مصرف الإمارات العربية المتحدة المركزي

CENTRAL BANK OF THE U.A.E.

Quarterly Economic Review

Third Quarter 2015

Table of contents

Boxes

Figures

Tables

Executive Summary

The third quarter of 2015 was dominated by two distinct events: First, is the downgrade of economic growth expectations for China which sent stock markets in a downward spiral and secondly is the renewed postponement of interest rate lift-off in the U.S. The latter reminded investors how uncertain policy makers are about monetary 'normalization' and the implications on derailing the fragile growth trend. The third quarter underlined previous observations that the only economy which is growing decently is the US while the rest, including the emerging economies, are barely growing. At the same time, the threat of deflation was still omnipresent in the third quarter. Canada and Norway lowered their policy rates as both economies continue to be adversely impacted by the fall in oil prices. Also China and Russia lowered their policy rates to revive growth, while Brazil had to raise the policy rate in order to stem the inflationary pressures on account of continued devaluation of the Real.

This Quarterly Review of the Central Bank features our effort at the Research and Statistics Department to measure economic activity and produce the 'Economic Composite Indicator' (ECI) for the UAE. This quarterly constructed index capitalizes on available quarterly data, both globally and domestically, that impact on economic activity in the UAE. Specifically, the ECI combines an advanced econometric technique and draws on available economic activity variables such as CPI (consumer price indicator), PMI (purchasing manager index) and the fluctuation of oil prices. Using this index, we are able to track annual data for GDP growth historically which provides us confidence in the quality of the index to judge the pulse of economic activity and expected growth in 2015, based on the performance of the index over the last three quarters.

The economy of the UAE continues its resilient growth pace, driven by the non-oil sector activity that is expected to grow by 3.5% in 2015 according to the central bank of UAE forecasts. To attest to the resilience of the economy, the Purchasing Managers Index (PMI) reading hovered comfortably above the 50 mark throughout the quarter. The efforts to diversify away from oil revenues are bearing fruit and non-oil GDP growth is expected to solidify the growth momentum, albeit at a slower pace.

The third quarter of 2015 was characterized by a CPI inflation rate around 4.6% Notwithstanding slower growth and the appreciation of the dirham with respect to major trading partners, inflationary pressures reflected continued surge in non-tradables' price inflation, particularly those related to housing and transportation which surged in the third quarter on account of fuel price subsidy removal.
The downward trend in oil prices continues to leave its mark on the fiscal balance; expected to register a deficit despite some reforms to consolidate spending and diversify revenue sources.

Growth of banking deposits slowed down in the 3rd quarter of 2015 as low oil prices persisted, which slowed down the growth of the money supply. Banks however, capitalizing on improved quality of loan portfolio and available, albeit tightening, liquidity were able to increase credit although at a moderate pace, thereby providing the non-energy sectors of the economy with the needed financing. The report features more specific analysis on developments in the UAE banking industry, zeroing in on the specifics of the growth on the assets and liabilities sides of the sector.

The Central Bank balance sheet exhibited decline in liquidity in the banking system in 2015 Q3 as banks reached out to excess liquidity to accommodate the demand for credit. On the assets side of the central bank balance sheet, preference for more liquid assets is evident.

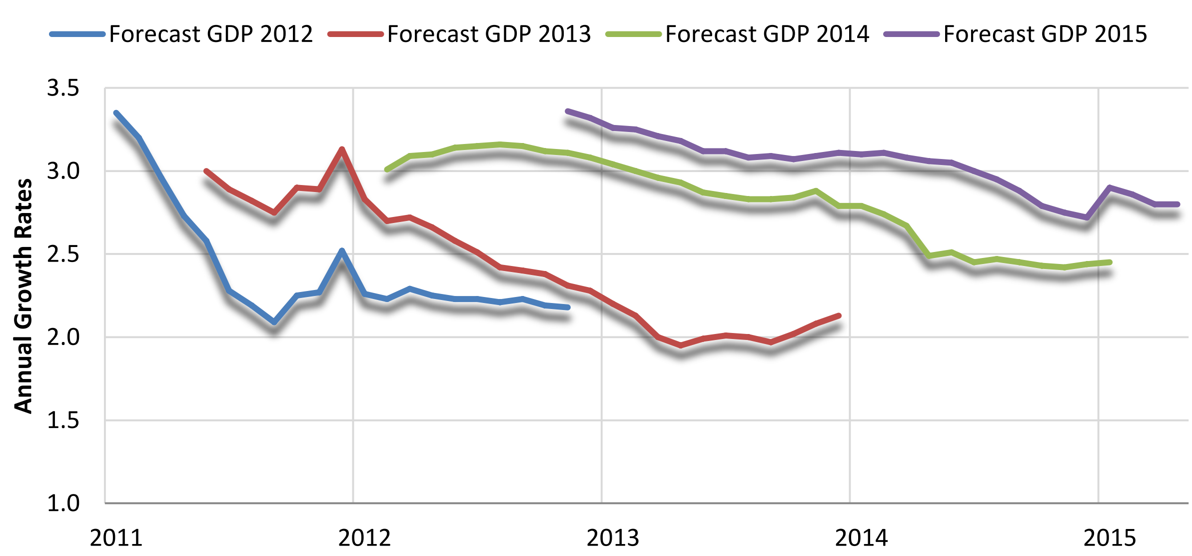
Chapter1. International Economic Developments

The third quarter was dominated by two distinct events: First, is the downgrade of economic growth expectations for China which sent stock markets in a downward spiral and secondly is the renewed postponement of interest rate lift-off in the U.S. The latter reminded investors how uncertain policy makers are about monetary 'normalization' and the implications on derailing the fragile growth trend. The third quarter underlined previous observations that the only economy which is growing decently is the US while the rest, including the emerging economies, are barely growing. At the same time, the threat of deflation was still omnipresent in the third quarter. Canada and Norway lowered their policy rates as both economies continue to be adversely impacted by the fall in oil prices. Also China and Russia lowered their policy rates to revive growth, while Brazil had to raise the policy rate in order to stem the inflationary pressures on account of continued devaluation of the Real.

1. Global Economy and Capital Markets

The consensus expectations for global GDP growth in 2015 were lowered during the course of the third quarter. Interestingly almost all GDP growth expectations have been revised downward in recent years. However, it is noteworthy that the 2015 forecasts appear to be among the highest if compared to the growth expectations of 2012 – 2014.

Figure 1.1.a
Global GDP Consensus Growth Forecasts



Source: Bloomberg.

One of the main features of the third quarter was the deceleration in the US growth figures (from 3.9% in the second quarter to 2.1% in the third quarter). The moderation was driven by almost all GDP components, starting from personal consumption to gross private investments and finally exports.

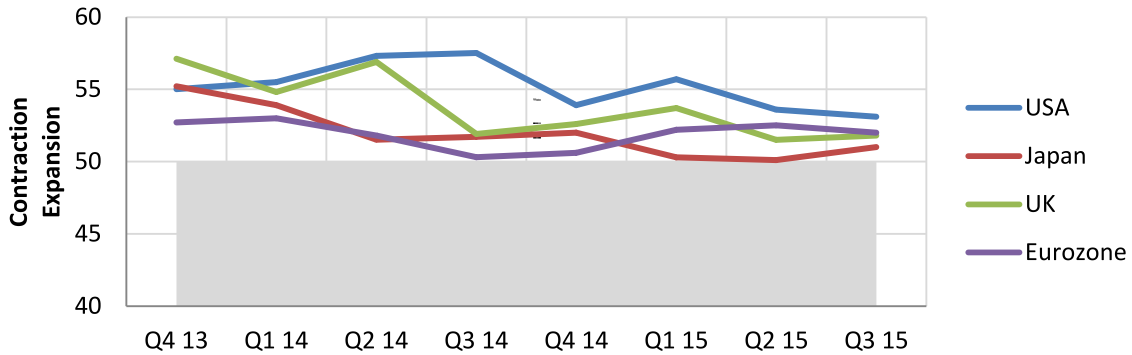
Table 1.1
Real GDP Growth Rates (%)

	Not Annualized quarterly 2015			Annualized quarterly			Yearly	
GDP Growth	**Q2**	**Q3**	**Q-o-Q Annualized**	**2015 Q2**	**2015 Q3**	**Y-o-Y**	**Q2**	**Q3**
Advanced Economies			**Advanced Economies**			**Advanced Economies**		
USA	1.0	0.5	**USA**	3.9	2.1	**USA**	2.7	2.2
Japan	-0.2	-0.2	**Japan**	-0.7	-0.8	**Japan**	1.0	1.0
United Kingdom	0.7	0.5	**United Kingdom**	2.8	0.5	**United Kingdom**	2.4	2.3
Euro Area	0.4	0.3	**Euro Area**	1.4	1.2	**Euro Area**	1.5	1.6
Germany	0.4	0.3	Germany	1.8	1.3	Germany	1.6	1.7
France	0.0	0.3	France	0.0	0.3	France	1.1	1.2
Italy	0.3	0.2	Italy	1.2	0.2	Italy	0.7	0.9
Developing Economies			**Developing Economies**			**Developing Economies**		
Brazil	-1.9	-	**Brazil**	-7.2	-	**Brazil**	-2.6	-
Russia	-2.0	-	**Russia**	-8.0	-	**Russia**	-4.6	-4.1
China	1.8	1.8	**China**	7.4	7.4	**China**	7.0	6.9

Source: Bloomberg.

Over recent quarters all of the (Purchasing Managers Indices) PMIs were in a positive territory, above 50 in consistency with expansion, and the changes in the third quarter vis-à-vis the second quarter were marginal (see chart). In the third quarter, the Eurozone did not benefit from a rapid devaluation of the Euro like in the first and the second quarters, where a potential US policy rate hikes have been discounted by the foreign exchange markets.

Figure 1.1.b
Purchasing Managers Indices (PMI) in Developed Economies



Source: Bloomberg

However, the third quarter was a bad quarter for equity investors. The MSCI World lost more than 7% in the three months to September, while the Japan stock market had a loss of 14% (see below). The reasons put forward were a growth scare emanating from China, a slowdown in EPS (earnings per share)–combined with expensive valuations - and the prospect of regime change by the US Federal Reserve.

Unemployment provided a mixed picture in the third quarter, with the US recording a further reduction, Japan a slight deterioration while the Eurozone witnessed a marginal improvement, with Germany and Italy seeing improved figures, while France witnessing a small deterioration.

Brazil saw its number of unemployed swell in the 3rd quarter, while Russia improved its numbers from 5.4% yoy rate to 5.2%. Also China saw a small deterioration in its unemployment statistics.

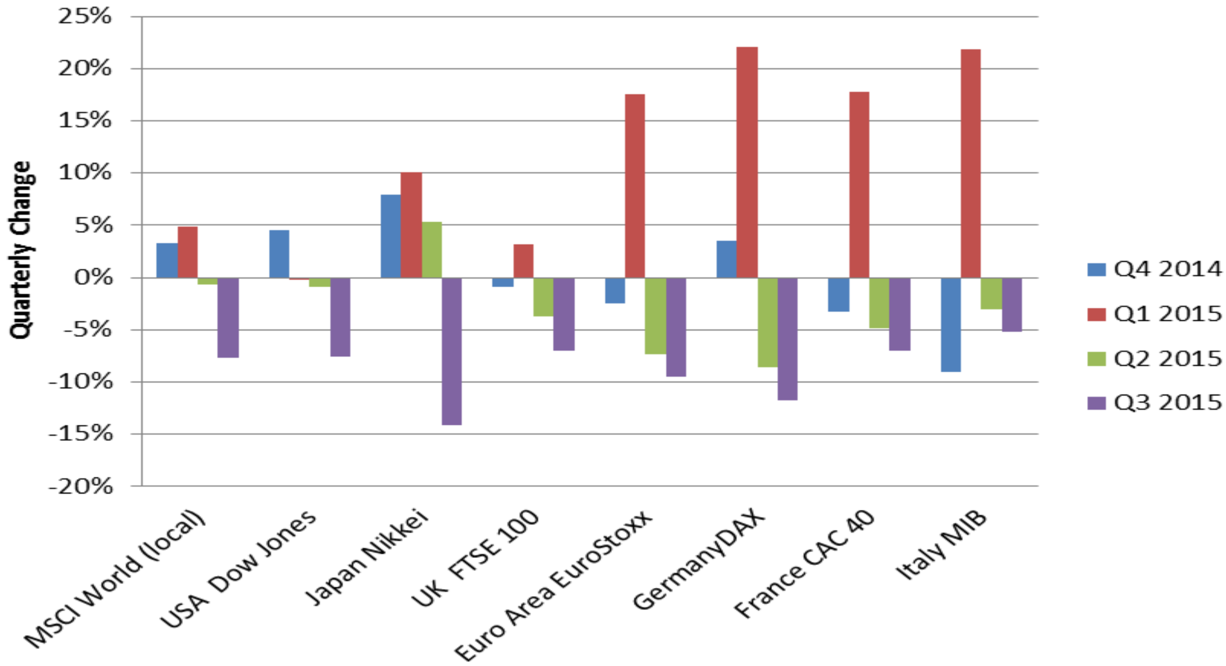
Table 1.2
Unemployment Rates in Advanced and Developing Countries (%)

	2015	
Advanced Economies	**Q2**	**Q3**
USA	5.3	5.1
Japan	3.3	3.4
United Kingdom	5.5	-
Euro Area	11.0	10.8
Germany	4.6	4.5
France	10.5	10.7
Italy	12.5	11.8
Developing Economies		
Brazil	6.9	7.6
Russia	5.4	5.2
China	4.0	4.1

Source: Bloomberg.

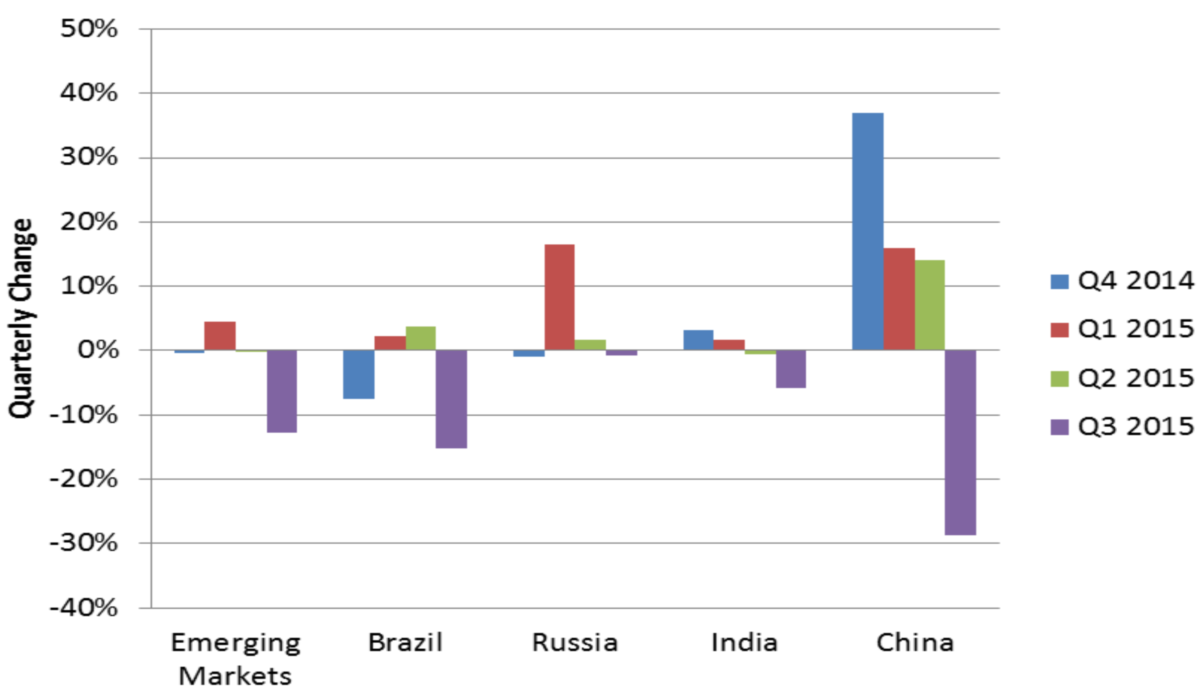
Figure 1.1.c

Quarterly Stock Market Index Changes in Developed Economies



Source: Bloomberg.

