June 2004
IMF Country Report No. 04/175

United Arab Emirates: 2004 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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **March 4, 2004**, 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 May 6, 2004.** 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 May 28, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

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

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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

UNITED ARAB EMIRATES

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with
The United Arab Emirates

Approved by Saleh M. Nsouli and Juha Kähkönen

May 6, 2004

The consultation discussions were held in Abu Dhabi, Dubai, and Sharjah from February 17 to March 4, 2004. The staff team comprised Messrs. Elhage (head), Thai, Davoodi, Wilson, Floerkemeier (all MCD), and Mr. Frydl (MFD).

The mission met with the Minister of State for Finance and Industry, the Governor and Deputy Governor of the Central Bank, Under Secretaries of the Ministries of Finance and Industry, Economy and Commerce, Labor and Social Affairs, and Planning, as well as senior officials of the federal government and the three largest Emirates—Abu Dhabi, Dubai, and Sharjah. Meetings were also held with representatives of the private sector, commercial banks, stock exchanges, and chief executives of several public enterprises.

In concluding the last consultation on February 12, 2003, Executive Directors welcomed the authorities' ongoing efforts to foster further development of the nonhydrocarbon sector and to promote the role of the private sector and foreign direct investment. They commended the authorities for the priority they have accorded to maintaining a sound and well-supervised banking system. Directors considered the main challenges facing the authorities would be to maintain strong economic growth and enhance job creation for nationals in a stable macroeconomic environment. Directors considered that the adoption of a common strategy for foreign ownership across the emirates would be helpful in promoting investment in the U.A.E. 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.

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 the World Bank Group, respectively. Statistical issues are discussed in Appendix III, and Appendix IV discusses the long-term fiscal sustainability analysis of the U.A.E. Financial sector developments, including the status of 2001 FSAP recommendations, are discussed in Appendix V.

The authorities have agreed to issue a PIN and to publish the Staff Report and the Statistical Appendix report following the conclusion by the Fund's Executive Board of the 2004 Article IV consultation.

Contents Page

Appendices

EXECUTIVE SUMMARY

Background

In 2003, reflecting favorable developments in the oil market, higher oil production and prices, the U.A.E.'s macroeconomic performance is estimated to have been strong. Nonhydrocarbon real GDP growth is estimated to have remained robust at about 5 percent, making it one of the highest in the GCC (Gulf Cooperation Council) area. A number of projects were launched in 2003 in the areas of construction, upstream gas, and downstream oil services. Inflation remained stable at 2.8 percent. Both the external current account and consolidated fiscal balances are estimated to have recorded large surpluses, 8.5 percent and 13.7 percent of GDP, respectively. The stock market index increased by about 32 percent.

The authorities were very cooperative and provided the staff with estimates of detailed information on official foreign assets of the government for the period 1999–2003. Accordingly, the fiscal accounts have been revised and prepared from the financing side, showing a significant improvement in the overall fiscal balance.

The U.A.E. banks remain well capitalized and profitable. The ratio of gross nonperforming loans to gross loans continues to decline. Following on the recommendations of the 2001 FSAP mission, the U.A.E. authorities have undertaken a number of initiatives to improve financial sector supervision and efficiency. Several important steps have been taken in the past few years to address money laundering and financing of terrorist activities. Tighter regulations now apply across the entire financial sector.

Medium-term Context

On the basis of current expectations for oil prices and the current policy stance, on average, over the medium term, both the fiscal and external current account balances are projected to remain in surplus. However, the stock of total net wealth (government foreign assets and the present value of oil and gas resources) and wealth per capita in real terms are projected to decline. To maintain wealth constant over the medium term, fiscal adjustment is needed to reduce the nonhydrocarbon fiscal deficit.

Staff Appraisal

The role of the private sector has been enhanced, and the economy is among the most diversified in the GCC region. Openness and a sound record in macroeconomic management have contributed to the accumulation of a large stock of official foreign assets and to lay the foundation for further economic and social progress into the future.

To maintain wealth constant over the medium term, the structure of the budget needs to be strengthened. On the expenditure side, government employment should be contained and subsidies phased out. The revenue base should be broadened, mainly through the introduction of a national value-added tax system.

Fiscal transparency needs to be improved and better coordination in setting policy objectives among emirates would enhance efficiency of fiscal policy and prepare the U.A.E. for the GCC monetary union. It is important that any future changes to labor policy do not impact adversely the competitiveness of the economy.

The U.A.E.'s economic statistics need to be improved significantly with respect to data quality, coverage, periodicity, timeliness, and consistency. Increased coordination between federal and emirate authorities, adequate resources allocated to data collection and management, and training of staff are necessary conditions for further progress on data issues.

I. Background

1. **The U.A.E. is a confederation of seven emirates,[1] all of which retain considerable political, judicial, financial, and economic autonomy**. The country has the third largest reserves of oil in the world and the fourth largest of natural gas, both estimated to last more than 100 years at current production rates. Abu Dhabi accounts for more than half of the country's total GDP, close to 40 percent of the population, and 90 percent of oil and natural gas resources. Dubai contributes one-quarter of the country's total GDP and has been at the forefront of developing nonhydrocarbon activities in anticipation of the depletion of its crude oil reserves over the next decade. The other emirates rely on a mix of trade and light manufacturing, and they depend on financial support from the federal government and the two larger emirates, Abu Dhabi and Dubai.

2. **The U.A.E.—a member of the Gulf Cooperation Council (GCC)[2]—has managed to avoid the pitfalls that at times result from having vast natural resources**. Economic development over the past three 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. This development strategy has made the economy more resilient to oil price fluctuations and contributed to a large accumulation of government financial wealth, which has provided ample latitude to respond to external shocks.

3. **Fund missions in recent years have encouraged the authorities to strengthen fiscal policy and address economic data deficiencies across sectors.** Modernization of the financial sector's legal framework and improvement in securities and insurance supervision and regulation have also been recommended. The decentralized policymaking process and the complexity of the U.A.E.'s political structure have made it difficult for the authorities to implement Fund's policy recommendations in the fiscal area. 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 to the Fund between consultations on macroeconomic developments, except for monetary statistics. In contrast, important progress has been made in financial sector reforms, as the Central Bank of the U.A.E. (CBU) has unified authority over most institutions in the sector.

4. **The U.A.E.'s economic success has not been matched by the development of its economic and social statistics which suffer from major shortcomings (discussed in Appendix III).** Significant weaknesses in the U.A.E.'s statistical base remain in terms of coverage, consistency, periodicity, and timeliness, all of which have hampered the staff's ability to conduct economic analysis and effective surveillance. The federal authorities agree on the need to improve the availability and quality of data on consolidated fiscal operations,

---

[1] The seven emirates are Abu Dhabi, Dubai, Sharjah, Ajman, Ras al-Khaimah, Umm al-Qaiwain, and Fujairah.

[2] Other GCC members are Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia.

the national accounts, balance of payments, and prices in order to enhance policymaking decisions. In this connection, they indicated interest in participating in the General Data Dissemination System (GDDS).

5. **The authorities were very cooperative and provided the staff with estimates of detailed information on official foreign assets of the government**. The provision of such information allowed the staff to prepare the overall fiscal accounts from the financing side, in contrast to previous consultations where absence of such information provided a measure of overall fiscal balance from above the line.

II. Recent developments

A. Introduction

6. **Reflecting favorable developments in the oil market, the U.A.E.'s macroeconomic performance in 2003 was strong** (Table 1, Figure 1).[3] Nonhydrocarbon real GDP growth is estimated to have remained robust with stable inflation. The stock market index, which has been rising since 2001, increased sharply in 2003 by about 32 percent on account of strong economic conditions and optimism regarding the economic outlook. Both the external current account and the consolidated fiscal balances are estimated to have registered large surpluses. At end-2003, foreign assets of the central bank were about US$15 billion, equivalent to about 4 months of imports.

7. **Progress in introducing structural reforms has varied among the emirates**. Dubai has extended foreign ownership of land and properties to some real estate developments and has also announced the launch of several new free zones (Box 1). Abu Dhabi is moving ahead with utility privatization, with the objective to privatize its entire water and electricity sector by 2006. Restrictions on foreign ownership of companies and real estate, however, remain in place in Abu Dhabi.

[3] The discussion of economic developments for 2003 is based on preliminary estimates.

Box 1. Major Tourism Developments

The tourism sector is expected to be one of the main sources of future growth in the U.A.E., especially in Dubai. Although considered a high risk industry, depending much on the political stability of the region, neither the Iraq war nor the SARS epidemic had significant adverse effects on the sector's performance in 2003. Occupancy rates have risen and reached more than 90 percent during events such as the shopping festival. Currently, around 5 million tourists visit Dubai each year. The average stay of tourists is 2.8 days, consisting mainly of shopping and business tourism. Dubai is increasingly targeting tourists who will stay for a longer period of time. The emirate's target is to attract 15 million tourists annually by 2010. Several large projects have recently been launched to spur the industry's growth: Dubailand, Dubai Healthcare City, and Palm Island, among others.

With a total investment of almost $6 billion and an assigned space of 4 billion square feet, **Dubailand** is one of the largest self-contained tourism projects internationally, offering leisure, sport, retail, and entertainment attractions. The launch phase, covering initial infrastructure like road works and utility provision, will extend from 2004 to 2006. The main construction phase will be completed by 2010. Financing is mostly from the private sector—domestic and foreign. Dubai will benefit from municipality taxes and infrastructure fees.

Dubai Healthcare City is a newly created free trade zone dedicated to the provision of specialized medical and healthcare services. The project targets customers from the GCC, the Indian subcontinent, East Africa, and Central Asia. The planners estimate to capture up to 50 percent of a potential market of $2 billion in 2005 in this region, with the help of high reputation partnerships and investors from regional and international clinics, diagnostic, and healthcare services. First operations will start end-2004.

The $3 billion **Palm Island** project, the construction of two artificial, palm-shaped islands off Dubai's coast, is a byproduct of the Jebel Ali harbor expansion. Each island will have around 60km of coastline. The islands will house residential homes, hotels, as well as entertainment and retail outlets. Infrastructure work on the first island is due to be completed in 2004. In addition, it is planned to build a similar group of 200 artificial islands in the shape of the world map.

Other projects are the construction of the world's first luxury underwater hotel as well as the only indoor skiing center in the GCC region, Dubai Snow World.

Table 1. U. A. E.: Selected Economic Indicators, 1999–2004

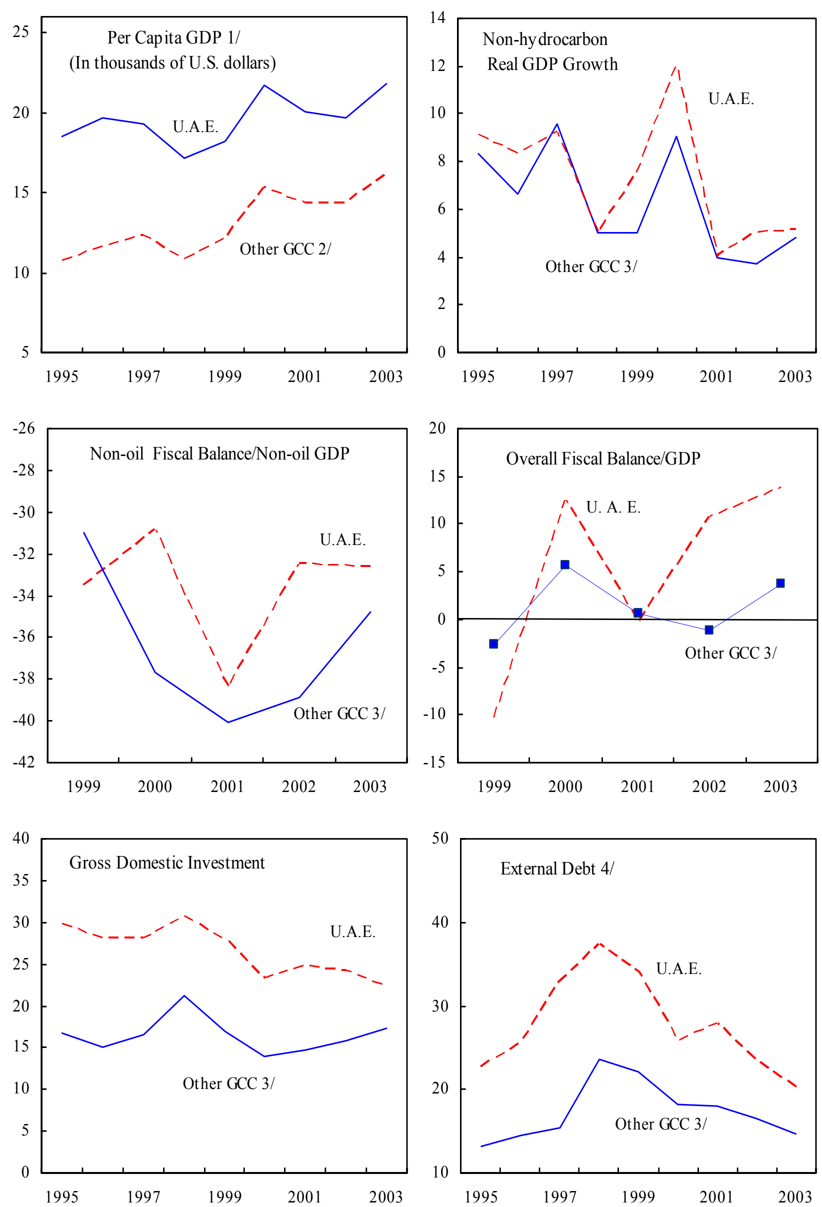
	1999	2000	2001	2002	Prel. 2003	Proj. 2004
	(In billions of U.A.E. dirhams)					
GDP at market prices	202.7	258.0	255.4	263.4	295.4	310.8
	(In millions of barrels per day)					
Oil production and exports						
Crude oil production 1/	2.26	2.41	2.44	2.27	2.59	2.47
Of which: Condensates	0.18	0.22	0.32	0.33	0.33	0.33
Average U.A.E. crude price (U.S. dollars per barrel)	17.93	27.51	23.91	24.75	28.11	29.50
	(In billions of cubic meters per year)					
Natural gas production and exports						
Natural gas production	34.6	35.9	45.0	46.0	46.0	49.2
LNG exports	7.2	7.1	7.5	7.3	7.3	7.6
NGL exports	11.1	12.3	11.5	11.3	12.7	13.6
	(Annual percentage changes)					
National income and prices						
Real GDP (at factor cost)	4.4	12.3	3.5	1.9	7.0	2.4
Crude oil, condensates, and natural gas	-4.5	13.1	1.7	-8.1	13.8	-5.3
Nonhydrocarbon sectors 2/	7.5	12.0	4.0	5.0	5.2	4.7
GDP deflator	9.0	13.9	-4.8	0.9	4.8	2.8
Consumer prices	2.1	1.4	2.8	3.1	2.8	2.6
	(In percent of GDP)					
Investment and saving						
Gross domestic investment	27.8	23.3	24.7	24.1	22.4	23.9
Government	6.8	4.4	5.2	4.7	5.2	5.1
Nongovernment	21.0	18.9	19.4	19.3	17.2	18.8
National saving	29.5	40.6	34.1	29.0	30.9	31.3
Government	-1.6	7.8	0.7	-2.4	2.7	2.5
Nongovernment	31.1	32.7	33.4	31.4	28.1	28.8
Consolidated government finances						
Revenue	27.0	44.5	37.1	43.7	44.4	38.0
Hydrocarbon	14.9	33.0	26.6	34.1	35.8	29.8
Nonhydrocarbon	12.2	11.5	10.5	9.6	8.6	8.3
Of which: Investment income	4.8	5.8	4.5	3.4	2.8	2.6
Expenditure	37.3	32.0	37.4	32.9	30.7	29.9
Of which						
Current	28.6	26.9	30.0	27.5	25.2	24.6
Development	8.0	4.6	7.0	5.0	5.1	5.0
Overall balance	-10.2	12.5	-0.4	10.8	13.7	8.1
Overall balance (excluding investment income)	-15.0	6.6	-4.9	7.4	10.9	5.5
(Excluding hydrocarbon revenue)	-29.9	-26.3	-31.5	-26.7	-24.9	-24.3
Financing	10.2	-12.5	0.4	-10.8	-13.7	-8.1
Domestic banks	0.5	-4.1	-0.2	-3.2	-0.8	-1.3
Other	9.7	-8.4	0.6	-7.6	-13.0	-6.8
Government debt 3/	7.2	4.6	4.0	5.5	7.3	7.0

