Country Report

United Arab Emirates

United Arab Emirates at a glance: 2006-07

OVERVIEW
A year after he succeeded his father as president of the UAE and ruler of Abu Dhabi, Sheikh Khalifa bin Zayed al-Nahyan's position appears very strong and is highly unlikely to be challenged. Sheikh Khalifa will maintain the UAE's well-established, relatively liberal social and economic policies as well as its pro-Western foreign policy stance. The programme of economic reform and liberalisation will continue and may pick up pace, as a result of both the new ruler's leadership and pressure from bodies such as the World Trade Organisation. Real GDP growth will remain strong, bolstered by high oil earnings and sustained expansion in the non-oil economy. The strength of oil revenue will ensure that the public finances also remain strong, and that the trade and current accounts continue to record large surpluses. There is no realistic prospect of the currency's peg to the US dollar coming under strain.

Key changes from last month

Political outlook
• The political outlook is unchanged, despite the death in January of the emir of Dubai, Sheikh Maktoum bin Rashid al-Maktoum. Power has transferred smoothly to the crown prince, who had long been the driving force behind policymaking in the emirate. No significant change in policy orientation or implementation is likely.

Economic policy outlook
• The economic policy outlook is largely unchanged. The Economist Intelligence Unit continues to expect the government to press forward with its broad reform agenda, with new commercial regulations likely to strengthen the position of foreign firms across the federation. Against a background of record high oil prices, the individual emirates of the UAE will focus their efforts on boosting non-oil economic growth, with Dubai remaining at the forefront of most new initiatives.

Economic forecast
• We have raised our forecast for consumer price inflation marginally since our previous report.

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Outlook for 2006-07

Political outlook

Domestic politics  The UAE's political outlook remains favourable and is largely unaffected by the death in January of the emir of Dubai, Maktoum bin Rashid al-Maktoum. Sheikh Maktoum played only a limited role in policymaking in either his emirate-level role as ruler of Dubai or in his federal capacity as vice-president and prime minister of the UAE. Within Dubai, power has long centred on Sheikh Maktoum's brother, Sheikh Mohammed, who had served as crown prince for over a decade, and acceded to the throne smoothly and without opposition. Sheikh Mohammed has also replaced his brother at a federal level, but decisions at this level are set to be left primarily to the rulers of the UAE's largest emirate, Abu Dhabi. More generally, power will remain primarily at the emirate rather than federal level.

Sheikh Maktoum's death comes a little over a year after the death of Sheikh Zayed bin Sultan al-Nahyan, who had been president of the UAE since its foundation and ruler of Abu Dhabi since 1966. Here too, however, power transferred smoothly to the long serving crown prince, Khalifa bin Zayed al-Nahyan, who has since firmly established his authority as the new ruler. Sheikh Khalifa enjoys support from within the ruling families of the seven emirates, and most UAE nationals appear satisfied with family rule in the country, particularly at a time of high oil prices and rising public largesse. Significantly, Sheikh Khalifa enjoys the support of his half-brother, the increasingly influential Sheikh Mohammed bin Zayed al-Nahyan, his successor as crown prince of Abu Dhabi. They share the same broadly liberal, pro-business, pro-Western philosophy as their father, and, although some tensions are inevitable, a serious power struggle is highly unlikely. Sheikh Mohammed is the younger, more dynamic figure and his growing influence over policymaking has been apparent in the pick-up in the pace of reform in Abu Dhabi. Sheikh Khalifa, however, remains the senior partner.