Figure 1.1.d
Quarterly Stock Market Index Changes in BRIC Countries

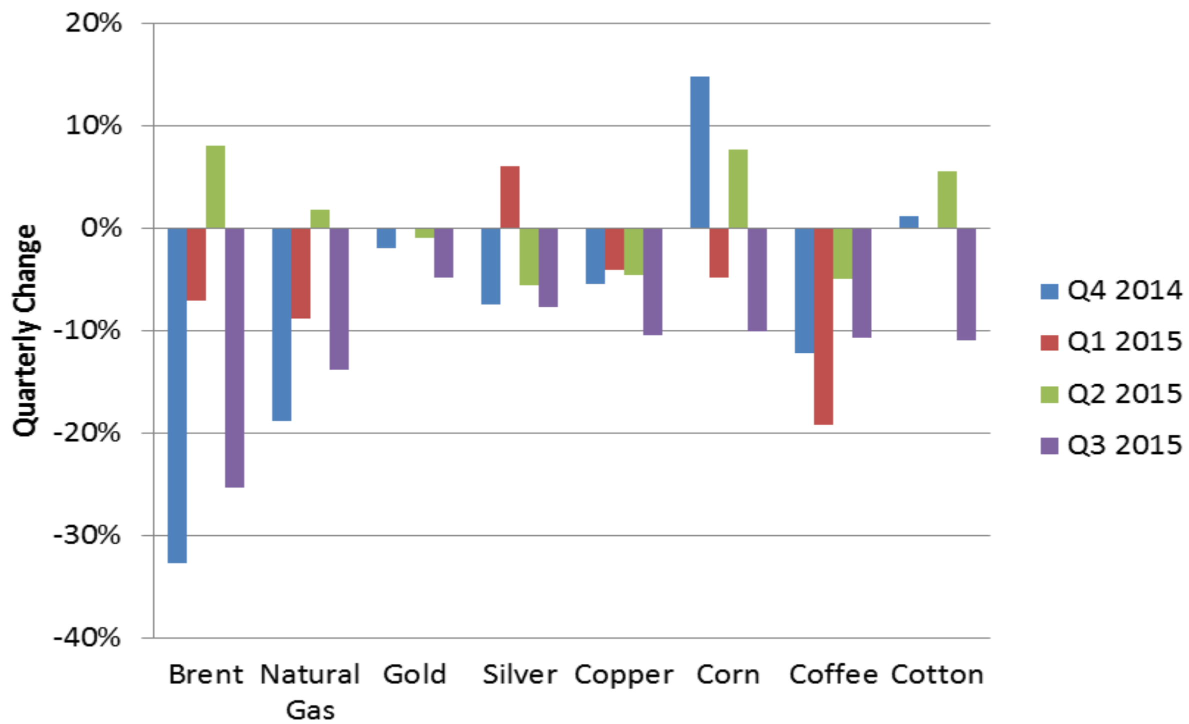


Source: Bloomberg.

The losses equity investors had to endure during the third quarter in the developing part of the world were even worse. The MSCI emerging market index lost 13% while investors in the Chinese stock market saw their investments decline by almost 30%. Russia lost only 1% during this time period, probably because it was already hammered in the months before and prospects improved on account of a short period of an increase in the oil price.

The commodity bloc also suffered during the 3rd quarter with Brent falling by over 25%. Gold suffered the smallest loss (-5%) followed by silver. The losses in the commodity space are a reflection of the growth concerns of the Chinese economy, as China acted for many commodity producers as a source of demand (see box 1).

Figure 1.1.e
Selected Commodity Price Levels Changes (Futures based)



Source: Bloomberg.

Box1. Fluctuations in commodities prices in Q3 2015

In the past month the commodity markets have shown mixed trends. Brent crude oil prices briefly pushed back above $50pb in early October and most of the metal markets rallied, with double-digit gains for palladium and silver. Steel prices have remained very weak though as excess capacity continues to overhang the industry and producer discipline is notably absent.

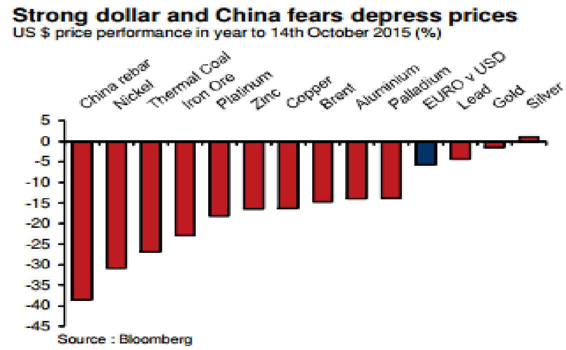
Positive drivers for the complex included a weaker US$ (helped by a view that interest rate hikes in the US will be delayed) and a modest improvement in industrial demand conditions in China. Vehicle sales, for example, picked up by 2% y/y in September after a soft patch in July and August. Moreover, some markets are clearly outperforming, helped by strong demand.

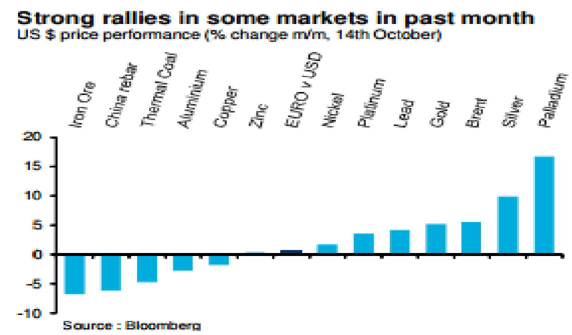
In the oil market, for example, downstream demand in China has been surprisingly robust into August. Low prices have helped to stimulate demand and consumer sectors like jet fuel and gasoline are expanding rapidly and outperforming industrial markets like diesel. Crude throughput at refineries in China grew 6% in the year to August, suggesting that demand in the country is set to outperform bearish expectations. Product inventories and exports are high though, so this warns of some downside risks to this rapid growth rate in the year ahead.

Oil supply remains very strong despite low prices. While US producers are cutting, this is being offset by increases within OPEC. The oversupply in oil is expected to persist for the time being, despite bloated inventory levels in both crude oil and products.

In the steel market, conditions remain extremely tough, with prices tumbling once more in China and the US in the past month. Mills in China show very little sign of cutting in response to low prices and negative margins, and crude steel production was actually slowly picking up momentum in September helped by very strong export levels. But this looks unsustainable and rising trade barriers will force production and demand to resynchronize soon.

Base metal markets are being buoyed by producer cutbacks, with zinc prices jumping this month in response to significant cutbacks by Glencore impacting on mines in Australia, Peru and Kazakhstan. In the major markets of aluminum and copper, demand continues to rise, although prices are trending broadly sideways due to fears about China. We continue to believe that negative sentiment in copper and many base metals is overdone and risks are to the upside on a one-year view.



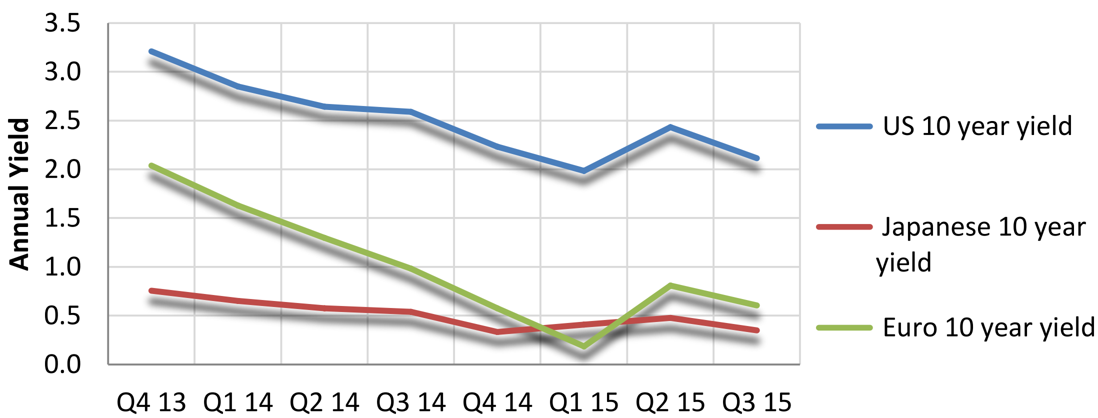


The exchange rate regime, cyclicality of fiscal policy, and depth of financial markets have a bearing on the difference in growth between upswings and downswings. Countries with fixed exchange rates tend to experience stronger variation in growth relative to countries with flexible exchange rates. This is consistent with the notion that a more flexible exchange rate tends to act as a shock absorber and cushion the domestic effects of terms-of-trade shocks. Likewise, the difference in the growth rate of output between upswings and downswings is larger in countries with more pro-cyclical fiscal spending. Countries with a lower level of credit to the private sector (relative to GDP) also exhibit stronger variation in growth. The growth slowdown in these countries is sharper during downswings, probably because they experience a greater tightening of borrowing constraints when commodity prices decline than do countries with greater financial depth.

This suggests that fluctuations in international commodity prices, through their impact on domestic spending, can lead to sizable output fluctuations in commodity exporters. In exporters of energy and metals, the co-movement between output and the commodity terms of trade tends to be particularly strong. It is also stronger in countries with lower levels of financial development, more pro-cyclical fiscal policies, and less flexible exchange rates, which is the case of many of the emerging commodity net exporters.

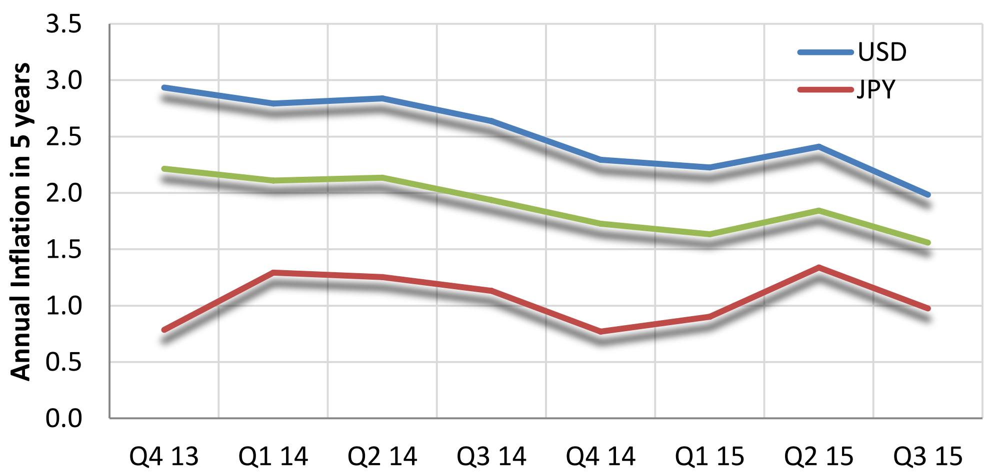
As a consequence of the 'growth scare' in the third quarter, 10–year government bonds yields declined across the board with Japan reaching a yield of just 35bp (see below). Meanwhile, the 5-year inflation expectations-- measured by the 5-year inflation swap rates in the various currencies-- fell in the third quarter of 2015 in the U.S., Japan and the Euro Area (see Figure 1.2.b). This implies that, inflation expectations are now far from inflation targets of Western Central Banks, oscillating around 2% targets. Against this backdrop, monetary policy is expected to stay accommodative for a while, if low inflation rates are seen as a sign of weak aggregate demand.

Figure 1.1.f
10-year Government Bond Yields (%)



Source: Bloomberg.

Figure 1.1.g
5-year Inflation Swap Rates (%)



Source: Bloomberg.

While inflation expectations have been constantly declining in recent years, the current inflation picture is almost deflationary in the developed world, in contrast to the developing world with the exception of China.

The table below on consumer prices shows the marked difference between the developed and the developing world, whereas the developed world is struggling with near zero inflation rates, the developing world sees higher single to double-digit inflation rates. In Brazil and in Russia the devaluation of their currencies since the beginning of the year was the driving force of this development.

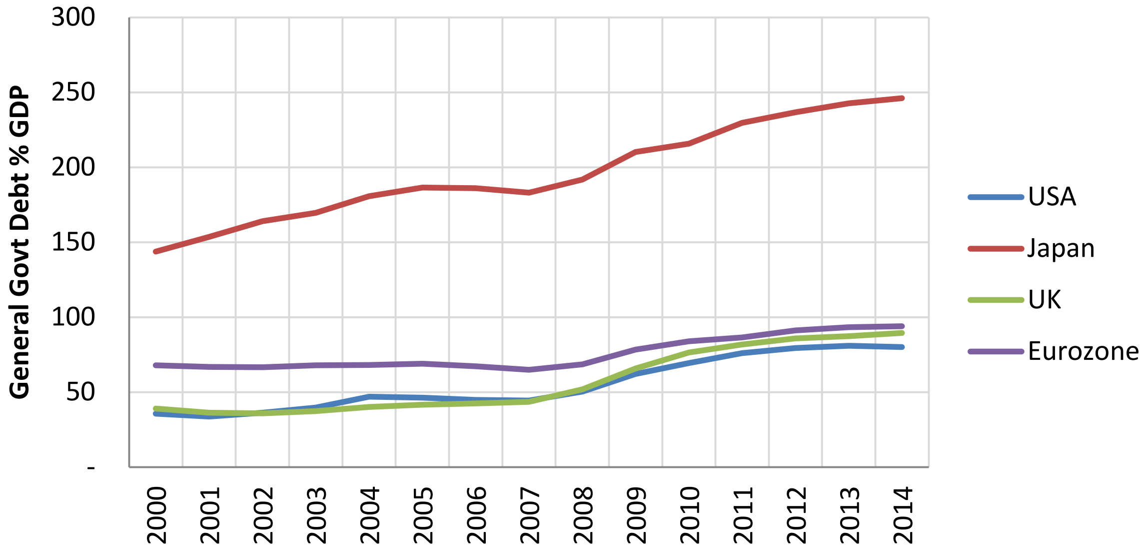
Table 1.3
Year-on-Year Consumer Price Change (%)

	2015	
Advanced Economies	**Q2**	**Q3**
USA	0.1	0.0
Japan	0.4	0.0
United Kingdom	0.0	-0.1
Euro Area	0.2	-0.1
Germany	0.1	-0.2
France	0.3	0.0
Italy	0.2	0.2
Developing Economies		
Brazil	8.9	9.5
Russia	15.3	15.7
India	5.4	4.4
China	1.4	1.6

Source: Bloomberg.

At present, the monetary authorities in the developed world are struggling with 'liquidity trap', where further lowering of interest rates, if there is any space, would have little impact on economic activity as the response of private demand is likely to be very weak. The textbook answer (Keynesian) is higher fiscal expenditures. However this road is blocked in most countries as the level of government debt to GDP has risen fast since the financial crisis in 2008 (see below).

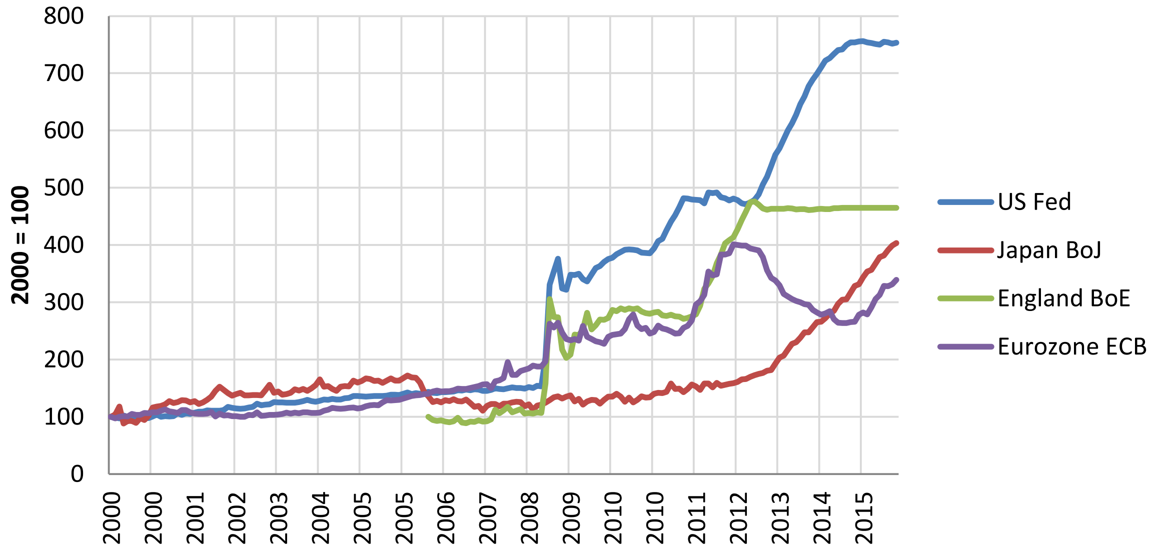
Figure 1.1.h
General Government Debt to GDP Development



Source: Bloomberg. IMF

For this reason, policy makers have used extraordinary measures such as quantitative easing to kick-start their economies and some analysts have called for another round of quantitative easing by major central banks. The earlier rounds of quantitative easing have left many central bank balance sheets expanding in an unprecedented fashion. It can be observed that the Bank of England (BoE) stopped their QE program already in 2013, while the ECB re-started its asset buying program beginning of 2015 that could be extended beyond 2016, and in Japan the program is likely to continue for a while, in light of weak economic growth data.