Table 1. U. A. E.: Selected Economic Indicators, 1999–2004

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
	(Changes in percent of initial stock of M2)					
Money and credit						
Broad money (M2)	11.4	15.1	15.5	15.6	16.1	9.8
Foreign assets (net)	3.2	20.2	8.7	20.1	1.9	1.7
Domestic assets	8.3	-5.1	6.7	-4.5	14.2	7.9
Of which:						
Claims on government (net)	1.1	-9.6	-0.4	-5.8	-1.3	-2.1
Claims on public sector enterprises	0.3	0.2	-0.4	1.3	3.5	0.2
Claims on private sector	7.6	9.0	8.5	10.4	11.9	11.4
	(In percent per annum, end of period)					
Average interest rates						
Dirham (three-month interbank)	5.53	6.53	3.50	1.79	1.28	1.17
Lending rate	10.59	9.60	7.82	6.82	5.81	4.92
	(In billions of U.S. dollars)					
External Sector						
Exports	36.5	49.6	47.5	51.2	60.8	63.6
Crude oil	13.6	21.7	17.6	16.7	22.1	22.2
Petroleum products	0.6	1.7	2.1	3.0	3.5	4.0
Gas	2.3	3.7	3.3	3.1	3.9	4.2
Non-hydrocarbon exports	6.3	7.5	8.5	10.6	11.3	13.1
Re-exports	13.7	15.0	16.0	17.8	20.0	20.1
Imports, f.o.b.	-27.9	-30.8	-33.5	-36.7	-41.7	-43.8
Trade balance	8.6	18.8	14.0	14.5	19.1	19.8
Services (net)	-5.9	-6.4	-6.2	-7.3	-7.5	-7.9
Income (net)	2.2	3.8	2.9	0.8	-0.1	0.5
Transfers (net)	-3.9	-4.0	-4.2	-4.4	-4.7	-6.1
Private	-3.6	-3.7	-3.9	-4.1	-4.4	-5.7
Official	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4
Current account balance	0.9	12.2	6.5	3.5	6.9	6.3
(In percent of GDP)	1.6	17.3	9.4	4.9	8.5	7.5
Overall balance	1.5	2.8	0.5	1.1	-0.2	0.6
Central Bank reserves	10.9	13.8	14.3	15.3	15.1	15.7
In months of imports	4.3	4.9	4.7	4.4	4.1	4.1
As percent of reserve money	199.8	250.2	242.8	223.5	181.8	180.2
As percent of short-term debt 4/	191.9	168.6	162.4	164.6	163.4	185.6
Total external debt 5/	18.8	18.2	19.4	16.7	16.6	15.3
(In percent of GDP)	34.0	26.0	27.9	23.3	20.7	18.0
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.
3/ Due to domestic banks; no official external debt is reported.
4/ Debt due within one year, from BIS/OECD statistics.
5/ Central Bank and commercial bank foreign liabilities, plus private non-banks (BIS source).

Figure 1. The U.A.E. and Other GCC Countries: Selected Indicators, 1995–2003
(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/ Simple arithmetic average for all GCC excluding U.A.E.
3/ Weighted average, using PPP GDP
4/ End of period.

B. Economic Developments in 2003

Real Sector

8. **Preliminary data show that real GDP growth was strong.** Nonhydrocarbon GDP growth is estimated at 5.2 percent, driven largely by rapid growth in the: (a) manufacturing; (b) transport and communication; (c) finance; and (d) tourism sectors. Overall, real GDP growth was about 7 percent. Inflation is estimated at about 2.8 percent in 2003 compared to 3.1 percent in 2002.

External sector

9. **The external current account surplus is estimated to have risen to about 8.5 percent of GDP from about 4.9 percent in 2002** (Table 2). Total exports increased to an estimated $61 billion from $51 billion in 2002. The U.A.E.'s nonhydrocarbon exports are heavily influenced by developments in the free zones, mostly located in Dubai. These exports which have been increasing steadily since the early 1990s reached an estimated $9 billion in 2003. Nonhydrocarbon exports by the emirates apart from the free zones are continuing their upward trend and estimated to have reached almost $2.5 billion.

10. **The financial account balance indicates net capital outflows.** The overall balance of payments is estimated to have registered a deficit of $0.2 billion, resulting in equivalent reduction in net foreign assets held by the CBU. Errors and omissions are estimated at about $3.3 billion reflecting mainly unrecorded capital flows.

Fiscal policy

11. **The existing fiscal arrangements (Box 2) make timely and accurate assessment of overall fiscal developments in the U.A.E. difficult.** There is no uniformity among the seven emirates and the federal government in classification of expenditures and revenues. At the same time there is considerable netting out of fiscal operations at the emirates level and, more importantly, the fiscal operations of Abu Dhabi National Oil Company (ADNOC) and some of Abu Dhabi's domestic government operations are not consolidated with the fiscal accounts.

12. **Assessment of the overall fiscal balance has been revised in light of new information received during the mission.**[4] The information, after taking into account investment income estimated by staff covering the 1999–2003 period, now show overall

---

[4] For 1999, the annual overall fiscal balance was revised from a deficit of 5.6 percent of GDP to deficit of 10.2 percent of GDP. Whereas, for 2000–01, on average, the annual fiscal balance was revised upward by about 6 percent of GDP. The 2002 fiscal outcome at the time of the last consultation, which took place in October 2002, was an estimate.

surpluses in the U.A.E.'s consolidated fiscal accounts, except in 1999 and 2001 (Figure 2).[5] It is estimated that in 2003 the U.A.E. recorded a fiscal surplus of about 13.7 percent of GDP, as oil prices surged above US$28 per barrel (Table 3). Over the 1999–2003 period, fiscal surpluses have been used to accumulate financial assets abroad.

Box 2: Fiscal Policy Setting in the U.A.E.

The emirate of Abu Dhabi provides the anchor for fiscal policy in the U.A.E. and as such its decisions influence the path of the U.A.E.'s public finances. Being the emirate with the highest hydrocarbon reserves, Abu Dhabi's management of oil receipts, which includes transfers to other emirates and the federal government, has allowed other emirates and the federal government to pursue a balanced-budget approach to fiscal policy. At the same time, dependence on rich and finite hydrocarbon reserves implies that the emirate of Abu Dhabi has to make long-run savings and investment decisions regarding the use of receipts from its hydrocarbon wealth and conduct expansionary or contractionary fiscal policy as needed. The resulting deficits or surpluses have been used to draw down the emirate's assets or augment them. Given the lack of a broad tax system in the U.A.E. and of effective automatic stabilizers, Abu Dhabi's fiscal policy decisions will continue to impact fiscal outcomes in the U.A.E. for many years to come. Abu Dhabi's budget is not cast in a medium-term framework, but is based on a conservative oil price assumption (US$20–21 per barrel in the 2004 budget).

The U.A.E.'s open and liberal economic development strategy has allowed each emirate to conduct autonomous fiscal policy within the bounds of the federation. With dwindling revenues from the oil and gas sector and a growing population, the emirate of Dubai, for example, is increasing its reliance on nonhydrocarbon revenues to fund its budget and is working closely with the private sector to shoulder the cost of providing infrastructure and other services that are traditionally provided and financed by the public sector. The continued drive toward further diversification within an open and business friendly environment, however, also implies increasing competition among the emirates for investments and limited funds. For example, the emirate of Sharjah, which borders Dubai, is competing to be a center for tourism, manufacturing, and banking. All the emirates have access to bank overdraft facilities and revenues from other government entities for their cash management, but all (except Abu Dhabi) in practice tend to run a balanced budget.

The U.A.E.'s federal government, although smaller in size relative to Abu Dhabi, plays an important role in the federation and often leads other emirates in public administration reforms. The federal government provides basic social services across the country, sets regulations and minimum standards, represents U.A.E.'s interests in international affairs, addresses inter-emirate disparities in resource endowments, and acts as a model for adopting public sector administration reforms such as performance-based budgeting and setting up a modern treasury system.

[5] The investment income earned by the U.A.E. from its financial assets, which is not included in the official fiscal accounts, has also been revised to reflect the information received by the staff.

Table 2. U.A.E.: Balance of Payments, 1999–2004

(In billions of U.S. dollars)

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
Trade balance	8.6	18.8	14.0	14.5	19.1	19.8
Exports	36.5	49.6	47.5	51.2	60.8	63.6
Oil and products	14.2	23.4	19.7	19.7	25.7	26.2
Crude oil & condensates	13.6	21.7	17.6	16.7	22.1	22.2
Petroleum products 1/	0.6	1.7	2.1	3.0	3.5	4.0
Gas	2.3	3.7	3.3	3.1	3.9	4.2
Nonhydrocarbon	6.3	7.5	8.5	10.6	11.3	13.1
Exports by Emirates	1.8	2.0	2.0	2.4	2.5	2.9
Free zone exports	4.5	5.5	6.4	8.3	8.8	10.2
Re-exports, *of which* : 2/	13.7	15.0	16.0	17.8	20.0	20.1
Nonmonetary gold	1.8	1.9	1.9	1.9	2.0	2.1
Imports (f.o.b.)	-27.9	-30.8	-33.5	-36.7	-41.7	-43.8
Imports by Emirates, *of which:*	-24.7	-25.9	-26.8	-28.9	-33.1	-34.6
Nonmonetary gold	-1.9	-2.0	-2.2	-2.2	-2.2	-2.2
Unrecorded govt. imports	-1.6	-1.6	-1.9	-1.6	-1.6	-1.6
Free zones	-3.2	-4.9	-6.7	-7.9	-8.7	-9.2
Income, net	2.2	3.8	2.9	0.8	-0.1	0.5
Banking system	1.1	1.6	1.0	0.5	0.4	0.5
Private nonbanks	0.4	0.4	0.3	0.1	0.1	0.1
Government	2.5	4.0	3.0	2.2	1.9	1.9
Foreign partners - oil 3/	-1.8	-1.9	-1.1	-1.9	-2.3	-1.5
Foreign partners - gas 3/	-0.1	-0.3	-0.2	-0.2	-0.2	-0.4
Services, net	-5.9	-6.4	-6.2	-7.3	-7.5	-7.9
Credits	2.1	2.2	2.4	2.4	2.8	2.9
Travel	1.0	1.1	1.2	1.2	1.4	...
Transport	0.8	0.8	0.8	0.9	0.9	...
Government services	0.3	0.3	0.4	0.3	0.4	...
Debits	-8.0	-8.6	-8.5	-9.8	-10.3	-10.8
Travel	-2.9	-3.0	-3.0	-3.7	-3.7	...
Transport	-1.0	-1.1	-1.1	-1.1	-1.2	...
Government services	-0.2	-0.3	-0.3	-0.4	-0.4	...
Freight 4/	-3.8	-4.2	-4.0	-4.6	-5.0	...
Transfers, net	-3.9	-4.0	-4.2	-4.4	-4.7	-6.1
Private	-3.6	-3.7	-3.9	-4.1	-4.4	-5.7
Official	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4
Current account balance	0.9	12.2	6.5	3.5	6.9	6.3
(In percent of GDP)	1.6	17.3	9.4	4.9	8.5	7.5

Table 2. U.A.E.: Balance of Payments, 1999–2004

(In billions of U.S. dollars)

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
Financial account balance	7.5	-9.7	-1.5	-10.7	-10.3	-8.7
Private capital	2.1	-3.8	-1.3	-5.3	0.9	-2.9
Direct investment, net 5/	0.9	-1.6	-0.2	-0.3	0.1	0.2
Outward	-0.1	-2.1	-0.4	-0.4	-0.1	...
Inward	1.0	0.5	0.3	0.1	0.2	...
Portfolio securities	0.0	0.0	0.0	0.2	0.0	1.7
Commercial banks	0.7	-3.2	-2.5	-6.9	-1.1	-4.0
Private non-banks	0.6	1.0	1.4	1.7	1.9	-0.8
Official capital 6/	5.4	-5.9	-0.2	-5.4	-11.2	-5.7
Errors and omissions	-6.9	0.3	-4.6	8.3	3.3	3.0
(As percent of GDP)	-12.4	0.5	-6.6	11.6	4.1	3.5
Overall balance	1.5	2.8	0.5	1.1	-0.2	0.6
Central Bank net foreign assets	-1.5	-2.8	-0.5	-1.1	0.2	-0.6
Memorandum items:						
Overall balance (as percent of GDP)	2.8	4.0	0.7	1.5	-0.3	0.7
Gross reserves of Central Bank	10.9	13.8	14.3	15.3	15.1	15.7
(In months of imports) 7/	4.3	4.9	4.7	4.4	4.1	4.1

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 based on foreign partner share of oil and gas sector net profits.
4/ Estimated freight to adjust imports (c.i.f. basis in U.A.E. BOP accounts) to f.o.b. basis.
5/ UNCTAD direct investment estimates (*World Investment Report*).
6/ Includes changes in government external assets.
7/ Imports of goods and services in the next 12 months.

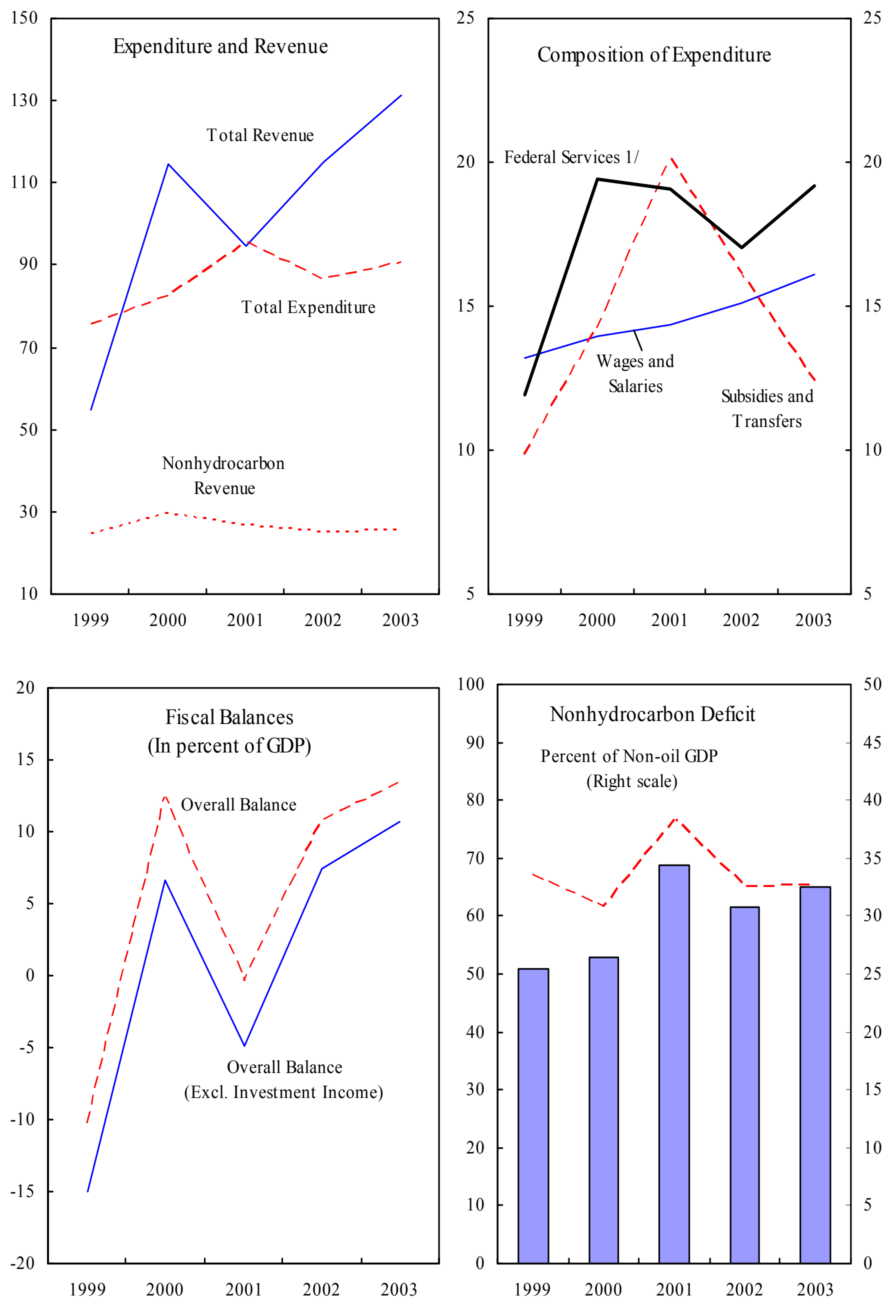
Table 3. U.A.E.: Consolidated Government Finances, 1999–2004

