

## UAE ECONOMIC REPORT

### WITHSTANDING WELL THE LOW OIL PRICE ENVIRONMENT DESPITE HEADWINDS

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- Weathering well the oil supply shock despite economic slowdown**  
The UAE economy is seemingly weathering well the oil price shock. In fact, the UAE is considered to be somewhat resilient to the impact of the slump in oil prices within the context of a well diversified economic structure, domestic political stability and a wide pool of foreign assets. Still, as part of its adjustment efforts, the UAE government has cut back on spending plans, creating some headwinds for economic growth in the emirates. Within this environment, real GDP growth declined to 1.3% in 2017, mainly tied to the drop in oil production along with fiscal adjustment spillover effects.
- Foreign trade surplus back on a rising path for the first time in five years**  
UAE's wise diversification efforts, particularly into tourism, non-hydrocarbon trade and financial services, continued to mitigate the adverse impact of the prolonged low oil price environment in 2017. In details, total exports of goods free on board picked up by an estimated 6.3% on a yearly basis, while imports increased by an estimated 4.2% year-on-year. Accordingly, the UAE's trade surplus grew, for the first time since 2012, by an estimated 13.2% year-on-year, to reach US\$ 77.3 billion, which continues to ensure a major buffer against leakages from the services and transfers accounts. At the fiscal level, UAE is reporting in 2017 its third deficit in a row, estimated at 3.7% of GDP despite fiscal adjustment efforts.
- Subdued inflation along with slow broad money supply growth**  
The year 2017 was marked by a continuous slow growth in monetary aggregates along with an uptick in inflation which remained subdued, while the Central Bank's gross international reserves managed to rebound, and the UAE monetary authorities remained firmly committed to the US dollar peg, which led to increases in key interest rates in line with the US Federal Reserve interest rate hikes. In details, the Consumer Price Index for the UAE reached 108.64 in October 2017, moving up by 2.1% relative to October 2016, partly reflecting new excise tariffs introduced on tobacco, energy and carbonated sugary drinks, in addition to higher imported inflation. The narrow measure of money supply (M1) widened by 3.8%. The Central Bank's gross international reserves saw a rebound in 2017, with international reserves coverage ratio to money supply (M1) and dirham deposits reporting 32.9% at end-October 2017.
- Decent banking activity growth withstanding slower economic momentum environment**  
Banks operating in the UAE witnessed a rather decent activity growth in 2017 given the relatively low oil price environment and fiscal consolidation measures at large. Measured by the total assets of banks operating in the UAE, the sector witnessed a 3.6% increase in activity since the start of the year, with assets reaching US\$ 731.7 billion at end-November 2017. The growth in volume proved slightly higher than that registered during the corresponding period of 2016, highlighting UAE banks' adequate adjustment to slower economic growth amid persistently low oil price levels. It is worth noting that net interest margins seem to have been under upward pressure since the start of 2017, with loans resetting at higher rates and funding costs improving as liquidity conditions eased in the emirates, while fee income generation capacity is somewhat impacted by the low growth environment.
- UAE equity markets under downward price pressures, two-way flow activity in bond market**  
The UAE equity markets saw downward price movements in 2017, as concerns over KSA's anti-corruption probe and the rising regional political tensions weighed on stocks, while the fixed income market saw two-way flows, along with stability in the cost of insuring debt in Abu Dhabi and contractions in Dubai's five-year CDS spreads.
- Growth projected to rebound at the horizon**  
Looking ahead economic diversification into tourism, trade and financial services would continue to mitigate the effects of the still low oil price environment and provide the basis for sound growth. Economic growth might improve in 2018, forecasted at 3.4% by the IMF, within the context of firming oil prices, an improvement in global trade and the expected easing pace of fiscal adjustment.

The UAE Economic Report can be accessed via internet at the following web address: <http://www.bankaudigroup.com>

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At the external level, unlike many of its GCC peers, the UAE's external position remains in surplus, though the surplus in the current account balance has declined in tandem with the drop in international oil prices. As a percentage of the emirates' GDP, the current account surplus reported 2.1% in 2017 within the context of a 132% coverage of imports by exports. A long run of current account surpluses, stretching back at least two decades, has helped the UAE maintain a large net external creditor position despite the low oil price environment.

At the monetary level, UAE monetary policy continues to track the US monetary policy. UAE's Central Bank continues to maintain the peg to the US dollar, thus mirroring the US Federal Reserve movements. With gross international reserves standing at US\$ 88.5 billion, the equivalent of 32.9% of Money Supply in AED, the peg remains in a comfortable position on the overall. As far as inflation is concerned, with Broad Money Supply growth at a low of 1.5% yearly as at October 2017, inflation remains subdued at 2.1% for full year 2017.

UAE's public finances have been adversely affected by the fall in oil revenues, and the government has embarked on a medium term fiscal plan to eliminate the deficit. UAE is reporting in 2017 its third deficit in a row, estimated at 3.7% of GDP, resulting from an expenditures to GDP ratio of 30.4%, partly offset by a revenues to GDP ratio of 26.8%. The emirates yet still enjoy a low indebtedness level, with government debt not exceeding US\$ 78.5 billion, the equivalent of 20.7% of GDP.

At the banking level, banks operating in the UAE continued to adjust to slower growth and higher interest rates. That said, the UAE banking sector is well regulated and supervised and continue to weather the effects of low oil prices and the moderation in non-oil economic activity. Banks remain fairly liquid with an eligible liquid asset ratio of 17.6%, well capitalized with a capital adequacy ratio of 18.7%, enjoying good asset quality with NPLs to total loans at 6.7% along with an 83.2% provisioning coverage and remain satisfactorily profitable with a return on average assets of 1.5% and a return on average equity of 10.8%.

At the level of UAE's capital markets, a mixed performance was reported in 2017. The Abu Dhabi equity market registered a 5.8% price contraction in the first 11 months of 2017 within the context of lower trading volumes, with the turnover ratio declining from 11.1% in 2016 to 10.3% in the first 11 months of 2017. While Dubai is more active in terms of trading, its turnover ratio still dropped from 39.4% to 30.1% between the two periods, contracting the price index by 3.1% over the 11-month period. At the fixed income level, Dubai's 5-year CDS spreads contracted by 22 bps year-to-date to reach 128 bps, while Abu Dhabi's 5-year CDS spreads remained almost stable at 63 bps.

#### UAE ECONOMIC PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

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

#### 1.1.1. Hydrocarbons Sector

*Declining share of hydrocarbons in economy amid diversification efforts*

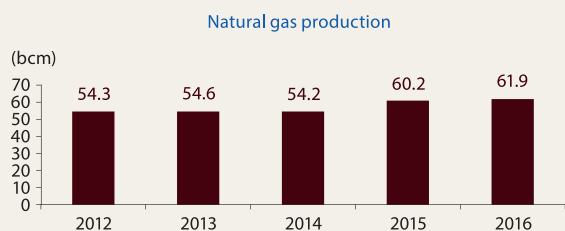
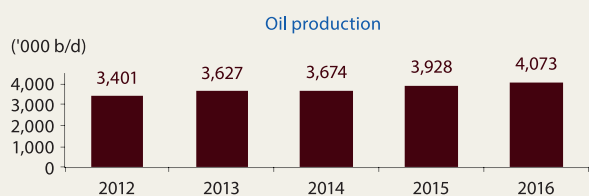
In line with its adopted diversification strategy, the UAE has continued putting in efforts to reduce the hydrocarbon sector's contribution to the economy. In fact, hydrocarbon exports out of total exports fell from 29.7% in 2014 to an estimated 18.3% in 2017. The performance of the hydrocarbons sector weakened as the country's real oil GDP growth slowed from 3.8% in 2016 to a negative 2.9% in 2017, as a result of the UAE's commitment to the OPEC agreement, but is projected to recover in 2018 and return to a rising trend over the medium term, as per the International Monetary Fund.

