United Arab Emirates

مصرف الإمارات العربية المتحدة المركزي

CENTRAL BANK OF THE U.A.E.

Quarterly Economic Review

Second Quarter 2015

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Our Vision

Leadership and excellence in preserving banking and financial stability

Our Mission

Through application of effective prudential supervision policies, adoption of efficient monetary policy and operation of payment systems compatible with best practices, we maintain a sound banking sector and support stability of the UAE financial system to ensure balanced economic growth.

Our Values

Transparency - Committed to transparency and continuous improvement.

Professionalism - Practice sound governance.

Participation - Achieve excellence through teamwork.

Collaboration - Build and develop integrative partnerships.

Trustworthiness - Maintain the confidence of our stakeholders.

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LIST OF ABBREVIATIONS AND ACRONYMS

AED	Arab Emirates Dirham
BPS	Basis Points
BRIC	Brazil, Russia, India and China
BoJ	Bank of Japan
CAC40	French Stock Market Index
CBUAE	Central Bank of the UAE
CDS	Credit Default Swap
CHF	Swiss Franc
CPI	Consumer Price Index
DAX	German Stock Market Index
ECB	European Central Bank
EIBOR	Emirates Interbank Offered Rate
EUR	Euro
EuroStoxx	Euro Area Stock Market Index
Fed	Federal Reserve in the US
FTSE100	UK Stock Market Index
GBP	British Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GREs	Government –Related Entities
IMF	International Monetary Fund
JPY	The Japanese Yen
M1, M2, M3	Monetary Aggregates
MENA	Middle East & North Africa
MENAP	Middle East, North Africa, Afghanistan and Pakistan
MIB	Italian Stock Market Index
MSCI	Morgan Stanley Capital International
NBS	National Bureau of Statistics, UAE
Nikkei	Japanese Stock Market Index
NPLs	Non-Performing Loans
PCE deflator	Personal Consumption Expenditures deflator in the US
UAE	United Arab Emirates
US	United States of America
USD	US dollar

Chapter1. International Economic Developments

The upward revision of the US GDP figures to 3.7% highlights the dilemma of US policy makers. The US economy is growing at a relatively brisk pace while Europe and Japan struggle to achieve positive growth rates in 2015. This situation is even more worrisome, as both regions should benefit from extraordinary monetary policies such as quantitative easing, accommodative fiscal policies and lower oil prices. Emerging economies, exporters of basic commodities, continue to struggle with lower export prices and tighter external financial conditions due to a reversal in capital flows. China is of particular concern as it is settling for lower growth rates, further depressing commodity prices. Therefore any decision to raise rates – the first in almost 10 years – will be a difficult one, as domestic conditions in the US almost mandate an interest rate rise, while it could cause havoc with the rest of the world economy.

1. Global Economy and Capital Markets

In contrast to the first quarter which witnessed a 5% increase in global stock markets and a fall in 10-year yields, the second quarter saw a reversal, with global equities experiencing a broad based sell-off. A notable exception was Japan whose equity market gained 5.4% in the second quarter. This reversal was initially triggered by a bond sell-off in May, intensified with increased concerns regarding Greece. Further, global capital markets prepared themselves for a rate increase in the US later this year – or a normalization as the Fed prefers to say –, which is becoming more likely given the improved labor and housing markets.

Looking at the manufacturing PMI (Purchasing Managers Index) over recent quarters, it becomes obvious that peripheral Europe is one of the areas where the improvements are most notable. In fact, the second quarter reading is the first quarter in over 12 months where all PMI levels stay conformably in expansion territory, i.e., above the 50 mark. The advantage of the PMI survey is its forward looking feature as many survey questions relate to business expectations.

Table 1.1.a
Purchasing Managers Indices (PMI) in Developed Economies

	USA	Japan	UK	Eurozone	Germany	France	Italy
				2015			
Q2	53.60	50.10	51.40	52.50	51.90	50.70	54.10
Q1	55.70	50.30	54.30	52.20	52.80	48.80	53.30
				2014			
Q4	53.90	52.00	52.70	50.60	51.20	47.50	48.40
Q3	57.50	51.70	51.50	50.30	49.90	48.80	50.70
Q2	57.30	51.50	56.80	51.80	52.00	48.20	52.60
Q1	55.00	53.90	55.30	53.00	53.70	52.10	52.40
				2013			
Q4	55.00	55.20	57.20	52.70	54.30	47.00	53.30
Q3	52.80	52.50	56.90	51.10	51.10	49.80	50.80
Q2	51.90	52.30	52.60	48.80	48.60	48.40	49.10
Q1	54.60	50.40	49.90	46.80	49.00	44.00	44.50

Source: Bloomberg.

Table 1.1.b
Stock Market Indices in Developed Economies

	MSCI World	US Dow Jones	Japan Nikkei	UK FTSE 100	Euro Area EUROSTOXX	Germany DAX	France CAC 40	Italy MIB
				2015				
Q2	3,531	17,620	20,236	6,521	3,424	10,945	4,790	22,461
Q1	3,556	17,776	19,207	6,773	3,697	11,966	5,034	23,157
				2014				
Q4	3,391	17,823	17,451	6,566	3,146	9,806	4,273	19,012
Q3	3,284	17,043	16,174	6,623	3,226	9,474	4,416	20,892
Q2	3,257	16,827	15,162	6,744	3,228	9,833	4,423	21,283
Q1	3,119	16,458	14,828	6,598	3,162	9,556	4,392	21,692
				2013				
Q4	3,.088	16,577	16,291	6,749	3,109	9,552	4,296	18,968
Q3	2,848	15,130	14,456	6,462	2,893	8,594	4,143	17,435
Q2	2,676	14,910	13,677	6,215	2,603	7,959	3,739	15,239
Q1	2,631	14,579	12,398	6,412	2,624	7,795	3,731	15,339

Source: Bloomberg.

Table 1.1.c
Stock Market Indices in BRIC Countries

	Emerging Markets	Brazil	Russia	India	China
			2015		
Q2	50449	53081	1655	27781	4480
Q1	50568	51150	1626	27957	3928
			2014		
Q4	48361	50007	1397	27499	3389
Q3	48543	54116	1411	26631	2745
Q2	48694	53168	1476	25414	2145
Q1	46733	50415	1504	21171	2214
			2013		
Q4	47159	51507	1504	21171	2214
Q3	45935	52338	1463	19380	2276
Q2	43798	47457	1330	19396	2071
Q1	46357	56352	1439	18836	2341

Source: Bloomberg.

Commodity prices expressed in future spot prices all suffered double-digit price drops on an annual basis (except for corn which fell by 3.4% only), while oil price staged a comeback with Brent price increasing by 9.1% on a quarterly basis. Gold price reached USD 1000 per ounce compared to USD 1900 per ounce in 2011, indicating that investors are less concerned about inflationary threats. Copper which is an important industrial metal being heavily used in the construction sector suffered from the slowdown and the re-orientation of the Chinese economy. In the agricultural sector, corn and cotton managed to see their prices increase in the second quarter of 2015 while the price of coffee continued its fall, reaching almost 30%, on year-on-year basis.

Table 1.1.d
Selected Commodity Price Levels (Futures based)

	Brent	Natural Gas	Gold	Silver	Copper	Corn	Coffee	Cotton
2015								
Q2	64.1	2.8	1,172.4	15.7	5,765	431.5	132.4	67.9
Q1	58.8	2.8	1,183.6	16.7	6,041	400.8	139.2	64.3
2014								
Q4	63.5	3.0	1,184.4	15.7	6,300	421.0	174.2	64.4
Q3	97.5	3.9	1,208.2	17.0	6,667	366.8	201.7	63.7
Q2	106.8	4.1	1,327.3	21.0	7,015	446.5	184.9	77.6
Q1	101.4	4.0	1,284.0	19.8	6,645	487.3	189.4	78.7
2013								
Q4	101.5	4.1	1,201.6	19.5	7,360	465.3	128.2	78.8
Q3	96.7	4.0	1,329.0	21.7	7,302	497.5	133.1	80.8
Q2	93.7	4.1	1,234.5	19.7	6,750	508.5	140.4	76.8
Q1	98.0	4.2	1,597.5	28.3	7,540	515.5	162.0	85.8

Source: Bloomberg.

The 10–year government bonds yields increased across the board against the backdrop of an improved growth outlook in Europe and the prospect of a shift in US monetary policy. Meanwhile, 5-year inflation expectations, measured by the 5-year inflation swap rates in the various currencies--a commonly used indicator by central banks and dealers worldwide--increased in 2015 Q2 in the US, Japan and the Euro Area (see Table 1.2.b).

