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May 23, 1983

To: Members of the Executive Board

From: The Secretary

Subject: United Arab Emirates - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the United Arab Emirates. This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Yaqub, ext. 76532.

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INTERNATIONAL MONETARY FUND

UNITED ARAB EMIRATES

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with the United Arab Emirates

Approved by A.S. Ray and Subimal Mookerjee

May 20, 1983

I. Introduction

The 1983 Article IV consultation discussions with the United Arab Emirates (U.A.E.) were held in Abu Dhabi and Dubai during the period March 26-31, 1983. The federal authorities were represented by the Governor of the Central Bank, the Deputy Minister of Finance, and senior officials from these and other federal institutions and Ministries. Discussions were also held with senior officials of the Emirates of Abu Dhabi and Dubai. The staff team was composed of Messrs. A.S. Ray (Head - MED), P. Clawson, J. Dodsworth, and D. Noursi (all of MED), and Ms. C. Nicholson (Secretary - MED). The U.A.E. accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement on February 23, 1974.

II. Background

The U.A.E. Federation, which was formed in December 1971, comprises seven Emirates, the most important of these being Abu Dhabi, Dubai, and Sharjah, which account for virtually all of the country's proven oil and gas reserves. Together they have an oil production capacity of 2.5 million barrels per day (mbd) though in 1982 their combined oil output was 1.3 mbd. The remaining Emirates 1/ have limited natural resources and make only a small contribution to national output. While oil sector policies remain within the authority of individual Emirates, in other areas of economic policy there has been a gradual transfer of responsibilities to federal institutions. However, partly because of the large disparities in wealth between the constituent Emirates, a considerable degree of financial autonomy has been retained at the local level and the Federal Government continues to depend for its resources on contributions from the oil producing Emirates.

During the period following the establishment of the Federation, rising oil revenues enabled the U.A.E. to make large public sector investments in basic physical infrastructure and in several oil-based industries

1/ Ajman, Fujairah, Ras Al-Khaimah, and Umm Al Qaiwain.

intended to diversify export earnings. Extensive social welfare programs were also introduced, with the Government providing subsidized housing and free education and health care for both U.A.E. nationals and for the growing numbers of foreign workers needed for the development effort. The consequent sharp increases in government capital and current spending and in the population provided stimulus to private sector economic activity and there was a large expansion in non-oil sector income. The rapid pace of development, however, also produced various economic and social strains. By 1977, the authorities, faced with accelerating inflation, uncoordinated investment projects, and a banking crisis, cut back sharply on the growth of public sector expenditures. This, in combination with the easing of import bottlenecks, led to a reduction in inflationary pressures. However, with the second wave of oil price increases, government expenditures again gathered momentum. Between 1979 and 1981 government current expenditures doubled, mainly as a result of greater emphasis on defense and security and the rising costs of social services and subsidies. Much of the latter were associated with the continued inflow of foreign workers, who were eligible for a wide range of benefits available to the indigenous population. Concern over the large numbers of expatriate workers led to the enactment of stricter labor laws in 1980 and, since that time, the objective of reducing dependence on foreign labor has become an explicit element in development strategy.

A number of policy initiatives have been taken since 1977 to strengthen the financial system and in December 1980 the Currency Board was converted into a Central Bank with much wider regulatory powers and, in principle, greater access to foreign exchange reserves. Under the Currency Board there had been a rapid and unregulated growth in commercial banks and the country became overbanked in terms of the domestic deposit base. A number of the smaller banks experienced periodic shortages of liquidity and suffered from low-quality lending portfolios. The main concern of the Central Bank since its inception has therefore been to maintain adequate liquidity for the banking system and to strengthen individual banks. To this end, the Central Bank has introduced more rigorous supervision and auditing of commercial banks, tightened reserve and capital requirements, and limited the number of branches of foreign banks. In recent years the lending portfolios of some commercial banks have benefited from federal and Abu Dhabi government refinancing of construction-related credit outstanding against U.A.E. nationals.