Against this strongly positive outlook, some vulnerabilities remain, most notably the concentration of political power in the hands of the state's ageing emirs. The state's formal political institutions remain too weak to offer an effective constitutional framework for political power, which will instead continue to be a product of the functioning of the large, and sometimes fractious, ruling families. Moreover, although the recent transfers of power have been executed smoothly, this offers no guarantee that disputes will be avoided in the future, particularly as there is no formal, legal structure for determining family seniority and claim on power. Indeed, almost a month after acceding to the throne, Sheikh Mohammed bin Rashid has yet to announce the name of the new crown prince, although a decision is expected soon. Concerns over security also persist, with the UAE's location in the volatile Gulf region carrying with it some risk of attack from armed Islamist groups. The UAE is by no means as exposed as neighbouring Saudi Arabia to the threat from al-Qaida and other similar groups, which have no apparent support in the Emirates and no track record of operating in the country. However, the recent threats against the UAE
carried on Islamist websites are a reminder that the pro-Western state (particularly liberal Dubai) is likely to be seen as an ideal target by some militant groups. Although the security forces take the issue very seriously, the large number of soft Western targets in the UAE and the size and fluidity of the substantial (predominantly Muslim) expatriate population make fully effective policing against violent Islamist activity difficult to achieve.

International relations

The UAE's pro-Western orientation will not alter, but the government is still concerned over some aspects of US policy in the region. Officials remain anxious that the situation in Iraq could deteriorate further and spill across its borders, and are uneasy over the possibility of further US military action elsewhere in the region, particularly against Iran. In part this reflects an awareness that the UAE's pro-US stance is out of step with regional popular opinion (and, to an extent, domestic sentiment too), which is hostile to US policy in the Middle East. The UAE is also aware that any escalation of conflict in the region has economic implications for the Emirates, undermining the bullish projections for growth in tourism, construction and foreign investment that the country's medium-term economic strategy is based on. Although the economy has ridden out the instability of recent years, it is not immune and would be particularly exposed if further conflict were to be coupled with an upsurge in anti-Western violence in the Gulf region and beyond.

Economic policy outlook

Policy trends

The federal economy and planning minister, Sheikha Lubna al-Qassimi, will continue to promote a progressive economic agenda, built around economic liberalisation, diversification and enhancing the role of the private sector. With support from Sheikh Khalifa, the government is also expected to take steps to further promote foreign investment, including the abolition of the sole agency law and regulations that restrict foreigners to minority stakes in local firms. However, although the federal government will provide the broad framework for policymaking, most important decisions will continue to be made at the emirate level.

Dubai will remain at the forefront of most new initiatives, with the recent death of Sheikh Maktoum unlikely to lead to any significant change in policy tone or direction, given that Sheikh Mohammed, the new ruler and former crown prince, has long been the dominant power within the emirate. Dubai will strive to accelerate its now well-established diversification process, compensating for the decline of its small oil industry by building on its emergent position as the region's services hub. Diversification will include developing further the emirate's tourism, media, shipping, financial and commercial services sectors, as well as expanding its manufacturing and industrial base. Abu Dhabi, meanwhile, will continue to invest heavily in the development of its large upstream hydrocarbons resources and downstream industrial projects, notably in the petrochemicals sector. The recent issuing of a decree allowing foreigners to “own” property on a long-term leasehold basis also symbolises a shift towards a more liberal approach to policymaking, as does the decision to establish several new industrial free zones targeted at
attracting more foreign firms to use the emirate as a base for production. As
the wealthiest emirate, Abu Dhabi will also dominate the federation's public
finances, providing the bulk of overall revenue and commanding considerable
influence over spending decisions.

The continuing strength of oil prices is likely to encourage additional spending
over the forecast period, particularly (but not exclusively) within Abu Dhabi, as
the government channels part of its windfall from export earnings into the
local economy, and the new ruler seeks to cement political support. This has
already seen large public-sector pay increases announced over the past six
months, as well as additional welfare payments for UAE nationals and the
initiation of a number of large publicly funded infrastructure projects. So far
the authorities appear comfortable with the boom the domestic economy is
experiencing, partly as a result of record oil prices and high government
spending, and are unconcerned about possible overheating. However, signs that
a long-term surge in asset prices is now being accompanied by a pick-up in
consumer price inflation, at a time when credit remains cheap and liquidity
strong, may force officials to reassess their position as the forecast period
progresses. There is a real risk that this could trigger a sharp correction in some
areas of the economy, and a marked drop-off in activity, particularly if a fall in
asset prices (shares and real estate) damages investor and consumer sentiment.
Bank asset quality would also be affected.