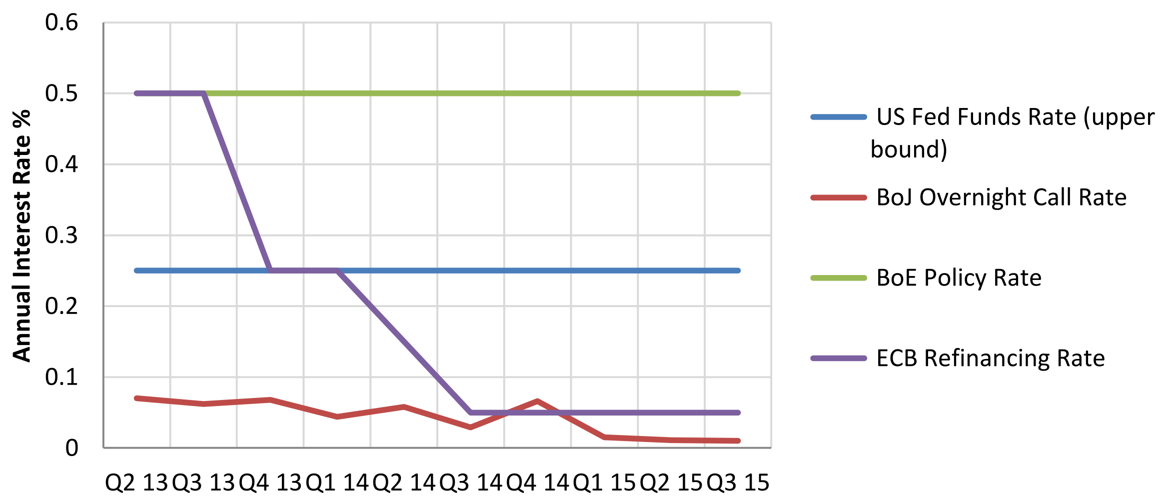
Figure 1.1.i
Total Assets of Central Banks (2000 = 100)



Source: Bloomberg

The third quarter of 2015 saw no changes in terms of monetary policy rates in the developed world. The four main central banks left their policy rates unchanged with the exception of Japan, where the BoJ (Bank of Japan) has shifted its monetary policy focus since March 2013 to a targeted monetary base via Japanese Government Bond (JGB) purchases, resulting in progressive decline in the policy rate.

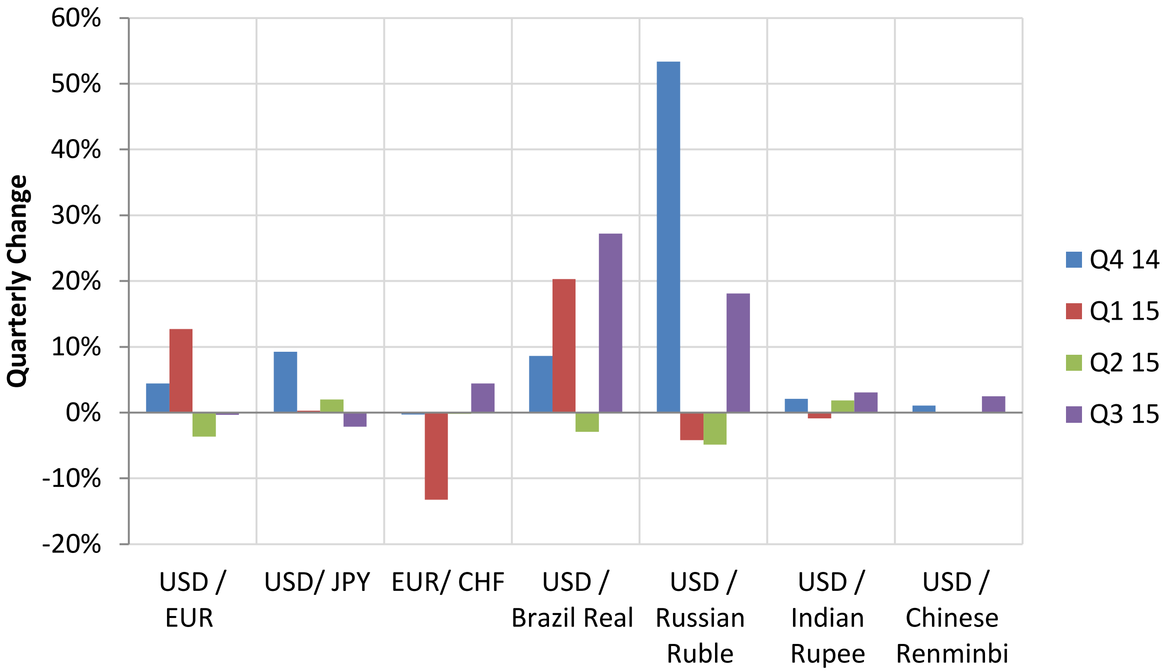
Figure 1.1.j
Policy Rates (%)



Source: Bloomberg.

One of the highlights of the third quarter in terms of Foreign exchange markets was the decision of the Chinese central bank to let the Renminbi depreciate against the USD beginning of August. This move amounted to further appreciation of the bilateral exchange rate of the US dollar, with adverse consequence on US growth through weaker exports, cheaper imports, suppression of overseas profits and a sharp increase in domestic labor costs in non-dollar terms. In general, the appreciation of the USD against its major trading partners have countered plans by US policy makers to raise the interest rate on account of further concerns about growth prospects. However in terms of quarterly change the weakening of the Brazilian Real and the Russian Ruble stand out. The Real and the Ruble suffered from continued commodity price weaknesses but also from rising inflation such as in Brazil (see below).

Figure 1.1.k
Exchange Rates in selected developed and emerging countries (USD per units of currency)



Source: Bloomberg.

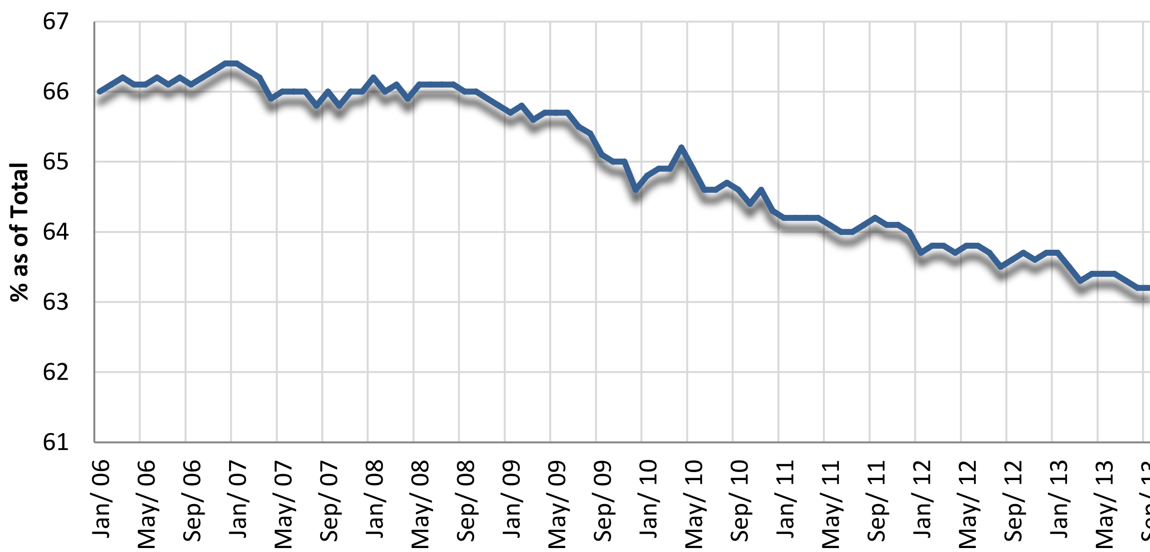
2. United States

The US economy saw its revised quarterly growth rate decelerating in the third quarter to 2.1% annualized quarterly compared to the second quarter (which was also repeatedly upgraded before it has reached the final 3.9%). The main reason for the upgrade in the third quarter figures was the revision of inventories. Measured in terms of contribution to GDP growth, the change in inventories contributed before the revision minus 144bp which was reduced to a drag of only 59bp. Consumer spending slowed in in the third quarter (3% vs. 3.6% previously). Government consumption slowed to 1.7% after having grown by 2.6% in the second quarter. Gross private investment recorded a small decline of 0.3% following a growth rate at 5% in the second quarter. Non-residential investment was almost halved to 2.4%, after having risen by 4.1% in the second quarter. Exports which grew in the second quarter at a brisk 5.1% slowed to 0.9% annualized quarterly growth in the third quarter.

All in all the upward revision of the third quarter has to be taken with a grain of salt as it is mainly due to inventory correction, which could weigh negatively on growth in the subsequent quarters.

Nonetheless, the third quarter saw a further improvement in the US unemployment rate which fell to 5.1%. The improved evidence did not encourage the US Fed to start lifting interest rates in its September meeting. This reluctance can be explained by at least two closely observed indicators: the labor participation rate and the development of hourly earnings which has steadily declined over the last 10 years, raising concerns about the health of the labor market. Further, the statement of the monetary policy meeting in the US reflected for the first time concerns about global growth.

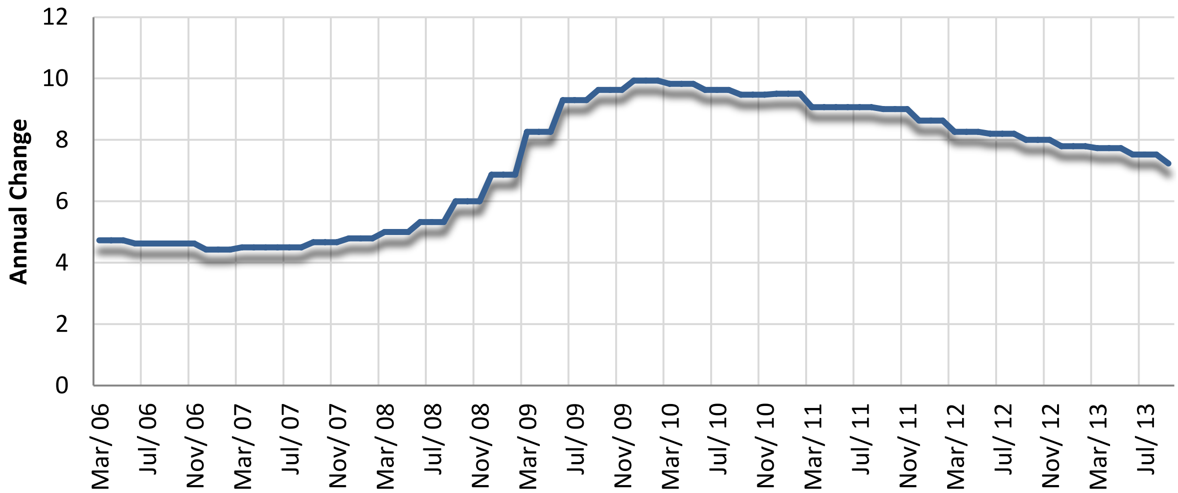
Figure 1.2.a
US Labor Participation Rate



Source: Bloomberg.

In a similar vein, US hourly earnings fell steadily in the last couple of years, reaching most recently 5% annual change, a development which is certainly not in line with the notion of an expanding economy with increased demand for labor skills.

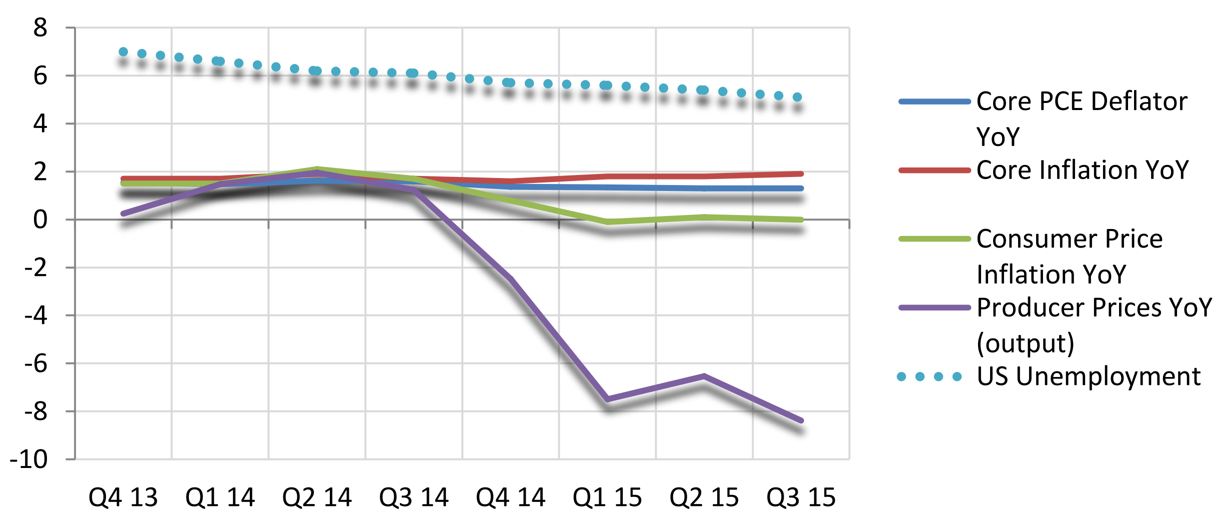
Figure 1.2.b
US Hourly Earnings Development



Source: Bloomberg.

The final component of the decision making process of the US Federal Reserve is the development of consumer prices in the US. The Fed prefers core indicators – excluding more erratic items such as food and energy – such as the core deflator for PCE (private consumption expenditures).

Figure 1.2.c
Various Inflation Indicators and the unemployment rate in the US (%)



Source: Bloomberg.

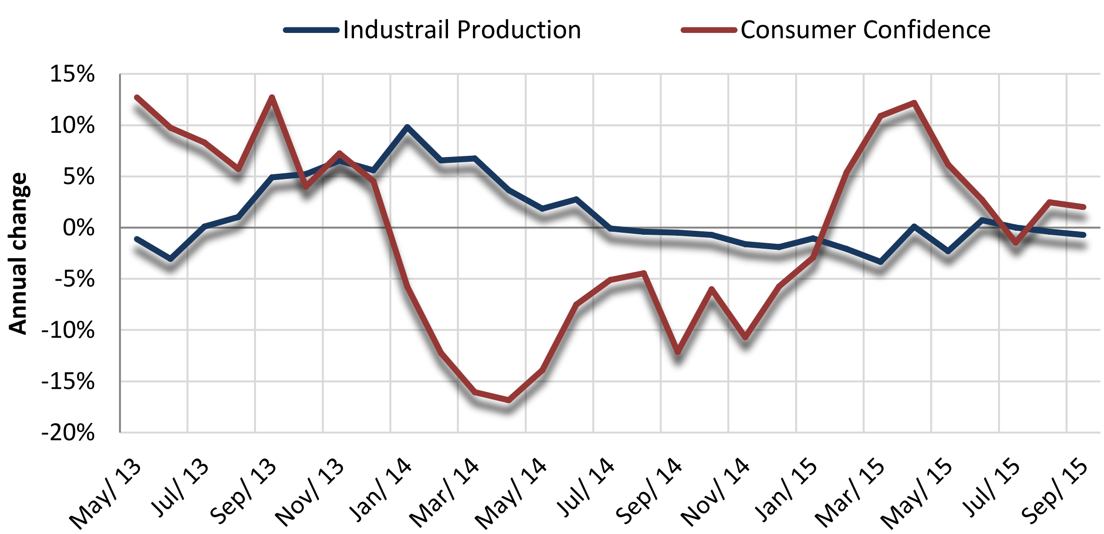
The third quarter did not witness any large changes neither for core inflation numbers nor in general consumer prices. Notable exception has been producer prices, whose fall coincided with the fall in commodity prices and dollar appreciation (see above).

3. Japan

Japan's 3rd quarter GDP shrank by a quarterly 0.8% seasonally adjusted annualized basis, which means that the Japanese economy has fallen into a technical recession. At the same time the second-quarter growth figure was revised upward to -0.7% from a -1.2%. A large part of the third quarter drop was caused by lower inventories which bode well for future economic activity. The drop in private inventories was caused by a recovery in consumption. Additionally weakness in Asian demand weighed on non-residential private investment, the statement of the Japanese Cabinet Office said.