The escalation of oil prices in 1979-80 resulted in a substantial rise in the U.A.E.'s current account external surplus. 1/ Despite increasing payments for imports, a high level of wage and profit remittances by expatriate workers and entrepreneurs, and a liberal provision of foreign aid, the current account surplus increased fourfold between 1978 and 1980 to over US$10 billion. In 1981, as oil demand began to slacken and exports showed a small decline, a continued expansion in imports and a widening of the deficit on services and private transfers reduced the current account surplus to about US$9 billion. The most

1/ Defined to include goods and services, private transfers, and official grants.

important elements in the disposition of the current account surplus in recent years have been official loans, private capital outflows, and portfolio investments by the Abu Dhabi Investment Authority (ADIA). These latter investments are estimated to have accounted for about one half of the current account surpluses between 1978 and 1981. In 1980 and 1981 there was also substantial accumulation of net foreign assets by the Central Bank and the commercial banks. 1/

The U.A.E.'s trade system is virtually free from restriction and there are no exchange restrictions on current international transactions. The dirham was pegged to the SDR in August 1978 with margins of 7.25 per cent, with the U.S. dollar as the intervention currency. As of April 30, 1983, the midpoint between the buying and selling rates for the dirham against the U.S. dollar was Dh 3.6710 = US$1.

III. Economic Policies and Prospects

1. Oil production and policies

Oil production has gradually declined since reaching a peak of 2 mbd in 1977. During the period 1979-80 rising oil prices allowed the authorities to restrict oil output and conserve oil reserves while maintaining the desired growth of oil receipts. In 1981 and 1982, however, the tightening of output restrictions was in response to the considerable weakening of world oil demand and the introduction, from April 1982, of an OPEC production quota system under which the U.A.E. was initially assigned an allowable production limit of 1.0 mbd. 2/ From April 1982, U.A.E. output fell to about 1.2 mbd, a level which was sustained through 1982. For the year as a whole, oil output fell by 16 per cent to an average 1.26 mbd. Almost all of the reduction in output was absorbed by the Emirate of Abu Dhabi; Dubai continued to produce at a level fairly close to capacity.

As in the past, the U.A.E generally followed OPEC guidelines in setting its oil prices during 1982. Per barrel prices for crude oils were reduced by approximately US$0.20 in January 1982 and US$1.00 in April 1982 and the average export price fell by 3 per cent to US$34.19 per barrel. With lower prices and reduced export volume, oil export receipts fell from US$18.3 billion in 1981 to US$14.5 billion in 1982, a 21 per cent decline.

With oil demand weakening further in the first quarter of 1983, U.A.E. oil exports are estimated to have fallen to about 1 mbd. In line with most other OPEC members, the U.A.E. reduced its prices by US$5.00 per barrel effective March 1, 1983. The authorities believe that the current

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1/ For details on economic developments up to 1981, see SM/82/103 and SM/82/108.

2/ The U.A.E.'s OPEC production quota was raised to 1.1 mbd effective March 1, 1983.

weakness in the world oil market may continue for some time and that oil production may have to be maintained at a low level in comparison with the U.A.E.'s capacity.

2. Government finances

The reduction in oil income in 1982 resulted in an overall government budget 1/ deficit of Dh 3.3 billion, equivalent to 3 per cent of GDP. This was the first significant budget deficit in over a decade; budgetary revenues fell by 22 per cent and the first steps were taken to adjust expenditure to the lower level of income. Overall, there was a 5 per cent decline in total expenditure and net lending in 1982, with initial savings being made by reducing foreign loans and foreign grants; however, growth in current and development expenditures was also markedly reduced from 21 per cent in 1981 to less than 6 per cent in 1982.

