13] (Fig 2.5). This is largely a consequence of major infrastructure projects and industrial development programmes. The shares of the other components of consumption in GDP in 2008 were:

- **Private consumption** 33%
- **Net exports** 21%
- **Government consumption** 15%

The recession in 2009 led to a fall in net exports and investment. This was compensated for by an increase in private consumption.

In 2010, we estimate that the shares of the four components returned nearly to their 2008 levels.

Fig 2.5 GDP by Consumption (2005-09)
(% share of GDP)



Source: MONE, 2010

[11] We estimate that the direct contribution of oil and gas production to nominal GDP was 46% in 2010, similar to its long-term average during the 2000s. These figures, however, do not take into account the contribution to GDP of liquefying natural gas and refining oil, as Oman includes these activities in the manufacturing sector. Together they make up a further 4-5% of GDP

[12] Agriculture at 1.3% is not shown, nor are deductions from financial intermediation (-2%) and taxes less subsidies (0.3%). Industry (Other) is a sub-set of the official industry sector, which also includes construction and LNG production

[13] Public data on GDP by consumption was not available for 2009, at the time of publication, but we expect that there was a sharp fall in investment, along with smaller declines in government and private consumption

E. Forecast for 2011-12

We forecast an average real GDP growth of 4.6% in 2011-12

We forecast that **real GDP growth** will ease slightly from 6.1% in 2010 to 5.2% in 2011 and then 3.9% in 2012. This will mainly be a consequence of a slowdown in the growth of oil and gas production.

The Ministry of National Economy (MONE) has targeted an average annual real growth of 5% in its 8th five-year plan (2011-15).

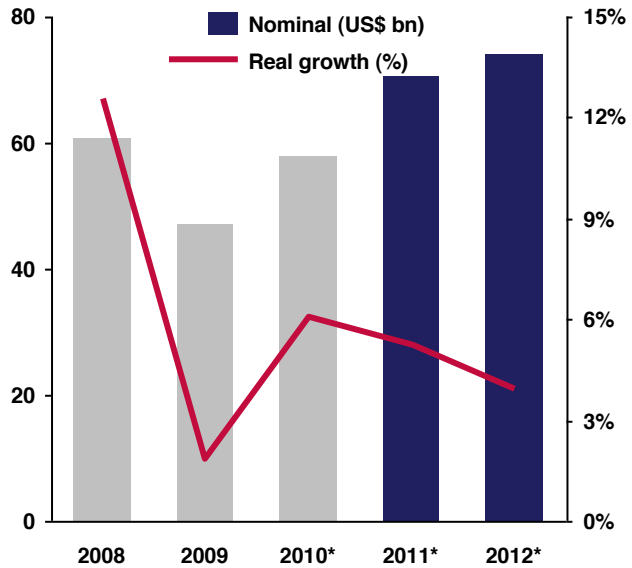
We forecast a rise in nominal GDP to US$74bn in 2012

We expect **nominal GDP** to rise by 22% to a record high of US$70bn in 2011 and by a further 5% to US$74bn in 2012.

The growth in 2011 will largely be a result of an increase in oil prices. We forecast that Omani oil will average US$102/barrel in 2011, 33% higher than in 2010. Therefore, nominal GDP in the **oil and gas sector** will grow by 36% in 2011. We are forecasting a small drop in oil prices in 2012, leading to a contraction in oil and gas GDP that year. However, the contraction will be limited to around 1% because of increases in both oil and gas production.

Meanwhile, the **non-oil and gas sector** is expected to achieve strong nominal GDP growth in both years. We forecast a 10% expansion in 2011 and 11% in 2012. This growth will be mainly led by manufacturing and construction.

Fig 2.6 GDP Forecast (2008-12)



Source: MONE, *QNB Capital estimates and forecasts, 2011

Looking at **GDP by consumption**, the important drivers of growth in 2011 are expected to be:

- Expanding exports
- Continuing recovery in fixed investment
- Increased government spending

In 2012, the growth in import values is likely to exceed the growth in export earnings. Indeed, net exports may even be negative if oil prices fall more than is anticipated. Therefore, it will be rising domestic demand, driven by government expenditure, that delivers the growth in nominal GDP.

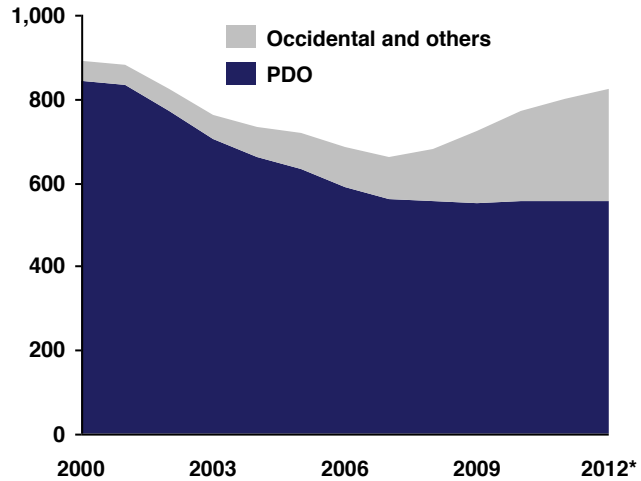
3. Production by Sector

A. Oil

Enhanced oil recovery techniques have boosted production

Oil production fell steadily from a peak in 2001 to a low in 2007 owing to declining production at mature fields. Since then, the application of **enhanced oil recovery (EOR)** programmes[14] has helped boost production from a low of 710,000 barrels per day (bpd) in 2007 to 865,000 bpd in 2010 (Fig 3.1), a 22% increase.

Fig 3.1 Oil Production (2000-12)
(k, bpd)



Source: Ministry of Oil and Gas, BP, *QNB Capital forecasts, 2011

Reserves would only last for 19 years at current production rates, but should increase

Oman's oil reserves stand at around 5.6bn barrels, equal to 19 years of production at current rates. The reserves ratio has been around this level since 1986. However, oil has not run out because new discoveries and improved recovery rates have always managed to replenish the reserves. Over the medium term reserves are likely to maintain their current level, or even increase, given:

- Implementation of EOR programmes, which could double the exploitable reserves from current fields
- An ongoing exploration drive covering the two-thirds of onshore territory that currently has no oil production
- The potential for discoveries in Oman's largely unexplored offshore regions

Exploration concessions have been awarded for most of Oman's sovereign territory. There are currently 18 companies involved in exploration[15]. A few exploration blocks remain unallocated[16].

[14] EOR involves the application of techniques such as miscible-gas, steam and polymer injection. These techniques can be used on both mature and new fields, and can improve extraction rates from perhaps 5-15% to 20-30% of in-place reserves

[15] 12 companies, in addition to the 6 that have been awarded exploration concessions: Circle Oil (US), Consolidated Contractors Energy Development (CCED, Lebanon), Epsilon Energy (Canada), Hunt Oil (US), Maersk Oil (Denmark), MOL Group (Hungary), OEPC (Oman), Reliance Industries (India), a joint venture of Rex Oil & Gas (US) and Petroci Holding (Côte d'Ivoire), Taqah (Oman) and Tethys (Sweden)

[16] The unallocated blocks are: the west corner of Dhofar, inland from Muscat and Sur, small areas in the west of Wusta, and offshore along the east coast

[17] Oman is divided into around 40 oil and gas concession blocks of greatly varying size and geology

[18] PDO's oil and gas fields run in a chain up the middle of the country across four provinces. The major field clusters are Harweel, RTQ, Nimr, Marmul, Bahja, Qarn Alam, Yibal, Fahud and Lekhwair

[19] PDO is implementing miscible-gas injection at Harweel, steam injection at Qarn Alam and most started polymer injection at Marmul in January 2011

[20] This is a large and unexploited field west of Duqm, which was transferred in 2005 from PDO to a consortium led by Occidental

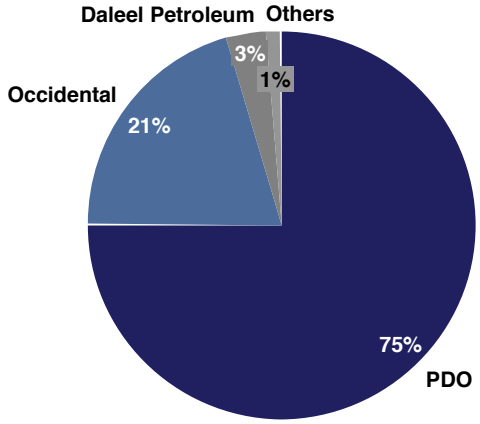
Fields and Production

PDO is the largest oil producer; most of its fields are small and hard to access

The geology in Oman is such that many of its onshore fields are relatively small and difficult to access, unlike other GCC countries which have large and easily exploitable fields. This raises the cost of production[17]. There were 135 fields under production in 2009, many producing only a few thousand bpd. In comparison, Saudi Arabia produces more than ten times as much oil from just 110 fields.

Petroleum Development Oman (PDO) is 60% owned by the Omani government and managed by Shell. It was the first oil company in Oman and is still responsible for the vast majority of production and ~80% of known reserves. Its concession areas cover a third of Oman's land area[18]. Crude production in PDO's fields declined by a third from 2001 to 2010. Consequently, it has invested heavily in EOR[19].

Fig 3.2 Oil Producers (2010)
(% share of total production)



Source: Ministry of Oil and Gas, 2011

Oman's second largest producer is US-based **Occidental Petroleum**. It has boosted production at one major field, Mukhaizna[20], from 10,000 bpd in 2006 to 99,000 bpd in 2010 using EOR techniques. This has been the main reason for the recovery in Oman's overall production. It also operates the Safah field near the UAE border, which produced 78,000 bpd in 2010, up by 15% from 2007.

There are also currently four smaller oil producers:

- Daleel Petroleum (a joint venture between Petrogas of Oman and China National Petroleum Corporation) produced 26,300 bpd in 2010 from the Daleel field, south of Ibri
- RAK Petroleum (UAE) produced 8,600 bpd in 2010 from Bukha, west of Musandum, which is Oman's only offshore production
- PTTEP (Thailand) produced 2,100 bpd from Block 44 west of Ibri
- Petrogas (Oman) produced 1,200 bpd from Block 7 on the western border of Wusta region

Production Forecast for 2011-12

Looking ahead, we forecast that oil production will increase by an average of 3.6% over the next two years to reach 927,000 bpd in 2012. This is slightly higher than the forecast of 896,000 bpd in the Ministry of National Economy's 8th five-year plan. The plan's lower growth rate assumption would imply a further decline in PDO's production. Conversely, we expect that PDO's EOR efforts in some fields will offset declines elsewhere and keep its overall crude production stable. Furthermore, its production of condensate oils from non-associated natural gas fields will increase in line with gas production. The five-year plan may err on the side of caution because the previous plan's production forecast turned out to be over-optimistic.

Most of the new production will come from the Mukhaizna field

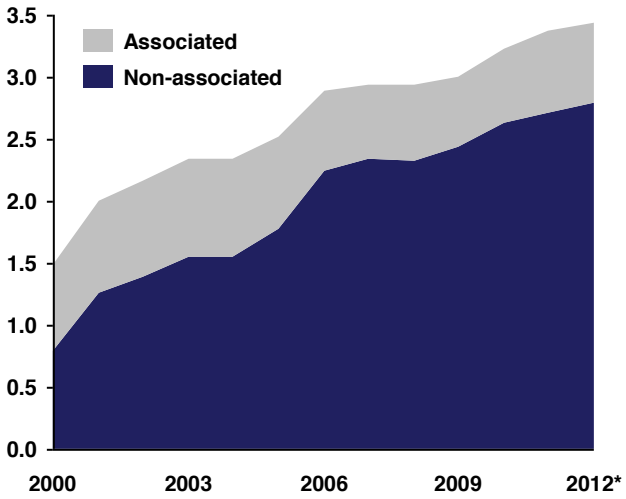
The bulk of the production increase will come from Occidental's development of the **Mukhaizna field**. We expect its production to increase by about 25% to average 125,000 bpd in 2012. Our forecast is lower than Occidental's stated target of 150,000 bpd, because the field's geology has proved more difficult than was originally expected. If Occidental were to achieve their stated target then real GDP would rise by almost an additional 1%. We also expect further small supply increments from other fields[21].

B. Natural Gas

Until 2000, most of the gas produced in Oman was an associated by-product of oil production. This associated gas usually comes out in quantities too small to make it feasible to transport it away from the oil fields to exploit. Instead it is mainly re-injected, used to power onsite equipment, or flared.

However, exploration in the early 1990s uncovered significant non-associated gas fields in central Oman[22]. These discoveries opened the way for economic diversification into gas-based industries. By 2010, the production from these non-associated fields reached an average of 2.6bn cu ft/day, having increased tenfold in 15 years. This has been an important contributor to Oman's recent economic growth spurt.

Fig 3.3 Natural Gas Production (2000-12)
(bn cu ft /day)



Source: MONE, *QNB Capital forecasts, 2011

Gas Reserves

Gas reserves are currently around 35trn cubic feet[23], equivalent to about 30 years production at current rates. The Ministry of Oil and Gas (MOG) aims to boost reserves by 1trn cu feet each year through improved recovery techniques and new finds. If achieved, this could extend years of production by a further decade.

The exploitation of gas reserves is hampered by geological constraints

As with Oman's oil, much of the gas is locked up in tight geological formations, which makes extraction costly.

The **Khazzan-Makarem field** is estimated to have up to 100trn cu ft of reserves, but only about 10% of these are practical to exploit due to their depth. British Petroleum (BP) is testing the field before it makes a decision on a major investment in further exploration and development. Production is unlikely to start before 2015, but may have the potential to reach 1bn cu ft/day.

The other big prospect is the **Abu Butabul field**. The BG Group (UK) relinquished its operator agreement in 2010, after concluding feasibility studies. Oman Oil Exploration and Production Company (OEPC), a state owned company, has now taken over the field and is aiming to start production of 90m cu ft/day in 2013.

There are no significant non-associated gas fields expected to come online in 2011-12. However, increased production from existing fields, both associated and non-

[21] Production is likely to be increased by: Occidental's Block 9 operations, Daleel, RAK Petroleum, and CCED (from the Khufai field in Block 4, which is likely to start production in 2012)
[22] Principally in the Qarn Alam, Yibal and Lekhwair clusters

[23] BP's Review of World Energy 2010

associated, should be able to boost total gas output by an average of 3.3% a year to 3.45bn cu ft/day in 2012.

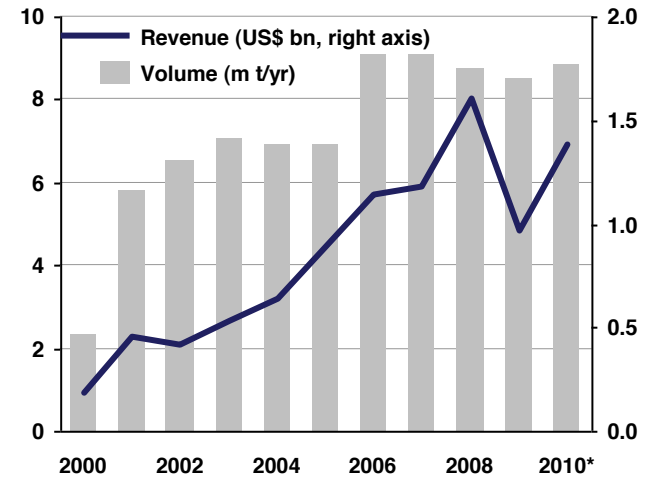
LNG

Oman is the second largest LNG exporter in the GCC

Oman started producing liquefied natural gas (LNG) in 2000 and currently produces this through three liquefaction trains[24]. Oman exported 8.9 tonnes of LNG in 2010.

The new non-associated gas fields began to pump gas in large quantities in 2000. The main usage was to supply the new **LNG export terminal at Sur**. This is operated by Oman LNG, a company managed by Shell in which Oman has a controlling stake. Oman now has the capacity to export 10.4m tonnes/year (t/yr) of LNG. This makes it the second largest LNG exporter in the GCC, after Qatar, which has a capacity of 77.1m t/yr.

Fig 3.4 LNG Exports (2000-10)



Source: Oman LNG, MONE, *QNB revenue forecast, 2011

Oman's actual LNG production tends to be well below capacity owing to the required maintenance downtime and possibly because of a shortfall in gas during periods of peak domestic use. The highest production achieved to date was 9.1m t/yr in 2007.

