

**EXECUTIVE
BOARD
MEETING**

SM/21/189

Correction 1

November 22, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **United Arab Emirates—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/189 (11/9/21) have been provided by the staff:

Evident Ambiguity **Pages 5, 13 (line 1), 17 (fourth bullet, line 5), 35, 47**

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views **Pages 12, 17 (fourth bullet, lines 3–4), 38**

Typographical Errors **Page 13 (line 2)**

Questions: Mr. Al-Eyd, MCD (ext. 37884)

hit. The UAE's population fell by 2.3 percent last year, with anecdotal evidence pointing to a crisis-induced temporary departure of expatriate workers, including a large share of females, underscoring the pandemic's impact on labor markets. Weak demand kept overall inflation in negative territory until recently (Text Figure 1).

3. The fiscal balance deteriorated notably, and government debt increased. The general government (GG) fiscal balance turned from a surplus of 0.6 percent of GDP in 2019 to a deficit of 5.1 percent of GDP in 2020. Revenue declined sharply, primarily from lower oil prices, but also reflecting stimulus-based tax and fee relief measures. Expenditures also decreased (in nominal terms), though much less than the decline in revenue. Fiscal transfers from government related entities (GREs) and the sovereign wealth funds (SWF) helped finance the deficit, though GG debt is estimated to have increased by 12.3 percentage points to 39.4 percent of GDP in 2020, including due to increased financing needs. (Annex III).

4. The external surplus narrowed with weak oil market dynamics. The current account surplus declined by about 3 percentage points to 5.8 percent of GDP in 2020 in response to lower oil prices and reduced oil production under the OPEC+ agreement. Re-exports fell along with imports, reflecting weak global demand. External buffers remain adequate for external stability, especially given the large stock of SWF foreign assets. As of end-September 2021, the real effective exchange rate (REER) weakened by 7.5 percent on average, in line with the US dollar. The external position was broadly consistent with the level implied by medium-term fundamentals and desirable policies (Annex IV).

5. The UAE benefitted from supportive global financial conditions. In 2020, Abu Dhabi, Dubai, and Sharjah raised a combined \$19.25 billion. In 2021, Abu Dhabi and Sharjah issued \$5 billion and \$2 billion, respectively. Dubai's long-term spreads are around 220 bps, some 110 bps higher than Abu Dhabi, though still well below the emerging markets average of 330 bps. The federal government issued external debt for the first time, successfully borrowing \$4 billion in October 2021. The UAE has significantly lengthened its debt maturity profile since 2015 (from around 5 to 10 years) through active debt management.

6. The financial sector weathered the crisis, but vulnerabilities have increased. Banks remain relatively well capitalized, with a Tier 1 capital ratio of 16.4 percent in 2021Q2, in line with pre-crisis levels. The NPL ratio stood at about 8.2 percent between 2020Q4 and 2021Q2, higher than end-2019 values (6.5 percent) (Text Figure 2). Deposit growth slowed, as foreign currency withdrawals increased in late 2020, before recovering somewhat. Banks' net foreign assets increased as holdings of foreign securities (mostly High-Quality Liquid Assets (HQLA)) increased. Credit provision to the private retail segment has recovered from its decline in 2020, but corporate lending continues to contract. Banks' net income has weakened, with ROA declining to 1 percent in 2020 Q2 from 1.6 percent at end-2019, though larger banks have fared better.

framework should be swift as banks, particularly Islamic banks, remain highly exposed to the real estate sector. Although the ongoing implementation of the Basel III framework will further buttress financial stability, risks arising from high concentrations in loans should continue to be closely monitored. The drafting and implementation of the Resolution and Recovery Framework should be completed as soon as possible, and the Bankruptcy Framework aligned to it, if necessary. Similarly, reforms in the regulation and supervision of the insurance sector should be completed, ensuring capacity gaps are quickly closed. Finally, collaboration with free zone Financial Authorities should continue and be expanded to avoid potential spillovers and spillbacks with financial institutions operating in these zones.

22. The new Dirham Monetary Framework (DMF) and planned federal debt issuance will support domestic capital market development, but require strong coordination between the CBUAE and the federal government. The DMF, when fully implemented, will contribute to efficiency gains in liquidity management by banks and the CBUAE. The streamlining of standing facilities and open market operations represent a concrete step toward strengthening the implementation of monetary policy, including under different monetary policy objectives, were they to be considered in the future. Staff encourages the publication of the DMF online to increase transparency and build trust. Moreover, the DMF should support money market development and local currency debt through the creation of a risk-free short-term yield curve. The planned federal debt issuance in Dirham will complement the establishment of the yield curve at longer maturities. As the CBUAE will be the issuing agent, coordination between the CBUAE and the federal government will be needed to mitigate any monetary repercussions.⁷

23. Efforts to promote digital innovation in the banking sector and payments system should proceed cautiously to ensure a balance between opportunities and risks. The CBUAE is underpinning digital developments in the economy, including through increased regulatory clarity and strengthened supervision, as well as exploratory efforts with innovative settlement assets (Annex VII). While digital innovation promises to unlock potential benefits, for instance by lowering cost of access to financial services, continued effective supervision, including of new fintech actors, and close monitoring of potential side effects is critical to ensuring financial stability.