Oil prices in 2017 were supported by the Organization of the Petroleum Exporting Countries (OPEC) production cuts and geopolitical tensions in the Middle East. Brent crude oil prices expanded by 8.1% in 2017, against a contraction of 22.2% in 2016 and a decline of 29.6% in 2015.

On the supply side, crude oil production is estimated to decline by 5% in 2017 in line with the OPEC+ agreement. The UAE has the fourth-highest petroleum production in OPEC behind Saudi Arabia, Iraq, and Iran. The UAE plans to increase crude oil production to 3.5 million b/d in 2020. One potential source of output growth is the Zakum petroleum system (ZADCO), which is owned jointly by ADNOC (60%), ExxonMobil, (28%) and the Japan Oil Development Company (12%). It manages UAE's Upper Zakum field, which currently produces about 670,000 b/d.

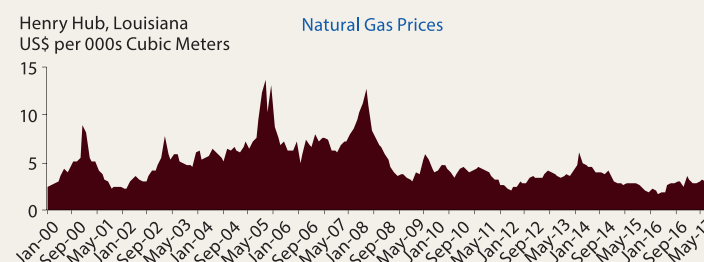
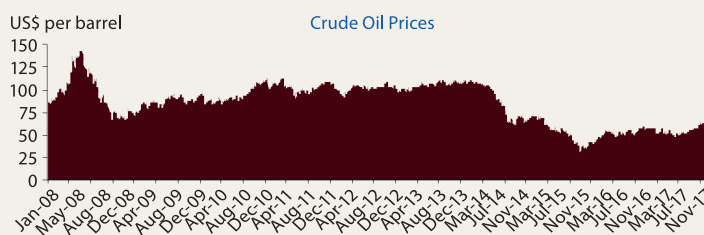
As for other upstream developments in the UAE, the Abu Dhabi Company for Onshore Operations invested up to US\$ 7 billion in the period 2015-2017 to increase production by around 180,000 b/d. Also, the Abu Dhabi Marine Operating Company plans to significantly raise production at the Lower Zakum

#### OIL & GAS PRODUCTION



Sources: British Petroleum, Bank Audi's Group Research Department

#### CRUDE OIL & NATURAL GAS PRICES



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

field (+90,000 b/d), and to bring onstream new output at the Umm Lulu (105,000 b/d), Nasr (65,000 b/d) and SARB (100,000 b/d) fields over the next five years.

According to the US Energy Information Administration (EIA), the UAE holds the seventh-largest proved reserves of oil in the world at 97.8 billion barrels, with most of the reserves located in Abu Dhabi (approximately 96% of the UAE's total). The other six emirates account for just 4% of the UAE's crude oil reserves, led by Dubai with approximately 2 billion barrels. The UAE holds approximately 6% of the world's proved oil reserves.

Moving on to the consumption of oil, it is important to point out that fuel price deregulation would have a limited impact on consumption in the UAE, due to increased vehicle sales and strong growth in the energy-intensive industrial sectors. For instance, the consumption of refined fuel products is set to rise by 1.5% year-on-year in 2017, in barrels of oil equivalent, as per BMI Research.

As for the UAE's gas sector, the country plans to boost domestic natural gas production over the next several years to help meet growing internal demand. The power sector accounts for the majority of gas consumption in the UAE, with gas representing more than 98% of total electricity generation in 2017. Gas consumption is expected to rise by 3.5% in 2017, against a growth rate of 5.5% in 2016. However, a growing role for nuclear and to a lesser extent renewables could see the share of gas in the overall energy mix fall in the future, as per the EIA. Downside pressure also stems from ongoing subsidy reforms, as electricity is heavily subsidized at around 85% of the total cost.

With regards to gas reserves, the UAE holds the seventh-largest proved reserves in the world, at slightly more than 215 trillion cubic feet. Nonetheless, despite its large endowment, the UAE became a net importer of natural gas in 2008. This phenomenon is a result of the UAE reinjecting approximately 26% of gross natural gas production in 2015 into its oil fields as part of EOR techniques and the country's rapidly expanding electricity grid.

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. The country is making notable progress in diversifying its economy through tourism, trade and manufacturing. However, in the near term, oil, natural gas and associated industries would continue to account for a remarkable chunk of economic activity in the seven emirates.

### 1.1.2. Non-Hydrocarbons Sector

#### Real Estate and Construction

##### *Real estate market performing on its softer end*

Economic diversification helped keep the UAE real estate market competitive in the Middle East region. However, property transactions slowed down in 2017 and the market was on its softer end in both Abu Dhabi and Dubai, despite the better performance in terms of supply in Dubai.

In Abu Dhabi, the first three quarters of 2017 saw declines in residential performance, mainly due to the continued reduction in the government spending and sentiment. According to Jones Lang Lasalle (JLL), residential rents and sales prices decreased in general as vacancies increased in consistence with subdued demand and further additions to supply. In details, mergers and job cuts, in addition to cuts in housing allowances negatively impacted rental demand. Alongside, suppressed sentiment resulted in lower sales transactions. Average rents for Prime two-bedroom apartments decreased by 13% year-on-year reflecting the increase in vacancy rates. Moreover, sales prices registered a similar decline.

Regarding the performance of the office market, the latter continues to be influenced by the number of mergers, job cuts and consolidation measures in the government and financial services entities. In terms of supply, no major completions took place in the third quarter of 2017, leaving the total office stock at 3.5 million square meters of gross leasable area (GLA) in the first three quarters of 2017, as per JLL. In terms of performance, headline rentals for Grade A and B office space were unchanged over the past year standing at AED 1,760/ square meter (sqm) and AED 1,030/sqm respectively. Vacancies rose from 20% in the third

quarter of 2016 to 22% in the same period of 2017, within the context of greater competition and more choice of space available to tenants. Demand on the other hand remained limited as some companies downscaled to smaller units.

Looking at the retail market, there were no major completions during the third quarter of 2017, with the total stock standing at around 2.6 million square meters. In the medium term, the delivery of Al Maryah Central Mall in 2018, in addition to the expansion of existing malls over the coming years is expected to increase supply. The sector's performance reveals that average store rents within well-located malls in Abu Dhabi remained unchanged over the past 12 months with vacancies stable at 2%. However, it is worth noting that mall operations were facing subdued demand and a decline in retail spending through offering retailers increased incentives, including flexible leasing terms and rent-free periods, among others.

According to JLL, Dubai is encountering a bulk of new projects. However, this sentiment raises the prospects of potential over supply. In the residential market, the majority of supply during the third quarter of 2017 was for apartments, with the total supply reaching 487 thousand units in the first three quarters of 2017. Sales prices of apartments retreated by 1.6% year-on-year in the third quarter, while rents declined by 6.2% over the same period. Moreover, sales prices of villas fell by a yearly 1.1% in 3Q2017, while rents edged down by 7.4%.

As for the office market, the third quarter of 2017 saw the delivery of 35,000 square meters of GLA. Total stock stood at 8.8 million square meters of GLA. However, the volatility of global markets and geopolitical conditions may cause corporates to delay or scale back future growth plans posing risks on the materialization of certain projects. In terms of performance, office rents have edged down across Grade A quality buildings. According to JLL, landlords are responding to the subdued demand by offering lower rentals, among other incentives.

In conclusion, the real estate sector seems to be doing well in terms of supply, but demand is not keeping up the same pace, pushing prices in terms of sales and rentals down in most of its segments, hence leaving the sector on a softer end, within the context of a number of projects already delivered and awaiting to be delivered.