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

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
Total revenue	54,680	89,691	78,440	66,094	82,525	84,154
Hydrocarbon	30,050	59,978	51,648	40,926	57,132	58,455
Nonhydrocarbon	24,630	29,713	26,792	25,168	25,393	25,699
Customs	1,886	1,779	1,846	1,663	2,323	2,432
Profit transfers	3,462	3,938	3,384	3,357	3,195	3,227
Income tax 1/	183	166	206	235	282	296
Fees and charges	4,581	4,173	5,120	6,429	6,845	7,050
Investment income 2/	9,714	15,065	11,576	8,877	8,246	8,147
Other	4,804	4,592	4,660	4,607	4,502	4,547
Total expenditure and grants	75,537	82,542	95,558	86,616	90,552	93,072
Current expenditure	57,930	69,441	76,732	72,426	74,466	76,363
Wages and salaries 3/ 4/	13,224	13,965	14,383	15,131	16,105	16,589
Goods and services 4/	22,616	21,287	22,491	23,745	26,265	27,053
Abu Dhabi "federal services" 5/	11,899	19,440	19,082	17,045	19,157	19,349
Subsidies and transfers	9,849	14,237	20,128	16,108	12,410	12,783
Other	342	513	648	397	528	590
Development expenditure	13,764	11,230	13,358	12,470	15,271	15,882
Loans and equity (net)	2,435	652	4,507	760	-240	-250
Domestic	2,564	714	903	592	-1,066	...
Foreign	-129	-62	3,604	168	826	...
Foreign grants 6/	1,408	1,219	961	960	1,055	1,076
Abu Dhabi	1,361	1,071	664	784	925	...
Federal	47	148	297	176	130	...
Overall balance (consolidated) 7/	-20,857	7,149	-17,118	-20,522	-8,027	-8,918
(In percent of GDP)	-10.3	2.8	-6.7	-7.8	-2.7	-2.9
Overall balance (including revenues from other government entities) 8/	-20,775	32,205	-905	28,377	40,563	25,118
(In percent of GDP)	-10.2	12.5	-0.4	10.8	13.7	8.1
Financing	20,775	-32,205	905	-28,377	-40,563	-25,118
Resident banks, net 9/	1,109	-10,530	-537	-8,483	-2,269	-4,057
Loans to government	3,086	-2,854	-1,595	4,292	5,613	...
Government deposits	1,977	7,676	-1,058	12,775	7,882	...
Privatization receipts 10/	...	...	2,000	...	3,004	...
Changes in official foreign assets (- = increase) 2/	19,666	-21,675	-558	-19,894	-41,298	-21,061
Memorandum items:						
Nonhydrocarbon balance 11/	-50,907	-52,829	-68,766	-61,448	-65,159	-67,373
(In percent of GDP)	-25.1	-20.5	-26.9	-23.3	-22.1	-21.7
(In percent of nonhydrocarbon GDP)	-33.5	-30.8	-38.4	-32.5	-32.6	-31.3
Nonhydrocarbon balance (excluding investment income)	-60,621	-67,894	-80,342	-70,325	-73,405	-75,520
(In percent of GDP)	-29.9	-26.3	-31.5	-26.7	-24.9	-24.3
(In percent of nonhydrocarbon GDP)	-39.9	-39.6	-44.8	-37.2	-36.7	-35.1
Hydrocarbon share of revenue	55.0	74.1	71.7	78.1	80.6	78.3
Balance on pension fund operations 12/	...	1,970	1,274	1,653	...	...

Sources: Federal government; Emirate finance departments; and IMF staff estimates.
1/ Taxes on profit of foreign banks. Income taxes on gas companies are included under hydrocarbon revenues.
2/ Fund staff 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 goods and services.
5/ Largely military and internal security expenditures paid by Abu Dhabi but not in the federal accounts.
6/ Intragovernmental grants are netted out in the consolidated fiscal accounts.
7/ Consolidated accounts of the federal government, Abu Dhabi, Dubai, and Sharjah.
8/ Fund staff estimates of ADNOC profits, other government entities and government domestic investments.
9/ From the monetary statistics.
10/ Abu Dhabi receipts from the sale of water and power assets.
11/ Nonhydrocarbon revenues less spending.
12/ Operations of the General Pension and Social Security Authority, which was established in 2000.

Figure 2. U.A.E.: Selected Consolidated Public Finance Indicators, 1999–2003
(In billions of U.A.E. dirhams; unless otherwise indicated)



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

1/ Provided by the Emirate of Abu Dhabi; mostly defense and internal security.

13. **In 2003, the nonhydrocarbon fiscal deficit excluding investment income remained constant at about 37 percent of nonhydrocarbon GDP.**[6] A policy shift in the emirate of Abu Dhabi reduced agriculture subsidies significantly. As a result, spending on subsidies, as reflected in the consolidated government operations, declined in 2002 and 2003. By contrast, since 2000, nonhydrocarbon revenues (excluding investment income) remained constant as a percent of nonhydrocarbon GDP. The low growth in nonhydrocarbon revenue reflects the fact that no significant revenue-enhancing measures have been introduced at the emirates or federal levels.

Monetary developments

14. **Monetary and credit developments in 2003 took place against a backdrop of continued high levels of liquidity, increased economic activity, and low interest rates**. The broad money stock increased by 16 percent (Table 4), close to the rates of the previous two years, compared to an annual average growth of nonhydrocarbon GDP of about 7 percent. In percent of initial money stock, credit to the private sector and public-sector enterprises (PEs) accounted for about 12 percent and 3.5 percent, respectively. Much of the private sector credit was granted to wholesale trade, construction, and personnel loans for business purposes. The increase in credit to PEs reflected the implementation of a number of projects in construction, electricity, water, and gas. The staff welcomed the decision by the CBU to publish, by June 2004, the broad money stock statistics according to internationally accepted standards, by excluding from it the deposits of U.A.E. residents in overseas branches/subsidiaries.[7]

15. **Following trends in global financial markets, the three-month interbank rate for the U.A.E. dirham (AED) declined to 1.28 percent in 2003**. Real interest rates on 3-month deposits became negative by about 2 percentage points in 2002 and 2003. However, a small interest rate differential, 10 basis points on average in 2003, was maintained in favor of the AED. A large differential between the business lending rates and the 6-month U.S. dollar LIBOR rates (400 basis points in 2003) also persists.

[6] Analysis of fiscal policy in countries in which government's revenue from the hydrocarbon sector is sizable has to take into account, among other things, the exhaustible nature of hydrocarbon reserves, volatility in price of oil as well as aggregate demand effects of any chosen fiscal aggregate. These features are captured in the above fiscal indicator known as nonhydrocarbon net primary fiscal balance which is increasingly being used to assess fiscal sustainability in oil producing countries. It is defined as nonhydrocarbon revenues (excluding investment income) less primary spending.

[7] Staff's discussion of monetary developments is based on the envisaged corrected presentation of the monetary survey.

Table 4. U.A.E.: Monetary Survey, 1999–2004 1/

End of Period	1999	2000	2001	2002	Prel. 2003	Proj. 2004
	(In millions of U.A.E. dirhams)					
Net foreign assets (NFA)	65,880	88,111	99,179	128,654	131,848	135,228
Foreign assets	121,971	141,112	149,991	166,960	167,255	170,635
Central bank	40,163	50,759	52,471	56,229	55,518	57,841
Commercial banks 2/	81,808	90,353	97,520	110,731	111,737	112,794
Foreign liabilities	56,091	53,001	50,812	38,306	35,407	35,407
Central bank	403	587	516	284	349	349
Commercial banks 2/	55,688	52,414	50,296	38,022	35,058	35,058
Domestic assets	44,248	38,657	47,186	40,590	64,703	80,218
Claims on government (net)	-7,698	-18,228	-18,765	-27,248	-29,517	-33,574
Claims	14,654	11,800	10,205	14,497	20,110	20,110
Deposits	22,352	30,028	28,970	41,745	49,627	53,684
Claims on public sector enterprises	5,581	5,780	5,258	7,122	12,990	13,444
Claims on private nonbanks	113,430	123,313	134,132	149,352	169,469	191,964
Capital and reserves (-)	-33,517	-35,833	-38,377	-42,583	-46,063	-49,442
Other assets (net)	-33,548	-36,375	-35,062	-46,053	-42,176	-42,174
Central bank	-16,261	-26,292	-27,994	-31,245	-28,416	-30,013
Commercial banks 2/	-17,287	-10,083	-7,068	-14,808	-13,760	-12,162
Domestic liquidity (M2)	110,128	126,768	146,369	169,244	196,551	215,812
Money	30,250	34,067	39,464	47,054	58,262	67,011
Currency outside banks	10,270	10,017	10,537	11,938	13,785	14,833
Dirham demand deposits	19,980	24,050	28,927	35,116	44,477	52,178
Quasi-money	79,878	92,701	106,905	122,190	138,289	148,801
Foreign currency deposits	23,354	28,196	33,078	39,605	46,295	49,814
Dirham time and savings deposits	56,524	64,505	73,827	82,585	91,994	98,987
	(In percent of beginnning money stock; unless otherwise indicated)					
Memorandum items						
Net foreign assets	3.2	20.2	8.7	20.1	1.9	1.7
Domestic assets, *of which*	8.3	-5.1	6.7	-4.5	14.2	7.9
Domestic credit (net)	9.1	-0.4	7.7	5.9	14.0	9.6
Claims on government (net)	1.1	-9.6	-0.4	-5.8	-1.3	-2.1
Claims on private sector (percent change)	7.1	8.7	8.8	11.3	13.5	13.3
Domestic liquidity (M2)	11.4	15.1	15.5	15.6	16.1	9.8
Money (percent change)	8.9	12.6	15.8	19.2	23.8	15.0
Quasi Money (percent change)	8.9	11.6	11.2	10.4	9.5	5.3

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

1/ Monetary survey is compiled in accordance with the residence principle.

2/ Including the restricted license bank.

Financial developments

16. **The financial sector in the U.A.E. remained strong as of end-2003.**[8] All 46 banks operating in the country met the minimum 10 percent capital-assets ratio (CAR); and the system-wide CAR exceeded 18 percent (Table 5). While the gross nonperforming loan (NPL) ratio remains relatively high at 14 percent, provisions are considerable, bringing the net NPL ratio below 2 percent. Bank lending has grown substantially, increasing at an annual rate of about 17 percent between end-2001 and September 2003, but was well diversified across industries. Market risk to banks was limited and profitability of banks remained strong in 2003.

17. **Securities markets in the U.A.E. continued to develop in 2003, as transactions volume expanded and new listings grew.** While the general market index[9] grew by 32 percent in 2003, the increase was among the lowest in the GCC area, and the average P/E ratio at end-2003 was 19.

18. **Following on recommendations of the 2001 FSAP mission, the U.A.E. authorities have undertaken a number of initiatives to improve financial sector supervision and efficiency.** Major actions included the implementation of annual comprehensive risk-focused examinations of banks, establishment of operational capability for the Securities Authority, implementation of an automated real time gross settlements interbank payment system, and improvements in the transparency of regulatory actions. Progress in legal reforms, however, has been slower. Revision of the Banking Law, for example, has been protracted, with additional amendments to deal with a number of relatively technical issues.

19. **Several important steps have been taken in the past few years to address money laundering and financing of terrorist activities.** Tighter regulations now apply across the financial sector. Many Hawala dealers have registered and been certified by the CBU, and are required to report on a quarterly basis their records on transactions exceeding AED 2000. As of end-February 2004, the CBU has received 112 applications for registration and 89 certificates have been issued.

---

[8] Financial sector developments which include the status of 2001 FSAP recommendations are discussed in Appendix V.

[9] This index is compiled by the Emirates Securities and Commodities Authority (ECSA). It is an average of prices on the two exchanges in the U.A.E., the Abu Dhabi Securities Market and the Dubai Financial Market.

Table 5. U. A. E.: Selected Indicators of External Vulnerability, 1999–2003

	1999	2000	2001	2002	Prel. 2003
External solvency indicators					
REER (CPI-based, percent change, annual average)	0.4	5.2	6.4	-0.5	-7.7
Total external debt (in billions of U.S. dollars)	18.8	18.2	19.4	16.7	16.6
Short-term debt (BIS source; in billions of U.S. dollars) 1/	5.7	8.2	8.8	9.3	9.3
Total external debt/GDP (percent)	34.0	26.0	27.9	23.3	20.7
Short-term debt/exports of goods and services (in percent)	14.8	15.9	17.6	17.3	14.5
Public sector solvency indicators (in percent)					
Overall fiscal balance/GDP	-10.2	12.5	-0.4	10.8	13.7
Government domestic debt/GDP	7.2	4.6	4.0	5.5	7.3
Hydrocarbon revenue/total revenue	55.0	74.1	71.7	78.1	80.6
Investment income/total revenue	17.7	13.1	12.2	7.7	6.3
Nonhydrocarbon revenue (excl. investment income)/ nonhydrocarbon GDP	9.8	8.6	8.5	8.6	8.6
Nonhydrocarbon balance/GDP	-25.1	-20.5	-26.9	-23.3	-22.1
Nonhydrocarbon balance (excluding investment income)/ nonhydrocarbon GDP	-39.9	-39.6	-44.8	-37.2	-36.7
External liquidity indicators					
Central bank foreign assets (in millions of U.S. dollars)	10,936	13,821	14,288	15,311	15,117
In months of imports of goods and services	4.3	4.9	4.7	4.4	4.1
As percent of M1	132.8	149.0	133.0	119.5	95.3
As percent of short-term external debt 1/	191.9	168.6	162.4	164.6	163.4
As percent of commercial banks foreign liabilities 2/	72.1	96.8	104.3	147.9	158.4
Commercial banks' NFA (in millions of U.S. dollars) 2/	7,112	10,331	12,859	19,798	20,879
Foreign assets	22,276	24,603	26,554	30,151	30,425
Foreign liabilities 2/	15,164	14,272	13,695	10,353	9,546
Crude oil exports/total exports (in percent)	37.3	43.8	37.0	32.6	36.3
Financial sector indicators					
Foreign currency deposits/total deposits (in percent)	23.4	24.2	24.4	25.2	25.3
Net domestic assets (annual change in percent)	22.6	-12.6	22.1	-14.0	59.4
Private sector credit (annual change in percent)	7.1	8.7	8.8	11.3	13.5
Private credit/total assets of banks (in percent)	47.3	46.5	47.4	47.3	48.2
Interest rate spread against U.S. dollar (in basis points) 3/	0.12	-0.12	0.06	1.79	1.28
Banking system indicators (in percent) 4/					
Commercial banks' capital to assets ratio	20.5	20.2	20.0	18.9	18.2
Gross nonperforming loans/total lending	13.6	12.7	15.7	15.3	14.3
Return on assets	1.5	1.8	2.6	2.2	2.3
Return on equity	12.8	14.9	16.7	15.6	16.4
Average interest rate spread (in percentage points) 5/	5.8	3.7	4.7	5.6	4.7

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

1/ On a remaining maturity basis.
2/ Based on the residency principle.
3/ Spread between 3-month dirham interbank and 3-month U.S. dollar LIBOR.
4/ Updated during 2004 consultation.
5/ Spread between 3-month dirham time deposits and local currency business loans.

20. **Considerable progress was made in 2003 in implementing plans to set up the Dubai International Financial Center (DIFC), a financial free zone.** This is an initiative of the Government of Dubai, and will encompass a comprehensive set of international financial functions. A unique aspect of the DIFC is the nature of its regulatory structure. The strategic conception is to provide a comprehensive, best practices regulatory capability supported by an extensive set of separate enabling laws and a separate judiciary at the emirate level. Since both the operating and regulatory arms of the DIFC are subordinate to the Government of Dubai, the governance structure holds the potential for conflicts of interest for regulation. The current track anticipates operations beginning in early 2005 with about 20–25 firms operating initially.

III. REPORT ON DISCUSSIONS

21. **Based on the latest (March 2004) WEO oil price of US$30 per barrel and despite the cut in OPEC-mandated oil production effective April 2004, macroeconomic conditions are projected to remain strong in 2004**. Growth in nonhydrocarbon GDP is projected at 4.7 percent, resulting from strong domestic activities in the areas of tourism, communication, and transport. Reflecting the nonhydrocarbon growth, imports are projected to increase by 5 percent to about $44 billion. Oil and product export receipts are projected to increase by about 2 percent to $26.2 billion, and nonhydrocarbon exports by 16 percent to $13 billion. The external current account surplus is projected at about 7.5 percent of GDP. Inflation is expected to ease to 2.6 percent and the consolidated fiscal balance is projected by the staff to be in surplus at about 8 percent of GDP.