LNG export revenues stood at US$970m in 2010, after having reached a high of US$1.6bn in 2008. The global gas market changed in 2009, as a result of a glut in production, including the rapid growth in Qatar's LNG production, and the development of shale gas in the US. The global recession was also a factor, driving down demand. As a result, in 2010 Oman received an average export price of US$6.3/mBTU[25], compared with US$10.1 in 2008. Although much of Oman's LNG production is fixed to long-term supply contracts, these prices still tend to be partly linked to global spot prices.

Other Usages of Natural Gas

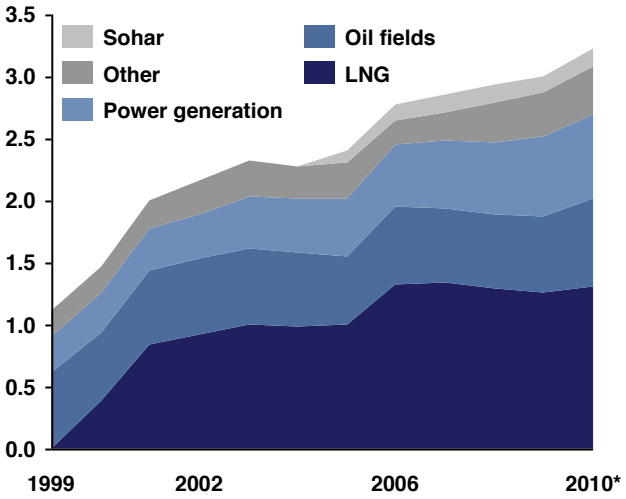
Natural gas usage in Oman is dominated by the LNG sector, followed by use in **power generation** (Fig 3.5). The Government Gas System (run by PDO) pipes gas to power stations, as well as cement and mining companies. Gas is also piped to Sohar, averaging 138m cu ft/day in 2009, for use in the heavy industries there. Meanwhile, most of the associated gas is used in the oil fields for fuel and re-injection.

Despite the considerable increase in gas production in recent years, Oman has faced a shortage of gas for domestic use. This is due to the following:

- Oman's commitment to long-term LNG contracts
- Increasing domestic industrial needs
- The use of gas to boost oil production through EOR techniques

As a result, Oman has been importing 200m cu ft/day of pipeline gas from Qatar since 2008[26]. As the price of this gas is fairly cheap relative to LNG, it is currently economical for Oman to be both exporting and importing gas.

Fig 3.5 Gas Usage (1999-2010)
(bn cu ft /day)[27]



Source: MONE, *QNB estimate, 2011

[24] LNG is split into three production trains, two of which began operations in 2000. The third, Qalhat LNG, started production in 2006 and is also operated by Oman LNG but with a different ownership structure

[25] Million British thermal units (mBTU) are the standard measures for gas pricing, and are equivalent to about 1,030 cubic feet of gas

[26] The imported gas is transported by Dolphin Energy from Qatar to Oman via the UAE. The Dolphin pipeline connects to Oman through a smaller pipeline that had previously been used to export 130cu ft/day of gas from Oman to the UAE's Qidfa power plant in 2004-07

[27] It is unclear what is included in the large "Other" category. MONE's Statistical Yearbook (in its table 8.12) notes that it includes "loss, meters discrepancies, deflation factor, exported gas to Ras Al Khama by Noves Oman Company"

C. Manufacturing and Utilities

Major manufacturing plants will continue to boost production

A series of major **metalworking and petrochemical plants** have come online over the last five years and others are under construction (see Appendix C). These plants are the realisation of a long-term plan to diversify the economy from hydrocarbons and create employment[28].

When the remaining plants are completed, production volumes should exceed:

- 5m t/yr of **petrochemicals**
- 4m t/yr of **cement**
- 3.5m t/yr of **fertilisers**
- 2m t/yr of **metals**

The plants have provided a notable boost to non-oil exports and government revenue. The state-owned **Oman Oil Company** (OOC) has a large stake in most of the plants.

Currently, the main projects under construction are:

- **Shadeed Iron and Steel plant**, which came online in January 2011, after being bought by Jindal Steel (India). It is looking to invest a further US$1bn to more than double capacity
- **Oman Petrochemical Industries** is managed and half-owned by Dow Chemicals (US)
- **Sohar International Urea and Chemical Industries** is owned by the local Suhail Bahwan Group

The latter two plants are well past their original deadlines for completion. This is largely a result of high construction costs in recent years. These costs were only partly alleviated by an easing of demand and hence prices for basic materials and construction services, following the global downturn and the real estate crash in Dubai in 2009.

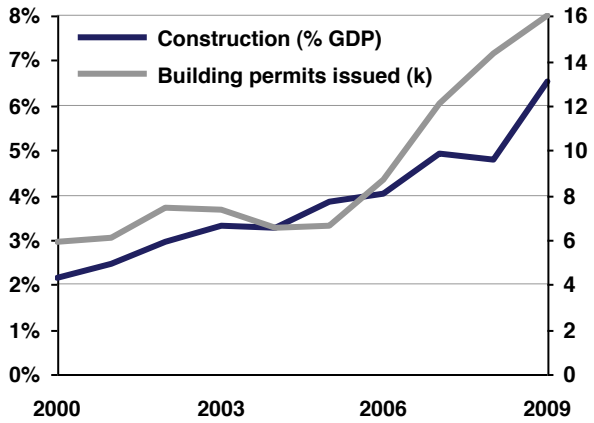
Private power plants and a GCC electricity network should reduce power shortages

Oman's gas fuels a dozen major **power plants** across the country. Some of these are integrated power plants that have a capacity to desalinate water at the same time as generating electricity. Oman was the first GCC country to licence private power projects[29]. More recently, it has corporatized the management structure of the state-owned plants and intends to privatise some of them.

Oman's shortfall in gas production, relative to its industrial developments, has resulted in an occasional shortage of electricity at peak times, disrupting industry. This situation should improve in the future as an interconnected GCC electricity grid enables power imports from the UAE and Qatar.

D. Construction

Fig 3.6 Construction Activity (2000-09)



Source: MONE, 2010

Construction continued to expand in 2009 despite some real estate problems

Oman, like other GCC states, has seen a sharp growth in the construction sector in recent years (Fig 3.6):

- The sector's contribution to GDP increased from 2.1% in 2000 to 6.5% in 2009
- The number of **building permits** issued nearly tripled between 2005 and 2009

The sector remained strong in 2009, despite regional real estate concerns. Developers capitalised on the fall in the prices of building materials that year, continuing with many of their projects. The various industrial plants in Sohar are examples.

However, some of the luxury real estate projects have been struggling. The biggest of these is **the Blue City**, a US$20bn plan to create a tourist resort and city for 200,000 people northwest of Muscat. Off-plan investment in the scheme was launched during difficult economic times in 2009, and interest was much lower than expected.

[28] Most manufacturing was small-scale until the 1990s when the discovery of large non-associated gas fields provided the possibility of fuel and feedstock for heavy industry. This was reflected in the Vision 2020 plan, drafted in 1995, which envisaged manufacturing growing to 15% of GDP by 2020

[29] Manah power plant in 1996

E. Services

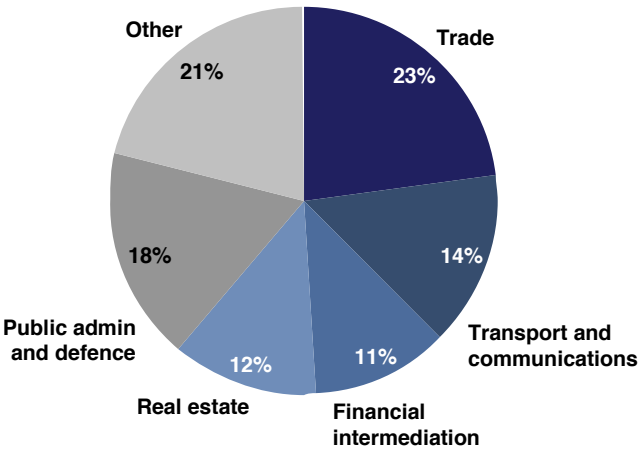
Rising oil prices have reduced the share of services in GDP despite strong real growth

Real growth in the services sector has been consistently high, relative to the overall economy. It averaged 10.6% in 2005-08, and only shrunk by 1.6% during the downturn in 2009.

However, prices in the services sector have grown more slowly than in hydrocarbons or industry, and even declined in areas such as communications. As a result, its share in nominal GDP declined from 44% in 2003 to 33% in 2008. Its share increased to 42% in 2009, on account of the large decline in commodity prices. However, we forecast that its share of GDP will slip back to around 33% in 2011-12.

The shares of the components of the services sector have remained fairly stable in recent years (Fig 3.7). An exception is the **hotels and restaurants** segment, which grew more rapidly before 2009 owing to rising tourism. However, it comprises less than 3% of the sector. Public administration and defence was the largest component of the sector until 2005. However, its growth has slowed, and trade is now the largest segment of the services sector.

Fig 3.7 Services Sector (2009)
(% share of total)



Source: MONE, 2010

F. Agriculture and Fishing

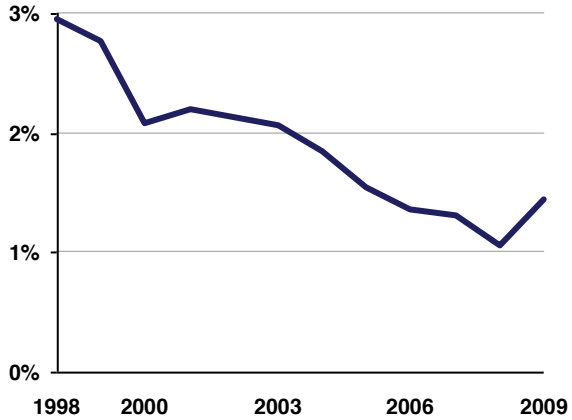
The agriculture sector is small but it is an important employer

The agricultural and fishing sector's share of GDP has declined from 3% in 1998 to 1% in 2008 (Fig 3.8). However, unlike in other GCC states, it remains a major employer. In some regions, such as Dhofar, around two-thirds of the population are involved in agriculture. In the north the main crops are dates, vegetables, citrus fruits and tobacco.

As rainfall is limited, agriculture in this region relies largely on groundwater. However, over-pumping of wells has depleted groundwater and led to the intrusion of seawater which damages crops.

Livestock-raising is a major part of the economy in Dhofar. Tropical fruits can also be cultivated there because of seasonal monsoon rains.

Fig 3.8 Agriculture and Fishing (1998-2009)
(% of GDP)



Source: MONE, 2010

4. External Sector

A. Balance of Payments

Strong export earnings yield consistent balance of payment surpluses

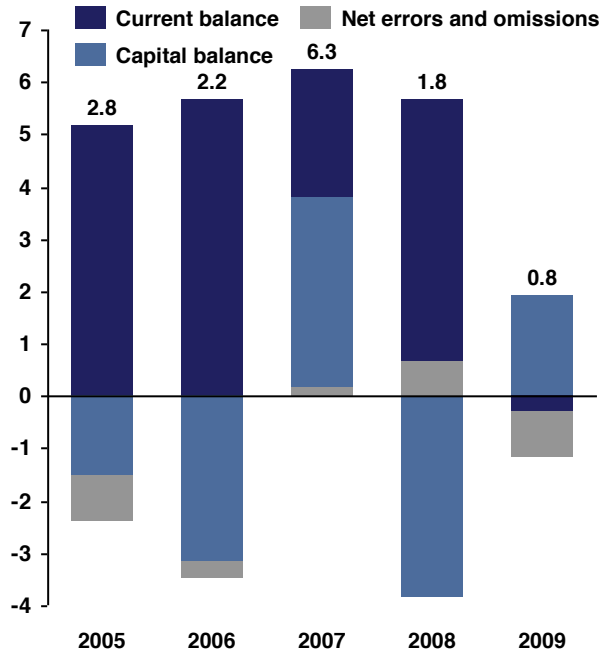
Oman was able to consistently post surpluses in its balance of payments in recent years. The bulk of the surplus usually comes from export earnings, part of the current account. The capital account, on the other hand, fluctuates between deficits and surpluses according to investment flows driven by shifts in financial market sentiment (see Section 4E).

The balance of payments surpluses peaked in 2007 at US$6.3bn when both the current and capital accounts were in surplus. It narrowed considerably in 2008 as a result of capital outflows following the global financial crisis.

In 2009, when the current account recorded a rare deficit due to a fall in oil revenue, the balance of payments nevertheless remained in surplus. This was because the fall in oil revenue, together with domestic needs, also meant that the government did not have excess capital to invest abroad that year.

Fig 4.1 Balance of Payments (2005-09)

(US$ bn, the overall surplus is indicated)



Source: Central Bank of Oman, 2010

These balance of payment surpluses have steadily boosted Oman's **foreign exchange reserves**. As a result, the Central Bank's reserves reached US$13bn at the end of 2010[30], up from US$4.4bn in 2005.

[30] Part of the payment surplus accrues to other state bodies, but only the Central Bank's reserves are published

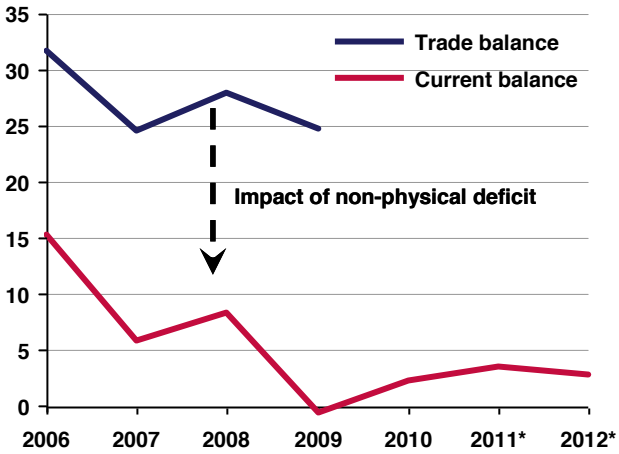
B. Current Account

The current account recorded its first deficit in a decade in 2009, but has since recovered

The largest component of the current account is the **trade balance** in physical goods (its breakdown into exports and imports is examined in Sections 4C and 4D). There is a close positive correlation between the trade balance and the current-account balance (Fig 4.2). Oman typically records a strong trade surplus because of its oil and LNG export earnings.

Fig 4.2 Current Account (2006-12)

(% of GDP)



Source: MONE, *QNB Capital forecast for the current balance (no trade balance forecast is given), 2011

The gap between the current-account balance and the trade surplus is due to the non-physical components of the current account. These components—the current transfers, trade in services and income balances—are usually in deficit in Oman.

The collapse in energy prices in 2009 resulted in Oman's first current-account deficit in a decade, although it was only 0.6% of GDP. This happened because the trade surplus fell sharply, reaching a low of 6.8% of GDP in the first quarter of 2009. It subsequently recovered to a surplus of 30.1% of GDP by the second quarter of 2010, as oil prices recovered[31]. The current-account balance is therefore estimated to have returned to a surplus in 2010.

Remittances, averaging US$5,800 per foreigner contributed to the deficit

Current transfers are the largest contributor to the non-physical deficit (Fig 4.3). Most current transfers are remittances sent home by expatriate workers. Remittances peaked at US$5.3bn in 2009, which equates to US$5,800 per foreign worker per annum[32].

[31] Full-year data for 2010 had not been released at the time of publication

[32] The inward remittances from Omanis working abroad are not included in the official balance of payments. However, they would be small in comparison to the outward remittances

There is a large but stable services deficit

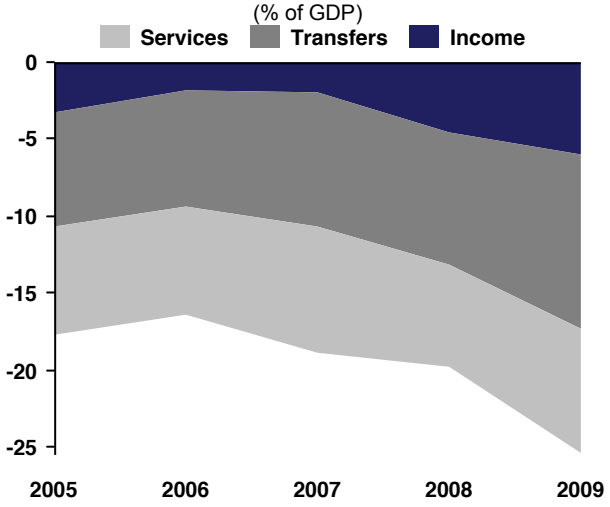
The second largest part of the non-physical deficit is trade in services. Oman receives substantial credits in its services account from foreign exchange spent by tourists visiting the country. However, these are more than offset by the debits. A large proportion of debits relate to services provided by foreign companies to the hydrocarbons sector. The services deficit peaked in 2008 at US$4bn. As a percentage of GDP, it was stable in 2008-09, averaging 7.4%.

