Rabobank

# Country report

# UNITED ARAB EMIRATES


**Summary**

The UAE escaped the turmoil that hit the Arab world over the past months, as the social and economic causes of the unrest hardly applied to the emirates. There is no suppressed frustration like in Saudi Arabia. Rich, powerful and conservative Abu Dhabi dominates the federation, with modern and market-minded but indebted Dubai playing second fiddle. Oil-rich Abu Dhabi bailed the creditors of Dubai out in 2009 and 2010, in exchange for a stronger role in the UAE. Abu Dhabi seems politically willing and is financially definitely able to do so again to prevent systemic collapse. Economic recovery started in 2010, especially in high-indebted Dubai. Depositors flocked back to the UAE as a 'safe haven' in the turbulent region, which shows improved banks' solvency and liquidity ratios. But non-performing loans (NPLs) were up from 2.5% of total loans in 2008 to 7.5% by the end of 2010, while loss provisioning is around 75% of NPL.

Relations with the West were and are friendly. Apart from Dubai's financial sector risks, the Iran factor is the only substantial risk for the medium term, but the UAE's vast external wealth provides sufficient comfort to allow for five years risk.


**Things to watch:**

- NPLs in banks' books
- Rivalries between rulers of Abu Dhabi and Dubai
- Spread of Arab Spring to the Gulf


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## UAE

| National facts | | | Social and governance indicators | rank / total |
|---|---|---|---|---|
| Type of government | Federation | | Human Development Index (rank) | 32 / 169 |
| Capital | Abu Dhabi | | Ease of doing business (rank) | 40 / 183 |
| Surface area (thousand sq km) | 84 | | Economic freedom index (rank) | 47 / 179 |
| Population (millions) | 6.5 | | Corruption perceptions index (rank) | 28 / 178 |
| Main languages | Arabic | | Press freedom index (rank) | 87 / 178 |
| | Persian | | Gini index (income distribution) | n.a. |
| Main religions | Muslim (96%) | | Population below $1.25 per day (PPP) | n.a. |
| | Others (4%) | | | |
| Head of State (president) | K. bin Zayid al-Nuhayyan | | | |
| Head of Government (PM) | M. bin Rashid al-Maktum | | | |
| Monetary unit | Emirati dirhams (AED) | | | |

| Foreign trade | | | 2009 |
|---|---|---|---|
| *Main export partners (%)* | | *Main import partners (%)* | |
| Japan | 18 | China | 15 |
| South Korea | 12 | India | 13 |
| Thailand | 7 | US | 9 |
| India | 7 | Germany | 6 |

| Economy | | 2010 |
|---|---|---|
| *Economic size* | *bn USD* | *% world total* |
| Nominal GDP | 295 | 0.47 |
| Nominal GDP at PPP | 390 | 0.52 |
| Export value of goods and services | 209 | 1.12 |
| IMF quotum (in mln SDR) | 612 | 0.28 |
| *Economic structure* | *2010* | *5-year av.* |
| Real GDP growth | 2.1 | 3.9 |
| Agriculture (% of GDP) | 1 | 1 |
| Industry (% of GDP) | 53 | 56 |
| Services (% of GDP) | 46 | 43 |
| *Standards of living* | *USD* | *% world av.* |
| Nominal GDP per head | 43740 | 444 |
| Nominal GDP per head at PPP | 57943 | 493 |
| Real GDP per head | 31565 | 394 |

| *Main export products (%)* | *2010* |
|---|---|
| Re-exports | 43 |
| Crude petroleum | 29 |
| Gas | 5 |
| *Main import products (%)* | *2010* |
| Machinery & electrical equipment | 17 |
| Precious stones & precious metals | 17 |
| Vehicles & other transport equipment | 9 |
| Base metals & related products | 7 |
| *Openness of the economy* | *2010* |
| Export value of G&S (% of GDP) | 71 |
| Import value of G&S (% of GDP) | 67 |
| Inward FDI (% of GDP) | 2.1 |

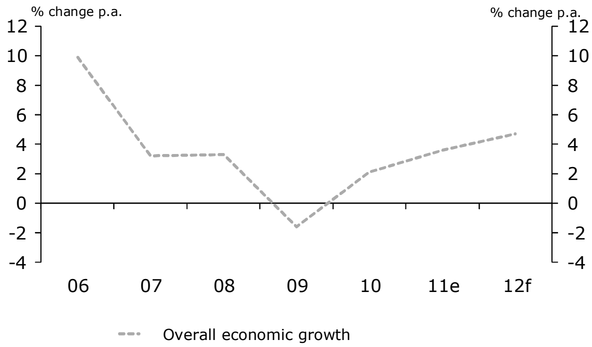
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

