UAE ECONOMIC REPORT

THE IMPORTANCE OF ECONOMIC DIVERSIFICATION IN A LOW OIL PRICE ENVIRONMENT

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- Positive though lower economic expansion in the Emirates
  UAE's economic expansion remained positive despite low oil prices, as the country has continued to benefit not only from its perceived safe haven status, its relatively diversified economy and its domestic political stability but also from its sound external buffers. Against this background, the UAE economy is expected to have expanded by 2.3% in 2016, though lower than the 4% reported in 2015, reflecting softer economic sentiment and the effects of fiscal consolidation that translated into weakened government spending on infrastructure projects, in addition to the continued slowdown in Dubai's real estate sector.

- Overall external position estimated to remain in surplus though relatively weakening
  The sharp decline in oil prices lowered hydrocarbon export revenues, while the diversification efforts and the higher spending in the country mainly on infrastructure projects, though relatively weakened this year, have widened the services and income deficits. Accordingly, the current account surplus has narrowed from 19.1% percent of GDP in 2013 to an estimated 1.1% of GDP in 2016, as per the IMF.

- Slightly improved fiscal position despite continued dwindling oil prices
  The UAE fiscal position has improved slightly over the year 2016, with the government fiscal balance posting a smaller deficit over the first nine months of the year amidst continued dwindling oil prices and therefore contracting oil revenues. This prompted some fiscal adjustments bolstering the non-oil revenue side, and the government is considering the possible implementation of a VAT in coordination with other GCC member countries in the aim of consolidating these efforts. General government revenues have registered a significant increase of 22% over the first nine months of 2016, while general government expenditures have registered an increase of 16.0%.

- Slower monetary growth with continued squeeze in liquidity
  UAE monetary conditions witnessed a slower growth in monetary aggregates in 2016 along with contained inflation, while the Central Bank's gross international reserves witnessed their first fall in more than six years, and monetary authorities maintained a firm commitment to the US dollar peg, which was translated into a rise in key interest rates in line with the US Federal Reserve interest rate hike. The Central Bank's gross international reserves fell from US$ 94.0 billion at end-2015 to US$ 81.1 billion at end-October 2016, down by 13.7% or the equivalent of US$ 12.9 billion, within the context of a low oil price environment and as the dollar-driven appreciation of the UAE dirham in real effective exchange rate terms weighed on competitiveness.

- Overall sound financial standing of banks amid a slow deposit growth environment
  The UAE banking sector witnessed a slowdown in activity growth during the year 2016 in an environment of persistently low oil prices affecting banks' liquidity position. Measured by the total assets of banks operating in the emirates, banking sector activity grew by 2.7% in the first ten months of 2016 to reach US$ 692.8 billion at end-October 2016. This compares to a 5.0% rise registered in the previous year's corresponding period. Bank deposits slightly inched up during the first ten months of 2016 (+2.1%), reaching US$ 409.3 billion at end-October 2016. While liquidity and profitability has been under some pressure, the banking sector continues to maintain sound financial standing.

- Price rebound in equity markets, significant contractions in CDS spreads in credit markets
  The UAE capital markets reversed in 2016 the downward trajectory that was traced in the previous year. The UAE equity markets registered healthy price gains, mainly supported by the world's largest oil producers' decision to reduce oil output starting January 2017, while the fixed income market saw two-way flows amid an oil price rebound and an anticipated US interest rate hike in December 2016, along with contractions in the cost of insuring debt in Dubai and Abu Dhabi. The Dubai Financial Market index surged from 3,151.00 at end-2015 to 3,505.18 on December 20, 2015, moving up by 8.7%, following a slump of 16.5% in 2015. Similarly, the Abu Dhabi Securities Exchange reported healthy price increases of 4.0% this year, following a 4.9% drop in the index in 2015.

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UAE's economic expansion remained positive despite low oil prices, as the country has continued to benefit not only from its perceived safe haven status, its relatively diversified economy and its domestic political stability but also from its sound external buffers that have helped limit negative spillover effects of lower oil prices and sluggish global economic growth. Against this background, the UAE economy is expected to have expanded by 2.3% in 2016, though lower than the 4% reported in 2015, reflecting softer economic sentiment and the effects of fiscal consolidation that translated into weakened government spending on infrastructure projects, in addition to the continued slowdown in Dubai's real estate sector.

At the external level, the UAE's external position is expected to maintain a surplus, though narrowing down over the past few years. The current account balance as a percentage of GDP reported a low of 1.1% in 2016, against 3.3% in 2015 and double-digit levels over the previous four years. Beyond the drop in the value of hydrocarbon receipts, the appreciation of the US dollar in the past couple of years to which the UAE dirham is pegged is also hurting non-oil exports of goods and services.

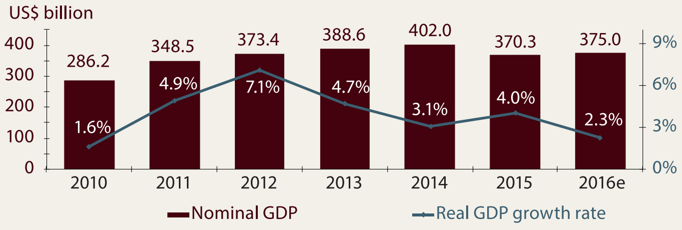
At the monetary level, international reserves subsequently fell in 2016, for the first time in six years, reaching US$ 81 billion at end-October 2016, against US$ 94 billion in 2015. As a percentage of Money Supply in local currency, the ratio of international reserves declines from 36.7% in 2015 to 31.6% at end-October 2016. It is worth mentioning that the growth in Broad Money (M2) slowed down, indicating lower liquidity in the economy. While Broad Money grew by 7.9% in 2014 and 5.5% in 2015, it grew by a mere 1.4% in the first ten months of 2016. Consequently, consumer price inflation which stood at 4.1% in 2015, is likely to slightly recede to 3.6% in 2016.

Reflecting the effects of the drop in oil prices within the context of limited fiscal consolidation measures, the government deficit is likely to rise to US$ 14.5 billion in 2016, the equivalent of 3.9% of GDP, against 2.1% of GDP in 2015 amid a decline in government revenues/GDP from 28.5% to 26.2% respectively. Subsequently, the debt to GDP ratio rises from 18.1% in 2015 to 19.0% in 2016, a five-year high. Whereas deficits are mostly financed by selling assets of the sovereign wealth fund -the Abu Dhabi Investment Authority, government debt is mostly in the form of loans from resident banks.

While the UAE banking sector looks prepared to cope well with the headwinds from low oil prices and liquidity tightening, many banks are experiencing challenges in asset quality and declines in profit growth in their business with SMEs, notwithstanding the spillover effects of real sector challenges in major emirates. It is worth mentioning as well that banks activity growth slowed down considerably this year, with asset growth declining from 7.5% in 2015 to 2.7% in the first ten months of 2016 within the context of a fall in public sector deposits. As the robust growth in credit to the economy has not been matched by deposit growth, bank liquidity has tightened relatively. In parallel, while profitability pressures have emerged, banks remain well capitalized on the overall.

At the level of capital markets, performance was mixed in 2016. The general share price index maintained a stability throughout this year, after a downward correction in 2015. This yet comes within the context of lower trading value, as the turnover ratio declines from 14.7% in 2015 to 11.1% in the first 11 months of 2016 (following a peak of 34.8% in 2014). As to the fixed income market, the Abu Dhabi CDS spreads contracted by 32 basis points this year, moving from 93 basis points to 61 basis points, after an expansion

UAE ECONOMIC PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

of 29 basis points throughout 2015. The Dubai CDS spreads contracted by 84 basis points this year, moving from 234 basis points to 150 basis points, after an expansion of 7 basis points throughout 2015.

