

COUNTRY REVIEW

Oman



25 September 2009

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Stable political system and a popular leader
- Good international and regional relations
- Per capita incomes are relatively high, limiting potential social dissent
- Despite official under-recording of the fiscal balance, regular budgetary surpluses are recorded
- Substantial foreign asset base contributes to a net creditor position that largely mitigates transfer risk and provides some protection in the event of a downturn in oil prices
- As a result of good macro-economic data in 2004-08 and sound management and policies, the global financial crisis and recession did not cause widespread cancellation of projects

Weaknesses

- Sultan Qaboos does not have an heir and the succession process is opaque
- The country is not immune to terrorist activity
- Expenditure on the military (almost 12% of GDP) is one of the highest in the world
- Growth volatility because of dependence on international oil price and output cycles
- Proven oil reserves have a limited time horizon (approximately 21 years) before depletion
- Despite a process of Omanisation and some evidence of job creation in the public sector, an estimated 84% of the private sector workforce is accounted for by expatriate labour, with associated outflows of workers' remittances and wage/rent inflationary pressures
- Export volatility

Key Risks

- **Collapse in oil and gas prices**
- **Oman has key military ties with the west but is geographically close to Iran and has strong commercial links with its neighbour. A confrontation involving the latter would likely have adverse consequences for the political and economic development of Oman**

Country Risk Assessment

Ratings	Oman		Median Grade BB	Peers		
	Latest	Previous		Saudi Arabia	Kuwait	Qatar
Systemic Political Risk:	P2-	P2-	P2+	P2-	P2-	P2-
Systemic Economic Risk:	E3	E3	E3	E3	E3	E3
ME rating:	ME3	ME3	ME3	ME3	ME3	ME3
<i>Structure</i>	5.0	5.0	3.3	5.0	5.0	5.7
<i>Policy</i>	5.2	3.8	4.2	5.2	5.6	4.2
<i>Solvency</i>	1.0	1.0	1.6	1.0	1.0	1.9
<i>External Liquidity</i>	1.9	1.3	3.3	3.3	1.7	2.3
SBE rating:	SBE2	SBE2	SBE2	SBE2	SBE2	SBE2
COUNTRY GRADE:	BB	BB	BB	BB	BB	BB

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Muscat
Population:	2.79 mn (2008)
GDP:	USD 54096 mn (2008)
Currency:	Rial (OMR)
Form of state:	Sultanate
Head of government:	Sultan Qaboos bin Said al-Said
Next elections:	Majlis al-Shura only

Major Industries (% of GDP at market prices, 2008)		Global Assumptions	2009f	2010f
Agriculture	2.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	36.0%	Inflation (% , av) *	-0.1	1.3
Services	62.0%	Dated Brent (USD/b)	61.0	72.0
		* major economies		

Main Exports (% of total, 2008e)		Main Imports (% of total, 2008e)	
Crude oil	58.0%	Machinery	50.0%
LNG	11.0%	Manufactured goods	21.0%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
China	26.8%	UAE	19.3%
South Korea	15.2%	Japan	17.6%
Japan	14.3%	US	7.4%
Thailand	10.4%	Germany	5.2%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	36,804	41,638	54,096	53,706	62,419
Population (mn)	2.67	2.73	2.79	2.85	2.91
GDP per capita (USD)	13,784	15,252	19,389	18,844	21,450
Real GDP growth (% yr/yr)	6.8	6.4	6.2	3.0	4.0
Inflation (% , average)	3.2	6.0	12.1	6.0	3.0
Fiscal balance (% of GDP)	0.4	0.3	1.4	0.7	1.7
Current account balance (% of GDP)	15.4	6.4	10.2	1.9	4.8
External debt/GDP (%)	13.1	14.3	14.2	14.0	12.8
External debt/Exports of goods & services (%)	19.6	20.9	18.8	23.3	20.8
Debt-service ratio (%)	1.2	2.3	1.6	2.0	1.7
Foreign exchange reserves (USD mn)	4,970	9,485	11,541	25,000	18,000
Import cover (months)	3.1	4.4	3.9	9.7	6.2
Exchange rate assumption, OMR:USD (av)	0.38	0.38	0.38	0.38	0.38
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Oman remains relatively stable under the generally popular Sultan Qaboos bin Said al-Said, who has ruled since 1970. However, Qaboos does not have a son to inherit the role as head of state, does not have brothers who can take over and he has not openly nominated an heir. Although the 1996 Basic Law stipulates the broad procedures to adopt in such situations, there remain significant **concerns and uncertainties in relation to succession**. The statute requires the royal family to choose a successor within three days of the sultan's death. However, if they are unable to agree, Qaboos' own nominee—whose identity will remain a secret in a sealed letter—will accede to power. While widely accepted, this method of selection is untried and therefore represents a risk of disruption to political stability.

