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United Arab Emirates: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Arab Emirates

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with the United Arab Emirates, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 31, 2002,** with the officials of the United Arab Emirates on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 24, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 12, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the United Arab Emirates.

The document(s) listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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UNITED ARAB EMIRATES

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with the United Arab Emirates

Approved by George T. Abed and Shigeo Kashiwagi

January 24, 2003

The consultation discussions were held in Abu Dhabi, Dubai, and Sharjah from October 19–31, 2002. The staff team comprised Messrs. Fasano (head), Wilson, Goswami, Goyal, and Mahyoub, (all MED).

The mission met with the Minister of State for Finance and Industry, the Governor of the Central Bank of the United Arab Emirates, Under Secretaries of the Ministries of Finance and Industry; Economy and Commerce; Labor and Social Affairs; and Planning, as well as other senior officials of the federal government and the three largest Emirates—Abu Dhabi, Dubai, and Sharjah. Meetings were also held with representatives of commercial banks, stock exchanges, and chief executives of several public enterprises. Mr. Shaalan, Executive Director for the United Arab Emirates, participated in the policy discussions.

In concluding the last consultation on October 12, 2001, Executive Directors commended the authorities for their ongoing efforts to diversify the economy and broaden the export base. To maintain the growth momentum and further enhance investor confidence, they encouraged the authorities to strengthen the fiscal position, particularly the non-oil balance, lift remaining impediments to foreign investment outside the free zones, and increase the long-term employability of the national labor force through training and education, as well as address important data deficiencies.

The United Arab Emirates has accepted the obligations of Article VIII, Sections 2, 3, and 4. It has also accepted the Fourth Amendment of the Fund's Articles of Agreement.

Appendices I and II provide information on relations with the Fund and Statistical Issues, respectively. Appendix III presents the background section of the PIN. The forthcoming Selected Issues and Statistical Appendix report elaborates on financial sector developments; long-term fiscal trends; permanent income estimates based on intergenerational economic equity objectives; and non-oil growth, competitiveness, and the labor market in the United Arab Emirates, as well as estimates of U.A.E. real gross domestic income.

Following the conclusion by the Fund's Executive Board of the United Arab Emirates' 2002 Article IV consultation discussions, the authorities are considering issuing a PIN and publishing the staff report and the Selected Issues and Statistical Appendix report. They recently agreed to publish through the IMF web page the Financial Sector Stability Assessment report based on the 2001 Financial Sector Assessment Program.

The principal author of this report is Mr. Fasano, with inputs from other mission members.

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Executive Summary

Background

Despite volatile crude oil prices, the United Arab Emirates—the sixth largest world oil exporter—has performed relatively well over the past years. In 2001, the external current account surplus remained large (15 percent of GDP), even though oil prices declined by close to 13 percent. Overall, real GDP grew by almost 4 percent, as a number of projects were launched in the areas of construction, water and electricity, and downstream oil activities. However, amid declining revenues, the upward trend in government spending continued in 2001, with the consolidated fiscal balance (including investment income) shifting to a deficit of about 5 percent of GDP.

The macroeconomic performance appears to have been mixed in 2002. While non-hydrocarbon growth remained robust, the external current account surplus narrowed to 6 percent of GDP owing mainly to further cuts in crude oil output in line with OPEC-mandated quota reductions, rising imports, and declining investment income. The consolidated fiscal deficit widened to 9 percent of GDP, as spending remained broadly unchanged despite lower revenue. The banking sector continued to perform well in 2002. Persistent large fiscal deficits threaten the country's medium term economic outlook, putting pressure on official foreign assets and increasing vulnerability to weakening oil prices.

Staff Appraisal

Following a sharp deterioration in the consolidated fiscal position in the past few years, restoring fiscal discipline (particularly at the emirate-level) remains a critical element to secure and broaden economic progress in the United Arab Emirates. To this end, in line with intergenerational economic equity objectives, a fiscal adjustment is needed to reduce the non-hydrocarbon fiscal deficit by Dh 26 billion over the medium term from an estimated Dh 68 billion in 2002 (or from 26 percent of GDP to about 19.5 percent by 2007). This adjustment will require primarily cuts in current expenditure. In the long run, a modern tax system should be also adopted to reduce fiscal vulnerability. The authorities should consider casting fiscal policy in a medium term framework.

The staff welcomes the progress made in implementing 2001 Financial Sector Assessment Program (FSAP) recommendations. The authorities have put in place a comprehensive regime to combat money laundering and terrorist financing. They are encouraged to pursue reforms in the insurance and securities sectors, modernize the legal system, and strengthen corporate governance.

The authorities are urged to step up their efforts to address data deficiencies across sectors. Priority should be given to improving the coordination and cooperation among government agencies, while strengthening their current good institutional base. Moreover, fiscal accounts should follow international standards of expenditure and revenue classification. The authorities are encouraged to collect comprehensive statistics on government and nongovernment capital flows. They provided available aggregate data on government foreign assets on a confidential basis.

I. BACKGROUND

1. **The U.A.E. economy performed relatively well in the second half of the 1990s** (Figure 1).[1] A market-oriented growth strategy aimed at diversifying the economy, an open trade system, and liberal capital flow regime have contributed to this performance. A pegged exchange rate—effectively fixed to the dollar—has also served as a nominal anchor for the economy since the early 1980s. In addition, given the small indigenous population—albeit rapidly rising—an open border foreign labor policy has been pursued to ensure sufficient supply of labor at competitive wages. Indeed, the United Arab Emirates—a federation of seven emirates and the sixth largest world crude oil exporter—has systematically recorded a trade- and income-driven external current account surplus, and remained a net creditor.[2] Substantial official foreign assets have also been accumulated, providing ample latitude to respond to oil price shocks. Moreover, the United Arab Emirates has become quite diversified, with petrochemicals, aluminum, tourism, banking, and entrepôt trade activities currently accounting for a large share of GDP (Figure 2). **However, fiscal vulnerability to weakening oil prices has increased in the past few years**. Rising current expenditure (notably agricultural subsidies and defense) since 1998 has contributed to deepening the weaknesses in the budget structure. In addition, the rapid expansion of non-hydrocarbon activities has not generated a corresponding increase in non-oil revenue due to the absence of a developed tax system.

2. **During the past few years, the Fund has encouraged the authorities to strengthen fiscal policy and address data deficiencies across most sectors**. Modernization of the financial sector's legal framework and improvement in securities and insurance supervision and regulation has also been recommended. Nevertheless, responsiveness of the U.A.E. authorities to past Fund policy advice has been impeded in some key areas, particularly fiscal, because of a decentralized policymaking process that reflects the complexity of the country's political structure—with each emirate retaining considerable political, judicial, financial, and economic autonomy. As a result, the United Arab Emirates'

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[1] The United Arab Emirates together with Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia, established the Cooperation Council of the Arab States of the Gulf (GCC) in the early 1980s to boost economic and financial ties in the region.

[2] Important regional disparities among individual emirates remain because of the uneven distribution of oil and gas. The Emirate of Abu Dhabi is the largest one, accounting for 90 percent of the country's oil reserves and about half of total GDP, while it has the highest per capita income in the country (about five times higher than the income in the poorest emirate). Dubai—the second largest emirate—accounts for one-quarter of the country's total GDP and has been at the forefront of developing non-hydrocarbon activities in anticipation of the depletion of its crude oil reserves over the next decade.

record on strengthening the non-hydrocarbon fiscal balance could be improved significantly.[3] Moreover, poor coordination and cooperation between federal and local agencies, and other public sector entities have precluded progress in addressing deficiencies in official statistics and providing information between consultations on macroeconomic developments (except monetary statistics).[4,5] In contrast, **important progress has been made in financial sector reforms**, as the Central Bank of the United Arab Emirates (CBU) has unified authority over most institutions in the sector. The 2001 Financial Sector Assessment Program (FSAP) was also an important step in evaluating the banking sector in the country.[6]

II. Recent Developments

3. **Despite lower oil revenue, the U.A.E. economy continued to perform well in 2001**. Average oil prices fell by 12.6 percent to $23.78 per barrel, contributing to a loss in crude oil export receipts of $4 billion. Despite this loss, the external current account surplus remained large (about 15 percent of GDP), as non-hydrocarbon exports, including reexports, continued to perform well (Tables 1 and 2, and Figure 3). Real GDP growth fell to 3.8 percent in 2001, owing to a 3 percent cut in oil production (excluding condensates) in line with OPEC-quota reductions. Non-hydrocarbon real GDP growth remained robust and one of the fastest in the GCC area, as a number of projects were launched in construction, water and electricity, upstream gas, and downstream oil sectors. Moreover, owing to strong growth of tourists from the region, the United Arab Emirates' tourism industry continued to grow in 2001, despite the adverse impact of the September 11 events. Meanwhile, inflation remained low at 2.2 percent.

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[3] Due to the volatility in oil revenue, the non-hydrocarbon fiscal balance—defined as the consolidated fiscal balance excluding hydrocarbon revenue—is a more useful indicator of underlying fiscal trends than the consolidated fiscal balance.

[4] The United Arab Emirates has seldom requested technical assistance from the Fund (Appendix I).

[5] The usefulness of the official data available for accurate economic analysis appears to be compromised by methodological weaknesses, deficient data sources, and poor compilation procedures, as reflected, for instance, in large and persistently negative errors and omissions in the balance of payments (Appendix II).

[6] According to findings of the FSAP, banks in the United Arab Emirates are broadly profitable, well supervised, and capitalized, while posing minimal near term system risk. In addition, the CBU largely complies with the Basel Core Principles for Effective Banking Supervision and observes the Transparency Code in the areas of banking supervision, monetary policy, and payment systems. For further details, see the 2001 Financial System Stability Assessment (FSSA) country report (No. 03/20).

2001, despite the adverse impact of the September 11 events. Meanwhile, inflation remained low at 2.2 percent.

4. **Amid declining revenues, government spending rose further in 2001**. Following an increase of 32 percent from 1998–2000 (mostly on account of higher defense and other current expenditure), total spending rose by 14 percent in 2001. In particular, transfers and subsidies—mainly to agriculture—increased by a further 41 percent, reaching almost 8 percent of GDP, and net lending by six-fold to finance upstream gas projects.[7] This increase in spending, together with lower oil revenue and investment income (on account of declining global interest rates), contributed to a sharp deterioration in the consolidated fiscal balance.[8] Indeed, this balance shifted from a surplus of 6 percent of GDP in 2000 to a deficit of about 5 percent in 2001, largely financed by drawing down official foreign assets (Table 3 and Figure 4). Mirroring these developments, the non-hydrocarbon fiscal deficit widened to 24 percent of GDP in 2001.

5. **In 2002, the United Arab Emirates' macroeconomic performance appears to have been mixed**. Although average crude oil prices are estimated to have risen by 4 percent to $24.70 per barrel, oil output is likely to have declined by about 9 percent in line with OPEC-mandated cuts. These cuts are estimated to have contributed to a fall in real GDP growth to 1.5 percent, even though non-hydrocarbon growth remained robust at close to 5 percent, on account of ongoing construction projects and rising petrochemical output (Table 1). Moreover, lower crude oil receipts, together with rising imports and lower investment income, has also contributed to reducing the external current account surplus to about 6 percent of GDP.

6. **Consolidated government spending is expected to have remained broadly unchanged in 2002 in spite of a further decline in oil revenue**. As a result, several fiscal indicators show a sharp deterioration in the fiscal accounts. The estimated consolidated fiscal balance registered a deficit of about 9 percent of GDP—significantly higher than the average deficit recorded in the period 1995–2001 (about 2 percent of GDP)—financed by drawing down official foreign assets. The non-hydrocarbon deficit widened to 26 percent of GDP—or to Dh 68.4 billion, almost double the level registered in previous years. In addition, the

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[7] For more details on long-term fiscal developments in the United Arab Emirates, see forthcoming Selected Issues and Statistical Appendix report, Chapter II.

[8] The consolidated fiscal balance represents a combination of federal and the four largest emirates, including investment income on official foreign assets. Based on the data on these assets provided by the authorities, investment income is estimated by the staff in line with movements in global short-term interest rates, as the authorities do not currently furnish this information. In 2001, it is estimated that the Emirate of Abu Dhabi accounted for 76 percent of total consolidated revenues and 79 percent of expenditures.

current balance recorded a deficit for the first time in more than two decades. Meanwhile, broad money growth is estimated to have fallen by end-2002 to less than 9 percent from 11 percent a year earlier (Table 4). This reflects lower growth of both net foreign and domestic assets. The central bank's international reserves are expected to remain at a comfortable external position at end- 2002, equivalent to about 5 months of imports (Table 5). On other developments, the strong performance of the banking sector posted in 2001 continued into 2002, and the Emirates equity market index increased by about 14 percent through the end of October 2002, on top of almost a 26 percent rise in 2001.[9]

7. **Reflecting its decentralized policymaking process, the promotion of privatization and foreign direct investment (FDI) has varied across emirates**. The Emirate of Abu Dhabi has embraced utility privatization, embarking on new power projects through joint ventures with foreign investors, and selling of some existing assets. The Abu Dhabi authorities also stated that they expect the electricity and water generation sector to be under the control of private operators by 2006 (from currently about 33 percent), though they plan to maintain direct control over tariffs, transmission, and distribution. Meanwhile, foreign ownership of companies remains limited to 49 percent in the Emirate of Abu Dhabi, which has not set up so far free zones. In contrast, the Emirate of Dubai and the other smaller emirates have established free zones that allow 100 percent foreign ownership (while maintaining the 49 percent limit outside the free zones). Moreover, Dubai recently allowed foreigners to own land and properties in some real estate developments, such as the Palm Island resorts and Dubai Internet City (the tax-free zone created to attract multinational information technology corporations), contributing to a construction boom. It also announced in 2002 the launch of several new free zones that aim to establish the emirate as a global hub for trade in gold bullion, research and development of technology, and financial activities.

