Country report

UNITED ARAB EMIRATESMIRATES

Summary

The UAE has hardly been touched by the political turmoil in the Arab world. The economic and social factors that have contributed to the unrest elsewhere in the region are less significant in the UAE and historically, the UAE has one of the most stable political systems in the wider Arab region. Even so, concerns exist on the medium to long-term fallout of the regional turmoil. The situation on the real estate market remains troublesome, especially in Dubai and to a lesser extent in Abu Dhabi. The aggregate UAE fiscal balances remain healthy, due to large oil export revenues which have led to continuous current account surpluses. As a result, the external position of the UAE is in very healthy shape. The economy is expected to grow a sound 3.5% in 2012.

Things to watch:

- Situation on the real estate market
- Medium to long-term fallout of the regional turmoil
- Volatility of global oil prices

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UAE

National facts	
Type of government	Federation
Capital	Abu Dhabi
Surface area (thousand sq km)	84
Population (millions)	6.7
Main languages	Arabic
	Persian
Main religions	Muslim (96%)
	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)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	358	0.52
Nominal GDP at PPP	402	0.51
Export value of goods and services	267	1.22
IMF quotum (in mln SDR)	753	0.35
Economic structure	*2011*	*5-year av.*
Real GDP growth	3.3	3.2
Agriculture (% of GDP)	1	1
Industry (% of GDP)	54	56
Services (% of GDP)	45	43
Standards of living	*USD*	*% world av.*
Nominal GDP per head	50477	469
Nominal GDP per head at PPP	56683	459
Real GDP per head	30777	379

Social and governance indicators	rank / total
Human Development Index (rank)	30 / 187
Ease of doing business (rank)	33 / 183
Economic freedom index (rank)	35 / 179
Corruption perceptions index (rank)	28 / 183
Press freedom index (rank)	112 / 178
Gini index (income distribution)	n.a.
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Japan	16	China	19
South Korea	15	India	14
Thailand	12	US	7
India	6	Germany	6

Main export products (%)	*2011*
Re-exports	42
Crude petroleum	30
Gas	5
Main import products (%)	***2011***
Machinery & electrical equipment	16
Precious stones & precious metals	16
Vehicles & other transport equipment	8
Base metals & related products	6
Openness of the economy	***2011***
Export value of G&S (% of GDP)	75
Import value of G&S (% of GDP)	64
Inward FDI (% of GDP)	1.8

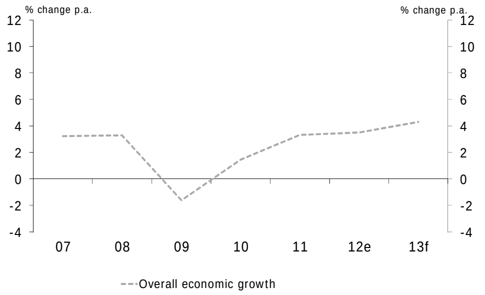
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Only since 1958, economic development started in the area now known as the United Arab Emirates (UAE), when oil was discovered off the coast of Abu Dhabi. In 2009, the UAE produced around 3.3% 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. The UAE has accumulated substantial wealth, since the country's per capita GDP is 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 25% in 2010. But the economy's openness made it vulnerable to the crisis of 2008-2009. Financial services, manufacturing, retail, and the 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 bail-out to Dubai.

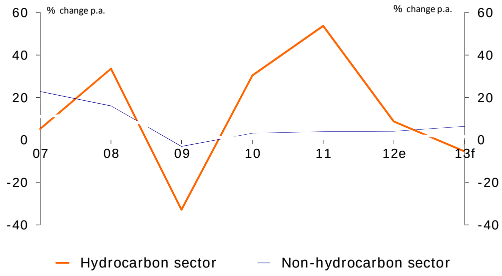
In 2009, Dubai World, a state-owned investment vehicle, experienced acute financing difficulties, via its real estate daughter Nakheel. Fortunately, it was saved from bankruptcy as Abu Dhabi lent Dubai USD 4.1bn for a bailout package. Since then, Dubai's external financing situation has improved, reducing the need for further Abu Dhabi support, particularly with the completion of the restructuring of Dubai World in mid-2010.