The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the UAE economy looking ahead on the back of fundamental challenges mainly tied to the new oil price environment at large.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

Sound growth in major economic sectors

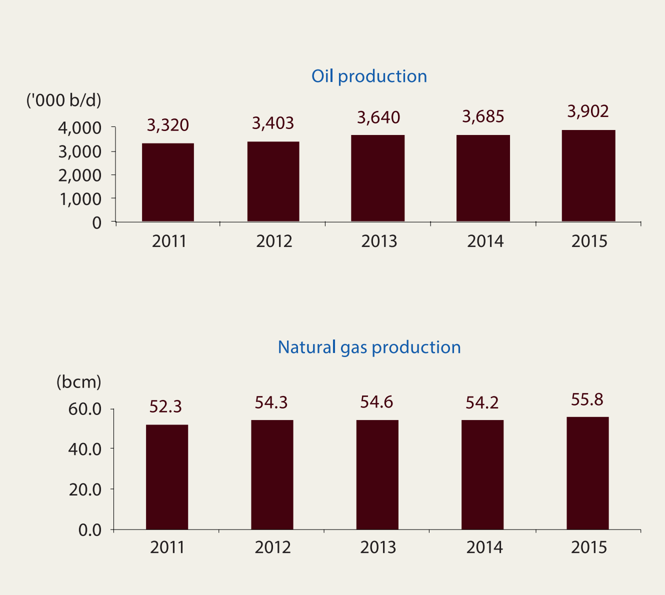
1.1.1. Hydrocarbons Sector

The UAE's drive for diversification is increasingly paying off, with the hydrocarbon sector's contribution to the economy diminishing with time. In fact, hydrocarbon exports out of total exports fell from 29.7% in 2014 to an estimated 18.0% in 2016. The sector's real output is expected to grow by 2.0% in 2016 compared to 4.6% last year, as per the International Monetary Fund.

The country's current reference production level is at 3,013 thousand barrels per day, and the country's expected production level effective January 2016 would decline by 139,000 thousand barrels per day to attain 2,874 thousand barrels per day, as per the OPEC.

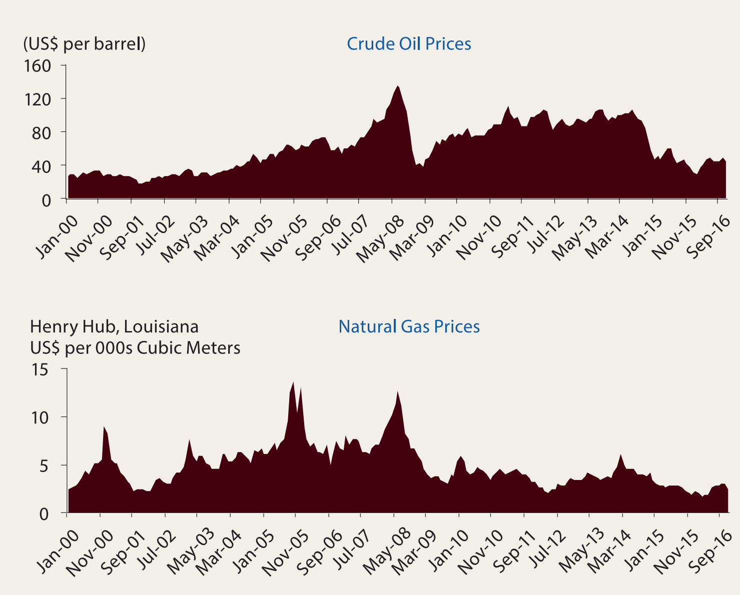
Consequently, global crude oil prices expanded by 21.0% in 2016 aided by OPEC's agreement on cutting production, against a contraction of 36.5% in oil prices in 2015. Within this context, Abu Dhabi National Oil Company (ADNOC) announced that it would cut crude supplies by 3% to 5% across its three export grades. The producer from the United Arab Emirates would reduce Murban and Upper Zakum crude supplies by 5%, and would cut Das crude exports by 3%. The company currently produces over 3.0 million barrels of oil per day, and over 9.8 billion cubic feet of raw gas per day.

OIL & GAS PRODUCTION



Sources: BP, Bank Audi's Group Research Department

CRUDE OIL & NATURAL GAS PRICES



Sources: IMF, Bank Audi's Group Research Department

Moving on to the consumption of hydrocarbons, fuel price deregulation would have a limited impact on consumption in the UAE, due to continued weakness in international fuels prices, high vehicle sales and robust growth in the energy-intensive industrial sectors. For instance, the consumption of refined fuel products is expected to rise by 2.3% year-on-year in 2016, in barrels of oil equivalent, against 2.0% year-on-year in 2015, as per the US Energy Information Administration (EIA).

As for gas consumption in the UAE, strong growth would be driven by rapidly increasing energy demand, especially from the power and oil sectors. Gas consumption is expected to rise by 5.5% year-on-year in 2016, in barrels of oil equivalent, unchanged from 2015, as per the US Energy Information Administration. At the same time, it is worth noting that the UAE is reinforcing its renewables program, targeting the switch from gas to solar energy, with gas consumption over the upcoming year anticipated to grow by only 3.5% annually.

Furthermore, the country's reserves are large on a global scale, with the UAE holding the seventh largest proved oil and gas reserves. UAE's oil reserves were estimated at 98 billion barrels in 2015, and the country's gas reserves were estimated at 6.1 trillion cubic meters, as per the EIA. The bulk of reserves are located in Abu Dhabi, at more than 90% of the total, followed by Dubai, Sharjah and Ras al-Khaimah.

Despite the vast amount of hydrocarbon resources in the UAE, the country is undertaking steps to diversify its economy and lessen its reliance on oil. As a matter of fact, despite hydrocarbon revenues representing the majority of revenues at the consolidated government level accounting for about 50.0% of the total in 2015 and 66% in 2014, this proportion dropped to 47.0% in 2016. The latter makes the UAE government less dependent on hydrocarbons than all other GCC countries, namely Saudi Arabia, Qatar, Kuwait, Oman or Bahrain.

1.1.2. Non-Hydrocarbons Sector

Real Estate and Construction

The UAE's real estate sector remains one of the pillars of the country's diversification strategy. The activity of the market remains soft and titled to the downside in both Abu Dhabi and Dubai with a slowdown in performance in general.

In Dubai, the overall sentiment reflected the relatively subdued nature of current real estate market conditions. Little room was left for new projects with the existing projects available. Furthermore, alternative real estate investments are being sought in the emirate especially in fields such as education, healthcare, infrastructure, logistics and student housing, as per Jones Lang Lasalle (JLL).

Regarding the residential performance, the downward trend took over the third quarter of 2016 with sales prices falling by around 2% year-on-year in the case of apartments and a yearly 2% in the case of villas. Rentals registered declines of 4% year-on-year in the case of apartments and a yearly 6% in the case of villas. Residential supply registered 467 thousand units in the first nine months of 2016, up from 456 thousand units in 2015. With only minimal change reported in prices in Q3, it appears the residential market has now reached the bottom of its current cycle. While it is expected that prices and rents would recover in 2017, and the pace of this recovery is expected to be limited by economic uncertainties and the volume of potential supply.

Regarding the office market, CBD vacancy rate declined from 22% in the third quarter of 2015 to 15% in the third quarter of this year, whereas prime CBD rents rose by 2% year-on-year to stand at AED 1,922 per square meter (US$ 523.3) in the third quarter of this year. On the other hand, activity in Dubai's retail market remained slow over the third quarter of 2016 with vacancy rates remaining constant at 8% compared to the third quarter of 2015, as per JLL.

According to JLL, Abu Dhabi's real estate market continued softening with a modest decline in performance across each of its sectors. Despite supply remaining under control, consolidation in government, oil and financial services sectors in addition to weaker sentiment continued to affect demand. In the residential market, total residential stock stood at 247 thousand units in the first three quarters of 2016, with an additional three thousand expected to enter the market with the delivery of several new residential projects. Average sales prices of apartments declined by 11% year-on-year in the third quarter of 2016, while villas' average sales prices declined by 7% over the same period.