Unlike neighbouring Saudi Arabia, Oman has remained relatively free from terrorist attacks or other activity. However, in 2005 and amid a high level of secrecy, 31 suspected militant Islamists were sentenced to imprisonment for allegedly plotting a coup. It is unlikely that the plot was as serious as some reports suggest but the episode provides two indicators of current security issues. Firstly, all countries in the region have to be on the alert for one-off or a concerted series of terrorist attacks and, secondly, the Omani security forces have reasonably effective procedures.

All the Gulf Co-operation Council (GCC) states have pledged to improve political representation. To date, progress has been lacklustre and terrorist activity within the Middle East has ensured that regimes have been less willing to open up to change. Oman has already established an electoral process for the **majlis al-shura (consultative council)** under a system of universal suffrage, although the assembly **does not have legislative powers**. Elections to the majlis took place in October 2007 and fresh polls are scheduled for October 2011, although they are unlikely to have a significant bearing on overall governance. Overall, despite these limited attempts to introduce a degree of democracy, real power remains concentrated in the hands of the sultan and the royal family, and therefore policy continuity is assured while he remains in good health. We therefore expect diversification into liquefied natural gas (LNG) output to continue in partnership with international oil companies (IOCs), but the overall pace of structural reforms will be slow. Job creation remains a key challenge over the medium term, despite a long-standing policy aimed at the "Omanisation" of the workforce, which has had only limited impact to date in the private sector.

International relations are good. Oman is not subject to significant outstanding border disputes, is a member of the Gulf Co-operation Council (GCC) and acceded to the WTO in October 2000. As a founding member of the GCC, Oman is committed to that organisation's plans but has indicated that it will not be able to meet convergence criteria leading to full monetary union, scheduled for 2010. In addition to strong military ties to the UK, the sultanate relies heavily on the US for security needs and re-signed in 2000 a 10-year deal allowing US forces to deploy on its soil. Although unconfirmed, there are strong suspicions that some support was provided for the US and UK during the Iraq War despite the leadership's public opposition to a non-UN backed strike. Relations will remain firmly pro-Western. Nevertheless, the first head of state to visit Iran after this year's re-election of President Mahmoud Ahmadi-Nejad was Sultan Qaboos, emphasising close commercial links between the two countries, particularly in relation to energy supplies.

Economic Stability

Following World Bank nomenclature, Oman is a high-income economy, with per capita GDP currently in excess of USD18,000. It is heavily reliant on the **oil and gas sector for around 50% of GDP (directly) and around 80% of stated government revenues and of export receipts**. As in most Gulf states, a combination of rapid population growth and fluctuating oil sector performance has limited long-term growth of real GDP per head to an annual average 3% (1989-2008). Declining oil production in the decade to 2008 and vulnerability to fluctuations in world petroleum prices have prompted diversification into production of liquefied natural gas, with LNG now accounting for 10-15% of total export revenues. The authorities are also promoting diversification into other industrial areas, notably petrochemicals, fertilisers, aluminium, port facilities and tourism. In addition to economic diversification, official planning focuses on a medium-term policy strategy involving gradual liberalisation, aiming to boost job generation, particularly for Omani nationals (Omanisation). However, privatisation has progressed only slowly since WTO accession, despite some progress in relation to power plants and mobile-phone networks.

Oman is **not a member of OPEC**, but follows the cartel's production trends. Unlike its neighbours, Oman's oil reserves have a limited life span, with current rates of extraction (728,000b/d in 2008)

providing just under 21 years of further output. Natural gas reserves provide a further 40 years of production at prevailing extraction rates. Investment in the gas sector and related industries (further large aluminium and petrochemical enterprises began operations in 2009, including **one of the world's largest private sector fertiliser complexes**) is the main driver of economic growth. We forecast that **real GDP will expand by only 3% in 2009 (half the rate recorded in the previous three years) and 4% in 2010**, reflecting weak global energy demand in 2009 and only lacklustre recovery through the early part of 2010.

Official fiscal records as reported by the finance ministry are usually misleading, as oil revenues are stated net of transfers to the **State General Reserve Fund (SGRF or oil stabilisation account)** and other funds, and data for these are not made public. Usually, when oil prices exceed budgeted levels, excess revenues are transferred to the SGRF and other funds to provide a buffer against future oil price shocks. The result is that the **underlying fiscal accounts are much healthier than official figures suggest**. Moreover, official budget projections are made using conservative oil price assumptions and therefore understate the strength of finances. For example, the 2009 budget assumes an oil price of USD45/barrel, whereas USD60/b appears more likely to prevail. We estimate that stated annual fiscal surpluses (expressed in terms of GDP) underestimate by around ten percentage points. Accordingly, the fiscal accounts are even better than indicated in our statistics (see table above). With oil prices recovering from recent lows in Q4 2008-Q1 2009, although not regaining record highs recorded in July 2008, the fiscal accounts will remain sound. Although there is an absence of official confirmation, it is likely that the existence of the SGRF and other foreign assets enable Oman to be a net creditor nation.