## Transport

### *Sector growth supported by preparations for World Expo 2020*

UAE's transport sector has been a major contributor to the country's construction industry, with the growth of the transport sector supported by investments and preparations for World Expo 2020 in Dubai and projects tackling congestion in and across the emirates. Thus, the country is further cementing its spot as a regional transport hub, a major component of its diversification strategy.

Consequently, the UAE passed a draft law approving the AED 51.4 billion budget of 2018, with the budget including an amount to solve traffic congestion. The Ministry of Finance explained that such amounts are allocated to conduct studies and research aimed at addressing the causes of congestion. The latter would be the responsibility of the Ministry of Infrastructure Development, which would receive an increased budget allocation of AED 659.9 million (US\$ 179.7 million) in 2018. It is worth noting that UAE's infrastructure allocation, which includes transport, increased by 46.5% during the fiscal year 2017, making up 21% of total government expenditure. This reflects the emirates' keen efforts to implement the Expo 2020.

More specifically, in Dubai, the emirate's budget made provisions for a sharp rise in infrastructure spending next year, focused on Expo 2020 projects and transport infrastructure. The emirate would increase its spending on infrastructure and construction projects, which include transport, by 43% year-on-year.

The number of active transport projects in the UAE increased from 470 during the first 11 months of 2016 to 496 in the same period of 2017, according to BNC Network. The total value of projects increased from US\$ 81.9 billion to US\$ 87.1 billion, an increase of 6.3% year-on-year. The study revealed that the transport sector constitutes 4% of all active projects in the UAE. In dollar terms, these projects account for 11%

of the total estimated value for all sectors in the country. High investment in infrastructure reflects the UAE's commitment to reduce dependence on hydrocarbons and make its economies more sustainable by expanding and improving infrastructure. This would help cross-border trade, tourism and public mobility that are essential for diversification.

Moving on to the country's airports subsector, it has been at the forefront of the transport sector, as the market saw robust growth in freight volumes. One of the largest airports in the world is currently under construction in Dubai, the US\$ 32 billion expansion project at Al Maktoum International Airport at Dubai World Central. The latter aims to achieve annual passenger capacity in excess of 200 million alongside a final cargo capacity of 16 million tons per annum. The existing passenger terminal will also be expanded, to increase annual passenger capacity from 5 million to 25 million by 2020 and 120 million by the mid-2020s.

UAE's port infrastructure played a major role to its diversification strategy, with the well-developed port facilities available in the country enabling it to take advantage of its location on one of the world's major trade routes between Europe and Asia. Strong international trade connectivity consequently results in highly efficient export and import lead times, ensuring that the country will remain an attractive prospect to investors. The UAE is continuing its efforts to develop its ports by furthering investments with an AED 500 million agreement signed for the development of the Port of Fujairah infrastructure. Additionally, DP World has begun the construction on the first phase of Container Terminal 4 in the Jebel Ali port, which would deliver capacity of 3.1 million TEUs by 2018, raising the port's total capacity to 22.1 million.

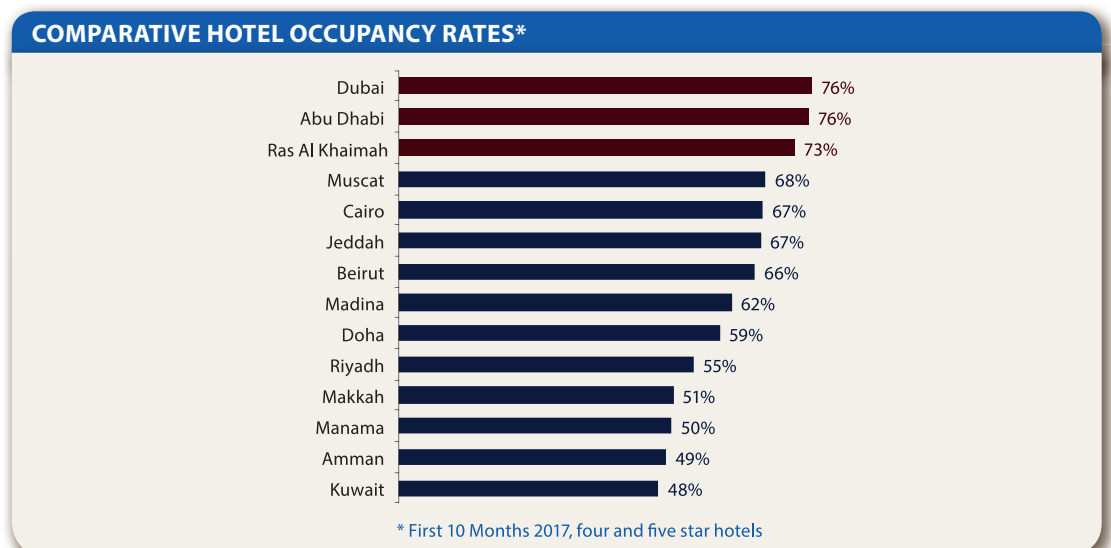
As for the railway sub-segment, the expansion of UAE's rail network would be a major driver of construction industry growth, driven by investment into major rail links, particularly expansion of the Dubai Metro. One of the key projects in the pipeline for the construction industry's growth is the Etihad Rail Project, which aims to stretch across the UAE, linking the emirates to eventually join other GCC countries.

In conclusion, investment into the transport sector is anticipated to remain robust over the medium term as the UAE works to position itself as a shipping, aviation and tourism hub and the governments of Dubai and Abu Dhabi seek to tackle growing congestion as their urban population rates climb.

## Tourism

*Tourism remains a pillar of diversification despite slowdown in hospitality sector*

The UAE tourism market is one of the best in the Middle East region and is expected to enjoy growth over the short and medium terms. A number of factors will drive growth in the market including sustained economic diversification efforts, heavy infrastructure investment projects and the ongoing effort to attract



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

global and regional holidaymakers and business travelers alike. Furthermore, the accommodations sector remains heavily active with hundreds of new properties in the pipeline. However, the hospitality sector came under pressure over the past year in terms of occupancy, average daily rates and RevPAR.

In Abu Dhabi, the third quarter of 2017 saw a decline in both occupancy levels and ADRs compared to the same period last year. The upcoming supply is expected to add further downward pressure on ADRs and occupancy levels throughout the rest of the year.

In Dubai, hotel performance remains under pressure, although the strategy of many hotels across the city is currently focused on maintaining high occupancy levels at the expense of daily rates. It is important to note that Dubai remains one of the strongest performing hotel markets globally in terms of RevPAR and other financial indicators. In the third quarter of 2017, the pace of decrease in ADRs has slowed compared to previous quarters.

It is worth noting that the decrease in the Dubai hospitality market performance is perceived as an adjustment of the market rather than an indication of distress, as per JLL. The emirate is putting continuous efforts to invest heavily in tourism infrastructure and as it diversifies towards new source markets such as South-East Asia. Moreover, Dubai has seen a 55% growth in arrivals from China, following the relaxation of visa regulations at the end of 2016.

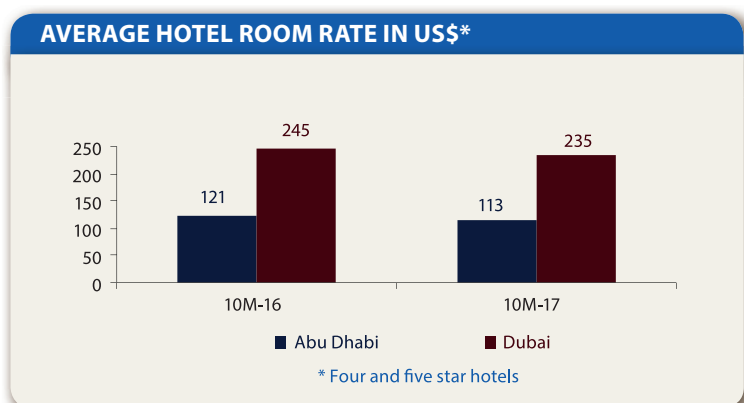
On a side note, the cities of Dubai, Abu Dhabi and Ras Al Khaimah occupied the top three positions in hotel occupancy during the first ten months of 2017, with 76% for Dubai and Abu Dhabi and 73% for Ras Al Khaimah, as per EY. In Dubai, average room rates declined from US\$ 245 to US\$ 235 over the same period, while they declined from US\$ 121 to US\$ 113 in Abu Dhabi. Accordingly rooms' yield in Dubai fell to US\$ 179, while dropping to US\$ 86 in Abu Dhabi in the first ten months of 2017.