In Abu Dhabi's office market, vacancy rates declined from 25% in the third quarter of 2015 to 20% in the third quarter of 2016. Grade A offices average rents fell by 5% year-on-year, while Grade B offices rents declined by 12% in the aforementioned period. Furthermore, office stock supply stood at 3.5 million square meters of gross leasable area (GLA) in the first three quarters of 2016. Regarding the retail market, current supply registered 2.6 million square meters worth of gross leasable area in the first three quarters of 2016, nearly unchanged from the value registered in the same period of 2015. Vacancy rates remained constant at 2% between the third quarter of 2015 and the same quarter of 2016. In addition, average retail rents remained unchanged year-on-year over the same period and are expected to remain stable over the short term.

In conclusion, the whole real estate sector is encountering an overall slowdown, however supply in both emirates and most of the sectors continues to adopt an increasing trend. Within this environment, the 2020 Expo and the diversification of the real estate portfolio aims to improve the cycle of the market.

Transport

On the back of a tighter fiscal environment, the UAE, like all GCC countries, faced significant challenges in maintaining the expansion of its transport infrastructure. Nonetheless, the country positioned itself as a regional leader in the growth of its transport sector, a major component of its diversification efforts.

Reflecting the emirate's concern for the gradual implementation of the Expo 2020 projects, the government plans to increase its spending on infrastructure, which includes transport, by 27% annually in the 2017 budget to reach 17% of total budget expenditures.

The UAE's airports segment, the most important component of the UAE's transport sector, supports trade and tourism, the two strategic pillars of the economy. Abu Dhabi and Dubai's joint airfreight reached 3.5 million tons in 2016, up by 5.6% from 3.3 million tons in the previous year. UAE's air freight sector has a positive outlook with economic expansion sustaining trade levels and private consumption. The country's modern airports segment also plays a vital role in strengthening the tourism sector. Dubai plans to build the world's biggest airport spending around US$ 35.7 billion to develop a second airport which would spread across 35,000 acres and would be able to accommodate 220 million passengers annually.

As for the rail sub-segment of the transport sector, the UAE plans to move forward with new metro and tram projects. For example, the Road and Transport Authority (RTA) awarded consultancy contracts for Dubai's rail masterplan and the second phase of the Dubai tram network. The UK's Atkins was awarded the contract for the rail masterplan and a team of France's Systra with the US' Aecom won the consultancy role for the team.

Given that the UAE does not have a rail network yet, heavy industry relies on roads, which is the most developed infrastructure in the UAE. Road freight, in tons, grew by 2.8% annually in 2016 to attain 28.4 million tons, compared to 27.7 million tons in 2015, as per BMI Research. The country remains committed to further modernize its road network. Within this context, a new road connecting Dubai with Sharjah was opened in September 2016, shortening travel time and addressing congestion problems. The road freight sector is expected to sustain healthy growth with trade and domestic demand increasing and road currently the only mode available to accommodate this expansion.

Furthermore, the UAE dominates the region in terms of container shipping driven by Jebel Ali's role as a transshipment hub which is why the UAE's port infrastructure is central to the economic diversification plans. Jebel Ali's and Port Khalifa's container tonnage throughput reached 28.2 million tons in 2016, compared to 26.8 million tons in 2015. It is worth noting that the country does not only serve as a transshipment hub for other Gulf states, but also takes advantage of its location at the meeting point of three continents: Africa, Asia and Europe.

Going forward, the outlook for the transportation sector remains optimistic. Investments related to Expo 2020 such as the expansion of the national network of airports and rail network, air and maritime transport means and roads, are expected to further support higher growth from 2017 onwards.

Tourism

The UAE's tourism industry remains on an expanding path as visitors continue to be drawn by the growing range of attractions, developed transport and diversified accommodation infrastructure among others. In this context, the country's relatively stable political and economic environment plays an important role in the positive performance of the sector.

The travel and tourism's direct contribution to GDP was AED 64.9 billion (4.2% of total GDP) in 2015, and is forecast to rise by 4.2% in 2016, as per the World Travel & Tourism Council.

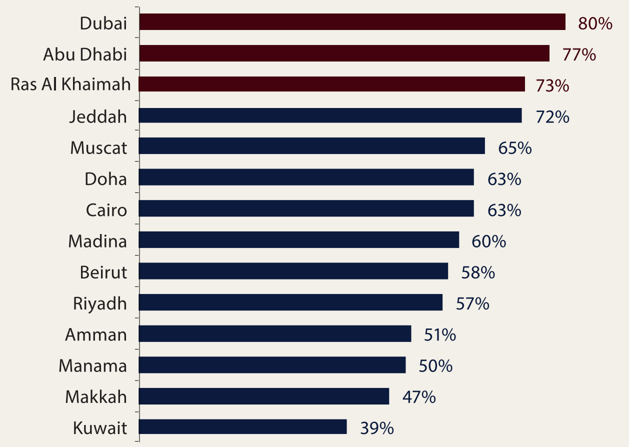
The tourism market in the UAE is quite developed. Both Abu Dhabi and Dubai offer numerous complementary attractions. While Abu Dhabi focuses its tourism strategy on meetings and conferences in addition to cultural tourism, Dubai focuses on developing various leisure facilities for families through theme parks and shopping among others.

It is worth noting that Abu Dhabi and Dubai, the UAE's main touristic emirates, are focusing their efforts and investment into the development and diversification of their tourist markets, aiming to attract more visitors, as per BMI Research. While the two emirates take over the largest share of the country's tourism industry, other regions are also experiencing healthy growth in arrivals and spending, as per the same source. Hence, the Sharjah Commerce and Tourism Development Authority reported that hotel revenue rose by 7% through the first half of 2016.

On a side note, the cities of Dubai and Abu Dhabi occupied the top two positions in hotel occupancy during the first 11 months of 2016, with 80% for Dubai (unchanged from the same period of last year) and 77% for Abu Dhabi (down by 1.0% from the same period of last year).

Furthermore, the hospitality market is attracting noteworthy investment and a number of projects under development. Many hotel chains are paving their way into the UAE hotel industry, widening the scope of properties offered. In addition, there are plans to build more budget-range hotels to attract more lower-income travelers.

COMPARATIVE HOTEL OCCUPANCY RATES *



* First 11 Months 2016

Sources: Ernst & Young, Bank Audi's Group Research Department

In conclusion, tourism is a key source of non-oil GDP for the UAE and supports other sectors, such as construction and real estate. In preparation for the Dubai 2020 Expo and aiming to diversify the economy, the country continues to focus on developing the sector through a number of investments and new projects, noting that it is denoted as a safe destination in the region.

1.2. EXTERNAL SECTOR

Overall external position estimated to remain in surplus though relatively weakening

Over the previous years, the UAE has managed to diversify partly away from the hydrocarbon activities with oil exports representing currently only 30% of exports of goods. However, the sharp decline in oil prices lowered hydrocarbon export revenues, while the diversification efforts and the higher spending in the country mainly on infrastructure projects, though relatively weakened this year, have widened the services and income deficits. Accordingly, the current account surplus has narrowed from 19.1% of GDP in 2013 to an estimated 1.1% of GDP in 2016, as per the IMF, before improving over the medium term as the projected moderate pick-up in oil prices is expected to help maintain somehow a current account surplus.

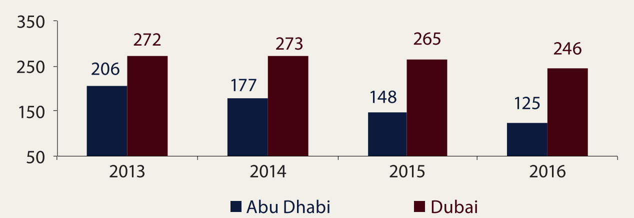
It is worth mentioning that the resilient non-oil merchandise export performance has offset some of the impact of plunging oil export revenue on the current account. The UAE Federal Customs Authority's (FCA) latest available statistics showed an increase in the total non-oil direct foreign trade of the UAE from US$ 145.9 billion in the first half of 2015 to US$ 150.7 billion in the first half of 2016, up by 3.3%.