Industrial production shrank by 0.7% on an annual basis at the end of the third quarter. At the same time consumer confidence grew by an annual 2% in September, in line with the positive contribution private consumption had on GDP growth in the third quarter. (see below). However the annual growth figures disguise the fact that the Japanese household consumer sentiment is in 'pessimistic territory' since years. Some relief comes from the external sector where exports have grown by 0.5% annually in September 2015 on account of further depreciation of the yen. The slowdown in exports is in line with the contribution of 0.1% to the 3rd quarter GDP figure, an improvement from the minus 0.2% drag in the 2nd quarter. The slowdown in Asia is still the main obstacle to a recovery in overseas sales, which may lead the BoJ to seek a devaluation of the Yen.

Figure 1.3
Japan Industrial Production and Consumer Confidence (y-o-y change)



Source: Bloomberg.

The Japanese labor market registered an unemployment rate of 3.4% by the end of the third quarter, whereas the job to applicant ratio increased in the 3rd quarter to 1.23 (1.19 end of second quarter). However, the relatively low unemployment rate disguises weak growth as it has been declining on account of shortage in supply of labor due to shrinking labor force.

4. Eurozone

Euro-area GDP grew in the third quarter at a slightly slower pace than in the second (0.3% versus 0.4%). Germany, France and Italy saw an expansion, especially France (0.3%) which has seen no quarterly growth in the second quarter. Germany's growth fell slightly to 0.3% responding to lower export demand from its Chinese trading partner. Even if growth is holding up, Eurozone's output remains below pre-crisis levels, in contrast to the U.S. and the U.K.

Based on the preliminary figures, it seemed that household consumption was one of the driving forces of the expansion, rising in all major economies over the period. This observation is in line with the idea that low inflation is boosting real earnings thereby lifting domestic consumption. Investment spending - already at anemic levels - remained in most economies stable in the third quarter.

One of the highlights of the third quarter was the continued strength in credit supply as the accommodative monetary policy stance from the European Central Bank is slowly but surely feeding through to the real economy. Total loans to households rose by 2.5% in September from a year earlier, slightly down from 2.6% in August. Lending to non-financial corporations rose just by 0.1% vis-à-vis a year earlier, after contracting for over 2 years. The ECB was traditionally very concerned that the transmission mechanism between interest rate policy and bank lending has been clogged.

Consumer confidence remains high in the Eurozone in the third quarter despite falling slightly from the second. Lower oil prices, rising real earnings and improving labor-market conditions are all factors supporting the mood among consumers. Their spending should continue to drive the region's recovery at least through the end of this year.

The unemployment rate in the Euro area stood at 10.8% at the end of September, representing a small improvement from the second quarter figure of 11%. This figure masks big difference as countries like Spain and Greece registered unemployment rates above 20% and Germany below 5% (Eurostat data).

As a reaction to the negative headline inflation reading of -0.1%, ECB President Mario Draghi warned that "we may see negative numbers of inflation in the coming months" and questioned whether that should be defined as deflation. "The Governing Council tends to think that these are transitory effects, mostly due to oil price effects," he said. One of the main drivers for the negative inflation development has been the decline in transport prices which is by definition very sensitive to fuel price developments. Core inflation – excluding erratic items such as food and energy prices – edged up by 0.9% in September. The situation in the Eurozone exemplifies the problem of consumer prices as a yardstick of economic strength, as supply-side induced deflation is difficult to separate from deflation which is caused by overcapacity.

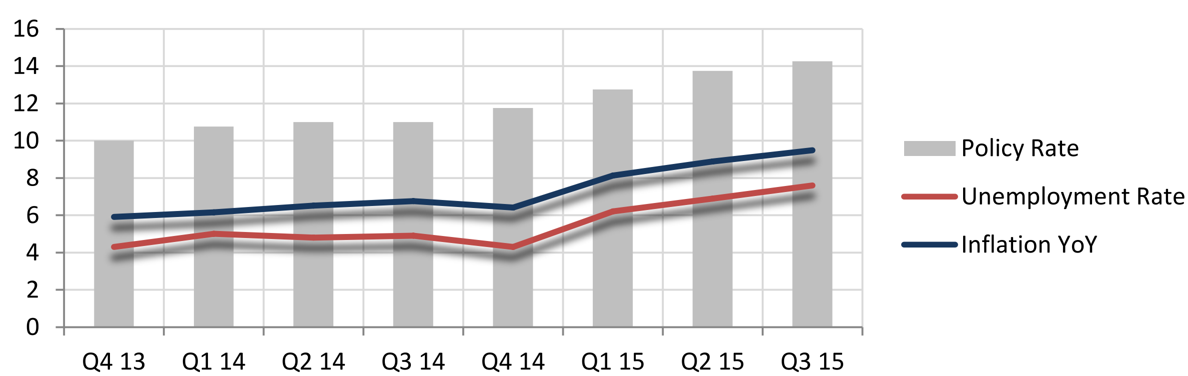
5. BRIC (Brazil, Russia, India & China) Economies

In the third quarter, the Brazil's central bank has increased its policy rate to a nine-year high in order to combat above-target inflation which has been accelerating on account of currency depreciation. The monthly economic activity indicator shrank in August more than forecast. The seasonally adjusted index, a proxy for gross domestic product, fell 0.76% in August from the prior month (-4.5% yoy).

Brazil's economic outlook has worsened as a political crisis drags on and the country has suffered consecutive credit rating downgrades that threaten investments. Fitch Ratings downgraded Brazil's sovereign credit rating to one level above junk at the beginning of October with a negative outlook. That is the second downgrade in little over a month as Standard & Poor's has already downgraded Brazil below investment grade beginning of September. The negative outlook "reflects Fitch's view that economic and fiscal underperformance is likely to persist while political uncertainty could continue weighing on broader confidence, delaying a turnaround in investment and growth and increasing risks for the medium term fiscal consolidation needed for debt stabilization."

Economists surveyed see Brazil's GDP dropping almost 3% this year and 1.2% in 2016. They also forecast inflation of 9.7% this year and 6% in 2016, deviating from the government's target of 4.5%. Unemployment has crept up continuously and stands now at 7.6% which is 2.7% higher than a year ago. As a result of a depreciating currency (see above) and rising inflation, the Central Bank of Brazil decided at end of July to increase the Selic rate by 50bp (see below).

Figure 1.5.a
Policy Inflation and Unemployment Rates in Brazil (%)

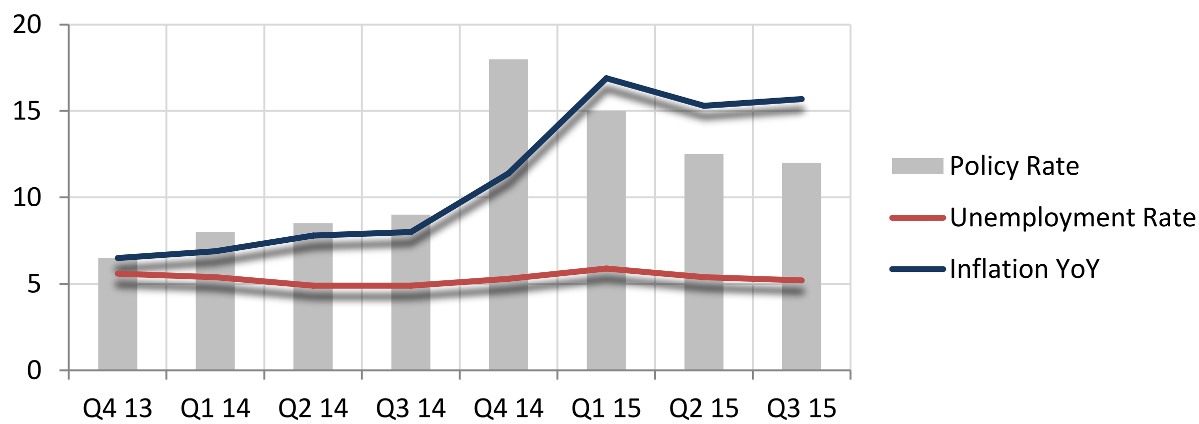


Source: Bloomberg.

Russian wages have been falling for 10 consecutive months with the last reading of a 10% annual decline in August. A similar grim picture emanates from Russia's retail sales statistics, indicating that retail sales fell by 9.1% in August. Since the beginning of the year retail sales volumes have already fallen by more than 25%. As a consequence, the unemployment rate stands now at 5.3%, representing a slight fall from the 5.9% registered at the end of the first quarter of 2015.

In the meantime, inflation has stabilized in recent months at a level of 15.7% annually. A fresh bout of ruble weakness forced the central bank to hold off on further policy easing. Compared to the end of the second quarter, policy rates have been reduced by 25bp in the third quarter (see below). With international sanctions and low oil prices roiling the economy, Standard & Poor's forecasts a continuing economic contraction as it predicts private consumption will remain weak in 2016.

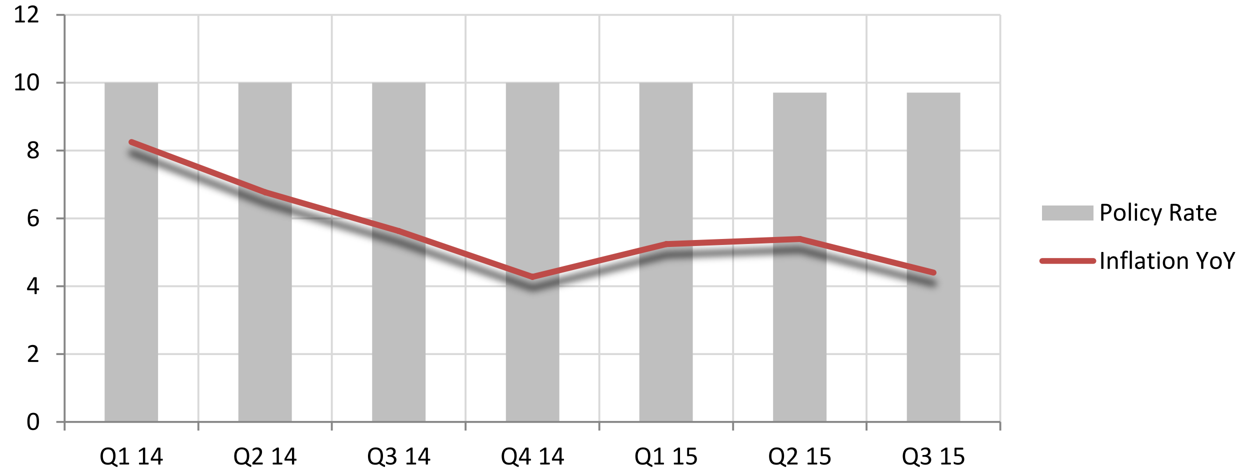
Figure 1.5.b
Policy, Unemployment & Inflation Rates in Russia (%)



Source: Bloomberg.

India's inflation decelerated in September to 4.41% year on year from a level of 5.4% in June. However, this quarterly perspective hides the fact that in July and August Indian inflation reached levels below 4%. The Reserve Bank of India (RBI) stated that the monthly increase was due to the start of a fading "large" favorable year-over-year comparison for food prices. By and large India's inflation is on a clear downward trend which certainly benefitted from a lower import bill for gasoline recently (see below). The RBI expects inflation to meet its interim target of 6%. The relatively benign inflation picture along with a strong 6.4% annual increase in August industrial production are providing the central bank room to continue to lower policy rates. Industrial production growth was driven by strong manufacturing of consumer durables, which rose 17% year on year. Capital goods rose 21.8% year on year following a decline of 2.1% in June.

Figure 1.5.c
Policy and Inflation Rates in India (%)



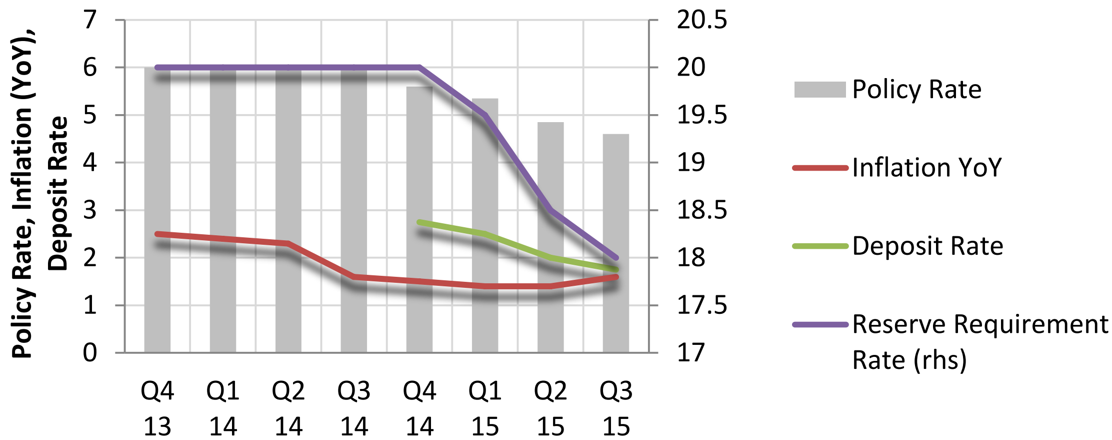
Source: Bloomberg.

China's economy slowed less than expected in the third quarter as a resilient service sector shrugged off the stock market crash and offset continued weakness in industry. During the third quarter, the monetary authorities lowered the policy rate to 4.6% from 4.85% in the second quarter of 2015 as a response to a weakening growth outlook. The 6.9% yoy GDP growth was propelled by credit expansion which is laying a foundation for short-term stabilization in growth. With a CPI inflation of 1.6%, the chances for further monetary easing are still intact. The 6.9% increase is the slowest rate of growth since the financial crisis. On a quarter-on-quarter annualized basis, the Chinese economy expanded by 7.4%, unchanged from the second quarter.

Looking at the various components of GDP growth, industrial output growth slowed to 5.8% year on year, down from 6% in the second quarter. Growth in the category: services accelerated to 8.6%, up from 8.5% in the second quarter. As a response to the economic weakness, the Bank of China decided to reduce its benchmark loan rate by 25bp to 4.6%. It also reduced its benchmark deposit rate to 1.75% (see below). The reserve requirement ratio has been reduced by 0.5%, a move that is expected to release about CNY 650bn in liquidity.

China has to cope with a fall in industrial production which slumped to 5.7% year on year from 6.8% growth rate in June driven by weak demand in the real estate and export sectors. Unemployment which is published quarterly has 4% as its latest reading (end of June 2015) and is therefore unreliable to assess the health of the Chinese economy more recently.

Figure 1.5.d
Policy, Deposit, Inflation and Reserve Requirement Rates in China (%)



Source: Bloomberg.

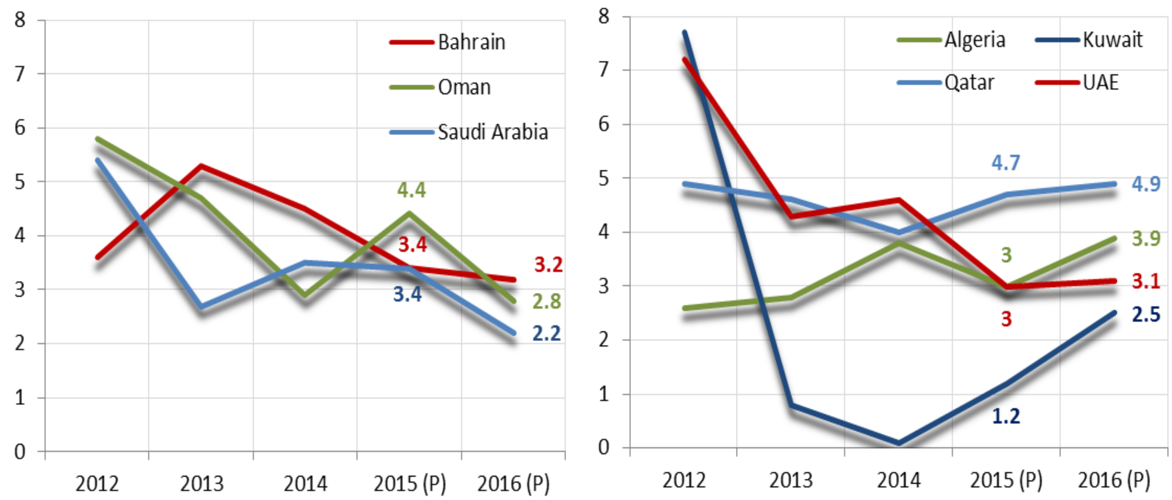
6. MENA Economies

The short-term outlook for the Middle East and North Africa (MENA) region is mainly driven by geopolitical and oil price developments. Regional political risks arising from the conflicts in Iraq, Libya, Syria and Yemen are impacting heavily the confidence. Low oil prices are also influencing economic activity in the oil-exporting countries. On the other hand oil importers are benefiting from lower oil prices as well as economic reforms and improved euro area growth. Overall, according to the IMF revised projections, the MENA growth this year will continue to be modest at 2.3%. Economic activity is projected to pick up to 3.8% next year, supported by improved prospects for Iran, some recovery in oil production and exports, and expected easing of regional conflicts. However, there is uncertainty about next year's projections. More positive economic prospects for the long-term will require extensive structural reforms.