Table 1.2.a
10-year Government Bond Yields (%)

	US 10 Year Yield	Japanese 10 year Yield	Euro 10 Year Yield
2015			
Q2	2.43	0.48	0.81
Q1	1.99	0.41	0.19
2014			
Q4	2.23	0.33	0.58
Q3	2.59	0.54	0.98
Q2	2.64	0.58	1.30
Q1	2.85	0.65	1.63
2013			
Q4	3.21	0.76	2.04
Q3	2.76	0.70	1.86
Q2	2.61	0.87	1.80
Q1	1.94	0.56	1.34

Source: Bloomberg.

Table 1.2.b
5-year Inflation Swap Rates (%)

	USD	JPY	EUR
2015			
Q2	2.412	1.340	1.845
Q1	2.226	0.903	1.635
2014			
Q4	2.295	0.771	1.727
Q3	2.638	1.133	1.937
Q2	2.838	1.255	2.137
Q1	2.795	1.295	2.110
2013			
Q4	2.937	0.785	2.216
Q3	2.959	0.865	2.218
Q2	2.744	0.915	2.220
Q1	2.998	0.788	2.265

Source: Bloomberg.

The second quarter of 2015 saw no major change in terms of monetary policy rates in the developed world. The three main central banks left their policy rates unchanged with the exception of Japan, where BoJ (Bank of Japan) has shifted its monetary policy focus since March 2013 to a targeted monetary base via Japanese Government Bond (JGB) purchases. Markets are gearing for a change in the policy stance in the US in the second half of the year, while the BoJ and the ECB (European Central Bank) are currently engaged in asset purchasing programs.

Table 1.2.c
Policy Rates (%)

	US Fed Funds rate	BoJ Overnight call rate	ECB Refinancing rate
2015			
Q2	0.25	0.01	0.05
Q1	0.25	0.02	0.05
2014			
Q4	0.25	0.07	0.05
Q3	0.25	0.03	0.05
Q2	0.25	0.06	0.15
Q1	0.25	0.04	0.25
2013			
Q4	0.25	0.07	0.25
Q3	0.25	0.06	0.50
Q2	0.25	0.07	0.50
Q1	0.25	0.06	0.75

Source: Bloomberg.

The second quarter did not witness major changes in the foreign exchange market, despite the Greek crisis. The USD/ EUR exchange rate saw some weakness in the US dollar (USD), mainly driven by expectations of a slower pace of Fed tightening, following initial release of contraction in the US economy in the first quarter that was later revised upward.

Table 1.3
Exchange Rates in selected developed and emerging countries (units of currency per USD)

	USD/EUR	USD/JPY	EUR/CHF	USD/Brazil Real	USD/Russian Ruble	USD/Indian Rupee	USD/Chinese Renimbi
2015							
Q2	0.90	122.50	1.04	3.10	55.34	63.65	6.20
Q1	0.93	120.13	1.04	3.20	58.19	62.50	6.20
2014							
Q4	0.83	119.78	1.20	2.66	60.74	63.04	6.21
Q3	0.79	109.65	1.21	2.45	39.60	61.76	6.14
Q2	0.73	101.33	1.21	2.21	33.98	60.19	6.20
Q1	0.73	103.23	1.22	2.27	35.17	59.89	6.22
2013							
Q4	0.73	105.31	1.23	2.36	32.87	61.80	6.05
Q3	0.74	98.27	1.22	2.22	32.39	62.62	6.12
Q2	0.77	99.14	1.23	2.23	32.84	59.39	6.14
Q1	0.78	94.22	1.22	2.02	31.06	54.28	6.21

Source: Bloomberg.

2. United States

After the BEA (Bureau of Economic Analysis) has already revised upward the first quarter GDP figures from 0.2% to 0.6% annualized, it recently upgraded the second quarter figures from 2.3% to 3.7% (annualized quarterly changes). The BEA mostly attributed this upward revision to acceleration in exports, a pickup in consumer spending, a slowdown in imports, and an upturn in state and local government spending. These positive growth drivers were partly offset by a reduction in inventories, in non-residential fixed investment, and in federal government spending and a slowdown in residential fixed investment.

In the meantime, US unemployment fell to 5.3% in 2015 Q2 while annual inflation is now posting just 0.1% in terms of price increases. The collapse in oil prices and the appreciation of the USD were the main drivers of the recent fluctuations in headline inflation. The two main indicators of the Fed, the price index for personal consumption expenditures (PCE) and unemployment have both declined in the second quarter. The Fed relies on the concept of the output gap, emphasizing developments in the labor market as an anchor for future inflation. Recent releases revealed that the Fed believes that the output gap is now very narrow, at only 1.04% compared to potential output.

The continued reduction in the unemployment rate to 5.3% provides further input that an interest rate hike is likely in the second half of the year, barring concerns about deterioration in the global economy.

Table 1.4
Personal Consumption Expenditures deflator and the unemployment rate in the US (%)

	PCE Deflator YoY	US Unemployment
2015		
Q2	1.289	5.3
Q1	1.349	5.5
2014		
Q4	1.372	5.6
Q3	1.601	5.9
Q2	1.617	6.1
Q1	1.474	6.6
2013		
Q	1.540	6.7
Q3	1.539	7.2
Q2	1.501	7.5
Q1	1.590	7.5

Table 1.5
Real GDP Growth Rates (%)

	Quarterly		Annualized quarterly		YoY growth	
	2015Q1	2015Q2	2015Q1	2015Q2	2015Q1	2015Q2
Advanced Economies						
USA	0.2	0.9	0.6	3.7	2.9	2.7
Japan	1.1	-0.3	4.5	-1.2	-0.8	0.7
United Kingdom	0.4	0.7	1.6	2.8	2.9	2.6
Euro Area	0.5	0.4	2.1	1.4	1.2	1.5
- Germany	0.3	0.4	1.4	1.8	1.1	1.6
- France	0.7	0.0	2.8	0.0	0.9	1.0
- Italy	0.4	0.3	1.5	1.3	0.2	0.7
Developing Economies						
Brazil	-0.7	-1.9	-3.0	-7.2	-1.6	-2.6
Russia	-1.3	N.A	-5.2	N.A	-2.2	-4.6
China	1.4	1.7	5.7	7.0	7.0	7.0

Source: Bloomberg.

Japan

The second quarter GDP figures from Japan saw a drop of -0.3% on a quarterly basis (-1.2% quarterly annualized). The main driver of this development has been weak consumption figures and deterioration in net exports (-0.4% and -0.3% contribution to GDP change).

Against this backdrop the data for industrial output in June indicated that Japan's economy could see some acceleration in 2015. Production plans, which are part of the data releases, showed that production is expected to grow by 0.5% (mom) in July and by 2.7% in August.
The manufacturing PMI reached 50.1 in June, pointing to a moderate expansion of new export orders. However, household spending, which dropped in 14 of the past 15 months, fell on an annual basis to 2% in June. In the meantime, annual inflation dropped to 0.4% which is

mainly due to a base effect following the consumption tax increase last year. The drop in the oil prices helped contain price inflation.

The Japanese labor market continues improving as the unemployment rate decreased form 3.5% at the end of March 2015 to 3.4% at the end of June. Japan recorded at the end of May, same as in April, an unemployment rate of 3.3% which is the lowest unemployment rate during the last 18 years.

Meanwhile, the number of employed increased progressively within the quarter. It reached 63.4M in April, 64M in May and 64.25 in June. The number of unemployed was 2.24M at the end of June, recording a decrease by 8.6% compared to the previous year.

On the other hand, the rate of labor force participation increased from 59.8% in May to 60%. The job finding rate remained at 1.19, indicating more jobs than applicants, with no change from May.

Table 1.6
Year-on-Year Consumer Price Change (%)

	2015	
	Q1	**Q2**
Advanced Economies		
USA	-0.1	0.1
Japan	2.3	0.4
United Kingdom	0.0	0.0
Euro Area	-0.1	0.2
- Germany	0.2	0.1
- France	0.0	0.2
- Italy	-0.1	0.2
Emerging Economies		
Brazil	8.1	8.9
Russia	16.9	15.3
India	6.3	6.1
China	1.4	1.4

Source: Bloomberg.

3. Eurozone

Despite a very accommodative monetary stance, a weaker currency and lower oil prices, the Eurozone recovery posted a quarterly increase of 0.4%. Performance however varied across members of the group, ranging from stagnation in France to moderate growth in Italy and Germany, 1.3% and 1.4% annualized, respectively.

In June, the index of executive and consumer sentiment rose to 104 from 103.5, at a four-year high. The increase in optimism coincided with the end of the Greek crisis, which has gripped the market throughout the second quarter of 2015. Eurozone industrial production fell by 0.4% in June after a decline by 0.2% in May. The poor performance was mainly driven by a sharp decline of 2% of the durable consumer goods component during the month of June. The Euro area PMI manufacturing index rose in June to its highest level in 13 months, reaching 52.5 supported by an upward trend of the new orders component. However, the weaker Euro and low oil prices failed to support economic activity, at least when looking at the second quarter GDP figures. The Euro area industrial output grew by 1.2% annually in June of 2015.