In details, total exports of goods free on board dropped by an estimated 5.2% on a yearly basis, moving from US$ 333.2 billion in 2015 to US$ 316.0 billion in 2016 as per the EIU (against a higher drop of 9.3% in the previous year), within the context of lower oil prices that result into a drop in crude oil exports by an estimated 10.2%. In parallel, imports dropped slightly by an estimated 1.0% year-on-year, to reach US$ 238.8 billion in 2016, down from US$ 241.2 billion in 2015. This compares to a slight growth of 0.2% in the previous year, and which comes in line with a slowdown in economic growth over the current year. Accordingly, the UAE's trade balance narrowed by an estimated 16.1% year-on-year, but remained in surplus to reach US$ 77.3 billion (or 21% of GDP), which continues to ensure a major buffer against leakages from the services and transfers accounts.

The services and income balances, which incorporate payments or receipts from transportation, business and tourism services, continued to register an estimated deficit of US$ 45.7 billion in 2016, up by 16.9% year-on-year, as per the EIU. Over the past few years, the UAE has been upgrading infrastructure of such services to enhance its performance in those areas, and thus payments naturally exceeded receipts.

As to current transfers balance, it posted an estimated deficit of US$ 29.6 billion, up by a yearly 12.2%. The main components of transfers outflows are remittances sent by the important expatriate labor force which accounts for the bulk of workers in the UAE, in addition to grant outflows mainly to Yemen and

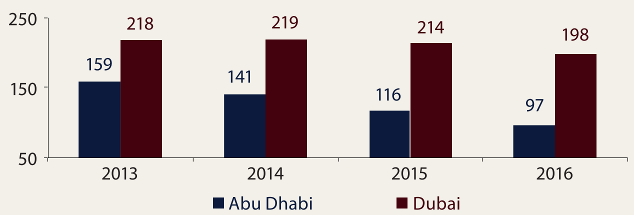
AVERAGE HOTEL ROOM RATE IN US$*



* First 11 months of each year

Sources: Ernst & Young, Bank Audi's Group Research Department

HOTEL ROOM YIELD IN US$*



* First 11 months of each year

Sources: Ernst & Young, Bank Audi's Group Research Department

Egypt. As such, the contraction in UAE's trade surplus in 2016, coupled with wider deficits at the level of services, income and current transfers deficits, resulted into a contraction in the current account surplus from 3.3% of GDP in 2015 to an estimated 1.1% of GDP in 2016, as per the IMF.

Last but not least, the wise policy of economic diversification and building sustainable national industries helped save the UAE status as a world trade hub, and the trade gateway to the near and middle east and North Africa, mainly driven by the implementation of national strategies in recent years that are aligned with the UAE 2021 Vision, and which will contribute to enhance customs performance and boost infrastructure at customs posts and shipping suitability and security. It is worth mentioning that the country has accumulated a large stock of external assets over the years and thus benefits from large buffers to shield the economy against potential external shocks in the near future.

1.3. PUBLIC SECTOR

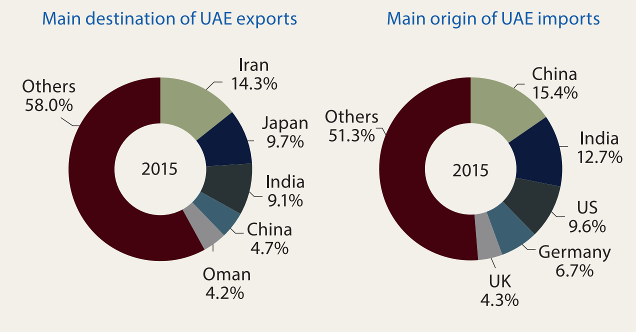
Slightly improved fiscal position despite continued dwindling oil prices

The UAE fiscal position has improved slightly over the year 2016, with the government fiscal balance posting a smaller deficit over the first nine months of the year amidst continued dwindling oil prices and corollary contracting oil revenues. This prompted some fiscal adjustments bolstering the non-oil revenue side, and the government is considering the possible implementation of a VAT in coordination with other GCC member countries in the aim of consolidating these efforts.

On the revenue front, general government revenues have registered a significant increase of 22% over the first nine months of 2016, rising from US$ 61.0 billion in 2015 to US$ 74.4 billion in 2016, as per the latest data released by the Ministry of Finance, following a contraction of 20.8% in the first nine months of 2015. Tax revenues fell significantly over the first nine months of 2016, registering US$ 20.7 billion compared to US$ 40.1 billion in the first nine months of 2015. However, other revenues rose from US$ 20.0 billion in the first nine months of 2015 to US$ 52.7 billion in the same period of 2016. Within this context, it is worth mentioning that hydrocarbon revenues represent the bulk of the revenues at the consolidated government level, accounting for circa 47% of the total in 2016, down from 50% in 2015 due to the drop in oil prices. Abu Dhabi, the main contributor to the budget, has a current fiscal breakeven price of around US$ 60 per barrel.

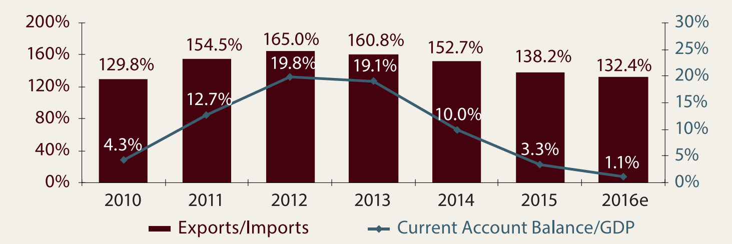
Abu Dhabi's revenues have been negatively affected by the fall in oil revenues. However, like other regional oil exporters, the UAE has accumulated significant fiscal reserves in recent years and benefits from these both as a fiscal cushion and a source of non-oil income. Recent policy announcements suggest that the end of the oil boom has sharpened appetite for structural reform. The UAE is due to introduce VAT at the start of 2018 in conjunction with other GCC States and has promised to push ahead with further subsidy cuts in a step towards reducing the government's reliance on oil receipts. The federal government has said it does not anticipate further new levies or taxes, but individual emirates may do so. However, authorities would be wary of imposing too heavy a burden on businesses and nationals.

EXPORTS & IMPORTS STRUCTURE



Sources: EIU, Bank Audi's Group Research Department

FOREIGN SECTOR INDICATORS



Sources: EIU, IMF, Bank Audi's Group Research Department

General government expenditures have registered an increase of 16.0%, rising to US$ 83.4 billion in the first nine months of 2016 up from US$ 71.9 billion in the same period of 2015. Compensation of employees increased by 5.3% in the first nine months of 2016 to reach US$ 12.8 billion. While expenditures on social benefits decreased by 59.2% from US$ 11.3 billion in the first nine months of 2015 to US$ 4.6 billion in the equivalent period of 2016, this comes with the recent decision to increase subsidy cuts. Other expenses rose by 32.6% to reach US$ 39.3 billion in the first nine months of 2016, up from US$ 29.6 billion in the corresponding period of 2015. In terms of non-financial assets, expenditure on fixed assets increased by 22.9% to reach US$ 6.5 billion in 2016, while expenditure on inventories rose from US$ 12 million in the first nine months of 2015 to US$ 2 billion in the same period of 2016.

Abu Dhabi's relatively cautious approach to spending during the oil boom years has meant that the near-term fiscal imbalances are not as acute as in some other GCC countries, and that the corresponding adjustment process would not as difficult. Public capital spending previously a key driver of domestic demand was below that recorded in the oil boom period. The effects extended to the real estate sector which witnessed a sustained fall in prices and a marked drop in turnover.

With general government revenues rising at a faster pace than general government expenditures, the overall UAE fiscal balance is estimated to have registered a deficit of US$ 9.0 billion in the first nine months of 2016, down from US$ 10.9 billion in the same period of 2015.