22. **In discussions, the authorities in Abu Dhabi informed the staff that because of the specifics of the emirates' institutional arrangements and the volatility of oil prices, they manage expenditure and budget resources on continuous and cautious basis.** Accordingly, they review oil price developments during the year with ADNOC and expenditures are adjusted as needed. If oil prices rise above the budgeted assumption, for example, spending is left intact, but adjusted downward when oil prices fall below the budget oil price. In 2004, Abu Dhabi's budget is based on a conservative oil price assumption, US$20–21 per barrel of oil. Abu Dhabi's deficit is financed mainly from its resources.

23. **Over the medium term (2004–09), based on current expectations of declining oil prices and the maintenance of a cautious policy stance, the overall fiscal balance (excluding investment income) would turn into a deficit starting in 2008** (Table 6). The budget financing requirement for 2008–09 could be met from investment income on government external assets while the value of these assets would continue to rise in real terms over the period.[10] However, under the current policy stance, both the stock of total net

[10] The medium-term projections are sensitive to assumptions about oil prices and rates of return on the U.A.E.'s foreign assets. With a $1 drop in the price of oil per barrel, the fiscal balance will weaken by 1 percent of GDP on average during 2004–09.

wealth and net wealth per capita in real terms are projected to be lower, as discussed in Appendix IV.[11] Under this baseline scenario, and the objective of maintaining net wealth constant over the medium term, fiscal adjustment is needed to reduce the nonhydrocarbon fiscal deficit annually by about AED 3.4 billion (1.1 percent of GDP).

24. **Given the present outlook, the growth rate of real nonhydrocarbon GDP is projected to stabilize at around 4.3 percent,** reflecting a number of long-term infrastructure and industrial projects, particularly in Dubai. Inflation is projected to trend downward to about 2 percent, mirroring projected developments in commodity prices.

25. **Policy discussions focused on how to broaden the economic and social progress achieved over the past decades, narrow regional income disparities, address the needs of a rapidly growing national labor force, lower the economy's dependence on oil, and increase transparency of government operations at all levels.** Current government policies are already in place to address some of these issues. However, to reinforce these policies and improve the efficiency of public expenditures, staff stressed that better coordination among the emirates—which continue to pursue different economic policies—is needed. Staff also emphasized the need to improve transparency, particularly in the fiscal area, in order to improve the policymaking environment and promote private investment to its full potential. Staff reviewed risks and developments in the financial sector and assessed performance in following up on the recommendations of the 2001 FSAP mission.

A. Structural Policies

Restructuring and privatization

26. **The authorities' reform agenda is appropriately centered on increasing the role of the private sector, with Dubai at the forefront of most new initiatives.** In Abu Dhabi, despite the privatization program in the electricity sector, current and capital spending on electricity has continued to rise. Electricity tariffs and charges for nationals are different than those for non-nationals. Water continues to be free for nationals, and only a small flat fee is paid by non-nationals. The staff stressed that market pricing of publicly supplied goods and services should go hand-in-hand with the efforts to increase private sector growth to ensure an efficient allocation of resources and to reduce the burden on the budget. The staff also stressed that there is a need to restructure companies in the transmission and distribution sector. To this end, establishing a national electricity grid with a common tariff policy should facilitate investment decisions nationwide. The staff stressed that targeted payments to some nationals below a certain income level could be considered to protect them from the increase in tariff rates. The authorities agreed with the staff recommendations; however, currently there are no plans to adjust tariff rates.

[11] An alternative scenario based on a conservative oil price, US$20 per barrel, and a long-term fiscal sustainability analysis are discussed in Appendix IV.

Table 6. U. A. E.: Medium-term Baseline Scenario, 2003–09

	Prel.	Projections					
	2003	2004	2005	2006	2007	2008	2009
Crude oil production (in mill. bbl/day) 1/	2.59	2.47	2.58	2.58	2.58	2.58	2.58
Of which: Condensates	0.33	0.33	0.44	0.44	0.44	0.44	0.44
Average U.A.E. oil export price (In U.S. dollars/barrel) 2/	28.11	29.50	26.50	25.50	25.00	24.50	24.50
	(In billions of cubic meters per year)						
Natural gas production and exports							
Natural gas production	46.0	49.2	52.7	56.4	60.3	64.5	69
LNG exports	7.3	7.6	7.8	8.0	8.3	8.5	8.8
NGL exports	12.7	13.6	14.6	15.6	16.7	17.9	19.1
	(Percentage change, except as noted)						
Nominal GDP (in billions of U.A.E. dirhams)	295.4	310.8	317.9	327.7	340.1	353.1	368.6
Real GDP (at factor cost)	7.0	2.4	4.6	3.4	3.4	3.4	3.4
Crude oil and natural gas 3/	13.8	-5.3	4.4	0.0	0.0	0.0	0.0
Nonhydrocarbon 4/	5.2	4.7	4.6	4.3	4.3	4.2	4.2
Consumer prices	2.8	2.6	2.4	2.2	2.1	2.0	2.0
	(In percent of GDP)						
National saving	30.9	31.3	34.0	36.0	35.1	34.7	34.6
Government	2.7	2.5	4.7	7.0	7.1	6.8	6.7
Nongovernment	28.1	28.8	29.3	29.0	28.0	27.9	27.9
Gross domestic investment	22.4	23.9	25.0	25.1	25.0	25.2	25.3
Government	5.2	5.1	5.2	5.2	5.3	5.3	5.2
Nongovernment	17.2	18.8	19.8	19.9	19.7	19.9	20.1
	(In billions of U.A.E. dirhams)						
Consolidated fiscal accounts							
Revenue	131.1	118.2	125.3	134.6	137.8	139.5	142.8
Hydrocarbon	105.7	92.5	86.9	84.6	83.9	83.2	84.1
Nonhydrocarbon	25.4	25.7	38.4	50.0	53.8	56.3	58.7
Of which: Investment income 5/	8.2	8.1	20.4	31.6	35.0	37.0	38.9
Expenditure, *of which:*	90.6	93.1	95.6	98.2	101.0	103.8	106.6
Current	74.5	76.4	78.3	80.2	82.2	84.3	86.4
Development	15.3	15.9	16.5	17.2	17.9	18.6	19.3
Overall balance	40.6	25.1	29.7	36.4	36.8	35.7	36.2
(In percent of GDP)	13.7	8.1	9.3	11.1	10.8	10.1	9.8
Overall balance (excluding investment income)	32.3	17.0	9.3	4.8	1.8	-1.3	-2.8
Excluding hydrcarbon revenue	-73.4	-75.5	-77.7	-79.9	-82.1	-84.5	-86.9
(In percent of GDP)	-24.9	-24.3	-24.4	-24.4	-24.2	-23.9	-23.6
(In percent of nonhydrocarbon GDP)	-36.7	-35.1	-34.0	-33.0	-32.1	-31.2	-30.4
Government debt 6/	21.6	21.6	13.3	13.3	13.3	11.8	11.8
(In percent of GDP)	7.3	7.0	4.2	4.1	3.9	3.3	3.2

Table 6. U. A. E.: Medium-term Baseline Scenario, 2003–09

	Prel.	Projections					
	2003	2004	2005	2006	2007	2008	2009
	(In billions of U.S. dollars)						
External Accounts							
Exports, *of which:*	60.8	63.6	63.9	65.2	67.1	69.4	72.3
Crude oil and products	25.7	26.2	24.5	23.6	23.1	22.6	22.6
Imports, f.o.b.	-41.7	-43.8	-46.3	-48.7	-51.3	-54.1	-57.0
Services (net)	-7.5	-7.9	-8.4	-8.8	-9.3	-9.8	-10.3
Investment income (net) 7/	-0.1	0.5	5.1	9.0	10.3	11.0	11.7
Transfers (net)	-4.7	-6.1	-6.5	-6.9	-7.5	-7.5	-7.5
Current account balance	6.9	6.3	7.7	9.7	9.4	9.1	9.3
(In percent of GDP)	8.5	7.5	9.0	10.9	10.2	9.5	9.2
Central Bank reserves	15.1	15.7	16.5	17.5	18.4	19.3	20.3
(In months of imports)	4.1	4.1	4.1	4.1	4.1	4.1	4.3
External debt 8/	16.6	15.3	15.5	15.7	15.9	16.2	16.4

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 March, 2004 WEO oil price projections.
3/ Crude oil output includes condensates. A large increase in condensates is planned for 2005.
4/ Includes refined oil products and liquid gas.
5/ Staff estimates based on information received from the authorities.
6/ Due to domestic banks; no official external debt is reported.
7/ Based on estimated assets and WEO interest-rate projections.
8/ Includes liabilities of resident banks.

27. **The staff stressed the need to have a coordinated strategy for economic development among the emirates**. Except for a number of areas such as labor, customs, education, and foreign investment outside the free zones, on which a uniform federal policy is in place, each emirate draws up and implements its own economic development strategy. As such, there is scope for efficiency gains from the perspective of the country as a whole.

28. **In line with efforts to continue the process of economic diversification, the U.A.E. is amending its Commercial Company Law,** which may see the federal ceiling on foreign ownership raised from the current 49 percent. This law is expected to establish a "Foreign Direct Investment Commission," which will oversee foreign investment activity and propose priority sectors. Certain foreign ventures with a high percentage of foreign participation would require the approval of the Minister of Economy and Commerce. To improve the business environment, Dubai has implemented a new Arbitration Law to fill the legislative gap regarding resolution of commercial disputes. Also, measures are underway to reform the commercial court system in Dubai and to establish a credit bureau system.

Labor policies

29. **Demographic dynamics point toward strains in the labor market emerging in the period ahead**. So far, most of the jobs in the private sector have been filled by expatriate workers, with the majority of nationals continuing to seek employment in the public sector. As a result, the authorities have implemented a number of new measures in recent years to increase the cost associated with hiring expatriate workers. These measures include quantitative quotas for nationals employed in the banking and insurance sectors and limited transfers of sponsorship for broad classes of professions.[12] The staff stressed that the liberal labor policies adopted thus far in the U.A.E. have allowed the private sector to recruit expatriate workers at internationally competitive wages. This policy has contributed to economic growth and improved competitiveness of the nonhydrocarbon economy in the U.A.E. As such, **it is important that any future changes to labor policy do not adversely impact the competitiveness of the economy.**

30. **To create employment opportunities for U.A.E. nationals in the private sector the authorities have developed programs at the emirates' level to encourage domestic entrepreneurship and small- and medium-sized enterprises (SMEs)**. Key benefits of these programs are simple and streamlined application process, competitive interest rates, and favorable repayment terms. Also, a National Human Resource Development and Employment Authority was created to train nationals to ensure that they have adequate skills to be hired by the private sector. The staff recommended that these measures be complemented by long-term structural policies in the areas of education, training, wage policy, and reform of the current social benefits system. The staff stressed that, as long as part of the salary of nationals in the public sector consists of social allowances (such as for housing, marriage, and transportation), this creates an incentive to work in this sector, while inflating nationals' reservation wage. The staff recommended that these benefits be separated from wage policies and be reduced gradually over time. Also, consideration should be given to gradually increase working hours in the public sector to match those in the private sector.

B. Macroeconomic Policies

Fiscal policies

31. **In discussing fiscal transparency, the staff stressed that the flow of data among the emirates and the federal government needed urgent improvement in order to enhance policy coordination and to be able to assess efficiency of fiscal policy.** Also, progress needs to be made in increasing transparency about the disposition of Abu Dhabi's

---

[12] The authorities have also increased various fees paid by foreign workers, including health care and visa charges, taken steps to crack down on an estimated large pool of illegal foreign workers, and reduced the mandatory retirement age for expatriate workers from 60 to 55 years. Also, employers are now required to deposit in a local bank, as guarantee, AED 3,000 for each foreign worker they hire. These deposits will not earn interest.

oil and gas proceeds. On the disposition of oil and gas revenues, a key feature is that some revenue is retained by the national oil company for financing of investments, or is transferred directly to Abu Dhabi's government's foreign assets, rather than accruing to the budget.

32. **The staff recommended that steps be initiated to ensure that the fiscal surpluses are large enough to be consistent with the intergenerational equity objectives over the longer term.** The stock of total net wealth and net wealth per capita are projected to decline, given the current policy stance and oil price projection. Moreover, pressures may build up for an increase in expenditures to address the emerging unemployment pressures and unfunded pension liabilities that are deemed to be large, but as yet have not been finalized. Accordingly, the staff stressed that the structure of the budget needs to be strengthened through expenditure and revenue measures.

33. **On the expenditure side, the staff welcomed the reduction in agricultural subsidies in the emirate of Abu Dhabi and stressed the need to reduce subsidies on water and electricity nationwide.** Government employment should also be contained with remuneration based on productivity and performance. The staff also stressed the need to budget for the growing size of unfunded pension liabilities.

34. **On the revenue side, a broadening of the revenue base is needed, in particular, the extension of the corporate income tax to the nonhydrocarbon sector and local banks**.[13] In addition, since service activities account for about 43 percent of GDP, a low-rate broad-based consumption tax on services, utilities, retail trade, and telecommunications was recommended. The authorities agreed on the need to broaden the tax base and informed the staff that a **discussion, at the cabinet level, on the introduction of a value-added tax (VAT) system is ongoing.** A VAT will also allow the federal government to reduce its dependence on charges and fees. Also, the emirates should consider introducing a property tax.

35. **The federal government has been instrumental in narrowing income disparities among the emirates** by providing services and goods to the poor emirates with transfers received from Abu Dhabi, Dubai, and own resources. However, the federal government's own finances are constrained by increasingly inelastic revenue sources and block transfers from the emirates of Abu Dhabi and Dubai that have been fixed over time.

36. **The staff welcomed the progress made by the federal government in improving the quality of public services and ensuring greater efficiency in public spending.** The 2004 budget incorporates a more thorough treatment of performance-based budgeting. The federal government has begun casting its budget in a three-year medium-term budget framework. In addition, the International Organization for Standardization quality

---

[13] Apart from profit tax on oil and gas companies, corporate income tax of 20 percent on foreign banks and low import tariffs, the U.A.E. has no other sources of tax revenue.

management principles are being applied across the federal government, with each agency clearly defining its mission and objectives that are consistent with performance-based budgeting. The federal government at the same time is also proceeding with corporatization of various supporting services to ministries that can be contracted out or completely financed and operated outside the federal government.

Monetary policy and the financial sector

37. **Given the significant increase in money supply since 2001, the staff recommended that the authorities monitor bank credit closely in 2004, and tighten conditions if needed**. The authorities were of the view that the increase in credit to the private sector was consistent with economic developments in the nonhydrocarbon sector, well diversified across sectors, and does not pose a concern at this point. However, they indicated that monetary conditions will be tightened, if needed.

38. **The money supply will continue to be regulated mainly by adjustments in domestic interest rates in order to maintain a small differential with rates prevailing in the global markets, and the use of certificates of deposits (CDs) and foreign exchange swaps.** The staff supported the authorities' strategy, but recommended that the CBU consider moving from tap sales of CDs to an auction supplemented by a penalty rate discount window in order to allow an interbank repo market to develop. The authorities agreed with this recommendation and as a first step in that direction, the CDs' maturity will be extended from the current 18 months to 36 months.

39. **The U.A.E. has a number of important unresolved issues in financial sector regulation and development.**[14] Perhaps most pressing is the need for the CBU to transfer regulatory role related to initial public offerings (IPOs) and mutual funds to the Emirates Securities and Commodities Authority. Also, with the growth of Islamic banking, the CBU should begin to develop a mechanism for institutional liquidity support that is compatible with Islamic banking practices. The authorities agreed with the staff that it would be useful to have the regulatory arrangements of the DIFC fully assessed by the Fund in the near future.

40. **The authorities have continued their efforts to combat money laundering and the financing of terrorism, an area that also covers informal funds transfers**. A new law dealing with financing of terrorism (FT) has been drafted and is expected to be enacted in the near future. With the enactment of the FT law, the U.A.E. would be compliant with most of the Financial Action Task Force (FATF) recommendations. The U.A.E. legal and institutional regime for AML/CFT is comprehensive, modern and reasonably implemented. A law criminalizing money laundering that was adopted in 2002 has been widely cited by the United Nations as a model of good practice.

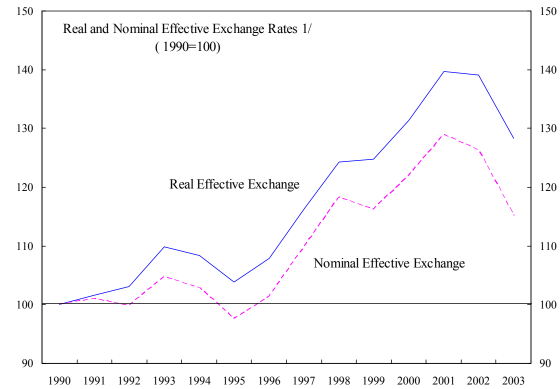
---

[14] For more details refer to paragraph 25 in Appendix V.