### Economic structure and growth

Economic development and outside interest in what are now the Emirates started only in 1958, when oil was discovered off the coast of Abu Dhabi. In 2008, the UAE produced around 3.6% of the world's crude, but was home to around 8% of proven reserves. Abu Dhabi is the largest, most powerful, oil-based and traditional emirate. Dubai has a more modern atmosphere, depending on international retail, tourism and financial services, but it lacks oil resources. The other five emirates have always played a minor role. For almost four decades, oil and global finance drove the UAE's economy, with the UAE's per capita GDP now on a par with those of leading Western European nations. In regional perspective, the emirates have, thanks to successful economic strategies, a diversified and open economy with the share of hydrocarbons in total GDP at 22% in 2010. But the economy's openness made it vulnerable to the crisis of 2008-2009. Financial services, manufacturing, retail, and hospitality and real estate sectors were severely hit by the downturn in regional and global growth, especially in Dubai. The Abu Dhabi authorities responded by increasing government spending and boosting liquidity in the banking sector and provided a Dubai bail-out. The return to positive growth in 2010 was largely driven by higher oil prices and output. In Abu Dhabi, non-oil growth accelerated through large public spending on infrastructure, while in Dubai, higher activity in services drove growth. Dubai is very dependent on spending originating in Iran and India, the main trading partners of Dubai.

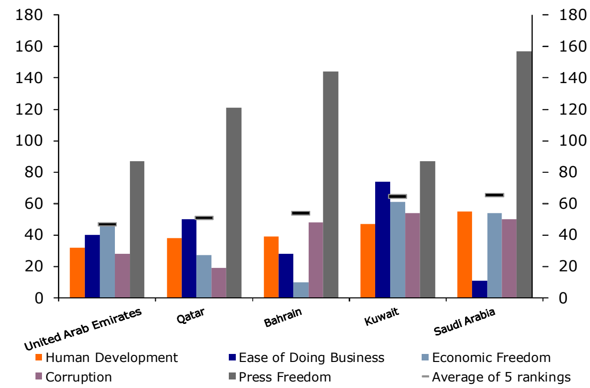
For 2011 and 2012 the economy is expected to continue the rebound of 2010. But there are risks: the current account and fiscal surpluses could turn into deficits, if the oil price is only moderately lowered from its current level of USD 100 pb. The non-oil economy, although increasing its share in total GDP, may dampen the impact of volatile oil prices somewhat. Also, revenues from the UAE's vast overseas investment portfolios are an additional source of income that is unrelated to oil prices. However, irrespective of UAE's relatively successful diversification, its economic destiny will doubtlessly remain largely based on hydrocarbon resources.

**Chart 1: Growth rates**




Source: EIU

**Chart 2: Social and governance indicators**




Source: see factsheet

Although the country's Free Trade Zones, offering 100% foreign ownership and zero taxes, attract foreign investors, foreign participation in the local economy encounters business regulations that favor Emiratis and Gulf Cooperation Council (GCC) nationals over foreign investors. Majority foreign ownership outside designated free zones is not allowed. Local clans' trading monopolies in many of the country's businesses may explain why the negotiations on the Free Trade Agreement with its important strategic ally, the US, have not moved forward for years.

During the financial crisis of 2008-2009, the Dubai dominated real estate market was severely affected. This led to losses in the Dubai financial sector and, despite a partial Abu Dhabi financed bail out in 2009 and restructuring resolution in 2010, remains a drag on the UAE's economy. The nonperforming loans to total loans (NPLs with three or more months of payment delays) for all UAE banks reached 7.5% at end-2010. NPLs of Dubai-based banks are significantly higher than those of Abu Dhabi-based banks. Federal government support since 2009 has helped raise the capital adequacy ratio from 13% at end-2008 to 21% at end-2010.

The September 2010 debt-restructuring settlement with the creditors of Dubai World, a leading Dubai government related entity (GRE), extended the maturities to 2014 and beyond at lower interest rates. In effect, this implied losses for the creditors of 15% on average, which is reported to be modest relative to similar real estate cases. As other GREs are still undergoing debt restructuring, worries persist about the remaining debt overhang and the tendency to lend on the basis of reputation or perceived government backing rather than on risk-reward considerations. The Dubai government is highly indebted if the contingent liabilities are added to its directly owed debt of USD 30bn. High debt service obligations require similarly high cash flows, complemented by asset sales, further rescheduling and maybe even support from Abu Dhabi is needed. Although the cost of borrowing (based on 5-yr CDS) for the Dubai emirate is within the 400-500bps range, the highest in the region, the spread for the Abu Dhabi sovereign (at 100bp) is among the lowest. The Dubai crisis did hurt the region's banking sector, but Abu Dhabi's rescue and Dubai's own handling of the debt crisis have shown that the UAE are able to avoid worse.