Although Germany has almost erased the losses since the crisis, industrial output is still below the 2008 level for Spain and Italy. Despite its strong expansion for the fifth successive month in June, the industrial output in Spain remains below the pre-crisis levels by around 21%, in spite of an increase by 1.7% in the second quarter according to the Spanish national institute for statistics. Similarly, in its last release, the Italian national institute for statistics announced an increase of 0.4% of the industrial output compared to the first quarter of 2015. This improvement was not sufficient to offset the losses generated by the financial crisis. In fact, the Italian industrial output remains below its pre-crisis level by around 18%.

The unemployment rate in the Euro area stood at 11.1% at the end of June, almost unchanged since May 2015. This rate hides vast differences between the various member states, such as Spain with 22% unemployment rate and Germany where unemployment is only 4.7%. Also in terms of underemployment, the Eurozone has still upside potential. Underemployed persons include those who hold part-time jobs but are seeking full-time work; also those who are overqualified for their present jobs in terms of education, skill level or experience. The underemployment rate measures the number of underemployed persons as a percent of the labor force (the total number of employed plus unemployed). The reading for the 2nd quarter of 2015 was 4.7%, up from 4.6% at the end of March 2015.

Meanwhile, consumer prices have risen by 0.2% well below the 2% target set by the ECB. The low inflation figure has been used by the ECB to justify its expanded asset purchase program and is used by commentators to call for an extension of the program beyond September 2016. In contrast, the German Bundesbank has emphasized that low or even negative real wage growth in the Eurozone is the only way to establish competitiveness. Accordingly, structural reforms are needed.

Table 1.7
Unemployment Rates in Advanced and Developing Countries (%)

	2015	
	Q1	Q2
Advanced Economies		
USA	5.5	5.3
Japan	3.5	3.3
United Kingdom	5.5	5.6
Euro Area	11.2	11.1
- Germany	4.8	4.7
- France	10.3	10.2
- Italy	12.4	12.5
Developing Economies		
Brazil	6.2	6.9
Russia	5.9	5.4
China	4.1	4.0

Source: Bloomberg.

4. BRIC Economies

The recently published second quarter GDP figures indicated that Brazil slipped into a recession, posting a quarterly drop of 1.9% or -7.2% annualized. After two consecutive quarters of negative growth, the economy is now formally in recession. Consumer confidence sapped by a high unemployment rate fell by 10% on annual basis in June, one of the steepest falls in recent years. It is important to note that Brazil is not going through a classical current account or currency crisis but suffers from the end of the commodity ‘super-cycle’ as well as the exhaustion of a domestic credit boom. However, its currency reserves are close to USD 400 billion, among the highest in the world. Annual inflation is rampant, reaching 8.9% at the end of June up from 8.1% in March, partly reinforced by currency depreciation, and an over-proportional share of government spending to GDP (42%). The central bank has stepped up efforts to rein in inflation by ratcheting up interest rates. At the same time, unemployment is on an upward trajectory (6.9% at end of June, up from 6.2% at end of March).

Table 1.8
Policy and Unemployment Rates in Brazil (%)

	Policy Rate	Unemployment Rate
	2015	
Q2	13.7	6.9
Q1	12.7	6.2
	2014	
Q4	11.7	4.3
Q3	11.0	4.9
Q2	11.0	4.8
Q1	10.7	5.0
	2013	
Q4	10.0	4.3
Q3	9.0	5.4
Q2	8.0	6.0
Q1	7.2	5.7

Source: Bloomberg.

In Russia, the Bloomberg survey indicates that real GDP is estimated to have shrunk by 4.5% in the second quarter, with an expectation of a negative growth rate of 3.5% for 2015 as a whole. The combination of falling oil prices and an inefficient domestic economy left its mark on the economy. Year-on-year inflation came down in June to 15.3% (compared to 16.9% in March), enabling the central bank to lower the policy interest rate to 12.5% from 15% at end of March 2015. The central bank has made it clear that lowering inflation and a relatively stable currency are the main priorities, while the business community fears that high rates are stymieing an already anemic economy.

Table 1.9
Policy, Unemployment & Inflation Rates in Russia (%)

	Policy Rate	Unemployment Rate	Inflation YoY
		2015	
Q2	12.5	5.4	15.3
Q1	15.0	5.9	16.9
		2014	
Q4	18.0	5.3	11.4
Q3	9.0	4.9	8.0
Q2	8.5	4.9	7.8
Q1	8.0	5.4	6.9
		2013	
Q4	6.5	5.6	6.5
Q3	6.5	5.3	6.1
Q2	6.5	5.4	6.9
Q1	6.5	5.7	7.0

Source: Bloomberg.

According to Bloomberg survey, the Indian economy is expected to have grown by 7.5% in the second quarter of this year on an annual basis, paving the way for an expected growth of 7.6% for 2015 as a whole. The composite PMI, which has been on a downward trend since February, fell recently below the magical 50 index line suggesting a weaker growth, while the manufacturing PMI is still in positive growth territory. At the moment, household spending appears to be supporting the overall economy. High inflation which stood at 6.1% at the end of June (compared to 6.3% in March) is the focus of the policy debate, constraining efforts to revive growth by monetary tools.

Table 1.10
Policy and Inflation Rates in India (%)

	Policy Rate	Inflation YoY
	2015	
Q2	9.7	6.1
Q1	10.0	6.3
	2014	
Q4	10.0	5.9
Q3	10.0	6.3
Q2	10.0	6.5
Q1	10.0	6.7
	2013	
Q4	10.0	9.1
Q3	9.8	10.7
Q2	9.7	11.1
Q1	9.7	11.4

Source: Bloomberg.

In China, growth figures in 2015 Q2 topped most analysts' forecasts with a quarterly increase of 1.7% and an annual growth rate of 7% vis-à-vis the second quarter of 2014. Most analysts saw this as the result of the various policy measures introduced by the Chinese authorities.

Year-on-year industrial output rose by 6.8% in June, and retail sales increased by 10.6% while fixed-asset investment increased by 11.4% on an annual basis by the end of the first half of 2015. On the down side, 'old-fashioned' industries such as crude-steel production shrank by 1.3% at the end of June 2015, compared to the same period of 2014. The GDP deflator (ratio of nominal to real GDP) decreased by 0.5% in the first half of the year, paving the way for further rate cuts by the People's Bank of China. The policy rate, measured by the 1 year lending benchmark rate, came down from 5.35% in March 2015 to 4.85% in June 2015. Interest rate cuts would in particular support the real estate sector which many analysts believe is a drag on economic performance.

Consumer prices rose by a moderate 1.4% in June, the same rate as in March 2015, paving the way for monetary easing. Food prices, the largest single component of the Chinese CPI basket, rose by 1.9% on an annual basis, up from 1.6% in May. Non-food prices posted a 1.2% annual increase, while house prices accelerated to an annual 0.8% in June from 0.6% in January 2015. Unemployment which hovers around 4.1% is expected to remain at that level for the rest of the year.

Table 1.11
Policy and Inflation Rates in China (%)

	Policy Rate	Inflation YoY
	2015	
Q2	4.85	1.4
Q1	5.35	1.4
	2014	
Q4	5.6	1.5
Q3	6.0	1.6
Q2	6.0	2.3
Q1	6.0	2.4
	2013	
Q4	6.0	2.5
Q3	6.0	3.1
Q2	6.0	2.7
Q1	6.0	2.1

Source: Bloomberg.

5. MENA economies

In the Middle East and North Africa (MENA) region, indicators of economic activity continue to support the resilience of this economy, given their capacity to weather the oil price shock. However, excessive government spending and huge fiscal deficit resulted in a downward revision of growth in Saudi Arabia. On the positive side, oil producing countries can still resort, at least partially, to the large financial buffers that they have accumulated in the form of international reserves and savings in Sovereign Wealth Funds in order to sustain the growth momentum in the non-energy sector and continue efforts to diversify their economies.

Table 1.12.a
Annual Real GDP Growth in MENA Countries (%)

	2014	2015P
Oil Exporters	**2.4**	**2.4**
Saudi Arabia	3.6	2.8R
Bahrain	4.7	2.7
Kuwait	1.3	1.7
Oman	2.9	4.6
Qatar	6.1	7.1
Oil Importers	**3.0**	**4.0**
Egypt	2.2	4.0
Jordan	3.1	3.8
Morocco	2.9	4.4
Tunisia	2.3	3.0

Source: IMF, Regional Economic Outlook for MENA, May 2015.
P: projection
R: revised

Indeed, growth estimates by the IMF for 2015 are higher compared to 2014 for Kuwait, Oman and Qatar, reaching 1.7%, 4.6% and 7.1%, respectively. While growth in Saudi Arabia is expected to slow down from 3.6% in 2014 to 2.8% in 2015 and from 4.7% to 2.7%, in Bahrain.