The income deficit is growing

The third component of non-physical payments, the income account, has also consistently been in deficit because of profit repatriation by foreign companies.

High energy prices have boosted the profits accruing to foreign oil companies, as has the sharp increase in production at Occidental Petroleum's Mukhaizna field. That production increase, together with the launch of the various foreign-managed industrial plants in Sohar, explains why profit repatriation only dipped slightly in absolute terms to US$3.1bn (and increased as a share of GDP to 6%) during the downturn in 2009.

Fig 4.3 Non-Physical Deficits (2005-09)



Source: MONE, 2010

We forecast a current account surplus averaging 3.1% in 2011-12

We estimate that the current account returned to a surplus of 2.3% of GDP in 2010, on the back of the global economic recovery and surging exports. In 2011-12, we forecast that the surplus will expand further to an average of 3.1% of GDP as a result of higher oil prices.

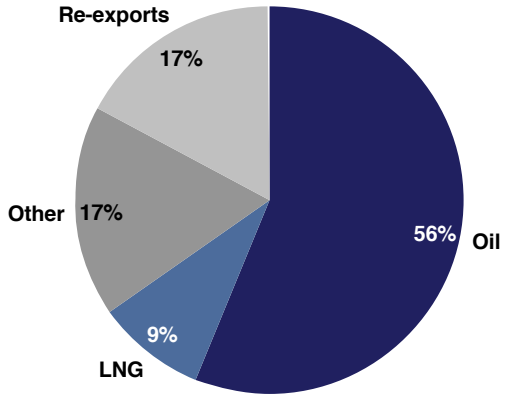
C. Exports

New oil and gas facilities have boosted the value of exports

Total exports were US$27.7bn in 2009. This was a 27% decrease from 2008, mainly owing to the collapse in oil prices. During the 2000s, **oil and gas** made up on average 78% of export earnings, other exports were 10% and re-exports were 12%. The oil and gas share dipped to 65% in 2009, owing to low prices, but is estimated to have recovered since then.

LNG and refined oil have become increasingly important components of exports. They now account for 20% of hydrocarbon export revenue. This is a result of the inauguration of new facilities, such as an oil refinery in Sohar in 2006.

Fig 4.4 Exports (2009)



Source: MONE, 2010

Non-hydrocarbons exports have also grown strongly, particularly minerals and metals

Non-hydrocarbon exports have performed strongly, increasing fivefold in 2004-08[33]. **Minerals and metals** accounted for much of this growth. They have grown from a relatively minor component of non-hydrocarbon exports to become the largest component (Fig 4.5). This is due to:

- Growth in mining output
- Increases in global commodities prices
- The opening of new metal refineries, such as the Sohar Aluminium Company in 2008. The newly opened Shaheed Iron and Steel plant should further boost this category of exports in 2011

Petrochemical products, both plastics and raw chemicals, are the next most important export category. They have also grown rapidly owing to the development of the gas-fed petrochemical industry in Sohar. Expansion of this sector will continue as there are a number of major plants under construction.

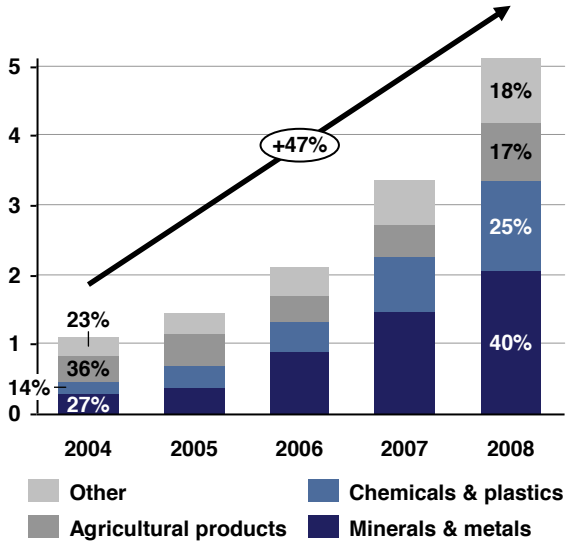
Agricultural products, mainly live animals, remain an important contributor to exports. This was the largest category of non-hydrocarbons exports until 2006, but had fallen to fourth place with a 17% share by 2008.

[33] 2009 data was not yet available at the time of publication

Some areas of exports have suffered. In 2000, **textiles** were the third largest export group. However, by 2008, textiles exports had declined by 85% because Oman ceased to be price competitive with Asian textile producers.

Fig 4.5 Non-Hydrocarbon Exports (2004-08)

(US$ bn, CAGR shown)



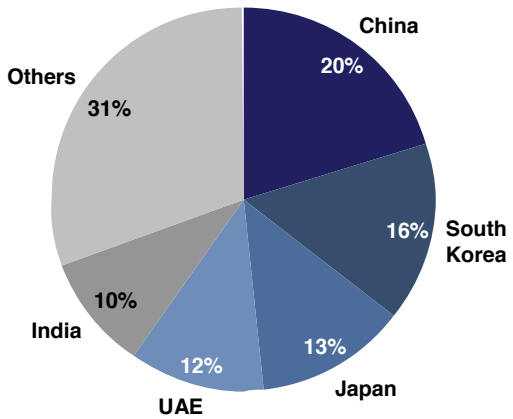
Source: MONE, 2010

Asia is the main destination for Omani goods

Oman's primary **export destination** is China, which received an average of 26% of exports during 2005-09. This was followed by South Korea at 18% and Japan at 11%. This is because these countries are major importers of oil and LNG.

The UAE is also a major export destination. However, this is partly for re-exports. Oman's exports to the rest of the GCC are not significant. The most important new market is India. Oman's exports to Indian reached 10% of total exports in 2009, up from an average of 2% during the previous five years.

Fig 4.6 Export Destinations (2009)



Source: IMF Direction of Trade Statistics, 2010

Port expansions could lead to growth in re-exports

Oman also has a growing **re-export** business, mainly in machinery and transport equipment. The destination of re-exports fluctuates from year-to-year, but medium-term averages show that the main destinations are:

- UAE, which receives more than 50%
- Iran, more than 10%
- Saudi Arabia, 4-5%

The expansion of port facilities[34] should boost Oman's share of the regional re-exports trade, particularly if unrest in Yemen threatens the viability of Aden port, which is a major competitor in the re-exports trade.

D. Imports

Total imports were US$17.9bn in 2009. This was a 22% drop from 2008, mainly as a result of a fall in activity and import prices during the global downturn.

Machinery and transport equipment dominate imports

About half of Oman's imports are **machinery and transport equipment**. This is owing to limited domestic capacity to manufacture these items. There are two main factors driving increases in imports of these goods:

- **Population growth**, which has boosted demand for cars
- The **industrialisation programme**, which has required sophisticated capital goods

Other important items on the import account are[35]:

- **Other manufactured items**, mainly electronics and other consumer goods (25% of imports)
- **Food** and agricultural products (11%)
- **Chemicals** (7%)

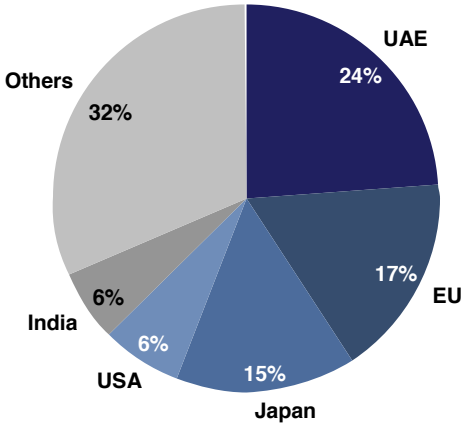
UAE is Oman's primary import source, but these are mainly re-exported from elsewhere

Oman's imports come from a fairly diversified range of countries (Fig 4.7):

- **UAE** supplies about a quarter of imports, but most of these are re-exports that originated elsewhere
- The **European Union** provides about a fifth of imports
- **Japan** provides 15%
- **India** and **China** together provide less than 10% of the imports, but their shares have both been growing in recent years

[34] Particularly at Salalah and Duqm
[35] Based on average contributions in 2005-09

Fig 4.7 Import Sources (2009)



Source: IMF, Direction of Trade Statistics, 2010

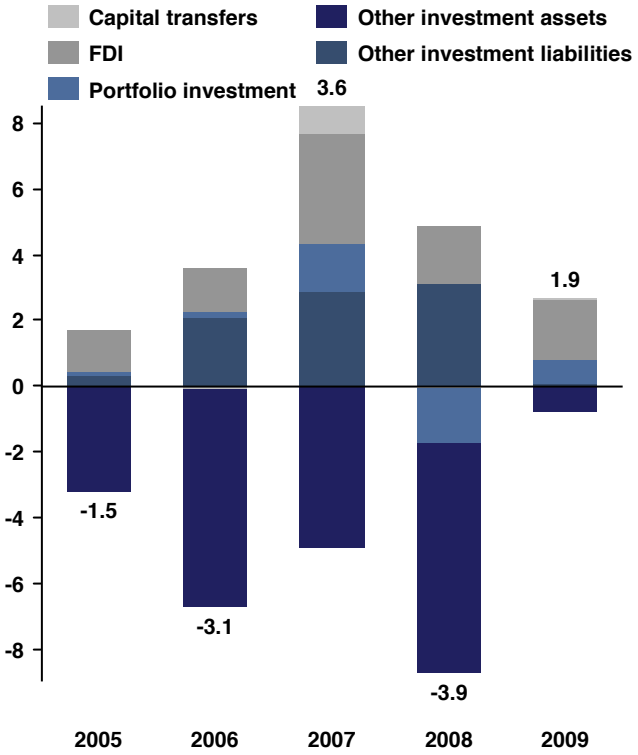
E. Capital Account

The overall balance of the capital account[36] and the flows of its various components fluctuate substantially year-to-year. In 2009, it recorded a surplus of US$1.9bn following a deficit of US$3.9bn in 2008 (Fig 4.8). The deficit in 2008 was a result of steep portfolio investment outflows in the last part of the year, following the onset of the global financial crisis. The surplus in 2009 was a result of reduced foreign investment by the government, combined with a return of inward portfolio investment as markets began to recover in the second half of the year.

The **other investment assets** category is usually in deficit. This includes much of the investment outflows from the State General Reserve Fund (SGRF), Oman's sovereign wealth fund. The net foreign direct investment (**FDI**) component generally makes a large and positive contribution and is mainly a result of the activities of foreign oil and industrial companies in Oman. **Portfolio investment** is relatively small, but is the component of the capital account that typically shows the most frequent fluctuation in direction. Its movements are dependent on local and global investor sentiment.

Fig 4.8 Capital Account (2005-09)

(US$ bn, the overall balance is indicated)



Source: Central Bank of Oman, 2010

F. Foreign Debt

Foreign currency debt fell from 34% of GDP in 1999 to 10% in 2006

Oman has a relatively low level of foreign debt. This is because the state has relied more on foreign equity investment to develop its oil and gas and industries. The debt amounted to only US$4.8bn (10% of GDP) in 2006 according to the World Bank[37]. This is well below the peak of US$6.8bn (34% of GDP) in 1999.

Long-term debt has fallen even more sharply, from 27% of GDP in 1997 to just 6% in 2006. This is largely because the government has been using surplus revenue to repay public sector foreign debt (see Section 6C). In addition, the development of the local equity market and banking sector has provided companies with alternatives to foreign debt.

Short-term debt has risen steadily in line with imports, as much of it is trade-related. Short-term debt comprised 41% of the total debt in 2006, double its share compared with 2000. The growing importance of Japan as a trading partner was reflected in an increase of the Yen-denominated debt to 13% of the total in 2006, although 60% remained denominated in US dollars.

[36] The capital account comprises payments that relate to ongoing obligations, such as investments or repayment of debt, as opposed to the current account, which comprises payments for immediate exchange with no future obligations, such as payments for imports

[37] This was the most recent data available on the date of publication

5. Monetary Issues

A. Currency

Monetary policy tools are limited by the peg to the US dollar, which will remain in place

The Omani rial (OR) is pegged to the US dollar, as are most GCC currencies. This limits the monetary policy tools available to the Central Bank.

The exchange rate has been fixed at US$1:OR0.3845 (or OR1:US$2.60) since 1986[38]. The peg is seen as providing stability, particularly given that Oman's hydrocarbon exports are priced in dollars. A floating exchange rate might increase the volatility of hydrocarbons-related revenue streams. As a result, there has been little interest in depegging or revaluation despite considerable dollar volatility against the currencies of Oman's main Asian and European trading partners in recent years.

Oman was the first country to withdraw from the planned GCC currency union in December 2006. It argued that the public debt and deficit convergence criteria would hinder its development. The Sultanate initially planned to just delay joining the union[39], but subsequently opted out. There could be scope for this policy to change, if the currency union proves successful and Oman judges that the convergence criteria no longer pose a problem. However, the most probable medium-term scenario is that the peg to the dollar remains in place at its current value.

B. Money Supply and Interest Rates

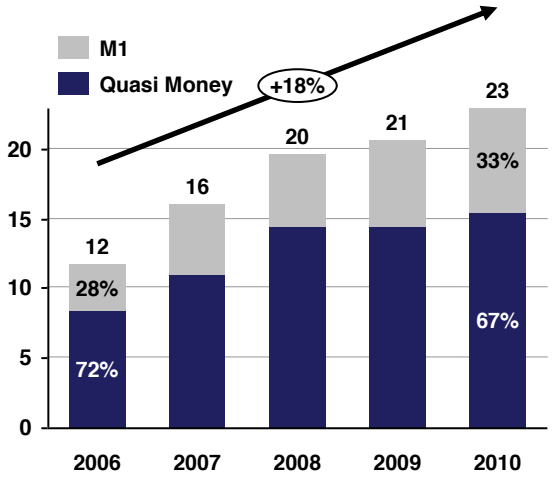
The Central Bank interest rates move in line with the US federal funds rate

The dollar peg requires Omani **interest rates** to broadly track US rates to deter major speculative capital flows seeking to exploit any interest-rate differential. Therefore, interest rates were cut sharply after the US Federal Reserve dropped its benchmark federal funds rate to 0.00-0.25% in December 2008. Consequently, the Central Bank's certificate of deposit rate was lowered to 0.05%. It remained near this level throughout 2010. Inter-bank rates were only slightly higher and usually under 0.1%. The US Federal Reserve is not expected to begin raising interest rates until 2012, when Oman will also follow suit.

The limitation on the interest rate policy forces the government to rely mainly on indirect instruments of monetary policy, such as:

- Certificates of deposit[40]
- Bank reserve and loan to deposit requirements
- Loan to deposit ratios
- Ceilings on bank interest rates

Fig 5.1 Money Supply (2006-10)
(US$ bn, CAGR indicated)



Source: IMF, 2011

Oman's **money supply** was fairly flat for a long period. It took a decade from 1995-2004 for the broad measure of money supply (M2) to double. However, the economic boom in 2005-08, resulted in a surge in the money supply, which grew with a CAGR of 25% over this period, slowing to 8% in 2009-10 to reach US$23bn at the end of 2010. Quasi-money, which now comprises about 70% of M2, accounted for most of the growth during the boom.

C. Inflation

An increase in rents and food prices drove inflation to historical highs in 2008

As with most GCC countries, Oman historically had a relatively low inflationary environment until the mid-2000s. Year-on-year consumer price inflation (CPI), as measured by the IMF, shot up from just 2.5% in June 2006 to a peak of 13.7% in June 2008 (Fig 5.2). The increase was driven particularly by:

- Rent inflation, as a result of property speculation and immigration
- Increases in global food prices
- Growth in the money supply

Government subsidies on fuel insulated consumers from the full impact of global oil price rises. However, indirect impacts of oil prices were felt through increases in the production and transportation costs of other goods.

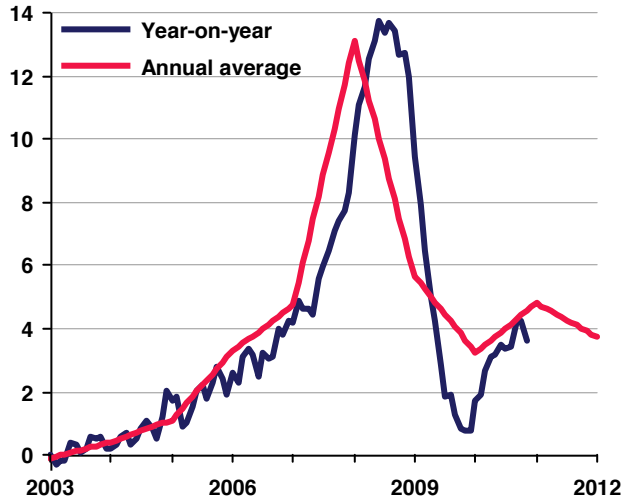
Inflation declined sharply in 2009, with the year-on-year rate slipping below 1% by late 2009. However, Oman did not slip into deflation, as some GGC states did, in part because rental prices had not reached the same extreme highs as elsewhere.