Paradoxically, the current upheaval in the region may proof a blessing in disguise for UAE's banking system. Capital from troubled countries in the region are diverted to the UAE, still considered a 'safe haven'. Deposits have risen significantly in recent months by 12.6% in the year to February 2011, reflecting regained confidence in the financial sector.

**Political and social situation**

The UAE has been hardly touched by the political turmoil in the Arab world. The economic and social factors (declining growth, rising food prices, youth unemployment etc.) that have contributed to the unrest elsewhere in the region are less significant in the UAE. With more than 85% of the labor force expatriate, the country's small national population of less than one million enjoys a high living standard in -from a regional perspective at least- a relatively open and tolerant society (chart 2). Nationals enjoy financial advantages through generous social security and housing support. But unemployment among nationals is high (14% in 2009) and concentrated in the smaller, less relevant Emirates, where the authorities responded with promises of public investments, wage rises and higher food subsidies. 'Emirization' of the labor market is thus a high political priority.

The UAE has one of the most stable political systems in the wider Arab region. The federation has maintained stability since unification in 1971 and there are no reports of imminent upheaval, even though the political system is inflexible and characterized by an almost complete lack of political freedom. The distribution of power between the emirates and the federal government is hardly contested, with the overall balance of power firmly and increasingly tilted in Abu Dhabi's favor given its size and wealth, but latent rivalries between and within individual emirates do exist. Government institutions may change, but society will remain overwhelmingly tribal and dominated by clans and patronage. Modern-minded Dubai is most prone to opt for a liberal economic agenda and its more easy going lifestyle, as it continues to seek private-sector investments. But its impact on federal institutions is reduced, as indebted Dubai lost political ground due to its home-grown financial crisis to more conservatively inclined and wealthy Abu Dhabi.

The semi-autocratic ruling families are broadly popular at emirate and federal levels. Embryonic 'liberal' political opposition emerged in the aftermath of mass-revolts in several Middle Eastern states in 2011, but was confined to informal social media groups, without any public manifestation having taken place. Reportedly four persons were arrested behind their computers. There is hardly any support for radical Islamists, who oppose the pro-Western policies of the ruling family. Any (unlikely) democratization would only affect the 16% of the population that are UAE nationals. Income disparity (millionaires vs. underpaid migrant workers) is extremely wide and a potential source of social tensions.

With regard to unrest in the region, UAE rulers align their response to the Arab Spring with the six state Gulf Cooperation Council. The GCC rulers fear the overthrow of any fellow monarchy, a Shi'a takeover in Bahrain, Iran's political power and its nuclear threat in the Gulf. The unrest in Yemen and Al-Qaeda's presence there is also a cause of concern. The UAE maintains good relations with the US and major Western powers. Relations with China, India and South Korea are improving, reflecting their increasing role in trade, security and investments in the Gulf area.

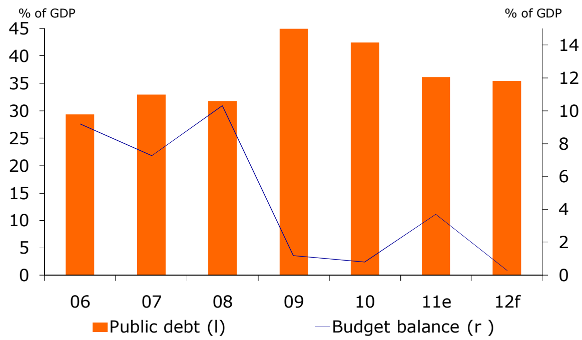
**Economic policy**

The UAE's financial position was, is and will remain based on hydrocarbons, although economic diversification is underway. Daring Dubai led the way in diversification, which now slowed as it needs to focus on repaying its debts through spending cuts. Abu Dhabi's diversification program consists of large-scale government investment in infrastructure and industry, while Dubai seeks to stimulate private sector involvement in trade and tourism.