Oil importers are expected to have improved economic outlook in 2015, benefiting from low prices of oil and other primary commodities, with growth expected to reach 4.4% in Morocco and 3.8% in Jordan. In Egypt, growth is expected to improve form 2.2% in 2014 to 4% in 2015, thanks to continued drive for reforms and the success of the Economic Development Conference organized in March 2015.

As regards to inflation, it remained moderate in oil-exporting countries due to low imported inflation and subdued demand. Jordan and Morocco have benefited from the decline in international food and fuel prices. Therefore, expected inflation in 2015 for these countries will be in the order of 1.2% and 1.5%, respectively.

Countries that remain in post-revolutionary turmoil, however, continue to witness a large increase in food prices, fueled by disruptions in local production and depreciating local currencies. Expected low oil prices in 2015 will benefit mostly governments where fuel subsidies are dominant, e.g., in Egypt, thereby blocking the transmission channel from lower energy prices to domestic inflation. In Egypt, inflation is expected to decrease only slightly from 10.1% in 2014 to 9.8% in 2015, while the estimate for Tunisia is 4.9% and 5% respectively. Inflationary pressures in these countries are expected to continue against the backdrop of currency depreciation, which are fueling popular discontent and labor demand for higher wages.

Table 1.12.b
Annual Inflation in MENA Countries (%)

	2014	2015
Oil Exporters	**5.8**	**5.8**
Saudi Arabia	2.7	2.0
Bahrain	2.5	2.1
Kuwait	2.9	3.3
Oman	1.0	1.0
Qatar	3.0	1.8
Oil Importers	**9.4**	**6.9**
Egypt	10.1	9.8
Jordan	2.9	1.2
Morocco	0.4	1.5
Tunisia	4.9	5.0

Source: IMF, Regional Economic Outlook for MENA, May 2015.

Following the general slump in GCC stock markets in 2014 Q4 and in 2015 Q1, mostly linked to tumbling oil prices, an upward correction was observed in 2015 Q2. Share prices increased on a quarterly basis by 3% in Oman, 3.5% in Saudi Arabia and 3.9% in Qatar, but decreased by 1.6% in Kuwait and 5.7% in Bahrain.

In non-resource-rich MENA countries, however, which are particularly dependent on exports to Europe, share prices in Q2 fell on the back of a slowdown in foreign demand, by 7% in Morocco and by 8.4% in Egypt, while in Tunisia, share prices increased by 7.6%.

Table 1.13
Stock Market Indices in MENA Countries

	Bahrain	Egypt	Jordan	Kuwait	Morocco	Oman	Qatar	Saudi Arabia	Tunisia
	2015								
Q2	1,368	8,372	2,116	420	7,837	6,425	3,256	9,087	5,719
Q1	1,450	9,135	2,135	427	8,428	6,238	3,134	8,779	5,313
	2014								
Q4	1,427	8,927	2,165	439	7,843	6,343	3,151	8,333	5,090
Q3	1,476	9,811	2,115	494	8,254	7,484	3,472	10,855	4,580
Q2	1,428	8,162	2,113	470	7,512	7,008	2,938	9,513	4,596
Q1	1,357	7,805	2,149	483	7,758	6,857	2,992	9,474	4,591
	2013								
Q4	1,249	6,783	2,066	453	7,418	6,835	2,588	8,536	4,381
Q3	1,194	5,621	1,851	463	7,046	6,647	2,418	7,965	4,462
Q2	1,188	4,752	1,981	447	7,140	6,338	2,349	7,497	4,608
Q1	1,092	5,099	2,101	433	7,364	5,990	2,163	7,126	4,726

Source: Bloomberg.

Chapter 2: Domestic Economic Developments

The UAE has benefited in 2015Q2 from resilient growth in the non-energy sectors, supported by continued spending on development projects, high foreign currency reserves and strong indicators of financial stability underpinned by robust credit growth, while securities markets improved during this period.

2.1 Resilient Economic Growth

Economic growth, particularly in non-oil activities, is expected to remain resilient. Given assessment of credit growth in the banking sector, the central bank projects somewhat higher growth in the non-energy sector, 4.6% compared to that projected by the IMF. This is mainly due to the following factors: (1) continued plans of public spending on ongoing infrastructure projects financed by the Government and Government-related entities (GREs) and (2) the upward rebound of the oil price since February 2015, notwithstanding continued volatility in the global economy. In addition, the UAE economy is benefiting from resilient growth in other GCC countries, as well as in some emerging Asian economies (see chapter 1). Based on economic activity by sector, we project moderate decline in growth forecast in 2015 on account of weaker than expected growth in major underlying sectors, coupled with more moderate growth in the energy sector.

Table 2.1
Economic Growth in the UAE (constant prices)

	2012	2013	2014	2015*
Total GDP annual growth rate (%)	6.9	4.3	4.6	4.0
- Oil GDP	7.6	2.9	4.0	2.6
- Non-Oil GDP	6.6	5.0	4.8	4.6
- Manufacturing	5.6	1.2	3.2	3.0
- Construction	5.5	3.4	7.3	7.0
- Wholesale & Retail Trade	0.3	4.9	5.6	5.0
- Real Estate & Business Services	12.1	6.6	-4.1	-4.0
- Transport & Communications	5.0	-1.1	8.6	8.0

Source: National Bureau of Statistics.
*: Central Bank estimates, based on credit growth and sectoral activity, subject to revision pending further analysis of data updates.

Growth in non-oil activities during 2015 is expected to remain balanced among the main economic growth sectors. Manufacturing (9% of GDP) is expected to grow by 3% due to investments in the free trade zones as well as in the mainland. Meanwhile, Construction (10.5% of GDP) is expected to increase by 7% due to housing and infrastructure developments as well as landmark tourism projects. In the Emirate of Abu Dhabi, progress is continuing in Saadiyat Island's cultural district on the Louvre Museum, Zayed National Museum, and Guggenheim Museum, despite the postponement of some flexible deadlines. In Dubai, infrastructure projects implemented in preparation for Expo 2020 are estimated to be in the order of AED 30 billion.

Moreover, Trade as well as Transport and Communications continue to receive a boost from tourism during the year, which is benefitting from worldwide low fuel prices and lower travel costs, recovery in advanced economies and competitive marketing packages, despite the Dirham appreciation. Accordingly, these services are expected to experience a moderate decline in growth rates, estimated at 5% and 8%, respectively in 2015. However, contraction in the "Real Estate and Business Services" is expected on account of the drop in the oil price which could slow down demand, relative to existing supply going forward.

2.2 Mild exchange rate appreciation

For the top 9 non-dollarized trading partners of the UAE, totaling 48 % of imports, the weighted currency effect over the second quarter 2015 was 0.31%. One of the main driver of this development has been the exchange rate change vis-à-vis the Indian Rupee which lost 1.9% against the Dirham in the second quarter, whereby India represent over 9% of the imports to the UAE. The appreciation was even more significant when considering the first six months of 2015, where on a trade weighted basis the Dirham appreciated by 3.9%, driven by a gain of almost 20% of the Dirham against the Euro.

Judged by the rate of appreciation imports became cheaper, an effect which would be even more pronounced when considering the real trade weighted development, i.e., higher inflation in the UAE relative to major trading partners for imports. Conversely, exports became more expensive due to the currency movement of the Dirham against its major non-dollarized export partners (totaling 57.2 % of non-energy exports). In the second quarter the appreciation was 0.84% while over the first half of 2015 it was 2.2% whereas the appreciation against the Turkish Lira was the most notable (17.2%).

The combined analysis of appreciation rates for imports and non-energy exports suggests a scope to capitalize on appreciation towards boosting competitiveness. Provided there is a high pass through from the cheaper imports to the cost of non-energy exports and lower inflation of tradables, competitiveness could be boosted where the import content is high in exports

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

Currency	Share of UAE imports (%) 2014	Average Currencies per Dirham 2014	Average Currencies per Dirham 2015		% Change of Currencies per Dirham (Q2 – Q1) 2015	Average Currencies per Dirham First half 2015	% Change of Currencies per Dirham (First half 2015–2014)
			Q1	**Q2**			
Chinese Yuan	11.68	1.6776	1.6978	1.6884	-0.55	1.6931	0.92
Indian Rupee	9.19	16.6109	16.9409	17.2607	1.89	17.1017	2.95
Germany (EUR)	6.09	0.2053	0.2420	0.2460	1.65	0.2441	18.88
Japanese Yen	5.55	28.8366	32.4493	33.0398	1.82	32.7462	13.56
UK Pound	3.53	0.1654	0.1798	0.1777	-1.18	0.1787	8.08
Swiss Franc	3.38	0.2493	0.2593	0.2561	-1.22	0.2577	3.39
Italy (EUR)	3.09	0.2053	0.2420	0.2460	1.65	0.2441	18.88
South Korean Won	2.95	0.2869	0.2999	0.2989	-0.34	0.2994	4.35
France (EUR)	2.54	0.2053	0.2420	0.2460	1.65	0.2441	18.88
Total	**48.00**						
Weighted Appreciation					**0.31**		**3.87**

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.