The weakening of government finances was more serious at the federal than at the Emirate level. Many categories of expenditure have, in recent years, been transferred from the Emirates to the Federal Government and correspondingly there have been increased contributions from Abu Dhabi and Dubai, paid under a 1980 agreement that one half of oil revenues be transferred to the federal budget. In 1982, however, these contributions fell by 31 per cent, somewhat faster than oil receipts, the consequence of which was that the budgetary deficit was entirely borne by the Federal Government, while the Abu Dhabi budget registered a small surplus. At the federal level, current expenditures in 1982 were only slightly higher than those in 1981. This was possible, in part, because of a halt in the rise in defense expenditures. In addition, subsidies and transfers were reduced by about 48 per cent.

Because of uncertainties with regard to oil prices and revenues, budgetary plans for 1983 had not been formally adopted at the time of the consultations. With a possible further 25 per cent fall in oil revenues in prospect, some government borrowing, either domestically or from abroad, is being contemplated by the Federal Government as one of the short-run options, though the authorities believe that such borrowing should be minimized and that more fundamental adjustments are required in widening revenue sources and rationalizing expenditure programs. On the revenue side, consideration is being given to raising indirect taxes as well as charging fees for some government services, such as health care and education, which have previously been provided free of charge. The long-term aim is to raise the level of federal government revenue from taxes and fees to 15 per cent of its total receipts compared to the 1982 level of 3 per cent. As for expenditure, the authorities believe that elimination of waste and inefficiency that had developed during past years, when budgetary funds were not constrained, should lead to considerable savings with no major impact on growth. Development expenditures are being subjected to a greater scrutiny and both the

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1/ Represents a consolidation of federal, Abu Dhabi Emirate, Dubai Emirate, and Dubai Municipality budgets.

Federal and Emirate Governments have imposed a freeze on new hirings. Current outlays are also expected to be reduced in 1983 through further cutbacks in subsidies which are provided for fuel, electricity, and water, and some food items.

The full effect of many of the measures being implemented will not be felt immediately and a government budget deficit in the region of Dh 5-6 billion is anticipated for 1983. The actual outcome for the deficit will depend largely, however, on the demand for U.A.E. oil and the behavior of oil prices during the remainder of the year. Without a restructuring of the basis for contributions from the Emirate Governments, the Federal Government will find it necessary to borrow, probably initially from the Central Bank, although as a longer-term policy the authorities are also exploring means of attracting private sector savings by way of public sector bond or equity issues. A small deficit appears probable also for the Abu Dhabi government budget, though this is likely to be covered by a drawdown in deposits or by utilization of investment income which is not at present budgetized.

3. Money and banking

In 1982 there was moderate growth in the main monetary aggregates. Domestic liquidity grew by 15 per cent compared with 24 per cent in 1981, partly reflecting the slowdown in government domestic expenditures. In addition, there was a reduced demand for private sector credit which rose by less than 6 per cent in 1982 compared with an increase of 18 per cent in the previous year. Both lenders and borrowers became more cautious as prospects in the economy became more uncertain. With a deceleration in domestic liquidity and little or no increase in import prices, the rate of inflation fell from about 15 per cent in 1981 to about 8-10 per cent, most of which was attributable to higher rents and reduced fuel subsidies.

For the commercial banks there was no overall shortage of liquidity in 1982. However, the distribution of liquidity among banks remained rather unequal--about 75 per cent of deposits being concentrated in one quarter of the banks--and, in response to a relatively slow growth in money and quasi-money in the first half of the year, the Central Bank eased the reserve requirements on domestic savings and time deposits, and made it more costly for commercial banks to lend dirhams abroad. In October 1982 interest rate ceilings on deposits of less than Dh 5 million were abolished, leaving all interest rates in the U.A.E. (on both deposits and lending) free from restrictions.

The financing of the 1982 fiscal deficit by a drawdown in the accumulated surpluses of the Federal Government had a direct effect on the level of Central Bank foreign assets which were derived mainly from federal government deposits. The depletion of foreign assets was offset, in the second half of 1982, however, by the receipt of foreign currency term deposits from the Emirate Governments and overall for 1982 the net foreign assets of the Central Bank showed a marginal increase. The commercial banks' net foreign asset position improved by about Dh 2 billion in 1982, reflecting in part the lack of lending opportunities within the U.A.E.