6.1 Oil-exporting countries

Growth in the GCC region is slowing as countries have initiated fiscal consolidation, while conflicts weigh on the prospects of other MENA oil exporters. GCC growth is expected to slow to 3.25% this year and further to 2.75% next year from 3.5% (see figure 6.1). Lower oil prices are reducing non-oil growth directly and indirectly, through fiscal adjustment or its expectations. However this is partly compensated by higher oil production, especially in Saudi Arabia. The conflict in Yemen and the slowdown in Iran, which is yet to benefit fully from the recent breakthrough in the "Iran deal", are projected to reduce the growth of non-GCC oil exporters. The assumed improvements of conflicts in the region, combined with the moderation of sanctions on Iran to come, could boost non-GCC growth to about 5% in 2016.

Figure 1.6.a
Real GDP Growth for Oil-exporting countries



Source: IMF, Regional Economic Outlook-October 2015 and CBUAE analysis.

Regarding oil, downside risks to global growth have increased, in part because of the possibility of a larger slowdown in China and other emerging markets in the context of higher financial market volatility, while from the supply side, oil production prospects in North America, and even more so, in Iran, remain uncertain. If conflicts prove more persistent than expected, they would reduce growth in the affected countries, with adverse spillovers to the region and beyond. On the upside, post-sanctions Iran could see higher growth if policymakers initiate complementary reforms. Risks to financial sectors in MENA oil exporters have increased as lower oil prices are slowing deposit and, in some cases, credit growth. The banking systems are generally well positioned to withstand these pressures, although pockets of weakness exist.

Inflation in most of the oil-exporting countries of the region is moderating, with decelerating food price growth and the appreciating U.S. dollar, to which many countries effectively tie their currencies. In the GCC region, inflation is expected to ease slightly from 2.6% in 2014 to 2.4% in 2015. In Iran, tighter monetary and fiscal policy helped to keep inflation steady at about 15%, after it reached an alarming 35% in 2013. Inflation accelerated in Algeria and especially in Yemen, driven by the large depreciation of the Algerian dinar vis-à-vis the dollar and by the conflict in Yemen. On average, the real effective exchange rates appreciated by 4% in GCC countries, and remained broadly stable in non-GCC oil exporters during the first half of 2015.

Table 1.6.a
Inflation in the Oil-Exporting countries (%)

	2014	2015 (projections)	2016 (projections)
Oil Exporters in MENA	**5.8**	**6.0**	**5.1**
Saudi Arabia	2.7	2.1	2.3
Bahrain	2.7	2.0	2.1
Kuwait	2.9	3.3	3.3
Oman	1.0	0.4	2.0
Qatar	3.0	1.6	2.3
UAE	2.3	3.7	3.0

Source: IMF, Regional Economic Outlook-October 2015 and CBUAE analysis.

In line with the low prices, diminishing government expenditure and more pessimistic investment environment, the performance of the GCC stock market has declined in the third quarter of 2015. The worst performer on a year-on-year basis is the Saudi stock market with a decrease of 32%.

Table 1.6.b
Stock Market Share Prices change for GCC countries (%)

	2015		Year-to-Sept 2015	2015Q3 Y-o-Y
	Q2	Q3		
Saudi Arabia	3.5	-18.5	-11.1	-31.8
Bahrain	-5.7	-6.7	-10.6	-13.6
Kuwait	-1.3	-7.7	-12.4	-24.9
Oman	3.0	-9.9	-8.7	-22.7
Qatar	4.2	-6.0	-6.7	-16.5
UAE	10.0	-6.4	0.7	-14.3

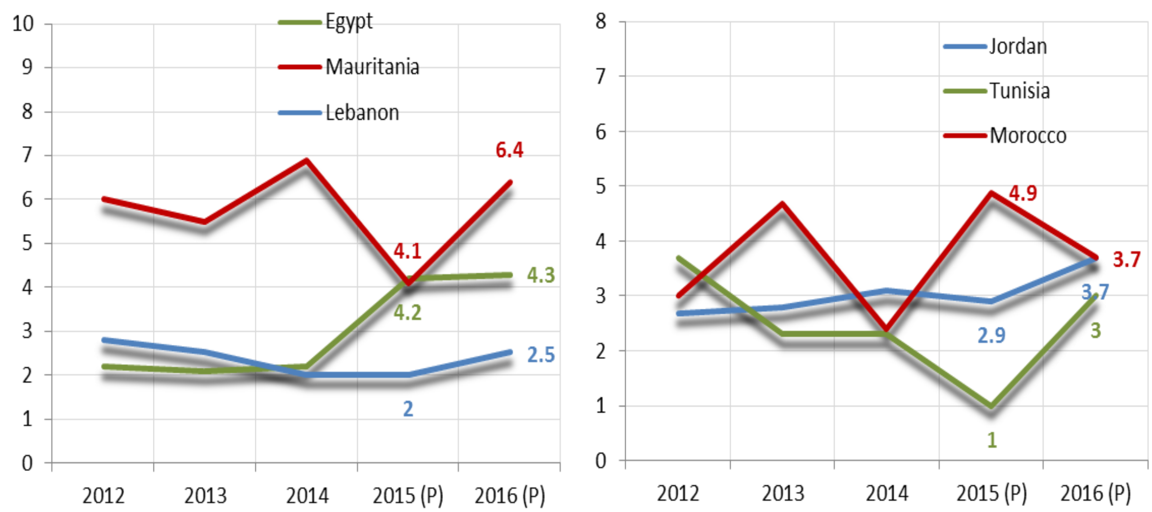
Source: Securities and Commodities Authority.

6.2 Oil-importing countries

Recovery in the MENA oil-importing countries is gaining momentum. After five years of subdued growth of 3%, growth is expected to rise to 4% in 2015 and 2016 (see table 6.2). Progress toward political stability, economic reforms, lower oil prices, and improving euro area growth are beginning to support confidence, investment, and exports. However, a stronger rebound in economic activity is being held back by spillovers from the devastating conflicts in Iraq, Libya and Syria that are also intensifying security and social tensions in neighboring countries, especially Lebanon.

Supply-side bottlenecks and strong currency valuations continue to hamper competitiveness and productivity growth. Unemployment remains high at 11.5% and large swathes of the population do not benefit from growth. If China's slowdown spills over to other emerging markets, the euro area and, through a further decline in oil prices, the GCC, oil-importing countries could further suffer from reduction in exports, tourism, remittances, and financing support. If normalization of U.S. monetary policy sparks financial market volatility, financing conditions could tighten by more than expected. On the upside, a further decline in oil prices would be positive for growth. In this challenging environment, stepping up the reform momentum is imperative. Gradual fiscal consolidation should continue so as to achieve sustainable debt profiles and strengthen buffers.

Figure 1.6.b
Real GDP Growth for Oil-importing countries



Source: IMF, Regional Economic Outlook-October 2015 and CBUAE analysis.

For the oil-importing countries, after a sharp decline, inflation is stabilizing. In 2015, persistently large negative output gaps and low food prices reduced inflation by almost 3 percentage points to 6.5% — raising households' real disposable incomes. These pressures were partly offset by energy subsidy phase-outs and, in some cases, currency depreciation, monetization of fiscal deficits, and accommodative monetary policies. A further, albeit small, decline in inflation for 2016 is expected, in line with continuing, but slower, food price declines. An anticipated continuation of weak pass-through of lower international oil prices, owing to remaining subsidies and/or low competition, implies little near-term benefit for firms' production costs and household incomes for most of the countries.

Table 1.6.c
Inflation in some Oil-Importing countries (%)

	2014	2015 (projections)	2016 (projections)
Oil Importers in MENA	**9.4**	**6.6**	**6.6**
Egypt	10.1	9.5	10.0
Jordan	2.9	0.2	3.1
Morocco	0.4	1.5	2.0
Tunisia	4.9	5.0	4.0

Source: IMF, Regional Economic Outlook-October 2015 and CBUAE analysis.

Despite the oil price decline, stock markets in oil-importing countries continued its decrease in the third quarter. Share prices have fallen by 12.4%, 3.4% and 5% in Egypt, Jordan and Morocco, respectively. Tunisia, who had a better performance in the second quarter of 2015, has witnessed a dramatic collapse in the third quarter where share prices decreased by 7.8% after an increase of 7.6% in the second quarter.

Table 1.6.d
Stock Market Share Prices change for some MENA oil-importing countries (%)

	2015		Year-to-Sept 2015	2015Q3 Y-o-Y
	Q2	Q3		
Egypt	-8.4	-12.4	-17.9	-25.3
Jordan	-0.9	-3.4	-5.5	-3.3
Morocco	-7.0	-5.0	-5.1	-9.8
Tunisia	7.6	-7.8	3.6	15.2

Source: Securities and Commodities Authority.

Chapter 2: Domestic Economic Developments

The economy of the UAE continues its resilient growth pace, driven by the non-oil sector activity that is expected to grow by 3.5% in 2015 according to the central bank of UAE forecasts. The third quarter of 2015 was characterized by a CPI inflation rate around 4.6% with an increasing contribution of the transportation component to the total CPI development due to the energy subsidy-cut.

2.1 Economic Activity and Growth

The economic growth of the UAE is still among the highest in the region despite its projected deceleration in 2015 to reach 3.1% compared to 4.6% in 2014, according to the latest published IMF revised projections. The average oil price decreased by 51% in 2015 Q3 compared to the average price recorded during the same period in 2014 and by 18% compared to 2015 Q2 (see figure 2.1.a). Despite projected moderation in growth, non-oil sector activity is likely to continue as the main driver of economic growth. However, non-energy growth is expected to moderate to 3.4% in 2015, underpinned by continuing momentum in the construction, transport and tourism sectors.

All these developments are in line with the economic composite indicator (ECI) results. The total ECI is expected to realize an annual growth of 3% in 2015, while the non-oil economic composite indicator growth is around 3.5%. Projections are based on quarterly performances of the indicator which grew during the third quarter of 2015 by 2.7% compared to 3.1% in the previous quarter. This synthetic indicator measures the domestic economic activity by taking into account the development of many economic aggregates such as domestic credit growth, monetary aggregates and oil prices (See box 2. for the indictor's construction methodology).

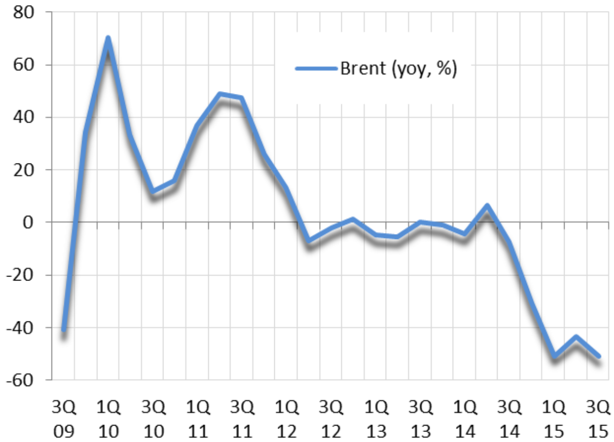
Table 2.1
Economic Growth in the UAE (%)

	2013 (actual)	2014 (estimates)	2015 (projections)
Total GDP annual growth rate*	4.3	4.6	3.1
Oil GDP annual growth rate *	2.9	4.0	2.1
Non-Oil GDP annual growth rate*	5.0	4.8	3.4
Total ECI annual growth rate**			3.0
Non-oil ECI annual growth rate**			3.5

Source: Central Bank of UAE and IMF.
*: IMF revised projections. **: Central Bank Estimates.

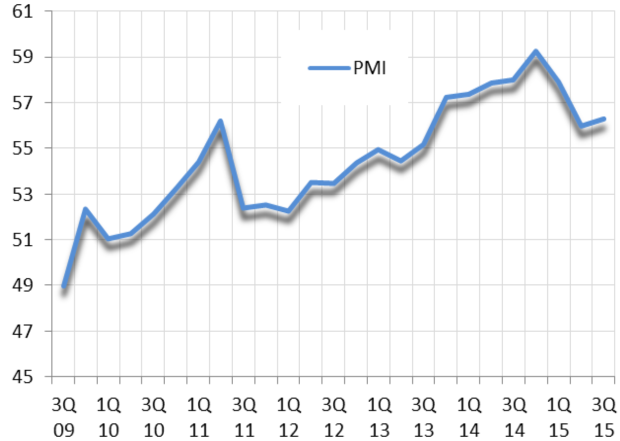
As shown in figure 2.1.b, the purchasing managers' index[1] softened during the first two quarters of 2015, but bounced back in the third quarter to an average level of 56.3 points, signaling continued expansion of the non-oil private sector activity. The output sub-index also rose sharply to 62 points on average in the third quarter of 2015, while the new orders sub-index remained almost stable around 60 points. The employment as well as the new export orders sub-indices decreased respectively by 2% and 13% in the third quarter of 2015 compared to the same period in 2014.

Figure 2.1.a
Oil price change (Brent, yoy %)



Source: International Energy Agency (IEA)

Figure 2.1.b
The Purchasing Managers' Index (PMI)



Source: Markit Group

[1] The Purchasing Managers' Indices (PMI) is an economic indicator derived from monthly surveys of private sector companies. This indicator provides a snapshot of the health of the economy and it is made of 12 sub-indices: Backlogs of Work Index, Employment Index, New Export Orders Index, New Orders Index, Output Index, Output Prices Index, Overall Input Costs Index, Purchase Prices Index, Quantity of Purchases Index, Staff Costs Index, Stocks of Purchases Index and Suppliers' Delivery Times Index.

Box 2. Economic Composite Indicator (ECI) for the UAE: Methodology and Estimates

In order to assess the economic activity for the UAE, policymakers examine different economic variables that could provide them high frequency information about the economic developments. Since the GDP of the UAE, the main measure of the economic activity, is available only on an annual basis with a considerable publication delay, policymakers have to make decisions with a large amount of information obtained from different sources. Nevertheless, not all economic variables are published simultaneously, with various lags and frequencies, delaying the appropriate policy responses.

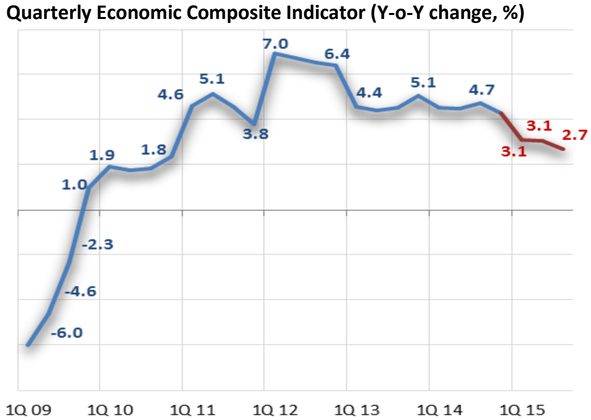
Adopted Methodology

To overcome this problem, we constructed an Economic Composite Indicator (ECI) that can closely track the economic activity of the UAE on a quarterly basis. According to the available data, the Principal Component Analysis (PCA) is the most appropriate method to calculate this indicator. This approach aims to extract a common factor from a group of relevant economic series and to capture the highest level of common trend. These macroeconomic variables are collected from different sources in order to obtain a dataset that covers a wide range of economic activity, such as global economy, sectorial activity, financial markets, money market, and price trends. However, this methodologically rigorous approach depends highly on the quality of the data and the number of observations. Hence, the historical series of the indicator changes with the update of the selected variables.

ECI advantages

This constructed indicator could be a useful analytical and empirical tool for the policymakers since it offers a timely clear picture about the current economic situation. The ECI has three important advantages: first, it takes into account all important policy issues by synthesizing a large number of economic variables, both at the national and international levels. Secondly, it captures economic fluctuations for the UAE at relatively high frequency, compared to the available information. Finally, it will be used to give an early indication of turning points.

Quarterly Economic Composite Indicator (Y-o-Y change, %)

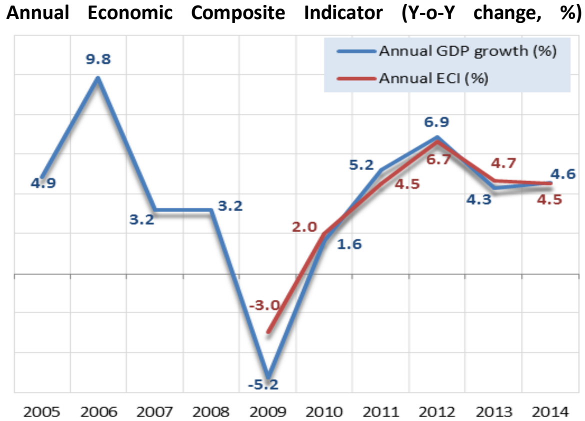


Source : CBUAE analysis

Annual analysis and results comparison

The annual ECI reflects the economy's historical performance and changes since 2009. There is a high correlation between the constructed ECI and the historical GDP growth of the UAE. This is not surprising since this indicator synthesizes a large number of information reflecting the economic activity.