The UAE's budget is set to remain in deficit, however the projected budget shortfall is modest when compared to those facing other GCC states, and as a consequence adjustments are expected to be less severe and less long-lasting. The more modest public borrowing requirement should also cap the upward pressure on rates. The emirate-level governments have announced plans for mergers and consolidation in the public sector in an apparent bid to boost efficiency and economies of scale. In order to encourage risk-taking and investment by the private sector, the UAE is also set to enact its first corporate bankruptcy law.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Slower monetary growth amid continued squeeze in liquidity

UAE witnessed a slower growth in monetary aggregates in 2016 along with contained inflation, while the Central Bank's gross international reserves witnessed their first fall in more than six years, and monetary authorities maintained a firm commitment to the US dollar peg, which was translated into a rise in key interest rates in line with the US Federal Reserve interest rate hike.

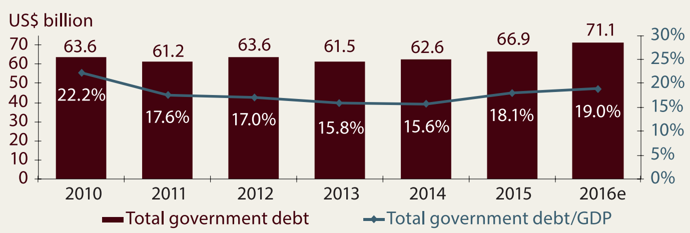
In details, the overall Consumer Price Index for the UAE reached 107.07 in October 2016, according to the UAE National Bureau of Statistics, moving up by 1.9% relative to 105.08 in October 2015, noting that the statistics authority shifted the base year for the consumer price index to 2014 from 2007 starting October 2016, and changed the weights for basket components.

SELECTED PUBLIC FINANCE INDICATORS

US$ billion	2012	2013	2014	2015	2016e
General government revenues	149.8	158.7	149.9	105.5	98.2
General government revenues/GDP	40.1%	40.8%	37.3%	28.5%	26.2%
General government expenditures	109.2	118.3	130.0	113.3	112.6
General government expenditures/GDP	29.2%	30.4%	32.3%	30.6%	30.0%
General government fiscal balance	40.6	40.4	19.9	-7.8	-14.5
General government fiscal balance/GDP	10.9%	10.4%	5.0%	-2.1%	-3.9%

Sources: IMF, Bank Audi's Group Research Department

PUBLIC DEBT AND INDEBTEDNESS RATIO



Sources: IMF, Bank Audi's Group Research Department

The division of the Consumer Price Index by sector shows that the medical care and health services sector registered the largest price increase of 5.39%, followed by the education sector (+4.99%), the housing, fuel, light and water sector (+4.85%), the recreation and cultural services sector (+4.75%), the hotels and restaurants sector (+3.06%), the alcohol & tobacco (+2.75%), the textiles, clothing and footwear sector (+2.59%), the other goods & services sector (+1.42%) and the furniture and other items sector (+0.09%). Contributions to inflation have been negative from the transportation sector (-3.79%), the communications sector (-1.97%) and the food and beverages sector (-0.35%).

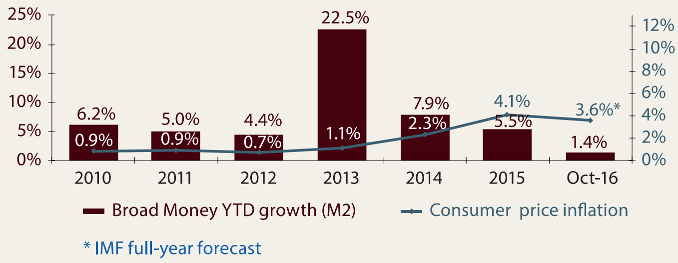
Growth in monetary aggregates in the UAE slowed further during the first ten months of 2016 as compared to the corresponding period of the previous year, because of low oil prices and reduced government deposits. The narrow measure of money supply (M1) widened by 3.4%, moving up from US$ 124.4 billion at end-2015 to US$ 128.6 billion at end-October 2016. This compared to a wider expansion of 4.5% during the corresponding period of 2015. The broader money supply (M2) accelerated by 1.4%, moving up from US$ 323.2 billion at end-2015 to US$ 327.7 billion at end-October 2016, mainly supported by a 9.7% surge in net claims on public sector (the equivalent of US$ 7.2 billion) and a 5.0% increase in claims on the private sector (the equivalent of US$ 14.0 billion). This compared to a wider expansion in (M2) of 3.7% over the first ten months of 2015. Overall money supply in its broadest sense (M3) witnessed a shy increase of 1.5%, moving up from US$ 365.7 billion at end-2015 to US$ 371.1 billion at end-October 2016.

EVOLUTION OF MONETARY CONDITIONS

Flows in US$ million	2014	2015	10M-16
Net international reserves	**11,196**	**-9,733**	**-2,742**
Central Bank (net)	**9,017**	**15,240**	**-11,803**
Gross international reserves	10,270	15,494	-12,882
Foreign Liabilities	1,252	254	-1,079
Banks (net)	**2,178**	**-24,973**	**9,060**
Foreign Assets	22,363	1,238	7,351
Foreign Liabilities	20,185	26,212	-1,709
Net Domestic Assets	**11,275**	**26,449**	**7,236**
Claims on private sector	26,967	22,059	14,025
Net claims on public sector	-2,014	14,969	7,211
Claims on financial institutions	-13,488	1,895	-1,069
Capital & Reserves	-6,958	-7,097	-4,805
Other Items (net)	6,769	-5,377	-8,125
Broad Money (M2)	**22,471**	**16,716**	**4,493**
Money Supply (M1)	15,407	5,664	4,214
Quasi-Money	7,064	11,052	280

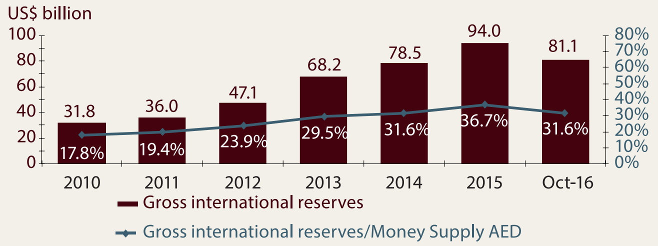
Sources: Central Bank of UAE, Bank Audi's Group Research Department

BROAD MONEY AND INFLATION



Sources: Central Bank of UAE, Bank Audi's Group Research Department

EXCHANGE MARKET INDICATORS



Sources: Central Bank of UAE, Bank Audi's Group Research Department

The continued squeeze in liquidity was reflected in Emirates interbank offered rates rising further, with the twelve-month EIBOR category reporting the highest increase of 62 basis points since the beginning of the year to reach 2.10% towards the end of 2016. This followed a 46 basis points expansion in 2015.

The UAE dirham remained pegged to the US dollar at AED 3.6725, as it provided stability to income flows and financial wealth and anchored prices of tradables and thus inflation, according to the IMF. Given the monetary authorities' firm commitment to the US dollar peg despite struggling economies with low oil prices and a stronger greenback, the Central Bank of the UAE raised interest rates on its certificates of deposits by 25 basis points in December 2016, shortly after the US Federal Reserves decided to raise its benchmark interest rate by a quarter point for the first time in 2016 amid signs of a growing economy and expectations for higher inflation in the US.

Last but not least, the Central Bank's gross international reserves fell in 2016, for the first time since 2009, moving from US$ 94.0 billion at end-2015 to US$ 81.1 billion at end-October 2016, down by 13.7% or the equivalent of US$ 12.9 billion, within the context of a low oil price environment and as the dollar-driven appreciation of the UAE dirham in real effective exchange rate terms weighed on competitiveness. Accordingly, the Central Bank's gross international reserves coverage ratio to money supply (M1) and dirham deposits went down from 36.7% at end-2015 to 31.6% at end-October 2016.

