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United Arab Emirates: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Arab Emirates

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the United Arab Emirates, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 3, 2006, with the officials of the United Arab Emirates on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 24, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of June 12, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 12, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the United Arab Emirates.

The document listed below has been or will be separately released.

Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

UNITED ARAB EMIRATES

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with the United Arab Emirates

Approved by Lorenzo Perez and Scott Brown

May 24, 2006

- **The consultation discussions were held in Abu Dhabi, Dubai, and Sharjah** from March 21 through April 3, 2006. The mission team met with the Minister of State for Finance and Industry, the Governor of the Central Bank, the Minister of Economy, as well as other senior officials of the federal government and the three largest emirates—Abu Dhabi, Dubai, and Sharjah. Meetings were also held with representatives of the private sector, commercial banks, stock exchanges, and chief executives of several public enterprises.

- **The staff team** comprised Messrs. Elhage (head), Goswami, Singh, Ms. Farahbaksh, and Ms. Jardaneh (all MCD), and Ms. MacLaren (MFD expert on capital markets).

- **The U.A.E. has accepted the obligations of Article VIII** and the Fourth Amendment of the Fund's Article of Agreement. The U.A.E.'s exchange regime is officially pegged to the U.S. dollar.

- **The U.A.E.'s economic statistics suffer from numerous structural weaknesses.** Data shortcomings continue to impose serious constraints on economic monitoring, analysis, and policy formulation for both the authorities and staff.

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EXECUTIVE SUMMARY

Background

In 2005, reflecting high oil prices and production, both the fiscal and external current account balances are estimated to have registered large surpluses. Real GDP growth is estimated at 8.5 percent, with an estimated 11 percent growth in nonhydrocarbon sector and 2.1 percent growth in hydrocarbon GDP. Inflation as measured by the consumer price index is estimated to have reached 8 percent.

Financial market developments were underpinned by abundant liquidity and booming asset markets. The equity markets, however, after having risen significantly since 2004, saw a sharp correction since their peaks in November 2005. Banks' profits increased substantially in 2005, mostly due to the sector's considerable involvement in the IPO and equity markets and the booming real estate sector. Capital adequacy ratio of banks remained high and the ratio of nonperforming loans declined.

Medium-term Context

Underpinned by current expectations that world oil prices will remain high and oil production will increase steadily to 3.5 million barrels per day by 2011, the medium-term outlook remains favorable. Although the downside risks to the projected outlook from a drop in oil prices are limited, there are risks that warrant close monitoring, particularly, asset price developments in the equity and real estate markets and accelerating inflationary pressures.

Staff Appraisal

The authorities' primary objective should be to ensure that economic expansion proceeds at a sustainable pace while maintaining macroeconomic stability. The recent sharp correction in equity prices and the increase in domestic interest rates are expected to dampen domestic demand. However, most likely, this slowdown will be offset by the planned large increase in public sector investment.

The large increase in social and infrastructure expenditure envisaged by the authorities is broadly appropriate, provided that it is balanced with the underlying risk factors. The comfortable fiscal position and the significant accumulation of financial assets argue for higher infrastructure and social spending to support the broadening of growth and increase the absorptive capacity of the economy. However, if the rapid increase in private sector credit and consequent inflationary pressures continue in 2006, it will be necessary to tighten financial policies, including reassessing public expenditure plans.

There is a need for better fiscal policy coordination among the emirates and the federal government. Wage increases in the public sector should be increasingly linked to productivity and the revenue base could be broadened by introducing a VAT system at the federal level.

The responsibilities of the different entities involved in regulating the capital markets and its participants should be clearly defined. Close coordination among these entities is needed to ensure that a comprehensive supervisory framework for the entire financial sector is in place. IPO prices should be set by the market through professional underwriters based on appropriate valuations of the companies and not by the Ministry of Economy.

The exchange rate peg has served the U.A.E. well, but the choice of the exchange rate regime under the planned Gulf Cooperation Council monetary union remains open.

The numerous structural weaknesses with respect to data quality need to be addressed urgently. Given the planned increase in borrowing by local governments' entities, it is crucial that data on domestic and external debt be compiled.

I. BACKGROUND

1. **An outward-oriented development strategy and prudent financial policies have resulted in impressive economic growth over the years and led to a large accumulation of external financial assets.** This success has been underpinned by Abu Dhabi's prudent management of its oil wealth and Dubai's strong push for economic diversification. All indications point to the fact that the liberal economic policies the U.A.E. has followed thus far will be broadened and accelerated in the period ahead.[1]

2. **The major emirates (Abu Dhabi, Dubai, and Sharjah) intend to leverage the favorable economic environment to carry out reforms that will foster more private sector participation.**[2] Dubai passed a property law which allows 100 percent foreign ownership of properties in pre-designated areas, while working with the private sector to provide infrastructure and other services that are traditionally provided and financed by the public sector. Sharjah has established a number of industrial free zones and also benefited from attracting new small and medium-sized enterprises that are rapidly expanding. Abu Dhabi has embraced utility privatization, rationalized its fiscal policy through outsourcing of public expenditure, and has recently announced a very ambitious medium-term development plan that will be carried out jointly with the private sector.

3. **The rapid growth of the capital markets and the significant increase in capital inflows have made the inter-linkages between the financial and real sectors more complex.** Therefore, broad and proper information collection is needed to allow comprehensive and timely monitoring of economic developments.

4. **In recent years, the Fund's policy advice has encouraged the authorities to strengthen fiscal policy and modernize the financial sector's legal framework and improve capital markets supervision and regulations.**[3] The decentralized policymaking process and the complexity of the U.A.E.'s economic and political structure have made it difficult for the authorities to implement the Fund's fiscal policy recommendations. In contrast, progress has been made in financial sector reforms, as the Central Bank of the U.A.E. (CBU) has authority over most institutions in the sector.

5. **Limited improvements have been made in the U.A.E.'s economic and social statistics.** Data shortcomings (discussed in Appendix III) continue to impose serious constraints on economic monitoring, analysis, and policy formulation and staff has recommended that data deficiencies across sectors be addressed urgently.

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[1] During the past 15 months, new rulers in Abu Dhabi and Dubai were appointed.

[2] The U.A.E. is a confederation of seven emirates each operating under considerable autonomy. The seven emirates are Abu Dhabi, Dubai, Sharjah, Ajman, Ras al-Khaimah, Umm al-Qaiwain, and Fujairah.

[3] Appendices I and II provide information on relations with the Fund and World Bank Group, respectively.

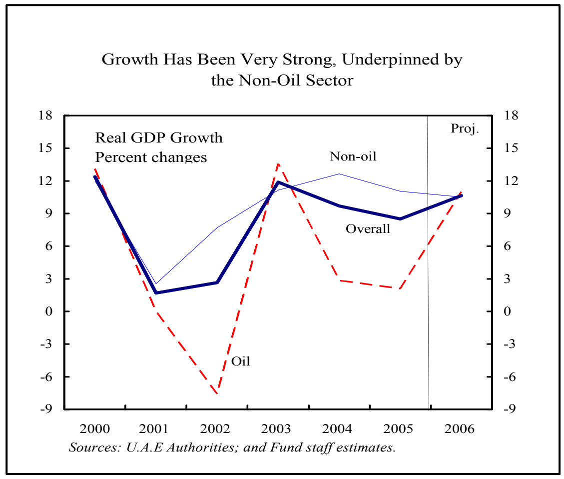
II. Recent Developments

6. **The consultation discussions were held against a backdrop of strong economic activity, high oil prices, and large fiscal and external surpluses.** Also, abundant liquidity and unconventional IPO pricing have fueled a surge in equity prices. The equity markets, however, have experienced a sharp correction since their peaks in November 2005. Nonetheless, economic fundamentals continue to be strong, bolstered by the large accumulation of financial surpluses and the surge in foreign direct investment (FDI) in Dubai.

7. **The growth in money supply and credit expansion were substantial in 2005.** Wages in almost all sectors of the economy have risen and further increases are expected. Also, prices of non-tradable goods and services have increased significantly. Although data is not available, it is reported that real estate prices have increased significantly since 2004, particularly in Dubai.

Real Sector

8. **Real nonhydrocarbon GDP growth for 2004 has been revised upward to 12.6 percent from 10 percent,** indicating stronger overall growth than previously estimated.[4] For 2005, real nonhydrocarbon growth is estimated to have been 11 percent.[5] Growth was broad-based and most sub-sectors grew at historically high rates. The hydrocarbon sector registered a growth rate of 2.1 percent (Table 1).



9. **The strong growth in domestic demand has been accompanied by rising inflation.** For 2005, official preliminary estimates (which were hampered by the lack of data collection on various prices) indicate CPI inflation at about 6 percent, significantly lower than recent market estimates.[6] However, with price developments of non-tradables like rents

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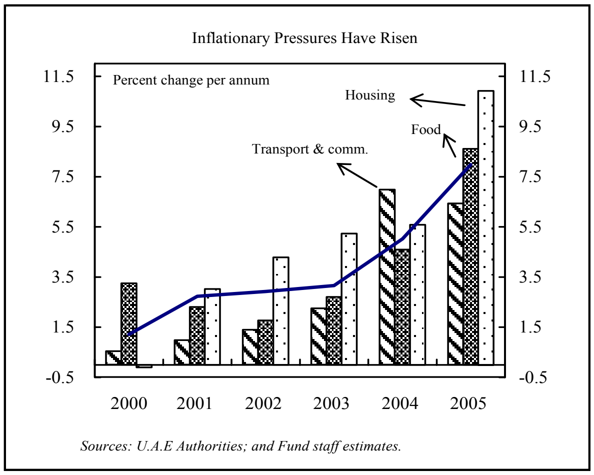
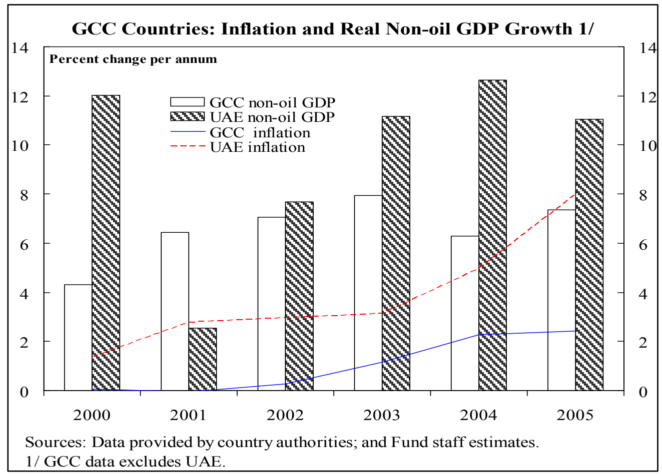
[4] During last year's consultation, real nonhydrocarbon GDP growth rates for 2002 and 2003 were also revised upward by an average of 4.2 percentage points to 7.7 percent and 11.2 percent, respectively.

[5] At the time of the mission, the authorities estimate for real nonhydrocarbon GDP was 6.2 percent. Since then, it has been revised upward to 10.8 percent.

[6] According to estimates in recent market reports, CPI inflation in 2005 was above 15 percent. A number of shortcomings exist with respect to the methodology used to compile the CPI, including: outdated weights, lack of imputations for missing data; and different reference periods for the base price and expenditure weights. The authorities do not compile information relating to producer prices. The CBU is currently coordinating with the Ministry of Economy (MOE) on how to proceed with their request for a TA mission on CPI from the Fund.

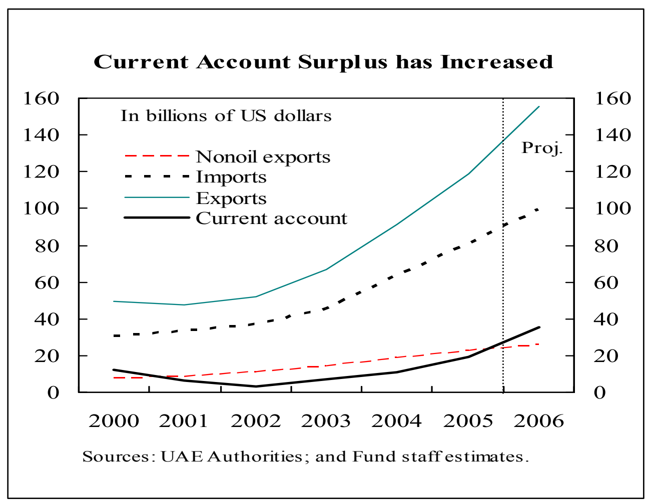
and services, and large increases in the money supply (34 percent) and in petroleum prices (31 percent), staff estimates inflation at about 8 percent, though this may be higher. During 2003–05, reflecting the significantly higher non-oil GDP growth, the U.A.E.'s average annual inflation rate was more than twice that of the other Gulf Cooperation Council (GCC) countries.





External Sector

10. **The sharp rise in oil prices and strong growth in nonhydrocarbon exports contributed to a large external current account surplus in 2005** (about 14.5 percent of GDP). The level of activity in the free zones continued to expand with the emirate of Dubai playing an increasingly important role as the point of entry into the GCC region. Reflecting strong domestic demand in the U.A.E., imports increased by 27 percent to about \$81 billion. FDI inflow remained strong and is estimated to have reached \$11 billion (Table 2).



Fiscal Sector

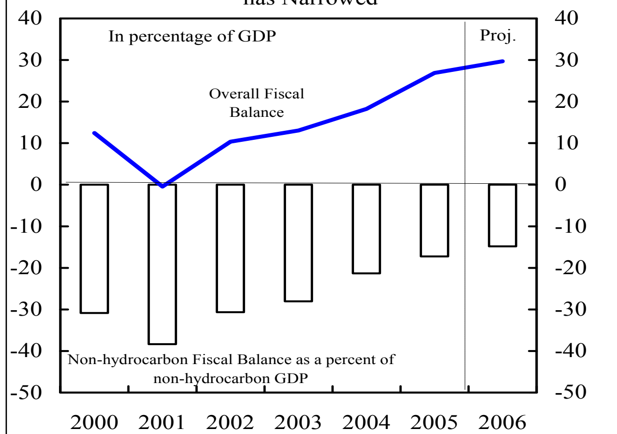
11. **The budgetary system of the U.A.E. and weaknesses in fiscal data have continued to impede a timely and accurate assessment of overall fiscal developments.** With lack of uniformity in the classification of expenditures and revenues among the seven emirates and the federal government, the unavailability of data on the government's investment income, and considerable off-budget spending, a comprehensive analysis of the

fiscal developments remains difficult. Nevertheless, the availability of data on net accumulation of government foreign assets and domestic financing allowed the staff to estimate the overall fiscal balance from the financing side.

12. **In 2005, Abu Dhabi's budget improved markedly due to high oil prices and moderate expenditure increases.** Expenditures grew by only 8 percent largely due to the outsourcing of some services previously provided by the municipality to the private sector. The sectors that were largely transferred off-budget include housing and community center programs and general administration. As a result, the work force was reduced by about 8,000 workers (14.5 percent) and, despite a 25 percent and 15 percent increase in the salaries of nationals and expatriates, the wage bill declined.[7] The government of Abu Dhabi contributed AED 6.2 billion to its pension fund from privatization receipts.

13. **The two other key emirates, Dubai and Sharjah, maintained their policy of executing budgets that are largely in balance.** However, Dubai's budget does not provide a comprehensive picture of its fiscal accounts. Considerable fiscal operations continue to be carried outside the budget, and information about these operations is currently not available.[8] The consolidated fiscal surplus of the federal government and the three largest emirates is estimated to have reached about 27 percent of GDP in 2005 (Table 3).

The Consolidated Fiscal Surplus Widened Significantly and the Nonhydrocarbon Deficit has Narrowed



Sources: U.A.E Authorities; and Fund staff estimates.

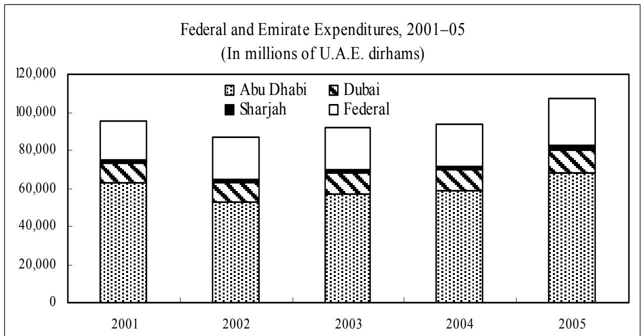
14. **The federal government has implemented a number of measures to improve public administration reforms.** These measures include: (i) budget classification consistent with the 2001 Government Finance Statistics; (ii) moves toward a single treasury account; and (iii) establishment of a new accounting framework. Progress in these basic areas has been commendable, and should help in greater transparency in federal government operations. However, the budget law, while an improvement over previous versions, does not create the needed incentives and measures to induce the ministries to use performance budgeting judiciously.