In conclusion, the tourism sector in the UAE remains one of the pillars of the country's diversification strategy, despite a relatively small setback in the hospitality, that could be associated with a number of reasons including relative instability in the MENA region at large.

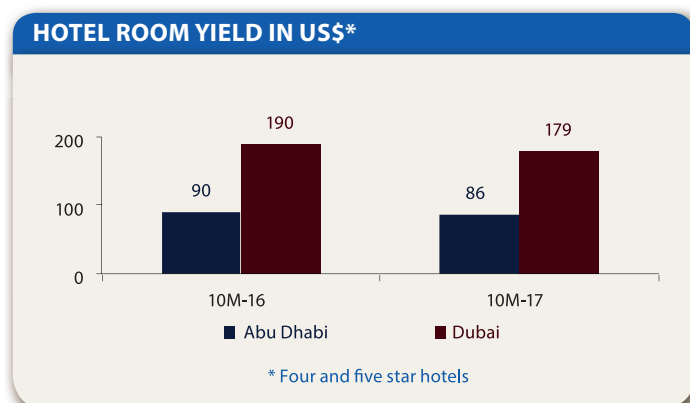
**1.2. EXTERNAL SECTOR**

*Foreign trade surplus back on a rising path for the first time in five years*

UAE's wise diversification efforts, particularly into tourism, non-hydrocarbon trade and financial services, continued to mitigate the adverse impact of the prolonged low oil price environment in 2017. As such, the country's non-oil trade continued its growth demonstration, yet at a weakening pace, overcoming all negative effects of the challenges that resulted from the slowdown of international trade movement and the retreat of global economic growth rates, in addition to the negative effects of the security disorders in the region. As such, the latest preliminary statistical data of the Federal Customs Authority (FCA) revealed that the UAE's non-oil general trade volume amounted to US\$ 213 billion during the first half of 2017, compared to US\$ 211 billion during the same period of 2016, signaling a 1% growth year-on-year.



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



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

Regarding the UAE trading partners map, the FCA pointed out that the regional structure of the country's trading partners in the field of non-oil general trade was stable regarding the regional shares during the first half of 2017. Asia, Australia and the Pacific region maintained the first rank among the non-oil trade partners with a share of 43% of the UAE's total non-oil trade. The FCA added that the share of the UAE's non-oil general trade with the GCC countries during the first half of 2017 constitutes 11% of the total non-oil trade with the world. In terms of trade with Arab countries, the FCA's preliminary data showed that the UAE's total non-oil trade with the Arab states constitutes 19% of the total non-oil trade of the country with the world.

In details, total exports of goods free on board picked up by an estimated 6.3% on a yearly basis, moving from US\$ 298.6 billion in 2016 to US\$ 317.3 billion in 2017 as per the EIU (against a drop of 1% in the previous year). In parallel, imports increased by an estimated 4.2% year-on-year, to reach US\$ 240.0 billion in 2017, up from US\$ 230.3 billion in 2016 (against a lower growth of 2.9% in the previous year). Accordingly, the UAE's trade surplus grew, for the first time since 2012, by an estimated 13.2% year-on-year, to reach US\$ 77.3 billion (against a drop of 10.8% in 2016), which continues to ensure a major buffer against leakages from the services and transfers accounts.

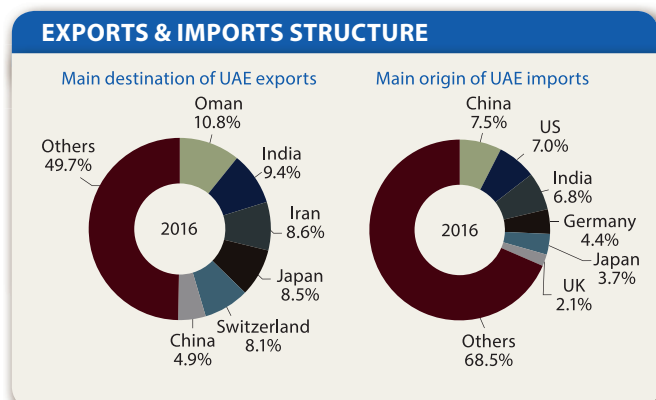
In fact, the UAE has been upgrading infrastructure over the past few years to enhance its performance in transportation, business and tourism services, and thus payments naturally exceeded receipts within the context of a modest recovery in regional liquidity and demand for UAE services (mainly tourism and financial services). In parallel, the main components of transfers' outflows remained workers' remittances sent by the important expatriate labor force, which accounts for the bulk of workers in the UAE. As such, the estimated rise in UAE's trade surplus in 2017, coupled with wider deficits at the level of services and current transfers' deficits, is expected to result into a slight contraction in the current account surplus from 2.4% of GDP in 2016 to an estimated 2.1% of GDP in 2017, as per the IMF.

Last but not least, UAE's current account balance is expected to remain in surplus in the medium term, as firmer oil prices, a rebound in global trade and easing of fiscal consolidation are expected to strengthen external balances, especially as investments and non-oil exports of goods and services ramp up ahead of Dubai's Expo 2020, backed by a vibrant non-oil sector as the country remains on track to establish a diverse knowledge/innovation-driven economy.

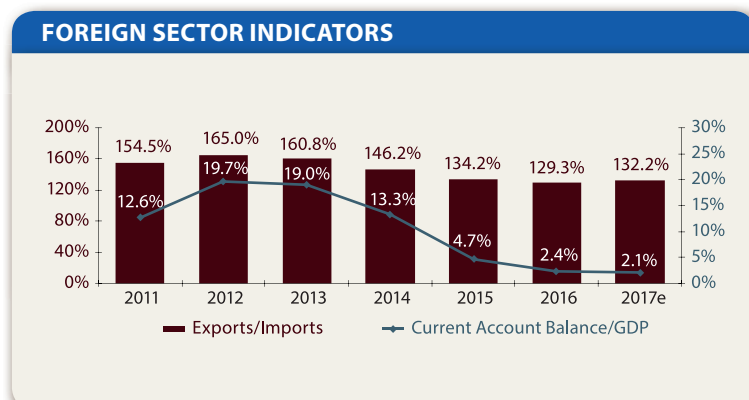
### 1.3. PUBLIC SECTOR

*Slightly weakened fiscal position amidst continued fiscal consolidation and reforms*

The UAE fiscal position has deteriorated slightly over the first half of 2017, with the government fiscal balance posting a larger deficit over the aforementioned period. This prompted some fiscal adjustments such as excise duties that came into effect as of end-2017 and VAT that is expected to be introduced in the beginning of 2018, which would bolster the progress made on the non-oil revenue side.



Sources: EIU, Bank Audi's Group Research Department



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

Within the context of fiscal consolidation, it is worth mentioning that some of the efforts seen in 2016 have been wound down in order to improve welfare, housing affordability, education and healthcare provisions.

On the revenue front, general government revenues have registered a significant increase of 50% over the first half of 2017, rising from US\$ 51.2 billion in the first half of 2016 to US\$ 76.9 billion in the first half of 2017, as per the latest data released by the Ministry of Finance. Tax revenues increased significantly over the first half of 2017, registering US\$ 31.2 billion compared to US\$ 12.8 billion in the first half of 2016. Other revenues rose as well from US\$ 37.7 billion in the first half of 2016 to US\$ 44.9 billion in the same period of 2017, an increase of 19.5%. Within this context, the IMF expects revenues to reach US\$ 101.3 in full-year 2017 and US\$ 109.4 billion in 2018.