During 1982 there were signs of a further strengthening in the overall position of the banks as evidenced by a decline in the ratio of credit to total deposits and an increase in the ratio of reserves to deposits, but wide disparities between banks remained and a number of new measures were taken: stricter rules were applied concerning minimum levels of paid-up capital for commercial banks; a Risk Bureau was established to collate information on individuals with accounts at different banks; and restrictions were placed on banks' lending to their own directors. In the belief that the country is overbanked, there is a moratorium on the opening of new foreign banks and the Central Bank is continuing to encourage the merger of banks wherever possible.

4. External sector

In 1982 the U.A.E. current account external surplus (including official grants) declined to US$7 billion from US$9 billion in 1981. Aside from reduced export receipts from crude oil, re-exports fell sharply as the entrepot trade from Dubai was restricted for most of the year by conditions in the Islamic Republic of Iran. Although refined petroleum exports represented a new source of income and there was an increase in gas exports, total exports fell by US$3.6 billion. This was partially offset by a small decline in imports reflecting the slowdown in government spending and economic activity, and higher domestic production of petroleum products. There was, moreover, a smaller deficit on the services and private transfers account as net investment income continued to rise despite lower international interest rates, and private transfers and other services payments showed a small decline. Foreign grants were also reduced by about 40 per cent as part of the general policy of cutting back on government expenditures. As in the past, a large proportion of the current account surplus accrued to the Emirate of Abu Dhabi. From the US$7 billion surplus, an estimated US$2.8 billion represented increased assets of the Abu Dhabi Investment Authority, while US$1 billion was used by Abu Dhabi for external loans, mainly to neighboring countries. A further US$1 billion represented an improvement in the net foreign assets of the banking system, most of the increase being with the commercial banks. Staff estimates indicate that, at the end of 1982, net foreign assets of the Government amounted to US$27 billion (equivalent to over three years of imports at the 1982 level) and net foreign assets of the banking system amounted to US$5.9 billion.

Tentative balance of payments projections for 1983 suggest a further US$2 billion decline in the current account surplus. The projections are based, inter alia, on oil production being maintained at the level of the most recent OPEC quota (1.1 mbd) and current oil prices holding for the remainder of the year. While the value of oil exports is projected to fall by US$3.6 billion, it is expected that this will be partly offset by an absolute decline in imports, a reduced level of workers' remittances, and a further significant cut in foreign grants.

As regards international reserve management, the Abu Dhabi Investment Authority, in view of the possible need for the Government to utilize investment income, which has to date been reinvested, or to draw down on accumulated reserves, is giving more attention to liquidity in its portfolio selection. Security of investments continues to be the major concern of the Authority and investment policy is in no way speculative. The Central Bank has also maintained a conservative policy with an emphasis on ensuring adequate liquidity and security of assets.

The dirham continues to be officially pegged to the SDR with margins of 7.25 per cent, with the U.S. dollar as the intervention currency. As the rate against the U.S. dollar has remained unchanged since December 1980, the dirham has appreciated against most other major currencies and the margin with the SDR has widened beyond the prescribed 7.25 per cent. At the end of 1982 the margin with respect to the SDR was 14.96 per cent. The appreciation in nominal effective terms since December 1980 was 20.5 per cent.

The U.A.E. authorities indicated that a memorandum on the increase in quota under the Eighth Review had been submitted to the Council of Ministers and that they expected to meet the timetable set by the Fund for approval and payment. It is expected that the next Article IV consultation will be held by April 1984.

IV. Staff Appraisal

After years of rapid growth, economic activity in the U.A.E. slowed considerably in 1982. This reflected a substantial decline in oil receipts which led to the emergence of a fiscal deficit and a significant reduction in the current account external surplus. The prospects are for a further large fall in oil income in 1983, which will add to the pressures on government finances and further reduce the surplus on the balance of payments. The authorities are not treating the change in economic circumstances as a temporary phenomenon and they are engaged in formulating substantial adjustments to adapt to the lower level of oil income. Initially, adjustments have taken the form of reductions in government expenditures, but various tax and nontax revenue measures are also being actively considered, as are plans for the mobilization of private savings to finance domestic investment.