24. Major efforts have been undertaken to improve the AML/CFT regime and should be continued. To address some of the deficiencies identified by the Financial Action Task Force,⁸ the UAE created ~~an inter-agency body~~ a Supernational Independent Federal body to oversee the implementation of the National AML/CFT strategy and action plan, and established a dedicated AML/CFT unit in the CBUAE to operationalize a new risk-based supervisory framework. New legislation was passed to require the submission of beneficial ownership information by all legal entities registered in the UAE. Ongoing Monitoring of the implementation of this law new requirement is needed to ensure that accurate and up-to-date beneficial ownership information

⁷ See Selected Issues Paper “New Dirham Monetary Framework”.

⁸ The Financial Action Task Force (FATF) is the internationally recognized standard setting body for AML/CFT. It assessed the UAE’s AML/CFT framework and its effectiveness in 2019. It identified several deficiencies, including on the understanding of money laundering and terrorism financing (ML/TF) risks, AML/CFT risk-based supervision, transparency of legal entities, and money laundering investigations and prosecutions.

is available to competent authorities on a timely basis. Further efforts, including to [improve understanding of](#) the ML/TF risks arising from new technologies and non-resident flows, strengthen oversight over DNFBPs, and enhance law enforcement efforts will be critical.

Authorities' Views

25. The authorities agreed with recommendations to further enhance financial stability monitoring. They emphasized the robust levels of capital and liquidity for the overall banking system but agreed with the need for continued close monitoring of asset quality and supervisory vigilance. They concurred with the importance of further strengthening the macroprudential and regulatory frameworks, including to meet the needs of an increasingly digitalized financial system. On the New Dirham Framework, the authorities noted the importance of ensuring high coordination with the federal government to facilitate the development of the dirham yield curve.

C. Strengthen Fiscal Policy Frameworks

26. Once the recovery firms, public finances must be strengthened to adapt to lower eventual oil revenue and ensure intergenerational equity and medium-term sustainability. The pandemic has hastened the global move to a more sustainable future, including lower demand for hydrocarbon energy. This outlook increases the urgency of limiting the decline in the UAE's public net financial assets and stabilizing them over the long run. A gradual, but determined, fiscal consolidation in the context of a credible medium-term fiscal framework (MTFF) would help achieve this outcome.⁹ Staff estimates the medium-term fiscal path consistent with intergenerational equity could be achieved with an average annual consolidation of the non-oil primary fiscal balance deficit by 0.5-0.8 percent of non-oil GDP (0.4-0.6 percent of overall GDP), taking it to the benchmark balance by 2030-35.¹⁰ A combination of fiscal restraint and reforms is needed to ensure this outcome, including by:

- *Delivering a growth-friendly consolidation.* A combination of fiscal restraint and reforms could help deliver this outcome, including through (i) commitment to proceed with planned public wage and employment reform; (ii) strengthening non-oil tax revenue by broadening the tax base and increasing the VAT and excise taxes, and improving the efficiency of tax collection, including by strengthening tax administration; (iii) phasing out burdensome and regressive fees and gradually removing subsidies, including energy and water subsidies, alongside measures to shield the most vulnerable; and (iv) improving the efficiency of targeted spending. Consistent with past Fund advice, consideration could be given to exploring alternative revenue models, including introducing a progressive federal corporate income tax on non-oil companies, which

⁹ Staff estimates that the non-oil primary deficit is some 7.6 percentage points of non-oil GDP above the benchmark needed to ensure sufficient saving for future generations.

¹⁰ The benchmark balance is obtained by calculating a constant real per capita government spending path (and related non-oil deficit) using a Permanent Income Hypothesis (PIH) model, that delivers a constant real per capita annuity to finance government spending after oil revenues are exhausted (Annex III). Here, there is no differentiation between the UAE citizens (about 15 percent of the population) and permanent residents (about 85 percent) for the PIH calculations, given current and future reliance of the UAE growth model on expatriate labor.