[38] Central Bank of Oman
[39] The union was initially scheduled to be launched in 2010, but has since been postponed
[40] Certificates of deposit are generally used, when necessary, to absorb excess liquidity (at the rate of about US$3.6bn a month during 2010). This is because fiscal surpluses (except in 2009) have mitigated the need for Treasury bond issuance since 2005

In 2010, inflation began to pick up again, but only gradually, averaging 3.3% over the year. The major price category which increased the most was rents which increased by 4.7% and has a weight of 15.3% in the CPI basket. Food prices (representing 30.4% of the basket) grew more moderately at an average of 2%.

Fig 5.2 Consumer Price Inflation (2003-12)

(% annual average)



Source: MONE (annual average), IMF (year-on-year), QNB Capital forecasts, 2011

Inflation is forecast to average 4.3% in 2011-12

We forecast a small pick up in annual average inflation to 5% in 2011, largely because of global food and commodity price increases. Inflation is expected to then ease back to 3.6% in 2012. The 8th five-year plan (2011-15) envisages an average inflation of 4%.

6. Public Finance

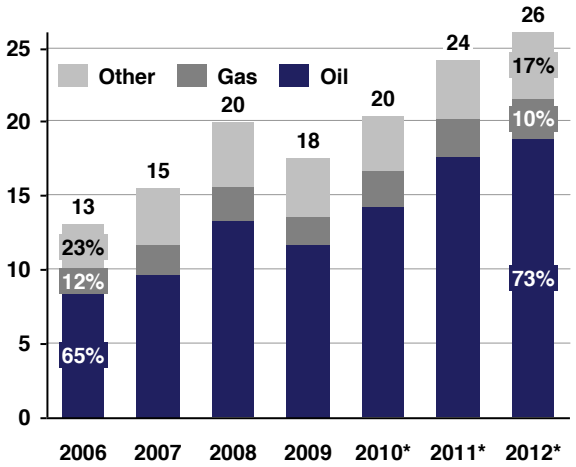
A. Revenue

Oil earnings accounted for 66% of in-budget Omani government revenue during 2006-10. This includes domestic sales and exports of crude and refined oil. Total government oil revenue in 2010 was US$20.4bn[41].

Gas earnings provided an average of 12% of revenue over the same period. This principally came from exports of LNG but also from domestic sales. Total gas revenue reached US$2.6bn in 2010.

There are two major contributors to the remaining 22% of revenue. The first is **tax**, mainly on corporate profits. The second is the earnings of **state-owned companies** such as Oman Oil Company and Oman Tourism Development Company (Omran).

Fig 6.1 Government Revenue (2006-12)
(US$ bn)



Source: MONE, *QNB Capital forecasts (see Section 6D), 2011

B. Expenditure

Wage growth and capital investment have driven increases in expenditure

Oman's government expenditure has expanded rapidly in recent years. It grew at a CAGR of 19% a year in 2005-08, before shrinking marginally in 2009 and then returning to a growth of 11% in 2010. The expansionary spending over this period has largely been a result of rising current costs, particularly public sector wages. Meanwhile, capital expenditure increased fivefold between 2002 and 2009.

Oil prices in 2006-10 were 75% above budget, enabling 20% greater expenditure

Oman, like most GCC states, has typically been conservative in the oil price assumptions for its budget. In 2006-10, Omani crude oil typically sold for an average of about 75% (US$30/barrel) more than the budgetary assumption. Low oil price assumptions have in turn led to conservative expenditure plans. As a result, the state has usually had room to spend more than its planned expenditure when oil revenue has exceeded its forecast[42]. Actual expenditure exceeded planned expenditure by an average of 20% in 2006-10.

Defence is the largest component of expenditure but its share is falling

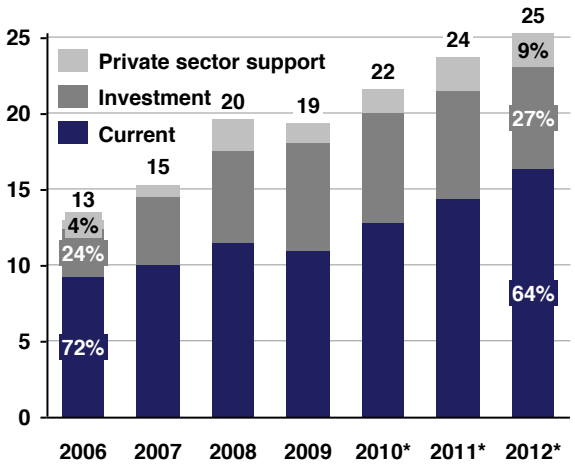
The largest single budget item is **defence**. This accounted for 30% of expenditure on average during the 2000s. Part of the reason for this is that the military is a key employer of Omani nationals. However, defence has been declining in importance in the budget. Its share fell to 23% in 2009.

The next largest component is **education and health** spending. This component comprise over 15% of total expenditure.

Current spending also includes **subsidies** on electricity and water. These average about US$550m a year[43].

The budget also includes a line for **support to the private sector**. This averaged 7% of total expenditure in 2006-10. Much of this relates to funding for state-owned companies.

Fig 6.2 Government Expenditure (2006-12)
(US$ bn)



Source: MONE, *QNB Capital forecasts, 2011

Capital spending on both hydrocarbons and non-hydrocarbons has grown steeply

The government has made significant **investment in hydrocarbons**, averaging nearly US$2.6bn per year in 2006-10. This was almost triple the level that was spent in the previous five years. Much of the investment has been focused on implementing enhanced oil recovery techniques to check the decline in oil production (see

[41] Preliminary 2010 fiscal figures from the Ministry of Finance

[42] Oil prices have exceeded budget projections, and expenditure has exceeded allocations, in every year since 1999

[43] Fuel subsidies are implemented outside the budget

Section 3A). Significant investment has also been made in boosting gas production and in infrastructure to deliver gas to industrial projects.

Non-hydrocarbon investment has been even more substantial, averaging US$3.1bn during the previous five years. It has focused largely on the development of air, sea and land transport infrastructure.

The 8th five-year plan (2011-15) plans to invest US$6.5bn a year

The Omani government conducts its medium-term budgeting on the basis of five-year plans. The 8th five-year plan (2011-15) is currently underway. It plans for:

- An annual growth in current expenditure of around 5% a year
- A gradual phase out of budgetary support to the private sector from 2013
- Relatively flat spending on investment of around US$6.5bn a year. This is equivalent to 10% of GDP, which is high by historic standards

This rough guideline of spending priorities will be refined in annual budgets as economic conditions are developing during the period of the plan. The plan is based on an assumption that oil prices will average US$59/barrel over the next five years. This is higher than recent budgets, but conservative relative to the current market consensus of around US$100/b.

The bulk of **investment expenditure** will be spent on infrastructure projects. About half of it is already allocated to ongoing projects. The major projects yet to be funded include:

- Completion of Muscat and Salalah airports
- Construction of four new regional airports
- Construction of Duqm port

In addition, US$1.5bn has been allocated for **tourism development** projects, to be implemented by the state-owned tourism company, Omran.

C. Fiscal Balance, Debt and Assets

The fiscal account had fallen into deficit during 2009-10

Oman's revenue from strong hydrocarbon exports ensured consistent budget surpluses during 2002-08, averaging about 1% of GDP. However, the collapse in oil prices in 2009 led to the largest deficit in a decade at 4% of GDP. Preliminary data for 2010 puts the balance in the red again at 2% of GDP.

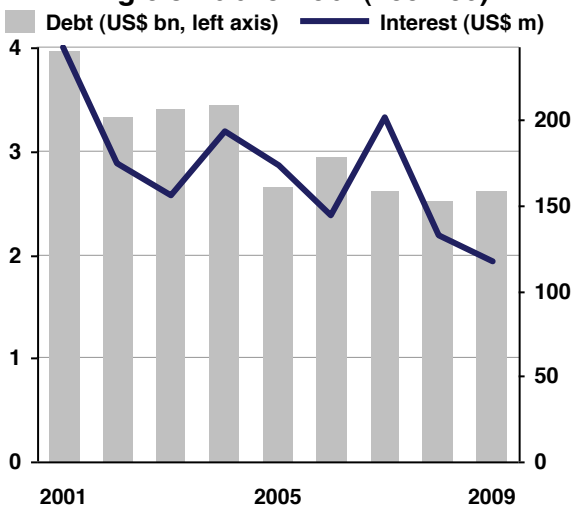
We estimate that nearly a fifth of oil export earnings are paid into the reserve fund

In reality, the surpluses during the boom of the 2000s were substantially stronger than the official fiscal accounts record. This is because a significant part of the oil revenue is transferred outside the budget to the SGRF[44]. The US-based Sovereign Wealth Fund Institute estimates the SRGF's size as being US$8.2bn[45]. However, the probable level of transfers into the SGRF in recent years implies that it could actually be triple this size[46].

Budget surpluses have been used to pay down public debt

Oman has little direct public debt. Most existing debt is concessionary lending from regional development agencies. Public debt stood at US$2.6bn (5.6% of GDP) at the end of 2009. About three-quarters was foreign debt. This is only a fraction of the SGRF's assets. Its interest payments were US$117m in 2009, implying an average interest rate of about 4.5%.

Fig 6.3 Public Debt (2001-09)



Source: Central Bank of Oman, 2010

The government has been utilising surpluses in recent years to steadily pay down debts. Since 2001, the debt stock has declined by a third in absolute terms (from US$3.9bn). As a percentage of GDP it has fallen from 20% in 2001 to 5.6% in 2009.

[44] The SGRF was established in 1980 as an oil stabilisation fund to smooth the fiscal impact of short-term fluctuations in oil prices. However, in the context of the long oil-market boom, it has increasingly functioned more like a sovereign wealth fund, channelling surpluses each year into long term domestic and foreign investments

[45] Compared with US$85bn for the Qatar Investment Authority

[46] Part of the reason why it is difficult to determine its size is that the SGRF is particularly secretive and there is rarely any information on flows into or out of it. It ranks lowest among GCC funds in the SWF Institute's transparency scale. In total, we estimate that the SRGF received about US$15bn, nearly a fifth of oil export earnings, during 2006-10. A comparison of gas revenue with LNG exports suggests that some of LNG revenue was also paid into the SRGF, at least in the early 2000s. The Oman Investment Fund is a much smaller and more recent sovereign wealth vehicle, created in 2006. It manages some of the state's foreign equity holdings, such as a 25% stake in the Dubai Mercantile Exchange

D. Forecast for 2011-12

The unofficial budget surplus, accounting for all oil revenue, will reach 10% of GDP in 2011-12

The 8th five-year plan forecasts deficits averaging about US$2.6bn a year in 2011-15. However, the strong outlook for oil prices means that Oman is likely to be able to meet and exceed expenditure plans without running any deficit at all.

In this scenario, however, the official balance is largely dependant on the proportion of hydrocarbons revenues that are taken into the budget rather than being allocated to reserve funds. This is essentially a policy decision and makes it difficult to forecast the balance.

If all state oil revenue was included in the budget, we would expect a surplus of around 10% of GDP in 2011-12. Instead, on the basis of past government practice, the official budget is likely to show a narrow surplus or deficit, in the region of 1% of GDP in either direction.

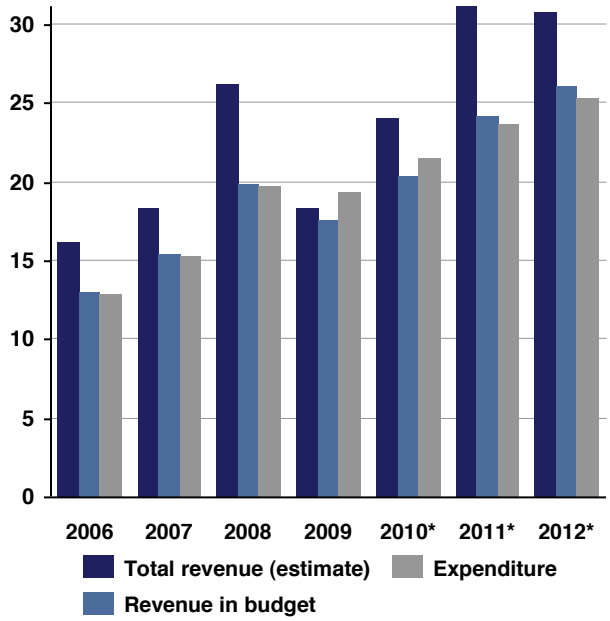
Expenditure is more straightforward to forecast. Our forecasts are based on the following:

- **Investment spending**: we have taken the five-year plan's projections with a small overshoot owing to rising construction costs
- **Support to the private sector**: again, the official allocations are likely to be a good guide to the actual fiscal outturn
- **Current spending**: based on historic trends, and new spending plans announced since the 2011 budget was prepared, we expect a substantial overspend on current items

Overall, we forecast that growth in spending will likely be 10%[47] in 2011 and 7% in 2012. This will take total expenditure to approximately US$25bn or 34% of GDP in 2012.

Fig 6.4 Fiscal Forecast (2006-12)

(US$ bn)



Source: MONE, *QNB Capital forecasts, 2011

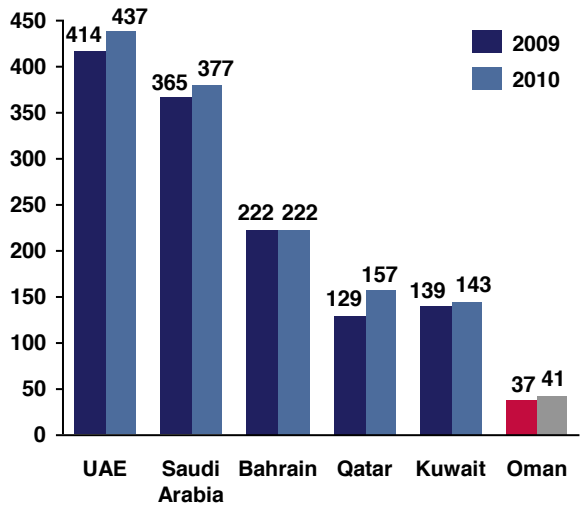
[47] This is 10% growth on the preliminary MONE actual expenditure figures for 2010

7. Banking Sector

A. Overview

Oman's banking sector is one the smallest in the GCC (Fig 7.1). It has remained largely focused on the domestic market. Omani banks have not benefited from inflows of hydrocarbons revenue to the same extent as banks in most other GCC countries.

Fig 7.1 Total Banking Assets (2009-10)
(US$ bn)

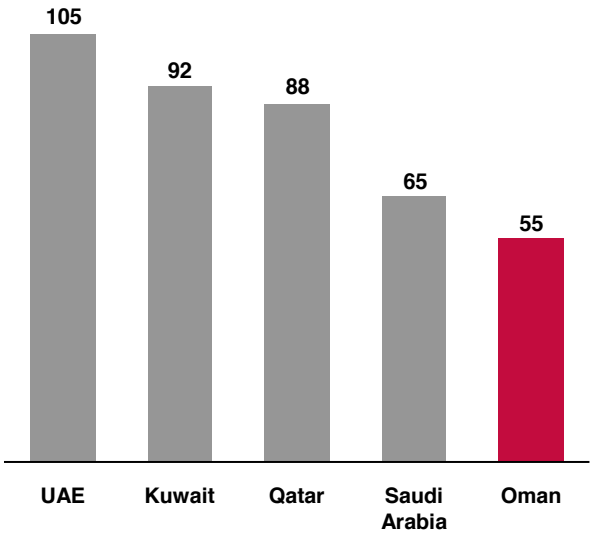


Source: National central banks, 2011

Low loan penetration leaves room for credit expansion

The banking sector is relatively underpenetrated with the lowest level of loans to GDP in the GCC. In 2009, total loans amounted to 55% of GDP in Oman compared with 105% in the UAE (Fig 7.2). Going forward this leaves room for growth in the banking sector.