Data show that the aggregated UAE fiscal balances remain in surplus. Changes in revenues levels are largely determined by oil prices changes. Abu Dhabi National Oil Company's profit transfers and

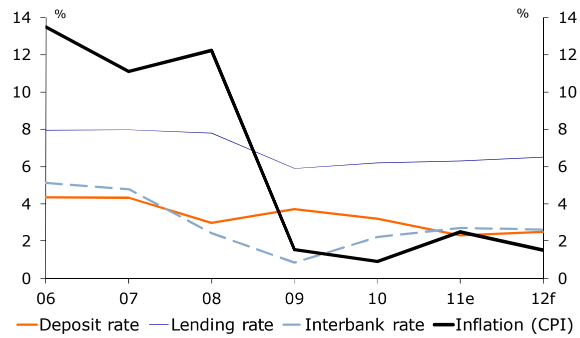
Abu Dhabi Investment Authority's (ADIA) investment income are the most important sources of revenues. There are no income taxes, while only foreign banks and foreign energy firms pay 'charges', but introducing broader taxation (incomes and VAT) is under consideration. On the expenditures side figure not only food and housing subsidies and large investment outlays, but also substantial capital support for the financial sector and Dubai, where further equity and loans injections may be needed. The level of these contingent Dubai-related liabilities are at UAE level considered manageable, given ADIA's estimated reserves of USD 300bn.
At the level of individual emirates, non-oil and indebted Dubai continues to report deficits. These are now decreasing and compensated by abundant oil-based surpluses of Abu Dhabi (see chart 3 for the UAE as an aggregate). The minimal oil price needed to break-even the consolidated budget increased from USD 30 pb in 2003 to around USD 80 pb in 2010. This higher minimum reflects much higher government expenditures and are a risk in the event of declining oil prices.

**Chart 3: Public finance**




Source: EIU

**Chart 4: Interest rates and inflation**



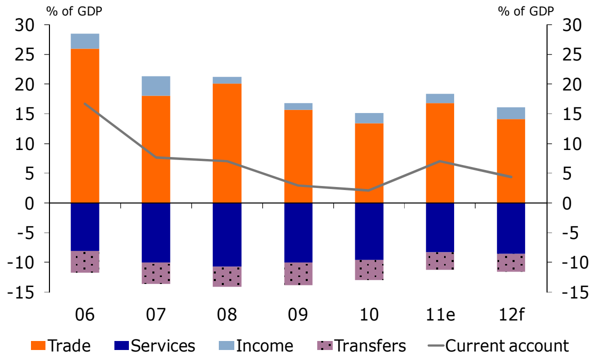

Source: EIU

Official data show that average annual inflation is down from 12% in the booming years to only 1-2% since the financial crisis of 2009 as especially rents kept inflation low. Recovery and rising commodity prices may lead to upward pressures, but declining rents will keep inflation low.
Although the decades long, uncontested and still credible peg of the UAE dirham to the low yielding USD severely restricts interest rate policies to steer the economy, the peg provided some economic and financial stability over the past decades, like in other Gulf states. The UAE's withdrew in May 2009 from the dollar-dominated Gulf Co-operation Council monetary union project, due to UAE-Saudi rivalry over the location of the seat of the GCC's central bank. The present peg will remain.

**Balance of Payments**

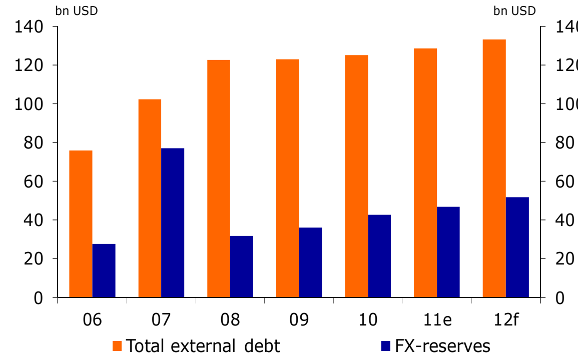
As chart 5 shows, the UAE structurally records (oil-based) trade surpluses of 15% to 20% of GDP. These are supplemented by a small surplus on the incomes balance (profits and interests) of around 2% of GDP. On the negative side are the structural deficits on the services balance (around 10% of GDP) and transfers of expatriates to their families in other countries (3% GDP). What resulted, were similarly structural surpluses on the current account of around 5% of GDP. These annual surpluses are reflected in the build-up of official FX reserves (chart 6) and contribute to the large net external asset position (chart 7) on a UAE consolidated basis. Overall, the current account surplus is projected to return to pre-crisis levels of 7% in 2011 from 2% to 3% during the crisis years 2009 and 2010.