The rapidity of growth in economic activity in the recent past has inevitably resulted in some misallocation of resources. The staff believes that the present situation offers an opportunity for consolidation and rationalization of policies and practices which, if carried out within a medium-term framework, can lead to the attainment of social goals such as reduced dependence on foreign labor, as well as to the maintenance of a reasonable rate of growth. In this respect, it is encouraging that government development expenditures, as well as transfer payments and subsidies, are being subjected to more intensive scrutiny and that the revenue measures being contemplated, in, for example, charging for public services, are likely to lead to improved allocation of resources. It is important, however, that adjustment, particularly in cutting back on public expenditures, should not be too drastic or abrupt and this may be achieved by use of the country's foreign reserves to smooth the transition.

Adjustment, even of a gradual nature, is likely to place strain on the U.A.E.'s banking system. With lower transfers to the Federal Government, the Central Bank faces a reduction in its principal source of foreign exchange. At the same time, the commercial banks may stand in need of an injection of liquidity by the Central Bank. To carry out the role of providing liquidity effectively, as well as to manage the exchange rate policy, the Central Bank requires access to adequate foreign exchange reserves. In these circumstances, deposits and transfers from the Emirate Governments will need to play an increasingly important role in providing the needed foreign exchange reserves to the banking system.

To date, the Government has assumed primary responsibility for the initiation and financing of development projects, while the private sector has had little direct involvement in the productive sectors and much of its savings has been invested abroad. The staff believes that in the longer-term perspective of U.A.E. development it would be desirable for participation by the private sector to be increased by stimulating private savings. The staff agrees with the authorities that such savings should be encouraged to remain within the country through the issue of bonds or equities and by setting up joint ventures. The first steps should necessarily be on a modest scale as there would be an initial need to establish confidence and educate the public in the holding of domestic securities.

With respect to the U.A.E.'s external policies, the staff notes that foreign grants are expected to be further reduced in 1983, though all prior commitments are to be met and the extent of foreign assistance will still represent by international standards a relatively high proportion of GDP. On the basis of present conditions in the world oil market, the staff does not expect any substantial decumulation of official external reserves in 1983 though any increase will be on a very modest scale compared with earlier years.

United Arab Emirates - Fund Relations 1/

Date of membership:	September 22, 1972.
Status:	Article VIII.
Quota:	SDR 202.60 million.
Fund holdings of U.A.E. dirhams:	SDR 106.16 million, equivalent to 52.4 per cent of quota.
Lending to the Fund:	The Emirate of Abu Dhabi, one of the constituent Emirates of the U.A.E., agreed to lend the Fund SDR 150 million under the supplementary financing facility, of which SDR 104.97 million has been utilized (as of January 31, 1982).
SDR Department:	The U.A.E. became a participant on December 21, 1978. Holdings amount to SDR 50.3 million, which is equivalent to 129.86 per cent of net cumulative allocation of SDR 38.74 million.
Gold distribution:	12,836.804 fine ounces.
Direct distribution of profits from gold sales:	The U.A.E. has ceded to the Trust Fund its share of profits from gold sales amounting to US$2.36 million.
Exchange rate system:	Since January 1978 the U.A.E. dirham has been pegged to the SDR at the rate of Dh 4.76190 = SDR 1; the margins were initially set at 2.25 per cent but were widened to 7.25 per cent in August 1978. The U.S. dollar has remained the intervention currency. As of March 31, 1983, the midpoint between buying and selling rates for the dirham against the U.S. dollar was Dh 3.6710 = US$1.
Technical assistance:	Two experts are working with the U.A.E. Central Bank under the Fund's CBD program.
Previous consultations:	The last Article IV consultation discussions were held in April 1982, and the Staff Report (SM/82/103) was discussed by the Executive Board on June 28, 1982.