Fiscal policy The Economist Intelligence Unit estimates that the UAE's fiscal revenue reached
Dh127bn (US$34.5bn) by the end of 2005—a 35% year on year
increase and an all-time high. Revenue will strengthen modestly in 2006 as oil prices
remain strong and production shows some pick-up, before trending downward
in 2007 as oil earnings ease. At Dh119.8bn, however, revenue in 2007 will still
be very strong by historical standards, standing at almost double the ten-year
appears to have accelerated sharply during 2005, not least as a result of the
government's recent decision to introduce large public-sector pay increases.
Together with other rises (particularly in capital expenditure), we expect total
spending to grow by an annual average of around 8% in 2006-07, although the
pace is likely to ease as the forecast period progresses.

Overall, we estimate that this resulted in an official budget surplus of Dh18.6bn
(4.3 of GDP) in 2005, compared with a reported shortfall of Dh855m (US$233m)
in 2004. The budget will generate a further, albeit smaller, surplus this year,
before registering a narrow deficit in 2007. The surpluses will be the first
the UAE has reported in more than 20 years, and compare with average reported
deficits of more than 10% of GDP over the previous decade. However, UAE
fiscal data substantially understate the real strength of the public finances, as a
significant portion of Abu Dhabi's oil earnings is not reported as recurrent
revenue but is instead paid directly into reserve accounts. The figures also
exclude the substantial income that the UAE generates from its large stock of
publicly owned foreign assets. These hefty earnings (estimated variously as
being worth an additional 8-12% of GDP), together with the surpluses
projected for the forecast period, will be added to state-controlled reserve
funds, estimated locally to be worth some US$225bn-275bn.
**Monetary policy**

Domestic interest rates will continue to track those of the US closely. We expect US rates to continue to rise for a further 6-9 months, before plateauing and eventually declining in the latter part of 2007. UAE interest rates will follow suit, although even at the peak of the current monetary cycle, average lending and deposit rates will remain below the highs seen in the late 1990s. Despite evidence of mounting inflationary pressures within the economy, there has been no indication that the Central Bank of the UAE is preparing to increase the narrow differential between local and US rates.

**Economic forecast**

### International assumptions summary

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<th>2005</th>
<th>2006</th>
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Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

We estimate that global growth (measured using purchasing power parity exchange rates) averaged around 4.4% in 2005—a performance that stands slightly above the long-term average, but that marks a deceleration on the 5% recorded in 2004. We expect global growth to ease further but remain relatively strong in 2006 and 2007, at around 4%. US interest rates will continue to rise over the coming 12 months before stabilising—an important consideration for the UAE, which is all but certain to retain the dirham’s peg to the US dollar.

The benchmark dated Brent Blend averaged close to US$56/barrel in 2005—an increase of almost 50% on the average for 2004, which was at that time a record high. The market is set to remain tight during 2006, with producers continuing to struggle to boost supply quickly enough to keep pace with demand. With most producers operating at close to their maximum, the market has little spare capacity, putting prices under sustained upward pressure. This will keep prices close to last year’s high, with the risks predominantly on the upside; any significant disruption (or even a serious threat of disruption) to existing supply is likely to lead to spikes that could push the average for the year sharply upwards. The market will begin to loosen in 2007 as supply growth outstrips increases in demand, and we expect the average price for the year to fall below US$50/b.
This remains an historically high price, however, equating to roughly double the ten-year (1995-2004) average. In such a price environment, we do not expect OPEC to enforce production quotas, allowing UAE output to trend upwards.