Looking ahead, the UAE authorities would focus on medium-term measures such as the VAT introduction in 2018 and new forms of taxation. This, combined with fuel prices currently indexed to international prices, the expected gradual policy rate hikes in the US in 2017, and the significant appreciation of the UAE currency in real effective terms, is set to put pressure on prices, making real estate prices and tourism more expensive, and hurting non-oil exports.

1.4.2. Banking Activity

Overall sound financial standing in a slow deposit growth environment

The UAE banking sector witnessed a slowdown in activity growth during the year 2016 in an environment of persistently low oil prices affecting banks' liquidity position. Measured by total assets of banks operating in the Emirates, banking sector activity grew by 2.7% in the first ten months of 2016 to reach US$ 692.8 billion at end-October 2016. This compares to a 5.0% rise registered in the previous year's corresponding period.

The main driver behind the slowdown in activity growth so far in 2016 stems from the funding side of banks' balance sheets. As a matter of fact, bank deposits slightly inched up during the first ten months of 2016 (+2.1%), reaching US$ 409.3 billion at end-October 2016.

A deeper look into deposit breakdown shows that resident and non-resident deposits (which account for 12% of the total deposit base) both contributed to the mild increase in the funding base of banks in the UAE (+1.2% and +9.3% respectively). Among non-resident funds, all categories registered an increase except for government and non-commercial entities.

Among resident deposits, private sector deposits drove the increase with a 3.5% rise since the start of the year, and the government sector deposits at banks slightly inched up. Non-banking financial institutions saw a slight drop in deposits, while the most important component holding back deposit growth this year proved to be government-related entities which saw a 9.2% decline. It is yet worth noting that the government sector and GREs altogether account for a quarter of the total deposit base, and continue to provide a structural support to banks' funding base.

From a currency standpoint (deposit breakdown excluding government deposits and commercial prepayments and borrowings under repurchase agreements, and interbank deposits), deposits in foreign currencies contributed to the slight rise in deposits more than those in local currency, bearing in mind that local currency time deposits retreated and held back overall deposit growth.

Amid a deposit growth slowdown, some banks resorted to increasing wholesale funding from abroad to finance slowing but still decent credit growth. Gross credit (including both domestic and foreign credit) rose by a decent 5.7% so far in 2016. Yet, the increase in volume proved 18% lower than that over the first ten months of 2015.

Domestic credit accounted for around 80% of the overall gross credit increase, with the remainder attributed to foreign credit. Among domestic credit, government and GREs credit were on the rise, but the major driver was the private sector with a 4.9% increase. That was mainly due to the corporate sector, while credit to individuals also rose. From a sector perspective, the latest available breakdown of bank credit to residents covering the first nine months shows that loans to construction and real estate, to non-bank financial institutions and retail loans (for business purposes more than for consumption purposes) were the main drivers of higher lending activity.

Demand for credit somewhat proved soft amidst tighter spending policies of major Emirati governments and as banks tighten credit underwriting standards and adopt a more conservative stance towards extending new waves of loans. Results from the Central Bank of UAE credit sentiment survey, which collects information from senior credit officers from all banks and financial institutions extending credit within the UAE, and covers the third quarter of 2016, revealed a downward trend in overall credit appetite for both business and personal loans. Lately, the UAE Central Bank said lending in 2017 will continue to grow at the same level as in 2016 as oil prices have stabilized.

With deposit growth falling short of lending activity growth, banking sector liquidity has tightened lately. The lending to stable resources ratio, i.e. the ratio of total advances (net lending + net financial guarantees & standby LCs + interbank placements of more than three months) to the sum of net free capital funds and total other stable resources, rose to 88.2% at end-October 2016 (87.1% at end-2015).

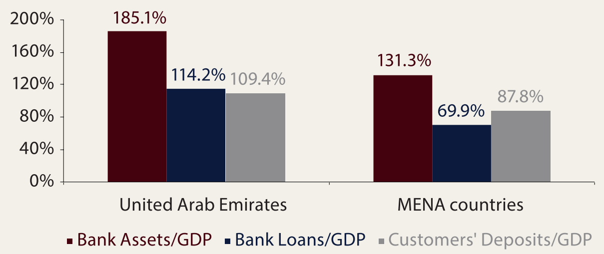
At the same time, the liquid assets ratio as published by the Central Bank (including reserve requirements mandated by the Central Bank, certificates of deposits held by banks at the Central Bank, in addition to zero-risk weighted government bonds and public sector debt and cash at banks), inched down from 17.4% at end-December 2015 to 15.7% at end-September 2016 (latest data available), putting some strains on banking sector liquidity stance.

EVOLUTION OF BANKING AGGREGATES

US$ million	2013	2014	2015	Oct-16
Total assets	571,899	627,611	674,799	692,825
% YTD growth in assets	11.9%	9.7%	7.5%	2.7%
Total deposits	348,237	387,012	400,708	409,312
% YTD growth in deposits	9.5%	11.1%	3.5%	2.1%
Total bank loans and advances	347,311	375,248	404,384	427,556
% YTD growth in bank loans and advances	7.7%	8.0%	7.8%	5.7%

Sources: Central Bank of UAE, Bank Audi's Group Research Department

COMPARATIVE BANKING SECTOR ECONOMIC DIMENSION *



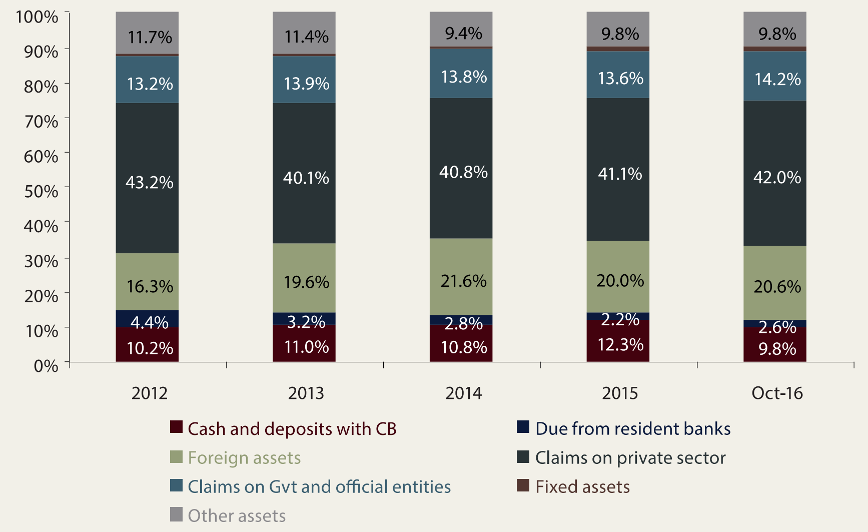
* October 2016 figures or latest available

Sources: Central Bank of UAE, Central Banks of MENA countries, IMF, Bank Audi's Group Research Department

In parallel with the tightening of liquidity, banks' asset quality saw further pressure, with some UAE banks reducing exposure to SMEs due to higher NPLs. SMEs were notably responsible for the rise in the NPLs ratio. The latter inched up from 5.2% at end-December 2015 to 5.3% at end-June 2016 as per the IMF. UAE banks have been building loan loss coverage levels in recent years, which could help offset rises in credit losses. Specific and general provisions both increased this year, thereby ensuring NPLs are adequately provisioned for. Nonetheless, banks do not want to write off bad loans, as per the Central Bank, implying that the NPL ratio could decrease below what is reported.