Inflationary pressures increased strongly in 2008, partly reflecting higher international prices for fuels and foodstuffs (food prices have a weighting of over 30% in the basket used to measure consumer prices), a tight real estate market and excess hydrocarbon-related liquidity. As a result, the consumer price index increased on average by over 12% yr/yr in 2008, double the rate recorded in 2007. Partly as a result, the focus of monetary policy—maintenance of an **exchange rate peg of OMR0.384:USD1**—came under scrutiny, as elsewhere in the GCC. However, since then the Omani authorities have announced that the country **will not join the GCC monetary union's initial (single currency) stage in 2010**, partly because it feels that more economic integration is required and that some convergence criteria need further resolution. To that extent, monetary policy in the period to end-2010 is now clearer, with the commitment to the dollar peg at the existing rate expected to be maintained throughout that period. The dollar peg means that **domestic interest rates will continue to track those of the US Fed**, with a premium of 100-200bps favouring Omani rates. With a weaker global economy and generally lower food costs, inflationary pressures have eased in 2009 and we forecast that annual average inflation rates will fall to 6% and 3% in 2009 and 2010, respectively.

Developments in the external sector depend on oil price and output fluctuations, but increasing LNG exports and large net outflows from the income and transfer accounts are also important factors. The 2004-08 period of sustained high oil prices (with benchmark Brent peaking at over USD140/barrel in July 2008 after averaging USD66/b and USD72/b in 2006 and 2007, respectively) boosted the trade and current account surpluses. The current account surplus in 2008 was equivalent to around 10% of GDP. Oil prices fell markedly in Q4 2008 and reached a recent low of USD36/b in December, although they have subsequently made a recovery to around USD60-70/b. Strong investment in enhanced oil recovery techniques appears to have halted, for now, the decade-long decline in oil output, so that higher crude oil production and expected stable prices should boost export receipts in 2010. However, import growth is also likely to remain strong as investments in the tourist sector and infrastructure require large foreign components and further upgrading is required in the hydrocarbons industry. Overall, we forecast that the **current account will remain in surplus in 2009 but only at a level equivalent to 1.9% of GDP, before improving to almost 5% in 2010** as global energy demand recovers and the world economy improves. Current account surpluses, combined with substantial foreign assets and a strong business environment (see below), will ensure that all external funding requirements are met with relative comfort over the forecast period.

Current account surpluses and net foreign investment have boosted FX reserves since 2001. At end-2008, FX reserves were USD11.5bn (USD3.5bn at end-2004), providing **almost four months of import cover**. It should be remembered that, in addition, 'excess' revenues associated with windfall oil earnings are lodged in the **SGRF (unofficial estimates suggest this amounts to around USD7-8bn, equivalent to around 14% of GDP)** and other funds and that the country possesses other foreign assets. Official data indicate that **FX reserves in June 2009 were USD28.5bn**, suggesting that some drawdown from reserve funds had been made to bolster the reserves and provide evidence to external agencies of financial strength. Overall, the country is considered a net creditor. External

debt ratios are sound, with total foreign debt equivalent to 13-14% and 20-23% of GDP and export earnings, respectively. The debt service ratio of 2% or less of GDP is modest.

Structural Business Environment

The business environment is sound and **generally above average** of all the countries we assess. Moreover, there is scope for further improvement in our business environment rating as a new corporate law has been drafted and is scheduled to come into effect in early 2010. The new law is designed to increase tax efficiency and is likely to engender higher foreign investment as it introduces a flat 12% tax rate for all businesses, including branches of foreign companies.

The Heritage Foundation's 2009 Index of Economic Freedom (IEF) categorises Oman as above the world average in eight of ten economic freedoms. In the IEF, Oman ranks 43 out of 179 countries assessed, below Hungary, Latvia and Malta but above South Korea, Trinidad and Tobago and Israel and scores particularly well in terms of fiscal, trade, labour (despite the policy of Omanisation) and corruption freedoms. A negative raised by the IEF is the high government intervention in the economy and, in turn, this is because of state control of the all-important oil and gas sector. The World Bank's Doing Business Survey 2010 ranks Oman 65 out of 183 economies in relation to the overall ease of doing business and notes that the insolvency process is drawn out—averaging four years and above the regional average—but the cost is significantly less than the regional average and the recovery rate is higher. Contract enforcement involves a high number of procedures (over 50) but takes less time than the regional average time for completion.

The financial sector is relatively sound and **banks are well provisioned**. Improvements in central bank supervision and risk management techniques in commercial banks have helped cut non-performing loans (NPLs) sharply since 2001. Although banks increased their provisioning **in 2008, NPLs were reduced to 2.4% of the total loan book**, compared with 5.2% in 2006. Recent bank mergers followed imposition of tight minimum capital requirements and capital adequacy ratios are now better than internationally-accepted standards under Basel II. Unlike most regional equity markets, the Muscat Securities Market is open to foreign investors.

Andrew Atkinson

London: +44 (0)20 7860 2577

Charts