**Economic growth**

We expect the UAE economy to expand at an average annual rate of around 6% in real terms over the forecast period. Industrial growth will be the mainstay of the overall expansion, underpinned by continued—albeit modest—rises in oil production, as high prices allow OPEC to hold back from enforcing quota levels. Growth in non-oil industrial output will be a more important direct driver, however, as investment in manufacturing and heavier industrial projects (focused mainly on energy-intensive sectors such as petrochemicals and metals) brings new capacity on stream and the competitiveness of UAE exports is bolstered by the weakness of the dollar. Domestic and foreign investment in new projects is expected to remain strong, and capital spending on real estate and infrastructure schemes (including new roads and high-profile programmes such as the Dubai Metro and airport expansion) will also stay high. The services sector should also attract substantial investment. Recurrent demand for services is likely to pick up, led by the tourism industry, which has shown itself resilient to instability elsewhere in the region. Continued rapid growth in the population, fuelled largely by increases in the size of the expatriate workforce, will also underpin robust domestic demand, as will the recently announced public-sector pay increases, particularly as they are likely to push private-sector pay settlements upwards too.

**Inflation**

Inflation has picked up over the past year, as the surge in domestic demand has generated price pressures, particularly in real estate and some parts of the services sector. This has begun to drive up wage demands in the private sector—a trend that will be compounded by the large pay increases recently introduced for government workers. The near-term stabilisation of the dollar will take some of the heat out of rising prices for imported goods, but there will be no significant reverse, and retailers are unlikely to lower prices while domestic demand is so strong. Official data showed price growth averaging around 4.5% in 2004, and we estimate that it rose to about 6% in 2005. We expect it to fall—albeit only slightly—over the forecast period, largely on the back of easing housing pressures. There are significant concerns, however, that the official data may be indicative only of the price trends being experienced by the minority Emirati population, which continues to benefit from a range of subsidies on core goods and services. A more representative figure that reflected the experience of expatriates (who make up some 80% of the population) would be significantly higher, and could even be approaching double digits, particularly in Dubai.

**Exchange rates**

There is little prospect of a change in the exchange-rate regime, and we expect the dirham to remain pegged to the dollar at the current value of Dh3.67:US$1 over the forecast period. Confidence in the peg remains high, bolstered by the Central Bank's long track record of maintaining the dollar value of the dirham and its absolute commitment to holding the peg in place. The forecast strength of the UAE's foreign-exchange earnings makes it highly unlikely that there will be any pressure on the peg, particularly as the Central Bank will be careful to
ensure that local interest rates track US rates steadily upwards over the coming two years. The Central Bank also has access to a substantial foreign asset stock, which it would use in the unlikely event that the peg came under real strain.

External sector

We estimate that total export revenue reached US$102bn in 2005—an increase of around US$20bn on earnings generated in 2004—as record oil prices were compounded by increases in volumes. Non-oil exports and re-exports also showed growth. Revenue is expected to rise further this year as oil production picks up and non-oil revenue shows further gains, before easing in 2007, although, at over US$100bn, earnings that year will remain very strong by historical standards. Import spending has risen sharply in recent years, and is expected to show further marked gains as domestic demand expands. Nevertheless, the trade surplus will remain very large at an average of around US$41bn this year (little changed on the 2005 outturn), easing to around US$34bn in 2007. Non-merchandise inflows will strengthen as exports of services rise and returns on the UAE’s stock of overseas assets pick up. These inflows will be more than offset, however, by large payments driven upwards by the higher costs associated with rising import volumes and the economy’s continued reliance on foreign labour. Overall, we believe that this will leave the UAE with a current-account surplus of around US$22.8bn this year, down slightly on the estimated surplus of US$24.9bn generated in 2005, but still the equivalent of 19% of GDP. The surplus is forecast to narrow further in 2007, but will remain very large at US$15.5bn.

Forecast summary

(% unless otherwise indicated)

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a Actual  b Economist Intelligence Unit estimates. c Economist Intelligence Unit forecasts.