[7] Analysis of fiscal developments in Abu Dhabi has been complicated by the ongoing restructuring of its budget.

[8] The Dubai government owns a number of public entities, such as, Dubai Ports World, Emirates Airlines, and Dubai Aluminum Company (DUBAL) which the staff has limited information on their financial operations.

Box 1. U.A.E.: Fiscal Institutional Framework

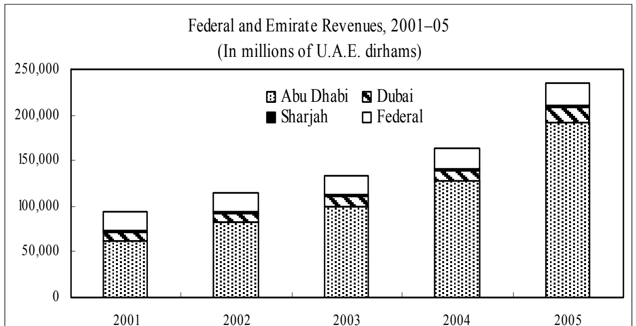
In the absence of a broad tax across the emirates, the federal government's revenue (which consists primarily of cash contributions from Abu Dhabi and Dubai) constitutes only 15 percent of the consolidated U.A.E. budget. Abu Dhabi's contribution to the federal budget has increased over the past years, Dubai also supplements its standard contributions to the federal government indirectly by the fees and other charges the federal government collects in Dubai from workers and tourists who visit the U.A.E. Sharjah supplies gas to the northern emirates in lieu of its contribution to the federal budget.



Sources: UAE authorities and Fund staff estimates.

The emirates have significant autonomy from the federation. With its sizable hydrocarbon holdings, the emirate of Abu Dhabi accounts for about 65 percent and 80 percent of the U.A.E.'s expenditures and revenues, respectively. Dubai with its dwindling revenues from oil and gas and a growing population, has increased its reliance on nonhydrocarbon revenues to fund its budget.

The U.A.E.'s consolidated budget reflects the accounts of the federal government and the emirates of Abu Dhabi, Dubai, and Sharjah. Data on the fiscal accounts of the remaining four smaller emirates are not available; however their exclusion from the consolidated accounts does not have a major impact since the Abu Dhabi and Dubai budgets form the bulk of the U.A.E. budget. Most emirates maintain a balanced budget with Abu Dhabi and its investment arm, Abu Dhabi Investment Authority, accounting for most of the fiscal surpluses. The emirate of Abu Dhabi has created a development arm, Mubadala, to be responsible for its investments in a wide range of strategic sectors including energy, real estate, and health care.



Sources: UAE authorities and Fund staff estimates.
Includes profits of ADNOC and other government entities and from domestic investments.

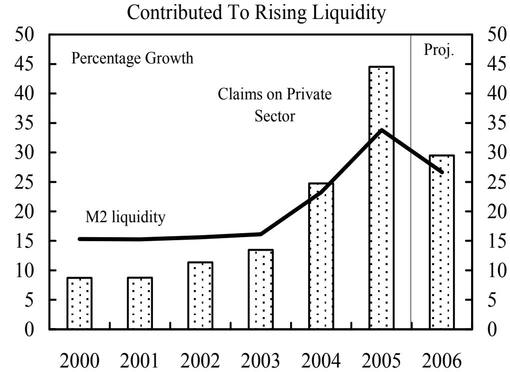
The federal government, although smaller in size relative to Abu Dhabi, plays an important role in the federation and often leads in public administration reforms. It provides basic social services across the country, sets regulations and minimum standards, and represents the U.A.E.'s interests in international affairs.

Overall, the public sector across the U.A.E. is undergoing a major shift to restructure and outsource many activities to the private sector. Planned development expenditures over the next 5 years are estimated at over $350 billion, a significant part of which will be shouldered by the private sector.

Monetary Developments

15. **Money and credit developments in 2005 took place against a continued backdrop of high level of liquidity, increased economic activity, and booming asset prices.** Broad money growth remained strong at about 34 percent (Table 4), driven mainly by 44.5 percent growth in credit to the private sector.[9] Most categories of private sector credit increased significantly, in particular, loans to construction (32 percent) and personal loans (93 percent). At end-2005, direct credit to the equity markets and mortgage loans accounted for about 40 percent of total personal loans. Excluding direct credit extended to the equity market, broad money increased by 27 percent.

Surging Credit Growth to the Private Sector Has Contributed To Rising Liquidity



Sources: U.A.E Authorities; and Fund staff estimates.

16. **In the aftermath of the decline in the regional equity markets that started in late 2005, the direction of capital flows reversed in the first 2 months of 2006.** Net foreign assets of the banking system declined by about AED 30 billion, as regional investors reduced their exposure to the U.A.E. markets. However, claims on the private sector increased by 13 percent, while broad money grew by 2.3 percent.

Financial Sector Developments[10]

17. **Banks' exposure to the booming real estate sector and equity markets (Box 2) increased substantially.**[11] As a percent of total credit, lending to construction increased by 2 percentage points to 12 percent and direct lending to the equity markets increased by 5 percentage points to 6 percent. However, indirect lending to the equity markets through personal loans could be even higher. Some banks have reportedly leveraged investments in excess of the permitted bank margin lending ratio of 5 to 1.

18. **The stock of nonperforming loans (NPLs) increased by 2.4 percent in 2005**. However, reflecting the significant growth in credit, the ratio of NPLs to total loans declined to 8.3 percent from 12.5 percent in 2004 (Table 5). Also, provisions were considerable,

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[9] In line with international standards, the authorities removed the deposits of U.A.E. residents in overseas branches/subsidiaries from the monetary survey. As a result, the monetary survey for 2004 presented in IMF Country Report No. 05/269 has been revised slightly.

[10] Financial market developments, including the status of 2001 FSAP recommendations, are discussed in detail in Appendix IV.

[11] In the absence of available data on the real estate market, the staff was not able to assess developments in this sector. Unofficially, it is reported that real estate prices increased by about 30 percent in 2005.

bringing net NPLs ratio to total loans below 2 percent. The capital assets ratio remained high at 17.4 percent and banks' balance sheet increased by 40 percent to AED 608.5 billion (about $166 billion). On an aggregate basis, banks complied with the CBU's prudential norms.[12]

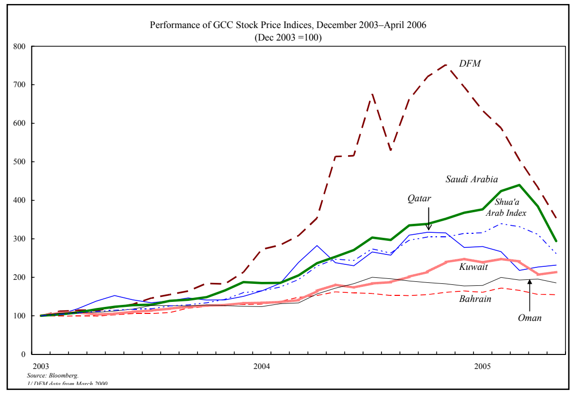
19. **Banks' profits more than doubled to $5.1 billion in 2005.** Non-interest income, which increased by over 112 percent, accounted for about one third of total banks' income. Most of this increase was driven by fees and commissions on IPO subscriptions, and income generated from banks' investment in the equity market. Receipt of deposits for IPOs also provided the banks with ample non-interest-bearing cash for considerable periods of time.

20. **Considerable progress has been made with respect to the regulatory framework governing the Dubai International Financial Center (DIFC), and an extensive set of laws have been enacted, benchmarked to best international practices.** While as of mid-February 2006, 160 companies and 40 financial institutions have been granted licenses to operate within the free zone, the actual volume of business conducted at DIFC is still relatively small.

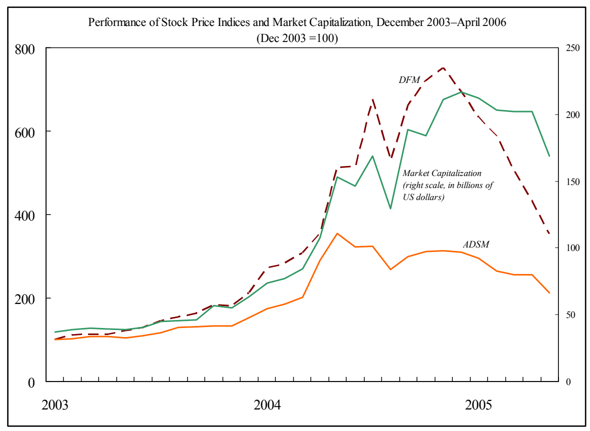
[12] The staff was not in a position to assess individual banks compliance with prudential norms.

Box 2. U.A.E.: Capital Markets: Recent Developments and Key Characteristics

Capital markets in the U.A.E. have posted strong growth in 2005, driven by ample liquidity, strong macroeconomic growth, low interest rates, and strong corporate performance. The Dubai Financial Market (DFM) and Abu Dhabi Securities Market (ADSM) indices gained 132 percent and 69 percent, respectively, in 2005. The overall U.A.E. market led the region's capital markets in terms of both market capitalization, and market activities, including volume and value of share traded. The U.A.E. also led the region in terms of the largest number of IPOs (11).



As of end-April 2006, both the DFM and ADSM have had sharp correction, declining by about 55 percent and 40 percent, respectively, since their peaks in November 2005. The sharp corrections in the U.A.E. bourses were due to market overvaluation together with liquidation of existing positions to fund subscriptions for IPOs activity. The high demand for IPOs was the result of under pricing of IPOs by the Ministry of Economy (MOE), which by law sets the prices of IPOs for both state-owned and private companies at a nominal value of the company's shares, rather than through accurate assessment of the fair market value of the company. The MOE also sets prices for subsequent offerings by public companies, usually at a substantial discount. As a result, IPO prices are set artificially low, leading to substantial over-subscription and considerable market volatility.1/



Key Stock Market Indicators 1/

	PER 2/		PBR 3/		Dividend Yield (percent)	
	End-2005	Apr-06	End-2005	Apr-06	End-2005	Apr-06
Dow 30 Avg.	18.9	21.7	3.1	3.2	2.3	2.2
S&P 500	18.2	17.8	2.8	2.8	1.8	1.8
ADSM	45.1	16.7	8.2	1.3	0.8	3.0
DFM	21.1	10.4	5.2	3.5	0.6	0.9
Saudi Arabia	40.0	29.1	12.1	6.9	1.1	1.8
Kuwait	12.7	11.9	2.6	2.8	2.0	2.1
Korea	11.7	11.4	1.6	1.6	0.6	1.6
Egypt	22.7	19.0	6.5	4.6	3.6	3.4

Source: Bloomberg, Bakheet Financial Advisor, and Global Investment House.

1/ Data as of 4/30/2006, except for ADSM. Data for ADSM is for April 17, 2006.
2/ Price earning ratio.
3/ Price book value ratio.

1/ The 2 IPOs (finance and telecommunications companies) issued in March 2006 were over-subscribed by 500 times and 165 times the shares offered. Bids were $74 billion (about 60 percent of 2005 GDP), and $109 billion (about 85 percent of 2005 GDP), respectively. The simultaneous IPOs attracted more than $180 billion from investors (compared to IPOs of $809 million), creating a liquidity crunch that triggered a sharp correction in the DFM of almost 12 percent on March 14, 2006.

III. Report on the Discussions

The policy discussions centered on the economic outlook and the underlying risk factors; fiscal policy coordination between the federal and emirates' governments and public finance reform; monetary policy and assets price inflation; structural and labor policies; and exchange rate policy. Banks' exposure to the equity and real estate markets, underpricing of IPOs, and the need to put in place a comprehensive supervisory framework to address the rapidly growing financial sector were also discussed. The structural weaknesses in the U.A.E.'s statistical database were highlighted.

A. Near- and Medium-Term Outlook

21. **Economic growth is projected to remain buoyant in 2006,** with real nonhydrocarbon activity largely expected to remain high and oil production rising significantly. Several large scale real estate and infrastructure projects in Dubai and Abu Dhabi are already in the pipeline as part of each emirates' economic diversification strategy. In the hydrocarbon sector, ambitious plans to expand capacity are expected to result in higher oil production in 2006. However, the recent sharp correction in equity markets and the increase in domestic interest rates, in line with the U.S. dollar rates, are expected to dampen domestic demand. On the inflation front, the stabilization of rental costs (Dubai has a 15 percent cap on rental increases until end-2006) and the wearing-off of the impact of the fuel price hike in 2005 could act as a balancing factor.

22. **The medium-term outlook remains favorable,** underpinned by current expectations that world oil prices will remain high,[13] oil production will increase steadily to 3.5 million barrels per day by 2011, and the nonhydrocarbon sector will gain further traction from the diversification strategy. Real nonhydrocarbon growth is projected to settle at a more sustainable pace of 6.5–7.0 percent during 2007–11. Both the external current account and the overall fiscal surpluses are projected to remain sizeable.

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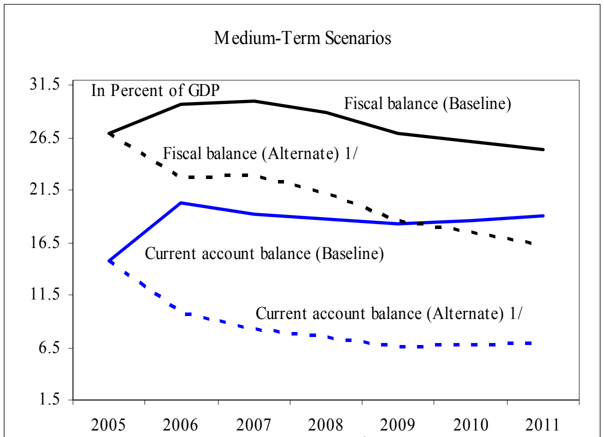
[13] In line with the April 2006 WEO projections, oil prices are projected to remain high and decline only marginally to an average of $67.3 during 2006–11.

23. Although the medium-term outlook is based on historically high levels of oil price and production assumptions, **the downside risks to the projected outlook from a drop in oil prices are somewhat limited.**[14] However, there are additional risks in the system that warrant close monitoring, in particular, asset price developments in the equity and real estate markets and accelerating inflationary pressure. The considerable supply of residential units expected to come on the market by early 2007 could put downward pressure on prices in this sector.



1. Alternative scenario is based on oil price at $20/bl below WEO projection.

B. Macroeconomic Policies

Fiscal Policy and Public Finance Reforms

24. **Fiscal policy discussions were conducted separately at the federal level and with the largest three emirates,** and focused on Abu Dhabi's fiscal policy stance and the public administration reforms of the federal government. Reforms of key issues such as reducing subsidies on water and electricity in Abu Dhabi, widening the tax base on a federation-wide scale, improving fiscal data coverage, and fiscal policy coordination between the emirates and the federal government were also discussed.

25. **The emirate of Abu Dhabi plans to continue to outsource most of its non-core budgetary activities and reduce the size of its government.** It is expected that an additional 20,000 jobs will be outsourced to the private sector in 2006, resulting in a significant reduction (about 40 percent) in its public work force. The authorities also intend to eliminate agricultural subsides by 2008. Plans are underway to have the private sector play a bigger role in the management and provision of power generation and health care.

26. **Overall coordination between the federal and emirates' governments remains weak.** Each emirate continues to implement its fiscal policy independently with little consideration to overall macroeconomic implications. To improve overall fiscal assessment and analysis, officials at the federal and emirates' level agreed that there is a need to improve fiscal transparency by adopting international standards of classification for expenditure and revenue statistics. The Ministry of Finance and Industry has asked for an advisor from the

[14] Staff estimates that for each $1 drop in the price of a barrel of oil, on average, the fiscal balance will weaken by only about 0.5 percent of GDP during 2006–11.

Fund to help it set up a macro-fiscal unit at the ministry. The aim of this unit is to develop a consistent macroeconomic framework and the capacity to provide advice on economic and financial policies.