Annual Economic Composite Indicator (Y-o-Y change, %)



Source : CBUAE analysis

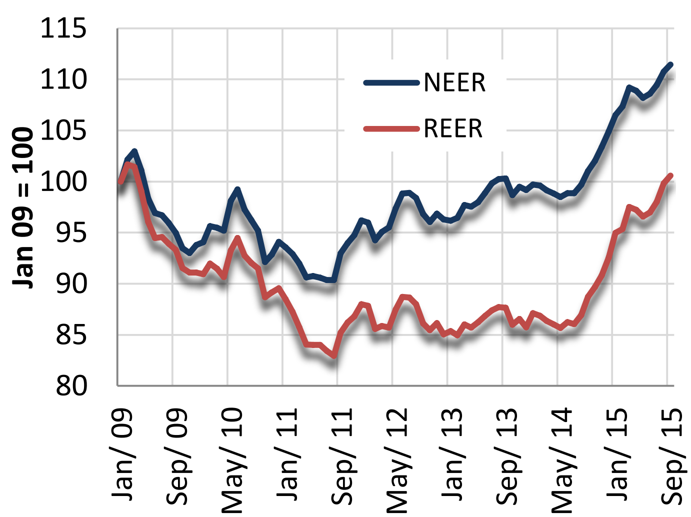
Since the quarterly GDP of the UAE is not available, the ECI will be a valuable tool for the policymakers to provide them timely information about the development of the UAE economic activity and an early indication of turning points.

2.2 Exchange Rate and Foreign Trade Balance

The Dirham continued its appreciation during the third quarter of 2015 against its major trading partners. The weighted currency change for the top 9 non-dollarized import partners has increased in the third quarter and reached 0.64%, while it was only 0.31% in the second quarter (See table 2.2.a). This development is explained mainly by the persistent depreciation of the Chinese Yuan and the Indian Rupee against the Dirham. They lost 1.6% and 2.5% against the Dirham respectively, where China and India represent together a total of 21% of the imports to the UAE. This appreciation is more important when considering the third quarter of 2014. The year-on-year import weighted appreciation of the Dirham reached 5%, driven mostly by the loss of more than 19% of the Euro against the Dirham as well as by the continuous depreciation of the Indian Rupee.

On the non-energy exports side, the weighted average currency change of the top 9 non-dollarized export partners is around 1.1% in the third quarter of 2015, higher than the previous quarter when it reached 0.84%. This appreciation is due mainly to the gains realized by the Dirham against the Indian Rupee (15% of total exports) and the Turkish Lira (see table 2.2.b). Compared to the third quarter of 2014 the Dirham appreciated by 4% against its non-energy export partners.

Figure 2.2
Nominal and Real Effective Exchange Rates



Source: Bank of International Settlement.

All these observations are confirmed by the recent developments of the nominal effective exchange rate (NEER). According to the Bank of International Settlement, the Dirham has appreciated by 10% in the third quarter of 2015 year-on-year in nominal effective terms, in line with the nominal effective appreciation of the U.S Dollar. Although these developments are not sufficient to assess competitiveness, cheaper imports could help spurring competitiveness in light of cheaper intermediate imports and the high import content of non-energy exports. In addition, according to the IMF's last country report, no changes in the non-oil trade volumes have been recorded so far, implying competitiveness of the non-oil sector does not seem to be affected, in consistency with improvement in the business climate shown by the PMI increase.

Table 2.2.a
Dirham appreciation against currencies of top non-dollarized import partners

Currency	Share of UAE imports (%) 2014	% Change of Currencies per Dirham (Q2 – Q1) 2015	% Change of Currencies per Dirham (Q3 – Q2) 2015	% Change of Currencies per Dirham (2015Q3–2014Q3)
Chinese Yuan	11.68	-0.55	1.63	2.23
Indian Rupee	9.19	1.89	2.49	7.20
Germany (EUR)	6.09	1.65	-0.51	19.06
Japanese Yen	5.55	1.82	0.70	17.47
UK Pound	3.53	-1.18	-1.08	7.75
Swiss Franc	3.38	-1.22	2.53	5.44
Italy (EUR)	3.09	1.65	-0.51	19.06
South Korean Won	2.95	-0.34	6.59	13.91
France (EUR)	2.54	1.65	-0.51	19.06
Total	**48.00**			
Weighted Appreciation		**0.31**	**0.64**	**4.99**

Table.2.2.b
Dirham appreciation against currencies of top non-dollarized partners for non-oil export

Currency	Share of UAE exports (%) 2014	% Change of Currencies per Dirham (Q2 – Q1) 2015	% Change of Currencies per Dirham (Q3 – Q2) 2015	% Change of Currencies per Dirham (2015Q3–2014Q3)
Indian Rupee	14.85	1.89	2.49	7.20
Saudi Arabian Riyal	8.15	-0.07	0.00	0.00
Omani Rial	6.61	0.00	0.03	0.01
Swiss Franc	6.34	-1.22	2.53	5.44
Turkish Lira	5.4	8.08	7.16	31.87
Iraqi Dinar	4.72	1.64	-0.28	3.39
Kuwaiti Dinar	4.48	1.86	0.19	6.41
Egyptian Pound	3.65	1.65	2.55	9.38
Chinese Yuan	3	-0.55	1.63	2.23
Total	**57.20**			
Weighted Appreciation		**0.84**	**1.06**	**3.99**

Source: Data on imports shares are provided by the National Bureau of Statistics (NBS) for the year 2014. Data on the exchange rate are the quarterly average of daily observations recorded and displayed by Forex.

2.3 Consumer Price Index and Inflation

The total CPI inflation continued its increase during the third quarter of 2015. The total CPI increased by 4.3% compared to an increase of 4.2%, in the second quarter of 2015. These developments are due to the increase of the CPI inflation of tradables by 1.6% compared to an increase by 0.1% only in the previous quarter, which could be in connection to price rises in the subcomponent "Food and Soft Drinks", especially in July and September Eid holiday. On the other hand, the CPI inflation of non-tradables continues its inflationary pressure, recording an increase by 5.9% (see table 2.3).

Table 2.3
UAE – CPI Inflation (%)

	Weight %	2014	2015		
		Q4	Q1	Q2	Q3
Total CPI Inflation	100	3.1	4.3	4.2	4.3
CPI Inflation of Tradables	34	1.5	0.9	0.1	1.6
CPI Inflation of Non-tradables	66	4.0	6.2	6.6	5.9
Housing CPI inflation	39	5.4	9.3	10.2	8.3
Transportation CPI inflation	10	1.8	1.6	0.4	5.9
% Change of Residential Rental Prices in Abu Dhabi	-	7.6	3.3	4.0	1.0
% Change of Residential Rental Prices in Dubai	-	15.5	8.2	1.4	-1.1

Source: National Bureau of Statistics and Reidin
Note: All the changes are computed on a YoY basis.

The inflation of non-tradables is driven essentially by the housing component that grew by 8.3%, albeit less than the previous quarter on a Y-o-Y basis but still at a very high pace. The marginal decrease of the housing CPI inflation is due mainly to the decrease of residential rental prices in Dubai during the third quarter (see figures 2.3.b and 2.3.c).

It is noteworthy that the transportation component of the total CPI inflation picked up in the third quarter significantly to reach roughly 5.9% with an increasing monthly contribution to the total CPI inflation (see figure 2.3.d). Price pressures stemming from the transportation component reflected the energy subsidy-cut implemented at the beginning of August which induced an increase of the fuel retail prices.

Other key contributors to the inflation surge during the third quarter included the cost of Education which was up by 3.4%, the price of Household Furniture growing by 1.7% and the price of Restaurants and Hotels Expenses growing by 3.4%.

Prices

Figure 2.3.a
CPI Inflation (monthly, yoy %)

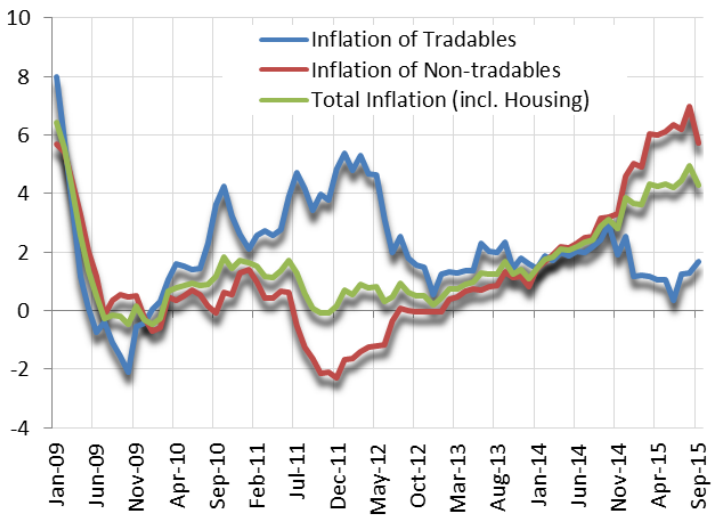


Figure 2.3.b
Total CPI Inflation vs Housing CPI inflation (monthly, yoy %)

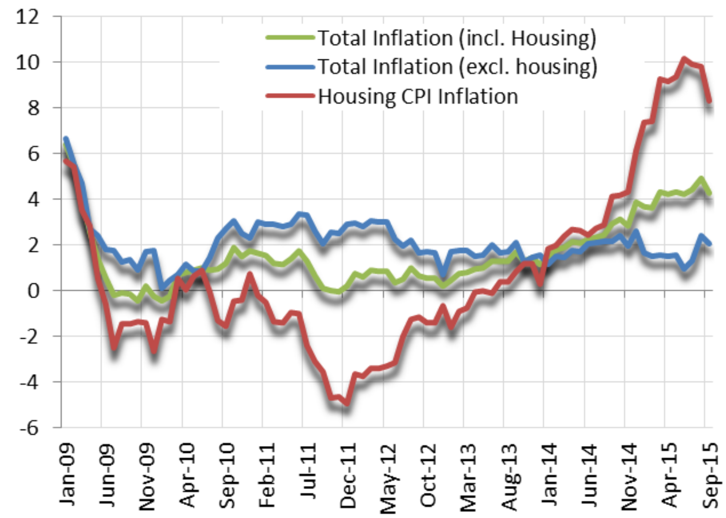


Figure 2.3.c
House Prices

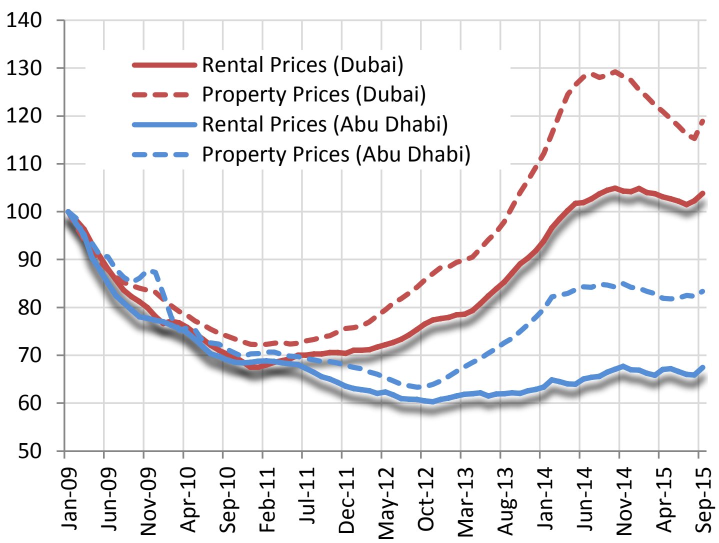
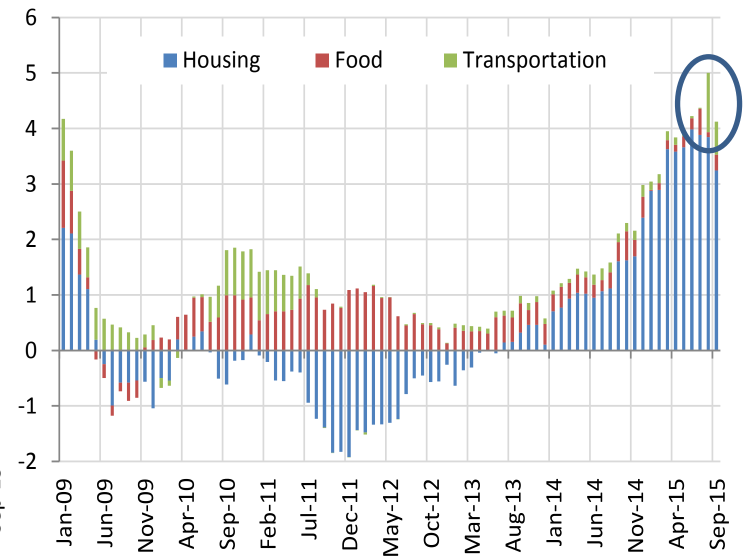


Figure 2.3.d
Contribution to CPI Inflation



Sources: National Bureau of Statistics and Reidin.

2.4 Fiscal balance

The fiscal balance for the UAE improved during the second quarter of 2015. The general government deficit decreased by 26% compared to the first quarter of 2015 as it dropped from a deficit of 12.1 AED Billions to a smaller deficit of 8.9 AED billions (see table 2.6 and figure 2.4.c). This improvement is due mainly to the increase in total revenues by 12%, which exceeded the increase in total expenditure by 7%. Moreover, the total expenditure drop is in line with fiscal consolidation initiated by the government in 2015, inducing a quarterly Y-o-Y decrease of total expenditure by 16.4% in the first quarter of 2015 and by 10.2% in the second quarter (see figure 2.4.b). The water, electricity and energy subsidy-cut announced by the government at the beginning of 2015 and implemented gradually until the third quarter of 2015, lowered the total amount of subsidies by more than 93% and 96% during the first and second quarters of 2015, respectively, on a Y-o-Y basis (see figure 2.6.d).

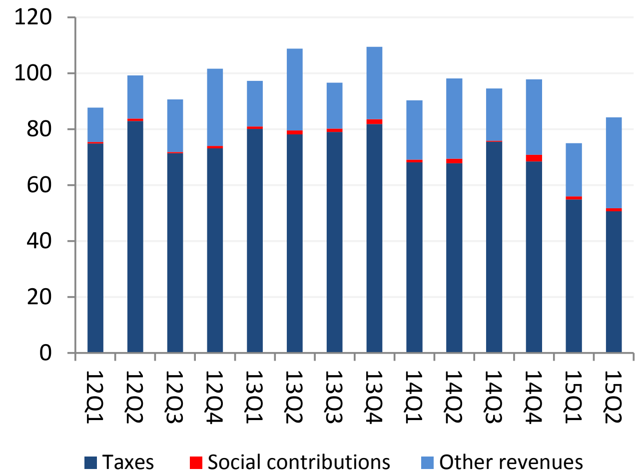
Table.2.4
Consolidated General Government Finances

	2014					2015 Q1 (Actual)	2015 Q2 (Actual)	2015* Annual (Budgeted)	% change 2015Q1-2014Q1	% change 2015Q2-2014Q2
	Q1	Q2	Q3	Q4	2014					
Revenues (a)	**90.2**	**98.1**	**94.5**	**97.8**	**380.7**	**74.9**	**84.2**	**286.9**	**-17.0**	**-14.2**
of which:										
Taxes	68.1	67.8	75.5	68.4	279.9	54.9	50.6	188.4	-19.4	-25.4
Social contributions	0.9	1.6	0.4	2.4	5.3	1.1	1.1	5.5	14.0	-27.8
Expenditure (b)	**104.0**	**103.7**	**98.9**	**107.9**	**414.6**	**87.0**	**93.1**	**411.1**	**-16.4**	**-10.2**
Compensation of employees	10.6	11.4	11.4	14.1	47.5	14.4	15.8	48.6	36.4	38.0
Use of goods and services	8.9	12.1	13.8	14.7	49.5	10.5	13.5	55.3	18.3	11.5
Consumption of fixed capital	0.9	0.7	1.0	1.1	3.8	0.9	1.1	3.8	0.3	48.1
Interest	1.0	1.0	0.9	1.2	4.1	0.5	0.5	3.1	-52.4	-49.1
Subsidies	2.5	3.6	3.4	2.6	12.1	0.2	0.2	13.0	-93.1	-95.6
Grants	9.8	6.2	5.5	0.4	21.9	3.1	2.8	11.3	-67.9	-54.9
Social benefits	12.6	13.8	16.1	18.8	61.4	12.9	15.2	56.7	2.2	9.5
Other expense	52.3	41.0	37.2	43.9	174.4	39.9	35.4	184.5	-23.8	-13.6
Net Acquisition of Nonfinancial Assets	5.5	13.7	9.5	11.2	39.9	4.7	8.7	34.8	-15	-36.7
Consolidated Fiscal balance (a-b)	**-13.8**	**-5.6**	**-4.4**	**-10.2**	**-34.0**	**-12.1**	**-8.9**	**-124.2**	**-12.5**	**-60.3**

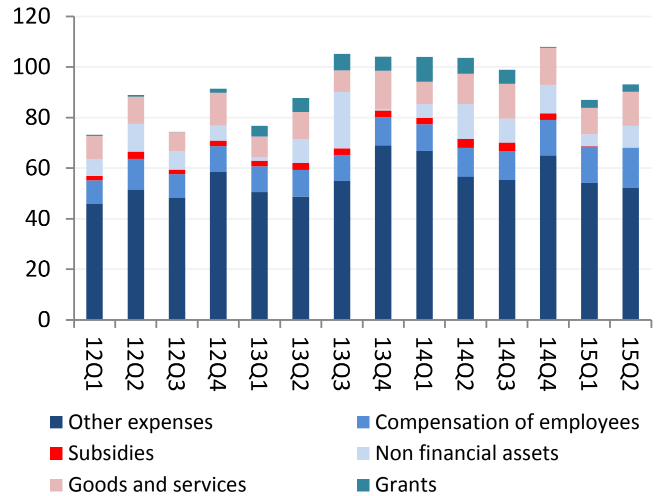
Source: UAE Ministry of Finance, revenues do not include ADNOC transfers and government investment income. Data for 2015are projections based on the latest Regional Economic Outlook, IMF.
Note: All values are expressed in Billions of Dirhams.