Figure 1: Growth performance



Source: EIU

Figure 2: Growth per sector



Source: IIF

However, several other government-related entities are still in the process of restructuring, and the situation in the real estate market is still troublesome. Since mid-2008, real estate prices have fallen by more than 60 percent in Dubai, and to a lesser extent in Abu Dhabi. In Dubai, the office vacancy rate (30 percent at end-2011) is expected to increase further as the supply will increase by a large margin this year. Retail and hotel vacancy rates (20 and 25 percent at end-2011, respectively) could stabilize as fewer new projects are in the pipeline and demand continues to be substantial. In Abu Dhabi, the real estate supply and demand gap continues to widen. The office market vacancy rate (23 percent at end 2011) is expected to grow in light of the expected large new supply. In the hotel segment, vacancies remain high at 35 percent. Overall, the large supply overhang and the completion of additional projects in the coming years render an early and broad-based recovery of the real estate sector unlikely and will continue to be a drag on economic growth.

The excess capacity in the real estate sector and the debt overhang still limit lending opportunities for the banking sector. Lending to the private sector has remained sluggish and lagged behind the credit growth seen in neighbouring Gulf Country Council (GCC) countries. The troubles in the real estate sector resulted in acute financing difficulties for the small Dubai Bank, which was owned by shareholders of Dubai Holding, a troubled conglomerate and by Emaar Properties, a large real estate group. The government dealt swiftly by bailing out Dubai Bank in May 2011 to protect depositors as loan losses increased rapidly and it ordered government-owned Emirates NDB bank to take over Dubai Bank. The banking sector in general has remained well-capitalized and profitable, as the net interest margin has remained comfortable, despite a continued rise in non-performing loans.

After the inception of the global financial crisis, the UAE economy returned to positive growth in 2010, 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.
Going forward, the economy is forecast to grow 3.5% in 2012. The hydrocarbon sector is expected to grow 4%, as potential for further increases in oil production is limited. Also, oil production levels are already close to maximum capacity and a possible slowdown in Asia could hurt demand for UAE's exports. Japan, South Korea, Thailand and India are the country's largest export partners. The non-hydrocarbon sector is expected to grow by 3-4%, supported by strong trade, tourism, logistics and manufacturing. Downside risks to this scenario are a more pronounced impact of the international sanctions on Iran that could affect the UAE, Dubai in particular, through a reduction of bilateral trade, real estate demand, tourism, and financial services to Iran-based consumers. Also,

a possible deepening of the sovereign debt troubles in the peripheral euro zone and a worsening of global financial conditions pose a significant downside risk.

Political and social situation

Historically, 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 have been no reports of imminent upheaval since, 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 conservative and wealthy Abu Dhabi.

The UAE has hardly been touched by the political turmoil in the Arab world. The economic and social factors 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. Nationals enjoy financial advantages through generous social security and housing support. But unemployment among nationals is high (14% in 2010) and concentrated in the smaller, less relevant Emirates, where the authorities responded with promises of public investments, wage raises and higher food subsidies. 'Emirization' of the labor market is thus a high political priority. The income disparity (millionaires vs. underpaid migrant workers) is extremely wide and a potential source of social tension.

