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IMF Executive Board Concludes 2008 Article IV Consultation with the United Arab Emirates

On January 9, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Arab Emirates.[1]

Background

The United Arab Emirates (U.A.E.) macroeconomic performance during 2007–08 was strong, with growth especially in the construction and services sectors and despite some slowdown in the last quarter of 2008, due to the global crisis. Annual average inflation accelerated, driven by domestic demand pressures (especially rents) and higher import prices (such as prices of food, building materials and skilled and unskilled workers). Higher oil prices contributed to large external current account and fiscal surpluses in both 2007 and 2008.

However, the outlook for 2009 and beyond has become more clouded, as the U.A.E. has been adversely affected by the turmoil in global financial markets. This is evident in a widening of sovereign risk spreads and a sharp downturn in stock markets—most pronounced for real estate companies. Large private capital inflows, driven by expectations of an appreciation of the dirham vis-à-vis the U.S. dollar, largely reversed over the summer of 2008; currency futures indicate that markets no longer doubt the peg. Foreign financing for many corporates has tightened, and a slowdown in real estate and construction seems underway. The global weakening will reduce demand for tourism, trade, and financial services, while lower oil prices may affect public spending. Growth in the non-oil economy is expected to slow down considerably, while inflationary pressures should recede.

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

The U.A.E. banking system appears adequately capitalized and highly profitable, but risks have risen. Banks' assets and profits increased sharply in 2007 and the capital adequacy ratio stood at 13.3 percent by mid-2008, above the regulatory minimum of 10 percent, though somewhat below the level of 2007. However, the fast pace of growth of consumer and real estate loans along with the uncertain outlook for asset prices has raised the risk of a future increase in nonperforming loans (NPLs). Capital outflows, and growing concerns about counterparty risk, have in recent months affected the functioning of the interbank market.

Money and private sector credit growth accelerated further in the first nine months of 2008, and liquidity became tight in late summer. Credit to the private sector rose by 51 percent (year-on-year) in September 2008, up from 40 percent in December 2007, with demand driven by the economic boom and highly negative real interest rates. In mid-2008, the central bank took several steps to address a drying-up of liquidity following the outflow of foreign deposits. Subsequently, to preempt spillovers from the global turmoil, the government issued a blanket guarantee for deposits and inter-bank lending for three years, and put in place a $19 billion emergency liquidity support fund to provide banks with long-term funding.

The short and medium-term outlook is subject to a number of downside risks arising from the difficult global environment as well as domestic financial vulnerabilities in the wake of the recent real estate and credit boom (especially in Dubai). The main risks to the outlook stem from (i) a more severe global weakening; (ii) further tightening of foreign financing for investment projects; (iii) an increase in the demand for domestic financing adding to banks' stress; (iv) a correction in the real estate market leading to a deterioration of asset quality in financial institutions; (v) a drop in oil prices that constrains the scope for fiscal policy to support growth; and (vi) an unexpected re-emergence of inflationary pressures.

Executive Board Assessment

Executive Directors commended the authorities of the U.A.E. for their outward-oriented development strategy and the impressive performance of the economy in recent years. The U.A.E.'s open economy and established linkages with international financial markets have played a key role in economic diversification and strong growth, but also make the U.A.E. vulnerable to the current global financial turbulence. They referred in this context in particular to the potential impact on external balances and growth through lower oil prices, more constrained access to international financial markets, and weaker prospects for tourism, trade, and real estate. Against that background, and taking into account the likelihood of an easing of inflationary pressures in coming months, Directors agreed that managing the impact of the global downturn and safeguarding financial stability have become the authorities' key policy challenges. Noting that it may be useful to coordinate the U.A.E.'s response to the economic crisis with that of other Gulf Cooperation Council (GCC) members, Directors welcomed the progress made toward coordinating monetary policies indicated by the recent establishment of the GCC Monetary Council.

Directors emphasized the importance of safeguarding the soundness and functioning of the financial sector, while facilitating a smooth and orderly deceleration in credit growth from an unsustainable pace. They welcomed the actions taken to guarantee deposits and inter-bank lending for three years, and to establish liquidity facilities. They cautioned, however, that contingency plans for a worse-than-expected downturn should focus on safeguarding only systemically important institutions. Going forward, the fiscal costs of assistance to the financial sector will need to be minimized, and incentives provided to prevent a buildup of risky assets.