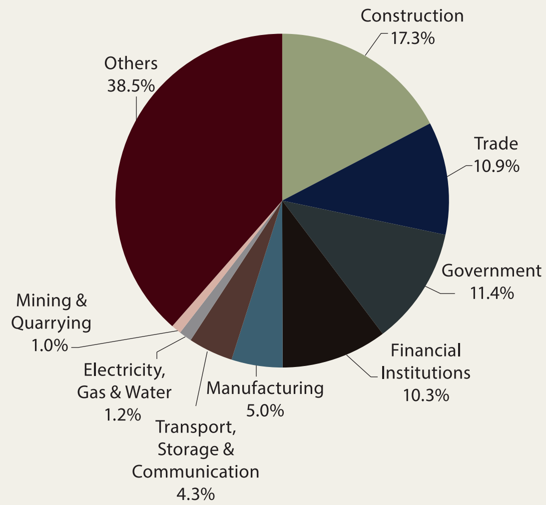
Banks operating in the Emirates are still highly capitalized, with the capital adequacy ratio of banks reaching 18.6% at end-September 2016 (18.3% at end-2015). The bulk of banks' capitalization consists of

BANK ASSET COMPOSITION



Sources: Central Bank of UAE, Bank Audi's Group Research Department

BANK LOAN BREAKDOWN BY ECONOMIC ACTIVITY *



*September 2016 figures for bank credit to residents

Sources: Central Bank of UAE, Bank Audi's Group Research Department

Tier 1 capital (Tier 1 ratio of 16.9% at end-September), well above the regulatory requirements set by the Central Bank (12% and 8% respectively).

Last but not least, it seems that the slowdown in economic growth coupled with higher provisions has taken a toll on banking sector profitability. In the absence of recent consolidated sector data, we resorted to the income statement analysis of the 19 listed banks domiciled in the UAE. On an aggregated level, net profits of those banks declined by 7.6% year-on-year in 9M2016, mostly weighed down by higher provisioning on behalf of banks.

1.4.3. Equity and Bond Markets

Price rebound in equity markets, significant contractions in CDS spreads in credit markets

The UAE capital markets reversed in 2016 the downward trajectory that was traced in the previous year. The UAE equity markets registered healthy price gains, mainly supported by the world's largest oil producers' decision to reduce oil output starting January 2017, while the fixed income market saw two-way flows amid an oil price rebound and an anticipated US interest rate hike in December 2016, along with contractions in the cost of insuring debt in Dubai and Abu Dhabi.

The UAE equity markets bounced back in 2016, mainly supported by improved investor sentiment after OPEC agreed late November on its first production cut since 2008 of 1.2 million barrels per day by January 2017, and non-OPEC oil producers agreed on December 10, 2016 to reduce output by 558,000 barrels per day, which spurred a strong oil price rally, with Brent oil prices quoted at around US$ 55 per barrel.

In details, the Dubai Financial Market index surged from 3,151.00 at end-2015 to 3,505.18 on December 20, 2015, moving up by 8.7%, following a slump of 16.5% in 2015. The breakdown of the DFM index by sector shows that the services sector witnessed the highest index surge over the covered period with 32.0%, followed by the consumer staples and discretionary sector (+22.8%), the telecommunications sector (+18.8%), the financial and investment services sector (+17.8%), the real estate sector (+16.6%), the transportation sector (+9.9%), the banking sector (+2.2%), while the industrial sector saw the highest index fall of -17.6%, followed by the insurance sector with -3.0%.

The total trading value in the Dubai Financial Market amounted to US$ 31.9 billion over the first eleven months of 2016, as compared to US$ 39.4 billion during the corresponding period of 2015, down by 18.9%. The total number of traded shares reached 93.9 billion shares over the first eleven months of 2016 against 92.3 billion shares during the same period of 2015, and the total number of trades was quoted at 1,172,971 during the first eleven months of 2016, versus 1,480,274 during the same period of 2015. On the back of price increases, the market capitalization in the Dubai Financial Market rose from US$ 83.9 billion at end-2015 to US$ 87.0 billion at end-November 2016, up by 3.7%, and reached US$ 91.1 billion by December 20, 2016. Within this context, the turnover ratio, measured by the annualized trading value to market capitalization, reached 40.0% over the first eleven months of 2016 as compared to 49.6% over the corresponding period of 2015.

Similarly, the Abu Dhabi Securities Exchange reported a healthy price increase of 4.0% since year-2015 to December 20 2016, as reflected by a rise in its index from 4,307.26 at end-2015 to 4,479.04. This followed a 4.9% drop in the index in 2015. The breakdown of the Abu Dhabi general index by sector shows that the highest growth was in the real estate sector with +19.9%, followed by the telecommunications sector (+14.6%), the energy sector (+7.2%) and the services sector (+2.0%). In contrast, the investment and financial services sector posted the largest price fall of 16.6%, followed by the industrial sector (-13.6%), the consumer staples sector (-4.8%), the insurance sector (-2.3%), and the banking sector (-0.7%).

The total trading value fell by 19.3% during the first eleven months of 2016 to reach US$ 11.8 billion. The total number of traded shares reached 23.8 billion shares over the first eleven months of 2016, against 23.9 billion shares during the same period of 2015. The total number of trades was quoted at 335,499 during the first eleven months of 2016 versus 407,512 during the same period of 2015. The market capitalization rose from US$ 111.9 billion at end-2015 to US$ 115.8 billion at end-November 2016 and US$ 119.4 billion on December 20, 2016. Within this context, the turnover ratio, measured by the annualized trading value to market capitalization, reached 11.1% over the first eleven months of 2016 as compared to 14.4% over the corresponding period of 2015.

All in all, the UAE equity markets outperformed regional stock markets between end-December 2015 and December 20, 2016, as reflected by an 8.7% surge in the S&P UAE price as compared to a 1.7% rise in the S&P Pan Arab Composite Index amidst an oil price rebound.

In parallel, UAE fixed income markets saw mixed price movements over the year 2016, except for the financial space where flows were mainly skewed to the buy side. Some papers posted price falls, tracking declines in US Treasuries amid fuelled bets about an interest rate hike. In fact, the US Federal Reserve raised in December 2016 interest rates by a quarter point to a range of 0.50%-0.75% amid signs of a growing economy and expectations for higher inflation, while anticipating three rate increases in 2017 instead of two, which prompted the Central Bank of the UAE to lift the interest rate on its Certificates of Deposits by a similar pace. Some other papers registered price gains on improved investor sentiment after Abu Dhabi and other GCC governments tapped international bond markets to cover budget deficits, and given an oil price rebound after OPEC and non-OPEC members agreed to reduce their oil production in an attempt to ease a global supply glut. UAE bond sales totalled US$ 12.6 billion in 2016 as compared to US$ 9.6 billion in 2015. Also, the share of UAE bond issues reached 24.9% of total MENA bond issues in 2016 as compared to a share of 41.6% in 2015.

In the Abu Dhabi space, sovereigns maturing in 2019 closed down by 5.13 pts. As to new issues, the Emirate of Abu Dhabi returned in April 2016 to international debt markets after an absence of seven years. The Emirate launched a US$ 2.5 billion five-year bond at 85 basis points over US Treasuries, and a US$ 2.5 billion ten-year bond at 125 basis points over US Treasuries. Proceeds of the bond sale would be used to cover the budget deficit.

Mubadala'19, '21 and '22 posted price declines of 4.50 pts, 2.00 pts and 0.13 pt respectively. Mubadala issued a 7-year US$ 500 million senior unsecured bond at 150 basis points over midswaps. IPIC papers maturing between 2017 and 2022 saw price falls ranging between 0.63 pt and 2.25 pts. Prices of Dolphin'19 and '21 decreased by 1.75 pt and 0.25 pt respectively. Etisalat'19 and '24 traded down by 1.00 pt and 2.00 pts respectively. Taqa papers saw two-way flows. Taqa papers maturing in 2017, 2018 (offering a coupon of 7.25%) and 2019 registered price drops of up to 3.63 pts. In contrast, Taqa'18 (offering a coupon of 2.50%), '21, '23, '24 and '36 saw price increases of 0.13 pt to 2.50 pts. Taqa sold US$ 500 million five-year bonds at a yield of 3.625% and ten-year US$ 500 million bonds at a yield of 4.375% in June 2016, and raised US$ 750 million in October 2016 by tapping the aforementioned issues.