**Chart 5: Current account**




Source: EIU

**Chart 6: Foreign debt and official FX reserves**



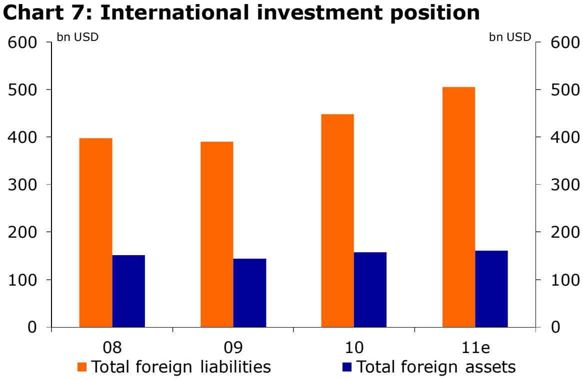

Source: EIU

Given the growth prospects for the Asian markets and UAE's comfortable position to deliver plenty of oil, export revenues will remain narrowly dependent on hydrocarbons (80% of exports). UAE's current-account balances will show surpluses. The current account surpluses end up partly in rising official FX reserves of the Central Bank. The remainder is largely added to the external assets of the government regulated ADIA. These FX reserves and high foreign asset portfolios of the UAE (mainly Abu Dhabi) as a back-up or times when oil revenues are weak.

**External position**

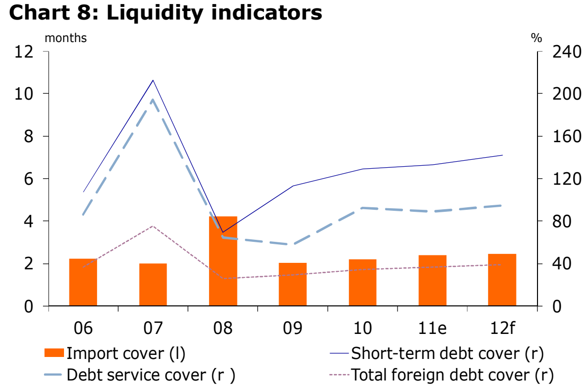
The external debt of the UAE is estimated at USD 125bn (43% of GDP), most of which (USD90bn) is owed by Dubai. Dubai's high external debt burden has reached 100% of its own GDP. Total gross foreign assets of the UAE are estimated at about USD 450bn at end-2010. These include foreign assets held at the Central Bank of the UAE (USD43bn), commercial banks' foreign assets (USD64bn) and foreign assets of ADIA of around USD300bn. These would result in an overall net external asset position of USD 292bn (chart 7), equivalent to 116% of GDP in 2010. The net external position of the UAE is projected to improve further given, the expected continuation of current account surpluses.

**Chart 7: International investment position**




Source: IIF estimates

**Chart 8: Liquidity indicators**




Source: EIU

Liquidity indicators (chart 8) are not as strong as in many other oil exporting countries. Official FX reserves cover less than 3 months of import, but when the foreign assets of government regulated and owned ADIA are included, this import cover will increase dramatically to around 20 months. Similarly, other liquidity indicators will improve dramatically. In terms of ability to pay there is little to fear in the medium term for federal UAE or exposures explicitly backed by Abu Dhabi.