III. Report on Discussions

8. **Persistent large fiscal deficits could negatively impact the U.A.E. economy**. During 2003, oil output and average export oil prices are expected to remain at about 2002 levels, but prices are forecast to decline by $4 per barrel in the following years, dropping to $20.50 by 2006–07 (Table 6).[10] Non-hydrocarbon real GDP growth in 2003–07 is expected to average close to 5 percent a year (slightly below the average growth recorded in the previous five years), underpinned by ongoing investments, including in new fertilizer and petrochemical plants and upstream natural gas, as well as large public and private construction projects, while inflation is expected to remain low. Nevertheless, even assuming

[9] For more details on recent financial sector developments in the United Arab Emirates, see forthcoming Selected Issues and Statistical Appendix report, Chapter I.

[10] The crude oil price and global short-term interest rates projections are based on early January 2003 *World Economic Outlook* (WEO) forecast.

low expenditure growth, the consolidated fiscal deficit is expected to remain at 7–8 percent of GDP in the period ahead, resulting in government dissavings. Thus, these deficits are likely to weaken the government's financial position over the medium term, as well as contribute to narrowing the external current account surplus significantly, increasing the country's vulnerability to oil price shocks.[11]

9. **The discussions focused, therefore, on the challenges facing the authorities to secure and broaden economic progress, and, in particular, to restore fiscal discipline**. Addressing these challenges will call for improving the budget structure, further strengthening the financial sector, developing human resources, as well as expanding FDI opportunities. In addition, renewed efforts are needed to improve the quality of and public access to timely official statistics to enhance the decision-making process and project a clearer picture of a rapidly expanding economy.

A. Fiscal Policy

10. **The staff urged the authorities to give priority to address the deterioration in the fiscal accounts**. Otherwise, persistent large budget deficits will most probably put pressure on official foreign assets and increase fiscal vulnerability to weakening oil prices. Given the present outlook, to ensure intergenerational economic equity objectives, a fiscal adjustment is needed to reduce the non-hydrocarbon fiscal deficit by about Dh 26 billion (about 9 percent of GDP) over the medium term from an estimated Dh 68.5 billion in 2002 (Figure 5).[12] This adjustment will contribute to returning the non-hydrocarbon fiscal deficit to a long-run sustainable path (based on permanent income estimates), as was the case during the past two decades.

11. **A significant portion of the strengthening of the non-hydrocarbon fiscal balance must come from cuts in current spending**. Following several years of rapid growth, the authorities should reduce nonproductive current spending across the board, in particular subsidies on water, electricity, and agriculture. These measures will account for at least half

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[11] At current crude oil production levels, the United Arab Emirates loses about 1 percent of GDP in export receipts for every dollar decline in the price of a barrel of crude oil.

[12] Countries in which wealth is derived from a nonrenewable resource, such as oil, need to determine what constitutes a sustainable level of government consumption to preserve resources for future generations. Under current crude oil output production (including condensates), the United Arab Emirates' permanent income from oil wealth was estimated at about Dh 42.5 billion under the reasonable assumptions of preserving this wealth constant in real terms (a government objective), and a conservative oil price of $18 per barrel. See forthcoming Selected Issues and Statistical Appendix report, Chapter III for further details on estimations of the United Arab Emirates' permanent income.

of the proposed adjustment, also contributing to improving the budget structure as well as reducing waste. The rest will come mostly from higher investment income, which, in line with the projected rise in global short-term interest rates from 2 to 6 percent over the medium term according to WEO, is likely to increase from Dh 7.1 billion in 2002 to Dh 17.3 billion in 2007. In addition, customs revenue is expected to increase beginning in early 2003, as import tariffs are raised from 4 percent to a flat 5 percent to comply with the adoption of the common external tariff among GCC countries. Nevertheless, the authorities should be ready to adopt deeper cuts for precautionary reasons if uncertainty in the international environment puts downward pressure on global crude oil prices and interest rates. The authorities pointed out that they are planning in the period ahead to cut subsidies to agriculture, which were increased as a way to distribute to the population the sharp rise in the oil wealth in the past few years.

12. **In the long run, the United Arab Emirates will also need to broaden the revenue base to sustain a strong fiscal position and reduce fiscal vulnerability**. However, relying mainly on increases in fees and charges on government services may not be sufficient or advisable. Ultimately, the country will also need to adopt a modern tax system to complement the oil revenue and investment income. As initial steps, the staff suggested that the authorities consider adopting the tax policy already in place in other GCC countries.[13] Thus, the corporate income tax could be extended to include companies in the non-hydrocarbon sector and local banks—only hydrocarbon companies and foreign banks are currently subject to income tax in the United Arab Emirates. In addition, since service activities account for about half of GDP, the authorities could also adopt a low-rate broad-based consumption tax on services, such as utilities and telecommunications, while emirate governments could introduce a property tax. These proposed revenue measures are likely to take quite some time to have an impact on revenue because of the need to build tax institutions in the country. Thus, the mission encouraged the authorities to start this process as soon as possible. The authorities agreed with the need to broaden the revenue base, but noted that the fragmentation of fiscal policy among emirates hinders at this stage establishing the political consensus to adopt a national tax system.

13. **The authorities should also consider casting fiscal policy in a medium-term framework**. Assuming a conservative oil price, this approach will likely make expenditure less driven by short-term revenue availability, building in precautionary savings to face oil

[13] In some other GCC countries, a corporate income tax is already levied on foreign industrial companies and foreign and local banks, and in Oman, also on local corporations. These taxes are currently bringing the equivalent of about 2 percent of non-oil GDP in revenue. Some GCC countries have also begun to explore the possibility of broadening the tax base through the adoption of a value-added tax, which could bring, assuming a single low rate and few exemptions, additional revenue equivalent to 2 percent of non-oil GDP.

price shocks.[14] The authorities saw some merit to this recommendation, but pointed out that their budget procedures and high level of foreign assets provide adequate flexibility to weather oil revenue fluctuations. In the Emirate of Abu Dhabi, for instance, fiscal oil revenue is usually budgeted on an oil price of about 15–20 percent below the international price to reduce the downside risks on the revenue side and dampen pressure on expenditure growth. As a result, the government always targets an ex-ante deficit (excluding investment income), with cuts in development spending being the main adjustable variable if the actual deficit widens beyond the investment income.

14. **The mission welcomed the progress made by the federal authorities to ensure greater efficiency in public spending.** Some services provided by a government-owned autonomous corporation established in 2001 have started to be transferred to the private sector. Following FAD technical assistance, objectives and targets for four pilot ministries and one autonomous entity (a university) will be applied beginning in the 2003 budget in line with the authorities' initiative to move toward a performance-oriented budget policy. Moreover, the federal authorities made further progress in consolidating the electronic government ("e-government") project to facilitate dealings and procedures; improving transparency and efficiency, (the Emirate of Dubai has also launched a similar initiative). The mission encouraged local authorities to follow the steps taken so far by the federal government in this area.

B. Financial Policies

15. **An open economy, liberal capital flows policy, and the exchange rate peg entail limited scope for an independent monetary policy in the United Arab Emirates.** As a result, domestic interest rates have closely tracked the decline in U.S. rates in recent years. To enhance liquidity management, the authorities are currently considering making central bank certificates of deposit more attractive by increasing their maturity structure.

16. **The mission commended the authorities for further strengthening the financial sector in line with 2001 FSAP recommendations**. Indeed, building-up on steps taken over the past few years, the authorities stressed that priority was given in 2002 to put in place a comprehensive framework to combat anti-money laundering (AML) and terrorism financing (CTF). Progress was also achieved in other areas, such as the adoption of a comprehensive system of overall risk management for the banking sector (Box 1). Reforms in the insurance and securities sectors have also been initiated, including the drafting of a new insurance law that will bring industry standards into line with current best practices. The government can

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[14] Government spending follows oil revenue in the U.A.E, suggesting a pro-cyclical expenditure policy to variations in oil revenue. For further details, see Fasano, U. and Wang, Q., 2002, "Testing the Relationship between Expenditure and Revenue: Evidence from GCC Countries," *IMF Working Paper* No. 02/201.

also play an active role in promoting consolidation in the insurance sector to create strongly capitalized and better-managed companies. Moreover, as pointed out in the FSAP, the authorities should also focus on improving securities sector supervision and monitoring, and enforcing existing regulations, particularly regarding the timely and adequate provision of company financial accounts and the adoption of international accounting standards, as banks did in 1999. Furthermore, for the United Arab Emirates to strengthen its position as a leading regional financial and banking sector hub and recipient of FDI, the authorities should consider modernizing its legal system, including in particular the bankruptcy law.

Box 1. Progress in Strengthening the United Arab Emirates' Financial System in 2002

- **Combat of anti-money laundering and terrorist financing**. A federal law was approved in January that fully incorporates the FATF 40 recommendations and the 8 special recommendations dealing with terrorist financing. Moreover, the authorities have fully implemented all U.N. Security Council Resolutions in this area since 1999, as well as strengthened the central bank's anti-money laundering and suspicious cases unit by providing it with important human, financial, and technical resources. As a result, the FATF Mutual Evaluation Team concluded that the United Arab Emirates has put in place a comprehensive regime of anti-money laundering law and regulations. In addition, the authorities have responded to the Fund's AML/CFT questionnaire, concluding that the system and provisions for international cooperation seem generally well developed.

- **Comprehensive system of overall risk management for the banking sector**. This system will cover all banks by early 2003, from about one-third at present. This system also incorporates corporate governance issues to assess overall risk.

- **New banking law**. A draft banking law under consideration should contribute to clarifying issues on Islamic banking, disclosure and responsibilities of Boards of Directors, and further strengthening the supervisory role of the CBU.

- **Supervision of the "hawala" system of informal money transfers**. Hawala dealers are required to provide details of remitters and beneficiaries as well as report suspicious transfers. Thus, this system is covered under U.A.E. AML/CFT legislation. However, the authorities emphasized that without a policy change by the remittance-receiving countries to reduce exchange restrictions and parallel exchange markets, the hawala system will likely remain an important channel for expatriate workers to transfer resources to their home countries.

C. Exchange Rate Policy

17. **Backed by large government and central bank foreign assets and an open economic system, the authorities indicated that the pegged exchange rate regime has served the U.A.E. economy well by providing a nominal anchor and strengthening confidence.** In line with developments of the dollar in international markets, the real effective exchange rate (REER) (based on consumer prices) has appreciated by more than

30 percent since the mid-1990s.[15] Nevertheless, the authorities noted that this does not seem to have hindered the country's competitiveness (Figure 6, Box 2). The mission agreed with the authorities' assessment, and highlighted that fiscal discipline and a sound banking system remain crucial elements to support the current exchange rate peg.[16]

Box 2. Non-hydrocarbon Growth and Competitiveness [17]

Despite a large REER appreciation in the second half of the 1990s, the United Arab Emirates experienced strong non-hydrocarbon output and export growth.

- Non-hydrocarbon real GDP grew at an annual average rate of 8 percent in the period 1995–2001, with growth in manufacturing, trade, and banking being particularly strong. At the same time, due mainly to the dollar nominal strength in international markets, the real effective exchange rate appreciated by nearly 35 percent over the same period. Nevertheless, the country's export market share in partner country imports continue to increase in the period, while investment remained high, averaging more than 26 percent of GDP in those years.

- Several reasons may explain this strong non-hydrocarbon growth performance, in spite of an apparent loss in competitiveness as measured by the CPI-based REER. Some 30 percent of the United Arab Emirates' non-hydrocarbon exports go to the GCC area and other countries in the region, whose currencies have also experienced a real appreciation in the past years. Nominal wages in local currency have declined slightly during the second half of the 1990s. In addition, good infrastructure and a business-friendly environment, particularly in the free trade zones, have made the United Arab Emirates a very attractive place to invest for companies wishing to serve the growing markets of the Middle East, North Africa, and Asia. Moreover, the presence of an elastic supply of expatriate workers at internationally competitive wages also played an important role in explaining growth in non-hydrocarbon sectors during the 1990s. However, the authorities indicated that high import tariffs in some large markets have continued to hinder a faster expansion of some non-hydrocarbon exports, such as aluminum.

D. Privatization and Foreign Direct Investment

18. **The staff welcomed the ongoing reform of the power and water sector and the broadening of FDI opportunities**. Although this reform has contributed to lowering costs

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[15] Movements in the REER should be interpreted with care because of concerns about the quality of consumer price data (Appendix II).

[16] In line with GCC decision to adopt a monetary union by 2010, the U.A.E. dirham has become officially pegged to the dollar since February 2002 (Appendix I).

[17] For a more detailed analysis of these issues, see forthcoming Selected Issues and Statistical Appendix report, Chapter IV.

and improving efficiency in the sector in the Emirate of Abu Dhabi, without a more comprehensive approach, including increases in tariffs (which remain highly subsidized) and the full restructuring of companies in the transmission and distribution sector, subsidies to the electricity and water sector are likely to remain high over the medium term.[18] The staff also pointed out that establishing a national electricity grid with a common tariff policy should facilitate investment decisions nationwide, particularly in the resource-poor Northern emirates. In fact, the authorities indicated that the feasibility study to implement a U.A.E. power grid, which will complement a GCC power grid project, has been completed and is currently awaiting government approval. **In line with past Fund advice, the mission encouraged the authorities to eliminate gradually remaining restrictions on FDI in areas outside the free zones**. This move should benefit the domestic private sector from the know-how and technology brought by this type of investment. In addition, the staff indicated that the adoption of a common strategy for foreign ownership across emirates could facilitate and broaden investment opportunities nationwide.

E. Labor Market

19. **A rapidly rising local labor force may create strains in the labor market in the coming years, despite expectations of robust economic growth**. In light of the segmentation of the labor market between nationals and expatriates in terms of sectors of employment, wages, and skills, the policy challenge facing the authorities is to increase the degree of substitutability between the two sources to expand employment opportunities for nationals, particularly in the nongovernment sector.[19] To address this challenge, the staff agreed with the authorities' strategy to rely mainly on long-term structural policies, while, in general, avoiding mandatory measures (such as quotas).[20] This strategy seeks to raise the skills of nationals through better education and training programs geared toward private sector labor demand. In line with this objective and past Fund recommendations, the National Human Resource Development and Employment Authority was created in 2001 to help improve the skills of U.A.E. nationals looking for a job, and a national labor database is being established to facilitate employment search efforts.

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[18] According to official estimates, the cost of power generation in Abu Dhabi because of these reforms declined by 16 percent over the period 1999–2002.