27. **The broadening of the revenue base will largely be driven by the prospective adoption of a VAT in the context of the GCC monetary union.** Regarding FAD's recommendations for the introduction of the VAT, the authorities at the federal government indicated that their implementation will await a GCC ministerial decision to introduce such a tax in all the six countries.

28. **On the expenditure side, there is a need to reduce subsidies on water and electricity gradually and to replace them by targeted payments to nationals below a certain income.** Also, the General Pension and Social Security System (GPSSA) needs a major overhaul as it suffers from structural imbalances due to the overly generous benefits. The actuarial study by the GPSSA that is to be completed soon would be useful in developing an overall reform strategy.

29. **The authorities are planning to increase development expenditures significantly in 2006 and over the medium-term.** Key government entities (such as the Abu Dhabi National Oil Company, Dubai Ports Authority, and Dubai Aluminum Company (DUBAL)) have massive investment plans to further increase the capacity of upstream activities in the petrochemicals sector, infrastructure in airports and ports, and new manufacturing plants in the metals sector. Over the medium-term, the total investment in Dubai is conservatively estimated at $200 billion. Similarly, about $160 billion worth of projects are planned for Abu Dhabi (Box 3). A major $25 billion investment plan for upgrading both upstream and downstream production capacity is underway in Abu Dhabi. Oil production capacity is planned for expansion from 2.9 million barrels to 3.5 million barrels per day within the next five to seven years. Also, in 2006, the federal government development expenditures are projected to increase by ten fold on health and education and by 400 percent on public housing.

Box 3. U.A.E.: Planned Investment Projects: 2006–11

The U.A.E. is currently undertaking a massive broad-based investment plan to further diversify the economy and increase oil production over the medium and long run. Dubai is leading the investment drive in the real estate and the infrastructure sector. Among the projects that have been announced are the expansion of the Dubai International Airport ($4 billion), Palm Jumeirah ($5 billion), Palm Jebel Ali ($7.5 billion), Palm Deira ($12.5 billion), Dubai light rail transport project ($3 billion), Jebel Ali Airport city ($20 billion), Dubai Land ($10 billion), Dubai Aerospace Enterprise ($15 billion), Emirates Pearl ($9.5 billion), and investments in utilities ($15 billion) and roads ($5 billion). Similarly, a number of projects are planned for Abu Dhabi including a new port ($2.5 billion), airport expansion ($5.7 billion), several large real estate projects, and a joint venture between DUBAL and Mubadala.

In Abu Dhabi, massive investments in natural gas production and infrastructure will—in combination with gas imports from Qatar—satisfy the country's rapidly rising domestic gas demand (for electricity generation and petrochemical feedstock) and create new potential for the exportation of condensates and natural gas liquids. Development of Abu Dhabi's petrochemicals sector is being accelerated through investment plans to produce ethylene, polyethylene, and other products.

Part of the planned projects in Dubai will be carried out by Dubai Holding which is a privately held company owned by the Ruler of Dubai. It is a conglomerate of 66 companies that operate within 7 clusters, which comprise of real estate investments in Dubai, international properties, equities, telecommunication, hotels, and properties in industrial city, health city and a theme park. It has an aggressive growth strategy and is pursuing investment opportunities both domestically and internationally. Various real estate projects in the Middle East and North Africa are in the pipeline and it is also looking to increase its investments via private equity deals in Asia, especially in China and India.

Monetary Policy and the Financial Sector[15]

30. **In the context of the fixed exchange rate system and full capital account convertibility the effectiveness of monetary policy is quite limited.** The recent sizeable capital outflow in the first 2 months of 2006 appears to have tightened monetary conditions somewhat. Nonetheless, given the scale of real estate and infrastructure projects under consideration, this tightening could be a temporary phenomenon.

31. **In the event of continued strong economic performance and a sustained pace of high credit growth to the private sector, a tightening of monetary conditions is warranted to stem inflationary pressures.** This could be achieved by raising reserve requirements on demand deposits, introducing tighter prudential norms for both banks and non-bank financial institutions, including tightening of margin lending, collateral valuation and provisioning requirements; and increase in certain risk weights for capital calculations. A gradual lowering of the percent at which individuals can borrow against their salaries could

[15] Capital markets key recommendations are discussed in Box 4.

also be considered.[16] The authorities indicated that they are considering these recommendations.

32. **Credit risk is the most important risk factor in the banking sector at this time.** Increased concentration of bank loans to a few large business groups that dominate the economy calls for close monitoring. While the CBU limit to a single borrower is appropriate, considerations may be given to reducing the limit on total large exposures, which is currently set at 8 times the capital base. The CBU needs to start including off-balance sheet items and interbank exposures of the U.A.E. banks with a maturity of less than 12 months in the definition of large exposures.

[16] In the U.A.E., individuals can borrow up to 40 percent of their salaries.

Box 4. U.A.E.: Capital Markets: Recommendations for Reforms[1]

- **There is a need to amend the Company Law with respect to the pricing of IPOs.** Subscription prices for new offerings should be set by the market through professional underwriters based on appropriate company valuation. Also, intervention (if any) in pricing of subsequent offerings by currently listed companies should be restricted to a limit on the discount of the market price.

- **The current CBU system, which sets multiple margin rates for the same publicly traded security based on the nature of the loan, should be replaced by a single rate for each class of securities.** The risk in the value of the collateral varies based on the nature of the collateral, not the loan for which it is pledged. The staff recommends that the maximum loan value that can be given for most liquid traded stocks be set at 50 percent, similar to the margin rate provided in major international markets.

- **There is an urgent need to define the responsibilities of the various entities involved in regulating the capital markets and its participants,** and addressing gaps in regulations in order to safeguard investor interests. In particular, the law should give the regulatory authorities clear powers to set and enforce comprehensive prospectus requirements and corporate governance standards for public companies.

- **There is a need to increase the size of the public float of securities to promote deeper and more liquid markets.** The pre-emptive rights of existing shareholders to subscribe pro-rata on new issue reduces the opportunity for wider ownership of these companies.

- **There is a need to increase the size of institutional investors in the securities markets.** Also, the equity markets would benefit from the introduction of market stabilization mechanisms, such as market maker system and hedging instruments that can provide liquidity and allow investors to manage their risks more effectively.

- **Collection and dissemination of statistical information** regarding the assets and the functions of non-bank financial intermediaries, including mutual funds, investment companies, and brokerage firms will need to be improved considerably.

- **There is a need for a comprehensive assessment of the capital markets regime against the standards set by the International Organization of Securities Commissions.** Conducting an assessment of the DIFC at the same time as for the rest of the U.A.E. has merit, despite the relatively recent establishment of the Dubai Financial Services Authority (DFSA), because regulatory coordination, overlap and gap issues will be easier to identify.

[1] A detailed description of the recommendations can be found in Appendix IV.

C. Structural and Labor Policies

33. **The broadening of FDI opportunities in the free zones in Dubai is a welcome development,** but there is a need to pass the new Company Law that includes higher foreign ownership thresholds. The authorities noted that the U.A.E. is amending the Commercial

Company Law, applicable across the federation, which may see the ceiling on foreign ownership raised from the current 49 percent.

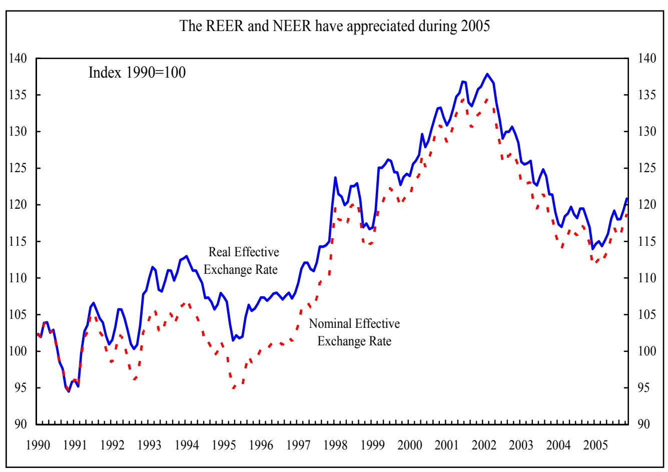
34. **Wage increases might be exceeding that of productivity gains.** The average 20 percent increase in wages in 2005, the significant increase in the prices of non-tradable goods and services, and some infrastructural bottlenecks that are appearing in the economy could impact the competitiveness of the non-oil economy.

35. **So far, most of the jobs in the private sector have been filled by expatriate workers, with the majority of nationals continuing to seek employment in the public sector.** In recent years, the authorities have implemented a string of new measures to increase the costs associated with hiring expatriate workers. At the same time, they applied a wide-range of quotas to increase the employment of nationals in the different economic sectors. It is critical that changes to labor policy do not adversely impact the competitiveness of the economy.[17] Employment opportunities for nationals will need to be created through long-term structural policies in the areas of education, training, wage policy, and labor legislation. A new labor law that is expected to be passed by year-end grants workers the rights to peacefully assemble and to form trade unions.

D. External Sector

36. **The authorities stressed that the pegged exchange rate regime has served the U.A.E. economy well by providing a nominal anchor and strengthening confidence in its economic policy.** While the equilibrium real exchange rate may have appreciated due to the positive terms-of-trade shock resulting from higher oil prices, the authorities do not foresee a change in the exchange rate policy in the period leading up to the planned establishment of the GCC monetary union by 2010. At that point, however, all options would remain open regarding the exchange rate regime under the monetary union.

37. **Reflecting developments in the dollar exchange rate, and notwithstanding the depreciation observed during 2002-04, the real effective exchange rate (REER) has appreciated by about 25 percent since 1990.** Until recently, the cumulative appreciation of the U.A.E. dirham did not seem to have eroded the country's competitiveness, because productivity gains appeared to have kept up with



[17] For a detailed discussion of labor issues in the U.A.E. and staff's recommendation, see the Chapter on Labor Market Issues in IMF Country Report No. 05/268, 6/17/05.

appreciation. However, competitiveness of the non-oil economy may come under pressure if productivity gains do not keep up with wage increases and if inflationary pressures are not contained. The private sector believes that wage increases are exceeding productivity gains.

38. **Continued coordination among the GCC countries ahead of the envisaged monetary union is ongoing.** In the area of legislation, GCC countries have agreed on a common trademark law and are working on common anti-dumping and subsidies legislation. Deliberations are continuing on the necessary institutional and legal changes needed for the monetary union. In the trade policy area, at the GCC level, a free trade agreement (FTA) with the EU is in the final stages of negotiation and is expected to be signed during 2006. Negotiations on other FTAs are also underway with a number of countries. On a bilateral basis, the U.A.E. is negotiating a FTA with the United States. The authorities indicated that in the future all FTAs would be negotiated at the GCC level.

IV. Statistical Issues

39. **The U.A.E.'s economic statistics continue to suffer from numerous structural weaknesses with respect to data quality, coverage, periodicity, timeliness, and inter-sectoral consistency.** As noted, shortcomings are particularly serious in the fiscal area. Data compilation and reporting are hampered by a shortage of trained staff and poor coordination within and between the emirates and federal government agencies.

40. **There is an urgent need to develop an effective program of reforms to strengthen the institutional framework and build-up a strong, comprehensive, and consistent statistical system.** Currently, there is an absence of such a system although most institutions are beginning to recognize its importance, especially given that the emirates, like Dubai, are interested in getting a credit rating. Also, it is crucial that data on off-budget fiscal operations and on domestic and external debt at the emirate level be compiled. The authorities are urged to finalize the GDDS metadata and nominate a GDDS coordinator.

41. **Officials at the MOE pointed out that the population census has been completed and its results will be published in 2006.** They also indicated that the household budget and the business establishment surveys are expected to be completed by end-2006 and that a number of experts were hired to strengthen statistical capacity at the ministry. These measures are welcome, but the fast evolving structure of the U.A.E. economy, its increasing linkages to the international capital markets, and the planned GCC-wide monetary union by 2010 require a comprehensive plan to address data weaknesses in most economic sectors.

V. Staff Appraisal

42. **The U.A.E. is capitalizing on the gains from high oil prices and from the transformation of Dubai as a regional hub for trade, commerce and finance.** Stronger economic fundamentals and a pro-business approach to economic management is resulting in high levels of domestic and foreign investment in the manufacturing, services, and real estate sectors. These dynamics bode well for the economy's medium-term growth prospects.

43. **The fast evolving structure of the economy, however, has the potential to create vulnerabilities.** The growth in the capital markets has fostered the expansion of various types of financial institutions and financial instruments along with a significant increase in capital flows. In the period ahead, it is expected that significant borrowing by state-owned entities and governments like Dubai will take place. The absence of comprehensive data on such activities precludes a meaningful assessment of these projects and could mask any vulnerabilities that might develop.

44. **The large increase in social and infrastructure expenditure envisaged by the authorities is broadly appropriate, provided that it is balanced with the underlying risk factors.** The comfortable fiscal position and the significant accumulation of financial assets argue for higher infrastructure and social spending to support the broadening of growth and increase the absorptive capacity of the economy. That said, the fiscal stance should be commensurate with the absorptive capacity of the economy and maintaining macroeconomic stability.

45. **The authorities are urged to monitor inflation, credit growth, and asset price developments and adjust policy accordingly.** If the rapid increase in private sector credit and inflationary pressure persist in 2006 and beyond, financial policies will have to be tightened. Because of the limitations of monetary policy, much of the burden of adjustment will fall on public spending.

46. **To improve the effectiveness of fiscal policy there is need to improve fiscal policy coordination among the emirates and the federal government.** The economic planning committee that was formed last year could play a more active role to improve such coordination. Assessment of overall fiscal developments continue to be handicapped by the considerable off-budget fiscal operations at the emirates level, particularly, in Dubai.

47. **On the expenditure side, wage increases in the public sector should be increasingly linked to productivity** and subsidies on water and electricity should be phased out and replaced by targeted payments to nationals below a certain income. Also, it is strongly recommended that the authorities introduce legislation to reform the General Pension and Social Security System while it is running operational surpluses. On the revenue side, the authorities could start the preparatory work based on FAD's recommendations for the introduction of a VAT system at the federal level.

48. **The U.A.E. banking system is strong and effectively supervised.** However, increased lending for real estate and equity financing has led to a rise in credit risk. Banks' direct and indirect exposure to these markets and the increased loan concentration to a few large business groups call for close monitoring by the CBU, and the adequacy of prudential regulation should be kept under review. A close supervision of banks that recorded significant growth in profits from equity markets related activities is particularly needed.

49. **The regulatory structure of the capital markets and intermediary activities are potential sources of fragility in the financial sector**. Many parts of the relevant legal

regime governing securities markets activities in the U.A.E. need to be updated. The authorities are urged to address the gaps in the regulation of the markets and their participants and rationalize the extensive overlaps in responsibilities.

50. **Appropriate pricing of IPOs will reduce market volatility and dampen unreasonable profit expectations on the part of retail investors.** Also, current consideration to ration subscription allotments will no longer be necessary once IPOs have been priced appropriately and according to the true value of the issuing company. The authorities are urged to only permit IPOs for companies that have had audited balance sheets for at least two years.

51. **The staff welcomes the authorities' agreement for a full assessment of the capital markets regime in the U.A.E. against the standards set by the International Organization of Securities Commissions.** Also, officials at the DIFC agreed to an assessment of the DIFC's legal regime and of the operations of the Dubai Financial Service Authority. A mission for that purpose could take place before year-end.

52. **The staff concurs with the authorities that the pegged exchange rate regime has served the U.A.E. economy well** and welcomes their position to remain open to the choice of the exchange rate regime under the planned monetary union. Since other exchange rate regimes with more flexibility would require greater institutional development, including in foreign exchange markets and risk management and intervention policies, staff urges the authorities to begin to formulate strategies to develop these areas at an early stage to keep their options open.

53. **There is an urgent need to improve the collection, compilation, and reporting of fiscal, national accounts, balance of payments, and price statistics (monthly CPI).** It will be important to finalize the GDDS metadata and to formally nominate a GDDS coordinator. While core data provision is adequate for overall surveillance purposes, data shortcomings have significantly affected the staff's analysis of some key issues in areas central to surveillance.