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

Currency	Share of UAE exports (%) 2014	Average Currencies per Dirham 2014	Average Currencies per Dirham 2015 Q1	Average Currencies per Dirham 2015 Q2	% Change of Currencies per Dirham (Q2 – Q1) 2015	Average Currencies per Dirham First half 2015	% Change of Currencies per Dirham (First half 2015–2014)
Indian Rupee	14.85	16.6109	16.9409	17.2607	1.89	17.1017	2.95
Saudi Arabian Riyal	8.15	1.0212	1.0218	1.0211	-0.07	1.0214	0.02
Omani Rial	6.61	0.1047	0.1048	0.1048	0.00	0.1048	0.09
Swiss Franc	6.34	0.2493	0.2593	0.2561	-1.22	0.2577	3.39
Turkish Lira	5.4	0.5960	0.6713	0.7255	8.08	0.6986	17.21
Iraqi Dinar	4.72	3.1883	3.2349	3.2881	1.64	3.2617	2.30
Kuwaiti Dinar	4.48	0.0775	0.0807	0.0822	1.86	0.0814	5.05
Egyptian Pound	3.65	1.9290	2.0427	2.0765	1.65	2.0597	6.78
Chinese Yuan	3	1.6776	1.6978	1.6884	-0.55	1.6931	0.92
Total	**57.20**						
Weighted Appreciation					**0.84**		**2.20**

Source: Data on exports 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. CPI inflation

Year-on-Year increase in the Consumer Price Index (CPI) continues to accelerate increasing from an average of 3.8% in 2015 Q1 to 4.3% in 2015 Q2.

Housing remains the main driver of the CPI inflation due to its dominant weight in the consumer price basket (39%). The National Bureau of Statistics figures show year-on-year increase in housing prices, rising from an average of 7.9% in 2015 Q1 to 9.6% in 2015 Q2.

For other so-called non-tradables, prices were supposed to clear the domestic market and therefore they could be subject to increase if local demand is high. In 2015 Q2, the main drivers of inflation other than housing include Education (4% of CPI basket) which recorded year-on-year price increase by 4% and Restaurants and Hotels (4.4% of the CPI basket) where prices increased by 3.1%. For Communications (7% weight in the consumer basket) prices decreased year-on-year by 0.1%, while prices increased by only1% for Transportation (10% weight in the consumer basket), on account of a cheaper cost of fuel.

As regards the price of tradables [Food, Textiles, and Furniture represent 26% of the total CPI basket in the UAE], the strengthening of the US dollar during the previous period (2014 H2 - 2015 Q1) is expected to have a delayed impact on import prices in 2015 Q2. The general depreciation of foreign currencies vis-à-vis the Dirham, in tandem with very low international inflation, particularly for commodity prices on account of a slowdown in the global economy, explain how items of the CPI that rely heavily on imports either decreased or exhibited moderate increase. Specifically, prices for Textile, Clothing and Footwear (7.6% of the CPI basket) year-on-year fell by 2.3% in 2015 Q2. Other prices exhibited a moderate annual increase of 1.3% for Food and Soft Drinks (14% of the CPI basket) and 2.4% for Furniture and Household Goods (4.2% of the CPI basket).

The increase in Housing prices in 2015 H1, however, may be transitory given current and pending supply; firming projections of fairly moderate and declining CPI inflation (3.8% for 2015 and 3% for 2016), according to IMF projections and our estimates in 2015 Q2.

Table 2.3
UAE Consumer Price Index* (2014 - 2015)
Year-on-Year percent change

Major Groups of Expenditure	Weights	2014								2015							
		June	July	Aug.	Sep.	Oct.	Nov.	Dec.	Yearly Average	Jan	Feb	March	Average Q1	April	May	June	Average Q2
General Consumer Price Index	100.0	2.2	2.3	2.4	2.9	3.1	2.8	1.6	2.3	3.7	3.5	4.3	3.8	4.3	4.3	4.2	4.3
Food and soft drinks	14.0	1.7	1.4	2.1	2.5	3.7	2.1	0.8	2.1	0.1	0.4	1.1	0.6	0.9	1.5	1.4	1.3
Beverages and tobacco	0.2	3.9	4.8	4.8	4.8	3.7	3.6	2.5	2.9	3.6	3.6	2.9	3.4	3.3	3.3	-0.1	2.2
Textiles, clothing and footwear	7.6	0.1	0.0	-0.3	0.5	0.4	-1.1	0.0	0.3	-0.9	-1.0	-1.7	-1.2	-1.1	-2.4	-3.4	-2.3
Housing	39.0	2.4	2.7	2.9	4.1	4.2	4.4	2.4	2.9	7.4	7.2	9.3	7.9	9.2	9.4	10.2	9.6
Furniture and household goods	4.2	4.5	4.6	4.9	4.8	4.6	4.7	3.1	4.1	5.1	4.5	3.7	4.4	2.8	2.5	1.7	2.4
Medical care	1.2	0.0	0.7	0.8	0.7	0.9	1.5	0.7	0.4	1.2	1.2	0.8	1.1	0.8	0.6	0.5	0.6
Transportation	10.0	1.9	2.1	1.8	1.6	1.5	1.7	1.1	1.3	1.5	1.6	1.6	1.6	1.4	1.3	0.4	1.0
Communications	7.0	0.8	0.8	0.8	0.8	0.8	0.8	0.6	0.5	0.7	0.7	0.7	0.7	-0.1	-0.1	-0.1	-0.1
Recreation and culture	3.1	0.9	0.9	0.9	0.7	0.7	0.7	0.7	0.8	0.8	0.2	0.1	0.3	0.1	-0.2	0.0	0.0
Education	4.0	4.6	4.6	4.6	4.0	4.0	4.0	1.4	4.1	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Restaurants and hotels	4.4	1.1	1.1	1.3	1.3	1.3	1.4	0.6	1.2	1.4	1.0	1.3	1.2	2.8	3.3	3.2	3.1
Miscellaneous goods and services	5.3	5.2	5.6	5.1	4.5	4.6	4.1	2.7	2.9	5.4	4.0	3.6	4.4	3.9	3.9	0.7	2.9

Source: National Bureau of Statistics.
Note: CPI Index= 100 for base year 2007.

2.4. Volatile Share Prices

The UAE securities markets remained volatile in 2015 Q2 with the share price index increasing by 8.9% in April, decreasing by 3.4% in May, and increasing again by 4.5% in June, resulting in a total gain of 10.1% in the index for the share prices at the end of 2015Q2.

Looming uncertainty about the global economic slowdown as well as regional instability has led to increased volatility in the UAE stock markets. However improved confidence in the second quarter was evident, thanks to the country's large buffers of foreign currency assets and continued drive to sustain growth in the non-energy sector.

Table 2.4
UAE Securities Markets

	2014							2015					
	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	March	April	May	June
Number of Listed Companies	120	120	120	121	122	125	125	126	126	126	126	126	126
Share Price Index	4657.8	5285.1	5356.9	5378.0	5092.4	4886.9	4508.1	4480.2	4744.6	4476..9	4877.1	4713.3	4927.3
Monthly change in Share price index (%)	-15.9	13.5	1.4	0.4	-5.3	-4.0	-7.8	-0.6	5.9	-5.7	8.9	-3.4	4.5
Market Capitalization	699.2	793.8	804.6	808.3	801.0	771.0	728.4	726.2	769.1	726.2	790.5	764.0	798.7
Traded Value Monthly	48.3	43.2	21.6	32.2	28.5	26.4	31.8	19.5	17.7	14.6	32.6	18.9	30.3

Source: UAE Securities and Commodity Authority.
Note: All numbers are in billions of Dirhams unless otherwise indicated.

2.5. Decreasing CDS Premiums

Credit Default Swaps (CDS) indicate the risk related to the entities issuing debt. Table 2.5 shows some decrease in the risk premium for UAE entities issuing debt instruments in international markets, during the second quarter of 2015, particularly Abu Dhabi Sovereign (decreasing by 20 basis points), Dubai Sovereign (decreasing by 45 basis points) and DP World (decreasing by 5.5 basis points), while CDS for Dubai Holding increased by 19.4 basis points.

Table 2.5
UAE - Credit Default Swaps (CDS)

	2008	2013	2014				2015	
	Q4	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Sovereigns								
Abu Dhabi	229.2	55.0	53.0	49.5	54.5	63.5	72.0	52
Dubai	470.0	220.0	173.2	155.0	170.0	226.0	220.0	175
GREs								
DP World	762.0	167.5	148.9	151.3	145.0	212.0	194.1	188.595
Dubai Holding	869.7	325.8	287.8	282.0	316.0	330.7	321.3	340.8

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

2.5. The fiscal stance

Based on official projections, the consolidated government revenue[1] is expected to fall by 24.6% in 2015, on account of a reduction in the revenues of local governments. Taxes, mostly fees paid by hotels and restaurants, fees on foreign banks' profits, and royalties on oil and natural gas, are expected to fall by AED 92 billion or 32.7%, in line with the fall in oil prices. Other revenues, made up mainly of property income, are expected to fall by 11.8% during 2015. The decline of the consolidated government revenue is reflecting an expected decline of the local government revenues in 2015 by almost the same amount.