[19] It is estimated that expatriate workers account for about 90 percent of the labor force, with most of them being employed in the private sector. The latter has created more than 100,000 new jobs annually over the past few years—though mostly low and semi-skilled positions. For a more detailed analysis of labor issues, see forthcoming Selected Issues and Statistical Appendix report, Chapter IV.

[20] Currently, quotas for hiring U.A.E. nationals are only applied—albeit flexibly—in the banking sector.

IV. Statistical Issues

20. **As in past consultations, the mission urged the authorities to step up efforts to improve the quality, coverage, collection, and timely dissemination of comprehensive national economic and social statistics (Appendix II).** The staff pointed out once again that improving coordination and cooperation among public agencies remains a priority, while increasing the manpower and financial resources devoted to the collection and dissemination of national statistics. In the meantime, progress could also be made by strengthening the current good institutional base that exists at the CBU and the Ministry of Planning. The Ministry of Finance and Industry could use its expertise to compile and disseminate comprehensive national fiscal statistics. Fiscal transparency could be improved by adopting international standards of economic classification of expenditures and revenue. The authorities stressed that they remain committed to improve the quality and dissemination of the country's national statistics despite the lack of progress since the last consultation. In this context, the staff welcomed the authorities' recent request for a multisector technical assistance mission from the Fund to help them establish a medium-term plan to address data deficiencies, as well as review the recent changes in the compilation of monetary statistics.

21. **The authorities have provided available aggregate data on the government sector's foreign assets on a confidential basis.** They were encouraged to develop comprehensive statistics on capital flows, particularly FDI and private sector external debt, as well as provide information on government foreign assets investment income to enhance macroeconomic assessment. In addition, the mission also encouraged the authorities to report key macroeconomic data to the Fund between consultations, particularly on consolidated fiscal accounts, and urged them to broaden and improve the timeliness of the information sent for publication in the IMF's *International Financial Statistics*. The mission also recommended that the authorities participate in the Fund's General Data Dissemination System (GDDS).

V. Staff Appraisal

22. **Despite the wide fluctuations in global oil prices during the past several years, the United Arab Emirates has sustained a comfortable external position and robust non-hydrocarbon growth.** An open economic system and sound economic management have contributed to this performance. However, macroeconomic performance appears to have been mixed in 2002. While non-hydrocarbon activities have remained strong underpinned by ongoing investments in infrastructure and manufacturing, additional cuts in crude oil output have contributed to slowing down overall economic growth, and narrowing the external current account surplus. Amid declining revenue, government spending has remained broadly unchanged, leading to a sharp deterioration in the fiscal accounts. Persistent large fiscal deficits could threaten the country's medium term economic outlook, putting pressure on official foreign assets and increasing fiscal vulnerability to weakening oil prices.

23. **Priority should be given to restore fiscal discipline to ensure intergenerational economic equity objectives**. To this end, the authorities will likely need to implement a fiscal adjustment to reduce the non-hydrocarbon fiscal deficit by about Dh 26 billion over the medium term from its 2002 estimated level of Dh 68.5 billion. In light of their rapid increase over the past few years, cuts in current expenditures should account for a significant portion of the proposed fiscal adjustment. In particular, subsidies on water, electricity, and agriculture should be phased out, and other nonproductive outlays reduce. These measures are also likely to improve the budget structure and reduce waste. To sustain a strong fiscal position in the long run, the United Arab Emirates will ultimately need to adopt a modern tax system. As initial steps, the authorities should expand income taxes in line with policy already in place in other GCC countries, and implement a low-rate broad-based consumption tax on services. Emirate governments could introduce a property tax, as well. Given high oil price uncertainty and volatility, the authorities are also encouraged to cast fiscal policy in a medium-term framework to make expenditure less driven by short-term revenue availability, building in precautionary savings to preserve official foreign assets.

24. **Strengthening domestic institutions is also vital to secure and broaden economic progress.** In this context, the staff welcomes the progress made in further strengthening the financial sector in line with the 2001 Financial Sector Assessment Program recommendations. The authorities have put in place a comprehensive regime to combat money laundering and terrorist financing, and have taken important steps to adopt in the short run a broad system of overall risk management in the banking sector. They are encouraged to focus in the period ahead on reforming the insurance sector, and improving securities sector supervision and monitoring, as well as enforcing existing regulations regarding the timely and adequate provision of company financial accounts based in international accounting standards.

25. **The staff welcomes the steps taken over the past few years to improve efficiency in the power and water sector, and broaden FDI opportunities**. Nevertheless, without increases in electricity and water tariffs to their true economic cost and full restructuring of companies in the transmission and distribution sector, subsidies to the electricity and water sectors are likely to remain high in the period ahead. In order to further increase FDI, the staff encourages the authorities to gradually eliminate remaining foreign investment restrictions in areas outside the free zones, as well as adopt a common strategy for foreign ownership across emirates to broaden and facilitate investment opportunities nationwide.

26. **The staff agrees with the authorities' long-term labor market strategy to increase employment opportunities for U.A.E. nationals**. This strategy should continue to rely on raising the skills of nationals through better education and training programs geared toward private sector labor demand, while, in general, avoiding mandatory measures, such as quotas.

27. **The staff endorses the authorities' commitment to the exchange rate peg.** Within an open economic system, this arrangement has contributed to anchoring economic stability.

Moreover, although the U.A.E. dirham has appreciated in real terms during the past years reflecting mostly the movements of the dollar in international markets, growth of non-hydrocarbon activities and exports has remained robust. Nevertheless, the staff emphasizes that fiscal discipline and a sound banking system remain crucial elements to support the peg.

28. **The authorities are urged to step up their efforts to address data deficiencies across sectors**. This is needed to enhance the decision making process in a rapidly expanding economy. In this context, the staff supports the authorities' recent request for a Fund's multisector technical assistance mission. Improving coordination and cooperation among public agencies should remain a priority, while strengthening the current good institutional base that currently exists at several government agencies. Fiscal transparency could be significantly improved by following international standards of economic classification of expenditure and revenue. The staff encourages the authorities to develop comprehensive statistics on capital flows, particularly FDI and private sector external debt, as well as provide data on government foreign assets investment income to enhance macroeconomic assessment. It also urges them to report key macroeconomic data to the Fund between consultations, as well as broaden and improve the timeliness of the information sent for publication in the IMF's *International Financial Statistics*. The staff recommends that the authorities participate in the Fund's GDDS as well.

29. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. United Arab Emirates: Selected Economic Indicators, 1997–2002

	1997	1998	1999	2000	Prel. 2001	Est. 2002
			(In billions of U.A.E. dirhams)			
GDP at market prices	188.0	178.1	202.7	259.0	256.6	262.2
			(In millions of barrels per day)			
Oil production and exports						
Crude oil production 1/	2.43	2.43	2.26	2.41	2.44	2.21
Of which: condensates	0.19	0.17	0.18	0.22	0.32	0.32
Average crude oil price (U.S. dollars per barrel)	18.80	12.57	17.48	27.21	23.78	24.70
			(Annual percentage changes)			
National income and prices						
Real GDP (at factor cost)	8.3	1.4	4.4	10.0	3.8	1.5
Crude oil, condensates, and natural gas	5.9	-7.6	-4.5	11.1	1.2	-9.4
Nonhydrocarbon sectors 2/	9.2	5.0	7.5	9.7	4.6	4.8
Real gross domestic income	7.4	-11.4	16.0	38.3	-3.3	1.9
GDP deflator	-1.5	-6.8	9.0	16.2	-4.7	0.6
Consumer prices	2.9	2.0	2.1	1.4	2.2	2.8
			(In percent of GDP)			
Investment and saving						
Gross domestic investment	28.1	30.6	27.8	23.2	24.4	26.6
Government	5.8	7.9	6.8	4.3	5.2	4.7
Nongovernment	22.3	22.8	21.0	18.9	19.2	22.0
National saving	41.1	35.1	38.8	49.1	40.0	32.4
Government	12.2	5.6	3.1	11.1	2.0	-3.8
Nongovernment	28.9	29.5	35.7	38.0	38.0	36.2
Consolidated government finances						
Revenue	37.5	34.5	31.7	38.6	32.1	27.3
Hydrocarbon	21.9	14.3	13.8	21.6	18.9	17.1
Non-hydrocarbon	15.6	20.2	17.8	17.0	13.2	10.1
Of which: investment income	7.2	10.4	9.5	9.8	6.1	2.7
Expenditure	34.1	40.3	37.3	32.6	37.4	36.2
Of which						
Current	25.2	28.9	28.6	27.5	30.2	31.1
Development	8.2	10.7	8.0	4.6	6.9	4.6
Overall balance	3.4	-5.8	-5.6	6.0	-5.3	-8.9
(Excluding hydrocarbon revenue)	-18.5	-20.1	-19.4	-15.6	-24.2	-26.0
Government debt 3/	4.3	6.6	7.2	4.6	4.0	4.5

Table 1. United Arab Emirates: Selected Economic Indicators, 1997–2002

	1997	1998	1999	2000	Prel. 2001	Est. 2002
	(Changes in percent of beginning M2 stock)					
Money and credit 4/						
Broad money (M2)	9.0	4.2	11.4	11.1	10.6	8.7
Foreign assets (net)	-1.2	0.4	4.3	10.9	4.0	3.7
Domestic assets	10.3	3.8	7.1	0.3	6.6	5.0
Of which:						
Claims on government (net)	0.7	-1.3	1.1	-4.7	1.7	-0.3
Claims on private sector	13.0	13.9	7.6	7.8	7.6	8.4
	(In percent per annum; end of period)					
Average interest rates						
Dirham (three month interbank)	5.58	5.45	5.53	6.53	3.50	2.00
Lending rate	9.54	9.02	10.59	9.60	7.82	7.05
	(In billions of U.S. dollars)					
External sector						
Exports	40.8	33.4	36.5	49.6	48.2	47.9
Of which: crude oil	14.6	10.0	13.6	21.7	17.7	15.9
Imports, f.o.b.	-30.0	-28.7	-27.9	-30.8	-32.8	-35.0
Current account balance	6.7	2.2	6.0	18.3	10.4	4.1
(In percent of GDP)	13.1	4.5	10.9	25.9	14.9	5.8
Central bank reserves	8.6	9.3	10.9	13.8	14.3	14.3
In months of imports	3.6	4.0	4.3	5.1	4.9	4.7
As percent of reserve money	209.5	210.4	199.8	250.2	242.8	219.8
As percent of short-term debt 5/	276.2	147.6	218.7	251.3	336.0	332.7
Total external debt 6/	16.9	18.1	18.5	18.2	14.1	14.2
(In percent of GDP)	33.0	37.5	33.6	26.0	20.3	20.1
Memorandum item:						
Dirhams/U.S. dollar (end of period)	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725

Sources: U.A.E. authorities; Bank for International Settlements (BIS); Organization for Economic Cooperation and Development (OECD); and IMF staff estimates.

1/ Crude oil output includes condensates, which are not subject to OPEC quotas.
2/ Includes refined products and liquid gas, staff estimates as of 2000.
3/ Due to domestic banks; no official external debt is reported.
4/ Beginning in 2000, adjusted for changes in official compilation procedure.
5/ Debt due within one year, from BIS/OECD statistics.
6/ Central bank and commercial bank foreign liabilities, plus private nonbanks (BIS source).

Table 2. United Arab Emirates: Balance of Payments, 1997–2002

(In billions of U.S. dollars)

	1997	1998	1999	2000	Prel. 2001	Est. 2002
Trade balance	10.8	4.7	8.6	18.8	15.3	12.9
Exports	40.8	33.4	36.5	49.6	48.2	47.9
Crude oil and products	15.3	10.4	14.2	23.4	19.9	18.9
Crude oil	14.6	10.0	13.6	21.7	17.7	15.9
Petroleum products 1/	0.7	0.4	0.6	1.7	2.2	3.0
Natural gas	2.9	2.1	2.3	3.7	3.4	3.0
Nonhydrocarbon	11.8	9.3	8.2	9.4	10.9	11.7
Of which						
Free zones	4.0	4.3	4.5	5.5	6.8	7.4
Nonmonetary gold	6.0	3.1	1.8	1.9	2.1	2.1
Reexports 2/	10.8	11.6	11.8	13.1	13.9	14.3
Imports (f.o.b.)	-30.0	-28.7	-27.9	-30.8	-32.8	-35.0
Imports by Emirates	-20.7	-22.3	-22.8	-23.9	-24.8	-26.5
Free zones	-3.1	-3.2	-3.2	-4.9	-5.9	-6.4
Nonmonetary gold	-6.2	-3.2	-1.9	-2.0	-2.2	-2.2
Investment income, net	5.7	7.1	7.3	9.6	6.1	2.9
Banks and private nonbanks	2.1	2.1	2.1	2.8	2.0	1.1
Government 3/	3.6	5.0	5.1	6.8	4.1	1.8
Services, net	-6.1	-5.9	-5.9	-6.2	-6.4	-6.4
Transfers, net	-3.6	-3.7	-3.9	-4.0	-4.6	-5.3
Private	-3.4	-3.4	-3.6	-3.7	-4.0	-4.5
Official	-0.2	-0.2	-0.3	-0.3	-0.6	-0.8
Current account balance	6.7	2.2	6.0	18.3	10.4	4.1
(In percent of GDP)	13.1	4.5	10.9	25.9	14.9	5.8
Financial account balance	-1.1	2.4	4.2	-7.4	-2.2	1.3
Private capital	0.8	-0.8	1.7	-3.6	-3.0	-3.6
Commercial banks	0.6	0.6	0.4	-2.9	-2.9	-1.5
Private nonbanks	0.2	-1.4	1.3	-0.7	-0.1	-2.0
Official capital 4/	1.7	3.1	2.6	-3.7	0.8	4.8
Errors and omissions	-5.3	-3.8	-8.7	-8.1	-8.1	-5.3
(In percent of GDP)	-10.3	-7.9	-15.8	-11.5	-11.6	-7.4
Overall balance	0.3	0.8	1.5	2.8	0.5	0.1
Change in central bank foreign assets (- = increase)	-0.3	-0.8	-1.5	-2.8	-0.5	-0.1
Memorandum items:						
Central bank gross foreign assets	8.6	9.3	10.9	13.8	14.3	14.3
(In months of imports) 5/	3.6	4.0	4.3	5.1	4.9	4.7
Net free zone exports	0.9	1.1	1.3	0.6	0.9	1.0

Sources: U.A.E. authorities; and IMF staff estimates.