54. **It is proposed that the next Article IV consultation take place on the standard 12-month cycle.**

Table 1. U.A.E. Selected Economic Indicators, 2002–06

	2002	2003	2004	Est. 2005	Proj. 2006
	(In billions of U.A.E. dirhams)				
GDP at market prices	273.9	323.8	384.1	476.3	642.0
	(In millions of barrels per day)				
Oil production and exports					
Crude oil production 1/	2.26	2.59	2.66	2.72	2.97
Of which: Condensates	0.33	0.33	0.33	0.34	0.37
Average UAE crude price (US dollars per barrel)	24.75	28.11	36.30	52.60	67.25
WEO oil price (US$ per barrel)	24.95	28.89	37.76	53.35	68.00
	(In billions of cubic meters per year)				
Natural gas production and exports					
Natural gas production	43.4	44.4	45.4	46.4	47.8
LNG exports	7.1	7.4	8.1	7.5	7.6
NGL exports	11.9	13.1	13.0	13.4	13.8
	(Annual percentage changes)				
National income and prices					
Real GDP (at factor cost)	2.6	11.9	9.7	8.5	10.7
Crude oil, condensates and natural gas	-7.6	13.6	2.9	2.1	11.0
Non-hydrocarbon sectors 2/	7.7	11.2	12.6	11.0	10.5
GDP deflator 3/	3.5	6.1	9.2	17.3	17.5
Consumer prices	2.9	3.1	5.0	8.0	7.7
Volume of imports	9.4	6.7	26.1	21.9	24.8
Volume of non-oil exports	10.4	25.8	36.5	14.0	15.9
	(In percent of GDP)				
Investment and saving					
Gross domestic investment	24.1	23.5	22.3	24.4	26.6
Government	4.6	5.0	4.0	2.8	3.8
Non-government	19.6	18.5	18.3	21.6	22.9
National saving	28.2	31.6	32.5	39.1	46.9
Government	15.5	18.4	21.8	30.9	34.2
Non-government	12.7	13.2	10.7	8.2	12.8
Consolidated government finances					
Revenue	42.0	41.3	42.5	49.4	48.6
Hydrocarbon	32.8	32.9	32.8	38.4	38.2
Nonhydrocarbon	9.2	8.4	9.7	11.1	10.3
Of which: Investment income	3.2	3.1	4.4	5.8	5.9
Expenditure	31.6	28.3	24.3	22.5	18.9
Of which:					
Current	26.4	22.9	20.7	18.5	14.4
Development 4/	4.8	5.0	3.4	3.8	4.3
Current balance	15.5	18.4	21.8	30.9	34.2
Overall balance	10.4	13.0	18.2	26.9	29.7
Overall balance (excluding investment income)	7.1	10.0	13.8	21.1	23.8
(Excluding hydrocarbon revenue)	-25.7	-22.9	-19.0	-17.3	-14.5
Financing	-10.4	-13.0	-18.2	-26.9	-29.7
Domestic banks	-3.1	-0.7	-0.5	-3.4	-2.5
Other	-7.3	-12.3	-17.8	-23.5	-27.2
Government debt 5/	5.3	6.7	8.4	9.5	9.1

Table 1. U.A.E. Selected Economic Indicators, 2002–06 (concluded)

	2002	2003	2004	Est. 2005	Proj. 2006
	(Changes in percent of intial stock of M2)				
Broad money (M2)	15.6	16.1	23.2	33.8	26.6
Foreign assets (net)	20.1	1.9	6.9	8.9	6.0
Domestic assets	-4.5	14.2	16.4	24.9	20.6
Of which:					
Claims on government (net)	-5.8	-1.3	-0.9	-6.6	-4.9
Claims on public sector enterprises	1.3	3.5	0.5	4.5	1.1
Claims on private sector	10.4	11.9	21.3	38.9	27.8
	(In percent per annum)				
Average interest rates					
Dirham (three month interbank)	1.9	1.2	1.6	3.9	5.2
Lending rate	6.8	5.8	5.9	7.4	8.6
	(In billions of U.S. dollars)				
External Sector					
Exports	51.8	66.8	91.0	118.8	155.6
Crude oil	16.6	22.1	29.6	43.5	60.8
Petroleum products	3.0	3.3	4.4	5.8	7.4
Gas	3.3	3.8	4.8	5.8	9.8
Non-hydrocarbon exports	10.6	14.1	18.3	22.4	25.6
Re-exports	18.3	23.4	33.9	41.3	52.1
Imports, f.o.b.	-37.5	-45.8	-63.4	-80.8	-99.5
Trade balance	14.2	20.9	27.6	38.0	56.1
Services (net)	-7.7	-9.1	-12.1	-15.1	-18.9
Income (net)	0.8	-0.1	0.2	2.0	4.7
Transfers (net)	-4.4	-4.7	-5.1	-5.8	-6.5
Private	-4.1	-4.4	-4.6	-5.4	-6.0
Official	-0.3	-0.3	-0.4	-0.4	-0.5
Current account balance	3.0	7.1	10.6	19.1	35.5
(In percent of GDP)	4.1	8.1	10.2	14.7	20.3
Overall balance	1.1	-0.2	3.5	2.5	3.5
Central Bank reserves	15.3	15.1	18.6	21.1	24.6
In months of imports	4.0	2.9	2.8	2.5	2.8
As percent of reserve money	223.5	181.8	176.7	176.4	181.1
As percent of short-term debt 6/	164.6	164.2	147.6	103.6	90.3
Total external debt 7/	16.7	16.5	22.6	36.5	48.9
(In percent of GDP)	22.4	18.7	21.6	28.1	28.0
Memorandum item					
Dirhams/US dollar (end of period)	3.6725	3.6725	3.6725	3.6725	3.6725

Sources: U.A.E. authorities; Bank for International Settlements (BIS); Organization for Economic Cooperation and Development (OECD); and Fund staff estimates.

1/ Crude oil output includes condensates, which are not subject to OPEC quotas.

2/ Includes refined products and liquid gas.

3/ Calculated using GDP at factor cost.

4/ Includes net loans and equity.

5/ Due to domestic banks; no official external debt is reported.

6/ Debt due within one year, from BIS/OECD statistics.

7/ Central Bank and commercial bank foreign liabilities, plus private non-banks (BIS source). The counterpart to this is partly reflected in the increase in foreign assets of commercial banks.

Table 2. U.A.E.: Balance of Payments, 2002–06

(In billions of U.S. dollars)

	2002	2003	2004	Est. 2005	Proj. 2006
Trade balance	14.2	20.9	27.6	38.0	56.1
Exports	51.8	66.8	91.0	118.8	155.6
Oil and products	19.6	25.4	34.0	49.3	68.2
Crude oil & condensates	16.6	22.1	29.6	43.5	60.8
Petroleum products	3.0	3.3	4.4	5.8	7.4
Gas	3.2	3.8	4.8	5.8	9.8
Non-hydrocarbon	10.6	14.1	18.3	22.4	25.6
Exports by Emirates	2.4	2.9	4.0	5.0	6.0
Free zone exports	8.3	11.3	14.3	17.4	19.6
Re-exports, of which: 1/	18.3	23.4	33.9	41.3	52.1
Non-monetary gold	1.9	2.0	2.3	2.3	2.4
Imports (f.o.b.)	-37.5	-45.8	-63.4	-80.8	-99.5
Imports by Emirates	-29.4	-35.4	-48.7	-63.6	-80.1
Free zones	-8.1	-10.4	-14.7	-17.2	-19.4
Income, net	0.8	-0.1	0.2	2.0	4.7
Banking system	0.5	0.4	0.6	1.47	2.2
Private non-banks	0.1	0.1	0.1	0.1	0.1
Government	2.2	1.9	3.8	6.7	10.4
Foreign partners - oil 2/	-1.9	-2.3	-4.1	-6.0	-7.6
Foreign partners - gas 2/	-0.2	-0.2	-0.2	-0.4	-0.4
Services, net	-7.7	-9.1	-12.1	-15.1	-18.9
Credits	2.6	2.8	3.0	3.1	3.5
Debits	-10.3	-11.8	-15.1	-18.2	-22.4
Transfers, net	-4.4	-4.7	-5.1	-5.8	-6.5
Private	-4.1	-4.4	-4.6	-5.4	-6.0
Official	-0.3	-0.3	-0.4	-0.4	-0.5
Current account balance	3.0	7.1	10.6	19.1	35.5
(In percent of GDP)	4.1	8.1	10.2	14.7	20.3

Table 2. U.A.E.: Balance of Payments, 2002–06 (concluded)

(In billions of U.S. dollars)

	2002	2003	2004	Est. 2005	Proj. 2006
Financial account balance	-7.3	-7.8	-8.4	-19.9	-31.9
Private capital	-1.9	3.9	10.2	10.6	15.7
Direct investment, net	3.1	3.3	7.8	7.1	4.2
Outward	-0.4	-1.0	-2.2	-3.8	-7.8
Inward	3.5	4.3	10.0	10.9	12.0
Portfolio securities	0.2	0.0	2.0	1.5	3.0
Commercial banks	-6.9	-1.1	-0.2	-3.4	-2.1
Private non-banks and other	1.7	1.7	0.6	5.4	10.6
Official capital 3/	-5.4	-11.7	-18.6	-30.5	-47.6
Errors and omissions	5.4	0.4	1.3	3.4	0.0
(As percent of GDP)	7.2	0.5	1.2	2.6	0.0
Overall balance	1.1	-0.2	3.5	2.5	3.5
Central Bank net foreign assets	-1.1	0.2	-3.5	-2.5	-3.5
Memorandum items:					
Overall balance (as percent of GDP)	1.5	-0.2	3.3	1.9	2.0
Gross reserves of Central Bank	15.3	15.1	18.6	21.1	24.6
(In months of imports) 4/	4.0	2.9	2.8	2.5	2.8

Sources: U.A.E. authorities; and Fund staff estimates.

1/ Not formally compiled; estimated at 40-50 percent of emirates imports.
2/ IMF staff estimates based on foreign partner share of oil and gas sector net profits.
3/ Includes changes in government external assets.
4/ Imports of goods and services in the next 12 months.

Table 3. U.A.E.: Consolidated Government Finances, 2002–06

(In millions of U.A.E. dirhams)

	2002	2003	2004	Est. 2005	Proj. 2006
Total revenue	66,086	84,079	110,574	163,955	216,093
Hydrocarbon	40,926	56,898	73,322	111,277	149,760
Non-hydrocarbon	25,160	27,181	37,252	52,678	66,332
Customs	1,663	2,458	3,040	3,846	4,418
Profit transfers	3,357	2,935	3,313	4,089	4,410
Income tax 1/	235	301	320	420	430
Fees and charges	6,429	6,479	6,327	8,145	10,417
Investment income 2/	8,869	9,881	16,863	27,669	38,063
Other	4,607	5,127	7,389	8,509	8,594
Total expenditure and grants	86,616	91,563	93,384	107,182	121,259
Current expenditure	72,426	74,255	79,536	88,147	92,638
Wages and salaries 3/	15,131	15,764	15,892	15,654	16,578
Goods and services	23,745	26,519	27,172	30,537	37,145
Abu Dhabi "federal services" 4/	17,045	19,198	23,533	22,431	23,458
Subsidies and transfers 5/	16,108	11,372	12,346	18,981	14,445
Other	397	1,402	593	544	1,011
Development expenditure	12,470	16,028	15,515	13,509	24,232
Loans and equity (net)	760	16	-2,308	4,499	3,280
Domestic 6/	592	-810	1,654	5,106	3,280
Foreign	168	826	-3,962	-607	0
Foreign grants 7/	960	1,264	641	1,027	1,109
Abu Dhabi	784	1,136	541	1,013	1,094
Federal	176	128	100	14	260
Overall balance (consolidated) 8/	-20,530	-7,484	17,190	56,773	94,834
(In percent of GDP)	-7.5	-2.3	4.5	11.9	14.8
Overall balance (incl. revenues from other government entities) 9/	28,368	42,198	70,052	128,175	190,655
(In percent of GDP)	10.4	13.0	18.2	26.9	29.7
Financing	-28,368	-42,198	-70,052	-128,175	-190,655
Resident banks, net 10/	-8,482	-2,269	-1,776	-16,039	-15,797
Loans to government	4,292	5,613	10,509	13,369	4,206
Government deposits	12,774	7,882	12,285	29,408	20,003
Of which: Privatization receipts 11/	...	3,004	2	6,207	0
Official foreign assets (- = increase) 2/	-19,886	-42,933	-68,278	-112,136	-174,858
Memorandum items:					
Non-hydrocarbon balance 12/	-61,456	-64,382	-56,132	-54,504	-54,926
(In percent of GDP)	-22.4	-19.9	-14.6	-11.4	-8.6
(In percent of non-hydrocarbon GDP)	-30.7	-28.0	-21.3	-17.3	-14.8
Non-hydrocarbon balance (excluding investment income)	-70,325	-74,263	-72,995	-82,173	-92,990
(In percent of GDP)	-25.7	-22.9	-19.0	-17.3	-14.5
(In percent of non-hydrocarbon GDP)	-35.1	-32.3	-27.7	-26.0	-25.1
Hydrocarbon share of revenue	78.1	79.7	77.2	77.6	78.7
Balance on pension fund operations 13/	1,653	3,593	3,582	3,558	...

Sources: Federal government; Emirate finance departments; and IMF staff estimates.

1/ Taxes on profit of foreign banks. Income taxes on gas companies are included under hydrocarbon revenues.

2/ Fund staff estimates.

3/ Excludes military wages and salaries.

4/ Largely military and internal security expenditures paid by Abu Dhabi but not in the federal accounts.

5/ Includes government's contribution to the pension fund in 2005 of AED 6,207 million.

6/ Includes government's share in the 2005 privatization of the telecom company, Etisalat

7/ Intragovernmental grants are netted out in the consolidated fiscal accounts.

8/ Consolidated accounts of the federal government, Abu Dhabi, Dubai and Sharjah.

9/ Fund staff estimates of ADNOC profits, other government entities and government domestic investments.

10/ From the monetary statistics.

11/ Abu Dhabi receipts from the sale of water and power assets.

12/ Non-hydrocarbon revenues less spending.

13/ Operations of the General Pension and Social Security Authority, which was established in 2000.

Table 4. U.A.E.: Monetary Survey, 2002–06 1/

End of Period	2002	2003	2004	2005	Proj. 2006
	(In millions of U.A.E. dirhams)				
Net foreign assets (NFA)	128,654	131,847	145,313	166,820	186,388
Foreign assets	166,960	167,255	194,654	253,177	301,213
Central Bank	56,229	55,518	68,546	78,149	91,180
Commercial banks 2/	110,731	111,737	126,108	175,028	210,034
Foreign liabilities	38,306	35,408	49,341	86,357	114,826
Central bank	284	349	548	1,142	2,342
Commercial banks 2/	38,022	35,059	48,793	85,215	112,484
Net Domestic assets	40,597	64,703	96,929	157,244	224,011
Claims on government (net)	-27,248	-29,517	-31,293	-47,332	-63,129
Claims	14,497	20,110	30,619	43,988	48,194
Deposits	41,745	49,627	61,912	91,320	111,323
Claims on public sector enterprises	7,122	12,990	13,884	24,797	28,517
Claims on private sector 3/	149,352	169,469	211,407	305,546	395,666
Capital and reserves (-)	-42,583	-46,063	-54,023	-79,692	-79,692
Other assets (net)	-46,046	-42,176	-43,046	-46,075	-57,351
Central Bank	-31,245	-28,416	-38,951	-47,798	-56,877
Commercial banks 2/	-14,801	-13,760	-4,095	1,723	-474
Domestic liquidity (M2)	169,251	196,550	242,242	324,064	410,398
Money	47,054	58,262	80,818	104,449	132,279
Currency outside banks	11,938	13,785	15,778	17,522	19,274
Dirham demand deposits	35,116	44,477	65,040	86,927	113,005
Quasi-money	122,197	138,288	161,424	219,615	278,119
Foreign currency deposits	39,612	47,980	62,496	73,804	88,565
Dirham time and savings deposits	82,585	90,308	98,928	145,811	189,554
	(Changes in percent of initial stock of M2, unless otherwise indicated)				
Memorandum Items					
Net foreign assets	20.1	1.9	6.9	8.9	6.0
Domestic assets	-4.5	14.2	16.4	24.9	20.6
Domestic credit (net)	5.9	14.0	20.9	36.7	24.1
Claims on government (net)	-5.8	-1.3	-0.9	-6.6	-4.9
Claims on private sector	10.4	11.9	21.3	38.9	27.8
Domestic liquidity (M2)	15.6	16.1	23.2	33.8	26.6
Money (percent change)	19.2	23.8	38.7	29.2	26.6
Quasi Money (percent change)	10.4	9.5	11.8	24.0	18.1
Domestic credit (in AED millions, net)	129,226	152,942	193,998	283,011	361,053

Sources: Central Bank of the U.A.E., and IMF staff estimates.