C. External Sector

41. **The pegged exchange rate regime has served the U.A.E. economy well by providing a nominal anchor and strengthening confidence in its economic policy.** In line with the GCC decision to adopt a monetary union by 2010, the AED has been officially pegged to the U.S. dollar since February 2002.[15] Reflecting developments in the dollar exchange rate, the real effective exchange rate (REER) (based on consumer prices) depreciated by 8.2 percent during the period 2002–03, but has appreciated by about 28 percent since 1990 (Figure 3). The cumulative appreciation does not seem to have hindered the country's competitiveness, the role of the private sector has been enhanced, and the economy is among the most diversified in the GCC region (Figure 4). Also, nonhydrocarbon exports and re-exports experienced rapid growth. Since 1995, non-oil exports have grown at over 17 percent per year, and re-exports at about 8 percent per year. A large part of the U.A.E.'s nonhydrocarbon exports go to the other GCC countries and Iran, which also have experienced similar appreciation.

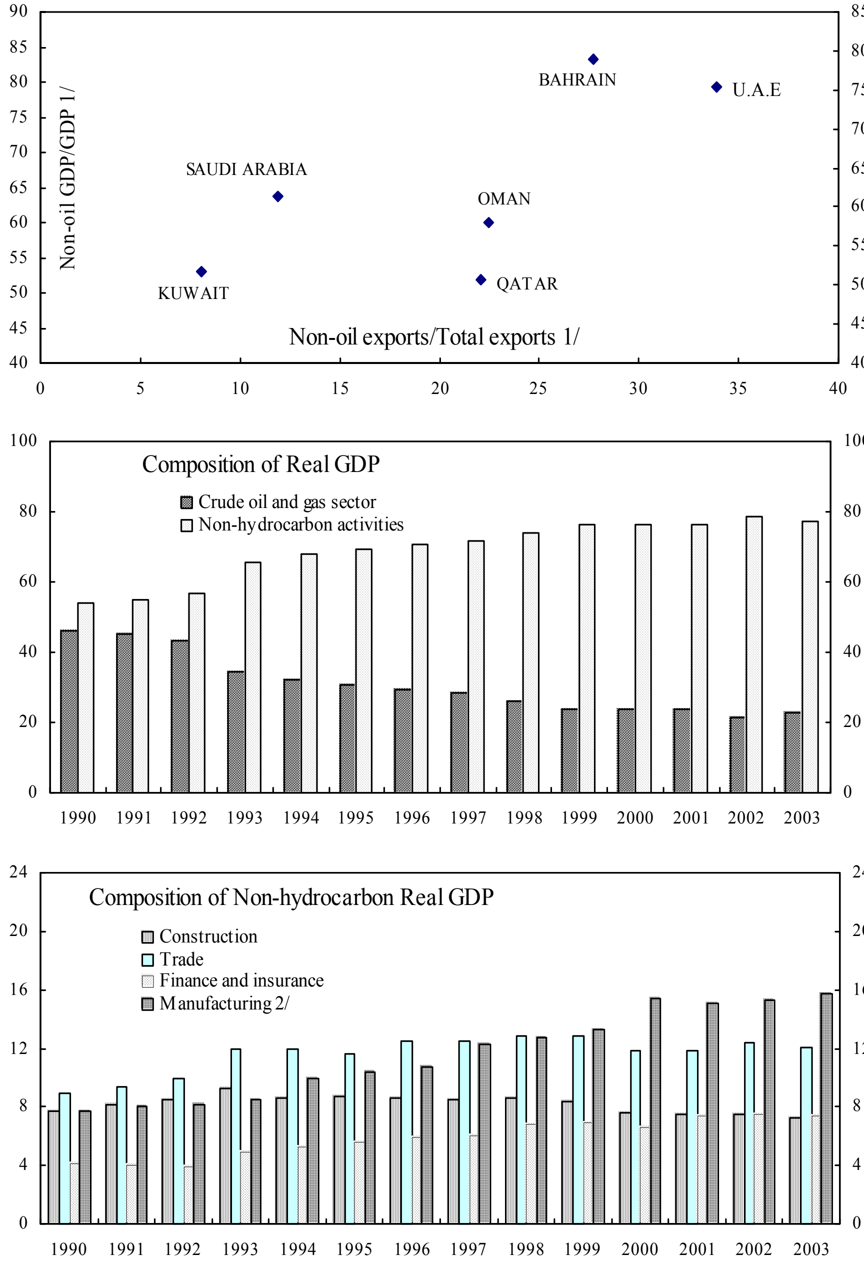
Figure 3. The U.A.E.: Effective Exchange Rates, 1990-2003



[15] During November 1980–February 2002, the AED was officially pegged to the SDR at a rate of AED 4.76190 = SDR 1, however, in practice it was pegged to the U.S. dollar at a fixed parity. Since November 1997, the mid-point between the official buying and selling rates for the dirham has been AED 3.3725 = $1.

Figure 4. U. A. E.: Diversification and Composition of GDP, 1995–2003

(In percent of total GDP; unless otherwise indicated)



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

1/ Average in the period 1995–2003.

2/ Includes natural gas and petroleum processing industries.

42. **The business-friendly environment; good infrastructure; access to expatriate workers at internationally competitive wages; have been key to maintaining competitiveness and growth in the non-oil sectors.** These factors have made the U.A.E. an

attractive place to invest, particularly in the free zones, for companies seeking to serve the growing markets of the Middle East, North Africa, India, and Pakistan.

43. **Progress continued toward regional integration within the GCC.** Tariff rates have been raised slightly to 5 percent effective 2003 in line with the Common External Tariff.[16] The U.A.E. has participated in various technical committees in preparation for the adoption of convergence criteria, scheduled for January 2005. In addition, the European Central Bank is currently providing assistance in identifying the main indicators that will need to be developed in preparation for the GCC-wide monetary union.

IV. Statistical Issues

44. **The staff welcomed the authorities' cooperative approach in the provision of detailed estimates on official foreign assets of the government.** Such information was necessary in clarifying the inter-sectoral linkages between oil, external, and fiscal developments. Staff also welcomed the renewed efforts to form the Interministerial Statistical Committee (ISC), in charge of collecting and compiling U.A.E. statistics, with members from across the emirates and federal ministries.[17] However, staff stressed that, in the near term, to improve the U.A.E.'s economic statistics (see Appendix III) there is a need to strengthen the current institutional base that exists at the CBU and the MOP for the collection and compilation of financial, national accounts, and price statistics. The staff recommended that an assessment of whether the MOP has sufficient resources to carry out its new mandate be carried out.

45. **As for the fiscal accounts, there is a need to adopt a consistent and comprehensive set of public sector accounts using a common methodology across the eight budget systems.** In this regard, staff recommended that a small unit, a Committee of Fiscal Policy Coordination, be formed within the MOFI to provide coordination between the federal government and the seven emirates with respect to classification and methodology.

46. **The authorities' indicated interest in participating in the General Data Dissemination System (GDDS).** This is an important step toward building a national statistics system that is consistent with internationally accepted best practice. In this connection, the staff recommended that the authorities finalize the draft GDDS metadata prepared jointly with the multi-sector mission from the Fund's Statistics Department that

---

[16] A minimum tariff rate of 5 percent applies to non-GCC imports while no tariffs apply to imports from other GCC countries with at least 40 percent local value added. Tariffs in the U.A.E. are consistent throughout the federation and all dutiable goods are subject to a 5 percent tariff with few exemptions. Most foods, raw materials, precious metals and stones are exempted from import duties in the U.A.E.

[17] The ISC has been recently moved to the Ministry of Planning (MOP) from the Ministry of Finance and Industry (MOFI).

visited the U.A.E. in December 2003 and to nominate a GDDS coordinator. The authorities will be writing to the Fund's Statistics Department on these issues after the formation of the ISC is complete.

V. Staff Appraisal

47. **The U.A.E. has made impressive economic progress over the years, by consistently pursuing an outward-oriented development strategy, prudent financial policies, the utilization of oil revenues to diversify the economy, and the strengthening of the financial sector**. As a result, the role of the private sector has been enhanced, and the economy is among the most diversified in the GCC region. Openness and a sound record in macroeconomic management have contributed to the accumulation of a large stock of official foreign assets.

48. **With high oil prices in 2002–03, the country's financial situation strengthened significantly, as reflected in the large fiscal and external current account surpluses**. Given the favorable prospects in the global oil market in 2004, economic developments are projected to remain strong. However, to maintain wealth constant in real terms over the medium term, the structure of the budget needs to be strengthened with the objective of reducing the nonhydrocarbon budget deficit annually by about 1 percent of GDP. On the expenditure side, government employment should be contained with remuneration based on productivity and performance. Subsidies on water and electricity should be phased out and replaced by targeted payments to nationals below a certain income. The revenue base could be broadened by introducing a VAT system and the emirates could consider introducing property taxes.

49. **While some emirates and the federal government are making efforts to improve the efficiency of public administration, fiscal transparency remains a key challenge for the authorities**. Given the autonomy of emirate governments in public finance matters, the staff is of the view that better coordination in setting policy objectives and instruments among emirates would enhance efficiency and reduce the tendency for individual emirates to outbid each other in investment incentives.

50. **The staff agrees with the thrust of the authorities' monetary policy**. On monetary instruments, the staff recommends that the CBU considers moving from tap sales of CDs to an auction, supplemented by a penalty rate discount window, in order to allow a repo market based on CDs to develop. The U.A.E. authorities have undertaken a number of initiatives to improve financial sector supervision and efficiency. Banks in the U.A.E. exceeded Basel capital adequacy standards, and were well provisioned against classified loans. Also, important measures have been implemented to combat money laundering and the financing of terrorism, and a mechanism has been created to monitor informal funds transfers. The U.A.E. legal and institutional regime for AML/CFT is comprehensive, modern and reasonably implemented.

51. **The U.A.E. has a number of unresolved issues in financial sector regulation and development.** Perhaps the most immediate is the need to complete the rationalization of responsibilities for securities regulation. With the growth of Islamic banking the CBU should begin to develop a mechanism for institutional liquidity support that is compatible with Islamic banking practices. Although complex financial groups are not now a factor in the U.A.E., the lack of a consolidated supervisor is an important gap looking forward. **The staff strongly recommends that the regulatory arrangements of the DIFC be fully assessed by the Fund in the near future**.

52. **The staff continues to endorse the pegged exchange rate arrangement, which is supported by the U.A.E.'s strong fundamentals, prudent macroeconomic management, and sound financial system.** This policy has served the country well by providing an anchor for price stability, contributing to low inflation and market confidence. The nonhydrocarbon GDP and exports have continued to experience buoyant growth over the past years suggesting that the exchange rate remains viable from the view point of external competitiveness.

53. **Overall, the staff agrees with the authorities' 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 avoiding mandatory measures, such as quotas. The staff also recommends the implementation of labor legislation reform to provide flexibility in hiring and firing. Also, reform of the current social benefits system to move toward equalization of wages in the private and public sectors is needed.

54. **Staff welcomes the provision of detailed data on the government foreign assets.** This provision improved staff's assessment of the overall macroeconomic conditions and resulted in revisions in the fiscal accounts for the period 1999–2002. The staff also welcomes the renewed efforts of the Interministerial Statistical Committee and the authorities' indication to participate in the GDDS. However, for the U.A.E.'s economic statistics to improve with respect to data quality, coverage, periodicity, timeliness, and consistency increased coordination between federal and emirates' authorities and training of staff are necessary conditions. Also, the authorities need to ensure that the MOP has sufficient resources to carry out its new mandate of addressing the shortcomings of the U.A.E.'s statistical data base.

55. **It is proposed that the next Article IV consultation take place on the standard 12-month cycle**.

United Arab Emirates: Fund Relations

(As of February, 2004)

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

II. General Resources Account:	SDR Million	Percent of Quota
Quota	611.70	100.00
Fund holdings of currency	372.36	60.87
Reserve position in Fund	239.39	39.14

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	38.74	100.00
Holdings	1.26	3.26

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				
	2004	2005	2006	2007	2008
Principal charges/ Interest	0.45	0.60	0.60	0.60	0.60
Total	0.45	0.60	0.60	0.60	0.60

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Exchange Rate Arrangement:

The U.A.E. dirham was officially pegged to the SDR at the rate of AED 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 AED 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 that are yet to be notified to the Fund, by the authorities, in accordance with Executive Board Decision No. 144 (52/51).[18]

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 October 19–31, 2002, and the staff report (IMF Country Report No. 03/66) and the Selected Issues and Statistical Appendix (IMF Country Report No. 03/67) were considered by the Executive Board on February 12, 2003. As background information to the staff report, and as part of the Financial Sector Assessment Program (FSAP), a Financial System Stability Assessment (FSSA) report 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
FAD	Public Expenditure Management follow up	May 2003
STA	Multisector	December 2003
MFD	Anti-Money Laundering/Combating terrorist financing	March 2004
STA	Coordinated Portfolio Investment Survey	April 2004

XII. Resident Representative: None.

[18] 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: Relations with the World Bank Group

As of March 30, 2004

At the request of the government, the World Bank has been providing the U.A.E. with technical assistance in the following areas:

- **A Framework Agreement** for annual technical cooperation programs was signed in 1994 that replaced the previous requests which were on an ad hoc basis. The first Annual Work Program 1995–96 included two main studies—a Comprehensive Health Assessment Study and a study to restructure Government Information Authority, the government's computer center.

- **Education sector, recruitment, and welfare.** Three projects in these areas were completed in 2000. Public Expenditure Review for the Education Sector; Review and Assessment of Recruitment Procedures for the Federal Government; and Analysis of Distribution of Welfare in Abu Dhabi.

- **Dubai Aid City.** In August 2003, the government requested Bank support in establishing Dubai Aid City in Jebel Ali Free Zone. Terms of Reference were submitted in January 2004 and the Bank is waiting for comments.

- **Children's Science Museum (CSM).** In May 2003, the Bank received a request from Dubai Municipality for assisting it in establishing a CSM. This project is on hold. After discussion with the Municipality, it was deemed not to be high on their priority list.

- **Environmental Assessment.** In August of 2003, the U.A.E. showed interest in Bank support for a U.A.E.-wide environmental assessment. A Bank needs-assessment mission visited Dubai early this year to develop the project concept.

- **Investment Climate**. In response to a request from the advisor to the Crown Prince of Ras Al Khaimah (RAK) for assistance with Foreign Investment and Economic Development, a World Bank mission visited the Emirates late February 2004. Following discussion in RAK, the Bank team prepared TORs for the first phase of a four-phase program, and an agreement was signed in late March. Implementation of the project is expected to begin at end of April.

United Arab Emirates: Statistical Issues

1. There are numerous shortcomings in the U.A.E.'s economic and financial data. These reflect inadequate compilation techniques, infrequent data reporting, shortage of trained staff, insufficient resources assigned to data gathering, and poor information flow between federal and emirate governments, and public sector entities.[19] As a result, provision of data to the Fund between missions remains poor, except for monetary and fragmentary trade statistics. 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 the attached Table.

2. The U.A.E. has received four STA technical assistance missions over the past decade. The most recent mission (December 2003) conducted a comprehensive assessment of the country's statistical database[20], the second such assessment since June 1993. The 2003 mission concluded that, while the methodology used to compile macroeconomic statistics is generally appropriate, in most sectors serious deficiencies exist. These are attributable to the lack of sufficient and regular data sources in the real sector; inadequate coordination among the data compiling agencies; and constraints from distribution of personnel and financial resources between the federal government and the largest emirates. In response to the authorities' interest in participating in the General Data Dissemination System (GDDS), the 2003 mission worked with U.A.E. officials to prepare draft GDDS metadata, which require finalization by the authorities. This step, together with nomination of a GDDS coordinator, and agreement by the authorities to use the GDDS as a framework for the development of the country's statistical system, would complete the criteria needed for the U.A.E. to become a GDDS participant.

I. Real Sector

3. The Ministry of Planning (MOP) compiles an annual CPI, which is disseminated three months after the end of the reference year. A number of shortcomings exist with respect to the methodology of the CPI, including: (i) outdated weights are not representative for all geographic regions; (ii) no imputations are made for missing price data; (iii) replacement product prices are not adjusted for changes in quality; and (iv) base price and expenditure weights refer to different periods. Because of the lack of resources, the MOP has no near-term plans to compile the CPI monthly. MOP does not currently compile a producer price index, an import price or an export price index, a significant deficiency, given the role of the oil sector in the U.A.E.

---

[19] During the period 2001–02, compilation staff in the Ministry of Planning 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.

[20] *United Arab Emirates: Report of the Multisector Statistics/GDDS mission*, December 2003.