1/ Includes fertilizers and lubricants.

2/ Not formally compiled; estimated at 40–50 percent of emirates imports.

3/ IMF staff estimates.

4/ Includes changes in official external assets, including estimates for ADNOC profit transfers.

5/ Imports of goods and services in the next 12 months.

Table 3. United Arab.Emirates: Consolidated Government Finances, 1997–2002

(In millions of U.A.E. dirhams)

	1997	1998	1999	2000	Prel. 2001	Est. 2002
Total revenue	70,493	61,425	64,200	99,991	82,480	71,496
Hydrocarbon	41,140	25,500	28,054	56,020	48,526	44,953
Nonhydrocarbon	29,353	35,925	36,146	43,971	33,954	26,543
Customs	1,676	1,821	1,886	1,779	1,846	1,689
Profit transfers	2,652	3,051	3,462	3,936	3,384	3,371
Income tax 1/	2,925	1,679	2,179	4,124	3,329	4,075
Fees and charges	5,039	5,554	4,581	4,173	5,120	5,611
Investment income 2/	13,580	18,489	19,234	25,373	15,625	7,128
Other	3,481	5,331	4,804	4,586	4,650	4,669
Total expenditure and grants	64,101	71,730	75,538	84,348	96,083	94,814
Current expenditure	47,420	51,487	57,930	71,247	77,372	81,530
Wages and salaries 3/ 4/	13,138	12,533	13,224	13,962	14,360	15,781
Goods and services 4/	18,993	19,657	22,616	23,385	23,582	26,942
Abu Dhabi federal services 5/	7,774	10,876	11,899	19,440	19,082	18,796
Subsidies and transfers	7,098	8,017	9,849	13,945	19,716	19,397
Other	418	404	342	516	632	615
Development expenditure	10,912	13,987	13,765	11,230	13,280	12,197
Loans and equity (net)	4,566	5,047	2,435	652	4,507	-210
Domestic	4,587	2,867	2,564	714	903	-155
Foreign	-21	2,180	-129	-62	3,604	-55
Foreign grants 6/	1,203	1,209	1,408	1,219	924	1,297
Abu Dhabi	983	1,045	1,361	1,071	664	858
Federal	220	164	47	148	260	439
Overall balance	6,392	-10,305	-11,338	15,643	-13,603	-23,318
(In percent of GDP)	3.4	-5.8	-5.6	6.0	-5.3	-8.9
Financing	-6,392	10,305	11,338	-15,643	13,603	23,318
Resident banks, net 7/	597	-1,248	1,109	-10,530	2,348	-545
Privatization receipts 8/	...	...	...	...	2,000	...
Changes in official foreign assets (- = increase) 2/	-6,989	11,553	10,229	-5,113	9,255	23,863
Memorandum items:						
Current balance	23,073	9,938	6,270	28,744	5,108	-10,035
(In percent of GDP)	12.2	5.6	3.1	11.1	2.0	-3.8
Overall balance excluding hydrocarbon revenue	-34,748	-35,805	-39,392	-40,377	-62,129	-68,271
(In percent of GDP)	-18.5	-20.1	-19.4	-15.6	-24.2	-26.0
Subsidies and transfers (In percent of GDP)	3.7	4.5	4.9	5.4	7.7	7.4
Balance on pension fund operations 9/	...	...	...	1,970	1,274	1,275

Sources: Federal government; Emirate finance departments; and IMF staff estimates.

1/ Mainly income taxes on gas firms in Abu Dhabi.
2/ Fund staff calculations and estimates.
3/ Excludes military wages and salaries, which are in goods and services.
4/ Water and electricity expenditure is allocated 25 percent to wages and salaries, 75 percent to goods and services.
5/ Largely military and internal security expenditures paid by Abu Dhabi, but not in the federal accounts.
6/ Intergovernmental grants are netted out in the consolidated fiscal accounts.
7/ From monetary statistics.
8/ Abu Dhabi receipts from the sale of electricity and water assets.
9/ Operations of the General Pension and Social Security Authority, which was established in 2000.

Table 4. United Arab Emirates: Monetary Survey, 1997–2002

End of Period	1997	1998	1999	2000	New Compilation 1/ 2000	New Compilation 1/ 2001	Est. 2/ 2002
	(In millions of U.A.E. dirhams)						
Net foreign assets (NFA)	62,365	62,737	67,000	88,111	115,045	120,685	126,458
Foreign assets	108,151	116,080	121,971	141,112	142,217	151,879	157,761
Central bank	31,431	34,148	40,163	50,759	50,759	52,471	52,477
Commercial banks 3/	76,720	81,932	81,808	90,353	91,459	99,408	105,284
Foreign liabilities	45,786	53,343	54,971	53,001	27,172	31,194	31,303
Central bank	52	11	403	587	587	516	300
Commercial banks 3/	45,734	53,332	54,568	52,414	26,585	30,678	31,003
Domestic assets	32,488	36,087	43,128	38,889	26,496	35,795	43,668
Claims on government (net)	-7,559	-8,807	-7,698	-18,228	-30,625	-28,277	-28,822
Claims	8,099	11,568	14,654	11,800	11,800	10,205	11,773
Deposits	15,658	20,375	22,352	30,028	42,425	38,482	40,595
Claims on public sector enterprises	5,511	5,236	5,581	5,780	5,780	5,258	5,468
Claims on private nonbanks	92,735	105,895	113,430	123,313	123,313	134,132	147,322
Capital and reserves (-)	-26,981	-31,430	-33,517	-35,833	-35,834	-38,377	-39,846
Other assets (net)	-31,218	-34,807	-34,668	-36,143	-36,138	-36,941	-40,454
Central bank	-12,906	-13,933	-16,261	-26,292	-26,292	-27,994	-27,164
Commercial banks 3/	-18,312	-20,874	-18,407	-9,851	-9,846	-8,947	-13,290
Domestic liquidity (M2)	94,854	98,824	110,128	127,000	141,540	156,476	170,126
Money	25,368	27,783	30,250	34,067	34,067	39,464	44,857
Currency outside banks	7,366	8,194	10,270	10,017	10,017	10,537	11,591
Dirham demand deposits	18,002	19,589	19,980	24,050	24,050	28,927	33,266
Quasi-money	69,486	71,041	79,878	92,933	107,473	117,012	125,270
Foreign currency deposits	18,570	19,731	23,354	28,428	35,754	37,189	39,061
Dirham time and savings deposits	50,916	51,310	56,524	64,505	71,719	79,823	86,209
	(Growth in percent of initial M2 stock, except as indicated)						
Net foreign assets	-1.2	0.4	4.3	...	10.9	4.0	3.7
Domestic assets	10.3	3.8	7.1	...	0.3	6.6	5.0
Of which							
Claims on government (net)	0.7	-1.3	1.1	...	-4.7	1.7	-0.3
Claims on private sector (percent change) 4/	13.9	14.2	7.1	...	8.7	8.8	9.8
Domestic liquidity (M2)	9.0	4.2	11.4	...	11.1	10.6	8.7

Sources: Central Bank of the U.A.E. and IMF staff estimates.

1/ Data reflect official change in compilation, which now treats offshore affiliates of local banks as if they were resident entities.

2/ Based on data through end-August 2002.

3/ Including the restricted license bank.

4/ Annual changes from a year earlier.

Table 5. United Arab Emirates: Selected Indicators of External Vulnerability, 1997–2002

	1997	1998	1999	2000	Prel. 2001	Est. 2002
External solvency indicators						
REER (CPI-based, percent change, annual average) 1/	7.7	7.0	0.5	15.8	6.7	-2.7
Total external debt (in billions of U.S. dollars)	16.9	18.1	18.5	18.2	14.1	14.2
Short-term debt (BIS source) 2/	3.1	6.3	5.0	5.5	4.3	4.3
Total external debt/GDP (percent)	32.7	37.7	33.4	25.9	20.2	19.9
Short-term debt/exports of goods and services (in percent)	7.3	17.9	13.0	10.6	8.4	8.5
Public sector solvency indicators (in percent)						
Overall fiscal balance/GDP	3.4	-5.8	-5.6	6.0	-5.3	-8.9
Government domestic debt/GDP 3/	4.3	6.6	7.2	4.6	4.0	4.5
Oil revenue/total revenue	58.4	41.5	43.7	56.0	58.8	62.9
Investment income/total revenue	19.3	30.1	30.0	25.4	18.9	10.0
Non-oil revenue (excluding investment income)/non-oil GDP	12.0	12.5	11.1	10.9	10.2	10.2
Non-hydrocarbon balance/GDP	-18.5	-20.1	-19.4	-15.6	-24.2	-26.0
External liquidity indicators						
Central bank gross foreign assets (in millions of U.S. dollars)	8,562	9,298	10,936	13,821	14,288	14,289
In months of imports of goods and services	3.6	4.0	4.3	5.1	4.9	4.7
As percent of M1	124.0	122.9	132.8	149.0	133.0	117.0
As percent of short-term external debt 2/	276.2	147.6	218.7	251.3	336.0	332.7
As percent of commercial banks foreign liabilities 4/	68.8	64.0	73.6	96.8	171.0	169.3
Commercial banks' net foreign assets (in millions of U.S. dollars) 4/	8,437	7,788	7,417	10,331	18,715	20,226
Foreign assets	20,890	22,310	22,276	24,603	27,068	28,668
Foreign liabilities 4/	12,453	14,522	14,859	14,272	8,353	8,442
Crude oil exports/total exports (in percent)	35.8	30.0	37.2	43.8	36.8	33.2
Financial sector indicators						
Foreign currency deposits/total deposits (in percent)	21.2	21.8	23.4	24.3	25.5	24.6
Net domestic credit (annual change in percent)	37.9	11.1	19.5	-9.8	-8.0	22.0
Private sector credit (annual change in percent)	13.9	14.2	7.1	8.7	8.8	9.8
Private credit/total assets of banks (in percent)	45.7	47.2	47.3	46.5	47.1	48.0
Interest rate spread against U.S. dollar (in basis points) 5/	-0.18	-0.14	0.12	-0.12	0.06	0.08
Commercial banks' capital to assets ratio	19.4	20.0	20.5	20.2	20.0	...
Gross nonperforming loans/total lending	14.4	13.5	13.6	12.7	11.2	...
Return on assets	2.0	2.0	1.5	1.8	1.7	...
Return on equity	18.3	17.7	12.8	14.9	14.6	...
Interest rate domestic spread (in percentage points) 6/	4.6	4.1	5.8	3.7	4.7	...

Sources: U.A.E. authorities; BIS; and IMF staff estimates.

1/ 2002 is for October versus year earlier.
2/ On a remaining maturity basis.
3/ Net of government deposits with banks.
4/ 2001onward distorted by change in compilation for positions with offshore affiliates of U.A.E. banks.
5/ Spread between 3-month dirham interbank and 3-month U.S. dollar LIBOR.
6/ Spread between 3-month dirham time deposits and business loans.

Table 6. United Arab Emirates: Medium-Term Baseline Scenario, 2000–07

	2000	Prel. 2001	Est. 2002	Projections 2003	2004	2005	2006	2007
Crude oil production (in millions bbl/day) 1/	2.41	2.44	2.21	2.21	2.21	2.33	2.33	2.33
Of which: condensates	0.22	0.32	0.32	0.32	0.32	0.44	0.44	0.44
Average U.A.E. oil export price (in U.S.dollars/barrel) 2/	27.21	23.78	24.70	24.50	22.00	21.50	20.50	20.50
	(Percentage change, except as noted)							
Nominal GDP (in billions of U.A.E. dirhams)	259.0	256.6	262.2	275.2	281.0	297.0	307.8	322.7
Real GDP (at factor cost)	10.0	3.8	1.5	4.0	4.0	5.1	3.6	3.7
Crude oil and natural gas 3/	11.1	1.2	-9.4	0.0	0.0	5.4	0.0	0.0
Non-hydrocarbon 4/	9.7	4.6	4.8	5.0	5.0	5.0	4.5	4.5
Consumer prices	1.4	2.2	2.8	2.9	2.1	2.1	2.1	2.1
	(In percent of GDP)							
National saving	49.1	40.0	32.4	35.6	36.5	35.9	33.7	32.5
Government	11.1	2.0	-3.8	-2.7	-2.3	-1.7	-2.2	-2.4
Nongovernment	38.0	38.0	36.2	38.4	38.8	37.6	35.9	34.9
Gross domestic investment	23.2	24.4	26.6	26.8	28.3	28.0	28.0	27.7
Government	4.3	5.2	4.7	4.7	4.9	4.8	4.8	4.8
Nongovernment	18.9	19.2	22.0	22.1	23.4	23.2	23.2	22.9
	(In billions of U.A.E. dirhams)							
Consolidated fiscal accounts								
Revenue	100.0	82.5	71.5	75.5	76.7	78.1	76.5	75.8
Hydrocarbon	56.0	48.5	45.0	45.3	40.7	40.7	38.8	38.9
Non-hydrocarbon	44.0	34.0	26.5	30.2	35.9	37.4	37.7	37.0
Of which: investment income 5/	25.4	15.6	7.1	10.1	15.4	16.4	15.4	14.3
Expenditure	84.3	96.1	94.8	97.1	97.9	98.6	99.4	100.3
Of which								
Current	71.2	77.4	81.5	83.0	83.1	83.2	83.4	83.7
Development	11.2	13.3	12.2	12.9	13.7	14.3	14.8	15.4
Overall balance	15.6	-13.6	-23.3	-21.5	-21.3	-20.5	-22.9	-24.4
(In percent of GDP)	6.0	-5.3	-8.9	-7.8	-7.6	-6.9	-7.4	-7.6
Excluding hydrocarbon revenue	-40.4	-62.1	-68.3	-66.9	-62.0	-61.2	-61.7	-63.3
(In percent of GDP)	-15.6	-24.2	-26.0	-24.3	-22.1	-20.6	-20.0	-19.6
	(In billions of U.S. dollars)							
External accounts								
Exports	49.6	48.2	47.9	50.3	49.9	51.9	53.2	55.6
Of which: crude oil and products	23.4	19.9	18.9	19.4	17.5	17.8	17.0	17.0
Imports, f.o.b.	-30.8	-32.8	-35.0	-36.8	-38.9	-41.0	-43.2	-45.7
Services (net)	-6.2	-6.4	-6.4	-5.5	-5.8	-6.1	-6.5	-6.4
Investment income (net) 5/	9.6	6.1	2.9	4.4	7.3	8.2	8.2	8.2
Transfers (net)	-4.0	-4.6	-5.3	-5.8	-6.2	-6.6	-7.0	-7.5
Current account balance	18.3	10.4	4.1	6.6	6.3	6.4	4.7	4.2
(In percent of GDP)	25.9	14.9	5.8	8.8	8.3	7.9	5.6	4.8
Central bank reserves	13.8	14.3	14.3	15.0	15.6	16.2	16.7	17.1
(In months of imports)	5.1	4.9	4.7	4.6	4.6	4.5	4.4	4.4
External debt 6/	18.2	14.1	14.2	14.6	14.9	15.1	15.4	15.7

Sources: U.A.E. authorities; and IMF staff estimates and projections.