1/ Monetary survey is compiled in accordance with the residence principle.
2/ Including the restricted license banks.
3/ Includes non-bank financial institutions.

Table 5. U.A.E.: Selected Indicators of External Vulnerability, 2001–05

	2001	2002	2003	2004	2005
External solvency indicators					
REER (CPI-based, percent change, annual average)	4.1	-1.3	-6.9	-4.5	-0.7
Total external debt (in billions of U.S. dollars)	19.4	16.7	16.5	22.6	36.5
Short-term debt (BIS source; in billions of U.S dollars) 1/	8.8	9.3	9.2	12.6	20.3
Total external debt / GDP (percent)	27.9	22.4	18.7	21.6	28.1
Short-term debt/exports of goods and services (in percent)	17.6	17.1	13.2	13.4	16.7
Public sector solvency indicators (in percent)					
Overall fiscal balance/GDP	-0.4	10.4	13.0	18.2	26.9
Government domestic debt/GDP	4.0	5.3	6.7	8.4	9.5
Oil revenue/total revenue	71.6	78.1	79.7	77.2	77.6
Investment income/total revenue	12.3	7.7	7.4	10.3	11.8
Non-oil revenue (excl. investment income)/non-oil GDP	8.5	8.1	7.5	7.7	7.9
Non-oil balance/GDP	-26.9	-22.4	-19.9	-14.6	-11.4
External Liquidity Indicators					
Central Bank foreign assets (in millions of U.S. dollars)	14,288	15,311	15,117	18,610	21,064
In months of imports of goods and services	4.6	4.0	2.9	2.8	2.5
As percent of M1	133.0	119.5	95.3	84.6	74.1
As percent of short-term external debt 1/	162.4	164.6	164.2	147.6	103.6
As percent of commercial banks foreign liabilities 2/	104.3	147.9	158.4	140.1	90.8
Commercial banks' NFA (in millions of U.S. dollars) 2/	12,859	19,798	20,879	21,052	24,456
Foreign assets	26,554	30,151	30,425	34,338	47,659
Foreign liabilities 2/	13,695	10,353	9,546	13,286	23,204
Crude oil exports/total exports (in percent)	37.0	32.1	33.0	32.6	36.6
Financial sector indicators					
Foreign currency deposits/total deposits (in percent)	24.4	25.2	26.3	27.6	24.1
Net domestic assets (annual change in percent)	21.3	-14.0	59.4	49.8	62.2
Private sector credit (annual change in percent)	8.8	11.3	13.5	24.7	44.5
Private credit/total assets of banks (in percent)	47.4	47.3	48.2	48.9	50.2
Interest rate spread against U.S. dollar (in basis points) 3/	0.18	0.02	0.03	-0.07	0.31
Banking system indicators (in percent)					
Commercial banks' capital to risk-weighted assets ratio	19.8	19.0	18.6	16.9	17.4
Gross non-performing loans/total lending	15.7	15.3	14.3	12.5	8.3
Return on assets	1.9	1.9	1.9	2.1	2.7
Return on equity	15.5	16.2	16.8	18.6	23.0
Average interest rate spread (in percentage points) 4/	4.7	5.6	5.1	4.9	4.1

Sources: U.A.E. authorities; and IMF staff estimates.

1/ On a remaining maturity basis.

2/ Based on the residency principle.

3/ Spread between 3-month dirham interbank and 3-month U.S. dollar LIBOR.

4/ Spread between 3-month dirham time deposits and local currency business loans.

Table 6. U.A.E.: Medium-Term Baseline Scenario, 2005–11

	Est.	Proj.					
	2005	2006	2007	2008	2009	2010	2011
Crude oil production (millions of barrels per day) 1/	2.72	2.97	3.07	3.15	3.22	3.31	3.46
Of which: Condensates	0.34	0.37	0.38	0.39	0.40	0.41	0.43
Average U.A.E. oil export price (In U.S. dollars/barrel) 2/	52.60	67.25	70.25	68.75	67.50	66.25	64.25
	(In billions of cubic meters per year)						
Natural gas production and exports							
Natural gas production	46.4	47.8	49.2	50.7	52.2	53.8	55.9
LNG exports	7.5	7.6	7.7	7.8	8.0	8.1	8.3
NGL exports	13.4	13.8	14.2	14.6	15.1	15.5	16.2
	(Percentage change, except as noted)						
Nominal GDP (In billions of U.A.E. dirhams)	476.3	642.0	697.0	728.9	764.3	802.9	844.9
Real GDP (at factor cost)	8.5	10.7	5.8	5.5	5.4	5.6	6.0
Crude oil and natural gas 3/	2.1	11.0	3.5	2.5	2.5	2.7	4.5
Non-hydrocarbon 4/	11.0	10.5	6.6	6.5	6.4	6.5	6.4
Consumer prices	8.0	7.7	5.0	4.7	3.6	3.7	3.7
	(In percent of GDP)						
National saving	37.4	46.9	46.6	48.5	49.3	51.0	53.0
Government	30.9	34.2	34.5	33.6	31.8	31.1	30.5
Non-government	6.5	12.8	12.1	14.9	17.5	19.9	22.5
Gross domestic investment	24.4	26.6	27.4	29.7	30.9	32.4	33.9
Government	2.8	3.8	3.9	4.1	4.2	4.3	4.5
Non-government	21.6	22.9	23.5	25.6	26.7	28.0	29.4
	(In billions of U.A.E. dirhams)						
Consolidated fiscal accounts							
Revenue	235.4	311.9	338.2	347.9	350.3	362.8	376.1
Hydrocarbon	182.7	245.6	257.8	258.2	249.4	250.9	253.1
Non-hydrocarbon	52.7	66.3	80.4	89.6	100.9	111.9	123.1
Of which: Investment income	27.7	38.1	51.7	60.2	70.7	80.9	91.5
Revenue, (in percent of GDP)	49.4	48.6	48.5	47.7	45.8	45.2	44.5
Expenditure, *of which:*	107.2	121.3	129.6	137.2	144.8	152.8	161.4
Current	88.1	92.6	97.9	102.7	107.7	112.9	118.5
Development	13.5	24.2	27.1	29.9	32.2	34.8	37.6
Expenditure, (in percent of GDP)	22.5	18.9	18.6	18.8	18.9	19.0	19.1
Overall balance	128.2	190.7	208.6	210.7	205.5	210.0	214.8
(In percent of GDP)	26.9	29.7	29.9	28.9	26.9	26.2	25.4
Excluding hydrcarbon revenue and investment income	-82.2	-93.0	-100.9	-107.8	-114.6	-121.9	-129.8
(In percent of GDP)	-17.3	-14.5	-14.5	-14.8	-15.0	-15.2	-15.4
(In percent of non-hydrocarbon GDP)	-26.0	-25.1	-25.0	-24.8	-24.5	-24.2	-24.0
	(In billions of U.S. dollars)						
External Accounts							
Exports	118.8	155.6	163.8	168.8	174.4	179.3	184.6
of which : Crude oil and products	49.3	68.2	73.5	73.5	73.8	74.2	74.8
Imports, f.o.b.	-80.8	-99.5	-106.9	-112.6	-119.0	-124.1	-129.5
Services (net)	-15.1	-18.9	-20.3	-21.4	-22.6	-23.6	-24.6
Investment income (net)	2.0	4.7	7.3	10.0	12.9	15.8	19.0
Transfers (net)	-5.8	-6.5	-7.5	-7.5	-7.5	-6.5	-5.6
Current account balance	19.1	35.5	36.4	37.3	38.2	40.8	43.9
(In percent of GDP)	14.7	20.3	19.2	18.8	18.3	18.7	19.1
Central Bank reserves	21.1	24.6	28.3	32.0	35.8	39.9	44.3
(In months of imports)	2.5	2.8	3.0	3.2	3.4	3.6	3.8
External debt 5/ (in percent of GDP)	28.1	28.0	29.7	31.7	32.7	31.6	30.5

Sources: U.A.E. authorities; and IMF staff estimates and projections.

1/ Includes condensates, which are not subject to the OPEC quota.

2/ Based on April, 2006 WEO oil price projections.

3/ Crude oil output includes condensates. A large increase in condensates was planned for 2005.

4/ Includes refined oil products and liquid gas.

5/ Central bank and commercial bank foreign liabilities, plus private non-bank (BIS source). The counterpart to this is partly reflected in the increase in foreign assets of commercial banks.

United Arab Emirates: Fund Relations

(As of March 31, 2006)

I. Membership Status: Joined 9/22/72; accepted Article VIII status in February 1974.

II. General Resources Account:	SDR Million	Percent of Quota
Quota	611.70	100.00
Fund holdings of currency	541.98	88.60
Reserve position in Fund	70.32	11.50

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	38.74	100.00
Holdings	7.30	18.85

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Payments to Fund:

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal charges/ Interest	0.81	1.09	1.09	1.09	1.09
Total	0.81	1.09	1.09	1.09	1.09

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Exchange Rate Arrangement:

The U.A.E. dirham was officially pegged to the SDR at the rate of AED 4.76190 = SDR 1 from November 1980 to February 2002—albeit, in practice, it was pegged to the dollar at a fixed parity. Since then, in line with commitments agreed on with other GCC countries toward the adoption of a common currency in 2010, the U.A.E. dirham has become *officially* pegged to the U.S. dollar. The mid-point between the official buying and selling rates for the dirham has been AED 3.6725 = $1 since November 1997.

IX. Exchange System

The U.A.E.'s exchange system is free of restrictions on the making of payments and transfer for current international transactions, except for those restrictions that are yet to be notified to the Fund, by the authorities, in accordance with Executive Board Decision No. 144 (52/51).[1]

X. Article IV Consultation

The U.A.E. is on the standard 12-month consultation cycle. The last Article IV consultation discussions were held during March 16–30, 2005, and the staff report (IMF Country Report No. 05/269) and the Selected Issues and Statistical Appendix (IMF Country Report No. 05/268) were considered by the Executive Board on July 1, 2005.

XI. Technical Assistance:

STA	Multi-sector	June 1993
FAD	Government financial management	June 1994
STA	Data collection and balance of payments	December 1995
STA	Terms of reference and arrangements for resident advisor in balance of payments	April 1997
STA	International reserves	May 1998
FAD	Public Expenditure Management	November 2000
FAD	Public Expenditure Management follow up	May 2003
STA	Multi-sector	December 2003
MFD	Anti-Money Laundering/Combating terrorist financing	March 2004
STA	Coordinated Portfolio Investment Survey	April 2004
FAD	Revenue Diversification and VAT Feasibility	November 2005
FAD	Public Financial Management	November 2005
FAD	Gulf Cooperation Council: Options for Indirect Taxation	March 2006
FAD	UAE: Options for New Indirect Taxation and Intergovernmental Fiscal Relations	March 2006

XII. Resident Representative: None.

[1] The staff has sought clarification with the authorities whether they intend to notify under Executive Board Decision 144, measures taken in line with U.N. Security Council resolutions against terrorist financing (e.g., 1373), as these measures may give rise to exchange restrictions subject to Fund jurisdiction. The staff is also awaiting a notification from the authorities regarding whether restrictions on transactions with the Federal Republic of Yugoslavia (Serbia and Montenegro) pursuant to resolutions of the U.N. Security Council have been lifted.

United Arab Emirates: Relations with the World Bank Group

As of April 30, 2006

- **A Framework Agreement** for annual technical cooperation programs was signed in 1994. It replaced the previous arrangement based on ad-hoc requests. The first Annual Work Program of 1995–96 included two main studies—a Comprehensive Health Assessment Study and a study to restructure Government Information Authority, the Government's computer center.

- **Education sector, recruitment and welfare.** Three projects in these areas were completed in 2000: Public Expenditure Review for the Education Sector; Review and Assessment of Recruitment Procedures for the Federal government; and Analysis of Distribution of Welfare in Abu Dhabi.

- **Environmental Assessment.** In August of 2003, the U.A.E showed interest in Bank support for a U.A.E.-wide environmental assessment. A Bank needs-assessment mission visited Dubai early this year to develop the project concept.

- **Investment Climate**. In response to a request from the advisor to the Crown Prince of Ras Al Khaimah (RAK) for assistance in the area of Foreign Investment and Economic Development, a World Bank mission visited the emirate in late February 2004. Following discussion in RAK, the Bank team prepared TORs for the first of a four-phase program, and an agreement was signed in late March. The second phase consisting in an assessment of the investment climate in RAK was followed by an Investors' Promotion Conference in May 27–28, 2005 to increase awareness that this emirate could quickly develop as a serious contender for investment destination.

United Arab Emirates: Statistical Issues

1. While data provision to the Fund is adequate for overall surveillance purposes, data shortcomings have significantly affected the staff's analysis of some key issues in areas central to surveillance. Numerous shortcomings in the U.A.E.'s economic and financial data reflect inadequate compilation techniques, infrequent data reporting, shortage of trained staff, insufficient resources assigned to data gathering, and poor information flow between Federal and Emirate governments and public sector entities. As a result, provision of data to the Fund between missions remains poor, except for monetary and fragmentary trade statistics. In addition, the frequency of official statistics is inadequate—most data are produced only on an annual basis.

2. The U.A.E. has received several STA technical assistance missions over the past decade. The 2003 STA multisector statistics mission concluded that, while the methodology used to compile macroeconomic statistics is generally appropriate, serious deficiencies exist in most sectors.[1] These are attributable to the lack of sufficient and regular data sources in the real sector; inadequate coordination among the data compiling agencies; and constraints from distribution of personnel and financial resources between the Federal government and the largest Emirates. In response to the authorities' interest in participating in the General Data Dissemination System (GDDS), the 2003 mission worked with U.A.E. officials to prepare draft GDDS metadata. Due to the delay in appointing a GDDS coordinator, updates of the 2003 metadata will be required for GDDS participation. The U.A.E. hosted a GDDS workshop in Abu Dhabi during February 27–March 9, 2005.

Real sector

3. The Ministry of Economy (MOE) compiles an annual CPI, which is disseminated three months after the end of the reference year. A number of shortcomings exist with respect to the methodology of the CPI, including: (i) outdated weights that are not representative of all geographic regions; (ii) no imputations are made for missing price data; (iii) replacement product prices are not adjusted for changes in quality; and (iv) base price and expenditure weights refer to different periods. The MOE, in coordination with the Central Bank has plans to improve the compilation and frequency of the CPI. The MOE does not currently compile a producer price index, an import price or an export price index, which is a significant deficiency, given the role of the oil sector in the U.A.E.

4. The MOE compiles and disseminates annual estimates of gross domestic product (GDP) by production and expenditure approach in current and constant 1995 prices. The national accounts compilation system suffers from a number of deficiencies, including the lack of a comprehensive data collection program. Instead, the existing system relies heavily

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[1] United Arab Emirates: Report of the Multisector Statistics/GDDS mission, December 2003.

on administrative and other ad-hoc data collected by Federal and Emirate institutions. The data collected are mostly quantity data. The last benchmark data available for compiling output are from 1995, and 1980 for intermediate consumption. Basic data remain inadequate for manufacturing, construction, wholesale and retail trade, and most of the other service sectors. In particular, real value added for petrochemicals, which accounts for nearly half of total manufacturing value added, is not estimated according to the *1993 SNA* methodology. Instead nominal value added is deflated by an estimated import price deflator, as is done with real hydrocarbon value added. This methodology yields a purchasing power measure of petrochemical output, which may result in under or overestimation of volume growth, depending on changes in crude oil prices. Despite their importance in total GDP, oil and gas sector data are received with a lag from the Abu Dhabi National Oil Company (ADNOC). No national household budget survey has ever been conducted. In addition to the inadequate sources, the statistical techniques used in compiling GDP by production and expenditure approach are not sound.

5. Although labor statistics collected in the census are broadly in line with ILO recommendations, there are divergences from ILO definitions, including inconsistency of some concepts and irregular and incomplete updating of the census data. Lack of regular household surveys prevents compilation of annual data on basic national labor force statistics such as wages, unemployment, labor force and employment. Wage statistics are, for example, available only for a small proportion of government employees.