- *Harness digital solutions and fintech.* The continued adoption of a new advanced technologies (including, cloud computing, Big Data and Machine Learning/Artificial Intelligence, and 5G) and further SMEs digitalization could enhance economic resilience, access to finance, and economic adaptability. Recent adoption of the UAE Data Law will support the move to higher digitalization by protecting the privacy of individuals and institutions and limiting entities' use of personal data for profit. Fintech will continue playing a catalytic role.
- *Advance technology creation and adoption.* Consideration should be given to welfare-improving government subsidies and funding of research and development in cutting edge technologies and to encourage higher growth of Information and Communication Technology (ICT) industries. To this end, the government's launch of the Fourth Industrial Revolution Network project,¹⁴ Tech Drive program, and "Project 5Bn", to promote the adoption of advanced technologies in the national industrial sector and entrepreneurship and innovation, are welcome and their implementation should be closely monitored to ensure efficiency.¹⁵

Modernizing the Labor Market

- *Ensure more flexible and equitable labor markets.* More efficient and inclusive investment in education and training in emerging fields would further enhance human capital. Modernization of visa and work permits will contribute to market flexibility and adaptability and help "up-skill" the labor force to meet future growth needs. Government initiatives to incentivize national employment in the private sector should help reduce fragmentation between national and expatriate labor markets. But further efforts are needed to reduce the size of the civil service, better align public and private wages, and incentivize active labor market policies, including for expatriate workers.
- *Adopt gender-positive recovery policies and practices.* Despite recent efforts in promoting female employment, including in wage equality and representation on publicly listed company boards, among others,¹⁶ female labor force participation declined ~~by 5 percentage points to 47 percent in 2020~~. Policies, including more progress through gender budgeting, are needed to address potential crisis impacts on female employment and gender balance, in line with the UAE's progress under the SDGs (Annex VI).

Investing in Green Energy and Future Infrastructure

- *Strengthen sustainable and green infrastructure.* Progress under the UAE Green Agenda 2030, UAE Energy Strategy 2050 and SDGs relating to both clean energy and climate is welcome

¹⁴ The project aims to establish and grow 500 national companies equipped with the technologies of the Fourth Industrial Revolution and technologically advanced workforce.

¹⁵ An independent body or commission with a mandate to regularly assess the effectiveness and phase out of failed policies is important (Beason et al., 1996; Ohashi, 2005).

¹⁶ In 2020, the UAE also implemented parental leave in both public and private sectors and imposed gender quota on the Federal National Council.

Annex II. Implementation of Past Fund Article IV Advice

Recommendation	Status
Fiscal	
Develop a consolidated fiscal framework for the UAE.	In progress. Issuance of the first foreign currency federal bonds in October 2021.
Conduct a study assessing economic distortions from government fees and exploring alternative revenue models more conducive to SME development.	Not implemented.
Improve fiscal risk management: strengthen GREs' reporting requirements; create a database of their financial indicators and public sector balance sheet.	Not implemented.
Monetary/Financial	
Design stringent stress testing scenarios, including for GREs.	In progress. Progress has been made to strengthen stress testing, including through a TA mission in July 2021. Further enhancements are planned.
Maintain prudential limits on bank lending to real estate.	In progress. Calibration of the new Framework for Bank's Real Estate Exposure is ongoing.
Continue to strengthen AML/CFT regime.	In progress. The UAE has delivered several important legislative and institutional reforms. Further initiatives efforts are needed.
Develop domestic debt markets.	In progress. The implementation of the new Dirham Monetary Framework in 2021 provided initial support. Further development will arise from the planned issuance of domestic federal debt.
Structural	
Liberalize foreign investment outside of free zones.	Implemented. UAE allowed 100 percent foreign ownership of onshore companies in June 2021.
Bring GREs within the scope of competition laws.	Not implemented.
Bring government wages and allowances in line with those in the private sector to facilitate Emiratization.	In progress. In mid-2021, the authorities announced salary top-ups, training grants, pension subsidies and child allowances for Emiratis working in the private sector.
Strengthen the important role of SMEs by reducing costs to open a business.	In progress. Business setup fees in Abu Dhabi have been reduced by 90 percent since July 2021, and Dubai issued directives to reduce government procedures for doing business by 30 percent.
Building human capital.	In progress. New visa regulations have been launched to attract high-skill workers. Programs to develop domestic human capital have been announced.
Statistics	
Produce and publish external statistics.	In progress. TA has been requested.
Produce and publish quarterly GDP data.	In progress. An issue of timeliness needs to be addressed.

contingent liability from a majority state-owned bank is taken into consideration, its debt ratio increases to 38.7 percent of UAE GDP. The UAE's substantial sovereign foreign assets mitigate risks and should also be considered; however, these data are unavailable for a more comprehensive debt sustainability analysis.

5. General government debt is expected to decline modestly over the medium-term with improved fiscal prospects from higher oil prices and oil production. This is largely driven by Abu Dhabi, which is assumed to save a large part of the projected oil windfall. Dubai, however, is expected to continue borrowing, in part to roll-over debt amassed ~~in the preparation for Expo prior to~~ 2020 as well as to finance ongoing diversification of its growth model. The increased borrowing will only be partly offset by higher growth starting from 2021, as medium-term growth is projected to remain moderate.