The UAE's key priority on the revenue side is a timely introduction of the VAT and excise taxes (the latter on tobacco, alcohol, and soft drinks), in coordination with other GCC countries, as this would help the UAE move forward with its fiscal adjustment efforts. The planned VAT introduction in 2018 is not expected to have a significant adverse impact on growth.

General government expenditures registered an increase of 48.6%, rising to US\$ 72.4 billion in the first half of 2017 up from US\$ 48.7 billion in the same period of 2016. Compensation of employees increased by 47.7% in the first half of 2017 to reach US\$ 12.6 billion, while expenditures on social benefits decreased by 18.9% from US\$ 4.8 billion in the first half of 2016 to US\$ 3.9 billion in the equivalent period of 2017. Other expenses rose by 32.2% to reach US\$ 33.8 billion in the first half of 2017, up from US\$ 25.6 billion in the corresponding period of 2016. In terms of non-financial assets, expenditure on fixed assets increased by 85.2% to reach US\$ 10.4 billion in the first half of 2017, while expenditure on inventories fell from US\$ 485 million in the first half of 2016 to US\$ 292 million in the same period of 2017. Within this context, the IMF expected expenditures to reach US\$ 115.2 billion in full-year of 2017 and US\$ 118.3 billion in 2018.

That said, stepped-up spending reviews supported by appropriate budget controls would be key to increase the efficiency of spending and contain its growth. Although general government revenues are rising at a slightly faster pace than general government expenditures, the overall UAE fiscal balance is estimated to have registered a deficit of US\$ 6.7 billion in the first half of 2017, up from US\$ 4.6 billion in the same period of 2016.

The IMF expects the fiscal balance to register a deficit of US\$ 13.9 billion in 2017 and a subsequent deficit of US\$ 8.9 billion in 2018. 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. It is worth finally mentioning that, under current policies, the budget is projected to return to balance by the year 2020.

### SELECTED PUBLIC FINANCE INDICATORS

US\$ billion	2013	2014	2015	2016	2017e
General government revenues	151.1	141.3	103.8	99.4	101.3
General government revenues/GDP	38.7%	35.0%	29.0%	28.5%	26.8%
General government expenditures	118.3	133.5	115.9	113.6	115.2
General government expenditures/GDP	30.3%	33.1%	32.4%	32.6%	30.4%
General government fiscal balance	32.7	7.7	-12.0	-14.2	-13.9
General government fiscal balance/GDP	8.4%	1.9%	-3.4%	-4.1%	-3.7%

Sources: IMF, Bank Audi's Group Research Department

### PUBLIC DEBT AND INDEBTEDNESS RATIO



Sources: IMF, Bank Audi's Group Research Department

### 1.4. FINANCIAL SECTOR

#### 1.4.1. Monetary Situation

##### *Subdued inflation along with slow broad money supply growth*

The year 2017 was marked by a continuous slow growth in monetary aggregates along with an uptick in inflation which remained subdued, while the Central Bank's gross international reserves managed to rebound, and the UAE monetary authorities remained firmly committed to the US dollar peg, which led to increases in key interest rates in line with the US Federal Reserve interest rate hikes.

In details, the Consumer Price Index for the UAE reached 108.64 in October 2017, according to the UAE Federal Competitiveness and Statistics Authority, moving up by 2.1% relative to 106.42 in October 2016, partly reflecting new excise tariffs introduced on tobacco, energy and carbonated sugary drinks, in addition to higher imported inflation.

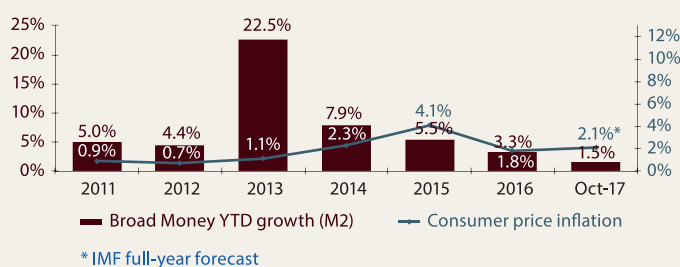
The division of the Consumer Price Index by sector shows that the tobacco sector registered the largest yearly price increase of 70.16% in October 2017 as the Federal Tax Authority imposed a tax of 100% on

#### EVOLUTION OF MONETARY CONDITIONS

Flows in US\$ million	2015	2016	10M-17
<b>Net international reserves</b>	<b>-9,858</b>	<b>3,380</b>	<b>15,268</b>
<b>Central Bank (net)</b>	<b>15,240</b>	<b>-7,441</b>	<b>3,082</b>
Gross international reserves	15,494	-8,587	3,068
Foreign Liabilities	254	-1,146	-14
<b>Banks (net)</b>	<b>-25,098</b>	<b>10,821</b>	<b>12,186</b>
Foreign Assets	1,238	13,735	4,538
Foreign Liabilities	26,336	2,913	-7,648
<b>Net Domestic Assets</b>	<b>26,574</b>	<b>7,139</b>	<b>-10,191</b>
Claims on private sector	22,059	16,337	-1,514
Net claims on public sector	14,969	2,102	-2,307
Claims on financial institutions	1,895	-5,306	1,131
Capital & Reserves	-5,077	-6,075	-6,206
Other Items (net)	-7,272	81	-1,295
<b>Broad Money (M2)</b>	<b>16,716</b>	<b>10,520</b>	<b>5,078</b>
Money Supply (M1)	5,664	4,662	4,892
Quasi-Money	11,052	5,858	186

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

tobacco starting October 2017, followed by the miscellaneous goods and services sector (+8.66%), the transportation sector (+5.72%), the education sector (+3.60%), the food and beverages sector (+2.40%) noting that the Federal Tax Authority imposed a tax of 100% on energy drinks and 50% on carbonated beverages starting October 2017, the furniture and household goods sector (+1.67%), the housing sector (+0.55%), the textiles, clothing and footwear sector (+0.54%), the restaurants and hotels sector (+0.45%) and the medical care sector (+0.38%). Contributions to inflation have been negative from the recreation and culture sector of (-11.77%) and the communications sector (-0.51%).

On the overall, the Consumer Price Index averaged 107.60 during the first ten months of 2017 as compared to an average of 105.58 during the same period of 2016, up by 1.9%, noting that the IMF expects inflation at 2.1% in 2017.

Monetary aggregates in the UAE continued to report a slow growth during the first ten months of 2017 as compared to the corresponding period of the previous year. The narrow measure of money supply (M1) widened by 3.8%, moving up from US\$ 129.1 billion at end-2016 to US\$ 134.0 billion at end-October 2017. This compared to a smaller expansion of 3.4% during the corresponding period of 2016. The broader money supply (M2) accelerated by a shy 1.5%, moving up from US\$ 333.7 billion at end-2016 to US\$ 338.8 billion at end-October 2017, mainly supported by a 3.6% rise in gross international reserves at the Central Bank (the equivalent of US\$ 3.1 billion) and a 3.0% increase in foreign assets at banks (the equivalent of US\$ 4.5 billion). This compared to a relatively similar expansion in (M2) of 1.4% over the first ten months of 2016.

The continued squeeze in liquidity was reflected in Emirates interbank offered rates rising further, with the twelve-month EIBOR category reporting an extended increase of 43 basis points since the beginning of the year to reach 2.53% towards the end of 2017. This followed a 62 basis points expansion in 2016.