Fiscal sector

6. Principal deficiencies can be attributed to both the lack of coordination among the Emirates and Federal government, and the low frequency in reporting of government financial operations. The Ministry of Finance and Industry (MOFI) compiles data for the Federal government only. Separate fiscal data on the Federal government and three Emirates (Abu Dhabi, Dubai, and Sharjah), which are provided to the annual Article IV consultations, are employed by Fund staff to provide a consolidated fiscal account for the U.A.E. An annual, "consolidated" fiscal statement is published in the central bank's *Statistical Bulletin*, which is different from the Fund staff presentation. Most notably, investment income from government assets is not included in the fiscal account. In addition, key information, such as investment income, and expenditure under the control of the respective Rulers' Offices and municipalities, remains off-budget in some Emirates, hindering comparison of fiscal developments across the Emirates and the Federal government. International standards of economic classification of expenditure and revenue are not fully followed.

7. The last data reported to STA for publication in the *Government Finance Statistics Yearbook* were for 1999 and covered only the Federal government. No financing information is provided by either the Federal authorities or any of the Emirates. No sub-annual data are reported for publication to the IMF's *International Financial Statistics* (IFS). Information on pension fund activities administered by the authorities through the Federal-level General

Pension and Social Security Authority (GPSSA) has been available since the 2002 consultation mission.[2]

Monetary sector

8. Until recently, the principal issues in monetary statistics were limited to the classification and sectorization of loans to the corporate, other resident, and non-resident sectors. Starting in mid-2001, however, the Central Bank of the U.A.E. (CBU) changed the method for compilation of banking data, such that deposits of U.A.E. residents booked in overseas branches/subsidiaries of locally incorporated banks were included in the measure of broad money, and cross border flows back to head offices were treated as "domestic."[3] The rationale behind this change, as explained by authorities, was their observation that almost all of the funds deposited in the overseas branches (to circumvent the reserve requirement) almost instantly found their way back into the domestic banking system. The compilation introduced in mid-2001 does not follow internationally accepted standards that are based on the residency principle. In 2005, the authorities reverted to the publication of monetary data based on the residency principle.

9. The 2003 STA multisector mission recommended that two sets of data be compiled—a core set for monetary reporting purposes and a supplementary data set that meets other objectives of the authorities. The multisector mission also recommended: that lags in monetary statistics, which are compiled monthly, but reported only quarterly, be reduced; full coverage of IMF accounts; further sectorization of financial transactions, in particular of various Emirate government accounts, that are currently reported in aggregate form; and further instrument classification of foreign securities and domestic investments into bonds, shares, and other equities.

External sector

10. Balance of payments (BOP) statistics suffer from a lack of primary data sources for most transactions. Staffing for BOP compilation is insufficient, and cooperation from other government agencies remains negligible. Many entries are estimates based on incomplete information and some important transactions, such as foreign direct investment (FDI), are not covered at all and only estimated by Fund's staff. There are major gaps in official and private transfers, oil companies' service payments, private and official investment income, and financial transactions for all sectors except banks. Progress in addressing these shortcomings

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[2] The GPSSA was established in January 1999 to provide pension and social security insurance benefits to all nationals working in the government and the private sectors (except Abu Dhabi government employees which have their own separate pension fund).

[3] The compilation initially introduced a bias into banking statistics, especially net foreign positions of commercial banks, of about AED 20 billion. Balance of payments flows are also compromised, because these statistics are the source of banking flows in the BOP accounts.

continues to be hampered by staffing limitations in the compilation unit, inadequate inter-agency cooperation, and other restrictions on the CBU with respect to collection of data from individuals and institutions other than the banking sector. The U.A.E. does not report BOP data for publication in the IMF's *IFS* (with the exception of trade statistics, which have been irregular at best), or the *Balance of Payments Statistics Yearbook (BOPSY).*

11. The 2003 STA multisector statistics mission provided recommendations to address these problems. These include the introduction of a comprehensive data collection system, the review of source data and compilation methods for important items such as trade and services, and the strengthening of the human resources for compiling departments in the CBU. Furthermore, the mission encouraged the CBU to start reporting time series data on the balance of payments, as well as methodological notes, to STA for publication in the *IFS* and the *BOPSY*. The authorities publish and provide data to Fund missions on banking system foreign assets. Detailed information on central bank reserves and foreign currency liquidity is available. Commercial bank data are also reported. These data are disseminated on a monthly basis. Since 2000, the authorities in the Emirate of Abu Dhabi have provided to Fund staff, during Article IV consultation missions, approximate information on the Emirate's stock of external assets. During 2004-06 Article IV consultations, details on the stock of official foreign assets of the government were provided.

12. The authorities do not compile or publish the International Investment Position (IIP) statement, despite ready availability of certain potential sources, such as banking and government statistics. Also, no data on FDI or private nonfinancial sector external assets and liabilities are collected—although, according to BIS statistics the U.A.E.'s external liabilities are relatively small.

Socio-demographic statistics

13. The U.A.E. follows the practice of many other countries, with the MOE taking the lead in conducting the population census and large surveys, while line ministries collect data through their administrative reporting systems. As in other countries, a population and housing census is conducted every 10 years. The 2005 population census has been completed but results are yet to be published. At present, no data exist on measures of income distribution, poverty and access to basic services. A Household Budget Survey has been initiated and is expected to be completed by the end of 2006.

United Arab Emirates: Table of Common Indicators Required for Surveillance

As of May 11, 2006

	Date of Latest Observation	Date Received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]
Exchange Rates	04/06	05/06	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	02/06	03/06	M	M	M
Reserve/Base Money	02/06	03/06	M	Q	Q
Broad Money	02/06	03/06	M	Q	Q
Central Bank Balance Sheet	02/06	03/06	M	Q	Q
Consolidated Balance Sheet of the Banking System	02/06	03/06	M	Q	Q
Interest Rates[2]	02/06	03/06	M	Q	Q
Consumer Price Index	2005	3/06	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	3/06	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2005	3/06	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2005	3/06	A	A	A
External Current Account Balance	2005	3/06	A	A	A
Exports and Imports of Goods and Services	2005	3/06	M	A	A
GDP/GNP	2005	3/06	A	A	A
Gross External Debt	...	...	...	...	...

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Financial Sector Developments in the United Arab Emirates

Overview

1. This appendix examines trends in financial soundness indicators and recent developments in the banking system; and developments in capital market regulations and supervision, as well as related staff's recommendations. It also discusses developments in the Dubai International Financial Center and updates the status of the 2001 FSAP mission recommendations.

Banking sector

2. **The banking sector's balance sheet and profits increased substantially in 2005**. Led by robust growth in deposits and credit, the overall size of banks' balance sheet increased by 40 percent to AED 608.5 billion ($166 billion). Government deposits in the banking sector increased by 54 percent. The overall rate of return on assets averaged 2.7 percent and the rate of return on equities increased to about 23 percent.

3. **Banks' exposures to the booming real estate sector and equity market increased substantially.** Lending to the real estate sector, excluding mortgages increased to 12 percent of total credit from 10 percent in 2004. The share of banks' direct lending to the equity market increased to about 6 percent of total credit from just slightly over 1 percent in 2004. Indirect lending through personal loans, however, could be higher.

4. **Banks' profits more than doubled to $5.1 billion during 2005**. Non-interest income, excluding income on foreign exchange, increased by over 112 percent, comprising about one third of total banks' income. Most of this increase was driven by fees and commissions on IPO subscriptions, and income generated from banks' investment in the equity market. IPO financing through margin lending also provided the banks with ample non-interest-bearing cash for considerable periods of time.[1]

5. **Macro-prudential indicators of the banking sector remained strong in 2005.** The capital-assets ratio (CAR) increased slightly to 17.4 percent. The ratio of nonperforming loans (NPL) to total loans declined to 8.3 percent and provisions were considerable. On an aggregate basis, banks complied with the CBU's prudential norms. Maturity mismatches grew, however, since lending for infrastructure and construction projects are of a long-term nature and the average maturity of deposits is only three months. While banks have a substantial long dollar position, foreign exchange risk is limited by the government's credible commitment to a dollar peg. Non-dollar exposures are small.

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[1] The CBU regulations set a maximum margin lending ratio of 5 to 1. Investors can also apply for credit collateralized by securities and other assets to use for IPO subscription.

Capital market regulations and supervision

6. **The capital markets in the U.A.E. are regulated by a number of entities.** The CBU is responsible for licensing and authorizing banks and non-bank financial intermediaries,[2] including brokers and investment companies. The Ministry of Economy (MOE) is responsible for implementing the Company Law, corporate governance standards for issuers, prospectus disclosure requirements and the pricing of IPOs. The Emirates Securities and Commodities Authority (ESCA) licenses intermediaries to trade on the two stock exchanges, Abu Dhabi Stock Market (ADSM) and Dubai Financial Market (DFM),[3] and the Dubai Gold and Commodity Exchange (DGCX). The two stock markets act as self-regulatory organizations,[4] authorize firms to trade on their respective exchanges, set listing standards, and accept listings of public company securities.

7. **The CBU's licensing requirements for investment companies and brokers dates from the mid-1990's**. The corporate law follows a pattern established in the UK in the 1920s and contains provisions regarding capital structure that may hamper the development of publicly traded companies. For example, new issues of equity securities require prior shareholder approval and shares can only be issued at a premium to their nominal value, regardless of current market price, with the consent of the MOE. Beyond a licensing regime for investment companies, there is no framework in place to govern the formation and operation of or disclosure by collective investment schemes (CIS).

8. **The responsibilities of regulatory agencies need to be clearly defined.** In particular, the law should give the regulatory authorities clear powers to set and enforce comprehensive prospectus requirements and corporate governance standards for public companies. Responsibility for licensing investment companies and brokers should be consolidated in one authority, which should also be responsible for establishing and enforcing initial (prospectus rules) and continuous disclosure requirements for public companies. As the ESCA's capabilities improve, responsibilities for securities oversight, including the regulatory role related to rules for IPOs and CISs should be transferred from the CBU to the ECSA.

9. **The authorities will need to develop and implement a comprehensive regime to govern the operations of CISs**. Also, the CBU should begin collecting statistical information on mutual funds. All regulatory authorities should build sufficient capacity to

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[2] As of end-2005, non-bank financial institutions include 102 money changers, 53 representative offices of foreign banks, 8 investment companies, 7 finance companies, 32 financial intermediaries (such as brokers), 12 financial consultants, and 33 electronic banking units.

[3] All public companies are required to be listed on one of these exchanges.

[4] The term self-regulatory organization refers to organizations that have some self regulatory functions, such as setting their own listing rules. In the UAE, the markets have not been specifically delegated this authority by the ESCA.

ensure that their staff have the right skills to carry out their mandate effectively. Although both the ESCA and the exchanges have investor education programs, the government should lend its support for an expansion of these programs.

10. **The MOE establishes the price of IPOs for both state-owned and private companies.** The price is set at the nominal value of the company's shares rather than through an accurate assessment of the company's fair market value. The MOE is also involved in the pricing of subsequent offerings by public companies. The MOE controls issuers' access to the market by accepting or rejecting applications for issues by companies. As a result, prices are set artificially low, this contributed to increased market volatility, unreasonable expectations of retail investors, and has deprived enterprises of the full value they should be getting for funds raised in the capital market.

11. **The Company Law needs to be amended with respect to the pricing of the public issues of securities.** Subscription prices for new offerings should be set by the market through professional underwriters based on an appropriate valuation of the company. Also, intervention in pricing of subsequent offerings by currently listed companies should be restricted to a limit on the discount of the market price. Rationing of subscription allotments may no longer be necessary once IPOs have been priced appropriately and according to the true value of the company. Also, the authorities should only permit IPOs for companies that have had audited balance sheets for at least two years.

12. **Public floating of securities needs to be increased to promote deeper and liquid markets**. In a deep market, large blocks of stocks can be traded quickly without unduly affecting the market price of the stocks. A wide distribution of shares among a large number of active traders helps increase liquidity. In the U.A.E., many public companies with significant numbers of shares outstanding have relatively few shareholders. The high government participation in the ownership of the shares of public companies has also resulted in fewer shares being available for trading in the market. Moreover, requirements that force founding shareholders to subscribe to a significant portion of a company's equity for long periods of time have resulted in few shareholders holding a significant number of shares outstanding. Finally, the pre-emptive rights of existing shareholders to subscribe pro-rata on any new issue reduces the opportunity for wider ownership of these companies.

13. **The participation of long-term institutional investors in the securities markets is low.** Retail investors represent a very high percentage of investors in the U.A.E. market. The estimated participation rate for retail investors varies from 60 percent to 90 percent of the market.[5] Impediments to market investments by insurance companies, collective investment schemes and pensions funds should be eliminated. Institutional investors that have a limited

[5] In contrast, retail investors represent about 50 percent of investors in the United States and less than 25 percent of the investors in Canada.

need to liquidate securities to fund redemptions, such as closed-end funds, can provide additional stability in volatile markets.

14. **The markets would benefit from the introduction of market stabilization mechanisms, such as market maker mechanisms and hedging instruments that can provide liquidity and allow investors to manage their risks more effectively.** Market maker mechanisms stand ready to trade securities if there are imbalances in the offers to buy or sell. These mechanisms help stabilize prices at times where there are significant buying or selling pressure. The rules of the new DGCX require the appointment of market maker mechanisms. The DFM and the ADSM should be encouraged to introduce the same. ESCA should upgrade its staff capability in order to monitor effectively such mechanisms. Moreover, the development of exchange-traded hedging instruments such as options should be facilitated so that market risks can be managed more effectively.

15. **In the U.A.E., multiple margin rates are set for the same publicly traded security based on the nature of the loan.**[6] In recognition of the volatile nature of this type of collateral, the market value of the securities is discounted by a percentage. However, multiple margin rates are applied to loans depending on the nature of the loan. Also, the discount applied is low, particularly for subscriptions for IPOs, where banks are permitted to lend up to five times the amount contributed by the borrower.[7] The multiple margin rates should be replaced by a single rate for each class of securities. The risk in the value of the collateral varies based on the nature of the collateral, not the loan for which it is pledged. Also, the maximum loan value that can be given for most liquid traded stocks should be set at 50 percent, similar to the margin rate provided in major international markets, such as those in New York and London. Consideration should also be given to setting a more conservative rate for less liquid stocks. The new rates could be introduced incrementally in order to avoid a credit crunch and margin calls in the market.

16. **Regulations on corporate governance needs to be amended.** ADSM is in the process of consulting with market participants about a corporate governance code for listed companies. The necessary resources need to be allocated to complete these corporate governance initiatives on a priority basis.

Dubai International Financial Center

17. **The DIFC has established its own set of civil and commercial laws, courts, and an arbitration system built on the common law of the UK.** Only the criminal laws of the

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[6] In the U.A.E. margin loans are available to finance the purchase of securities and are secured by a pledge of the assets purchased. Marketable securities may also be pledged to a lending institution as collateral to secure other types of loans.

[7] Until 2005, this limit was 50 percent that is, half the value of the purchase would have to be contributed by the subscriber.

U.A.E. apply within the DIFC. The Dubai Financial Securities Authority (DFSA) has entered into memoranda of understandings (MOU) with the UK's Financial Services Authority, the U.S. Commodity Futures Trading Authority, and the ESCA in the U.A.E. The DIFC is in discussions about entering into an MOU with the CBU.

18. **Considerable progress has been made with respect to the regulatory framework governing the DIFC, and an extensive set of laws have been created based on best international practices.** As of mid-February 2006, 160 companies and 40 financial institutions have been granted licenses to operate within the free zone. However, the actual volume of business conducted at the DIFC is still small. By design, its operations are intended to be segregated from those of the financial markets in the rest of the U.A.E. Banking operations are confined to institutional wholesale banking, with both deposit taking and lending in dirham prohibited.

19. **In the event that some of the operations of the U.A.E. banks that are currently taking place in the domestic markets migrate to the DIFC**, a working relationship with the CBU will be very important. The agreement between the two authorities should provide for information sharing arrangements and detail how the actual supervision, risk management and capital management of banks will be carried out. The opportunity for financial innovations to exploit regulatory arbitrage and produce shifts of funds between the DIFC and the U.A.E will depend on the specifics of regulations and operations and will require careful monitoring.