Directors welcomed the plans to amend the banking law to strengthen the central bank's supervisory and regulatory power and to launch a thorough review of banks' balance sheets, off-balance sheet items, and large exposures. They urged the authorities to improve the classification of loans in order better to assess risks, and to strengthen surveillance over bank and finance company risk management practices.

Directors concurred with the authorities on the need to maintain essential ongoing infrastructure investments to boost productive potential, while reining-in commitments for new projects and rationalizing subsidies. They emphasized that any financial support for corporates should aim to cushion the fallout from the drying up of foreign financing and promote adjustment to a less-buoyant outlook. Directors agreed that if the economic environment deteriorates more than expected, a more active countercyclical fiscal stance would be called for to support growth and employment. Directors welcomed the establishment of the Federal Council to Coordinate Fiscal Policy, aimed at coordinating budgets and expenditures between the emirates and at the federal level and ensuring that the U.A.E.'s overall fiscal stance safeguards macroeconomic stability. They supported plans to introduce a VAT over the next 2–3 years, which would make the budget less vulnerable to oil price fluctuations.

Directors agreed that the exchange rate peg of the dirham to the U.S. dollar remains appropriate, providing a strong and proven anchor in the stormy economic conditions that may lie ahead. They took note of the staff assessment that the real appreciation of the dirham in 2008 and the ongoing reversal of terms-of-trade gains with the recent drop in oil prices may have eliminated any dirham undervaluation.

Directors welcomed the U.A.E.'s participation in the General Data Dissemination System. They looked forward to the establishment of a National Bureau of Statistics, as planned, and the dissemination of monthly CPI data in 2009. They encouraged the authorities to continue to strengthen national accounts and public sector statistics. Directors emphasized that greater transparency on public financial assets and liabilities could help shore up investor confidence.

Directors welcomed the U.A.E.'s active participation in the International Working Group on Sovereign Wealth Funds (IWG) and its endorsement of the IWG's voluntary principles to promote an open and conducive climate for international investment.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with the United Arab Emirates is also available.

United Arab Emirates: Selected Macroeconomic Indicators, 2005–09 1/

	2005	2006	Est. 2007	Proj. 2008	Proj. 2009
Output and prices	(Annual percent change, unless otherwise indicated)				
Nominal GDP (in billions of AED)	496.5	602.9	661.7	970.9	936.6
Nominal GDP (in billions of U.S. dollars)	135.2	164.2	180.2	264.4	255.0
Real GDP (at factor cost)	8.2	9.4	6.3	7.4	3.3
Real oil and gas GDP	1.6	6.5	-1.6	3.6	-0.2
Real non-oil GDP	10.8	10.4	9.1	8.6	4.4
CPI inflation (average)	6.2	9.3	11.1	12.7	6.7
Public finances	(In percent of GDP, unless otherwise indicated)				
Revenue	41.0	49.6	50.4	48.1	41.1
Oil	30.8	38.1	35.4	39.5	30.3
Non-oil	10.3	11.5	14.9	8.6	10.8
Expenditure and net lending	21.0	21.2	25.2	24.9	29.0
Budget Balance	20.0	28.4	25.2	23.2	12.1
Non-hydrocarbon balance (excluding investment income) 2/	-24.8	-23.7	-25.5	-34.5	-33.9
Monetary sector	(Annual percentage change)				
Credit to private sector	44.5	36.9	40.1	39.2	23.9
Broad money	33.8	23.2	41.7	25.2	13.7
External sector	(In billions of U.S. dollars, unless otherwise indicated)				
Exports of goods	117.2	145.7	170.3	259.9	234.0
Oil and gas	55.0	70.2	73.8	109.2	80.8
Imports of goods	-74.5	-88.1	-116.6	-176.8	-179.1
Current account balance	24.3	37.1	29.0	45.4	22.3
Current account balance (in percent of GDP)	18.0	22.6	16.1	17.2	8.7
Gross official reserves	21.3	28.0	77.9	38.1	53.5
In months of next year imports of goods and services	2.3	2.3	4.3	2.1	2.8
Real effective exchange rate (2000=100)	96.0	101.2	103.6	109.9	111.9

Sources: U.A.E. authorities; and IMF staff estimates.
1/ Projections are based on information received through November 2008.
2/ In percent of non-hydrocarbon GDP.