1/ Includes condensates, which are not subject to the OPEC quota.

2/ Based on WEO oil price projections.

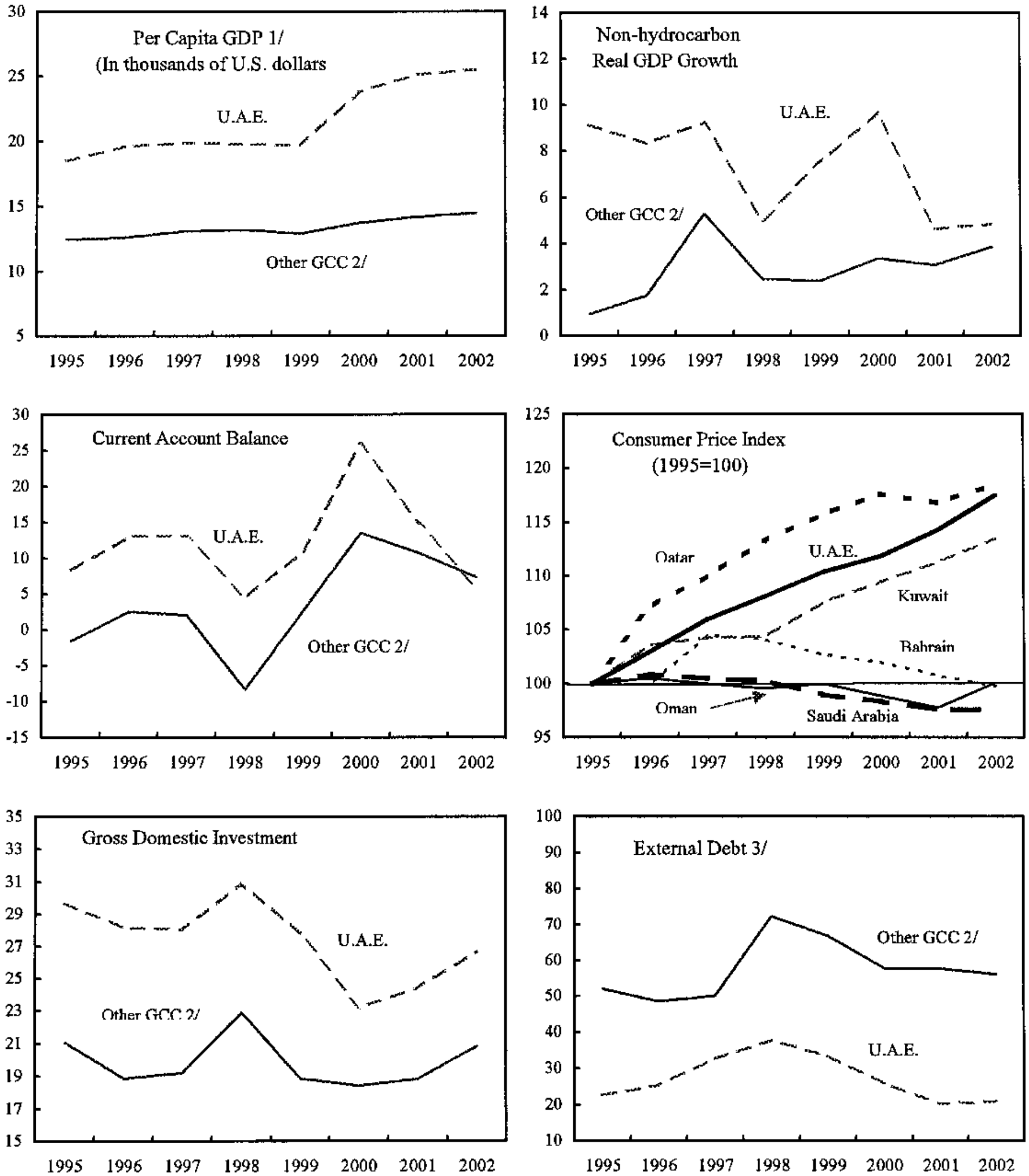
3/ Crude oil output includes condensates. The increase in 2005 reflects the completion of ongoing condensate projects.

4/ Includes refined oil products and liquid gas.

5/ Based on WEO global short-term interest rate projections.

6/ Includes liabilities of resident banks.

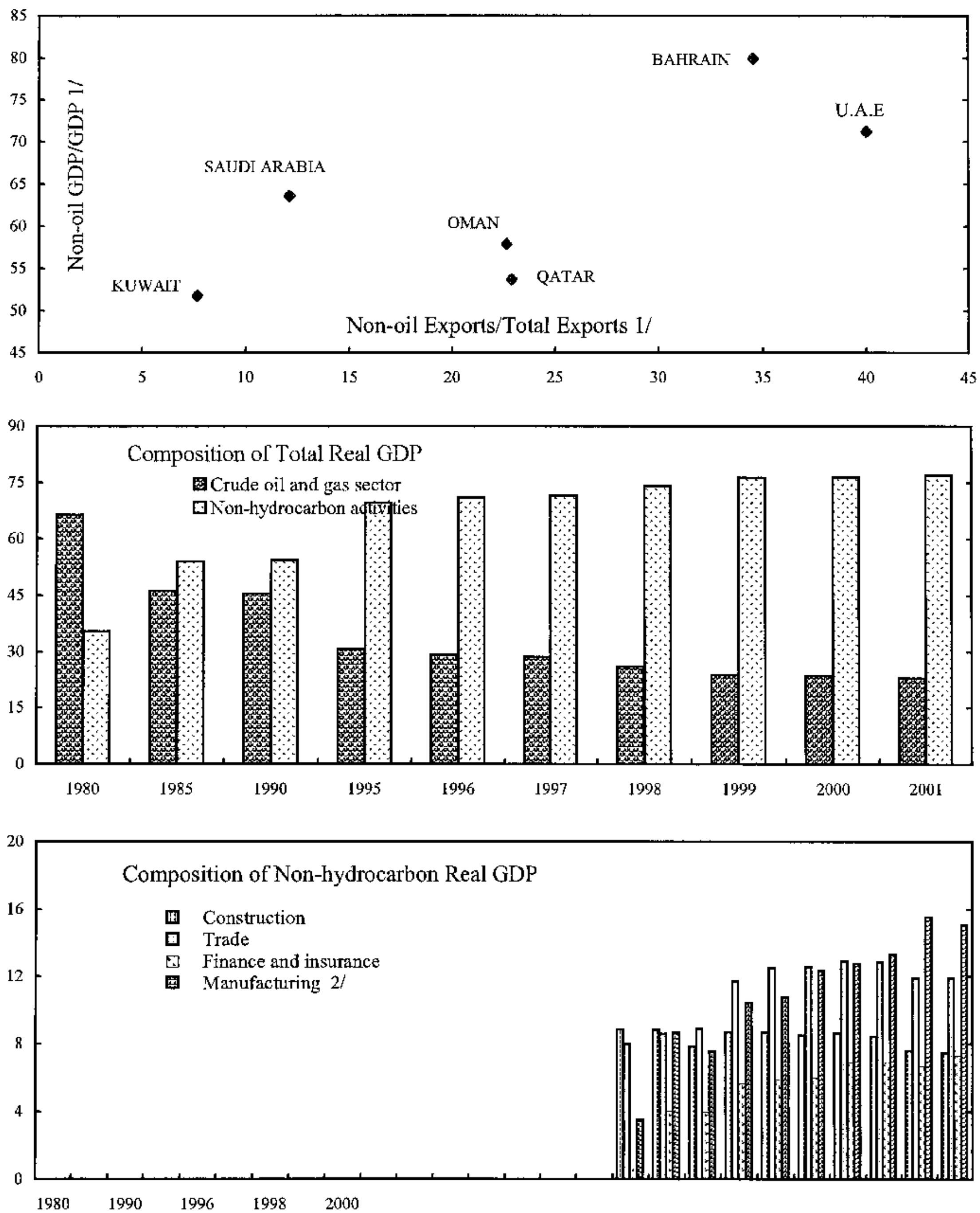
Figure 1. The U.A.E. and Other GCC Countries: Selected Indicators, 1995–2002
(In percent of GDP; unless otherwise indicated)



Sources: Data provided by the U.A.E. authorities; and IMF staff estimates.

1/ Purchasing power parity (PPP) basis.
2/ Weighted average.
3/ End of period.

Figure 2. U. A. E.: Diversification and Composition of GDP, 1980–2001

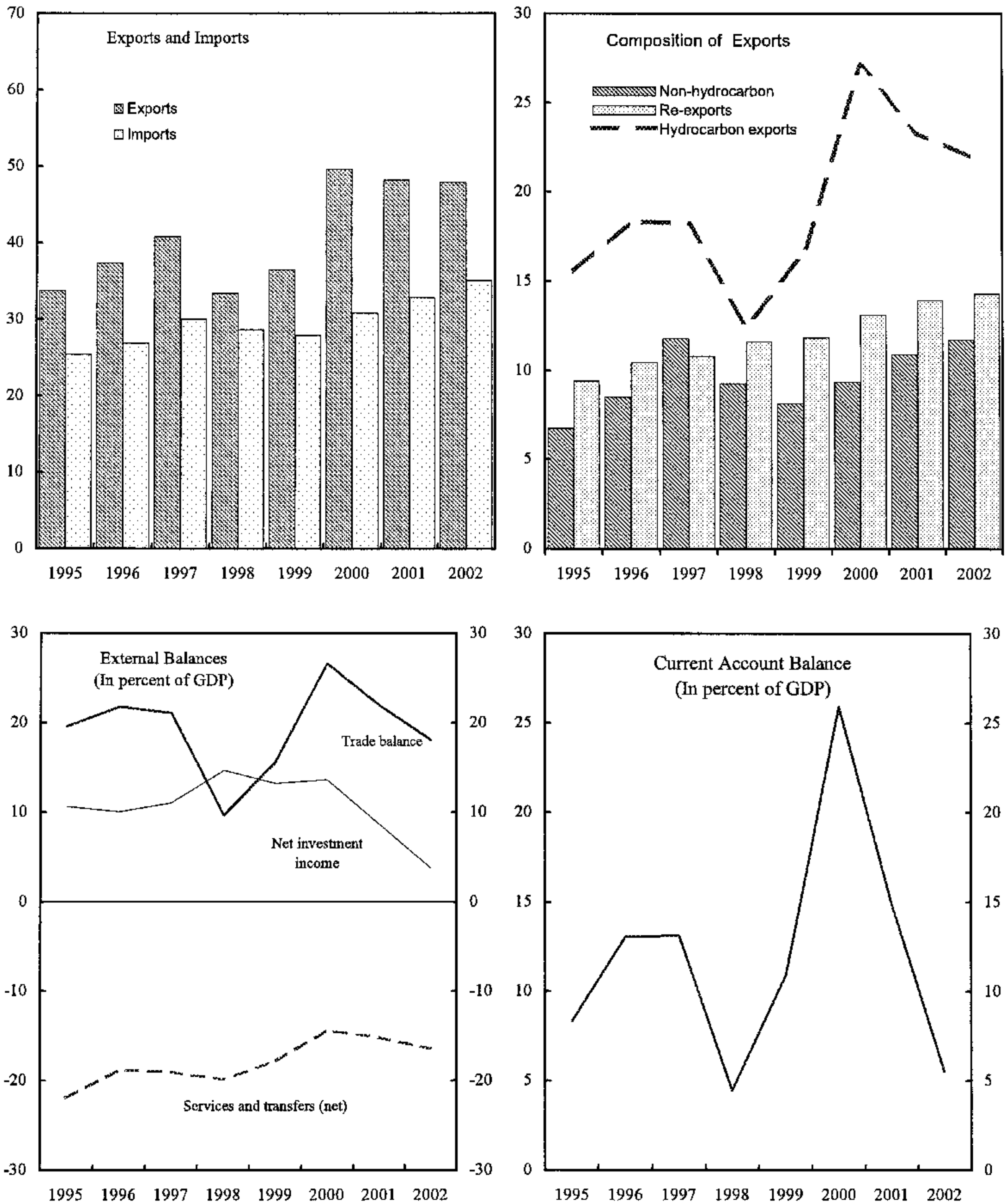


Sources: U.A.E. authorities, and IMF staff estimates.

1/ Average in the period 1995–2002.