Fig 7.2 Regional Loan Penetration (2009)
(% of GDP)

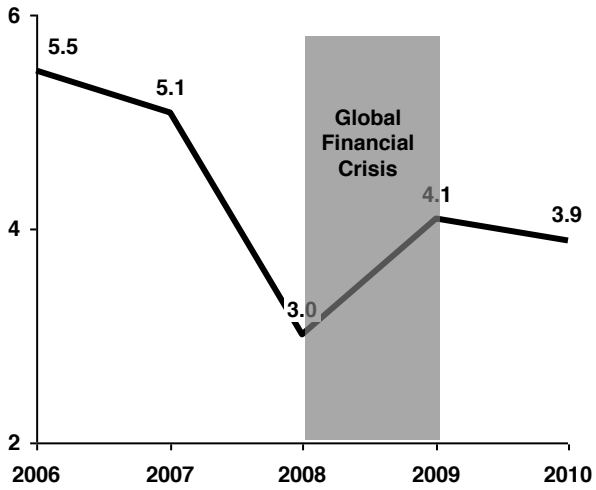


Source: National central banks, 2010

Conservative oversight has kept the sector small and well protected

The **conservative oversight** of the Central Bank of Oman (CBO) has helped keep loan penetration low. It has also limited international debt exposure. These factors have kept the banking sector well protected during the recent turbulent period in global markets.

Fig 7.3 Non-Performing Loans (2006-10)
(% of total loans)



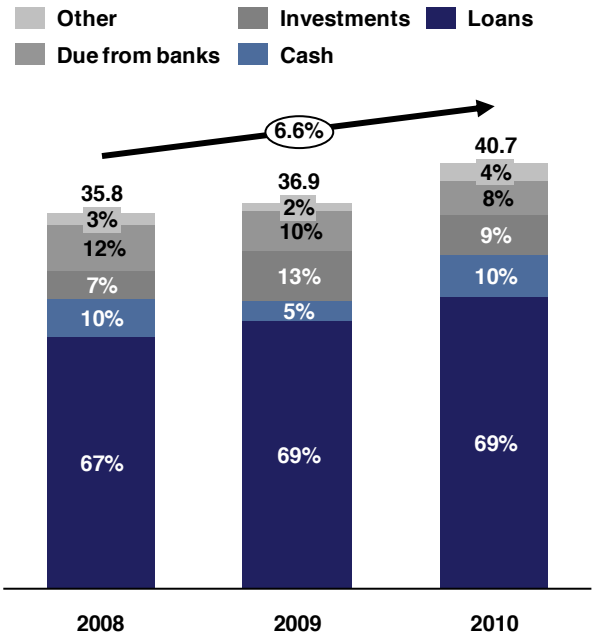
Source: Individual bank statements and QNB estimates, 2010

Nonetheless, like most countries, non-performing loans (NPLs) rose following the global financial crisis (Fig 7.3). This was mainly due to exposure to two Saudi Arabian corporate defaults (see Footnote 56, Section 7F). The CBO's conservative oversight helped to limit the rise in NPLs. Subsequently, NPLs declined as bank debtors that were exposed to the financial crisis have recovered.

Since 2008, the assets of commercial banks have grown. The 2008-10 CAGR of total assets was 6.6% (Fig 7.4). The key driver has been loan growth, which expanded at a 2008-10 CAGR of 7.6% due to increases in private sector credit and lending to state-owned enterprises. This has increased the share of loans as a component in assets to 69% in 2010.

Fig 7.4 Commercial Bank Assets (2008-10)

(US$ bn)



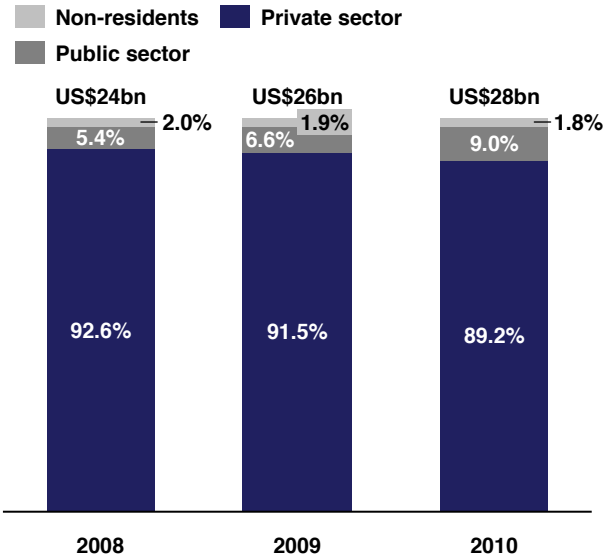
Source: CBO, statistical bulletins, 2008-2011

Government spending and housing debt have been key drivers in credit growth

The bulk of loan growth has been in the private sector (Fig 7.5). Borrowing by state-owned enterprises has expanded, mainly to finance major infrastructure projects. Public sector borrowing has grown at a CAGR of 40% to US$2.5bn in 2010 from US$1.3bn in 2008.

Fig 7.5 Loans by Borrower (2008-10)

(% of total)



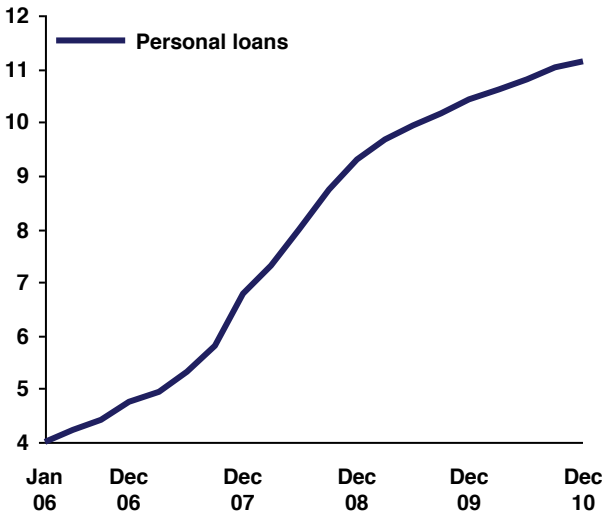
Source: CBO, statistical bulletins, 2008-2011

Personal loans have been a growth driver in the private sector. They have almost tripled since January 2006, growing at a CAGR of 23% (Fig 7.6). Some of this growth has been driven by private consumption, which expanded by a CAGR of 13% over the same period. Personal loans are also thought to be widely used to part-finance house purchases, which has further boosted their growth. This has led to personal loans taking a share of 40% in total bank loans at the end of 2010.

Among the other sectors, construction and services contributed to strong credit growth.

Fig 7.6 Personal Loans (2006-10)

(US$ bn)

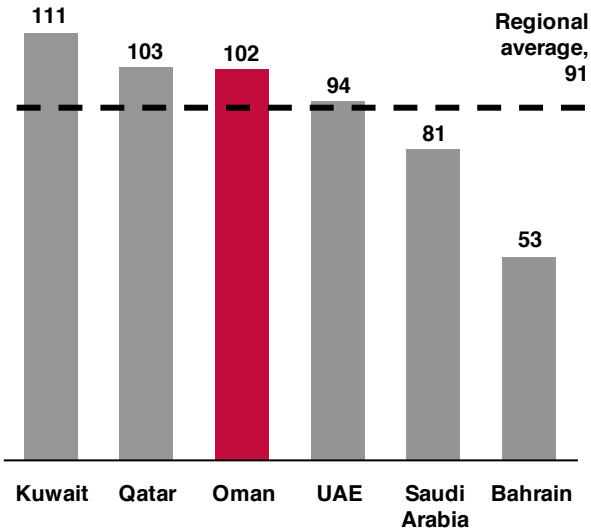


Source: CBO, statistical bulletins, 2006-10

Oman's loans to deposits ratio is slightly above the average for the GCC (Fig 7.7). However, it remains lower than Kuwait and Qatar, leaving some room for further lending growth.

Fig 7.7 Loans to Deposits Ratios (2010)

(%)



Source: National central banks, 2011

Local Commercial Banks

There is a **high degree of government ownership** of commercial banks. State exposure amounted to over 26% of banking sector assets in 2008 according to the IMF. This level is unlikely to have changed significantly and is expected to remain stable in the near future.

Bank Muscat (BM) is the largest bank in the sector (Fig 7.9). It has a network of 125 branches within Oman and overseas branches in Riyadh, Kuwait and a representative office in Dubai. It also has stakes in banks and financial services companies in Bahrain, Saudi Arabia and Pakistan. The bank is listed on both the Muscat and London stock exchanges. It is one of the few banks in Oman that has issued bonds.

National Bank of Oman (NBO) has been focusing on the expansion of its branch network and on underpenetrated segments of the banking sector, such as microfinance and SMEs. Commercial Bank of Qatar took a 35% stake in NBO in 2005.

Bank Dhofar (BD) is known for its project financing capabilities. The specialised nature of the business, its small size and the large proportion of its equity that is publicly traded.

Bank Sohar (BS) is relatively new to the sector but has been marketing itself aggressively with a focus on the retail segment.

Oman International Bank (OIB) has claims to be one of the more innovative banks in Oman. For example, it was the first bank to introduce Visa services in the Sultanate.

Oman Arab Bank (OAB) regards itself as a leader in the securities and investment business in Oman. It has the largest share of investments to assets (15%, see Fig 7.10) of all the local banks. Along with Bank Muscat, it was appointed in 2009 to manage Oman's Investment Stabilisation Fund, a joint public-private investment fund established to support the stockmarket. OAB had US$367m of assets under management at the end of 2010.

Ahli Bank (AB) was a mortgage-only finance institution until the end of 2007 when it became a fully-fledged bank.

Local Commercial Banks Being Established

Al Izz International Bank was approved for establishment by the CBO in September 2010. It is expected to begin operations after an IPO in Q3 of 2011. The main investor is reported to be Assad bin Tariq bin Taimour al-Said, a member of the royal family and businessman.

B. Financial Services Sector Structure

There are 17 commercial banks operating in Oman. Seven of these are local banks and ten are international.

Local commercial banks dominate the financial services sector

There are also:

- Six finance and leasing companies. These mainly conduct retail financing, leasing and factoring
- 23 insurance companies (11 local)
- Two government credit institutions[48]

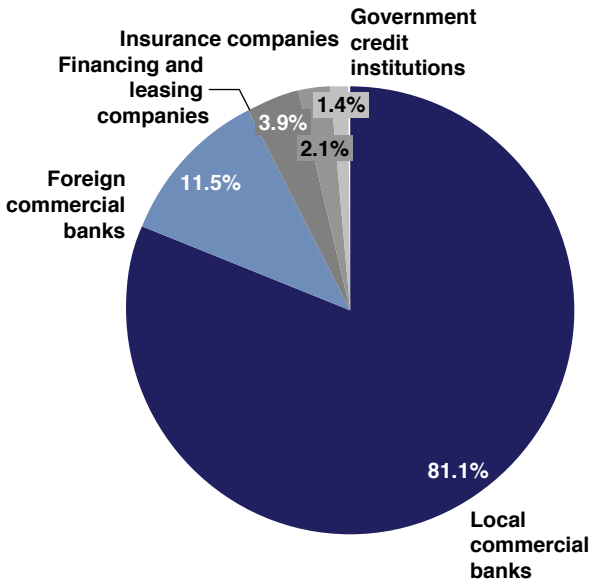
There are ten international banks registered with the CBO with a market share by assets that rose from 11.5% in 2008 to 14% in 2010[49]. **HSBC** is the most active foreign bank, offering a wide range of services. Other foreign banks are primarily focused on:

- Remittance business
- Project finance
- Trade finance

Islamic finance is not currently licensed in Oman, although there are market analysts who think it may be allowed soon.

The local commercial banks dominate the financial services sector (Fig 7.8).

Fig 7.8 Financial Services Sector (2008)
(% of total financial assets)[50]

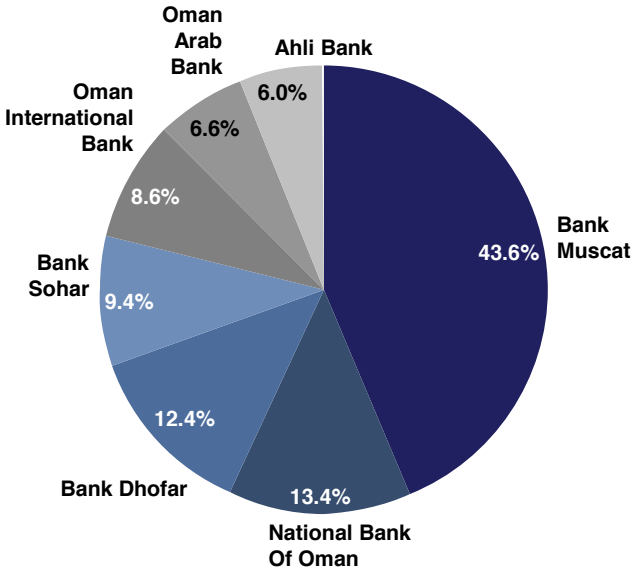


Source: IMF, Banking Sector Resilience, March 2010

Market share is concentrated among the top 3 banks (Fig 7.9), which control 69% of assets, provide 71% of loans and take 72% of customer deposits.

[48] Oman Housing Bank and Oman Development Bank, which specialize in housing finance and lending to development projects
[49] Based on CBO and IMF data and individual bank balance sheets
[50] See Appendix B for full lists of international banks

Fig 7.9 Market Share of Local Banks (2010)
(% of total assets)



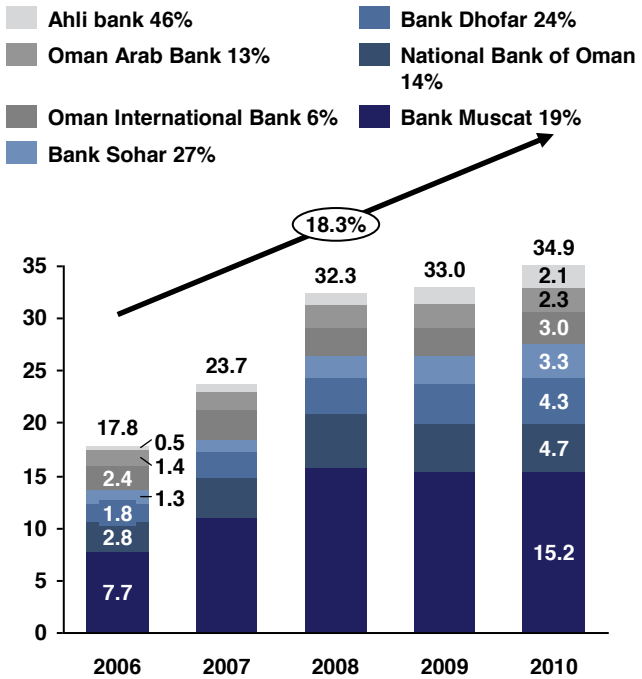
Source: Individual bank financial statements, Bankscope, QNB Capital estimates for Oman Arab Bank (based on H1 results)

C. Bank Performance

Assets, loans and profits have expanded, however, growth has been uneven

Total assets have grown at a CAGR of 18.3% in 2006-10 (Fig 7.10).

Fig 7.10 Total Assets of Local Banks (2006-10)
(US$ bn, bank CAGRs in legend, total CAGR in graph)



Source: Individual bank financial statements, Bankscope, QNB Capital estimates for Oman Arab Bank (based on H1 results)

Asset growth has been varied across banks. The **strongest performers** (by 2006-10 CAGR of assets) have been:

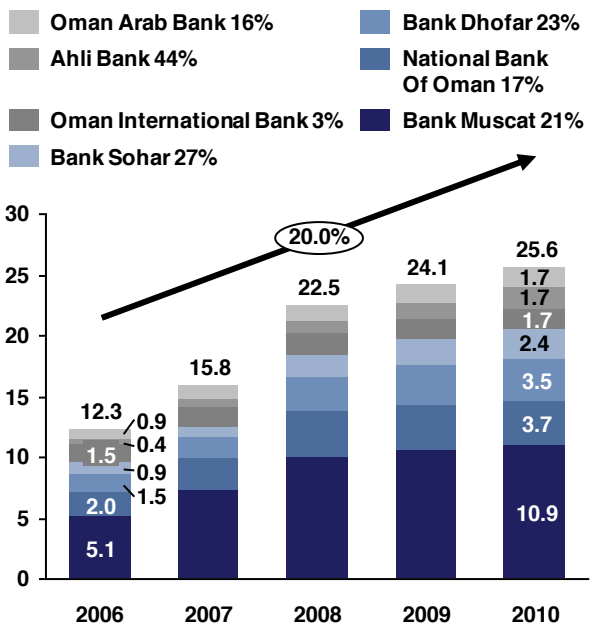
- Ahli Bank with a CAGR of 46%, which has a focus on housing finance
- Bank Sohar with a CAGR of 27%, which is a relatively new bank and has implemented an aggressive market entry strategy
- Bank Dhofar with a CAGR of 24%, which has a focus on corporate banking

Asset growth in the other banks has almost stagnated.