The UAE dirham remained pegged to the US dollar, mainly supported by comfortable external financial buffers and open and flexible labor markets, and as the UAE monetary authorities believe that the peg safeguards economic stability and that the gains from a flexible exchange rate regime are limited. Within this context, interest rates in emirates continued to closely track US interest rate movements. In fact, the Central Bank of the UAE raised the interest rates applied to the issuance of its Certificates of Deposits three times over the year 2017 by a total of 75 bps to 2%, and lifted the repo rate for borrowing short-term liquidity from the UAE Central Bank against Certificates of Deposits three times by a cumulative of 75 bps to 1.75%, tracking three interest rate hikes by the US Federal Reserve as the US labor market has continued to strengthen and the US economic activity has been growing at a solid rate.

Last but not least, the Central Bank's gross international reserves saw a rebound in 2017, moving from US\$ 85.4 billion at end-2016 to US\$ 88.5 billion at end-October 2017, up by 3.6%. Accordingly, the Central Bank's gross international reserves coverage ratio to money supply (M1) and dirham deposits remained stable at 32.9% at end-October 2017.

Looking forward, inflationary pressures from the introduction of the Value Added Tax at 5% in early 2018 is expected to be partly offset by further declines in rents if supply continues to increase and demand remains subdued. Accordingly, the IMF expects inflation to rise moderately to 2.9% in 2018. In parallel, the UAE monetary authorities would keep on prioritizing the currency peg to the US dollar and would continue to track the US tightening cycle.

#### 1.4.2. Banking Activity

##### *Decent activity growth withstanding slower economic momentum environment*

Banks operating in the UAE witnessed a rather decent activity growth in 2017 given the relatively low oil price environment and fiscal consolidation measures at large. Measured by the total assets of banks operating in the UAE, the sector witnessed a 3.6% increase in activity since the start of the year, with assets reaching US\$ 731.7 billion at end-November 2017 according to the most recent figures released by the UAE Central Bank. The growth in volume proved slightly higher than that registered during the corresponding period of 2016, highlighting UAE banks' adequate adjustment to slower economic growth amid persistently low oil price levels.

Deposits at banks in the UAE, accounting for a sizeable 61% of total banking sector balance sheets, were responsible for the larger part of activity growth across the emirates in 2017. Bank deposits actually grew by 4.4% between December 2016 and November 2017 to reach US\$ 444.5 billion. Among the depositors, residents who account for nearly 90% of the total deposit base were the driving force behind the rise in deposits in 2017, while non-resident deposits slightly retreated in the first 11 months of 2017.

Among resident depositors, all components contributed to the increase in funds parked at banks in the UAE, most notably the government sector which accounted for three quarters of the total resident deposit increase. Having said that, although deposit growth strengthened over the covered period, banks continued to access wholesale market financing in the aim of diversifying their funding base.

On another note, the breakdown of deposits by type and currency, which is only available for the period ending in October 2017 and excludes inter-bank deposits, shows that foreign currency deposits have declined while those in dirhams have risen, suggesting a decline in the deposit dollarization ratio (which according to this breakdown amounts to close to 28%).

On the asset utilization side, gross credit continued to grow in 2017 albeit at a moderating pace relative to the year 2016. As a matter of fact, gross credit progressed by 2.6% year-to-date to reach US\$ 434.3 billion at end-November 2017. The growth in volumes, reaching US\$ 11.2 billion, proved to be 54% less than that during the first 11 months of 2016, reflecting slower economic growth in the UAE as well as lower appetite for lending in the current economic environment of slower business activity. This also comes in parallel to a technical reduction in the system balance sheet following the conclusion in 2017 of the merger between two large banks.

While foreign credit accounted for 18% of total credit growth in 2017, domestic credit got the lion's share (82%). That was in turn driven by the private sector, which saw a 2.8% rise in gross credit over the covered period, well outpacing the government sector and noting that credits to GREs slightly contracted. Among private sector borrowers, business and industrial sectors benefited more than individuals. In fact, banks reportedly made some adjustments to the amount of refinancing related to personal loans. But credit growth is expected to accelerate as the economy gains momentum, especially with regards to the construction, hospitality and tourism sectors in the run-up to Expo 2020, as per the IMF.

It is worth noting that the breakdown of bank credit to residents by economic activity (currently available until period ending September) shows that over the first nine months of 2017, the construction and real estate sector was by far the largest beneficiary of new credits granted by UAE banks.

Having said that, bank liquidity conditions in the UAE have ameliorated. On the one hand, the lending to stable resources ratio, measured as the ratio of total advances (net lending and net financial guarantees & standby LC and interbank placements more than three months) to the sum of net free capital funds and total other stable resources, has declined from 86.2% at end-2016 to 84.8% at end-November 2017. On the other hand, the ELAR ratio (eligible liquid assets ratio), measured as the ratio of total banks' eligible liquid assets (consisting of cash at hand, liquid assets at the Central Bank and eligible bonds/Sukuks as prescribed by regulation 33/2015 & Basel Principles but excluding interbank positions) to total assets (balance sheet total assets minus sum of capital & reserves and all provisions except staff benefit

#### EVOLUTION OF BANKING AGGREGATES

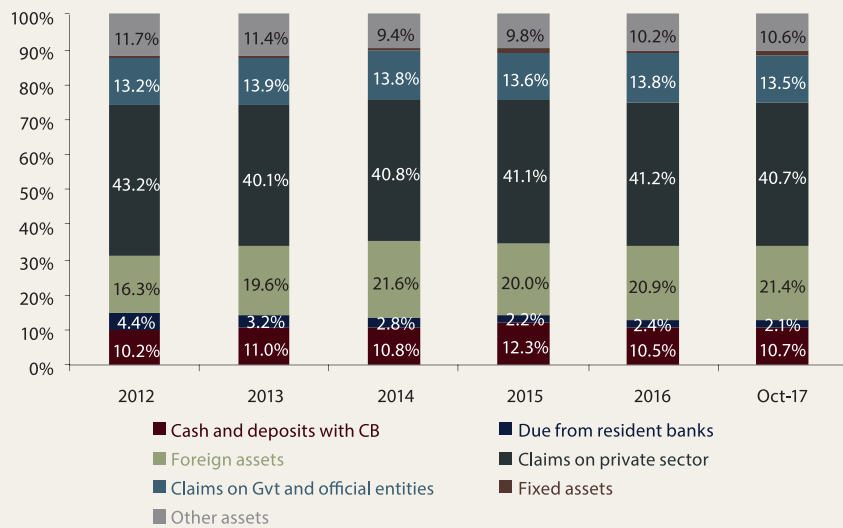
US\$ million	2013	2014	2015	2016	Nov-17
Total assets	571,899	627,611	674,806	711,671	731,681
% YTD growth in assets	11.9%	9.7%	7.5%	5.5%	3.6%
Total deposits	348,237	387,012	400,713	425,582	444,493
% YTD growth in deposits	9.5%	11.1%	3.5%	6.2%	4.4%
Total bank loans and advances	347,311	375,248	404,384	428,809	434,255
% YTD growth in bank loans and advances	7.7%	8.0%	7.8%	6.0%	2.6%

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

provisions and refinancing and subordinated borrowing/deposits) increased from 16.2% at end-2016 to 17.6% at end-November.

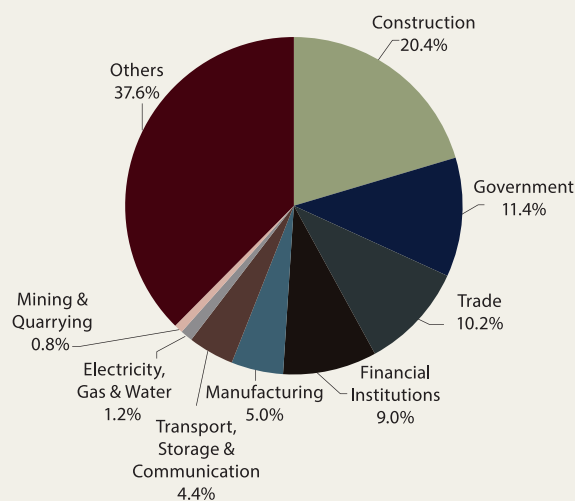
Bank asset quality remains satisfactory despite being under some pressure lately. With the domestic economy slowing, the NPL ratio increased and rescheduled loans were edging up lately partly owing to a weakening asset quality of SME loan portfolio as per the latest IMF Article IV mission report on the UAE issued this summer. IMF figures released more recently show an uptick in the NPL/total loans ratio from 6.1% at end-2016 to 6.7% at end-September 2017, practically in line with international averages. NPLs remain adequately provisioned and provisions have continued to increase in this respect.