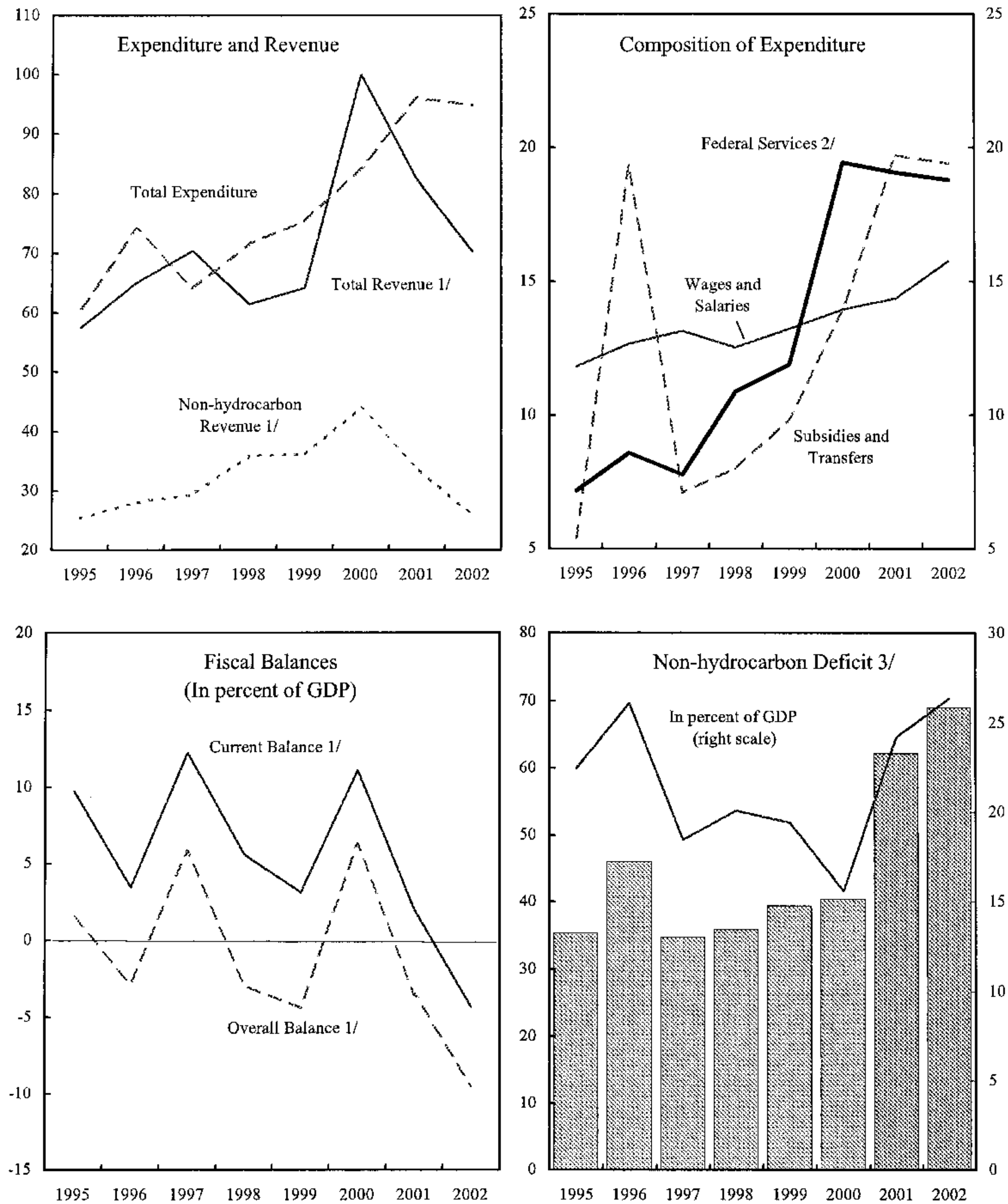
2/ Includes natural gas and petroleum processing industries.

Figure 3. U.A.E.: Selected External Sector Indicators, 1995–2002
(In billions of U.S. dollars; unless otherwise indicated)



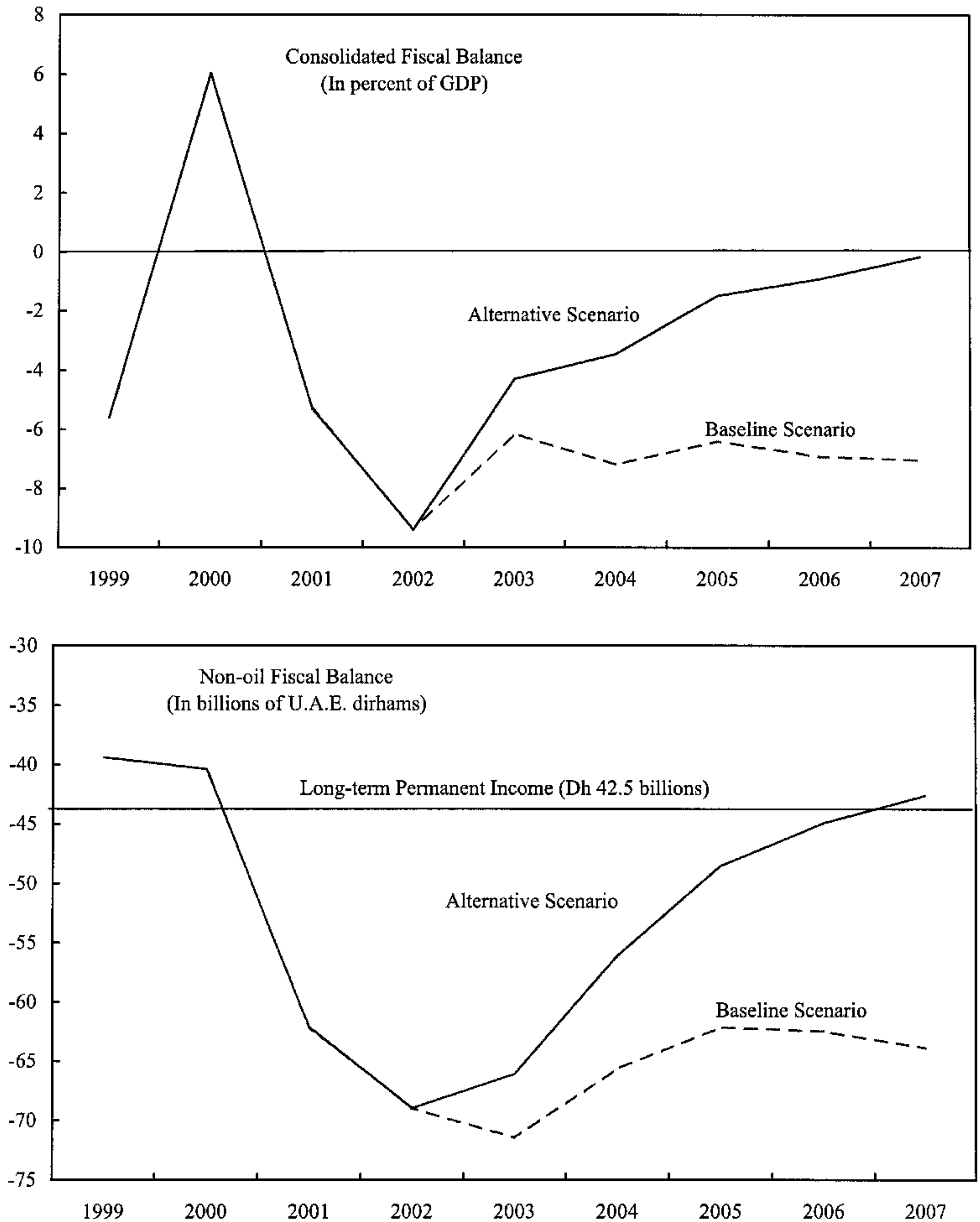
Sources: U.A.E. Central Bank, and IMF staff estimates.

Figure 4. U.A.E.: Selected Consolidated Public Finance Indicators, 1995–2002
(In billions of U.A.E. dirhams; unless otherwise indicated)



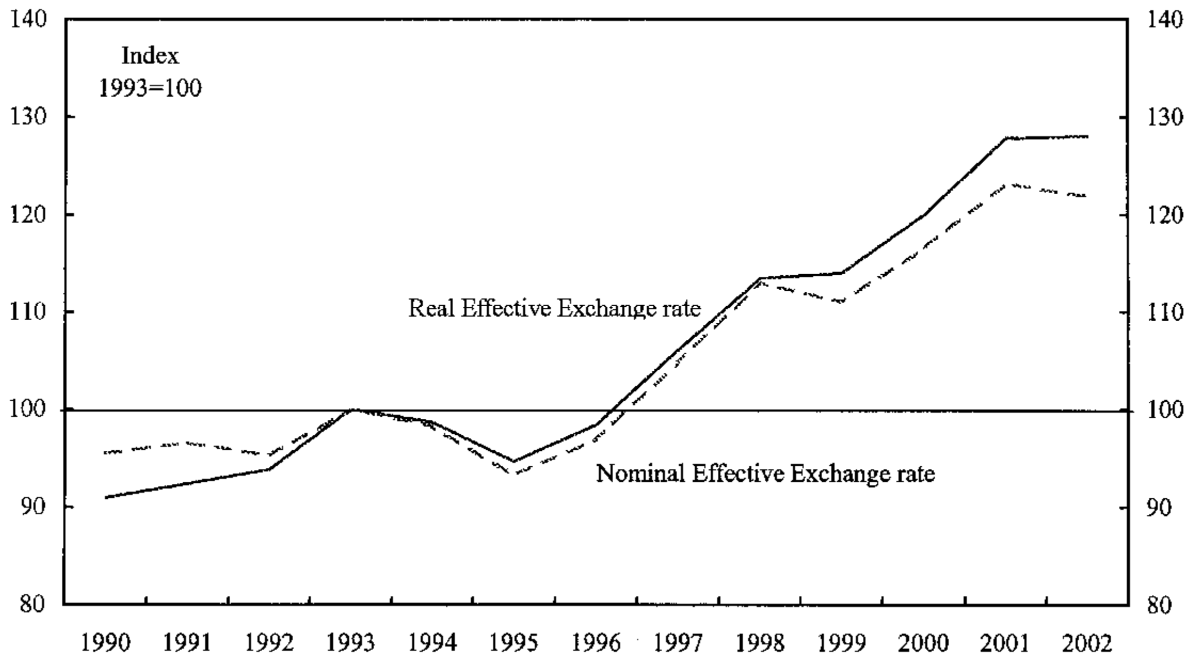
Sources: U.A.E Authorities; and IMF staff estimates.
1/ Including investment income (staff estimates).
2/ Provided by the Emirate of Abu Dhabi; mostly defense and internal security.
3/ Excluding hydrocarbon revenue.

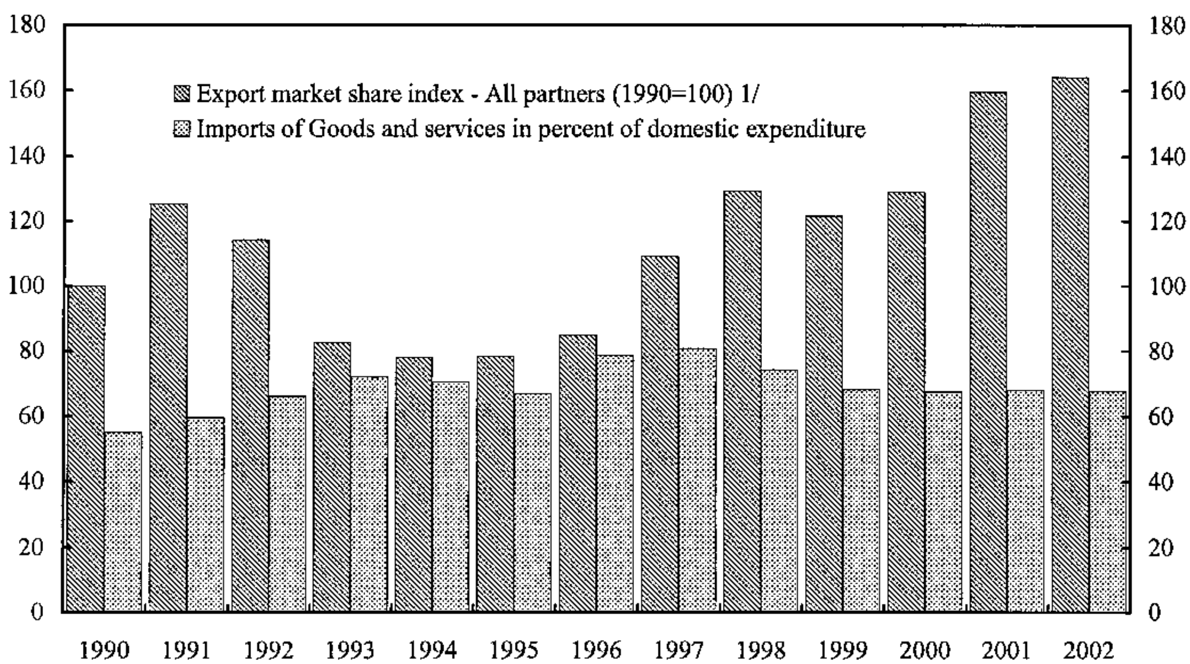
Figure 5. U.A.E.: Medium-Term Baseline and Alternative Fiscal Scenario, 1999–2007



Sources: U.A.E. authorities; and IMF staff estimates, and projections.

Figure 6. United Arab Emirates: Selected Indicators of Competitiveness, 1990–2002





Sources: Data provided by the authorities; IMF, *Information Notice System;* and IMF estimates.

1/ Export market share is defined as the index of U.A.E.'s non-oil export volume relative to the index of partner countries' import volume.

United Arab Emirates: Fund Relations

(As of December 31, 2002)

I. **Membership Status:** Joined 9/22/72; accepted Article VIII status in February 1974.

		SDR Million	Percent of Quota
II.	**General Resources Account:**	SDR Million	Percent of Quota
	Quota	611.70	100.00
	Fund holdings of currency	375.87	61.45
	Reserve position in Fund	235.83	38.55
	Financial Transactions Plan transfers (net)	11.00	

		SDR Million	Percent of Allocation
III.	**SDR Department:**	SDR Million	Percent of Allocation
	Net cumulative allocation	38.74	100.00
	Holdings	1.13	2.93

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to Fund:**
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal charges/ interest	0.73	0.72	0.72	0.72	0.72
Total	0.73	0.72	0.72	0.72	0.72

VII. **Safeguards Assessments:** Not Applicable

VIII. **Exchange Rate Arrangement:**

The U.A.E. dirham was officially pegged to the SDR at the rate of Dh 4.76190 = SDR 1 from November 1980 to February 2002—albeit, in practice, it was pegged to the dollar at a fixed parity. Since then, in line with commitments agreed with other GCC countries toward the adoption of a common currency in 2010, the U.A.E. dirham has become *officially* pegged to the dollar. The mid-point between the official buying and selling rates for the dirham has been Dh 3.6725 = $1 since November 1997.