As a result, following an expansionary fiscal stance in 2014 when public expenditures increased by 10.9%, the first step in a gradual fiscal consolidation has started in 2015, with a decrease in public spending by AED 17 billion in the first quarter of the year compared to the first quarter of 2014, equivalent to a decrease of 16.4%. This cut is in line with a drop in Subsidies and Grants by 93.1% and 67.9% respectively, compared to the same period of 2014 (see table 2.7). Subsidies' decrease is due mainly to the partial removal of subsidies of water and electricity in Abu Dhabi, with the aim of taming waste and reinforcing fiscal consolidation.

Towards enforcing additional fiscal consolidation, the UAE Government has announced on 22nd July 2015 its plan for the removal of energy subsidy starting from 1st August 2015, which could amount to savings of USD 29 billion (AED 107.3 billions) per year according to the IMF estimates, the equivalent of 25.9% of the 2014 total expenditures (See Table 2.6). Following this reform, the UAE is now applying the highest prices of petrol and Diesel among the group of oil producers (see figures 2.1 and 2.2).

[1] These estimates do not take into consideration the revenues stemming from Abu Dhabi National Oil Company (ADNOC) transfers and government investment income.

The price reform came at the right time as oil prices have resumed recently their falling path on the back of a supply glut that may increase as prospects for higher production from Iran and some Non- and OPEC producers are increasing. Projected decrease in the international price is likely to mitigate the impact of the complete removal of the subsidy on the cost of fuel for consumers. However, there is an upside risk of higher inflation when the price of oil moves higher again.

The more important and direct impact is expected to be on the non-tradable consumer price inflation, namely the price of transportation, which could spill over to the tradable component of price inflation. Consequently, the cost of living is expected to increase as a result of the propagation of the subsidy removal on the domestic inflation space, absent measures to stem the magnitude and speed of this propagation mechanism.

Figure 2.1 Petrol prices (US$ per litre)

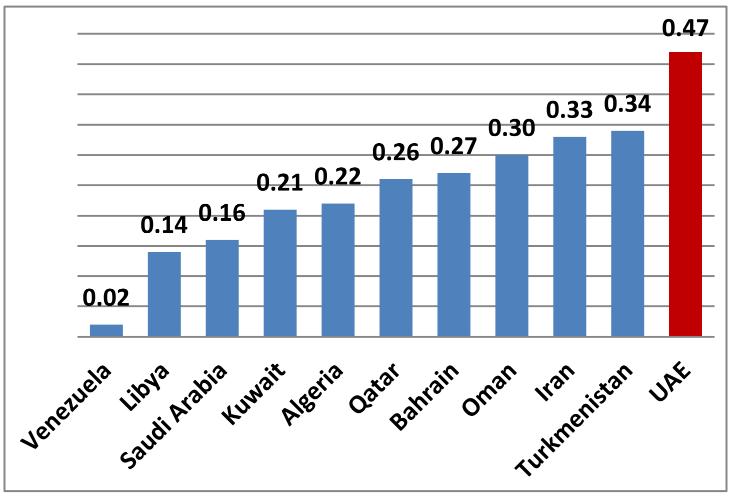
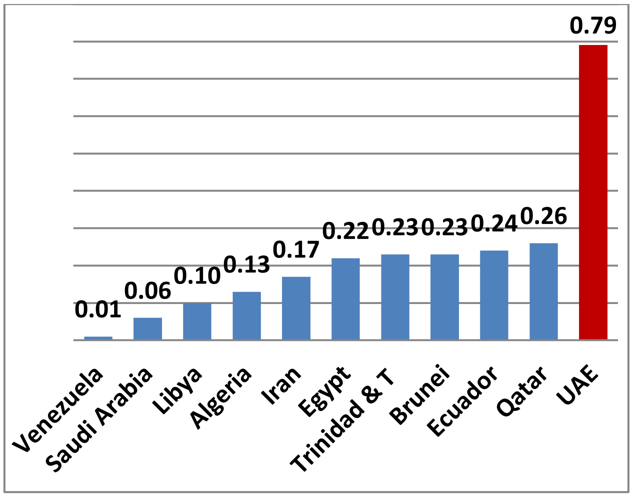


Figure 2.2 Diesel prices (US$ per litre)



Source: globalpetrolprices.com

Table.2.6

Consolidated General Government Finances (Billions of Dirhams)

	2013					2014					2015Q1 (Actual)	2015* (Projected)	Percentage change 2015Q1-2014Q1
	Q1	Q2	Q3	Q4	2013	Q1	Q2	Q3	Q4	2014			
Revenues (a)	**97.2**	**108.8**	**96.6**	**109.4**	**412.1**	**90.2**	**98.1**	**94.5**	**97.8**	**380.7**	**74.9**	**286.9**	**-17.0**
of which:													
Taxes	80.1	78.2	79.0	81.8	319.1	68.1	67.8	75.5	68.4	279.9	54.9	188.4	-19.4
Social contributions	0.9	1.4	1.2	1.7	5.1	0.9	1.6	0.4	2.4	5.3	1.1	5.5	14.0
Expenditure (b)	**76.7**	**87.7**	**105.2**	**104.2**	**373.8**	**104.0**	**103.7**	**98.9**	**107.9**	**414.6**	**87.0**	**411.1**	**-16.4**
Compensation of employees	10.2	10.5	10.3	11.2	42.1	10.6	11.4	11.4	14.1	47.5	14.4	48.6	36.4
Use of goods and services	8.4	10.8	8.6	15.4	43.2	8.9	12.1	13.8	14.7	49.5	10.5	55.3	18.3
Consumption of fixed capital	0.7	0.8	0.8	1.0	3.3	0.9	0.7	1.0	1.1	3.8	0.9	3.8	0.3
Interest	0.2	1.2	1.2	3.3	5.9	1.0	1.0	0.9	1.2	4.1	0.5	3.1	-52.4
Subsidies**	2.2	2.7	2.6	2.6	10.1	2.5	3.6	3.4	2.6	12.1	0.2	13.0	-93.1
Grants	4.1	5.5	6.5	5.5	21.6	9.8	6.2	5.5	0.4	21.9	3.1	11.3	-67.9
Social benefits	8.2	13.4	12.6	18.3	52.4	12.6	13.8	16.1	18.8	61.4	12.9	56.7	2.2
Other expense	41.4	33.5	40.3	46.3	161.6	52.3	41.0	37.2	43.9	174.4	39.9	184.5	-23.8
Net Acquisition of Nonfinancial Assets	1.3	9.4	22.3	0.5	33.5	5.5	13.7	9.5	11.2	39.9	4.7	34.8	-15
Consolidated Fiscal balance (a-b)	20.5	21.1	-8.5	5.3	**38.3**	-13.8	-5.6	-4.4	-10.2	**-34.0**	**-12.1**	**-124.2**	**-12.5**

Source: UAE Ministry of Finance, revenues do not include ADNOC transfers and government investment income. Expenditure do not include Abu Dhabi Capital transfers.
2015 Projections: based on published 2015 IMF Staff Report.
***:** Projected revenues are adjusted so that ADNOC transfers and government investment income are excluded, in line with historical official data. Projected expenditure is also adjusted so that Abu Dhabi capital transfers are excluded.
****:** the amount of subsidies reported does not capture the impact of the further reduction in the deficit on account of the fuel price subsidy reform, effective August 2015.

Table.2.7
The Fiscal Balance in the UAE

	2012	2013	2014	2015 (Projection)
Consolidated Fiscal Balance as % of total GDP	10.9	10.4	5.0	-2.9
Consolidated Fiscal Balance as % of Non-oil GDP	17.9	16.6	7.6	-3.7

Source: IMF estimates. All ratios above take into account the ADNOC transfers and the government investment income in the revenues estimates and Abu Dhabi capital transfers in the expenditure estimates.

The consolidated budget is projected to turn into deficit in 2015 reaching AED 124.2 billion (table 2.6), which is estimated to shrink to 2.9 percent of GDP and 3.7 percent of non-oil GDP after factoring in the Abu Dhabi government capital transfers and the mitigating revenue effect of transfers from ADNOC and government investment income (table 2.7).

Chapter3. Monetary & Banking Developments

Monetary and banking indicators maintained robust growth in deposits and loans in 2015 Q2, consistent with the continued improvement in the quality of loan portfolio and resilient non-energy economic activity.