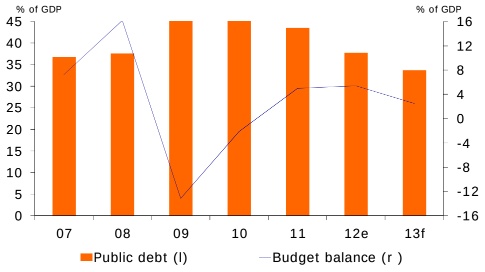
The UAE government has not been outspoken on the Arab Spring protests in the region. There is no doubt the government is concerned about the potential longer-term fallout, not least given the heightened tensions in Bahrain. With regards to Bahrain, the UAE has similar fears as Saudi Arabia. It not only fears the possibility that a Gulf monarchy could be overthrown, but also the possibility of a Shi'a state emerging on the Gulf that could serve to boost Iran's sense of influence and power in that area. Yemen's continued descent into political turmoil is another major concern for the UAE due to Al-Qaeda's resurgent presence in the country. The UAE will likely continue to take pro-active measures to mitigate domestic social tensions, while aligning its regional response with that of its fellow Gulf Cooperation Council (GCC) countries.

Economic policy

The UAE's financial position 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.

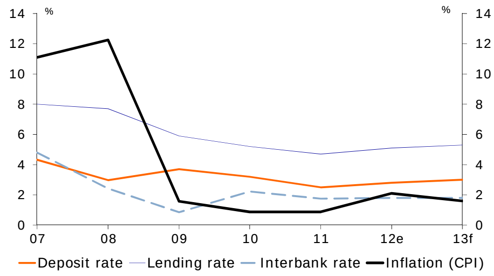
Data show that the aggregated UAE fiscal balances remain in surplus. Changes in revenues levels are largely determined by oil prices changes. Abu Dhabi National Oil Company's profit transfers and Abu Dhabi Investment Authority's (ADIA) investment income are the most important sources of

Figure 3: Public finances



Source: EIU

Figure 4: Interest rates and inflation



Source: EIU

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.

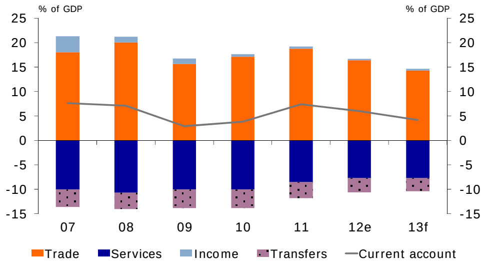
At the level of individual emirates, non-oil and indebted Dubai continues to report deficits. These are now decreasing and compensated by abundant oil-based surpluses of Abu Dhabi. The minimal oil price needed to break-even the consolidated budget increased from USD 30 per barrel in 2003 to around USD 92 per barrel in 2011. This higher minimum break-even price reflects much higher government expenditures and is a risk in the event of declining oil prices. We expect a budget surplus of 5.4% in 2012.

Average annual inflation is down from around 12% in the boom years to only 1-2% since the financial crisis of 2009, as especially rents kept inflation low. Inflation is expected to average a modest 2.1% in 2012. Although the decade-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. In 2009, the UAE withdrew 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

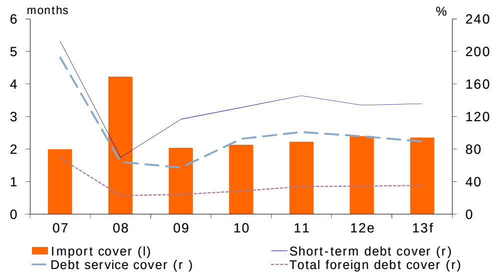
The current account is in healthy shape, it has posted an average surplus of 5.7% of GDP in the past five years. In 2012, it is expected to post a surplus of 5.9% of GDP. The trade balance is the main pillar of these consistent current account surpluses, with an expected surplus of 16.4% of GDP in 2012. The UAE structurally records large trade surpluses ranging from 15-26% of GDP due to oil exports. These are supplemented by small surpluses on the income balance (profits and interest); a surplus of 0.3% of GDP is expected in 2012. On the other side, the services and transfer balances show structural deficits. The services balance by 7.8% of GDP and the transfer balance by 2.9% of GDP in 2012 due to expatriates (8% of the population) transferring funds to their families abroad. We forecast no significant changes in 2013, but the largest risks to this forecast are a significant and unexpected increase or decrease in the oil price and an accelerated growth slowdown in Asia, the UAE' largest export market. The annual current account surpluses are reflected in the stock of official FX-reserves, which is expected to grow to USD 57bn at end-2012, up from USD 53bn at end-2011.