Papers issued by financial institutions saw two-way flows in the Abu Dhabi credit space. ADIB Perpetual closed up by 0.75 pt. Prices of FGB'19 and '20 rose by 0.13 pt and 1.19 pt respectively. ADCB'18 (offering a coupon of 2.5%), '19 (offering a coupon of 2.75%), '20 and '23 recorded price gains of up to 1.13 pt. In contrast, Al Hilal Perpetual was down by 1.50 pt. FGB'17 (offering a coupon of 4.046%) and '17 (offering a coupon of 2.862%) closed down by 1.69 pt and 0.38 pt respectively. ADCB'19 (offering a coupon of 3%) traded down by 0.13 pt. Prices of NBAD'17 and '19 decreased by 1.50 pt and 1.00 pt respectively. Regarding new bond issues in the Abu Dhabi financial space, Noor Bank issued in May 2016 a US$ 500 million debut Tier 1 Sukuk. Also, Union National Bank raised US$ 600 million from the sale of a 5-year senior unsecured bond.

As to the cost of insuring debt, Abu Dhabi's five-year CDS spreads contracted by 32 basis points to reach 61 basis points, mainly supported by improved investor sentiment amidst an oil price rebound and the successful launching of a US$ 5 billion bond.

In the Dubai space, sovereign papers saw mixed price movements over the year 2016. Sovereigns maturing in 2017, 2020, 2021 and 2022 registered price decreases of 0.63 pt to 4.25 pts. In contrast, sovereigns maturing in 2023, 2029 and 2043 posted price gains of up to 5.00 pts. Emaar Properties'19 was down by 2.75 pts, while Emaar Properties'24 closed up by 0.50 pt. Prices of DP World'17 decreased by 2.88 pts, while DP World'20 and '37 traded up by 1.50 pt and 7.50 pts respectively. Majid Al Futtaim'17 and '19 were down by 3.31 pts and 2.00 pts respectively, while Majid Al Futtaim'24 and '25 registered price gains of 0.75 pt and 1.25 pt respectively. Majid Al Futtaim Perpetual traded up by 3.75 pts.

Papers issued by financial institutions saw mostly upward price movements over the year 2016. DIB Perpetual (offering a coupon of 6.25%) and DIB Perpetual (offering a coupon of 6.75%) closed up by 2.50 pts and 1.00 pt respectively. Commercial Bank of Dubai'18 and '20 traded up by 0.38 pt and 1.50 pt respectively. ENBD'19, '22 and '23 saw price gains of up to 5.25 pts. In contrast, DIB'17 was down by 2.50 pts. EIB'17 and '18 closed down by 2.00 pts and 1.19 pt respectively. Prices of ENBD'17 decreased by 1.88 pt.

Finally, Dubai saw several new bond issues in 2016. Emaar Properties raised US$ 750 million from the sale of ten-year Sukuk, priced at 225 basis points over midswaps. DP World raised US$ 1.2 billion from the sale of seven-year Sukuk, priced at 237.5 basis points over midswaps. In the financial space, Dubai Islamic Bank launched a US$ 500 million five-year Sukuk issue at 230 basis points over midswaps. Emirates Islamic Bank raised US$ 750 million from the sale of international bonds at a coupon of a 3.542%. As to the cost of insuring debt, Dubai's five-year CDS spreads contracted by 84 basis points in 2016 to reach 150 basis points.

ABU DHABI STOCK MARKET INDICATORS

	2012	2013	2014	2015	Nov-16
Market capitalization (in US$ billion)	69.4	109.5	113.7	111.9	115.8
Trading value (in US$ billion)	6.1	23.1	39.6	16.4	11.8
Turnover ratio	8.7%	21.1%	34.8%	14.7%	11.1%
Trading volume (in millions)	16,394	51,519	58,531	27,825	23,747
Number of transactions	258,685	556,290	864,066	456,376	335,499
General share price index	2,631	4,290	4,529	4,307	4,309
% Change in share price index	9.5%	63.1%	5.6%	-4.9%	0.0%

Sources: Abu Dhabi Securities Exchange, Bank Audi's Group Research Department

DUBAI STOCK MARKET INDICATORS

	2012	2013	2014	2015	Nov-16
Market capitalization (in US$ billion)	50.1	70.7	87.9	83.9	87.0
Trading value (in US$ billion)	13.3	43.5	103.9	41.2	31.9
Turnover ratio	26.5%	61.6%	118.2%	49.1%	40.0%
Trading volume (in millions)	40,463	127,180	160,533	98,231	93,884
Number of transactions	621,434	1,337,858	2,412,839	1,570,369	1,172,971
General share price index	1,623	3,370	3,774	3,151	3,361
% Change in share price index	19.9%	107.7%	12.0%	-16.5%	6.7%

Sources: Dubai Financial Market, Bank Audi's Group Research Department

2. CONCLUDING REMARKS

Looking ahead, the UAE economy is likely to be impacted by a number of evolving factors, of which the outlook on oil prices. In the near term, external risks remain pronounced in view of the dependence on oil receipts, which account for more than 30% of exports, within the context of increasing macro-financial stability risks and tightening financial conditions. In the medium term, non-hydrocarbon growth is forecast to increase considerably as the dampening effect of fiscal consolidation would be offset by improvements in economic sentiment and financial conditions as oil prices increase and a pick-up in private investment in the run-up to the Expo 2020, notwithstanding the stronger external demand tied to the expected improvement in global growth outlook.

At the fiscal level, commitment to pursue fiscal consolidation is undoubtedly key to contain increasing deficits and subsequently debt growth. It is worth mentioning within this context that the 2017 government deficit is likely to be financed largely by issuing bonds in international market and by tapping into international market and by tapping into Abu Dhabi's large sovereign wealth funds. In early 2018, the UAE authorities are expected to introduce a low-rate VAT (in the realms of 5%) in coordination with other GCC countries, which could be followed by increases in excise and corporate income taxes. Having said that, whatever the adjustment magnitude is, the policy mix needs to minimize the short-term effect on growth while boosting equity and medium-term growth prospects.

At the monetary level, it is true that the peg came under some pressure in early 2016 as a result of lower oil prices. But the peg regime is expected to hold in the foreseeable future even if oil prices stay low, for a number of considerations. First, GCC countries can to a large extent allow themselves to defend pegs as they are underpinned by still large buffers (though declining) on the back of a large foreign exchange reserves base and low indebtedness ratios. Also, the peg has been for decades a warrant of investor confidence and monetary and economic stability while reducing chances of social discontent. Currency devaluation might trigger a surge in inflation, damage investor confidence, lead to outflows of capital, damage Central Bank credibility and add uncertainty to potential future adjustments.

Having said that, within the context of the continuing peg of the UAE dirham to the US dollar, gradual and steady policy rate hikes in the US over the next couple of years would imply further increases in interest rates in the UAE, along with a significant appreciation in the UAE currency in real effective terms. This might however hurt non-oil exports, make tourism more expensive and dampen loan demand.

When assessing the outlook of the UAE economy, it is important to address the key strengths and major weaknesses facing the economy. At the level of strengths, we mention the domestic political stability coupled with strong international relations, the high income per capita (one of the highest worldwide), the large hydrocarbon reserves, the substantial level of external financial assets, the prudent fiscal management and the diversified export base. At the level of weaknesses, we mention the growing regional geopolitical tensions, the vulnerability to exogenous shocks amid a prolonged period of declining oil prices, the relatively high contingent liabilities from government related entities, the lack of visibility on consolidated fiscal policy trends and the relatively weak institutional framework and limited data transparency.

While weaknesses are real, we believe opportunities outpace threats at the horizon. Challenges are tied to safeguarding the UAE growth model that has delivered strong economic development in the past two decades. As such, further reforms are needed to raise total factor productivity, to align education and skills further to market needs and to improve the overall institutional framework, while ensuring further progress toward diversification and subsequently reinforcing economic growth in the medium term.

DISCLAIMER

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