3.1 Monetary Expansion

Money supply M1 increased by 1.6% in 2015Q2 and by 6.9% year-on-year up to June 2015. Currency in Circulation (12.7% of M1) contributed with 0.9% to the latter, while Monetary Deposits (87.3% of M1) contributed with 6%.

M2 increased by 1% in 2015Q2 and by 4.1% year-on-year up to June 2015. The latter was brought about by a contribution of 0.3% increase in Currency in Circulation (4.9% of M2), 2.3% contribution of the increase in Monetary Deposits (34.1% of M2), while Quasi-Monetary Deposits (61% of M2) contributed with an increase of 1.5%.

Despite a decrease by 0.7% in 2015Q2, M3 increased year-on-year at the end of June by 2%, with the main contributors being 1.9% increase in Monetary Deposits (30% of M3) and 1.3% increase in Quasi-Monetary Deposits. Government Deposits (12.2% of M3) however contributed with a decrease in the order of 1.6%.

3.2 Resilient Banking Activity

The 23 locally-incorporated banks increased their branches from 871 at the end of March 2015 to 873 at the end of June, while the 6 banks from the GCC countries remained with 4 branches, and the number of foreign banks remained at 20, with 82 branches. The total number of wholesale banks operating in the country remains at 8 during this period.

As regards banking activity, the oil price slump could increase the downside risks for banks operating in the UAE, due to a slowdown in the real estate sector, more volatile securities markets and added uncertainties about banks' exposure to business partners in hardly hit oil-dependent economies. However, the Central Bank continues to monitor closely indicators in the banking sector to ensure stability and growth.

Table 3.1
Monetary Developments: 2014 – 2015

	2014				2015		Year to Date Change (%)	Contribution to Aggregate Growth (%)	Year on Year Change (%)	Contribution to Aggregate Growth (%)
	Q1	Q2	Q3	Q4	Q1	Q2				
Money Supply M1	**412.0**	**434.3**	**431.1**	**436.1**	**456.9**	**464.1**	**6.4**		**6.9**	
Currency in Circulation	53.4	54.9	57.3	59.0	56.2	58.8	-0.3	0.0	7.1	0.9
Monetary Deposits	358.6	379.4	373.8	377.1	400.7	405.3	7.5	6.5	6.8	6.0
Money Supply M2	**1124.3**	**1142.6**	**1136.1**	**1141.1**	**1178.8**	**1190.0**	**4.3**		**4.1**	
Currency in Circulation	53.4	54.9	57.3	59.0	56.2	58.8	-0.3	00	7.1	0.3
Monetary Deposits	358.6	379.4	373.8	377.1	400.7	405.3	7.5	2.5	6.8	2.3
Quasi Monetary Deposits	712.3	708.3	705.0	705.0	721.9	725.9	3.0	1.8	2.5	1.5
Money Supply M3	**1280.2**	**1328.4**	**1344.2**	**1332.0**	**1364.1**	**1355.1**	**1.7**		**2.0**	
Currency in Circulation	53.4	54.9	57.3	59.0	56.2	58.8	-0.3	0.0	7.1	0.3
Monetary Deposits	358.6	379.4	373.8	377.1	400.7	405.3	7.5	2.1	6.8	1.9
Quasi Monetary Deposits	712.3	708.3	705.0	705.0	721.9	725.9	3.0	1.6	2.5	1.3
Government Deposits	155.9	185.8	208.1	190.9	185.3	165.1	-13.5	-1.9	-11.1	-1.6

Source: Research & Statistics Department, Central Bank of the UAE.
Note: All values are expressed in billions of Dirhams. Monetary aggregates data indicate the end-of-quarter values.

Table 3.2.a
Banks and Other Financial Institutions

	2014				2015	
	Q1	Q2	Q3	Q4	Q1	Q2
Locally Incorporated Banks						
Main Branches	23	23	23	23	23	23
Additional Branches	843	858	866	869	871	873
Electronic Banking Service Units	29	33	33	34	31	32
Cash Offices	89	89	89	90	90	90
GCC Banks						
Main Branches	6	6	6	6	6	6
Additional Branches	4	4	4	4	4	4
Foreign Banks						
Main Branches	22	22	22	20	20	20
Additional Branches	83	83	83	82	82	82
Electronic Banking Service Units	53	53	54	48	48	48
Cash Offices	1	1	1	1	1	1
Other Financial Institutions						
Wholesale Banks	4	5	5	7	8	8
Representative Offices	120	122	121	121	122	122
Finance Companies	25	26	26	26	26	26
Financial Investment companies	25	25	25	25	25	25
Moneychangers	134	137	138	140	140	141
Offices for Intermediating in Currency Trading & Money Market Operations	12	12	12	12	12	12

Source: Banking Supervision Department, Central Bank of the UAE.
Note: All data indicate the end-of-quarter values.

Despite a decrease by 4.4% in 2015 Q2, Customer Deposits at banks increased by 3.1% year-on-year up to June 2015, reaching AED 1,444.3 billion and Domestic Credit increased by 6.5% reaching AED 1335.8 billion. Meanwhile, the ratio of Bank Lending to Stable Resources increased from 85% at the end of March 2015 to 87.6% at the end of June of the same year (see Table 3.3 for definition).

Domestic Credit growth is supported by a strong deposits base, ample liquidity in the banking system and, on the demand side, by the resilient growth in the non-oil sectors (more than 60% of GDP). Moreover, even though some banks' foreign business partners suffered from low oil prices, other business partners benefitted from it, particularly in India (38.6% of UAE exports) and in China (11.5% of UAE exports).

Table 3.2.b
UAE Banking Indicators

	2014			2015		
	Q2	Q3	Q4	Q1	Q2	Year- on- Year Change (%)
Total Bank Assets	2236.9	2311.3	2304.9	2379.9	2419.5	8.2
Domestic Credit	1254.2	1290.6	1277.6	1303.6	1335.8	6.5
Personal loans to residents	295.5	306.8	299.8	309.8	319.3	8.1
Customers deposits at banks	1400.2	1414.5	1421.3	1449.3	1444.3	3.1

Source: Banking Supervision Department, CBUAE.
Note: All data indicate the end-of-quarter values. Values are expressed in billions of Dirhams.

The Quarterly Credit Sentiment survey (The Central Bank survey of credit officers at banks) for 2015 Q2 showed softening demand for loans as well as less willingness to lend by banks which may slow down bank credit in the period ahead.

As regards Islamic banks, they continued to thrive with their assets increasing by 3%, in 2015 Q2 reaching AED 445 billion, increasing their share in total assets from 18.2% in 2015 Q1 to 18.4% in 2015 Q2. Meanwhile, their financing increased to reach AED 290 billion in 2015 Q2 (21.7% of Domestic Credit).

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

	2014				2015	
	Q1	Q2	Q3	Q4	Q1	Q2
Assets	378	389	402	405	432	445
Percent of total banking assets	17.3	17.4	17.4	17.6	18.2	18.4
Islamic financing	229	244	260	266	280	290
Percent of Domestic Credit	18.7	19.5	20.1	20.8	21.5	21.7

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.

3.3 Financial Soundness Indicators

The overall outlook regarding the soundness of the banking sector remains positive during this period, due to: (1) continued improvement in the quality of the loan portfolio, and (2) strong capital base of banks, and (3) ample liquidity in the banking sector against the backdrop of resilient economic growth, particularly in the non-oil sectors of the economy.

The quality of the loan portfolio of banks continued to improve, as evidenced by the decline of the ratio of non-performing loans (NPLs) from 7% at the end of December 2014 to 6.6% at the end of March 2015 and further to 6.3% at the end of June. As a result, bank specific provisions for NPLs decreased from a peak of AED 91.1 billion at the end of November 2014 to AED 71.7 billion at the end of March 2015 and to AED 70.6 billion at the end of June. Nonetheless, NPLs remained fully provisioned during this period.

Banks operating in the UAE maintained high capitalisation, stable funding and sufficient liquidity, 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, decreased from 15.7% at the end of December 2014 to 14.7% at the end of March 2015 and to 14.3%.

Table 3.3
Financial Soundness Indicators in the UAE

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

Source: Research & Statistics Department, Central Bank of the UAE.
Note: (*) Net Lending + Net Financial Guarantees+ Stand-by Letters of Credit+ Interbank Placements (3 months and more)/ (Net Free Capital Funds+ Other Stable Resources). All numbers are in percentage.

Chapter4. Central Bank Financial Position & Reserve Management

The Central Bank balance sheet continues to exhibit ample liquidity in the banking system in 2015 Q2, while interest rates increased moderately in line with the direction of projected interest rates hikes on the US dollar

4.1 Central Bank Balance Sheet

On the liabilities side, “Current Accounts and Deposits” of banks at the Central Bank increased by AED 6 billion, during 2015 Q2, and “Currency Issued” increased by AED 3.2 billion. Meanwhile, banks’ balance of “Certificates of Deposit” issued by the Central Bank decreased by AED 10.4 billion, reaching AED 101.3 billion at the end of June 2015.