4. The MOP compiles and disseminates annual estimates of gross domestic product (GDP) by production and expenditure approach in current and constant 1995 prices. The national accounts compilation system suffers from a number of deficiencies. There is no comprehensive data collection program to provide a basis for compiling national accounts aggregates. The existing system relies heavily, instead, on administrative and other **ad hoc** data collected by federal and emirate institutions. The data collected are mostly quantity data. The last benchmark data available for compiling output are from 1995, while for intermediate consumption from 1980. 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 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 overestimation of volume growth, depending on changes in crude oil prices. Despite their importance in total GDP, oil and gas sector data are estimated by MOP staff based on news sources and data received with a lag from the Abu Dhabi National Oil Company (ADNOC). No national household budget survey has ever been conducted. In addition to the inadequate sources, the statistical techniques used in compiling GDP by production and expenditure approach are also not sound.

5. Although labor statistics collected in the census are broadly in line with ILO recommendations, there are notable divergences from ILO definitions, including inconsistency of some concepts and irregular and incomplete updating of the census data. Lack of regular household surveys prevents compilation of annual data on basic national labor force statistics such as wages, unemployment, labor force and employment. Wage statistics are, for example, available only for a small proportion of government employees.

II. Fiscal Sector

6. Principal deficiencies can be attributed both to the lack of coordination among the emirates and federal government, and the low frequency in reporting of government financial operations. The Ministry of Finance and Industry (MOFI) compiles data for the federal government only. Separate fiscal data on the federal government and three emirates (Abu Dhabi, Dubai, and Sharjah)[21], which are provided to the annual Article IV consultations, are employed by Fund staff to provide a consolidated fiscal account for the U.A.E. An annual, "consolidated" fiscal statement is published in the central bank's *Statistical Bulletin*, which is different from the Fund staff presentation. In particular, investment income from government assets is not included in the fiscal account. In addition, key information, such as investment income, and expenditure under the control of the respective Rulers' Offices and municipalities, remains off budget in some emirates, hindering

[21] In the past, information on the emirate of Ras Al Khaimah was also included, but this information was not available in the 2004 Article IV consultation.

comparison of fiscal developments across the emirates and the federal government. International standard of economic classification of expenditure and revenue are not fully followed.

7. The last 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 provided. 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 IMF's *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 been available since the 2002 consultation mission.[22]

III. Monetary Sector

8. Until recently, the principal issues in monetary statistics were limited to the classification and sectorization of loans to the corporate, other resident, and non-resident sectors. Starting in mid-2001, however, the Central Bank of the U.A.E. (CBU) changed the method for compilation of banking data, such that deposits of U.A.E. residents booked in overseas branches/subsidiaries of locally incorporated banks were included in the measure of broad money, and cross border flows back to head offices were treated as "domestic."[23] The rationale behind this change, as explained by authorities, was their observation that almost all of the funds deposited in the overseas branches (to circumvent the reserve requirement) almost instantly found their way back into the domestic banking system. The compilation introduced in mid-2001 does not follow internationally accepted standards that are based on the residency principle. This compilation results 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.

9. The 2003 STA multisector mission recommended that two sets of data be compiled—a core set for monetary reporting purposes and a supplementary data set that meets other objectives of the authorities. The multisector mission also recommended that lags in monetary statistics, which are compiled monthly, but reported only quarterly, be reduced; full coverage of IMF accounts; further sectorization of financial transactions, in particular of various emirate government accounts, that are currently reported in aggregate form; and further instrument classification of foreign securities and domestic investments into bonds, shares, and other equities. During the 2004 Article IV consultation mission the authorities

[22] 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 (except Abu Dhabi government employees which have their own separate pension fund).

[23] The compilation initially introduced a bias into banking statistics, especially net foreign positions of commercial banks, of about Dh 20 billion. BOP flows are also compromised, because these statistics are the source of banking flows in the BOP accounts.

indicated that publication of the corrected numbers (including relevant history), based on the residency principle would begin with the June 2004 issue of the CBU Quarterly Bulletin.

IV. External Sector

10. Balance of payments (BOP) statistics suffer from a lack of primary data sources for most transactions.[24] 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. There are major gaps in official and private transfers, oil companies' service payments, private and official investment income, and financial transactions for all sectors except banks. Although technical assistance was provided by the Fund in 1995, there has been no progress in addressing these shortcomings. Progress continues to be hampered by staffing limitations in the compilation unit, inadequate inter-agency cooperation, and other restrictions on the CBU with respect to collection of data from individuals and institutions other than the banking. The U.A.E. does not report BOP data for publication in the IMF's IFS (with the exception of trade statistics, which have been irregular at best), or the *Balance of Payments Statistics Yearbook (BOPSY).*

11. The authorities publish and provide data to Fund missions on banking system foreign assets. Detailed information on central bank reserves and foreign currency liquidity is available. Commercial bank data are also reported. These data are disseminated on a monthly basis. Since 2000, the authorities in the emirate of Abu Dhabi have provided to Fund staff, during Article IV consultation missions, approximate information on the Emirate's stock of external assets. In the 2004 Article IV consultation, some details on the stock of official foreign assets of the government were provided; in addition to an approximate aggregate stock figure as has been the practice since 2000.

12. The authorities do not compile or publish an International Investment Position (IIP) statement, despite ready availability of certain potential sources, such as banking and government statistics. Also, no data on FDI or private nonfinancial sector external assets and liabilities are collected—although, according to BIS statistics the U.A.E.'s external liabilities are relatively small.

V. Socio-demographic Statistics

13. The U.A.E. follows the practice of many other countries, with the Central Statistics Department (CSD) of the Ministry of Planning taking the lead in conducting the population census and large surveys, while line ministries collect data through their administrative reporting systems. In the area of socio-demographic statistics, cooperation between the CSD and the various line ministries is effective, with the CSD using data from the other ministries

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

in its annual statistical yearbook. The CSD also cooperates with the line ministries as needed and has provided methodological support for the various household surveys that have been conducted. As in other countries, a population and housing census is conducted every 10 years. However, public dissemination of the latest census, which relates to 1995, is rather limited. At present, no data exist on measures of income distribution, poverty and access to basic services.

United Arab Emirates: Core Statistical Indicators
(As of End-March, 2004)

	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	3/04	12/03	12/03	12/03	12/03	12/03	2003	12/03	2003	2003	2003	...	...
Date Received	3/04	3/04	3/04	3/04	3/04	3/04	3/04	3/04	3/04	3/04	3/04	...	...
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, Mission	To STA, Mission	To STA Mission	To STA, Mission	To STA Mission	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 three 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.

United Arab Emirates:
Fiscal Sustainability with Low Debt and High Wealth

1. Following a methodology similar to previous consultations, staff conducted a long term sustainability of the U.A.E.'s fiscal position until it runs out of oil.[25] This appendix describes the underlying analysis for staff recommendations regarding the nature and size of fiscal adjustment.

2. At end-2003, U.A.E. government debt was only 7.3 percent of GDP and is projected to decline to 3.2 percent of GDP under the baseline scenario presented in Table 6.[26] The issue of fiscal sustainability is thus one of preserving oil wealth for future generations. At the assumed production rate (see Table 1 below), U.A.E. would have oil for another 100 years. In addition, the U.A.E. also has largely untapped gas reserves which would last for at least 100 years. However, the U.A.E. has high dependence on revenues from its hydrocarbon sector. During the last 10 years, for example, hydrocarbon revenues stood at 79 percent of the consolidated government revenues (excluding staff estimates of investment income). At current WEO prices, this ratio is projected to rise to 84 percent in 2004 and decline to 81 percent in 2009 as oil prices fall (Table 6).

3. Due to the volatile nature of oil prices and uncertain oil production, any fiscal adjustment that comes about as a result of adverse developments in the oil market will have to rely on a mix of above-the-line adjustment, revenues and expenditures, and below-the-line financing. In the absence of any sizable adjustments in non-oil revenues and structure of expenditures, official assets have to be drawn down to finance the overall deficit. However, this would entail giving up the government's objective of at least maintaining real wealth constant for future generations. Therefore, the decision to use investment income to finance the deficit, that is, to liquidate assets, means reducing government's gross stock of wealth.

4. Against the above, the standard framework for fiscal sustainability in oil producing countries is the permanent income theory which takes a long-term view of the value of oil in the ground. A conservative and reasonable assumption within this framework calls for maintaining government net wealth constant in real terms. Government net wealth consists of oil wealth (present value of oil in the ground) plus official government financial assets less government debt. As oil in the ground is being depleted, part of the government revenue from sale of its oil is consumed and part is saved in financial assets. Therefore, as oil wealth declines over time, financial wealth net of government debt has to increase enough in order

[25] See the Selected Issues and Statistical Appendix report (SM/03/35) and the Staff Report (SM/03/31) prepared for the 2002 Article IV consultation. This framework has been featured in several staff reports or Selected Issues for oil rich countries.

[26] Repayment of the principle on the bond issued by the Emirate of Dubai in 2003 in advance of the Annual Meetings is the main reason for the decline.

to maintain net wealth constant in real terms. Under the permanent income theory, the required government consumption out of net wealth is in fact the maximum permissible nonhydrocarbon deficit (excluding investment income). Any higher deficit means a declining net wealth and any lower deficit implies rising net wealth as higher saving than that implied by the permanent income allows a faster accumulation of financial assets.

5. Given the U.A.E.'s fiscal vulnerability to oil price fluctuations, nonhydrocarbon fiscal deficit (excluding investment income) should not exceed the estimated permanent income implied under the permanent income theory.[27] At the current WEO oil price projection of US$26 per barrel over the 2004–09 period and other assumptions in Table 1 below as well as the objective of maintaining net wealth constant in real terms, U.A.E.'s permanent income is estimated at AED 77.7 billion. Under the same set of assumptions, but using a conservative long run oil price of US$20 per barrel, which is roughly 20 percent below the WEO projection for the 2004–09 period[28] U.A.E.'s permanent income is estimated at AED 63 billion per year over the 2004–09 period.[29] By contrast, the projected nonhydrocarbon fiscal deficit (excluding investment income) under the baseline fiscal policy scenario (Table 6) is AED 81 billion per year over the same period. Therefore, a fiscal adjustment of AED 18 billion, equivalent to 20 percent of government spending in 2003 or 6 percent of 2003 GDP, is needed over the period to bring nonhydrocarbon fiscal balance (excluding investment income) in line with the estimated permanent income. At current WEO average oil price of US$26 per barrel, the size of adjustment is lower, amounting to AED 3.4 billion per year which is equivalent to 3.6 percent of government spending in 2003 or 1.1 percent of 2003 GDP.

6. If the government's objective is to maintain net wealth per capita constant in real terms, then a higher level of saving is need in order to allow for the population growth rate. Given the assumed population growth rate of 2.5 percent, and other assumptions in Table 1 below, the estimated permanent income would be AED 26.8 billion. Therefore, a much larger fiscal adjustment (AED 54.2 billion, equivalent to 60 percent of spending in 2003 or 18 percent of GDP) is needed to ensure intergenerational equity in the sense of giving each citizen equal share of net wealth. Although this is a very tight fiscal policy and not practical in a medium-term horizon of 3 to 5 years, it illustrates that over time the U.A.E. economy needs to generate higher non-oil revenues and cut expenditures in order to maintain per capita wealth constant.

---

[27] Inclusion of investment income results in the same fiscal stance since it will be added to both the permissible nonhydrocarbon deficit under the permanent income theory and the nonhydrocarbon deficit in the baseline scenario.

[28] This is the stated government objective although actual implementation of budget during the year is not based on the "budgeted" assumption, but on recent price developments; see Box 2 and Para 22 for more details.

[29] This estimate therefore takes into account over 100 years of oil production.

7. Staff also conducted a long-term fiscal sustainability analysis of the U.A.E.'s baseline fiscal policy at a horizon extending beyond 2106, the year in which the U.A.E. is estimated to exhaust its oil reserves. Even under this long term scenario, net wealth is projected to decline in real terms unless corrective actions are taken in the interim period.[30]

Table 1. Main Assumptions and Parameters

(Long-run unless otherwise indicated)

Proven stock of crude oil reserves, end-2003 (millions of barrels)	96,855
Initial (2003) annual production of crude oil (millions of barrels of crude oil)	945
Annual rate of growth of crude oil production (percent per annum)	0.01
Real interest rate (percent per annum)	4.0
World crude oil price (in U.S. dollars per barrel)	20.0
Average long term production cost (in U.S. dollars per barrel)	2.6
Population growth rate (percent)	2.5
National population (excl expatriates; in millions in 2003)	0.81
Gross government stock of debt (in percent of GDP, end 2003)	7.3
Inflation (in percent per annum)	2.0

Source: Fund staff estimates.

[30] This analysis uses the assumptions in Table 1 above, except for an average U.A.E. oil export price of US$ 26 per barrel, consistent with the current average WEO oil price projection over the 2004–09 period.

Financial Sector Developments in the United Arab Emirates

Overview[31]

1. This Appendix examines trends of financial soundness indicators and recent developments in the equity, bonds, and insurance markets, as well as in the payment system. Performance in following up on the recommendations of the FSAP mission in 2001 is also assessed.

Banking sector

2. **The soundness of the banking sector in the U.A.E. remained strong as of end-2003**. All 46 banks operating in the country met the minimum 10 percent capital-assets ratio (CAR); the system-wide CAR exceeded 18 percent (Table 1 below). While the gross nonperforming loan (NPL) ratio remains relatively high at 14 percent, this reflected court practices that create significant disincentives to writing off bad loans. Provisions are considerable, however, bringing the net NPL ratio below 2 percent and no major credit problems have developed since 1998. Bank lending has grown solidly, increasing at an annual rate of about 17 percent between end-2001 and September 2003, but was well diversified across industries. Bank exposure to the booming construction sector has stayed under control; that sector's share of total loans actually fell to 15.5 percent in 2003 from 16.4 percent a year earlier.

3. **Although there has been some shift from interbank placements to securities investments, market risk overall remained limited**. Interest rate mismatches are small, since longer-term fixed rate lending is not well developed. The share of mortgages in total loans declined in 2003 to 4.7 percent from 6.3 percent in 2002. While banks have a substantial long dollar position, foreign exchange risk is limited by government's credible commitment to a dollar peg, while non-dollar exposures are small. Profitability remained strong in 2003, with banking system rate of return on assets (ROA) averaging 2.3 percent and rate of return on equity (ROE) at 16.4 percent.

4. **Banking supervision has improved.** Annual comprehensive examinations of banks' risk control capabilities were implemented in 2003 and have been completed for about half of the banks, including most of the major ones. These are followed up by targeted examinations of areas where weaknesses are identified and by action plans for improvements.

5. **Several important steps have been taken in the past few years to address money laundering and financing of terrorist activities**. Tighter regulations now apply across the emirates financial sector. Some Hawala dealers have voluntarily registered and been certified by the CBU and are required to report on a quarterly basis to the CBU their records on transactions exceeding AED 2000. As of end-February 2004, the CBU had received 112 applications for registration and 89 certificates had been issued.

---

[31] This appendix was prepared by Edward J. Frydl (MFD).

Table 1: Financial Stability Indicators

(In percent, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001	2002	2003
Lending								
Bank lending to private nonbanks to GDP	46.2	50.1	60.9	59.2	55.0	58.4	63.4	70.4
Foreign currency denominated loans to total loans	19.6	19.4	19.4	19.8	22.7	23.2	23.7	23.9
Capital								
Capital to asset ratio (CAR)[1]	20.8	19.4	20.0	20.5	20.2	20.0	18.9	18.2
Number of banks with CAR above 10 percent	46	46	47	49	47	46	46	46
Asset quality								
Nonperforming loans[2]	15.2	14.4	13.5	13.6	12.7	15.7[3]	15.3	14.3
Loan loss reserves to nonperforming loans	88.6	89.6	89.5	86.1	86.0	87.0	87.5	88.5
Management efficiency								
Total expenses to total revenue	35.0	36.3	35.4	38.3	37.5	38.3	38.3	38.6
Earnings per employee (millions of AED)	0.25	0.27	0.28	0.23	0.27	0.35	0.37	0.40
Earnings/profitability								
Return on assets	1.9	2.0	2.0	1.5	1.8	2.6	2.2	2.3
Return on equity	17.1	18.3	17.7	12.8	14.9	16.7	15.6	16.4
Average interest rate spread (percentage points)[4]	4.86	4.57	4.13	5.78	3.71	4.72	5.64	4.72
Liquidity								
Liquid assets ratio[5]	37.3	38.0	34.5	31.3	34.8	31.8	28.1	22.7
Foreign currency deposits to M2	19.9	19.6	20.0	21.2	22.2	23.8	23.9	23.0

Source: Central Bank of the United Arab Emirates

[1] BIS Tier I plus Tier II capital (net of deductions) to risk-weighted assets.
[2] In percent of total lending.
[3] Series break: suspended interest added to nonperforming loans.
[4] Difference between average rate on new business loans and average rate on 3-month deposits for large banks.
[5] Ratio of net liquid assets over total assets adjusted for provisions and for funds due from or to the CBU.