6. Lower oil prices and contingent liabilities from GREs are the main sources of vulnerability. Although the UAE's substantial fiscal buffers are expected to be sufficient against these risks, the urgency of strengthening risk monitoring and management has intensified with the significant deterioration in GREs' financials during the crisis (Annex III Box I). Priority should be given to collecting regular and timely information for fiscal risk analysis—with formal reporting requirements for GREs—and enhancing mechanisms to improve control over contingent liabilities by requiring approval of GREs' annual borrowing and investment plans by finance authorities; setting up predictable dividend payout rules; establishing clear criteria (based on credit risk assessments) for issuance of guarantees; and putting in place guidelines for allocation of risks in private-public partnerships (PPPs). In the medium-term, consideration should be given to incorporating GREs in overall fiscal targets as this would promote greater fiscal discipline and transparency.

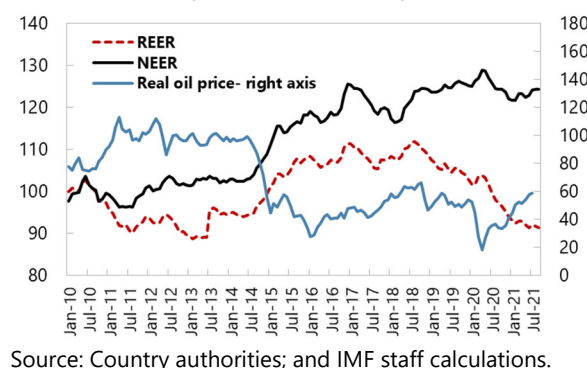
	UAE: Model Estimates for 2020 (in percent of GDP)	
	CA gap	CA norm
EBA Lite CA approach	-1.2	13.10
Constant annuity in real terms	5.9	0.0
Constant annuity in real per capita terms	-0.1	6.0

Real Exchange Rate

Background. The dirham has been pegged to the US dollar at a rate of 3.6725 since November 1997. On average, the REER depreciated by 5.3 percent in 2020 (while NEER appreciated by 0.6 percent) but was 7 percent below its 5-year average. As of end-September 2021, the REER has depreciated by 7.5 percent on average so far in 2021.

Assessment. Consistent with the staff CA gap and based on an elasticity of 0.7, staff assesses the REER to be overvalued by about 0.26 percent with a range of -1.6 to 2.0 percent. Exchange rate movements have a limited impact on competitiveness in the short run as oil is the main exported product and there is limited substitutability between imports and domestically produced products.

Nominal and Real Effective Exchange Rates, 2010-2021
(Index; 2010=100)



Capital and Financial Accounts: Flows and Policy Measures

Background. Net financial outflows increased in 2020 compared to 2019 due to foreign banks' home bias effects in the midst of the crisis. The outflows were temporary and banks' foreign liabilities have been growing steadily since 2021Q2. The equity market witnessed outflows in March and April of 2020 as oil prices declined and COVID-19 struck market confidence but has rebounded since August 2020. The equity market has continued to experience positive inflows in 2021 except for some outflows in April.

Assessment. The UAE has an open capital account. The large central bank reserves and sovereign wealth fund assets limit risks and vulnerabilities from capital flows. A lack of detailed information on capital flows, and data gaps on GREs and SWFs activities, complicates analysis of the financial account and hinders a more comprehensive assessment.

FX Intervention and Reserves Level

Background. The central bank buys and sells unlimited dollars and dirhams to registered counterparties at the official exchange rate to maintain the peg. Gross FX reserves declined to \$106.7 billion (29.7 percent of GDP, 7.6 months of imports and 74 percent of the Fund's reserve adequacy metric) at end-2020 from \$108.4 billion at end-2019. This was mainly driven by large outflows via the banking system in Q2 2020; inflows resumed later in the year, [according to staff estimates](#). Reserves are expected to increase by \$13.6 billion (3.3 percent of GDP) in 2021 including the allocation of SDR 2.2 billion (0.8 percent of GDP). Reserves are expected to increase further over the medium term as oil revenues recover.

Assessment. Reserves play a dual role of buffers for precautionary motives and savings for future generations. Reserves are adequate for precautionary purposes (measured by the Fund's metrics). Fiscal consolidation is needed over the medium term to strengthen the external position and increase savings for future generations.

¹ The average oil export price is assumed to be \$66.9 a barrel in 2021 (\$42.3 a barrel in 2020). Oil export volumes are expected to decrease by 2.0 percent in 2021.

² See Bems, R., and I. de Carvalho Filho, 2009, "Exchange Rate Assessments: Methodologies for Oil-Exporting Countries," IMF Working Paper 09/281.