Loans have grown slightly faster with a CAGR of 20% in 2006-10 (Fig 7.11). Bank Muscat's loans have grown each year, but its assets have contracted slightly since 2008 (Fig 7.10). This was mainly a result of a decline in its investment security portfolio.

Fig 7.11 Gross Loans of Local Banks (2006-10)

(US$ bn), bank CAGRs in legend, total CAGR in graph



Source: Individual bank financial statements, Bankscope, QNB Capital estimates for Oman Arab Bank (based on H1 results)

Major project financing is too large for local banks which face dollar liquidity constraints

Oman's economic development has created major opportunities in **project financing**. This has been in areas such as tourism developments, infrastructure, utilities, real estate, petrochemicals, aluminium and hydrocarbons.

The financing requirements of many of these projects is beyond the scope of most local banks. Therefore, project financing is predominantly conducted by large international syndicates with only small local involvement. The domestic focus of local banks has led to dollar liquidity constraints on project financing. This means that many projects have been financed in Omani Riyals. The pipeline of projects has continued to flow, but many major infrastructure projects would have preferred the lower interest rates available from dollar denominated debt.

Consolidation could help the sector compete regionally and overcome its constraints

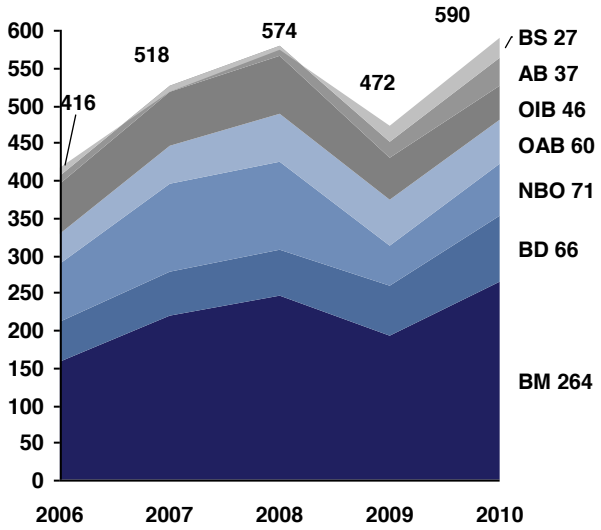
The constraints on the local banking system have fuelled speculation about potential local and regional mergers. Consolidation would better enable local banks to compete with regional rivals.

Banks profitability recovered in 2010 and the impact of the financial crisis was minimal

All the Omani banks have remained profitable in 2009, despite a contraction in profits following the global financial crisis (Fig 7.11). **Net interest income** is the main driver of profits, accounting for around 75% of net income. This has continued to expand at a CAGR of approximately 10% in 2009-10, driven by lending growth. The contraction in profits in 2009 was mainly due to higher provisions for loan losses that were made by banks.

Fig 7.12 Local Bank Profits (2006-10)

(US$ m)



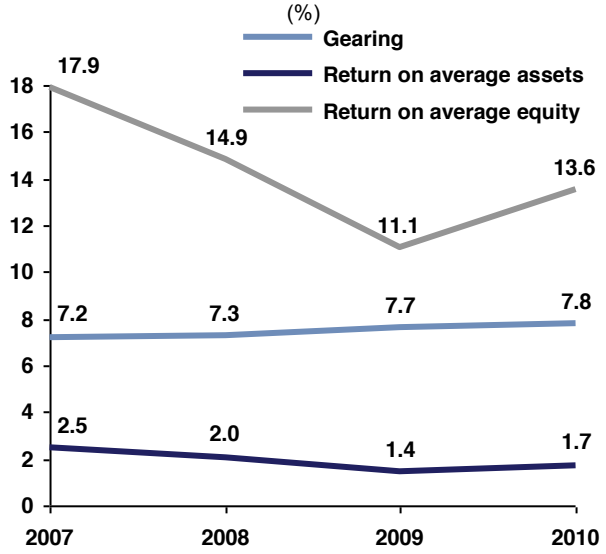
Source: Individual bank financial statements, Bankscope, QNB Capital estimates for Oman Arab Bank (based on H1 results)

Total sector **profits** are heavily influenced by Bank Muscat's performance. Bank Muscat accounted for 42% of profits on average in 2006-10. The sale of a stake in HDFC Bank of India in 2009 supported profits in that year. This helped to counteract an increase in loan loss provisions of US$100m. In 2010, net income at Bank Muscat grew by 38% to US$264m. The bulk of income (74%) was net interest income. No other bank increased loan loss provisions by more than US$19m (Bank Dhofar) in 2009.

Profits at all of the banks grew in 2010 over 2009 with the exception of Oman International Bank (OIB). OIB's fall in profits was mainly a consequence of lower net

interest revenue, which has contracted every year since 2006. In 2010, net interest income also fell at National Bank of Oman while it increased at all the other banks.

Fig 7.13 Local Bank Returns and Gearing (2007-10)



Source: Individual bank financial statements, Bankscope, QNB Capital estimates

Returns for Omani banks grew in 2010 (Fig 7.13), assisted by a stable cost of funds. The level of **gearing** (the ratio of assets to equity) in the sector has remained relatively constant. It rose from 7.2 in 2007 to 7.8 in 2010. The leverage of Omani banks has therefore risen while banks in other countries have deleveraged significantly. This is another indication of the minimal impact of the financial crisis on Omani banks.

D. Regulations

Tight regulation protects the sector but limits access to credit and creates excess liquidity

The CBO's hands are largely tied in terms of **interest-rate policy** due to the Omani Riyal's peg to the US dollar (see Section 5). It has therefore tended to use reserve requirements and some other banking sector ratios as a policy tool to control lending. The CBO's **regulatory requirements** have ensured that debt-levels remain low:

- Personal loans are not permitted to be more than 40% of total bank loans
- Mortgage loans are limited to 10% of total loans
- Commercial loans are not permitted to be more than 60% of total loans
- Loans to individuals cannot be more than 15% of their net worth
- Bank loans must be below the lending ratio[51] of 87.5%. This was increased from 85% in January 2009. All banks are within this limit

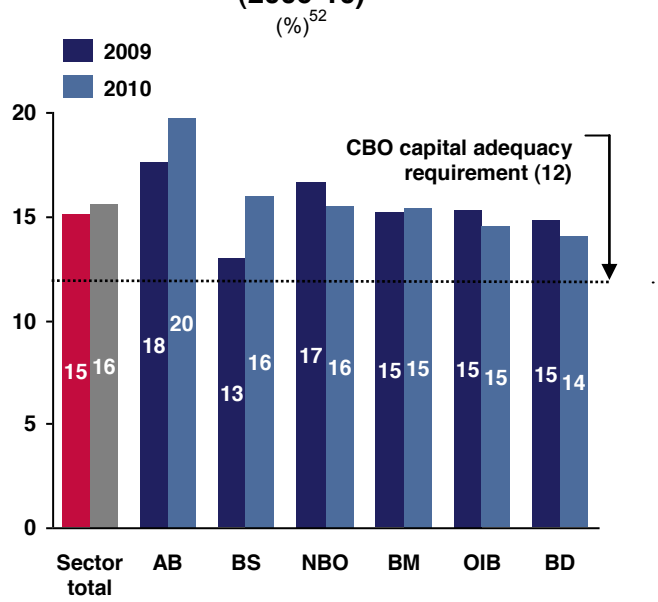
[51] The lending ratio used by CBO is based on loan to deposits but also includes net interbank borrowing, other borrowings, and shareholders' equity

There are also restrictions on bank's lending exposure to non-residents:

- The limit for lending to a particular non-resident entity or individual is 2.5% of the bank's net worth (down from 5% previously)
- Aggregate lending to all non-residents is limited to 20% of the bank's net worth (down from 30%)

The CBO has limited **interest rates** on personal loans to 8%. As regulations limit lending ability, banks face a surplus of demand. This gives them **no incentive to charge interest at less than 8%** to attract more borrowers.

Fig 7.14 Capital Adequacy Ratios (2009-10)



Source: Individual bank financial statements, Bankscope.

Furthermore, the lending limits encourage an **excess of liquidity** in the banking system. This has led to complaints from individuals and companies that banks have plenty of cash but still charge high interest rates.

Local banks are capitalised above the minimum capital adequacy ratio

In April 2010, the CBO raised the minimum **capital-adequacy ratio** from 10% to 12%. Fig 7.14 shows that capitalisation in the banking sector is well above this level at around 16% in 2010 and that the ratios are generally rising.

The CBO requires that reserves are more than 5% of capital. This was lowered from 8% in January 2009.

The CBO created a US$2bn lending facility during the financial crisis. This was only used by two banks for relatively small loans, which were repaid in 2010. This indicates that the impact of the financial crisis on Omani banks was minimal. They had little need for government

[52] OAB Omitted as full year 2010 results are not yet available

borrowing in the aftermath of the financial crisis while banks in other countries depended on government handouts for their survival.

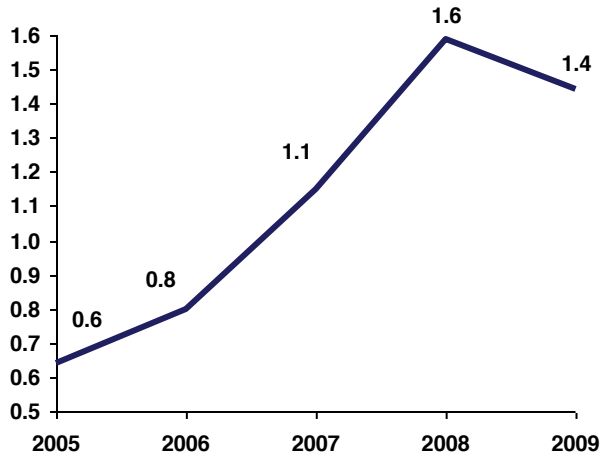
E. Finance and Leasing Companies

There are currently six finance and leasing companies (FLCs). They have a network of 33 branches. Total assets in the sector have grown rapidly, more than doubling between 2005 and 2008 (Fig 7.15).

As illustrated before in Fig 7.8, around 4% of financial assets are held by FLCs, which are separate from the commercial banks. The main areas of business for the FLCs are:

- **SME loans**: This includes a large number of oil services companies, requiring financing for equipment
- **Car loans** to individuals
- **Electrical equipment loans** to individuals

Fig 7.15 Finance and Leasing Company Assets (2005-09)
(US$ bn)



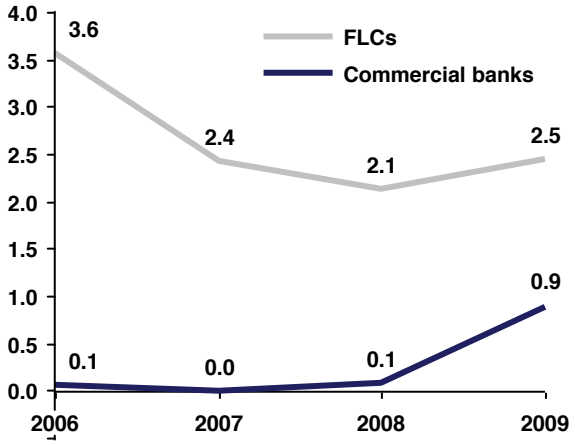
Source: CBO, statistical bulletins, 2005-10

Commercial banks are taking business from the finance and leasing companies

FLCs are focused on lending to SMEs and have become the dominant players in this sector. However, some banks have been offering SME loans and car loans since 2008 and are beginning to take some FLC business, assisted by the fact that the sector is underpenetrated.

The level of NPLs was considerably higher in the FLC sector at 9.9% in 2009. This was compensated for by higher interest rates and higher provisioning. The weighted average of FLC interest rates in 2009 was 11.1%. Fig 7.16 shows the ratio of loan loss provisions to total assets has historically been higher amongst the FLCs than the commercial banks. However, there has been some convergence in recent years mainly as loan loss provisions in commercial banks have risen following the financial crisis.

Fig 7.16 Loan Loss Provisions (2006-09)
(% of total assets)



Source: CBO, statistical bulletins, 2009-10

F. Risks

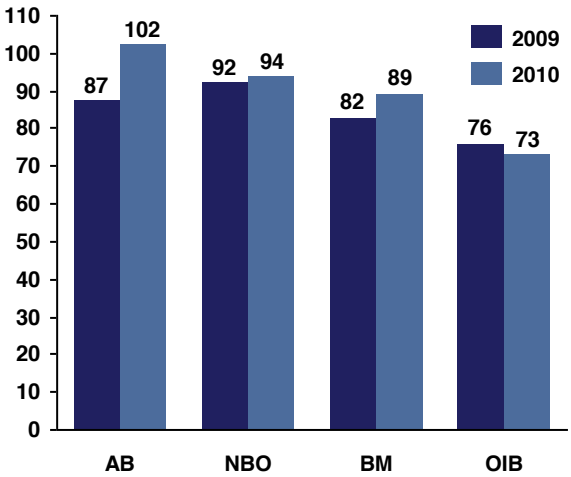
Conservative oversight has limited exposure to regional defaults

According to the IMF, the conservative stance of the CBO helped to mitigate the adverse effects of the financial crisis[53]. The principal reasons the sector has been protected from global financial shocks are:

- Controls on lending to non-residents
- Focus on local corporate and retail lending
- Limited use of investment banking and derivatives

Fig 7.17 shows the **loan to deposit ratios** (LTDs) for four banks[54] that constitute 72% of the market by assets. The LTDs are rising but remain at manageable levels. Only Ahli Bank has an LTD of over 100%.

Fig 7.17 Loans to Deposits (2009-10)
(%)[55]



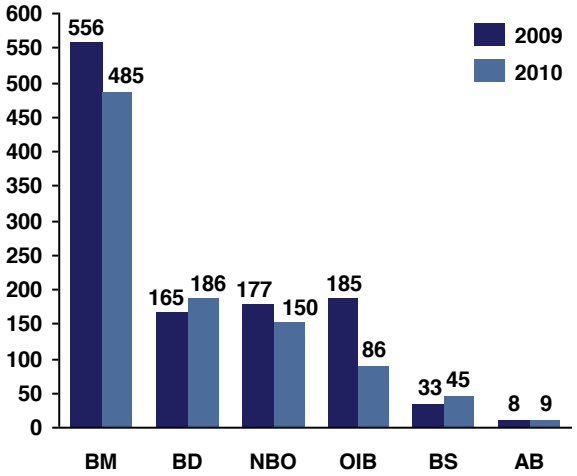
Source: Individual bank financial statements, Bankscope, 2010

[53] Working paper, March 2010
[54] Data for the other local banks was not available at the time of publication
[55] Net loans to total deposits and borrowing

Nonetheless, the financial crisis had a slightly detrimental effect on loan quality and depth of provisions. In the six months from December 2008, new provisions for bad loans increased by 24.6% to US$33m. The total stock of provisions for bad loans on the balance sheet rose from 2007-09. However, they have fallen in 2010 at the banks that had little exposure to the regional corporate defaults (Fig 7.18).

Fig 7.18 Total Provisions for Bad Loans (2009-10)

(US$ m)[56]



Source: Banks' financial statements, Bankscope, 2010

The increase in **NPLs** (Fig 7.3) and the fall in the provisions coverage ratio were mainly a consequence of **exposure** to corporate defaults in Saudi Arabia[57]. This exposure was concentrated in Bank Muscat, which had US$171m of exposure, or 1.1% of its assets, in June 2009. Half of this amount was covered by provisions. NBO and Bank Dhofar also announced much smaller exposures of US$17m and US$10m respectively. This illustrates that banking system risk was minimal.

Omani banks' exposures to the debt woes in Dubai were also limited. In December 2009, in total, local banks declared an exposure of US$77m to Dubai World after it declared a standstill on debt of US$26bn. This exposure was split as follows:

- Bank Muscat, US$50m, via a syndicated loan
- NBO, US$23m
- Bank Sohar, US$4m

Relative to bank assets, none of these exposures posed a significant risk to Omani banks.

The limited risk was reinforced by domestic overnight **interbank lending rates**. These peaked at 2.1% per annum in September 2008 during the Lehman crisis. However, they dropped off quickly, reaching 0.3% by December 2008. Interbank rates have recently been averaging around 0.1%.

Looking ahead, the real estate sector is the most likely source of financial stress

The principal risk in the banking system is most likely to be in the **real estate** sector. However, the sector only accounts for 6% of banks' loans. Nevertheless, this figure may be misleading as personal loans are often used to finance house purchases. Personal loans have risen rapidly in recent years (Fig 7.6). There is therefore some risk that excessively indebted households could fail to repay loans.