| UAE | | | | | | | |
|---|---|---|---|---|---|---|---|
| GDP (in bn USD) | 175.2 | 206.4 | 254.4 | 248.9 | 269.1 | 312.4 | 332.1 |
| Selection of economic indicators | 2006 | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f |
| *Key country risk indicators* | | | | | | | |
| GDP (% real change pa) | 9.9 | 3.2 | 3.3 | -1.6 | 2.1 | 3.6 | 4.7 |
| Consumer prices (average % change pa) | 13.5 | 11.1 | 12.3 | 1.6 | 0.9 | 2.5 | 1.5 |
| Current account balance (% of GDP) | 21.1 | 9.5 | 8.8 | 3.1 | 2.3 | 7.9 | 4.9 |
| Total foreign exchange reserves (mln USD) | 27617 | 77239 | 31695 | 36104 | 42785 | 46785 | 51790 |
| *Economic growth* | | | | | | | |
| GDP (% real change pa) | 9.9 | 3.2 | 3.3 | -1.6 | 2.1 | 3.6 | 4.7 |
| Gross fixed investment (% real change pa) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Private consumption (real % change pa) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Government consumption (% real change pa) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Exports of G&S (% real change pa) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Imports of G&S (% real change pa) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Economic policy* | | | | | | | |
| Budget balance (% of GDP) | 9.2 | 7.3 | 10.3 | 1.2 | 0.8 | 3.7 | 0.3 |
| Public debt (% of GDP) | 29 | 33 | 32 | 45 | 43 | 36 | 35 |
| Money market interest rate (%) | 5.1 | 4.8 | 2.4 | 0.8 | 2.2 | 2.7 | 2.6 |
| M2 growth (% change pa) | 23 | 42 | 19 | 10 | 6 | 11 | 11 |
| Consumer prices (average % change pa) | 13.5 | 11.1 | 12.3 | 1.6 | 0.9 | 2.5 | 1.5 |
| Exchange rate LCU to USD (average) | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| Recorded unemployment (%) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| *Balance of payments (mln USD)* | | | | | | | |
| Current account balance | 37054 | 19644 | 22282 | 7804 | 6075 | 24520 | 16270 |
| Trade balance | 57536 | 46522 | 62925 | 42095 | 39290 | 58760 | 51800 |
| Export value of goods | 145586 | 178631 | 239213 | 191802 | 197979 | 230150 | 233470 |
| Import value of goods | 88050 | 132109 | 176288 | 149707 | 158689 | 171390 | 181670 |
| Services balance | -18030 | -25962 | -33827 | -27320 | -28311 | -29080 | -31780 |
| Income balance | 5745 | 8372 | 3803 | 3213 | 5204 | 5260 | 7290 |
| Transfer balance | -8196 | -9288 | -10619 | -10184 | -10108 | -10420 | -11040 |
| Net direct investment flows | 1914 | -381 | -2100 | 1280 | 2700 | 4000 | 7000 |
| Net portfolio investment flows | -39802 | -1672 | -57794 | -7549 | -12000 | -17700 | -22500 |
| Net debt flows | 19325 | 26568 | 20238 | 392 | 2240 | 3240 | 4860 |
| Other capital flows (negative is flight) | -11884 | 5462 | -28170 | 2482 | 7666 | -10060 | -630 |
| Change in international reserves | 6607 | 49621 | -45544 | 4410 | 6681 | 4000 | 5000 |
| *External position (mln USD)* | | | | | | | |
| Total foreign debt | 75832 | 102400 | 122639 | 123031 | 125271 | 128510 | 133370 |
| Short-term debt | 25753 | 36321 | 45560 | 31952 | 33192 | 35130 | 36490 |
| Total debt service due, incl. short-term debt | 31998 | 39797 | 49118 | 62510 | 46337 | 52720 | 54780 |
| Total foreign exchange reserves | 27617 | 77239 | 31695 | 36104 | 42785 | 46785 | 51790 |
| International investment position | n.a. | n.a. | 246000 | 246000 | 292000 | 344000 | n.a. |
| Total assets | n.a. | n.a. | 397000 | 390000 | 449000 | 505000 | n.a. |
| Total liabilities | n.a. | n.a. | 151000 | 144000 | 157000 | 161000 | n.a. |
| *Key ratios for balance of payments, external solvency and external liquidity* | | | | | | | |
| Trade balance (% of GDP) | 32.8 | 22.5 | 24.7 | 16.9 | 14.6 | 18.8 | 15.6 |
| Current account balance (% of GDP) | 21.1 | 9.5 | 8.8 | 3.1 | 2.3 | 7.9 | 4.9 |
| Inward FDI (% of GDP) | 7.3 | 6.9 | 5.4 | 1.6 | 2.3 | 2.7 | 3.5 |
| Foreign debt (% of GDP) | 43 | 50 | 48 | 49 | 47 | 41 | 40 |
| Foreign debt (% of XGSIT) | 48 | 52 | 48 | 59 | 58 | 51 | 52 |
| International investment position (% of GDP) | n.a. | n.a. | 97% | 99% | 109% | 110% | n.a. |
| Debt service ratio (% of XGSIT) | 20 | 20 | 19 | 30 | 21 | 21 | 21 |
| Interest service ratio incl. arrears (% of XGSIT) | 2 | 3 | 1 | 3 | 2 | 2 | 2 |
| FX-reserves import cover (months) | 2.2 | 2.0 | 4.2 | 2.0 | 2.2 | 2.4 | 2.5 |
| FX-reserves debt service cover (%) | 86 | 194 | 65 | 58 | 92 | 89 | 95 |
| Liquidity ratio | 151 | 136 | 139 | 115 | 123 | 130 | 129 |

Source: EIU