### BANK ASSET COMPOSITION



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

### BANK LOAN BREAKDOWN BY ECONOMIC ACTIVITY \*



\*September 2017 figures for bank credit to residents

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

UAE banks remain highly capitalized, with the capital adequacy ratio and Tier 1 capital of banks further growing to reach 18.7% and 17.1% respectively at end-September, which is well above the regulatory requirements set by the Central Bank, reflecting an overall solid financial standing and ability to withstand pressures on the capital base.

Last but not least, net interest margins seem to have been under upward pressure since the start of 2017, with loans resetting at higher rates and funding costs improving as liquidity conditions eased in the emirates, while fee income generation capacity is somewhat impacted by the slow economic growth environment. In the absence of consolidated sector statistics, we resorted to the aggregation of banks that have already published results for the first nine months of 2017 as per Bureau Van Dijk-Moody's figures. The latter shows that for 20 banks with results available, the aggregated net profits rose by a yearly 5.8% in 9M2017.

### 1.4.3. Equity and Bond Markets

*UAE equity markets under downward price pressures, two-way flow activity in bond market*

The UAE equity markets saw downward price movements in 2017, as concerns over KSA's anti-corruption probe and the rising regional political tensions weighed on stocks, while the fixed income market saw two-way flows, along with stability in the cost of insuring debt in Abu Dhabi and contractions in Dubai's five-year CDS spreads.

The UAE equity markets came under downward price pressures over the year 2017, mainly dragged by lingering geopolitical concerns, and worries that the Saudi anti-corruption crackdown would prompt Saudi investors to pull money out of local stock and real estate markets.

In details, the Dubai Financial Market index fell by 3.1% during the first eleven months of 2017, moving from 3,531 at end-2016 to 3,420 at end-November 2017, and pursued its downward trajectory in December closing at 3,332 on December 26, 2017. This followed a 12.1% rise in the index in 2016. The year-to-date breakdown of the DFM index by sector shows that the consumer staples and discretionary sector registered the highest index drop of 53.3%, followed by the telecommunications sector (-19.5%), the real estate sector (-7.8%), the transportation sector (-2.2%), and the financial and investment services sector (-1.1%), while the services sector witnessed the highest index rise of 21.8%, followed by the banking sector (+3.3%) and the insurance sector (+1.9%).

The total trading value in the Dubai Financial Market amounted to US\$ 28.9 billion over the first eleven months of 2017, as compared to US\$ 31.9 billion during the corresponding period of 2016, down by 9.4%. The total number of traded shares reached 77.0 billion shares over the first eleven months of 2017 against 93.9 billion shares during the same period of 2016, and the total number of trades was quoted at 1,012,404 during the first eleven months of 2017 versus 1,172,971 during the same period of 2016. The number of listed companies increased from 61 companies at end-2016 to 64 companies at end-November 2017. On the back of new listings, the market capitalization in the Dubai Financial Market rose from US\$ 91.9 billion at end-2016 to US\$ 104.7 billion at end-November 2017, up by 13.9%, despite price drops. Within this context, the turnover ratio, measured by the annualized trading value to market capitalization, reached 30.1% over the first eleven months of 2017 as compared to 40.0% over the corresponding period of 2016.

Similarly, the Abu Dhabi Securities Exchange traced a downward slope during the first eleven months of 2017, with the Abu Dhabi general index moving from 4,546 at end-2016 to 4,283 at end-November 2017, down by 5.8%, yet registered a shy rebound in December, reaching 4,320 on December 26, 2017 and reducing the year-to-date decline to 5.0%. This followed a 5.6% rise in the index in 2016. The year-to-date breakdown of the Abu Dhabi general index by sector shows that the highest drop was in the consumer staples sector with -25.9%, followed by the real estate sector with -17.3%, the telecommunications sector (-10.4%), the services sector (-8.9%), the investment and financial services sector (-4.1%) and the banking sector (-1.8%). In contrast, the energy sector posted the largest price rise of 27.4%, followed by the insurance sector (+13.7%) and the industrial sector (+1.2%).

The total trading value fell by 4.8% during the first eleven months of 2017 to reach US\$ 11.2 billion. The total number of traded shares reached 22.9 billion shares over the first eleven months of 2017 against

23.8 billion shares during the same period of 2016, and the total number of trades was quoted at 313,329 during the first eleven months of 2017 versus 335,499 during the same period of 2016. The number of listed companies rose from 72 companies at end-2016 to 75 companies at end-November 2017. The market capitalization rose from US\$ 111.3 billion at end-2016 to US\$ 119.3 billion at end-November 2017 given new listings and despite price falls. Within this context, the turnover ratio, measured by the annualized trading value to market capitalization, reached 10.3% over the first eleven months of 2017 as compared to 11.1% over the corresponding period of 2016.

All in all, the UAE equity markets registered higher price falls when compared to regional stock markets between end-December 2016 and December 26, 2017, as reflected by the 3.7% fall in the S&P UAE price index and a 0.5% retreat in the S&P Pan Arab Composite Index.

In parallel, UAE fixed income markets saw mixed price movements over the year 2017. Some papers posted price falls, mainly weighed down by lingering regional geopolitical tensions and concerns about Saudi Arabia's anti-corruption crackdown, while also tracking shy declines in US Treasuries. Some other papers registered price gains as some market players found a buying opportunity in regional bonds that were downbeat by regional political tensions and rising uncertainties. UAE bond sales totalled US\$ 19.5 billion in 2017 as compared to US\$ 12.6 billion in 2016. Also, the share of UAE bond issues reached 24.2% of total MENA bond issues in 2017 as compared to a share of 24.9% in 2016.

In the Abu Dhabi space, sovereigns maturing in 2019 closed down by 4.90 pts, while ADGB'21 and '26 were up by 0.13 pt and 0.62 pt respectively. As to new issues, Abu Dhabi raised US\$ 10 billion in October 2017 from the sale of US\$ 3 billion five-year notes at 65 basis points over US Treasuries, US\$ 4 billion 10-year notes at 85 basis points over US Treasuries and US\$ 3 billion 30-year notes at 130 basis points over US Treasuries. The bond sale attracted bids in excess of US\$ 30 billion, and the pricing was narrowed by 20 basis points across the board.

IPIC papers maturing between 2018 and 2026 registered price falls of 0.50 pt to 3.09 pts. In contrast, IPIC'41 traded up by 1.66 pt. Dolphin'19 and '21 were down by 1.38 pt and 1.41 pt respectively. Etisalat papers maturing between 2019 and 2026 saw price gains of up to 2.69 pts. Mubadala'19 and '21 closed down by 4.79 pts and 1.49 pt respectively, while prices of Mubadala'22 and '23 rose by 0.96 pt and 1.77 pt respectively. Mubadala Development Company raised US\$ 1.5 billion via a two-part international bond sale. The company sold US\$ 850 million in a seven-year debt at 100 basis points over mid-swaps and US\$ 650 million in a 12-year tranche at 140 basis points over mid-swaps.

As to other new bond issues, Abu Dhabi Crude Oil Pipeline (ADCOP), a subsidiary of Abu Dhabi National Oil Company (ADNOC), raised circa US\$ 3 billion from the sale of a US\$ 837 million 12-year bullet bond, and a US\$ 2.2 billion 30-year bond, with a coupon rate of 3.65% and 4.6% respectively.