Some housing finance is thought to be provided through personal loans. Most banks are therefore close to the limit on personal loans but well within the mortgage limit. This implies that a relatively low percentage of loans is collateralised by property or other assets. However, this risk is partly mitigated as most loans are repaid directly from salaries.

Risks are limited but could be better managed

In spite of the specific risks outlined above, the risk to the overall economy is limited owing to the relatively low level of loans to GDP.

Banks would be better able to manage risks in the real estate sector with an effective private **credit bureau**. There is an existing public credit bureau but it could be improved by better sharing of information between banks[58]. Work is in progress to improve access to information on borrowers.

G. Capital Raising

Bank Muscat has taken steps to issue international bonds to access foreign currency borrowing. The bank's shareholders approved an US$800m Eurobond programme in February 2011. This will permit the bank to issue bonds in various currencies over a range of maturities for the next 10 years. The bank has also issued a number of local bonds and certificates of deposit. Some of the other banks have **bond programmes**, but they are limited:

- Ahli Bank received shareholder approval to issue a RO35m (US$91m) bond in December 2010
- National Bank of Oman received shareholder approval for a US$600m bond issue in March 2011

The CBO has issued RO100m (US$260m) "development bonds" on a regular basis since the 1990s. This has created a foundation for the establishment of an interest-rate yield curve in Oman.

[56] Oman Arab Bank had not released its final financial statements for 2010 at the time of publication

[57] A major Saudi corporate, Ahmad Hamad Al-Gosaibi and Brothers, defaulted on its debt in May 2009, and impacted the financial services sectors in the region.

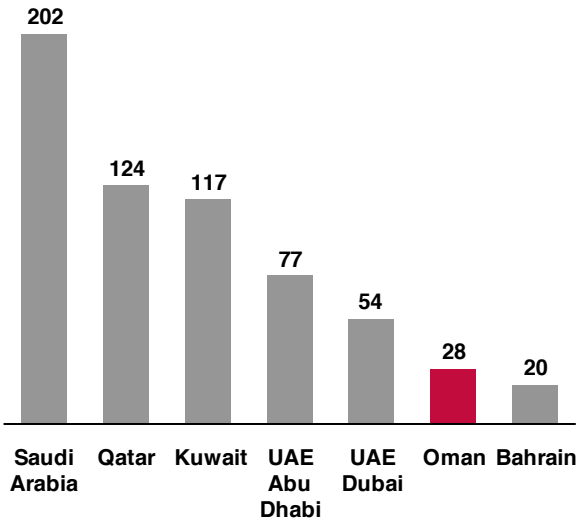
[58] IMF Working Paper, March 2010

8. Equity Market

A. Overview

The market capitalisation of the Muscat Securities Market (MSM) reached US$28.3bn at the end of 2010. This makes it one of the smallest markets in the GCC by market capitalisation (Fig 8.1). By the end of March 2011 it had fallen by 3.7% to US$27.3bn.

Fig 8.1 GCC Market Capitalisation (2010)
(US$ bn)

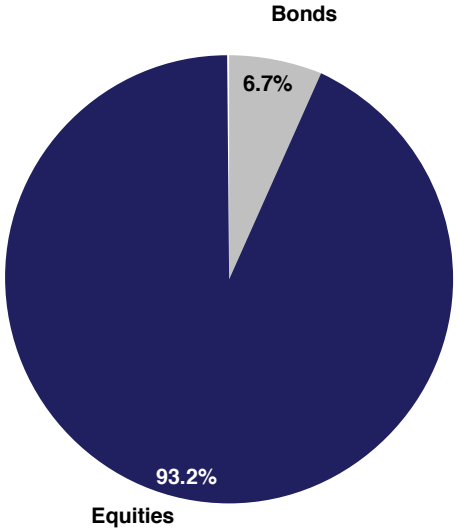


Source: Various stock-exchange websites and annual reports, 2011

Equities dominate the Muscat Securities Market

The MSM is mainly dominated by equities with almost all of the remainder being listed bonds (Fig 8.2). There are also US$22m of listed mutual funds (just 0.1% of the total).

Fig 8.2 Capitalisation of Securities (2010)
(% share, year end)

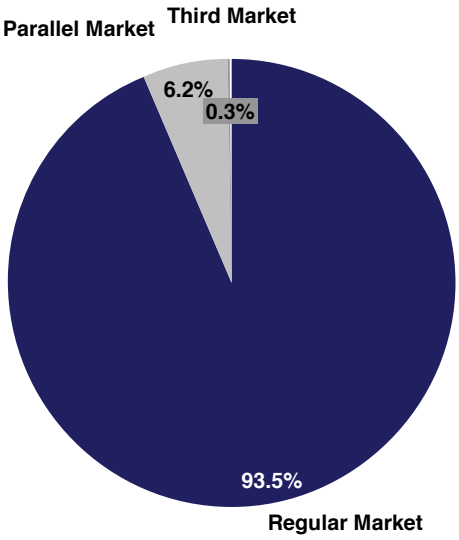


Source: Muscat Securities Market website, 2011

The equities sector can be broadly categorised into liquid stocks and **closely held** stocks (thinly-traded companies in which voting rights are predominantly owned privately). The latter accounts for 25% of total equities.

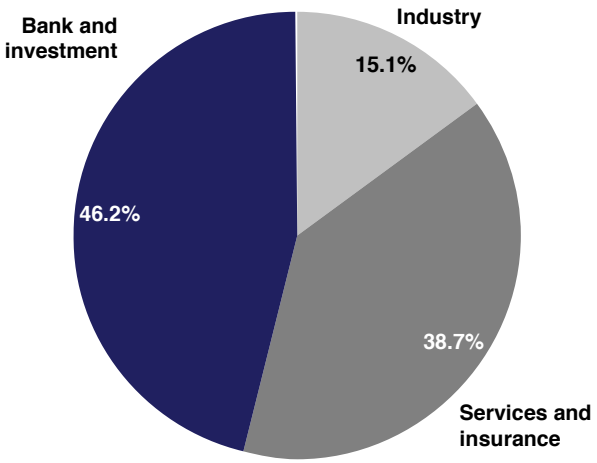
The equity market can also be subdivided into different types of stocks (Fig 8.3). The majority of equities come under the **regular market** (companies must meet requirements such as US$5.2m of capital and 2 years of net profits to list on this market). Companies that do not meet this requirement, list on the **parallel market** if they have shareholders' equity of more than 50% of capital. If they have less capital than this, they are listed on the **third market**.

Fig 8.3 MSM Breakdown by Market (2010)
(% share, year end)



Source: Muscat Securities Market website, 2011

Fig 8.4 Equity Sectors (2010)
(% share)



Source: Muscat Securities Market website, 2011

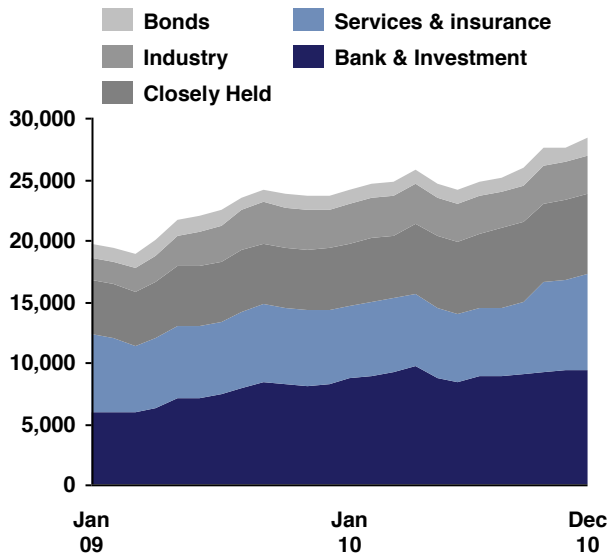
Fig 8.4 shows the share of different sectors in the equity market. It includes all equities on the regular, parallel and third market and those that are closely held. The share of services and insurance sector has expanded since 2009.

The share of both the Industry sector and the Bank and Investment sector has contracted slightly.

B. Performance

The MSM has been growing steadily in terms of capitalisation at a CAGR of 14% between January 2009 and December 2010, as shown by Fig 8.5. The country's steady economic development and growing financial markets have attracted capital to the stock exchange.

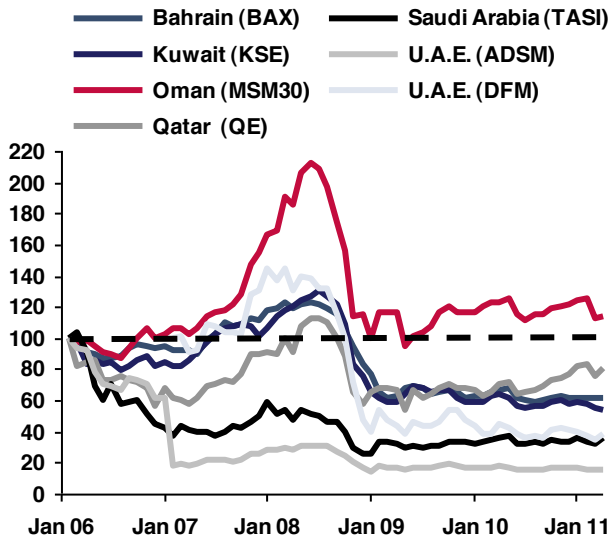
Fig 8.5 MSM Capitalisation by Security (2009-10)
(US$ m)



Source: Muscat Securities Market website, 2011

Oman's stock exchange has outperformed the GCC average by 100% in 2006-11

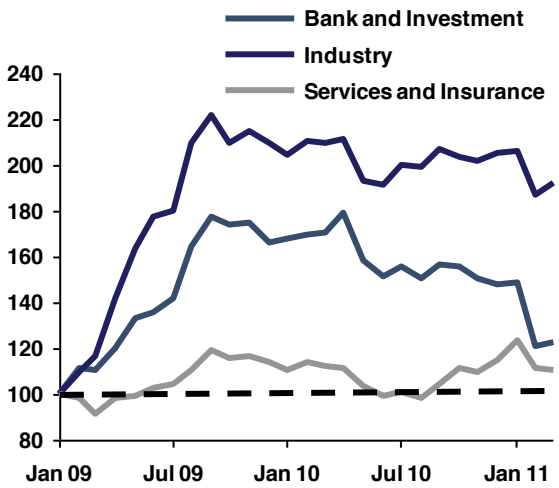
Fig 8.6 GCC Stock Index Performance (Jan 2006 to March 2011)
(Monthly index, based as at Jan 2006)



Source: Stock exchanges websites, 2011

The MSM30 (the main equity market index) has outperformed the other major stock markets indices in the GCC over the last five years, based on the average performance of all the GCC market indices (Fig 8.6).

Fig 8.7 MSM Sector Performance (2009-11)
(Monthly index, based as at Jan 2009)



Source: Muscat Securities Market website, 2011

The Industry sector has been the strongest performer since January 2009 (Fig 8.7). The services and insurance sector has underperformed. Its growth in market capitalisation has mainly been driven by IPOs.

The MSM is the only GCC stock market with an index trading above its level at the beginning of 2006. However, Oman has underperformed the GCC stock market average in early 2011.

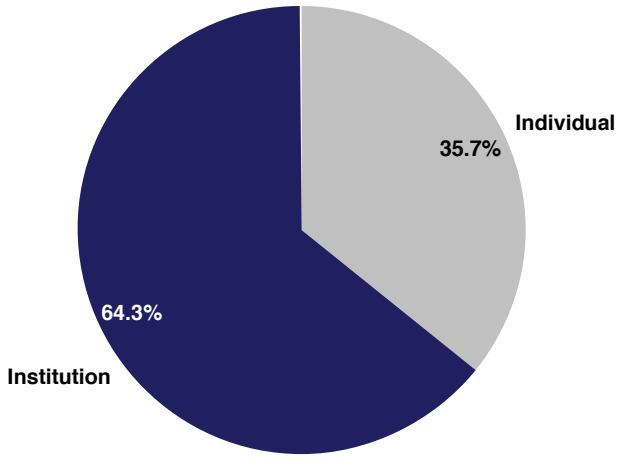
A growing institutional presence will most likely reduce volatility

The total market value of shares traded on Omani securities markets was US$3.4bn in 2010. This represented a drop of 42% from 2009. Institutions accounted for the bulk of turnover in 2010 (Fig 8.8) with the remainder by individuals. The large majority of individual turnover (86%) is by Omanis. The strong institutional may help to reduce volatility.

The share of trading conducted by institutions increased from 54% in 2009 to 64% in 2010. This was principally the result of a 55% fall in the value of trades by individuals. During 2009, both individuals and institutions broadly purchased the same value of shares as they sold. However, in 2010 individuals were net sellers (reducing overall exposure by US$25m) while institutions have been net buyers.

Fig 8.8 Turnover by Investor (2010)

(% share)



Source: Muscat Securities Market website, 2011

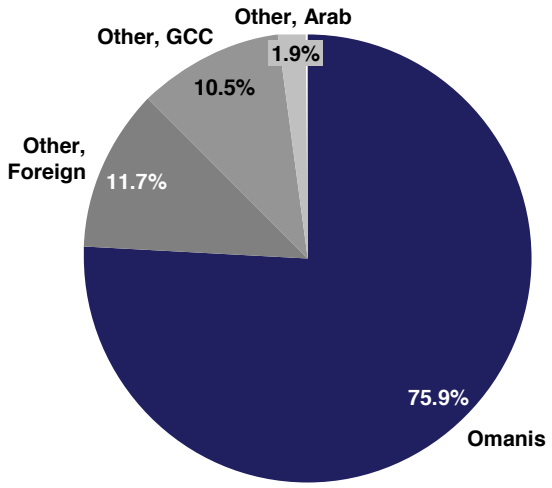
Non-GCC participation in the MSM has fallen while GCC investors have been more active

Lower market turnover has led to slightly lower interest from non-Omani investors in 2009 than in 2010 (Fig 8.9). This was most probably a consequence of foreign investors repatriating capital to their own developed markets as these economies began to move out of recession.

Investors from the GCC have increased their share of the Omani market (from 8.4% in 2009 to 10.5% in 2010). A number of GCC markets suffered setbacks resulting from debt-related issues, such as the corporate defaults in Saudi Arabia and Dubai. This may have led GCC investors to take more interest in the Omani market, which was less affected by these issues.

Fig 8.9 Turnover by Nationality (2010)

(% share)



Source: Muscat Securities Market website, 2011

The leading company by market capitalisation is Bank Muscat (Fig 8.10). Of the largest ten companies:

- Five are banks (Bank Muscat, Bank Dhofar, National Bank of Oman, Oman International Bank and Ahli Bank)
- Two are cement companies (Raysut Cement and Oman Cement)
- Two are services companies (Renaissance Services and Shell Oman Marketing)
- One is a telecoms company (Omantel)

Fig 8.10: Top Ten Companies by Size

(31 March 2011)

	Company name	Market Capitalisation (US$ m)
1.	Bank Muscat	2,763
2.	Omantel	2,146
3.	Bank Dhofar	1,581
4.	National Bank of Oman	897
5.	Renaissance Services	722
6.	Oman International Bank	651
7.	Ahli Bank	611
8.	Shell Oman Marketing	581
9.	Raysut Cement	566
10.	Oman Cement	491

Source: Muscat Securities Market website, 2011

The top five performing companies in 2010 were all either food companies or mining* companies:

1. Dhofar Poultry (gained 362%)
2. Asaffa Foods (gained 324%)
3. Al Fajar Al Alamia* (gained 247%)
4. Sweets of Oman (gained 141%)
5. Oman Chromite* (gained 88%)

10. Business Environment

World Bank Doing Business ranking unchanged in 2011

Oman ranked **57th out of 183** economies in the World Bank's (WB) Doing Business 2011 report. Its global ranking was unchanged from the previous year. In the sub-category, "paying taxes", Oman ranked 8th. This partly reflects its relatively low corporate income tax rate of 12% and taxable profit rate of 9.7%. Among GCC countries, Oman was only ahead of Kuwait.