The total assets of the Central Bank of the UAE decreased by 3.9% during 2015 Q2, reaching AED 331.3 billion. This was mainly the result of a decrease in “Held-to-Maturity Foreign Securities” which decreased by AED 14.4 billion.

Table 4.1
Central Bank Balance Sheet

	2014	2015	
	Q4	**Q1**	**Q2**
Assets			
Gold Bullion	-	-	347
Cash & Bank Balances	42,001	42,409	40,708
Deposits	76,917	70,057	92,880
CDs Under Repo	-	6,000	-
Liquidity Support Facility	321	321	321
Held-To-Maturity Foreign Securities	157,753	159,947	145,574
Held-To-Maturity Bonds Issued by MOF & Dubai Government:	49,443	49,443	49,443
Available-for-sale investments	378	378	368
Derivative Assets*	7,530	955	1066
Advances to Government	2,500	2,500	-
Other Assets	7,996	447	469
Property and Equipment's	79	78	85
Total Assets	**344,918**	**332,535**	**331,260**
Off Balance Sheet Commitments	**134,105**	**145,303**	**119,150**
Liabilities			
Current Accounts & Deposits	142,168	129,404	135,394
Certificates of Deposit	99,534	111,759	101,335
Currency Issued	74,472	69,353	72,549
Other Liabilities	1,683	1,810	1399
Derivative Liabilities*	-	381	771
Total Liabilities	**317,857**	**312,707**	**311,448**
Capital & Reserves			
Authorized Issued & Fully Paid Capital	2,500	2,500	2500
Other Reserve	-		-6
Fair Value Reserve	-11	-11	-21
General Reserve	16,080	17,339	17339
Retained Earnings	962		
Total Liabilities & Capital	**337,388**	**332,535**	**331,260**
Off Balance Sheet Commitments related to foreign exchange fluctuations	**134,105**	**145,303**	**119,150**

Source: Financial Control Division, Central Bank of the UAE.
Note: All numbers are end-of-quarter values. They are expressed in millions of Dirhams.
***:** Market value of adjustment on open Swap contracts.

4.2 Central Bank Financial Results

The Central Bank's balance of foreign currency assets which include USD 10 billion Dubai Government bonds, increased by 1.6% in 2015 Q2, reaching AED 310.9 billion. This was mainly due to an increase in "Deposit Account and Cash with Banks Abroad by AED 19.1 billion.

Table 4.2
Investment of the Central Bank's Foreign Currency Assets

	2014	2015	
	Q4	Q1	Q2
Total Foreign Currency Assets	320.6	306.0	310.9
Central Bank's Investments Abroad In Highly Rated Securities, Government Bonds And Treasury Bills	157.8	159.9	145.6
Deposit Account and Cash with Banks Abroad	115.4	105.5	124.6
Central Bank's Investment In Local Government Bonds	36.7	36.7	36.7
Other Foreign Assets	10.7	3.9	4.0

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

4.3 Interest Rates

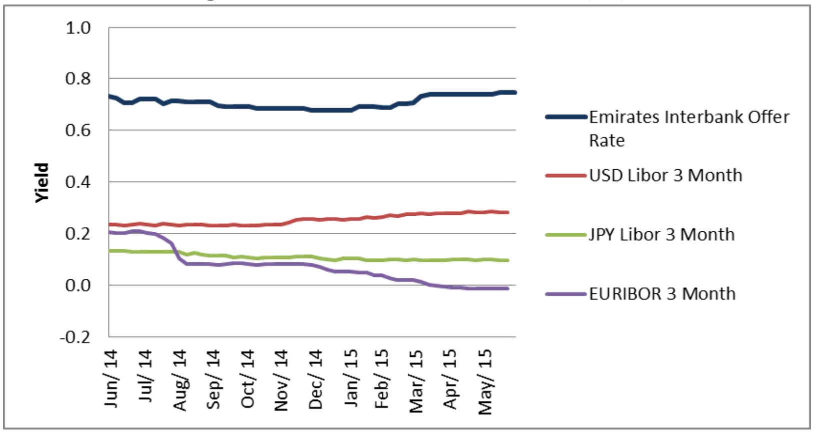
The fixed peg of the exchange rate of the dirham to the US dollar means that the CBUAE has limited degree of freedom to set interest rates, independently from the direction of the interest rate as laid out by the US monetary policy which is defined by the Federal Reserve System in the United States. 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 defending the fixed peg regime.

4.3.1 Short-term interest rates

The 3-month Emirates Interbank Offer Rate (Eibor) barely moved in the second quarter. Its latest reading from end June 2015 is only 1.5bp lower than its value at the end of March 2015 (0.73 vs 0.74). Also, the 3-month USD Libor moved up only slightly, from 0.27% to 0.28%. Markets during the second quarter eased expectations concerning a potential interest rate hike by the Fed on account of a downward revision of global growth against the backdrop of pending resolution of the Greek crisis and concerns about slowdown in China.

Accordingly, the spread of AED Eibor over the USD 3-month Libor remained stable at around 0.45%. The Eibor is calculated by the Central Bank of the UAE, comprising daily quotes of the largest banks operating in the country. The spread between the highest and the lowest quotes came down from 0.66% in March 2015 to 0.57% in June 2015.

Figure 4.1 3-month Libor Rates (%)



Source: Bloomberg

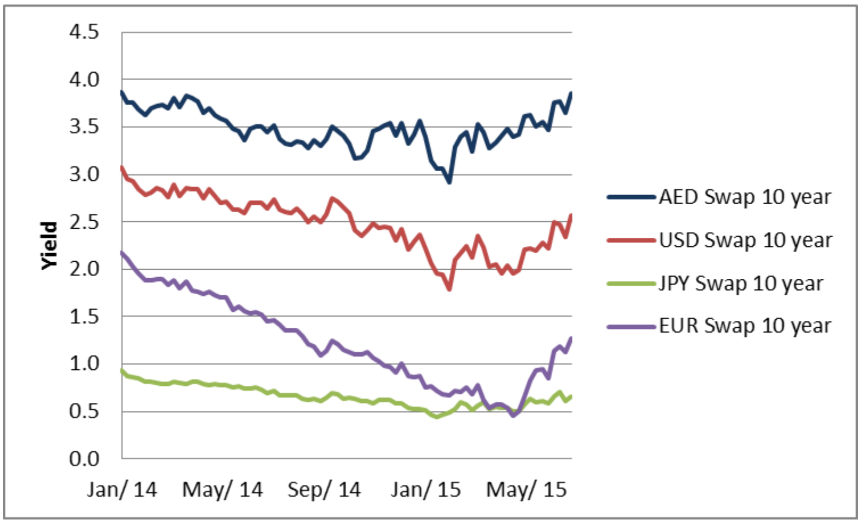
In the second quarter both the JPY and the EUR Libor rates remained virtually unchanged, with the EUR Libor getting into negative territory of -0.014%. Policies in Japan and the Euro area are still gearing towards further stimulus, capitalizing on some sort of quantitative easing by their central banks in order to support their domestic economies.

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, there was a slight movement on the AED 10-year swap rate which increased from 3.4% at the end of March 2015 to 3.7% at end of June. This move tracked basically the development of the USD 10-year swap rate which increased from 2.02% in March 2015 to 2.46% in June 2015. The spreads between the AED 10-year swap and the USD 10-year swap declined marginally during the second quarter from 1.4% in March 2015 to 1.2% in June 2015.

The rise in yields is a reflection of a perceived acceleration of the US economy accompanied by the prospect of a higher US inflation, which manifested itself in higher 5-year USD inflation swap rates. The steepest increase occurred on the 10-year EUR swap rate, rising from 0.55% to 1.15% in the three months to June 2015. The steep increase reflects higher inflation expectations due to the pickup in economic momentum, particularly following the agreement reached between Greece and its major creditors.

Figure 4.2 10-year swap rates



Source: Bloomberg.

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.

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 holding of CDs. Banks' current account at the Central Bank increased from AED 16.7 billion at the end of 2015 Q1 to AED 17.3 billion at the end of 2015 Q2, while Certificates of Deposit held by banks decreased by AED 10.5 billion, from AED 111.8 billion to AED 101.3 billion.

Total bank liquidity, including reserve requirements and highly-rated government and public sector debt, decreased by AED 6.6 billion, reaching AED 282.6 billion at the end of 2015 Q2. Nonetheless, liquidity remained sufficient, during this period, as indicated by the fact that there was no use by banks of 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 Q2 comprise AED 124.6 billion deposits at banks abroad and AED 145.6 billion Held – to – Maturity Securities, in foreign currencies, in addition to other reserves amounting to AED 4.4 billion, which brings total foreign reserves to AED 274.6 billion, excluding USD 10 billion Dubai Government Bonds.