6. **A new law dealing with financing of terrorism (FT) has been drafted and is expected to be enacted in the near future**. With the enactment of the FT law, the U.A.E. would be compliant with most of the FATF recommendations. The U.A.E. legal and institutional regime for AML/CFT is comprehensive, modern and reasonably implemented. A law criminalizing money laundering that was adopted in 2002 has been widely cited as a model of best practices.

Payment system

7. **The CBU has implemented, as of August 2003, an automated real time gross settlements interbank payment system** for large interbank transfers that replace the previous Telex Transfer System, which is now used only by some small banks and government agencies.

8. **The CBU has not changed its overdraft policies**. Overdrafts are still granted on an uncollateralized basis for amounts that exceed the reserve account balance of the drawing bank at a penalty rate (5 percentage points over the three-month interbank rate) for up to six days, by which time the bank must reconstitute a positive clearing balance. This procedure potentially exposes the CBU but it has not been a practical problem because there have been no instances of overdraft in recent years since the FSAP mission considered the matter in 2001.

9. Following on an instance of ATM fraud, the CBU issued a notice in June 2003 directing banks to tighten ATM security and to pay all legitimate customer claims promptly.

Monetary operations

10. The CBU continues to provide CDs to banks of up to 18 months maturity at set rates on tap and to buy them back from banks when offered. This practice has tended to inhibit the development of a domestic interbank market, as any short-term liquidity needs of banks are met directly by the central bank. The mission recommended that the CBU consider shifting to an auction of CDs and extending the range of maturities out to 36 months while shifting from the current practice of buybacks to utilizing a discount window with collateral as the key mechanism to inject liquidity. These steps would allow an interbank market for short-term liquidity to emerge among U.A.E. banks based on repos of outstanding CBU CDs. It would also substitute collateralized discount window borrowing for the current arrangement of uncollateralized overdraft credit.[32]

Securities markets

11. **Securities markets in the U.A.E. continue to develop**, with transactions volume up 40 percent in 2003. Still, market liquidity remains relatively low and speculation is restrained. The general market index[33] grew 32 percent last year, among the lowest appreciations in the GCC area, and the average P/E ratio was only 19.

12. **There are two exchanges in the U.A.E., the Abu Dhabi Securities Market (ADSM) and the Dubai Financial Market (DFM)**. Equities are also traded in an over-the-counter market, which

[32] The Government of Dubai has issued dirham bonds that could also be suitable collateral for the discount window.

[33] This index is an average of prices on the two exchanges in the U.A.E., the Abu Dhabi Securities Market and the Dubai Financial Market.

is a small fraction of the capitalization of the exchange-listed stocks. The two markets are fully electronically linked, allowing investors to place orders for stocks from either exchange with brokers from either exchange. The markets continue to settle trades on different bases, however (ADSM at T+1 and DFM at T+2).

13. **The ADSM is the third largest stock market by capitalization in the Arab world** (behind Saudi Arabia and Kuwait) at more than AED 111 billion at end-2003. Prices on the market rose about 22 percent in 2003. Market listings are dominated by banks and services firms (including Etisalat, the telecommunications company). Thirty companies are listed, with ten or more expected to be added this year. The ADSM has cross listing with Qatar and Sudan and is seeking to add an Egyptian firm.

14. **The DFM has a market capitalization of about AED 60 billion and saw price increases of about 45 percent last year**. The higher price appreciation in Dubai reflects a greater number of firms involved in construction and real estate, which have been booming. For example, the new listing for AMLAK, the financing arm of Emaar Properties, the largest real estate developer in the country, was oversubscribed some 30 times. Two domestic bond issues, for Emirates Airlines and the Government of Dubai, are also listed on the DFM.

15. **The Emirates Securities and Commodities Authority (ECSA) is now staffed with over 35 personnel and is conducting informal visits with brokers,** but not yet full examinations. ECSA has become a member of IOSCO and indicated a willingness to have a ROSC, which was not conducted during the 2001 FSAP.

16. **The ECSA licenses brokers on the two exchanges**. Listed companies are required to publish IAS-compliant accounts and ECSA is moving to require that all public stock companies list on the exchanges, an action that would effectively eliminate the OTC market.

17. **The ECSA intends to merge the two exchanges**; it has approached EuroNext (the common exchange of France, Belgium, and the Netherlands) to study how to effect the merger. Regulatory authority related to securities markets is still divided. The CBU retains licensing authority for OTC brokers and investment advisors and regulates IPOs and investment trusts and mutual funds.

Insurance

18. The Ministry of Economy and Commerce (MOEC) has proposed various amendments to the Insurance Law. Among these are:

- A new structure for the control and supervision of insurance that sets up a Supervision and Oversight Department and Commission to ensure the financial soundness of companies. A Higher Insurance Commission will be established to set up overall policy;

- New rules on risk allocation and financial solvency margins that bring technical specifications up to international good practice;

- Empowerment of the Council of Ministers to establish a fund to guarantee contracts to policy holders and beneficiaries;

- A possible relaxation of foreign equity participation in insurance companies of up to 49 percent. At present, no participation is allowed. This amendment was previously rejected by the Emirates Assembly and a final decision on its inclusion has not been made. The presence of foreign insurance companies in the U.A.E. would be limited to representative offices.

The MOEC is expected to have legal action taken in 2004.

Legal developments

19. In addition to the proposed changes to the Insurance Law discussed above, the following legal changes are under consideration:

- **Proposed amendments to the Companies Law are before the Cabinet**. These changes would allow foreigners to acquire a greater than 49 percent equity share of domestic businesses (except insurance) on a case-by-case basis to be determined by the Minister of Economy and Commerce.

- **A variety of draft amendments to the Banking Law are under consideration in the CBU.** The process of implementing Banking Law amendments has been protracted by adding additional amendments to the vehicle on the grounds that this law has a relatively good prospect of final enactment. Among the actions proposed are giving the CBU power to approve external auditors of banks on fit and proper criteria, reserving to the CBU powers to license brokerages, giving legal standing to the computerized records of banks, protecting the legal rights of widows to joint bank accounts, strengthening the requirement for prior CBU approval for purchase of a 5 percent or greater shareholding, and protecting supervisors from liability in carrying out their duties.

Dubai International Financial Market

20. **Considerable progress was made in 2003 in implementation of plans to set up the Dubai International Financial Center (DIFC).** The DIFC, an initiative of the Government of Dubai, is a financial "free zone" that will be located within Dubai in a multi-billion dollar complex of modern structures, called Capital Dubai, on which construction began in 2003. The DIFC will encompass a comprehensive set of international financial functions, including institutional and investment banking, asset management, insurance and re-insurance, Islamic finance, back-office operations, and the Dubai Regional Exchange (DRX), an international exchange that will trade a full range of financial instruments. The DIFC Operating Company (DOC) facilitates the establishment of the center and will be responsible for its operation.

21. **A unique aspect of the DIFC is the nature of its regulatory structure**. The strategic conception is to provide a comprehensive, international good practice regulatory capability supported by an extensive set of separate enabling laws and a separate judiciary at the emirate level. This regulator, the Dubai Financial Services Authority (DFSA), is a full-scope regulator modeled on the FSA of the U.K., much as the DIFC itself mirrors many aspects of the London Euromarkets. This approach has been legitimated by a constitutional amendment and a U.A.E. federal law that allow emirates to form financial free zones independent of the civil and commercial (but not criminal) laws of the U.A.E. and the emirates. Although the architects of the DIFC have sought to build a strong legal foundation, the structure of the DIFC is apparently without precedent and creates untested legal risks. Furthermore, since both the operating and regulatory arms of the DIFC are subordinate to the Government of Dubai, the governance structure holds the potential for conflicts of interest for regulation.

22. **By design, of course, the DIFC is intended to be segregated from the financial sector of the U.A.E.** Banking operations in the DIFC are confined to institutional wholesale banking, with both deposit taking and dealing in dirham prohibited. Moreover, since the U.A.E. pegs the dirham to the dollar and does not follow an independent monetary policy, loss of monetary control arising from the leakage of funds between the sectors is not major issue. Still, the opportunity for financial innovations to exploit regulatory arbitrage and produce shifts of funds between the DIFC and the U.A.E. will depend on the specifics of regulations and operations and will require careful monitoring.

23. **The DIFC has strong momentum**. Its basic law is essentially finalized and much of the enabling legislation and regulations have been drafted. High level staffing of the DOC and DFSA is advanced. Capital Dubai is under construction. A number of major international firms have announced plans to participate and some key bond issuers, including the World Bank, have committed to listing issues on the DRX. The current track anticipates operations beginning in early 2005 with about 20–25 firms operating.

FSAP recommendations

24. Following on FSAP recommendations, **the U.A.E. authorities have undertaken a number of initiatives to improve financial sector supervision and efficiency**. Major actions include the implementation of annual comprehensive risk-focused examinations of banks' risk control, establishment of operational capability for ECSA, liberalization of foreign ownership of real estate, implementation of an automated RTGS interbank payment system, and improvements in the transparency of regulatory actions (Table 2). Progress in legal reforms, however, has been slower. The process of amending the Banking Law, for example, has been protracted by adding additional amendments to deal with a number of relatively technical issues.

Table 2: Status of FSAP Recommendations

Recommendation	Status
Banking and bank supervision	
(1) Provide adequate lead time to ensure that significant structural changes can be safely and effectively implemented.	Comments that the mission received did not indicate a problem and the authorities appear to move deliberately on major changes.
(2) Develop a strategy to further reduce NPLs.	The treatment of NPLs remains unchanged. Court practices create significant disincentives to writing off bad loans, so they remain booked and amplify the NPL ratio. Banks, however, have provisioned heavily. A resolution requires legislative and judicial reform.
(3) Improve the supervision of complex financial groups through regular contacts among the different regulators.	Although complex financial groups are not now a factor in the UAE, the lack of a consolidated supervisor is an important gap looking forward. Inter-regulator communication has improved but is still in need of a more formalized structure.
(4) Establish procedures to pre-approve equity holdings in banks exceeding 5 percent.	The CBU issued a circular in October 2003 requiring approval and stricter language is included in the draft amendments to the Banking Law.
(5) Issue appropriate rules requiring banks to have a comprehensive risk management process.	This recommendation is being well-implemented. The CBU has conducted comprehensive risk reviews for nearly half of the commercial banks.
(6) Include off-balance sheet and interbank exposures of less than 1 year in large exposures.	The CBU resists this action as too disruptive to the bank financing of construction and thinks that risks can be controlled through their system of monitoring large unfunded exposures.
(7) Protect bank staff members who report suspicious behavior from liability.	This is being dealt with through an amendment to the Banking Law
Payment system	
(1) Review overdraft policy to lend against proper collateral.	The CBU still has a policy of extending overdraft credit to a bank on an uncollateralized basis, although no instance has developed since the FSAP mission in 2001.
(2) Increase automation of procedures.	The CBU implemented in August 2001 a RTGS automated interbank transfer system that replaces the old Telex transfer system. Only few small banks and

Table 2: Status of FSAP Recommendations

Recommendation	Status
	government participants still utilize the Telex system, but they are expected to convert in the near future.
Securities	
(1) Staff and establish operations of the Securities Authority	ECSA has at least 35 staff and is adding more. Informal contacts with brokers have begun, but not yet formal exams.
(2) Rationalize the regulatory responsibilities of the ECSA, CBU, and MOEC.	While some progress has been made along these lines with the establishment of the ECSA, regulatory authority regarding areas such as IPOs and mutual funds should be shifted to the Securities Authority.
(3) Complete linkage of the electronic trading/clearing operations of the two security exchanges.	DFM and ADSA do not cross list but have an electronic linkage for their listed stocks. The discrepancy between the two exchanges in settlement dates still persists and should be addressed.
(4) Develop corporate debt market and increase participation of nonbanks	Emirates Airlines and the Government of Dubai have listed bond issues on the DFM.
Insurance	
(1) Increase the staff and skills of the Insurance Division of the MOEC	Amendments to insurance law that will set up a Supervision and Control Department and improve oversight capabilities are expected to be finalized in 2004.
(2) Conduct a full review of insurance regulations.	Authorities stated that: (1) a Ministerial Decree was issued to improve the transparency of information provided by the sector and to bring its operations closer to international standards; (2) regulations on reserves were brought up to international standards and improved standards are being embodied in law.
(3) Develop a deeper market for local property and securities by allowing investment by foreign insurers.	Authorities are considering changing laws to allow increased foreign purchases in company equities.
Legal, regulatory, and judicial systems	
(1) Enact proposed amendments to companies' legislation and make provision for improved minority	The process of amending the Companies Law is underway. It is expected that the amendments will

Table 2: Status of FSAP Recommendations

Recommendation	Status
shareholder rights, better corporate governance, and simplified company formation procedures. Improve operation of and accessibility to the Company Register.	relax the constraint against majority foreign ownership of companies, at least on a case by case basis.
(2) Improve registration of movable property.	Not yet implemented
(3) Simplify the real estate laws and improve the operation of the Land Registry.	UAE law has been changed to allow individual emirates to extend ownership rights for real property to foreigners from non-GCC countries. Dubai and other emirates have applied this change in the law. At present, Abu Dhabi does not allow foreign purchases.
(4) Enact proposed amendments to the Banking Law.	Draft amendments to the Banking Law are being considered by the CBU Board. These amendments basically embody in law the current regulatory practices of the CBU and do not contain any major new initiatives.
(5) Consider providing specialized training for judges on commercial matters.	Measures are under way to reform the commercial court system in Dubai. Dubai also implemented a new Arbitration Law to fill the legislative gap regarding commercial disputes.
Transparency	
(1) More actively seek stakeholder comments about proposed regulations and laws relating to the financial sector.	Market participants indicated that this recommendation is met.
(2) The CBU should publish more information.	Market participants indicated that this recommendation is met.
(3) The CBU should provide full sets of circulars and regulations to market participants.	Market participants indicated that this recommendation is met.

Issues

25. **The U.A.E. has a number of important open issues in financial sector regulation and development.** Perhaps most immediate is the need to finish the rationalization of responsibilities for

securities regulation. The CBU retains a principal regulatory role related to rules for IPOs and mutual funds that should be transferred to ECSA. There are regulatory gaps that will become more important as the financial sector develops: (a) the CBU should be empowered as the consolidated supervisor for financial groups that include banking institutions; (b) as domestic mortgage and bond markets develop, the central bank should move to implement procedures to require capital support for market risk exposures. The CBU should consider moving from tap sales of CDs to an auction supplemented by a penalty rate discount window in order to allow an interbank repo market based on the CDs to develop. With the surging growth of Islamic banking, the CBU should begin to develop a mechanism for institutional liquidity support that is compatible with Islamic banking practices. Finally, since the unique nature of the governance relationships in the DIFC and its broad scope of activities raise concerns about the nature what risks are being created, it would be useful to have the regulatory arrangements of the DIFC fully assessed by the Fund in the near future.

Statement by A. Shakour Shaalan, Executive Director
for the United Arab Emirates
May 28, 2004

At the outset, on behalf of the authorities, I would like to thank the staff for a very constructive and valuable consultation process. The staff report is comprehensive and provides a thorough review of recent developments and the challenges that lie ahead.

Recent Economic Developments

Underpinned by a market-oriented and forward-looking economic development strategy and an unwavering commitment to financial stability, the United Arab Emirates has made impressive progress in promoting the role of the private sector and diversifying the economy's productive base, particularly in the areas of tourism and financial services. While hydrocarbon is still a dominant sector in the economy and, in all likelihood, will remain so in the foreseeable future, the authorities have been steadfast in optimizing the use of oil resources to build up the infrastructure needed to support private sector activity in the non-oil sectors.

Reflecting these developments, economic performance in the U.A.E. remains strong as evidenced by the continuing improvement in economic and financial indicators. Overall, economic growth reached 7 percent on the back of favorable developments in the oil sector and continued robust growth of around 5 percent in the non-oil sector. While the expansion of activity in the free zones has been a driving force in the steady increase in non-oil exports, it is to be noted that exports from non-free zone companies are also showing healthy increases. Along with higher oil prices, this has helped improve the external current surplus to around 8.5 percent of GDP in 2003. Developments in the fiscal area are consistent with the authorities' prudent approach to the use of oil resources. The consolidated fiscal accounts are estimated to have registered a sizeable surplus equivalent to 13.7 percent of GDP following a similarly large surplus in 2002. These surpluses have allowed the authorities to increase their holding of foreign assets in recent years and further support the drive toward inter-generational equity. Looking forward, the outlook for the U.A.E. economy is favorable. In addition to higher projected oil receipts in 2004, growth in the non-hydrocarbon sector is expected to remain robust given the continued strong activity in the areas of tourism, trade, communication, and transport.