Table 1: United Arab Emirates: Financial Sector Indicators

	2001	2002	2003	2004	2005
Core indicators					
Deposit-taking institutions					
Regulatory capital to risk-weighted assets	19.8	19.0	18.6	16.9	17.4
Regulatory Tier I capital to risk-weighted assets 1/	19.6	18.6	18.2	16.3	16.9
Nonperforming loans net of provisions to capital	10.5	9.6	7.7	3.5	1.9
Nonperforming loans to total gross loans	15.7	15.3	14.3	12.5	8.3
Return on assets	1.9	1.9	1.9	2.1	2.7
Return on equity	15.5	16.2	16.8	18.6	22.5
Interest margin to gross income	73.7	69.9	59.5	64.6	49.3
Noninterest expenses to gross income	34.0	38.7	43.6	40.3	26.9
Liquid assets to total assets	31.8	28.1	22.7	23.2	26.9
Encouraged indicators					
Deposit-taking institutions					
Capital to assets	11.9	11.8	11.4	11.1	8.3
Personnel expenses to noninterest expenses	30.3	31.6	29.5	38.6	41.8
Customer deposits to total (non-interbank) loans	72	76	80	88	89
Households					
Household debt to GDP	6.1	6.7	6.6	6.1	6.9
Real estate loans to total loans	7.1	7.2	5.4	4.7	5.0
Other indicators					
Loan loss reserves/non-performing loans	87	87.5	88.5	94.6	95.7
Deposits as percent of M2	92.8	92.9	93.0	93.5	79.8
Commercial banks loans to private sector as percent of total deposits	98.7	94.9	92.7	93.4	76.8
Number of commercial banks (end-of-period)	46	47	47	46	46
Number of banks with C.A.R. above 10 percent	46	47	47	46	46
Spread between 3-month interest rate on local currency deposits and loans	4.7	5.6	5.1	4.9	5.0
Maximum spread between 3-month local currency interbank rates for different banks (in basis points)	6.0	6.1	6.2	6.2	6.2
Foreign currency deposits as percent of M2	22.6	23.4	24.4	25.8	28.1
Foreign currency denominated lending/total lending	23.2	23.7	23.9	20.7	19.7
Total expenses to total revenues	38.3	38.3	38.6	35.9	58.5
Earning per employee (in millions of AED)	0.35	0.37	0.4	0.5	0.7

Source: Central Bank of the United Arab Emirates

1/ BIS Tier I plus Tier II Capital (net of deductions).

FSAP recommendations[8]

Table 2: Update of FSAP Recommendations

Recommendation	Status
Banking Supervision	
(1) The supervision of groups containing both banks, insurance companies and securities firms should be enhanced by having regular contact between the CBU and insurance supervisor and securities regulator, and by ensuring that the CBU has assured access to the prudential returns of insurance companies in such groups. (Core Principle (CP) 1(6)).	*Still under discussion.* A dialog is ongoing to determine how best to address this recommendation.
(2) The new securities legislation requires the CBU to pre-approve holdings exceeding 5 percent in listed banks. Procedures for such pre-approvals should be established within the CBU. The principle of pre-approval should also be extended to non-listed banks. (CP 4)	*Partial progress.* There are no procedures to pre-approve holdings in listed banks in excess of 5 percent. The draft banking law extends the principle of pre-approval to non-listed banks.
(3) The CBU should issue guidelines or circulars requiring banks to have adequate policies and procedures for the identification, measurement and control of market risk (CP 12) and should introduce explicit requirements for banks to have a comprehensive risk management process to identify, measure and control material risks. (CP 13) (A pilot study on risk-based supervision that is now under way, may establish the basis for the CBU providing guidance in these areas.)	*Informal progress only.* No guidelines or circulars have been issued to address market risk in this context or require banks to have a comprehensive risk management process. However the CBU is in the third year of its risk-based supervision, in which they examine a bank's credit risk, operational risk, and market risk and how the bank implements policies to address them.

[8] United Arab Emirates: Financial System Stability Assessment (IMF Country Report No. 03/20).

Recommendation	Status
(4) Off-balance sheet items and inter-bank exposures to U.A.E. banks with maturities of less than 12 months should be included in the definition of large exposures. (CP 9)	*Not yet implemented.* This issue is most relevant in the case of import guarantees and guarantees for large construction projects. In the case of import guarantees, the authorities indicate that the banks would be protected because they could seize control of the goods in case of nonpayment. In the case of construction, the banks are partly protected by the practice of requiring certification before any contractor receives a payment, and enforcing this restriction would be infeasible since it would create a major obstacle to development in the construction industry.
(5) Members of a bank's staff who report suspicious transactions in good faith to the compliance officer of the CBU should be protected from being held liable (protection is included in the draft Banking Law). (CP 15)	*Completed.* Federal Law no. 4 of 2002 (regarding the criminalization of money laundering), Article 20 addresses this.
Securities	
(1) Work to eliminate the current state of market confusion which exists as a result of the ESCA's delay in fully commencing operations.	*Completed.* ESCA is fully operational.
(2) Rationalize the regulatory responsibilities of the ESCA, the CBU, the MOE, and the securities markets as soon as possible, and effectively communicate the results to the markets.	*Groundwork has been laid.* There is an expectation that ESCA will gradually undertake more responsibilities, but this shift cannot take place until the ESCA builds up its staff and capacity, which is an ongoing process. Under the law the ESCA has supervisory responsibility for brokerage houses, listed companies, and the two stock exchanges. It should also have responsibility for investment companies, mutual funds, IPOs, and nongovernment pension funds (which do not yet exist, but are envisioned). An ordinary broker may only deal with U.A.E. listed securities. A broker who wants also to deal with international securities has to be licensed by the Central Bank.

Recommendation	Status
(3) The ESCA should expeditiously commence its staffing exercise (the adequacy of qualified staff will greatly enhance the perception of market integrity).	*Good and ongoing progress.* Increases in staffing and training have been ongoing. Training is provided locally, in the GCC region, and outside the region.
(4) The two securities exchanges (Abu Dhabi and Dubai) should establish an electronic trading/clearing linkage as required under the law as soon as possible (this will contribute to both market efficiency and integrity).	*Completed.* There is an electronic trading linkage. There is no clearing linkage, but according to the authorities this is not required by the law. Companies are not cross listed on the exchanges. There are plans to completely merge the two exchanges. Both exchanges now settle on a T+2 basis.
(5) Significant effort should be expended to develop the corporate debt market and increase the participation of nonbank financial institutions such as pension funds, insurance companies, and mutual funds.	*Progress is underway*. The ESCA plans shortly to issue a set of rules on the listing of bonds. A committee that includes all banks in the region has been established to develop bond markets in the region.
(6) Improvements should be made to the corporate governance environment including minority shareholder protections.	*Not implemented.*
Transparency	
(1) Transparency could be improved if all financial sector regulators and supervisors were more active in seeking stakeholders', including the private sector, inputs when they are contemplating changes in laws, regulations, technical requirements, policies, or otherwise.	*Good progress.* All banks reported that they have good, continual communication with the CBU. Whenever changes in laws, regulations, technical requirements, or policies are contemplated their input is sought.

Recommendation	Status
Legal reforms	
(1) Enact the proposed amendments to the companies legislation and make provision for improved minority shareholder rights, better corporate governance provisions and simplified company formation procedures. Improve operation of and accessibility to the Company Register.	*Progress is underway.* The authorities are currently drafting a new banking law and a new company law, both of which address corporate governance and minority shareholder rights.
(2) Improve registration procedures for movable property and create mechanisms for the registration of non-possessory pledges.	*Good and ongoing progress.* Registration procedures for many types of movable property have been improved. No information was provided on non-possessory pledges.
(3) Simplify the law relating to the ownership, transfer, and charging of real estate. Improve operation of the Land Registry and make it freely and fully accessible to the public.	*Good and ongoing progress.* Foreigners are now allowed to own land in Dubai and there are plans to allow this in all the Emirates. The Land Registry is freely available and fully accessible to the public.
(4) Enact the proposed amendments to the Banking Law, including the proposed anti-money laundering provisions.	*Good and ongoing progress.* Several key laws have been passed, including Federal law #4 of 2002 on anti-money laundering, Federal Law #1 of 2004 which addresses combating the financing of terrorism, and Federal Law #8 of 2004 which addresses AML/CFT in the financial free zone. Work continues on the new banking law, which has not yet been enacted.
(5) Consider introducing an accelerated and simplified procedure for the handling of small value claims, e.g., claims under AED 50,000.	*No progress.*

Recommendation	Status
Insurance	*Some progress.*
(1) Increasing the staff of the Insurance Division of MOE to include more individuals who possess the skills necessary to carry out off-site analyses and on-site inspections. In addition, an appropriate official should be appointed as the U.A.E. Insurance Commissioner.	There is an ongoing process of hiring and training new staff. The creation of an independent authority for the supervision of insurance—which it was hoped would be completed by end-2004—is still-envisioned. Once a new Authority is in place the relevant staff of the MOE would be transferred to it.
(2) Carrying out a full review of the insurance law and regulations with a view to bringing it up to current best practice, while allowing for the unique U.A.E. context. In the interim the proposed amendments to the insurance law should probably be held back. In particular a formal study of the capital requirements and investment risks for foreign branches is highly desirable.	*Not yet implemented.* No comprehensive study of the insurance law and regulations has taken place. However, gradual improvements have been ongoing. Two Ministerial decrees have been issued in recent years; one to improve transparency, and another to allow foreign entry into the insurance market. Amendments to the law in order to bring it into line with international standards are still envisioned.
(3) Reviewing the constraints inhibiting industry rationalization, with a view to making it more desirable for domestic companies, and easier for foreign branches to merge. In addition, where insurers are engaged in regional rather than local market activities there may be grounds for easing the rules on work visas and other requirements for non-nationals, although this would have to be tightly monitored.	*Progress is unclear.* No specific legislation has been enacted. Review of constraints to rationalization or work visas has taken place only at a low level.
(4) Developing a deeper and more liquid market for local property and securities by allowing some portfolio investment in key sectors by foreign insurers operating in the domestic market. This would encourage further development of local currency denominated investment and savings products, including Takaful. To ensure local participation in a growing life insurance industry joint ventures could be allowed (or required), for foreign involvement in local markets.	*Limited progress.* There has been no specific progress on legislation. Publicly traded companies have gradually been allowing more foreign investment, though this is at their initiative. The upcoming free trade agreement with the United States and compliance with the WTO will require greater openness.

Recommendation	Status
Payment system	
(1) The CBU should review its procedures for providing overdrafts and implement a system whereby the CBU only lends to banks against proper collateral. Publication of its overdraft procedures could also be considered.	*Partial progress.* Lending is still made without requiring proper collateral, but the amount of the loan cannot exceed reserves on deposit with the CBU, so the loan can be recovered by seizing required reserves. Such loans are for a maximum of six days and a penalty interest of five percent over the three-month interbank rate is applied. These rules for overdrafts are publicly disclosed in a circular on the internet. The amounts of the overdrafts are not publicly disclosed.
(2) To prepare for increases in transaction volume and reduce reliance on manual procedures, the CBU should consider greater automation and computerization of the existing systems. In the interim, it could also consider limiting the value of different types of transfers—a minimum amount for a Telex Transfer and a maximum amount for a check.	*Completed.* Automation and computerization have moved forward at a fast pace. Telexes are no longer used for any transfers. All transfers are made electronically and there is no need for any limits on different types of transfers.
(3) In the medium term, a move to a more advanced automatic system that would give the payment system both increased capacity and greater protection from operational risks. This might include moving from a T+1 system for check settlement to same day settlement. Consideration should also be given to the risks involved with the introduction of the new real time gross settlement system that would replace the Telex Testkey System.	*Good progress.* Automation and computerization have been expanded. Telexes are no longer used for any transfers.

Statement by IMF Staff Representative
June 12, 2006

This statement provides information on recent developments in the U.A.E. that has become available since the staff report was circulated to the Executive board on May 25, 2006. The new information does not change the thrust of the staff appraisal.

Recent economic developments

1. During January-April, 2006, credit to the private sector increased by 10.8 percent and broad money increased by 8.1 percent. At end-May, the U.A.E. increased diesel prices by 2.3 percent to 8.90 dirham ($2.43) per gallon.

Capital markets related issues

1. As of June 7, the Abu Dhabi Securities Market (ADSM) and Dubai Financial Market (DFM), respectively, declined by about 41 percent and 62 percent from their peaks in November 2005.

2. In May, the Central Bank of the U.A.E. (CBU) issued a circular to commercial banks requiring them to report their exposure to the equity markets and instructed them to provide full details on their outstanding loans to both institutional and individual investors. Also, in May, the CBU issued a circular that increased the ceiling for loans extended by banks against pledges of shares of companies which have been in operations for more than 5 years. The ceiling was raised from 70 percent to 80 percent of the market value of these shares.

3. Recently, the cabinet approved new rules allowing companies to buy back up to 10 percent of their own shares. Previously, companies could only buy their own shares if the shares fell below book value. The federal government is currently in the process of amending the Company Law. Under the amended law, the existing regulation that requires private businesses to float a minimum of 55 percent of their shares to become a public joint stock company will be reduced to 30 percent. This change is expected to encourage more companies to go public.

4. The authorities agreed to an FSAP Update. This will include a full assessment of the capital markets in the U.A.E; and the legal regime of the Dubai International Financial Center and the Dubai Financial Service Authority. Developments in the banking sector will also be assessed.

5. In April, the cabinet approved amendments to the Commercial Agency Law. The two main amendments include setting the ceiling for ownership of nationals in publicly traded insurance companies at 75 percent, and requiring the two stock markets, ADSM and DFM, to convert to public joint stock companies. Recently a decree was issued to form a committee to transform the DFM into a public joint stock company.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with the United Arab Emirates

On June 12, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Arab Emirates.[1]

Background

An outward-oriented development strategy and prudent financial policies have resulted in impressive economic growth over the years and have led to a large accumulation of external financial assets. This success has been underpinned by Abu Dhabi's prudent management of its oil wealth and Dubai's strong push for economic diversification. All indications are that the liberal economic policies followed thus far will be broadened and accelerated in the period ahead. Strong economic fundamentals and a pro-business approach to economic management are resulting in high levels of domestic and foreign investment in the manufacturing, services, and real estate sectors. These dynamics bode well for the economy's medium-term growth prospects.

Economic growth has been impressive, reflecting sharply higher oil prices, increased oil production, strong investor confidence, and a significant increase in foreign direct investment. Preliminary data for 2005 indicate that real nonhydrocarbon GDP grew at 11 percent, while the hydrocarbon sector registered a growth rate of 2.1 percent. Growth was broad-based with most sub-sectors growing at historically high rates, especially in manufacturing, real estate and construction, and trade. However, inflation has been on the rise, driven by the strength of domestic demand, a hike in gasoline prices and a significant increase in the prices of non-

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

tradables such as rents and services. Both the external current account and overall consolidated fiscal balances are estimated to have recorded large surpluses in 2005 (14.7 percent and 26.9 percent of GDP, respectively). The nonhydrocarbon deficit (excluding investment income) narrowed by 1.7 percentage points of GDP, to 17.3 percent. The broad money stock rose by 34 percent, mainly on account of a rapid increase in private sector credit.

In 2005, Abu Dhabi's budget improved markedly owing to high oil prices and moderate expenditure increases. Its work force was reduced by about 8,000 workers (14.5 percent) because some services previously provided by the municipality were outsourced to the private sector. The two other key emirates, Dubai and Sharjah, maintained their policy of executing budgets that are largely in balance. However, Dubai's budget does not provide a comprehensive picture of its fiscal accounts. Considerable fiscal operations continue to be carried outside the budget, and information about these operations is currently not available. The public sector across the U.A.E. is undergoing a major shift to restructure and outsource many activities to the private sector.

The equity markets, after having risen significantly since 2004, have had a sharp correction since their peaks in November 2005. The sharp corrections in the U.A.E. bourses were due to market overvaluation and the liquidation of existing positions to fund subscriptions for Initial Public Offerings (IPOs). The high demand for IPOs was in turn the result of a policy of underpricing them.

The banking sector in the U.A.E. remains strong, bolstered by effective supervision, but the fast growing capital markets and nonbank financial institutions pose new regulatory challenges. Overall, the capital-asset ratio increased slightly to 17.4 percent, while the ratio of nonperforming loans (NPL) to total loans declined and provisions were considerable, bringing the net NPL ratio below 2 percent. The share of banks' direct lending to the equity market increased to about 6 percent of total loans in 2005 from just slightly over 1 percent in 2004. The U.A.E. authorities, are taking steps to continue to strengthen supervision of capital markets and nonbank financial institutions. Also, considerable progress has been made with respect to the regulatory framework governing the Dubai International Financial Center and an extensive set of laws have been enacted, benchmarked to best international practices.