Papers issued by financial institutions saw two-way flows in the Abu Dhabi credit space. ADIB Perpetual closed down by 2.00 pts. Al Hilal'18 closed down by 0.99 pt, while Al Hilal Perpetual was up by 1.50 pt. FAB'19 (offering a coupon of 3.25%) posted price falls of 0.38 pt, while FAB'19 (offering a coupon of 3%) and FAB'20 registered price gains of up to 0.77 pt. As to the cost of insuring debt, Abu Dhabi's five-year CDS spreads remained stable at 63 basis points.

In the Dubai credit space, sovereign papers saw mixed price movements over the year 2017. Sovereigns maturing in 2020, 2021 and 2022 registered price decreases of up to 3.52 pts. In contrast, sovereigns maturing in 2029 and 2043 posted price gains of 1.51 pt and 10.7 pts respectively. ICD'20 and '24 closed up by 1.14 pt and 1.12 pt respectively. ICD raised in January 2017 US\$ 1 billion from the sale of 10-year Sukuk at a coupon of 5.0%. DAMAC'19 traded up by 3.00 pts. DAMAC issued in April 2017 a five-year US\$ 500 million bond at a coupon of 6.25%.

Emaar Properties'19 was down by 2.76 pts, while Emaar Properties'24 and '26 closed up by 3.24 pts and 1.82 pt respectively. Prices of Majid Al Futtaim'19 and Perpetual (offering a coupon of 7.125%) declined by 0.59 pt and 2.84 pts respectively, while Majid Al Futtaim'24 and '25 registered price gains of 2.06 pts and 2.15 pts respectively. Majid Al Futtaim issued US\$ 500 million worth of perpetual bonds at a coupon of 5.50%.

Papers issued by financial institutions saw mixed price movements in 2017. DIB'20 and 21 closed up by 0.76 pt and 0.27 pt respectively, while DIB Perpetual (offering a coupon of 6.25%) and DIB Perpetual (offering a coupon of 6.75%) registered price falls of 0.44 pt and 0.10 pt respectively. Commercial Bank of Dubai'18 was down by 0.57 pt, while Commercial Bank of Dubai'20 traded up by 0.47 pt. As to the cost of insuring debt, Dubai's five-year CDS spreads contracted by 22 bps to 128 bps year-to-date.

As to credit rating changes, Moody's changed in May 2017 the rating outlook on the Government of United Arab Emirates to "stable" from "negative", while affirming the long-term "Aa2" issuer rating. The key drivers of the outlook change are effective policy response to the low oil price environment via an acceleration in the country's reform agenda; expected improvement in the fiscal and current account positions; and the economy's growth and diversification prospects. The affirmation of the "Aa2" rating incorporates Moody's view that the government of Abu Dhabi ("Aa2/stable"), the wealthiest of the seven emirates that compose the UAE, stands fully behind the federal government of the UAE, with the rating of the federal government being linked to the credit profile of the government of Abu Dhabi.

#### ABU DHABI STOCK MARKET INDICATORS

	2013	2014	2015	2016	Nov-17
Market capitalization (in US\$ billion)	123.8	127.0	119.0	111.3	119.3
Trading value (in US\$ billion)	23.0	39.3	15.4	12.3	11.2
Turnover ratio	18.6%	30.9%	13.0%	11.1%	10.3%
Trading volume (in millions)	51,506	56,938	25,263	24,683	22,893
Number of transactions	556,233	858,283	436,363	362,141	313,329
General share price index	4,290	4,529	4,307	4,546	4,283
% Change in share price index	63.1%	5.6%	-4.9%	5.6%	-5.8%

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

#### DUBAI STOCK MARKET INDICATORS

	2013	2014	2015	2016	Nov-17
Market capitalization (in US\$ billion)	70.7	87.9	83.9	91.9	104.7
Trading value (in US\$ billion)	43.5	103.9	41.2	36.3	28.9
Turnover ratio	61.6%	118.2%	49.1%	39.4%	30.1%
Trading volume (in millions)	127,180	160,533	98,231	106,387	76,984
Number of transactions	1,337,858	2,412,839	1,570,369	1,305,208	1,012,404
General share price index	3,370	3,774	3,151	3,531	3,420
% Change in share price index	107.7%	12.0%	-16.5%	12.1%	-3.1%

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

## 2. CONCLUDING REMARKS

Looking ahead, non-oil growth is projected to rebound as the improvement in oil prices and its favorable effects on confidence and financial conditions dampen the effects of fiscal consolidation. Economic diversification into tourism, trade and financial services would continue to mitigate the effects of the still low oil price environment and provide the basis for sound growth. Economic growth might improve in 2018, forecasted at 3.4% by the IMF, within the context of firming oil prices, an improvement in global trade and the expected easing pace of fiscal adjustment.

At the monetary level, inflation is likely to remain subdued, especially that the continued decline in rents offsets higher imports prices. It is believed that the inflationary pressures tied to the introduction of VAT later in 2017 would be partly offset by further declines in rent. Within this context, inflation is forecasted at 2.9% in 2018, though slightly higher than in 2017. As far as the exchange rate regime is concerned, no adjustment is expected in the near term. The labor market flexibility combined with structural reforms would improve competitiveness without the need for currency adjustment. The real estate market is yet expected to face headwinds because of higher interest rates and overall fiscal restraint amid rising supply of properties.

At the fiscal level, the UAE can afford a more gradual pace of fiscal adjustment to reduce the impact of low oil prices on economic growth. It is estimated that fiscal adjustment in 2018 would reduce the public finance deficit to 2.2% of GDP in 2018, the lowest since the beginning of the drop in oil prices in 2014, with a fiscal breakeven Brent prices of oil at US\$ 58 during the year. VAT is expected to increase public revenues by 1% with no significant adverse effect on real GDP growth. Fiscal deficit financing will continue to come from non-bank and external sources, with the UAE avoiding to finance its fiscal deficit from its domestic banking system.

At the banking level, the rising interest rate environment on the back of further tightening expected from the US Federal Reserve is set to be supportive of banking sector profitability, with the improvement in the yield on average assets rising at a higher pace than the cost of liabilities. Still, a fast rise in US interest rates or higher financial market volatility could increase borrowing costs for banks, potentially affecting liquidity in the banking system.

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 that the UAE is the most diversified economy within the GCC and thus the least vulnerable to the low oil price environment of the past two years. Also, the emirates with a relatively large financial buffer can afford a more gradual pace of fiscal adjustment to reduce the impact of lower oil prices on economic growth. Strengths likewise include the long history of domestic political stability coupled with strong international relations, the high GDP per capita on the back of a well developed infrastructure and the diversified current account receipts' base.

Among challenges, we mention the economic and budgetary pressures caused by persistent reliance on hydrocarbons, the recently accentuating regional geopolitical tensions, the possible crystallization of large contingent liabilities and the persistent lack of full data and policy transparency despite the recent improvements. In addition, in case of a decline in oil prices driven by a faster recovery of the US shale production or reduced compliance with OPEC oil production cuts, this could reduce fiscal revenues and consequently investment and confidence. While all those challenges are real and represent risks at the horizon, we believe strengths outpace weaknesses and opportunities exceed threats in a relatively resilient economic environment.

Within this environment, the key policy challenge is to foster economic adjustment to the new oil market realities. In its recent Article IV Consultation Mission report on the UAE, the IMF reveals well the required policy issues looking ahead. In fact, to foster the adjustment, especially given downside risks, the momentum in fiscal reforms needs to be sustained and coordinated with structural reforms. In parallel, to ensure credibility, fiscal adjustment should be accompanied by strengthening the medium term policy framework and improving transparency. While the IMF welcomes ongoing initiatives to upgrade the supervisory and regulatory framework for the financial sector, focused initiatives to raise productivity and diversify the economy would be key to improve medium term economic prospects at large.

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