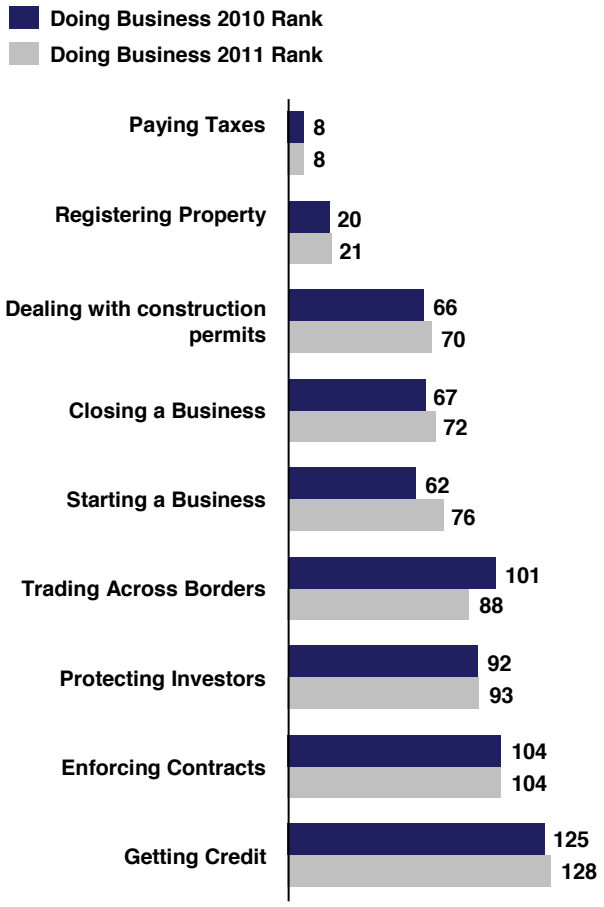
Oman gained 13 places in Trading Across Borders. This was a result of cutting:

- Time to export by 4 days
- Costs of exporting by 6.7%
- Time to import by 6 days
- Cost of importing by 3.4%

Oman's overall ranking was held back by lower ranks in almost every other category (Fig 9.1). It underperforms in getting credit, falling to 128th in 2011. Getting credit is held back by:

- Low depth of credit information
- Zero private credit bureau coverage

Fig 9.1 Doing Business Ranks (2010-11)
(Rank out of 183)



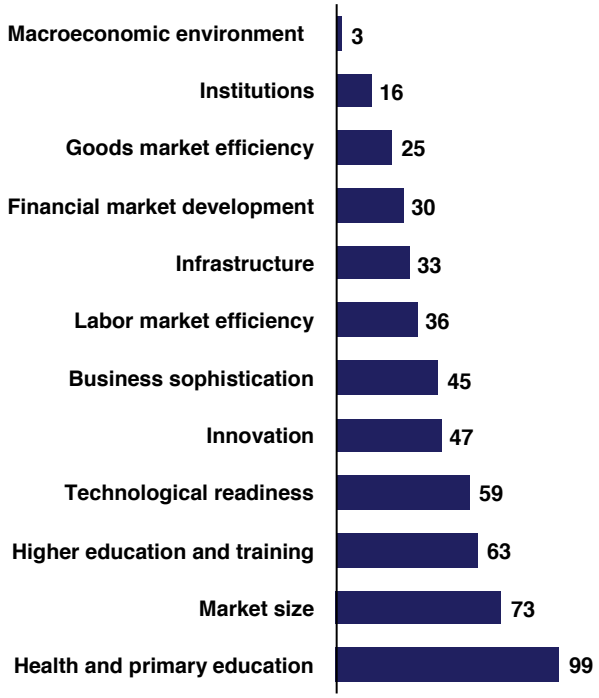
Source: World Bank Doing Business, 2011

The Global Competitiveness Report 2010-2011 produced by the World Economic Forum (WEF) ranked Oman 34th out of 139 countries. This was a marked improvement from 41st position out of 133 countries in 2009-10. In the Global Competitiveness Report, Oman outperformed achieving 3rd place for the macroeconomic environment.

Oman has performed below average in some of the overall areas:

- Efficiency enhancers (48th)
- Innovation and sophistication factors (47th)
- Social development indicators such as health and education

Fig 9.2 Competitiveness Ranks by Category (2010-11)
(Rank out of 139)



Source: World Economic Forum, The Global Competitiveness Report, 2010-2011

Both WB and WEF see difficulties in borrowing

The WEF conducts an annual survey as part of its competitiveness rankings. The main factors cited as holding back Oman's business environment were:

- Restrictive labour regulations
- Inadequately educated workforce
- Access to financing

10. Qatar's Activities in Oman

Qatar's leading banks are active in Oman's financial sector

Qatar's two largest banks are present in Oman. **Commercial Bank of Qatar** entered the country in 2005 by taking a 35% stake in the National Bank of Oman.

Qatar National Bank (QNB) launched operations in Oman in December 2007, offering full banking services to Omani and Qatari businesses and individuals. QNB has four operating branches in Oman with plans to open two more in 2011.

Oman's trade surplus with Qatar has narrowed owing to gas imports

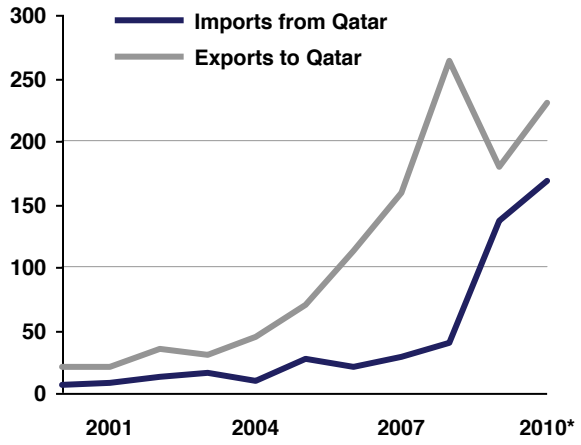
Trade between Qatar and Oman has increased significantly since 2000 (Fig 10.1). **Exports** from Oman to Qatar grew strongly in 2003-10 at a CAGR of 40%. The main export items are:

- Electrical machinery
- Copper cables
- Processed articles of iron and steel

These materials are important for construction. Exports increased as Qatar's construction boom gathered pace and commodities prices rose in 2004-08. A slowdown in new construction and falling commodities prices reversed this trend in 2009. However, exports to Qatar have recovered in 2010.

Fig 10.1 Qatar-Oman Trade (2000-10)

(US$ m)



Source: IMF, Direction of Trade Statistics, 2011, *QNB Estimates based on monthly data to October 2010

Imports from Qatar increased strongly in 2008 when Oman began importing gas through the Dolphin pipeline. A 25-year contract was put in place for the import of 200m cu ft/day of Qatari gas. We estimate that the annual value of this trade is around US$100m per year.

The other main imports from Qatar in 2010 were:

- Polyethylene used for plastics
- Raw iron and steel used for inputs in Oman's iron and steel industry

Qatari companies have large stakes in Omani companies

Qatar Telecom (Qtel) is active in Oman through its affiliate Nawras Telecom. Nawras is 55% owned by Qtel and 40% owned by the public. The remainder is owned by various Omani pension funds. Nawras was the company:

- That won Oman's second mobile network licence in 2005. It planned to invest US$1.7bn over ten years
- That won a fixed-line license for telecoms and internet in 2008 with plans to invest US$300m over 5 years
- That issued an IPO in September 2010 as per the guidelines of Oman's Capital Market Authority and to find its capital expenditure

The **Qatar Oman Investment Company** was established in 2006 to take advantage of investment opportunities in both countries. The company had assets under management of US$92m at the end of 2010 and made a net profit of US$3.7m. The company is quoted on the Qatar exchange.

Dhofar Tourism Company (DTC) was established in 1993 to take advantage of the potential in Oman's tourism sector. Qatar Holding Company holds 49 % of DTC's US$20m of share capital. The company is listed on the Muscat Securities Market.

Oman Qatar Insurance Company was formed in 2004 and operates in the general insurance and life insurance sectors.

Al-Hosn Investment Company (HIC) was incorporated in Muscat in 2007. It is a 50:50 joint venture between the Qatar Investment Authority (QIA) and the Ministry of Finance of Oman. HIC plans to invest in a diverse range of sectors in Oman and has US$130m of capital.

A growing number of Omani expatriate workers are present in Oman. A memorandum of understanding on labour cooperation was signed between the two countries in that year. It was aimed at creating more job opportunities for skilled Omanis in Qatar.

Appendices

Appendix A: Key Indicators for Local Banks

	2006	2007	2008	2009	2010
Total assets (US$ m)	**17,818**	**23,688**	**32,333**	**32,964**	**34,923**
Ahli Bank	456	796	1,184	1,602	2,095
Bank Dhofar	1,807	2,484	3,443	3,867	4,328
Bank Muscat	7,685	10,969	15,678	15,216	15,217
Bank Sohar	1,258	1,093	2,192	2,665	3,272
National Bank of Oman	2,815	3,840	5,161	4,677	4,694
Oman Arab Bank	1,406	1,692	2,026	2,234	n/a
Oman International Bank	2,391	2,814	2,648	2,703	3,006
Gross loans (US$ m)	**12,335**	**15,847**	**22,507**	**24,068**	**25,565**
Ahli Bank	396	630	983	1,162	1,716
Bank Dhofar	1,503	1,951	2,780	3,271	3,468
Bank Muscat	5,080	7,271	10,022	10,538	10,908
Bank Sohar	914	789	1,675	2,079	2,378
National Bank of Oman	2,003	2,497	3,811	3,717	3,695
Oman Arab Bank	897	1,047	1,441	1,517	n/a
Oman International Bank	1,542	1,663	1,796	1,784	1,748
Customers' deposits (US$ m)	**12,146**	**14,754**	**20,010**	**21,211**	**22,184**
Ahli Bank	198	396	830	1,214	1,644
Bank Dhofar	1,293	1,754	2,527	2,864	3,250
Bank Muscat	4,726	6,039	8,252	7,980	9,173
Bank Sohar	999	632	1,425	2,165	2,598
National Bank of Oman	2,124	2,434	3,490	3,279	3,446
Oman Arab Bank	1,025	1,388	1,589	1,810	n/a
Oman International Bank	1,781	2,111	1,897	1,898	2,073
Net profit (US$ m)	**416**	**518**	**574**	**472**	**590**
Ahli Bank	10	6	15	22	37
Bank Dhofar	52	59	62	66	87
Bank Muscat	157	219	244	192	264
Bank Sohar	10	-7	-6	21	27
National Bank of Oman	79	116	118	55	71
Oman Arab Bank	39	51	64	60	n/a
Oman International Bank	68	73	77	56	46
Return on Average Equity (%)	**n/a**	**17.9**	**14.9**	**11.1**	**13.6**
Ahli Bank	13.7	4.0	7.0	9.5	14.5
Bank Dhofar	23.3	22.4	15.9	13.0	15.5
Bank Muscat	19.9	17.8	14.0	10.3	13.5
Bank Sohar	9.2	-6.8	-3.2	7.9	9.2
National Bank of Oman	17.2	21.4	19.0	8.5	10.5
Oman Arab Bank	22.3	24.1	24.8	19.5	n/a
Oman International Bank	21.9	19.6	17.6	12.5	10.4
Return on Average Assets (%)	**n/a**	**2.5**	**2.0**	**1.4**	**1.7**
Ahli Bank	2.4	0.9	1.6	1.6	2.0
Bank Dhofar	3.1	2.8	2.1	1.8	2.1
Bank Muscat	0.9	-0.8	-0.4	0.9	0.9
Bank Sohar	2.4	2.4	1.8	1.2	1.7
National Bank of Oman	3.2	3.5	2.6	1.1	1.5
Oman Arab Bank	3.0	2.8	2.8	2.1	1.6
Oman International Bank	3.2	3.3	3.4	2.8	2.6

Source: Banks financial statements, 2007-11

Appendix B: Foreign Banks and Branches

	Operating offices in Oman
Habib Bank Ltd	8
National Bank of Abu Dhabi	8
HSBC Bank Middle East	6
Standard Chartered Bank	2
Bank of Baroda	2
Bank of Beirut	2
Qatar National Bank	2
Bank Melli Iran	1
Bank Saderat of India	1
State Bank of India	1

Source: CBO, 2010

Appendix C: Major Manufacturing Plants: Investment and Production Volumes

	Plant	Investment (US$ m)	Launch	m t/yr	Owners
Sohar	Oman Petrochemical Industries	2,600+	2012+	1	Dow Chemicals, OOC
	Sohar Aluminium Company	1,700	2008	0.35	Alcan, OOC, ADEWA
	Aromatics Oman	1,600	2010	1	LG, OOC
	Sohar Int. Urea & Chemical Ind.	1,000	pending	1.8	Suhail Bahwan Group
	Oman Methanol Company	430	2007	1	MH Trinidad, OMZEST
	Shadeed Iron & Steel Company	500	2011	1.5	Jindal Steel
	Oman Polypropylene	300	2006	0.34	LG, OOC, GIC
	Liwa Petrochemical	300	pending	0.3	LG, OOC, NPC-Iran
	Al Hafri Sugar Refinery	230	2010	0.65	Asaad bin Tariq al-Said
	Sohar Steel	-	2006	0.3	Sharq Sohar Steel
Sur	Oman-India Fertiliser Company	1,000	2005	1.7	OOC, Krishak Bharati, IFFC
Salalah	Raysut Cement	-	1984	3	Listed company
	Salalah Methanol	900	2010	1.1	OOC
Muscat	Oman Cement	-	1983	1.26	Listed company

Source: Company websites and press reports, 2008-2011

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Key Indicators

	2006	2007	2008	2009	2010	2011	2012
Population							
Total (m)	2.58	2.74	2.87	3.17	2.69	**2.76**	**2.82**
Growth (%)	2.7	6.4	4.5	10.7	-15.1	**2.4**	**2.4**
GDP							
Nominal GDP (US$ bn)	36.8	41.9	60.6	46.9	**57.9**	**70.4**	**73.9**
Hydrocarbons sector	47.6	44.3	50.6	40.6	**46.3**	**51.8**	**49.0**
Other sectors (inc. LNG)	54.1	57.2	50.4	61.6	**55.4**	**50.0**	**52.7**
Nominal GDP growth (%)	19.1	13.8	44.5	-22.6	**23.5**	**21.6**	**5.0**
Real GDP growth (%)	4.5	6.2	12.6	1.9	**6.1**	**5.2**	**3.9**
Hydrocarbons growth (%)	-4.4	-5.0	7.6	6.2	**6.4**	**4.2**	**2.8**
Other sectors growth (%)	9.5	11.9	14.9	0.5	**5.3**	**6.0**	**4.1**
Fiscal indicators (% of GDP)							
Revenue	35.2	36.7	32.8	37.5	**35.2**	**34.3**	**35.2**
Expenditure	34.9	36.5	32.5	41.2	**37.2**	**33.6**	**34.2**
Balance	0.3	0.2	0.3	-3.8	**-2.0**	**0.7**	**1.1**
Public debt	8.0	6.2	4.1	5.6	-	-	-
Current account (% of GDP)							
Balance (US$ bn)	5.7	2.5	5.0	-0.3	**1.3**	**2.5**	**2.0**
(as % of GDP)	15.4	5.9	8.3	-0.6	**2.3**	**3.5**	**2.8**
Trade balance	31.8	24.7	28.1	24.8	-	-	-
Exports	58.7	58.9	62.3	59.0	-	-	-
Imports	-26.8	-34.2	-34.2	-34.3	-	-	-
Services balance	-7.0	-8.1	-6.7	-8.0	-	-	-
Income balance	-1.8	-1.9	-4.6	-6.0	-	-	-
Current transfers balance	-7.6	-8.8	-8.6	-11.3	-	-	-
International reserves	13.6	22.7	19.1	26.0	22.5	-	-
External debt	10.3	-	-	-	-	-	-
Industry indicators							
Oil production ('000 bpd)	738	710	759	813	865	**901**	**927**
Omani crude price (US$/barrel)	62	65	101	57	77	**102**	**99**
Gas production (m cu ft/day)	2.88	2.93	2.93	3.01	3.22	**3.36**	**3.44**
Monetary indicators (%)							
Consumer price inflation	3.3	4.7	13.1	5.6	3.2	**5.0**	**3.6**
Food, beverage & tobacco	5.8	9.0	22.5	0.4	-	-	-
Rent, water and fuel	1.6	5.2	16.6	12.9	-	-	-
Wholesale price inflation	-	4.9	13.8	-2.1	4.6	-	-
Interest rate (Base rate)	3.6	2.0	0.9	0.1	-	-	-
Interest rate (Lending)	7.4	7.3	7.1	7.4	-	-	-
Interest rate (Time deposits)	4.0	4.1	4.5	4.1	-	-	-
Broad money growth	24.9	37.0	23.2	4.8	11.3	-	-
Exchange rate US$:OR (av)	0.3845	0.3845	0.3845	0.3845	0.3845	**0.3845**	**0.3845**

Source: Ministry of National Economy, Ministry of Finance, Central Bank of Oman, IMF, **QNB Capital estimates and forecasts**, 2011

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