Fiscal Policy

The conduct of fiscal policy is guided by developments in the oil sector with the objective of using oil resources for developing the non-oil sectors and preserving inter-generational equity. Given the concentration of oil resources in Abu Dhabi and the institutional arrangements among the country's seven emirates, the government of Abu Dhabi plays a pivotal role in determining the overall direction of fiscal policy. The authorities closely review developments in the oil market along with the Abu Dhabi National Oil Company and adjust spending accordingly. As a rule, when the actual price falls short of the budgeted assumptions, spending is curtailed in order to achieve the fiscal targets, while it is kept constant when the price exceeds the conservative level assumed in the budget and the resulting excess is saved. The authorities intend to continue with this prudent policy in the period ahead.

There is a widely held recognition of the importance of improving the structure of the budget on both the spending and revenue side for strengthening public finances dynamics. While admittedly there is no urgency to making adjustment at this time, spending pressures may well arise in the future to finance unfunded pension liabilities and address the potential increase in unemployment. Consistent with their overall prudent and pre-emptive approach, the authorities have reduced agricultural subsidies in Abu Dhabi and are considering similar action on the national level with regard to water and electricity. To complement the ongoing reforms on the spending side, the authorities are considering measures to broaden the tax base and bring the non-oil sector into the revenue net. In particular, discussions are under way in the cabinet on the introduction of a value-added tax, which should reduce reliance on charges and fees, and more generally, on oil and gas revenues.

The federal government is now casting its budget in a three-year medium-term framework and is applying the International Organization for Standardization quality principles in its agencies. The authorities are also looking into other possible reform measures in the area of public employment and pension. Important advances have been made in improving the quality of public services and the efficiency of public spending. Progress indeed is underway in corporatizing support services for ministries and in moving toward performance-based budgeting.

Exchange Rate/Monetary Policy

The authorities share the staff’s view that the pegged exchange rate system, backed by large government and central bank foreign assets and prudent financial policies, has served the economy well. As evidenced from the buoyancy in the non-hydrocarbon sector and the strong growth of non-oil exports over the past decade, the appreciation in the real exchange rate since the early 1990s (notwithstanding the recent depreciation) does not appear to have undermined the economy’s competitiveness.

In addition to the prudent fiscal policies pursued over the years, the authorities are committed to maintaining their market-based interest rate and prudent credit policy to support the exchange rate. While they believe that the recent increase in credit to the private sector is consistent with developments in the non-oil sector, they stand ready to tighten monetary conditions as needed. Given the limited availability of instruments to control liquidity, the authorities agree with the staff on the need to lengthen the maturity of central bank certificates of deposit and are giving consideration to moving from the current system of tap sale to auctioning CDs.

Financial Sector Issues

The role of the U.A.E. as a regional financial sector continues to strengthen. The banking sector is well-developed, well-supervised, and well-capitalized, with the minimum requirements for the capital-assets ratio met by each of the 46 banks and exceeded by the sector as a whole. The monetary authorities are keen on ensuring that the supervisory and regulatory framework remains commensurate with the ongoing rapid development of the financial sector. A number of initiatives based on the recommendations of the 2001 FSAP mission were undertaken to strengthen the efficiency of the sector and its supervision, including carrying out annual comprehensive examination of risk controls in banks. Tighter regulations against money laundering and financing of terrorism apply across the system, and a new law in this regard is expected to be enacted soon.

Moving forward, the authorities are turning their attention to three main financial areas, namely securities market, Islamic banking, and the Dubai International Financial Center (DIFC). Consideration is given to the transfer of the regulatory mandate over initial public offerings and mutual funds to the Securities and Commodities Authority, and to the development of a mechanism for institutional liquidity support for Islamic banks. The development of the DIFC as a free financial zone segregated from the financial sector of the U.A.E. and with a comprehensive, international good practice regulatory capability is proceeding smoothly, and activities therein are expected to commence in 2005. Given the original structure of the DIFC and the high priority accorded to having in place a sound supervisory and regulatory framework, the authorities agree with the staff that it would be useful to review the center soon after the start of its operation.

Structural Reform and Economic Diversification

In addition to promoting the development of the financial sector, a major effort has been directed at supporting the expansion of private sector investment in tourism and industry. This effort has been focused on improving the economy's competitiveness so as to allow the private sector to play a leading role in sustaining growth in the non-hydrocarbon sector and creating employment opportunities for the growing national labor force. While adhering to prudent macroeconomic policies, the authorities are also committed to providing a modern and efficient infrastructure, improving the ownership and other rights for foreigners, and privatizing public utilities. On the latter, progress has been made in privatizing the electricity company in Abu Dhabi and the privatization of water and electricity is planned to be concluded by 2006. In addition to announcing the launching of a number of free zones, which have proven instrumental in encouraging non-oil sector activity, the emirate of Dubai has extended foreign ownership of land and properties to some real estate developments. The national government is amending the Commercial Company Law which may include an increase in the current foreign ownership limit. A new Arbitration Law has also been implemented in Dubai to improve the resolution of commercial disputes.

The authorities recognize the need to create employment opportunities for the growing domestic labor force. Being mindful of the importance of addressing this issue without undermining the competitiveness of the non-oil sector, they have developed programs at the emirates' level to promote domestic entrepreneurship and small- and medium-sized enterprises, and have created a training agency to better prepare nationals for private sector employment.

Statistical issues

The authorities are well aware of the problems associated with the country's statistical base. While the institutional arrangements among the emirates present a challenge in this regard, particularly with regard to fiscal data, the authorities are making every effort to address the existing weaknesses in all areas. They are redoubling their efforts to strengthen the Inter-ministerial Statistical Committee in charge of collecting and compiling national statistics. They are also interested in participating in the General Data Dissemination System, which they are hopeful will anchor the ongoing efforts to improve the quality and coverage of comprehensive national economic database.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/66
June 29, 2004

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

IMF Concludes 2004 Article IV Consultation with the United Arab Emirates

On May 28, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the United Arab Emirates.[1]

Background

The pursuit of a highly liberal, business friendly and market-oriented growth strategy continues to guide the evolution of U.A.E.'s economic development. Consistent with this strategy, each emirate and the federal government conduct economic policies that reflect differences in their natural resource endowments and their respective role within the federation. Openness and a sound record in macroeconomic management have enhanced the role of the private sector and contributed to the diversification of the economy.

In 2003, reflecting favorable developments in the oil market, higher oil production and prices, the U.A.E.'s macroeconomic performance is estimated to have been strong. Non-hydrocarbon real GDP growth is estimated to have remained robust at about 5 percent, one of the highest in the Gulf Cooperation Council area. A number of projects were launched in 2003 in the areas of construction, upstream gas, and downstream oil services. Inflation remained stable at 2.8 percent. Both the external current account and consolidated fiscal balances are estimated to have recorded large surpluses, 8.5 percent and 13.7 percent of GDP, respectively.
The non-hydrocarbon deficit (excluding investment income) remained constant as a fraction of non-hydrocarbon GDP, at about 37 percent. The stock market index, which has been rising since 2001, increased sharply in 2003, by about 32 percent, on account of strong economic

[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.

conditions and optimism regarding the economic outlook. Foreign reserves of the central bank at end-2003 remained steady at about US$15.0 billion, equivalent to about 4.0 months of imports. The broad money stock increased by 16 percent, close to the rates of the previous two years, mainly on account of about 13.5 percent increase in private sector credit. Much of this credit was granted to wholesale trade, construction, and personnel loan sectors.

The financial sector continued to perform well. The U.A.E. banks remained well capitalized and profitable. While the gross nonperforming loan (NPL) ratio at end-2003 remained relatively high at 14 percent, though lower than 2001 and 2002, provisions are considerable, bringing the net NPL ratio below 2 percent. The U.A.E. authorities have undertaken a number of initiatives to improve financial sector supervision and efficiency. Several important steps have been taken to address money laundering and financing of terrorist activities. As a result, U.A.E. is being regarded as a best practice model in this area. Tighter regulations now apply across the entire financial sector. Many Hawala (informal money transfers) dealers have registered and been certified by the U.A.E. central bank and are required to report on a quarterly basis their transactions records on transactions exceeding AED 2,000. As of end-February 2004, the central bank has received 112 applications for registration and 89 certificates have been issued. Considerable progress was made in 2003 in implementing plans to set up the Dubai International Financial Center (DIFC)—a financial free zone—an initiative of the Government of Dubai, which will deliver a comprehensive set of international financial functions.

Progress in introducing structural reforms has varied among the emirates. Dubai has extended foreign ownership of land and properties to some real estate developments and has also announced the launch of several new free zones. Abu Dhabi is moving ahead with utility privatization, with the objective to privatize its entire water and electricity sector by 2006. Restrictions on foreign ownership of companies and properties, however, remain in place in Abu Dhabi. The federal government has been implementing a series of reforms that include a phased implementation of performance-based budgeting within a newly-introduced three-year medium-term budget framework and corporatization of various supporting services.

In the area of labor policies, to create employment opportunities for U.A.E. nationals in the private sector the authorities have developed at the emirates' level programs to encourage domestic entrepreneurship and small and medium enterprises (SMEs). Key benefits of these programs are simple and streamlined application process, competitive interest rates, and favorable repayment terms. Also, a National Human Resource Development and Employment Authority was created to train nationals to ensure that they have adequate skills to be hired by the private sector.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They commended the United Arab Emirates for pursuing prudent macroeconomic policies, the prudent management of oil resources, and an outward-oriented development strategy, which have resulted in low inflation and high growth, as well as sizable fiscal and external current account surpluses, a comfortable international reserve position, and the accumulation of foreign assets. Further, they noted that sound policies supported by structural reforms have enhanced the role of the private sector, contributed to growth of the nonhydrocarbon sector and diversification of the economy, and enhanced the economy's resilience to external shocks. Directors agreed that the U.A.E. is in a strong position to take advantage of the global recovery and that the macroeconomic outlook over the medium term remains strong.

To sustain these encouraging developments, Directors saw scope for further strengthening fiscal policy and the financial sector, and further strengthening of the economic structure. They called on the authorities to improve the structure of the budget over the medium term. In particular, they noted the importance of reducing the deficit in the nonhydrocarbon portion of the budget to ensure a measure of intergenerational equity. In this context, they recommended constraining government employment and establishing a system of civil service remuneration based on productivity and performance. Some Directors, however, noted that achieving intergenerational equity could also be accomplished through the accumulation of productive capital and improvement in labor productivity. Directors also supported reducing budgetary subsidies, and in this regard welcomed the reduction in agricultural subsidies in the Emirate of Abu Dhabi and recommended phasing out subsidies on water and electricity and replacing them with targeted payments to nationals whose incomes fall below an established threshold.

On the revenue side, Directors were of the view that the revenue base needs to be strengthened to reduce its reliance on oil and gas revenues, and recommended introducing a value added tax in coordination with other members of the Gulf Cooperation Council, expanding the base of the corporate income tax, and considering the introduction of a local property tax.

While noting the efforts of some emirates and the federal government to improve the efficiency of public administration, Directors also stressed the importance of improving fiscal data and transparency, and the use of medium-term budget frameworks. They also encouraged the authorities to improve fiscal policy coordination among the emirates.

Directors endorsed the pegged exchange rate arrangement. They noted that this policy has provided an anchor for price stability, and contributed to low inflation and market confidence. Directors agreed with the thrust of the authorities' monetary policy and supported strengthening the central bank's instruments for controlling liquidity and encouraged the authorities to move from tap sales of certificates of deposit to an auction system, in order to allow the development of a repurchase market in certificates of deposit.

Directors noted the progress achieved in improving financial sector supervision. They also highlighted the need to address a number of issues in financial regulation. In particular, they supported the authorities' intention to complete the rationalization of responsibilities for securities regulation and develop a mechanism for adjusting liquidity that is compatible with Islamic financial principles. Directors also agreed that there is a need to assess fully the regulatory arrangements for the Dubai International Financial Center. They commended the authorities for putting in place a comprehensive and modern AML/CFT regime, and looked forward to the adoption of the draft law on the financing of terrorism. They also welcomed the creation of a mechanism to monitor informal funds transfers and urged its vigorous implementation.

Directors commended the U.A.E.'s open-border foreign labor policy, which has enabled the private sector to recruit expatriate workers at internationally competitive wages, contributed to economic growth, and improved competitiveness of the nonhydrocarbon economy. They endorsed the authorities' long-term labor market strategy to increase employment opportunities for U.A.E. nationals. Directors stressed that such a strategy should continue to rely on raising the skills of nationals through better education and training programs to meet private sector labor demand, while avoiding mandatory measures such as quotas. Directors further noted that labor market reforms should increase flexibility in hiring and firing, and move towards equalizing benefits in the private and public sectors.

Directors encouraged the authorities to set up a transparent investment regime, and to improve ownership rights for foreigners. In this regard, they endorsed the proposed amendment to the Commercial Company law and a law to improve the resolution of commercial disputes. They also encouraged the privatization of public utilities.

Directors commended the authorities for the provision of data on the government's foreign assets. They also welcomed the renewed efforts of the Interministerial Statistical Committee and the authorities' intention to participate in the GDDS. However, they noted that improvements in the U.A.E.'s economic statistics, with regard to data quality, coverage, periodicity, timeliness, and consistency, depend on increased coordination between the federal and emirates' authorities and the training of staff. They endorsed providing the Ministry of Planning with sufficient resources to carry out its new mandate to improve the statistical data base.

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

The United Arab Emirates: Selected Economic Indicators 1/

	1999	2000	2001	2002	Prel. 2003
	(Annual Change in percent)				
National accounts and prices					
Real GDP (at factor cost)	4.4	12.3	3.5	1.9	7.0
Hydrocarbon 2/	-4.5	13.1	1.7	-8.1	13.8
Nonhydrocarbon 3/	7.5	12.0	4.0	5.0	5.2
Consumer price index	2.1	1.4	2.8	3.1	2.8
Investment (in percent of GDP)	27.8	23.3	24.7	24.1	22.4
	(In percent of GDP; unless otherwise indicated)				
Financial variables					
Total revenue	27.0	44.5	37.1	43.7	44.4
Hydrocarbon	14.9	33.0	26.6	34.1	35.8
Nonhydrocarbon 4/	12.2	11.5	10.5	9.6	8.6
Total expenditure	37.3	32.0	37.4	32.9	30.7
Of which: Current expenditure	28.6	26.9	30.0	27.5	25.2
Consolidated fiscal balance (deficit-) 5/	-10.2	12.5	-0.4	10.8	13.7
Excluding hydrocarbon revenue and investment income 6/	-29.9	-26.3	-31.5	-26.7	-24.9
In percent of nonhydrocarbon GDP	-39.9	-39.6	-44.8	-37.2	-36.7
Change in broad money supply (In percent)	11.4	15.1	15.5	15.6	16.1
Change in private sector credit (In percent)	7.1	8.7	8.8	11.3	13.5
	(In billions of U.S. dollars; unless otherwise indicated)				
External sector					
Exports	36.5	49.6	47.5	51.2	60.8
Of which: Crude oil 2/	13.6	21.7	17.6	16.7	22.1
Imports, f.o.b.	-27.9	-30.8	-33.5	-36.7	-41.7
Current account balance 4/	0.9	12.2	6.5	3.5	6.9
In percent of GDP	1.6	17.3	9.4	4.9	8.5
Central bank reserves	10.9	13.8	14.3	15.3	15.1
In months of imports of goods and services	4.3	4.9	4.7	4.4	4.1
Total external debt 7/	18.8	18.2	19.4	16.7	16.6
In percent of GDP	34.0	26.0	27.9	23.3	20.7
Average real effective exchange rate (CPI based; in percent) (appreciation +) 8/	0.4	5.2	6.4	-0.5	-7.7

Sources: Data provided by the authorities; and IMF staff estimates.
1/ Based on official data as of March 2004, though it varies by indicator.
2/ Includes condensates.
3/ Includes refined products and liquid gas.
4/ Includes investment income on government foreign assets estimated by IMF staff.
5/ Includes the fiscal position of the federal government and the three largest emirates.
6/ Investment income is Fund staff estimates.
7/ Includes central bank and commercial bank foreign liabilities, plus private nonbanks based on reporting BIS banks.
8/ IMF staff estimates.