IX. Exchange System:

The U.A.E.'s exchange system is free of restrictions on payments and transfers for international transactions, except for those restrictions notified to the Fund in accordance with Executive Board Decision No. 144 (52/51).[1]

X. Article IV Consultation:

The U.A.E. is on the standard 12-month consultation cycle. The last Article IV consultation discussions were held during May 14–28, 2001, and the staff report (SM/01/233) and the Statistical Appendix (SM/01/234) were considered by the Executive Board on October 12, 2001. As background information to the staff report, and as part of the Financial Sector Assessment Program (FSAP), a Financial System Stability Assessment (FSSA) report (SM/01/292) was issued on September 26, 2001.

XI. Technical Assistance:

STA	Multisector	June 1993
FAD	Government financial management	June 1994
STA	Data collection and balance of payments	December 1995
STA	Terms of reference and arrangements for resident advisor in balance of payments	April 1997
STA	International Reserves	May 1998
FAD	Public Expenditure Management	November 2000

XII. Resident Representative: None

[1] The staff is clarifying with the authorities whether they intend to notify under Executive Board Decision 144, measures taken in line with U.N. Security Council resolutions against terrorist financing (e.g., 1373), as these measures may give rise to exchange restrictions subject to Fund jurisdiction. The staff is also awaiting a notification from the authorities regarding whether restrictions on transactions with the Federal Republic of Yugoslavia (Serbia and Montenegro) pursuant to resolutions of the U.N. Security Council have been lifted.

United Arab Emirates: Statistical Issues

1. There are numerous shortcomings in the U.A.E. economic data. These reflect inadequate compilation techniques, shortage of trained staff, insufficient resources assigned to data gathering, information flow among federal and emirate government, and public sector entities.[1] As a result, provision of data to the Fund between missions, except for monetary and fragmentary trade statistics, remains poor. In addition, the low frequency of official statistics—most data are produced only on an annual basis—also hampers this provision. This appendix reviews the overall status of statistical issues by sector. Data on core economic indicators are found in Attachment I.

2. The U.A.E. has requested a few STA technical assistance missions over the past decade. The last time a comprehensive assessment of the country's statistical base took place was in June 1993, when a multisector statistical mission examined compilation methods of official statistics and assessed their suitability for economic analysis and monitoring.[2] The mission concluded that, while a good institutional base existed for the collection and compilation of data, major enhancements were needed, including the development of additional data sources and the application of internationally accepted methodologies. It also noted that there was a need for strengthening coordination among data collection agencies.

I. Real Sector

3. The compilation and dissemination of the monthly consumer price index (CPI) have been erratic in recent years. After lack of compilation during much of 1997, reportedly to allow processing of the 1996 Abu Dhabi household expenditure survey, in June 1998, the Ministry of Planning (MOP) resumed compilation. Dissemination was deficient for much of 2001, but CPI data became available in 2002, though the quality of information available is questionable.

4. The national accounts statistics suffer from a lack of basic information for all sectors, except government, financial institutions, and agriculture. With regard to the production account, basic data remain inadequate for manufacturing, construction, wholesale and retail trade, and most of the other service sectors. In particular, real value added for petrochemicals, which accounts for nearly half of total manufacturing value added, is not estimated according to the 1993 SNA methodology. Instead, as is done with real hydrocarbon

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[1] During 2001–02, compilation staff in the MOP was reduced somewhat, as was financial support for surveys and other activities. Key members of the remaining staff (all expatriates) are nearing retirement; questions of training and replacements are not known to have been addressed.

[2] United Arab Emirates: Aide-Mémoire on the Multisector Statistics Mission, August 1993.

value added, nominal value added is deflated by an estimated import price deflator. This methodology yields a purchasing power measure of petrochemical output, which may result in under or overestimates of volume growth, depending on changes in crude oil prices. Despite their importance in total GDP, oil and gas sector data are basically estimated from news sources, because the Abu Dhabi National Oil Company does not provide information to compilation staff at the MOP—missions have pointed out this critical data gap to the authorities on several occasions.

5. In the expenditure accounts, data are lacking on final consumption by households and on changes in stocks, while no information is compiled on the expenditure accounts in real terms. For various areas, due to the lack of regular surveys, national accounts compilers rely on *ad hoc* information, causing wide margins of error in the statistics. In addition, there are no regular or reliable wage and salary statistics for economic sectors, and labor statistics remain scant, including data on unemployment.

II. **Fiscal Sector**

6. Principal deficiencies relate to the lack of coordination among the emirates and federal government, and the low frequency in reporting government financial operations. The Ministry of Finance and Industry (MOFI) compiles data for the federal government only. The three largest emirates provide annual fiscal data to Article IV consultations, which consolidate them with the federal accounts. An annual, "consolidated" fiscal statement is published in the Central Bank's *Statistical Bulletin*, but various elements appear to be missing, in particular, investment income. There are certain "federal services" expenditures made by the Emirate of Abu Dhabi that are "attributed" to the federal government, but are not included in the federal accounts. In addition, key information, such as on investment income, and expenditure under the control of the respective Rulers' Office and municipalities, remains off-budget in some emirates, hindering comparison of fiscal developments across emirates. Furthermore, international standard of economic classification of expenditure and revenue are not fully followed.

7. The last annual data reported to STA for publication in the *Government Finance Statistics Yearbook* were for 1999 and covered only the federal government. Data on government foreign assets and income are not published. No financing information is provided by either the federal authorities or any of the emirates. No sub-annual data are reported for publication to the *International Financial Statistics* (IFS). Information on pension fund activities that are administered by the authorities through the federal-level General Pension and Social Security Authority (GPSSA) has become available since the 2002 consultation mission.[3]

[3] The GPSSA was established in January 1999 to provide pension and social security insurance benefits to all nationals working in the government and the private sectors.

III. Monetary Sector

8. Until recently, the principal issues in monetary statistics were limited to the classification and sectorization of loans to corporate, other resident, and non-resident sectors. Compilation errors may have caused an underestimation of personal loans, and information on banks' foreign currency lending is missing. As from mid-2001, however, the Central Bank of the U.A.E. (CBU) also changed its method for compilation of banking data, such that foreign affiliates of U.A.E. banks now are treated as if they were resident entities. The rationale behind changing the compilation methodology, as explained by authorities, was based on their observation that almost all of the funds that were deposited in the overseas branches (to circumvent the lower but still existing reserve requirement) almost instantly found their way back to the domestic banking system. This new form of compilation does not follow internationally accepted standards, resulting in distortions in both net foreign assets of the banking system, which are needed for the balance of payments (BOP) accounts, and in measurement of broad money, which now includes deposit liabilities of these non-resident entities.[4]

IV. External Sector

9. Balance of payments (BOP) statistics suffer from the lack of primary data sources for most transactions, resulting in large errors and omissions.[5] Only one CBU staff member is assigned to BOP compilation, and cooperation from other government agencies remains negligible. Many entries are estimates based on incomplete or outside information, and some important transactions, such as foreign direct investment (FDI), are not covered at all. The major gaps relate to both official and private transfers, oil companies' service payments, private and official investment income, and financial transactions of the oil and private sectors and the emirates. Although technical assistance was provided by the Fund in 1995, there has been no progress in addressing these shortcomings. In addition, the U.A.E. does not report BOP data for publication in IFS (with the exception of trade statistics, which have been irregular at best), or the *Balance of Payments Statistics Yearbook (BOPSY).*

10. The authorities provide available data to Fund staff on official foreign assets. Detailed information on gross and net official central bank reserves and foreign currency liquidity is regularly available, including balances and investments of CBU's foreign assets. These data are disseminated on a monthly basis. Moreover, since 2000, the authorities have provided to Fund staff during Article IV consultation missions information at end-period on the Emirate of Abu Dhabi's stock of external assets, which are administered by the Abu Dhabi

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[4] The new form of compilation introduces a bias into banking statistics, especially net foreign positions of commercial banks, of about Dh 20 billion. BOP flows are also compromised, because the banking compilations are the source of banking flows in the BOP accounts.

[5] Errors and omissions averaged about 11 percent of GDP during the 1990s.

Investment Authority (ADIA)—the federal government does not hold any type of foreign assets. Information on the composition of these assets or on their investment returns is, however, not available.

11. The authorities do not publish a basic International Investment Position (IIP) statement, despite ready availability of certain potential sources, such as banking and government statistics. Also, no data on FDI, and nonfinancial sector external assets and liabilities are collected—though according to BIS statistics, the U.A.E.'s external liabilities are relatively small in percent of GDP.

United Arab Emirates: Core Statistical Indicators
(As of January 24, 2003)

	Exchange Rate	International Reserves 1/	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account	Overall Govt. Balance 2/	GDP	External Debt 3/	Debt Service 3/
Date of Latest Observation	11/02	11/02	08/02	08/02	08/02	09/02	2001	09/02	2001	2001	2001	...	...
Date Received	12/02	12/02	11/02	11/02	11/02	11/02	09/02	06/02	06/02	11/02	06/02	...	...
Frequency of Data	D	M	M	M	M	M	M 4/	M 5/	A	A	A	...	...
Frequency of Reporting	M	Q	Q	Q	Q	Q	A	A	A	A	A	...	...
Source of Update	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Ministry of Planning	Central Bank	Central Bank	Central Bank, Federal and Emirate Govts	Ministry of Planning	...	...
Mode of Reporting	To STA	To STA	To STA	To STA	To STA	To STA	Mission	To STA, Mission	Mission	Mission	To STA, Missions	...	...
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	...	...
Published Data	Central Bank Bulletin	Central Bank Bulletin	Central Bank Bulletin	Central Bank Bulletin	Central Bank Bulletin	Central Bank Bulletin	Planning Ministry Bulletin	Central Bank Bulletin	Central Bank Bulletin	Central Bank Bulletin	Planning Ministry Report	...	...

1/ Gross international reserves of the Central Bank of the U.A.E.
2/ General government (federal plus the four largest emirates).
3/ The only reported international debt is external liabilities of the banking system; these data are available monthly.
4/ CPI data are compiled monthly, but published on an annual basis.
5/ Monthly data only available on crude oil exports.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with the United Arab Emirates

On February 12, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Arab Emirates.[1]

Background

U.A.E. economic development over the past decades has been based on a highly liberal, business friendly and market-oriented growth strategy aimed at diversifying the economy and strengthening the export base. With a pegged exchange rate used as a nominal anchor for the economy and an open border foreign labor policy, this development strategy has made the economy more resilient to oil price fluctuations, as well as contributed to a large accumulation of government financial wealth, which has provided ample latitude to respond to external shocks. Amid volatile oil prices, the United Arab Emirates has also systematically recorded a trade- and income-driven external current account surplus, and remained a net creditor nation. However, fiscal vulnerability to weakening oil prices has increased lately owing to rapidly rising current expenditures, notably defense and subsidies to agriculture since 1998, as well as the absence of a developed tax system.

[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.

Despite lower oil revenue, the U.A.E. economy performed relatively well in 2001. The external current account surplus remained large, even though average oil prices declined by 12.6 percent to $23.78 per barrel, leading to a loss in oil export receipts equivalent to 5 percent of GDP. Real GDP grew by about 4 percent, as a number of projects were launched in construction, electricity and water, and downstream oil sectors. Nevertheless, a continued rapid increase in current spending in the face of declining oil revenue led to a sharp deterioration in the fiscal accounts. In 2001, the consolidated fiscal balance moved back into a deficit (of about 5 percent of GDP) largely financed by drawing down official foreign assets. On monetary developments, broad money growth remained stable at about 11 percent in 2001—the increase in domestic assets accounted for much of this expansion. Private sector creditor grew by 9 percent from a year earlier, with personal lending and construction loans experiencing the fastest growth. The central bank's reserves reached US$14.3 billion at the end of 2001—equivalent to five months of imports of goods and services.

The banking system in the United Arab Emirates remains strong, broadly profitable, well supervised, and capitalized. Benefiting from relatively low operating costs and widening margins between deposit and lending interest rates, net profits of national banks rose by 8 percent in 2001. The ratio of gross nonperforming loans (which are adequately provisioned for) to total loans continued to decline, while capital adequacy ratios remained significantly above international standards.

In 2002, the U.A.E.'s macroeconomic performance, however, appears to have been mixed. Although average crude oil prices are estimated to have risen by 4 percent to US$24.70 per barrel, oil output is likely to have declined by about 9 percent in line with OPEC-mandated cuts. These cuts are estimated to have contributed to a fall in real GDP growth, even though non-hydrocarbon growth remained robust on account of ongoing construction projects and rising petrochemical output. Moreover, lower crude oil receipts, together with rising imports and lower investment income, have also contributed to reducing the external current account surplus. Amid declining revenue, government spending is expected to have remained broadly unchanged, leading to a sharp deterioration in the fiscal accounts. The estimated consolidated fiscal balance registered a deficit of about 9 percent of GDP, and the non-hydrocarbon deficit widened to 26 percent of GDP. Meanwhile, monetary developments through end-November 2002 showed a stable broad money growth, with central bank foreign assets reaching more than US$15 billion. The stock markets remained bullish during much of 2002, mostly as a result of continued strong bank profits.

Domestic institutions have been strengthened over the past few years. The authorities took important steps in 2000 to address deficiencies in the securities markets. These included the enactment of the Federal Securities Law and the creation of the Emirates Securities and Commodities Markets Authority. Also, the first two formal stock exchanges, the Dubai Financial Market and the Abu Dhabi Securities Market, opened in that year. The authorities have also put in place a comprehensive regime to combat money laundering and terrorist financing. The federal government is currently implementing a public expenditure management reform, aiming at gradually introducing a performance-oriented budget to ensure greater efficiency in public spending. It is also restructuring support services to ministries, while carrying out an electronic government project to improve fee collection and significantly reduce red tape. On other reforms, privatization of the power sector has been stepped up, particularly in the emirate of Abu Dhabi where several independent power projects are currently under way, while Dubai has expanded foreign direct investment opportunities by launching new free zones and allowing foreign ownership of properties.