Figure 5: Current account



Source: EIU

Figure 6: External liquidity



Source: EIU

External position

The external debt of the UAE is estimated at USD 167bn (40% of GDP), most of which is owed by Dubai. Dubai's high external debt burden has reached over 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, 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.

Liquidity indicators are not as strong as in many other oil exporting countries. Official FX reserves cover less than 3 months of imports, 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

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.2	3.3	-1.6	1.4	3.3	3.5	4.3
Consumer prices (average % change pa)	11.1	12.3	1.6	0.9	0.9	2.1	1.6
Current account balance (% of GDP)	7.6	7.1	2.9	3.8	7.4	5.9	4.2
Total foreign exchange reserves (mln USD)	77239	31695	36104	42785	53585	57085	61190
Economic policy							
Budget balance (% of GDP)	7.3	16.2	-13.1	-2.1	5.0	5.4	2.5
Public debt (% of GDP)	37	38	55	51	44	38	34
Money market interest rate (%)	4.8	2.4	0.8	2.2	1.7	1.8	1.8
M2 growth (% change pa)	42	19	10	6	5	11	12
Consumer prices (average % change pa)	11.1	12.3	1.6	0.9	0.9	2.1	1.6
Exchange rate LCU to USD (average)	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Balance of payments (mln USD)							
Current account balance	19644	22282	7825	11211	26320	25030	20350
Trade balance	46522	62925	42069	50849	66931	69080	68860
Export value of goods	178631	239213	191776	212262	252556	288120	305420
Import value of goods	132109	176288	149707	161413	185625	219040	236560
Services balance	-25962	-33827	-27273	-29931	-30682	-32820	-37490
Income balance	8372	3803	3213	1565	1689	1080	2020
Transfer balance	-9288	-10619	-10184	-11273	-11618	-12310	-13040
Net direct investment flows	-381	-2100	1280	1933	4100	4100	3600
Net portfolio investment flows	-1672	-57794	-7549	-14020	-13700	-14600	-16400
Net debt flows	36568	28238	8392	2753	6954	8760	5590
Other capital flows (negative is flight)	-4538	-36170	-5539	4804	-12873	-19800	-9040
Change in international reserves	49621	-45544	4410	6681	10800	3500	4100
External position (mln USD)							
Total foreign debt	112400	140639	149031	151784	158737	167500	173090
Short-term debt	36321	45560	30952	32705	36858	42620	45110
Total debt service due, incl. short-term debt	40087	49582	63386	46216	53072	59640	68580
Total foreign exchange reserves	77239	31695	36104	42785	53585	57085	61190
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)	18.0	20.0	15.6	17.1	18.7	16.4	14.2
Current account balance (% of GDP)	7.6	7.1	2.9	3.8	7.4	5.9	4.2
Inward FDI (% of GDP)	5.5	4.4	1.5	1.3	1.8	1.7	1.6
Foreign debt (% of GDP)	44	45	55	51	44	40	36
Foreign debt (% of XGSIT)	57	55	71	67	58	54	52
International investment position (% of GDP)	n.a.	n.a.	91	83	82	81	n.a.
Debt service ratio (% of XGSIT)	20	19	30	20	19	19	21
Interest service ratio incl. arrears (% of XGSIT)	3	2	3	2	2	2	2
FX-reserves import cover (months)	2.0	4.2	2.0	2.1	2.2	2.4	2.4
FX-reserves debt service cover (%)	193	64	57	93	101	96	89
Liquidity ratio	135	139	115	124	129	129	126

Source: EIU