Government Finance

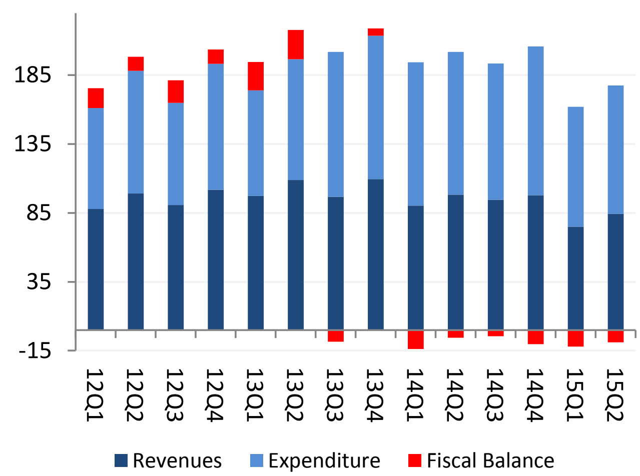
2.4. a General Government Revenues
(Billions of Dirhams)



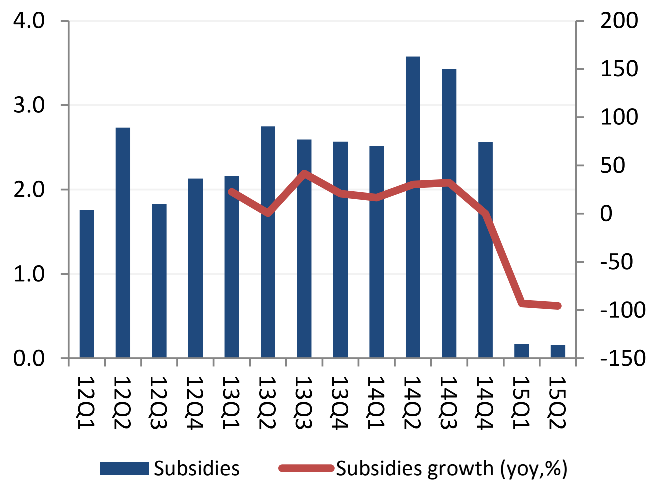
2.4.b General Government Expenditures
(Billions of Dirhams)



2.4.c Fiscal Stance
(Billions of Dirhams)



The subsidies' development



Source: Ministry of Finance.
Note: Other expenses cover all the payments of Abu Dhabi made on behalf of the federal government including the Armed Forces expenditures. The total revenues do not include ADNOC transfers and government investment income.
Total expenditures are also adjusted so that Abu Dhabi capital transfers are excluded.

2.5 Financial developments

2.5.1 Share Prices Volatility

The volatility of the share price index remained quite high during the third quarter of 2015. The 90-day volatility[2] increased by more than 33% during the third quarter compared to the second quarter (see table 2.6.1). After a significant decrease in volatility during the second quarter, the share price index picked up by 2% in July to fall dramatically by 8.5% in August and to rise again by 0.3% in September.

The share price index decrease, coupled with a fall in the securities market capitalization, reflected primarily the oil prices decline in August amid concerns regarding the economic outlook of China, the world largest oil consumer, as well as the appreciation of the US dollar.

Table 2.5.1
UAE – Securities Markets

	2015								
	Jan.	**Feb.**	**Mar.**	**Apr.**	**May**	**Jun.**	**Jul.**	**Aug.**	**Sep.**
Change of Share Price Index (%)	-2.2	5.9	-5.6	8.9	-3.4	4.5	2.0	-8.5	0.3
90-days Volatility	31.5	30.9	**30.8**	16.8	13.5	**13.1**	11.5	16.6	**17.4**
Change of Market Capitalization (%)	-0.3	5.9	-0.01	2.79	5.21	1.03	6.66	-6.65	-8.26

Source: UAE Securities and Commodity Authority and Bloomberg.
Note: Changes computation is based on end-of-period numbers for the share price index and market capitalization.

2.5.2 Credit Default Swaps Premiums

Abu Dhabi commands still a risk premium expressed as CDS spreads – which is a gauge of default probability – less than half of Dubai. However the third quarter level is now the highest value in the last 2 years, while Dubai's CDS spread has remained more or less stable over the same period. Government related entities (GRE) such as Dubai World saw its CDS spread widening since the fourth quarter of 2014 – the quarter where the fall in oil prices was most pronounced – while DP World's spread oscillated between 320 and 340 points over the last 12 months.

Table 2.5.2

[2] A measure of the risk of price moves for a security calculated from the standard deviation of day to day logarithmic historical price changes. The 90-day price volatility equals the annualized standard deviation of the relative price change for the 90 most recent trading days closing price, expressed as a percentage.

UAE - Credit Default Swaps (CDS)

	2013	2014				2015		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Sovereigns								
Abu Dhabi	55.0	53.0	49.5	54.5	63.5	72.0	52.0	77.4
Dubai	214.8	191.7	193.5	198.1	201.6	197.4	191.4	196.9
GREs								
DP World	167.5	148.9	151.3	145.0	212.0	194.1	188.5	190.0
Dubai Holding	325.8	287.8	282.0	316.0	330.7	321.3	340.8	322.5

Source: Bloomberg.
Note: All data are the observed end-of-quarter values. Premiums are expressed in basis points.

Chapter3. Monetary & Banking Developments

Growth of banking deposits slowed down in the 3rd quarter of 2015 as low oil prices persisted, which slowed down the growth of the money supply. Banks however, capitalizing on improved quality of loan portfolio and available, albeit tightening, liquidity were able to increase credit although at a moderate pace, thereby providing the non-energy sectors of the economy with the needed financing

3.1 Monetary Aggregates

During 2015 Q3, all Money Supply Aggregates witnessed a decline. The decrease in M1 by 2.2% was due to a decrease in Monetary Deposits by AED 8.9 billion, while the decline of M2 by 1.2% and in M3 by 1% was also impacted by a decrease in Quasi Monetary Deposits in the amount of AED 3.1 billion, as Government Deposits, which is the difference between M2 and M3, remained roughly flat on Q-o-Q basis.

Y-o-Y up to September 2015, however, M1 increased by 5.2%, due to the exclusive contribution of Monetary Deposits as Currency in Circulation remained flat during this period, at AED 57.2 billion. Meanwhile, M2 increased by 3.5%, an increase that was brought about by a contribution of 2% in Monetary Deposits (33.7% of M2) and 1.6% in Quasi-Monetary Deposits (61.4% of M2).

Y-o-Y, M3 decreased by 0.2% as the increases of 1.7% brought about by Monetary Deposits (29.5% of M3) and of 1.3% brought about by Quasi-Monetary Deposits (53.9% of M3), were more than compensated for by a decrease of 3.2% brought about by Government Deposits (12.3% of M3).

Table 3.1
UAE Monetary Developments (%) – 2015 Q3

	Year-to-Date		Year-on-Year	
	Change	**Contribution to Aggregate Growth**	**Change**	**Contribution to Aggregate Growth**
Money Supply M1	**4.0**		**5.2**	
Currency in Circulation	-3.1	-0.4	-0.2	0.0
Monetary Deposits	5.1	4.4	6.0	5.2
Money Supply M2	**3.1**		**3.5**	
Currency in Circulation	-3.1	-0.2	-0.2	0.0
Monetary Deposits	5.1	1.7	6.0	2.0
Quasi Monetary Deposits	2.5	1.6	2.5	1.6
Money Supply M3	**0.7**		**-0.2**	
Currency in Circulation	-3.1	-0.1	-0.2	0.0
Monetary Deposits	5.1	1.4	6.0	1.7
Quasi Monetary Deposits	2.5	1.3	2.5	1.3
Government Deposits	-13.3	-1.9	-20.5	-3.2

Source: Central Bank of the UAE
Note: UAE Government Deposits in M3 include deposits both at commercial banks as well as at the Central Bank.

3.2 Banking Activity

The 23 locally-incorporated banks increased their branches from 873 at the end of June 2015 to 875 at the end of September, while the 6 banks from the GCC countries remained with 4 branches, and the number of other foreign banks remained at 20, with 82 branches. The total number of wholesale banks operating in the country remains at 8 during this period.

Customer Deposits at banks decreased in 2015 Q3 by AED 7.5 billion or 0.5%. During the same period, Non-resident Deposits increased by 1.8%, an increase that could be explained by the following factors: (1) the softening in real estate does not seem to affect significantly bank deposits since many transactions by foreigners in this regard take place on a cash basis, and (2) the UAE's ability to maintain its safe haven status.

As regards to Government Deposits, the increase in July by AED 7.5 billion was compensated by a decrease roughly by the same amount in August, thereby Government Deposits reached AED 165 billion at end of September, i.e., roughly the same level as of end of June.

Year-to-September, however, Government Deposits decreased by 13.3% as the government drew down deposits to finance spending in the wake of falling oil revenues.

Banks responded to the loss in deposits by withdrawing in 2015 Q3 AED 2.5 billion from their excess reserves, i.e., current account deposits at the Central Bank, and by reducing their balances of Certificates of Deposit issued by the Central Bank, by AED 3.9 billion.

Domestic Credit increased in 2015 Q3 by AED 30.5 billion, or 2.3%, an increase which benefited the government-related entities –GREs (AED 9.4 billion) and the private sector (AED 21.5 billion), including individuals for whom credit for consumption as well commercial purposes increased by AED 10.4 billion.

The Quarterly Credit Sentiment survey (The Central Bank survey of credit officers at banks) showed a stabilization of demand for business credit in 2015 Q3 in tandem with less willingness to lend by banks, which tightened credit standards pertaining to collateralization requirements.

Table 3.2.a
UAE Banking Indicators

	2014		2015			Year- on- Year Change (%)
	Q3	Q4	Q1	Q2	Q3	
Total Bank Assets	2,311	2,305	2,380	2,420	2,422	4.8
Gross Credit*	1,382	1,378	1,410	1,446	1,479	7.0
Domestic Credit	1,291	1,278	1,304	1,336	1,366	5.9
Personal loans to residents	307	300	310	319	330	7.5
Customers' deposits at banks	1,415	1,421	1,449	1,444	1,437	1.6

Source: Central Bank of the UAE
Note: All data indicate the end-of-quarter values. Values are expressed in billions of Dirhams.

Islamic banks continued to thrive with their assets increasing by 1.6%, in 2015 Q3, reaching AED 452 billion, with their share in total assets increasing to 18.7%. Meanwhile, their financing increased by 3.4%, reaching AED 300 billion, or 22% of Domestic Credit.

Table 3.2.b
Assets and financing of Islamic Banks (2014 – 2015)

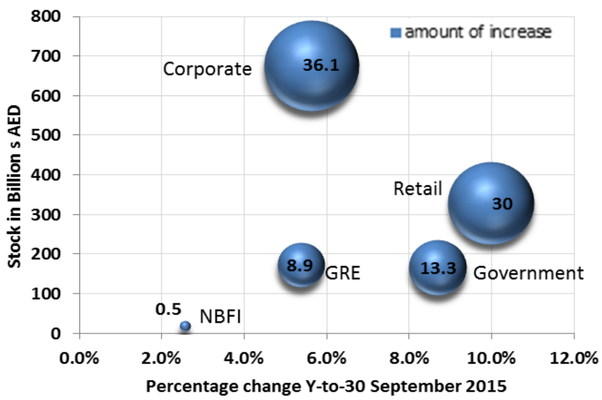
	2014		2015		
	Q3	Q4	Q1	Q2	Q3
Assets	402	405	432	445	452
Percent of total banking assets	17.4	17.6	18.2	18.4	18.7
Islamic financing	260	266	280	290	300
Percent of Domestic Credit	20.1	20.8	21.5	21.7	22.0

Source: Banking Supervision Department, Central Bank of the UAE
Note: All data indicate the end-of-quarter values. Assets values are expressed in billions of Dirhams.

Box 3. Disaggregate Analysis of Loans and Deposits in the UAE

Gross Credit

During the first nine months of 2015, gross credit grew by 7.3% year-to-date and 7% Y-o-Y, as of September. This is slightly lower than the 8% in the whole 2014. The asset classes that were mainly growing are retail, government and corporate by correspondingly 10%, 8.7% and 5.6% year-to-date.

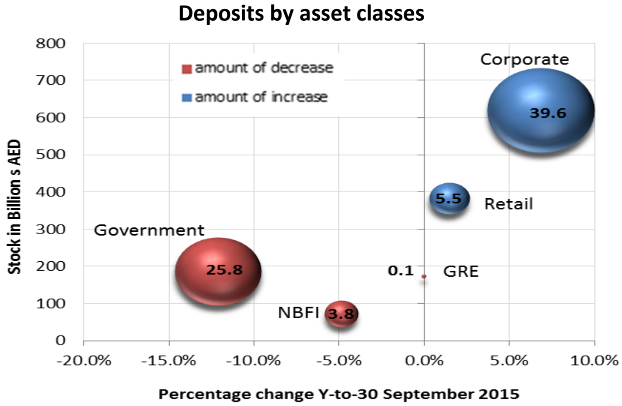


Source: Central Bank of the UAE, Central Bank of the UAE analysis

Deposits[3]

In 2015, deposits grew by 1.1% year-to-date, and 1.6% Y-o-Y, as of September, much lower than the 11.1% in the whole 2014. Despite a decrease by 12.1% of the government deposits in 2015, corporate deposits grew at 6.8% over the same span.

The proportion of non-resident deposits out of the total deposits remains stable as of end of September 2015, at 11% slightly higher than the proportion at the end of 2014 of 10.8%.

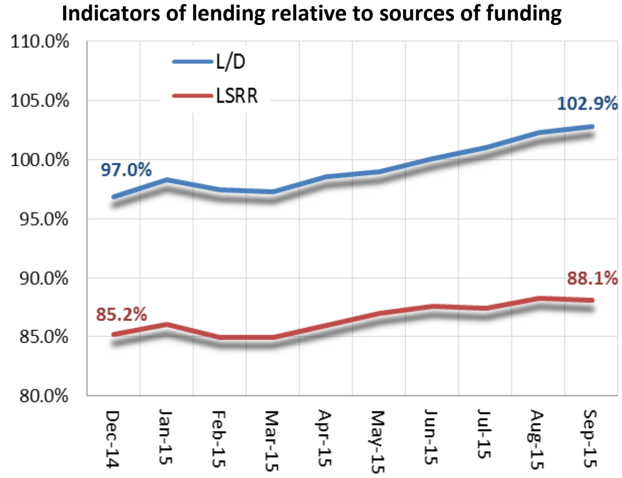


Source: Central Bank of the UAE, Central Bank of the UAE analysis

Key ratios

To capture the composite effects of changes in loans and deposits, two key ratios related to the funding of the banks are considered for the last quarter: the Loan-to-Deposit[4] (L/D) ratio and the Lending to the Stable Resources Ratio[5] (LSRR).