Executive Board Assessment

Executive Directors noted that the U.A.E.'s open, market-oriented economic system, and the authorities' sound economic management have helped sustain robust economic growth, low inflation, and a comfortable external position, notwithstanding the wide fluctuations of global crude oil prices over the years. They welcomed the continuing progress in diversifying the economy, as evidenced by the rapid expansion of a broad range of economic activities and services. Going forward, Directors considered that the main challenges facing the authorities will be to maintain strong economic growth and enhance job creation in a stable macroeconomic environment. This will require a sustained strengthening of the fiscal position, which has deteriorated markedly since 2001, and pushing ahead with structural reforms—in particular, by further strengthening the financial sector, developing human resources, and expanding opportunities for foreign direct investment.

Directors underscored that a key challenge in 2003 will be to restore fiscal discipline, in accordance with the authorities' intergenerational economic equity objectives. In the immediate future, a significant portion of the fiscal strengthening will need to come from cuts in current spending, with priority given to phasing out subsidies on water, electricity, and agriculture, and cutting back nonproductive outlays. Directors encouraged the federal authorities to persevere in their efforts to ensure greater efficiency in public spending, including by fully implementing a performance-oriented budget policy.

Directors urged the authorities to develop and implement budgetary policy in a comprehensive, viable, and sustainable medium-term framework and, given the complexities of the U.A.E.'s political structure, stressed the importance of initiating soon the process of mobilizing the necessary political consensus to do so. Such a framework will strengthen the budget structure and reduce the still considerable dependence of the economy on volatile hydrocarbon resources, and help the authorities to build-in precautionary savings to preserve official foreign assets. Within this framework, the authorities should aim at strengthening the budget formulation process and improving fiscal transparency by adopting international standards of economic classification for expenditure and revenue statistics.

Key to the medium-term strategy will be steps to strengthen and diversify the revenue base. Directors urged the authorities to adopt a broad-based modern tax system with a view to reducing fiscal vulnerability. As initial steps, they suggested that the authorities should expand taxes in line with policies that are already in place in other members of the Cooperation Council of the Arab States of the Gulf (GCC), and consider implementing a broad low-rate consumption tax on services, while local governments should introduce a property tax. Several Directors encouraged the authorities to avail themselves of Fund technical assistance for tax reform and institution building.

Directors commended the authorities for the priority they have accorded to maintaining a sound and well-supervised banking system, which should play an important role as a regional financial center for the Middle East. They welcomed the progress made in further strengthening the financial sector, including through the adoption of a broad system of risk management in the banking sector and of the recommendations of the Financial Sector Assessment Program. Directors also praised the authorities for putting in place a comprehensive regime to combat money laundering and terrorist financing that also covered informal fund transfers. They encouraged the authorities to focus in the period ahead on reforming the insurance sector, improving securities sector supervision and monitoring, and enforcing existing regulations for companies to adopt international accounting standards.

Directors welcomed the authorities' ongoing efforts to foster the further development of the non-hydrocarbon sector and to promote the role of the private sector and foreign direct investment. They also encouraged the authorities to gradually eliminate remaining foreign investment restrictions outside of the free zones. Moreover, Directors considered that adoption of a common strategy for foreign ownership across the emirates would be helpful in promoting investment opportunities throughout the U.A.E. They welcomed the reform of the power and water sectors in recent years, and called for further efforts in this direction, including steps to restructure companies in the transmission and distribution sector.

Directors endorsed the authorities' commitment to the exchange rate peg, which has promoted economic stability by serving as a nominal anchor in the U.A.E.'s open economic system. They considered that the country's success as a resource exporter in maintaining a fixed exchange rate and competitiveness in the face of significant export price volatility owes much to its flexible labor policy. Directors stressed that fiscal discipline and a sound banking system will remain crucial supports for the exchange rate regime.

Directors noted that the U.A.E.'s open border foreign labor policy has enabled employment growth to contribute significantly to non-hydrocarbon sector growth and diversification. They endorsed the authorities' long-term labor market strategy to increase employment opportunities for nationals of the U.A.E, which will help absorb the rapidly rising local labor force and strengthen the prospects for robust economic growth. Directors suggested that this strategy should continue to focus on improving the skills of nationals through better education and training programs geared toward private sector labor demand, while, in general, avoiding mandatory administrative measures, such as quotas.

Directors urged the authorities to make stronger efforts to improve the quality, coverage, and timeliness of official data to support policymaking in an increasingly complex economy. Directors considered that improving coordination and cooperation across public agencies should remain a priority, while strengthening the good institutional base that currently exists within several government agencies. Directors also encouraged the authorities to develop comprehensive statistics on capital flows, particularly foreign direct investment and private sector external debt, as well as to provide available data on government foreign assets investment income on a timely basis to enhance macroeconomic assessment. Directors recommended that the U.A.E. participate in the Fund's General Data Dissemination System.

It is expected that the next Article IV consultation with the U.A.E. will be held on the standard 12-month cycle.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

The United Arab Emirates: Selected Economic Indicators, 1997–2001 1/

	1997	1998	1999	2000	Prel. 2001
		(Annual change in percent)			
National accounts and prices					
Real GDP (at factor cost)	8.3	1.4	4.4	10.0	3.8
Hydrocarbon 2/	5.9	-7.6	-4.5	11.1	1.2
Non-hydrocarbon 3/	9.2	5.0	7.5	9.7	4.6
Consumer price index	2.9	2.0	2.1	1.4	2.2
Investment (in percent of GDP)	28.1	30.6	27.8	23.2	24.4
		(In percent of GDP; unless otherwise indicated)			
Financial variables					
Total revenue	37.5	34.5	31.7	38.6	32.1
Hydrocarbon	21.9	14.3	13.8	21.6	18.9
Non-hydrocarbon 4/	15.6	20.2	17.8	17.0	13.2
Total expenditure	34.1	40.3	37.3	32.6	37.4
Of which: current expenditure	25.2	28.9	28.6	27.5	30.2
Consolidated fiscal balance (deficit -) 5/	3.4	-5.8	-5.6	6.0	-5.3
Excluding hydrocarbon revenue 6/	-18.5	-20.1	-19.4	-15.6	-24.2
Change in broad money supply (in percent)	9.0	4.2	11.4	11.1	10.6
Change in private sector credit (in percent)	13.9	14.2	7.1	8.7	8.8
		(In billions of U.S. dollars; unless otherwise indicated)			
External sector					
Exports	40.8	33.4	36.5	49.6	48.2
Of which: crude oil 2/	14.6	10.0	13.6	21.7	17.7
Imports, f.o.b.	-30.0	-28.7	-27.9	-30.8	-32.8
Current account balance 4/	6.7	2.2	6.0	18.3	10.4
In percent of GDP	13.0	4.5	10.9	25.9	14.9
Central bank gross foreign assets	8.6	9.3	10.9	13.8	14.3
In months of imports of goods and services	3.6	4.0	4.3	5.1	4.9
Total external debt 7/	16.9	18.1	18.5	18.2	14.1
In percent of GDP	33.0	37.5	33.6	26.0	20.3
Average real effective exchange rate (in percent) (appreciation +) 8/	7.7	7.0	0.5	15.8	6.7

Sources: Data provided by the national authorities; and IMF staff estimates.

1/ Based on official data available as of November 2002.
2/ Including condensates.
3/ IMF staff estimates from 2000 onwards.
4/ Includes investment income on government foreign assets estimated by IMF staff.
5/ Includes the fiscal position of the federal government and the four largest emirates, and, following internationally accepted methodology, investment income from the government's financial wealth as part of revenue.
6/ The non-hydrocarbon fiscal balance is defined as the overall fiscal balance excluding hydrocarbon revenue.
7/ Includes central bank and commercial banks foreign liabilities, plus private nonbanks based on reporting BIS banks.
8/ IMF staff estimates.

Statement by A. Shakour Shaalan, Executive Director for the United Arab Emirates
February 12, 2003

Despite the global economic weakness of the past two years, and the volatility in international oil prices, the UAE economy has continued to perform well. The consistent implementation of a well-thought-out long-term economic strategy focused on the promotion of a diversified economic base has served the country well. The strategy is centered around the development of a modern and technologically advanced infrastructure, a business-friendly environment attractive to foreign investors, a liberal trade system and an open border labor policy. Progress in diversification has been impressive, as evidenced by the rapid expansion of a broad range of economic activities, including tourism, banking, trade, petrochemicals and aluminum industries. As a result, in about two decades, non-hydrocarbon activities have grown from a mere 35 percent to well over 75 percent of GDP. Additionally, from the mid 1990s through 2000, non-oil exports grew at a pace of about 16 percent per year, reaching an average value of 40 percent of total exports during the period 1995–2002. These developments clearly attest to the authorities' success in reducing the economy's vulnerability to oil price volatility.

Recent real sector developments

The robust performance of the non-hydrocarbon sector has been maintained in the past year in spite of the lower growth in the oil and gas sector. Thus, while overall real GDP growth declined to 3.8 percent in 2001, the pace of non-hydrocarbon GDP growth recorded a 4.5 percent increase, comparing most favorably with other countries in the Gulf Cooperation Council (GCC) region. These trends continued into 2002 with the growth in the non-hydrocarbon sector exceeding the high level of the previous year as a result of rising petrochemical output, ongoing construction projects and strong tourism activities. These developments have contributed to an external current account surplus of some 15 percent of GDP in 2001 despite a significant decline in oil export receipts. In fact, both in 2001 and 2002, non-hydrocarbon exports and re-exports surpassed hydrocarbon exports in value, a clear indication of the success of the diversification strategy. Understandably, the current account surplus declined in 2002 with the further decline in crude oil receipts due to production cuts, declining investment income, and rising imports, in part associated with increased domestic investments. The banking sector performed well in both 2001 and 2002, as did the equity market whose index rose by about 26 percent and 14 percent in 2001 and through October 2002, respectively.

Structural reforms

Structural reforms to strengthen economic activity further were introduced over the past two years, as the various emirates continued to improve their investment climate and their infrastructure to attract foreign direct investment. In Abu Dhabi, the privatization of utilities is proceeding apace, through the sale of some existing assets as well as through the initiation of new joint venture power projects with foreign investors. While about 33 percent of the electricity and water generation sector is currently run by the private sector, Abu Dhabi is planning to bring the whole sector under the control of private operators by 2006. Furthermore, in preparation for the establishment of a national electricity grid, which will complement a GCC power grid project, a feasibility study has already been completed and is awaiting government approval. The grid is expected to promote a broader geographical distribution of investments, to the benefit of resource-poor emirates. In Dubai, tax-free zones, where 100 percent foreign ownership is allowed, have also continued to flourish and to provide increasing employment opportunities. Following the recent success achieved by Dubai Internet City in attracting multinational technology corporations, the launch of several new free zones has been announced. These new zones are directed at promoting research, development of technology, and financial activities. A construction boom is also underway in Dubai, facilitated by the recent permission granted to foreigners to own land and properties in some real estate developments and in Dubai Internet City. Labor market reforms have also continued to focus on long-term market-based structural policies that would enhance private sector employment of nationals. These have included improvements in education and training programs as well as the provision to nationals in the private sector with pension benefits similar to those in the public sector. The authorities are keenly aware of the need to maintain the flexibility of the labor market in order to sustain non-oil growth and competitiveness.

Fiscal policy

Not surprisingly, the decline in oil prices and in investment income over the past few years have contributed to a weakening of the fiscal accounts. The fiscal surplus of 2000 shifted to a deficit of 5 percent in 2001, and is estimated to have widened further in 2002. The increase in the consolidated deficit in the latter year is more than accounted for by the sharp decline in oil revenue associated with reduced output as total expenditures were cut back somewhat. Consistent with the authorities' policy of smoothing expenditure levels in the midst of oil revenue fluctuations, these deficits were financed largely by a draw down in official foreign assets.

The authorities are aware of the need to strengthen the fiscal accounts in order to assure sustainability over the medium term and to maintain intergenerational equity. To this end, progress continues to be made in revenue and expenditure management. A major effort is being undertaken to attain greater efficiency in public spending and the provision of government services. It includes the transfer of some services to the private sector and a move by four pilot federal ministries toward a performance-oriented budget policy. The federal authorities are also making progress in consolidating the electronic government project, which is expected to streamline a number of government operations and procedures. The Emirate of Dubai is also following suit with a similar project. Fees and charges on government services are also being increased regularly. While the authorities recognize the need for more efforts to broaden the government's revenue base, measures such as the adoption of a national tax system will require building a broad political consensus within the seven emirates before their consideration.

Monetary and financial policies

The authorities believe that the pegged exchange rate of the UAE dirham, backed by large government and central bank foreign assets, has served the economy well. While the effective exchange rate (REER) has appreciated by over 30 percent with the movement of the dollar since the mid 1990s, the rapid growth in exports indicates that the economy has, nonetheless, maintained its competitiveness. As has been repeatedly manifested in other countries, CPI based exchange rate measurements are far from meaningful.

The UAE continues to play an important role as a regional financial center for the Middle East. It has a well-developed and well-supervised banking system that is the second largest in the GCC in terms of total assets. UAE banks remain well capitalized, with the risk-weighted capital adequacy ratio of the overall sector remaining at 20 percent, which is significantly above the 10 percent minimum requirement set by the central bank. In 2002, a comprehensive framework to combat money laundering and terrorism financing was put in place. The framework is based on a federal law, promulgated in January 2002 that fully incorporates the FATF 40 recommendations and the 8 special recommendations dealing with terrorist financing. Informal money transfers are fully covered by the AML/CFT legislation, and dealers are required to provide details of remitters and beneficiaries and to report suspicious transfers. Overall risk management has also been strengthened with the adoption of a comprehensive system that will cover all banks by early 2003. A new banking law is also being drafted to strengthen the central bank's supervisory role, and to address issues of islamic banking and disclosure and responsibilities of Boards of Directors. The Bank is also considering issuing central bank's certificates of deposit with longer maturities to enhance its liquidity management capability. A new insurance law has also been drafted to bring industry standards into line with current best practices.

Statistical issues

The authorities continue to exert strong efforts to improve the country's statistical base, but acknowledge the need to further improve the quality and coverage of comprehensive national economic database. They have requested a multi-sector technical assistance mission from the Fund to help establish a medium-term plan to address data deficiencies and to review the recent changes that have been implemented in the compilation of monetary statistics.

To conclude, the UAE authorities would like to thank staff and management for useful and productive consultation discussions. They are according serious consideration to the Fund's recommendations.