The major emirates (Abu Dhabi, Dubai, and Sharjah) are capitalizing on the favorable economic environment to carry out reforms that will foster more private sector participation and further diversify the economy. Dubai passed a property law which allows 100 percent foreign ownership of properties in pre-designated areas, while working with the private sector to provide infrastructure and other services that are traditionally provided and financed by the public sector. Sharjah established a number of industrial free zones and also benefited from attracting new small and medium-sized enterprises that are rapidly expanding. Abu Dhabi has embraced utility privatization and rationalized its fiscal policy through outsourcing of public expenditure.

The authorities are planning to increase development expenditures significantly in 2006 and over the medium-term. Key government entities (such as the Abu Dhabi National Oil Company, Dubai Ports Authority, and Dubai Aluminum Company) have massive investment plans to further increase the capacity of upstream activities in the petrochemicals sector, infrastructure in airports and ports, and new manufacturing plants in the metals sector. Over the medium-term, the total investment in Dubai is conservatively estimated at $200 billion. Similarly, about $160 billion worth of projects are planned for Abu Dhabi. Over the next five to seven years, oil production capacity in Abu Dhabi is expected to expand from 2.9 million barrels to 3.5 million barrels per day.

Limited improvements have been made in the U.A.E.'s economic and social statistics which continue to suffer from numerous structural weaknesses with respect to data quality, coverage, periodicity, timeliness, and inter-sectoral consistency.

Executive Board Assessment

Executive Directors commended the authorities of the U.A.E. for pursuing market friendly policies, an outward-oriented development strategy, and prudent financial policies, which have resulted in an impressive economic growth over the years and led to a large accumulation of external financial assets. Directors welcomed the continued progress in diversifying the economy and the implementation of structural reforms. They agreed that the U.A.E. is in a strong position to take advantage of the buoyant regional economic growth, but stressed that the authorities' primary objective should be to ensure that economic expansion proceeds at a sustainable pace while maintaining macroeconomic stability.

Directors viewed that the medium-term economic outlook remains favorable. They stressed, however, that, in the near term, a number of risks, including, price developments in the equity and real estate markets and accelerating inflationary pressures, warrant close monitoring. Given the limitations of monetary policy resulting from the fixed exchange rate and liberalized capital account, Directors stressed that if the rapid increase in private sector credit and inflationary pressure persist in 2006, much of the burden of tightening financial policies would need to fall on public spending.

Directors agreed that the comfortable fiscal position and the significant accumulation of financial assets support increases in infrastructure and social outlays to broaden growth and enhance the absorptive capacity of the economy. Spending should be set in line with the economy's absorptive capacity, in order to maintain macroeconomic stability. They encouraged the authorities to link wage increases to gains in public sector productivity, and to replace subsidies on water and electricity with income-related payments to nationals below a certain income level. Directors urged greater policy coordination between the emirates and the federal governments, and recommended the introduction of legislation to reform the General Pension and Social Security System, while it is running operational surpluses. They urged the authorities to start the preparatory work based on the recommendations of the IMF Fiscal Affairs Department for the introduction of a Value Added Tax system at the federal level.

Directors noted that, notwithstanding the limitations of monetary policy in the U.A.E., if credit growth to the private sector continues at a rapid pace and inflationary pressures persist, the authorities could tighten credit by raising provisioning rates for credits carrying greater-than-average risks, increasing the minimum amount of equity needed for approval of real estate and margin trading loans, and tightening collateral requirements. A gradual reduction of the percent at which individuals can borrow against their salaries could also be considered.

Directors commended the authorities for the financially sound and well-supervised banking system. However, they cautioned that increased lending for real estate and equity financing has led to a rise in credit risk, and stressed that banks' direct and indirect exposure to these markets and the increased loan concentration in a few large business groups call for close monitoring by the central bank. The adequacy of prudential regulation should be kept under review, and banks that recorded significant growth in profits from equity markets related activities should be closely supervised.

Directors highlighted the urgent need to define the responsibilities of the various entities involved in regulating the capital markets and its participants, addressing gaps in regulations, and rationalizing the extensive overlaps in responsibilities. They welcomed the planned full assessment of the capital markets regime against International Organization of Securities Commissions' standards. Directors stressed that the pricing of IPOs should be set by the market through professional underwriters based on an appropriate company valuation. Equity markets would benefit from the introduction of market stabilization mechanisms, such as a market maker system and hedging instruments that can provide liquidity and allow investors to manage their risks more effectively. They welcomed the authorities' agreement to undertake a Financial Sector Assessment Program update.

Directors agreed that the fixed exchange rate policy has served the U.A.E. economy well. They welcomed the authorities' intention to remain open regarding the choice of exchange rate regime under the planned Gulf Cooperation Council monetary union.

Directors stressed the importance of enhancing the investment climate beyond the free zones, and fostering private sector participation more generally. They encouraged the authorities to pass the amended company law, which will allow higher foreign investment in U.A.E.-based companies. They stressed that labor policies should be implemented flexibly to avoid undue pressures on private sector salaries, in order to preserve competitiveness.
To address employment of nationals, attention should be given to long-term education, training, appropriate wage policies, and labor legislation.

Directors urged the authorities to strengthen the institutional framework and build-up a strong, comprehensive, and consistent statistical system. Data should be compiled on off-budget fiscal operations and on domestic and external debt at the emirate level, and fiscal transparency at the emirates' level should be enhanced by adopting international standards of classification for expenditure and revenue statistics. The authorities are urged to finalize the General Data Dissemination Standard (GDDS) metadata and nominate a GDDS coordinator.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

The United Arab Emirates: Selected Economic Indicators, 2001–05 1/

	2001	2002	2003	2004	Prel. 2005
	(Annual percent change, unless otherwise indicated)				
National accounts and prices					
Real GDP (at factor cost)	1.7	2.6	11.9	9.7	8.5
Hydrocarbon 2/	0.0	-7.6	13.6	2.9	2.1
Non-hydrocarbon 3/	2.5	7.7	11.2	12.6	11.0
Consumer price index	2.8	2.9	3.1	5.0	8.0
Investment (in percent of GDP)	24.7	24.1	23.5	22.3	24.4
	(In perent of GDP, unless otherwise indicated)				
Financial variables					
Total revenue	37.0	42.0	41.3	42.5	49.4
Hydrocarbon	26.5	32.8	32.9	32.8	38.4
Non-hydrocarbon 4/	10.5	9.2	8.4	9.7	11.1
Total expenditure	37.4	31.6	28.3	24.3	22.5
Of which: Current expenditure	30.0	26.4	22.9	20.7	18.5
Consolidated fiscal balance (deficit -) 5/	-0.4	10.4	13.0	18.2	26.9
Consolidated fiscal balance (excluding investment income)	-5.0	7.1	10.0	13.8	21.1
Excluding hydrocarbon revenue 6/	-31.5	-25.7	-22.9	-19.0	-17.3
Change in broad money supply (in percent)	15.3	15.6	16.1	23.2	33.8
Change in private sector credit (in percent)	8.8	11.3	13.5	24.7	44.5
	(In billions of U.S. dollars, unless otherwise indicated)				
External sector					
Exports	47.5	51.8	66.8	91.0	118.8
Of which: Crude oil 2/	17.6	16.6	22.1	29.6	43.5
Imports, fob	-33.5	-37.5	-45.8	-63.4	-80.8
Current account balance 4/	6.6	3.0	7.1	10.6	19.1
In percent of GDP	9.5	4.1	8.1	10.2	14.7
Central Bank reserves	14.3	15.3	15.1	18.6	21.1
In months of imports of goods and services	4.6	4.0	2.9	2.8	2.5
Total external debt 7/	19.4	16.7	16.5	22.6	36.5
In percent of GDP	27.9	22.4	18.7	21.6	28.1
Average real effective exchange rate (CPI based; in percent) (appreciation +)	4.1	-1.3	-6.9	-4.5	-0.7

Sources: Data provided by the authorities; and IMF staff estimates.

1/ Based on official data as of March 2006.

2/ Includes condensates

3/ Includes refined products and liquid gas.

4/ Includes investment income on government foreign assets estimated by IMF staff.

5/ Includes the fiscal position of the federal government and the three largest emirates.

6/ The overall balance excluding investment income and hyrocarbon revenue.

7/ Includes central bank and commercial bank foreign liabilities, plus private non-banks based on reporting BIS banks.

Statement by Shakour Shaalan, Executive Director for United Arab Emirates
June 12, 2006

1. On behalf of the United Arab Emirates (U.A.E.) authorities, we would like to express our appreciation to staff for their contribution to another round of productive consultation and well-balanced advice reflected in the rigorous report before us. The authorities are in broad support of the thrust of the staff analysis and policy recommendations.

Recent Developments and Outlook

2. The U.A.E.'s liberal and business-oriented approach to economic policy, set against a background of buoyant oil prices, has contributed to yet another year of impressive economic performance. Indeed, 2005 was marked by continued strong growth, supported by robust expansion in the non-oil sector at 11 percent, and the accumulation of record surpluses on the fiscal and external accounts. Underpinning this performance is the steadfast commitment to judiciously utilize hydrocarbon revenues, to intensify the diversification process, and to further solidify economic fundamentals. The economy's dynamism rendered it a natural destination for the ample regional liquidity. Consequently, and similar to developments elsewhere in the region, asset prices surged, which together with the increased vigor in economic activity and a hike in domestic fuel prices, seem to have pushed up prices somewhat. The recent correction in the equity markets, also witnessed in regional economies, is expected to facilitate a stabilization in prices.

3. The near- and medium-term prospects for the economy remain strong, reinforced by deliberate policies geared towards expanding domestic absorptive capacity and further strengthening the resilience of the economy. The authorities' ambitious medium-term development agenda—to be executed with a prominent participation of the private sector—features sizable investments in infrastructure, manufacturing, and hydrocarbon activities, as well as education and health. In addition to supporting the creation of productive employment to new entrants to the labor market, these investments are expected to set the stage for a structurally higher productivity growth and output potential while deepening the diversification drive along each Emirate's competitive advantage. Moreover, and while the economic transformation should temper any potential weakness stemming from hydrocarbon price volatility, the strength of public finances is such that they remain resilient to slides in oil prices as low as US$40 per barrel. Finally, notwithstanding the sharp correction in the equity markets that is partly induced by global shifts in risk aversion, banks are highly profitable and well capitalized.

Fiscal Policy

4. Bolstered by higher hydrocarbon revenues and a prudent expenditure policy, the fiscal position strengthened further, with the consolidated fiscal balance posting a record surplus of 27 percent of GDP, and the non-hydrocarbon deficit narrowing steadily. The steady decline in expenditures as a proportion of GDP was accompanied by a diminishing share of current spending, while accommodating increased investment outlays. Attesting to the cautious

expenditure approach is the virtual stability of the nominal wage bill over the past few years in the face of growing revenues. This reflects in large part ongoing efforts to outsource non-core budget activities to the private sector and retrench the size of the government. Consequently, and despite recent wage increases for civil servants, the consolidated wage bill to GDP ratio declined in 2005. This trend is expected to continue into 2006. On the revenue side, Fund technical assistance is being provided on the introduction of a value-added tax (VAT) in the context of the Gulf Cooperation Council (GCC), which should contribute to a broadening of the revenue base.

5. With the existing legal framework conferring significant autonomy to the individual Emirates, the authorities remain cognizant of the importance of further enhancing the coordination and consistency of fiscal reporting at the federal and Emirate levels. To this end, a macro-fiscal unit within the Ministry of Finance and Industry, charged with devising a consistent macroeconomic framework, is being established with some assistance from the Fund. At the same time, and with the federal government typically leading the reforms, budget classification has been aligned with the 2001 GFS standards. The U.A.E. is also currently pursuing concrete measures to successfully implement performance-based budgeting. A stronger institutional anchor for harmonized fiscal accounting is likely to emerge within the context of the GCC monetary union.

Monetary and Exchange Rate Policies

6. With the capital account fully convertible, monetary policy aims to achieve a prudent credit stance to stabilize domestic liquidity and support the peg. Developments in 2005 may have posed some challenges to liquidity management. The substantial expansion in broad money, induced by the rapid growth in private sector credit, was partly tempered by the implicitly tightened monetary conditions, following the sharp correction in equity markets and the reversal of capital flows. To smooth out fluctuations in domestic liquidity, the Central Bank of U.A.E. (CBU) substantially increased its issuance of certificate of deposits. At the same time, monetary policy continued to tighten, with the CBU successively hiking interest rates. The three-month interbank rate increased from 2.4 percent in end-2004 to 4.7 percent in 2005, and currently stands at 5.14 percent. Going forward, the authorities are contemplating a number of measures, along the lines proposed by staff, to further tighten monetary conditions, if needed.

7. By providing a credible nominal anchor, the authorities believe the pegged exchange rate remains instrumental in anchoring confidence in their macroeconomic policies. The oil price-induced appreciation does not appear to erode competitiveness, given the continued growth in the volume of non-oil exports. Greater trade integration, as envisaged within the GCC context, should help alleviate the impact of any potential appreciation pressures on competitiveness.

Financial Sector Issues

8. Considerable progress has been achieved in financial sector reforms, in line with staff recommendations, despite the complexity of the U.A.E.'s economic and political structure. Building on Dubai's successful diversification drive, the U.A.E. is successfully positioning

itself as a regional financial hub. Despite an increased exposure to asset markets, the banking sector remains strong and well capitalized, bolstered by sizable increases in profitability. Considerable provisioning has contributed to a net ratio for nonperforming loans (NPL) of less than 2 percent. Moreover, albeit rising, banks' exposure to the real estate market through household credit remains low, and total household indebtedness remains modest.

9. The global increase in liquidity and buoyant oil prices are driving the surge in regional equity markets, including in the U.A.E. Admittedly, it is difficult to discern the extent to which the recent correction was precipitated by speculation or warranted by fundamentals. It is clear, however, that economic fundamentals have improved. To some extent, the correction in equity prices was fueled by the wave of Initial Public Offerings (IPO) in 2005 and early 2006, and the associated liquidation of existing positions to finance subscriptions for IPOs activity. While they will continue to exercise vigilance regarding future movements in equity prices, the authorities have stressed their intention to refrain from any intervention in the market. Effectively managing the balance of risks stemming from abrupt shifts in sentiment would require domestic financial institutions to keep pace with the rapid evolution of global capital markets. In this connection, the authorities recognize the need for a national supervisory framework to regulate capital markets, and are in general agreement with the staff's detailed recommendations outlined in Box 4. They will undergo a full assessment of the capital market regime against the benchmarks established by the International Organization of Securities Commission (IOSC) by end-2006. At the same time, activities in the Dubai International Financial Center (DIFC) continue to expand, supported by a sound regulatory framework aligned with best international practices. The authorities have agreed to a mission to assess the legal framework of the DIFC and procedures of the Dubai Financial Services Authority, to take place concurrently with the IOSC assessment in order facilitate the identification of supervision gaps and overlaps. The mission will also assess the links of the DIFC with the broader economy.

Structural Policies

10. The U.A.E. economy continues to rank favorably when gauged by various indices of competitiveness and business climate indicators. Fostered by an outward-oriented and streamlined regulatory environment, the attractiveness of the U.A.E. as a destination for foreign direct investment (FDI) has increased. The authorities have indicated that the various investment and trade agreements that the U.A.E. has signed with its major trading partners have contributed to the surge in FDI inflows and to the exceptionally high rates of growth attained in recent years. Furthermore, the double taxation treaties that accompany these agreements have encouraged the activities of U.A.E. investors overseas.

11. Regarding the labor market, and in order to safeguard the competitiveness of the private sector, the authorities remain committed to a flexible implementation of the Emiratization policy. They wish to reiterate that their strategy to enhance employability of their nationals in the private sector relies on human capital accumulation and active labor market policies, with a view to enhancing the compatibility of the skills of the national labor force with the demands of the private sector.

Statistical Issues

12. Progress has been achieved in addressing some of the structural weaknesses in the statistical database. The population census has been completed and the results are expected to be released by year-end. The census is expected to provide an important statistical backbone that will enable the gathering of data on other sectors in the economy, including the real sector. A household budget survey is also expected to be concluded by end-2006, which would inform ongoing efforts to improve the statistical properties of the consumer price index (CPI). In this connection, several experts were recruited to strengthen the statistical capacity at the Ministry of Economy and Planning (MEP). Coordination efforts are currently ongoing between the CBU and the MEP to advance with the request for Fund technical assistance on the CPI.