L/D has moved from 100.2% at end of quarter two to 102.9% in the third quarter and year-to-date it increased by 6.1%. Consistently, LSSR increased by 0.5 percentage points to the level of 88.1% during the last quarter. This implies that banks have been funding robust credit growth, relying on other sources as the pool of available deposits has been growing more moderately. Indeed, analysis of liquid assets for banks at the central bank suggests alternative sources of funding. Specifically, excess reserves in the current account have declined by 68.2% and banks' holdings of certificates of deposits have declined by 2.1% as of the end of September 2015, compared to end of 2014.



Source: Central Bank of the UAE, Central Bank of the UAE analysis

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3 Deposits include resident and non-resident

4 The Ratio of Total Loans to the Total Deposits

5 The Ratio of the Total Advances (Net Lending + Net Financial Guarantees & Stand -by LC + Interbank Placements more than 3 months) to the sum of (Net Free Capital Funds + Total Other Stable Resources)

3.3 Financial Soundness Indicators

The overall outlook regarding the soundness of the banking sector remains positive during this period, due to an improved quality of the loan portfolio, while liquidity conditions tightened.

The improved quality of the loan portfolio of banks is evident by the fact that the ratio of non-performing loans (NPLs) remained flat at 6.3%, during 2015 Q2 and 2015 Q3, well below its peak at 8.6% in 2014 Q2. Meanwhile, bank specific provisions for NPLs increased from AED 70.6 billion at the end of June to AED 72.6 billion at the end of September, thereby ensuring that NPLs remain fully provisioned.

Banks operating in the UAE remain highly capitalised, with the capital adequacy ratio of banks reaching 18.3% (16.5% for Tier1 capital) in 2015 Q2, which is well above the regulatory requirements set by the Central Bank (12% and 8%, respectively).

Meanwhile, liquid assets which include reserve requirements, certificates of deposit held by banks at the Central Bank, in addition to zero-risk weighted government bonds and public sector debt and cash at banks, as a ratio of total assets, remained roughly flat reaching 14.3% at the end of June 2015 to 14.2% at the end of September. Therefore, excess reserves banks hold at the Central Bank provided liquidity buffer to continue to extend their loan book.

Table 3.3
Financial Soundness Indicators in the UAE (%)

Indicators	2014				2015		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio[6]	85.5	84.5	86.0	85.2	85.0	87.6	88.1
Ratio of Non-performing loans	8.2	8.6	8.3	7.0	6.6	6.3	6.3
Capital Adequacy Ratio of which:	18.5	18.2	18.3	18.2	18.2	18.3	18.3
Tier 1 Capital	16.2	16.0	16.3	16.2	16.2	16.5	16.5
The Liquid Assets Ratio	14.74	15.57	15.09	15.67	14.74	14.3	14.2
Quarterly Domestic Credit Growth	1.7	2.5	2.9	-1.0	2.0	2.5	2.3

Source: Central Bank of the UAE.

[6] Net Lending + Net Financial Guarantees+ Stand-by Letters of Credit+ Interbank Placements (3 months and more)/ (Net Free Capital Funds+ Other Stable Resources).

Chapter4. Central Bank Financial Position & Reserve Management

The Central Bank balance sheet exhibited decline in liquidity in the banking system in 2015 Q3 as banks reached out to excess liquidity to accommodate the demand for credit. On the assets side, preference for more liquid assets is evident in the balance sheet.

4.1 Central Bank Balance Sheet

On the liabilities side, “Current Accounts and Deposits” of banks at the Central Bank decreased by AED 2.7 billion, during 2015 Q3, while “Currency Issued” decreased by AED 1.5 billion, and banks’ holdings of “Certificates of Deposit” issued by the Central Bank decreased by AED 4 billion, reaching AED 97.4 billion, at the end of September 2015.

The total assets of the Central Bank decreased by 2.2% during 2015 Q3, reaching AED 324.1 billion. This was mainly the result of a decrease in “Held-to-Maturity Foreign Securities” by AED 38.5 billion, due to the fact that some of the securities came to maturity. In parallel, deposits at banks abroad increased by AED 5.4 billion, reaching AED 98.2 billion

Table 4.1

Central Bank Balance Sheet **In Millions of Dirhams**

	2014	2015		
	Q4	**Q1**	**Q2**	**Q3**
Assets				
Gold Bullion	-	-	347	664
Cash & Bank Balances	42,001	42,409	40,708	66,883
Deposits	76,917	70,057	92,880	98,241
CDs Under Repo	-	6,000	-	-
Liquidity Support Facility	321	321	321	228
Held-To-Maturity Foreign Securities	157,753	159,947	145,574	107,078
Held-To-Maturity Bonds Issued by MOF & Dubai Government:	49,443	49,443	49,443	49,230
Available-for-sale investments	378	378	368	362
Derivative Assets	7,530	955	1066	47
Advances to Government	2,500	2,500	-	-
Other Assets	7,996	447	469	462
Property and Equipment's	79	78	85	78
Total Assets	**344,918**	**332,535**	**331,260**	**324,126**
Off Balance Sheet Commitments	**134,105**	**145,303**	**119,150**	**115,166**
Liabilities				
Current Accounts & Deposits	142,168	129,404	135,394	132,727
Certificates of Deposit	99,534	111,759	101,335	97,365
Currency Issued	74,472	69,353	72,549	71,047
Other Liabilities	1,683	1,810	1399	1,931
Derivative Liabilities	-	381	771	1,256
Total Liabilities	**317,857**	**312,707**	**311,448**	**304,327**
Capital & Reserves				
Authorized Issued & Fully Paid Capital	2,500	2,500	2,500	2,500
Fair Value Reserve	-11	-11	-21	-26
General Reserve	16,080	17,339	17,339	17,339
Retained Earnings	962	-	-	-
Total Liabilities & Capital	**337,388**	**332,535**	**331,260**	**324,126**
Off Balance Sheet Commitments related to foreign exchange fluctuations	**134,105**	**145,303**	**119,150**	**115,166**

Source: Financial Control Division, Central Bank of the UAE.
Note: All numbers are end-of-quarter values.

4.2 Central Bank Financial Results

The Central Bank's balance of foreign currency assets which include USD 10 billion Dubai Government bonds, decreased by 2.4% in 2015 Q3, reaching AED 303.8 billion. This was mainly due to a decrease in investment abroad in "Highly Rated Securities, Government Bonds and Treasury Bills" by 26.5%, or AED 38.5 billion.

Table 4.2
Investment of the Central Bank's Foreign Currency Assets (in AED Bn)

End of Quarter	2014	2015		
	Q4	Q1	Q2	Q3
Total Foreign Currency Assets	320.6	306.0	311.3	303.8
Central Bank's Investments Abroad In Highly Rated Securities, Government Bonds And Treasury Bills	157.8	159.9	145.6	107.1
Deposit Account and Cash with Banks Abroad	115.4	105.5	124.6	156.4
Central Bank's Investment In Local Government Bonds	36.7	36.7	36.7	36.7
Other Foreign Assets	10.7	3.9	4.4	3.6

Source: Central Bank of the UAE

4.3 Interest Rates

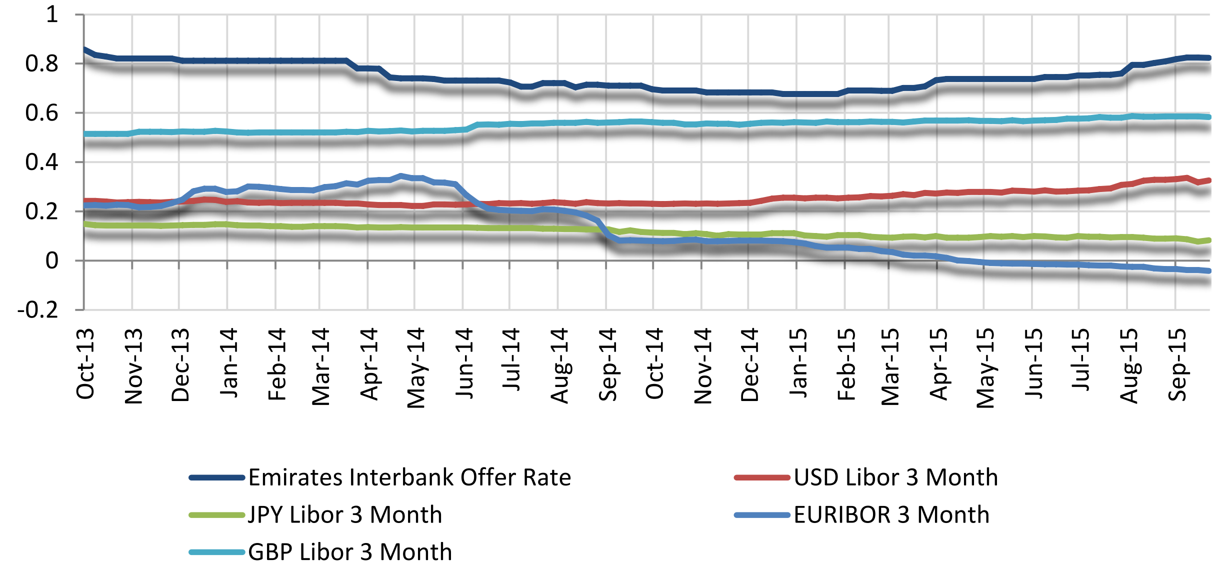
The fixed peg of the exchange rate of the dirham to the US dollar means that the CBUAE has limited degree of freedom to set interest rates, independently from the direction of the interest rate as laid out by the US monetary policy which is defined by the Federal Reserve System in the United States. Nonetheless, the CBUAE uses monetary tools at its disposal to manage liquidity in the banking system, in order to support credit growth and stem the risks to financial vulnerability, while maintaining its continued commitment to the fixed peg regime.

4.3.1 Short-term interest rates

The 3-month Emirates Interbank Offer Rate (Eibor), which is calculated by the Central Bank of the UAE, comprising daily quotes of the largest banks operating in the country, went up by 8bp in the third quarter, widening the spread over the 3-months USD Libor rate from 46bp to 50bp. It partly reflects the tightening in liquidity. The spread tightening between the maximum and the minimum quote continued in the third quarter and stood at 42bp at the end of September 2015.

Also, the 3-month USD Libor moved up slightly, before retreating by the end of September when the Fed decided to keep the policy rates on hold. In contrast, the Euro 3-month Libor rate continued its retreat in the third quarter, reflecting the tepidness of the Eurozone recovery. On the other hand, both the European Central Bank (ECB) as well as the Bank of Japan (BoJ) remained committed to quantitative easing; realizing that interest policy has reached its limits. The Emirates interbank rate edged lower a bit, indicating some relaxation of liquidity constraints in the banking system.

Figure 4.3.1
3-month Libor Rates (%)

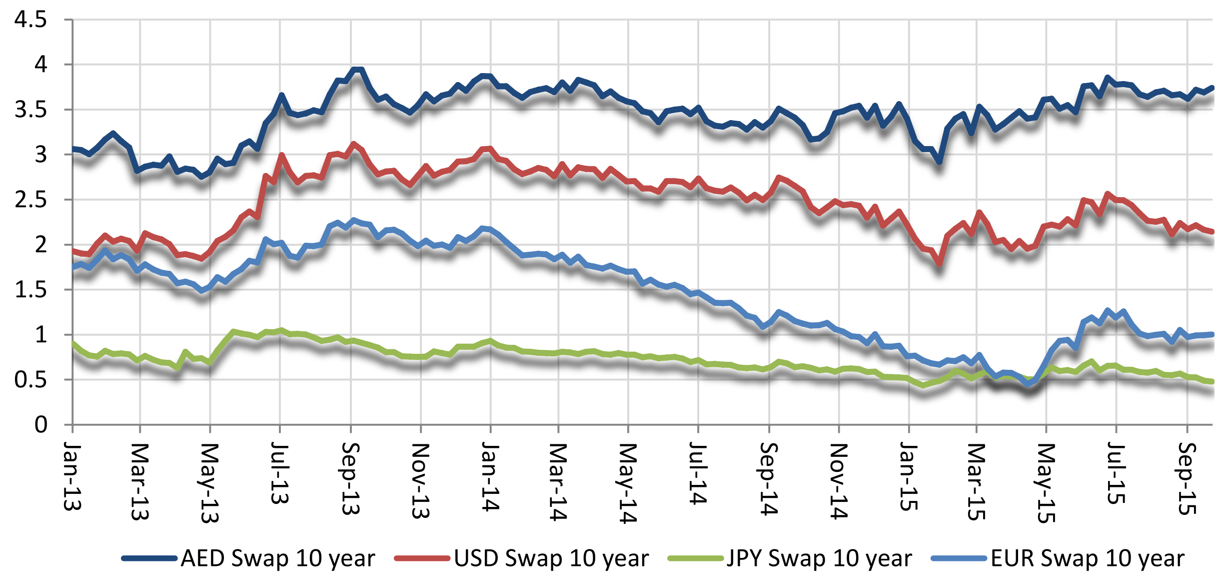


Source: Bloomberg

4.3.2 Long-term swap rates

In the absence of a deep and liquid government bond market in the UAE, the swap market is the only way to get an idea about yields at longer maturities. The swap market reflects mainly the supply and demand of corporates to hedge against interest rate risk. In contrast to the short end of the curve, the AED 10-year swap rate declined from 3.7% at the end of June 2015 to 3.6% at end of September. This move tracked the development of the USD 10-year swap rate which declined from 2.4% in June 2015 to 2% in September 2015. This move can be explained by the reluctance of the Fed to increase its policy rate. As a result, the spreads between the AED 10-year swap and the USD 10-year swap increased marginally during the third quarter from 1.3% in June 2015 to 1.6% in September 2015.

Figure 4.3.2
10-year swap rates



Source: Bloomberg.

Long term yields have in general fallen in the third quarter as a reflection of a perceived deceleration of the world economy on account of concerns of the slowdown of the Chinese economy. The third quarter was a ‘risk-off’ environment for financial markets which typically lead to a stampede into riskless assets such as government bonds. The swap market mimics the developments in the government bonds market almost one for one.

4.4 Monetary Tools

The primary tool for the Central Bank of the UAE is the dollar/dirham spot window which offers banks two-way liquidity, i.e., to exchange dollars against dirhams and vice-versa. This provides confidence to the market in the Central Bank’s commitment to defend the exchange rate and enables banks a bigger scope to better manage their liquidity in both currencies.

4.5 Certificates of Deposits

Certificates of Deposits (CDs) were first issued by the Central Bank in 1988, in tenors varying from 1 month to 6 months. This program offers banks an alternative tool of investing their excess liquidity in dirhams instead of investing it in dollars abroad. The initial program was revamped in 1994 when it was made available for daily issuance, with tenors extended up to 18 months. Banks were also offered the possibility of redeeming their CDs, before maturity, allowing them to get immediate liquidity when needed at a rate set by the Central Bank.

4.6 Bank Liquidity Developments

The main liquidity indicator monitored at the Central Bank in this regard is banks' excess reserves, i.e., their current account at the Central Bank and their holdings of CDs. Banks' current account at the Central Bank increased from AED 17.3 billion at the end of 2015 Q2 to AED 17.7 billion at the end of 2015 Q3 while Certificates of Deposit held by banks decreased from AED 101.3 billion to AED 97.4 billion, during the same period.

Total bank liquidity, including reserve requirements and highly-rated government and public sector debt, decreased from AED 282.8 billion at the end of 2015 Q2 to AED 280.1 billion at the end of 2015 Q3. Nonetheless, liquidity remained sufficient, during this period, as no bank tapped CBUAE's facilities to borrow Dirhams, namely the Interim Marginal Lending facility, the Collateralized Murabaha Facility, and the CDs Repo Facility.

4.7 Reserve Management

Foreign currency reserves are managed by the Reserve Management Division within the Monetary and Reserve Management Department.

CBUAE's reserves are managed with a goal to strike a balance between guaranteeing a reasonable return while ensuring adequate liquidity buffers. Following the global financial crisis and subsequent adverse effects on the UAE economy, the CBUAE has adopted a more vigilant strategy towards risk management. As a result, the benchmarks for the investment strategy of the Central Bank reserves aim to ensure adequate liquidity, capital preservation and appropriate return, with liquidity being the most important driver to ensure banking stability. Investments are based on the Reserve Management Policy approved by the Board of Directors and in consistency with Union Law 10 of 1980, concerning the Central Bank, The Monetary System and Organization of Banking.

CBUAE's foreign currency assets at the end of 2015 Q3 comprise AED 156.4 billion deposits at banks abroad and AED 107.1 billion Held – to – Maturity Securities, in foreign currencies, in addition to other reserves amounting to AED 3.7 billion, which brings total foreign reserves to AED 267.1 billion, excluding USD 10 billion Dubai Government Bonds.