1/ As of April 27, 1983.

United Arab Emirates - Basic Data

Area	77,000 square kilometers
Population (1980 estimate)	1,040,000
GDP per capita (1980 estimate)	US$28,457

	1979	1980	1981	1982
	(In millions of barrels)			
Crude oil production	668	626	549	459
Abu Dhabi	534	494	414	329
Dubai	129	128	131	127
Sharjah	5	4	4	3
	(In billions of dirhams)			
National accounts (at current prices)				
Private final consumption	15.3	19.0	24.1	24.9
Government final consumption	9.6	12.0	17.3	18.4
Gross fixed investment	28.4	30.1	29.3	31.9
Change in stocks	-0.8	1.0	2.7	1.6
Domestic expenditure	52.5	62.1	73.4	76.8
Exports, goods, and nonfactor services	56.9	85.6	84.9	69.8
Imports, goods, and nonfactor services	-29.4	-37.9	-40.8	-37.7
Gross domestic product (market prices)	80.0	109.8	117.5	108.9
	(Rate of change)			
Real gross domestic product				
Crude oil	--	-6	-12	-16
Other	8	14	9	3
Total GDP	4	4	-2	-6

	1979	1980	1981	Prelim. 1982
	(In billions of dirhams)			
Public sector finances 1/				
Revenues, of which:	28.7	46.7	47.8	37.5
Oil	(26.9)	(44.6)	(45.0)	(34.9)
Expenditures, of which:	26.1	36.2	42.5	40.8
Development	(9.3)	(7.5)	(7.7)	(8.9)

1/ Estimates cover the Federal Government and the Governments of Abu Dhabi and Dubai only. Oil revenues in the budgetary data differ from oil export proceeds as recorded in the balance of payments mainly because Abu Dhabi budget does not include retained earnings by Abu Dhabi National Oil Company and Dubai budget includes only the revenues transferred by the Ruler to finance expenditures.

United Arab Emirates - Basic Data (Concluded)

	1979	1980	1981	1982
	(Annual change in millions of dirhams)			
Monetary survey				
Net foreign assets	1,122	6,662	8,583	3,540
Net domestic assets	209	-1,619	-3,396	468
Claims on Government (net)	(-1,489)	(-3,063)	(-2,768)	(3,383)
Claims on official entities (net)	(1,021)	(-340)	(-216)	(-659)
Claims on private sector	(2,043)	(4,023)	(4,753)	(1,699)
Other items (net)	(-1,365)	(-2,239)	(-5,165)	(-3,955)
Domestic liquidity 1/	1,332	5,043	5,187	4,008
	(Annual change in per cent)			
Credit to private sector	10.5	18.7	18.6	5.6
Domestic liquidity 1/	8.8	30.8	24.2	15.1

	1979	1980	1981	Prov. 1982
	(In billions of U.S. dollars)			
Balance of payments				
Exports, f.o.b., of which:	15.0	22.2	21.8	18.2
Crude oil	(13.1)	(19.6)	(18.3)	(14.5)
Imports, f.o.b.	-6.1	-7.6	-8.6	-8.1
Services and private transfers (net)	-2.4	-2.6	-3.1	-2.4
Official grants	-1.0	-1.7	-1.1	-0.7
Current account balance	5.5	10.3	9.0	7.0
Official loans (net)	-0.1	-0.6	-1.7	-1.0
Errors and omissions (including private capital)	-1.8	-3.1	-1.6	-2.2
Government, foreign investments 2/	-3.3	-4.9	-3.4	-2.8
Net foreign assets of banking system	-0.3	-1.7	-2.3	-1.0
Central Bank	(-0.6)	(-0.5)	(-1.3)	(-0.2)
Commercial banks	(0.3)	(-1.2)	(-1.0)	(-0.8)

	1979	1980	1981	1982
	(In dirhams per U.S. dollar)			
Exchange rate				
Period average	3.82	3.71	3.67	3.67

1/ Excludes deposits held by official entities.
2/ Includes estimated investment income.