مصرف الإمارات العربية المتحدة المركزي

CENTRAL BANK OF THE U.A.E.

Quarterly Economic Review

Fourth Quarter 2015

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Executive Summary

At the international level, the fourth quarter of 2015 was dominated by three important events. First, global growth prospects continue to deteriorate with the slowdown in China, global markets turmoil and Emerging Markets woes due to collapsing currencies, capital outflows and rising risks. Second, the dipping oil and other commodity prices exacerbated exporters' difficulties and added to market volatility worldwide. Third, the interest rate increase in the US triggered additional capital flows out of emerging and developing economies.

At the domestic level, the Central Bank of the UAE continues to develop its forecasting capabilities with: (1) the construction of the 'Economic Composite Indicator' (ECI) for the UAE which combines advanced econometric techniques with available economic variables such as CPI (consumer price indicator), PMI (purchasing manager index) and oil prices, and (2) the set-up of an econometric model to project economic growth for both oil and non-oil activities over a period of two years.

The Central Bank's estimates for the UAE show a resilient growth, driven by the non-oil activities which are expected to grow by 3.7% in 2015, while oil-GDP is expected to grow by 2.2%. Also, CPI inflation (Y-on-Y) slowed down to 3.6% in 2015 Q4 due mainly to a slowdown in Housing and lower imported inflation, on account of continued strengthening of the Dirham.

At the fiscal level, the dipping oil prices led to a fall in government revenues by 20.8% in the first three quarters of 2015 compared to the same period of the previous year, while public expenditures declined by 13.9% over the same period.

As regards banking activity, a reversal took place for customer deposits which grew in 2015 Q4 by 2.4% against a decrease by 0.5% in 2015 Q3. Domestic credit growth, nonetheless, decelerated Q-on-Q from 2.3% in 2015 Q3 to 1.1% in 2015 Q4, reflecting a downward trend in credit appetite at banks, consistent with the results of the "Credit Sentiment Survey" in 2015 Q4 published by the Central Bank.

Overall, however, banks remain liquid as evident by the ratio of liquid assets to total assets. The central bank closely monitors development in liquidity in the banking system with a goal to strike the right balance between credit growth and financial stability.

Chapter 1. International Economic Developments

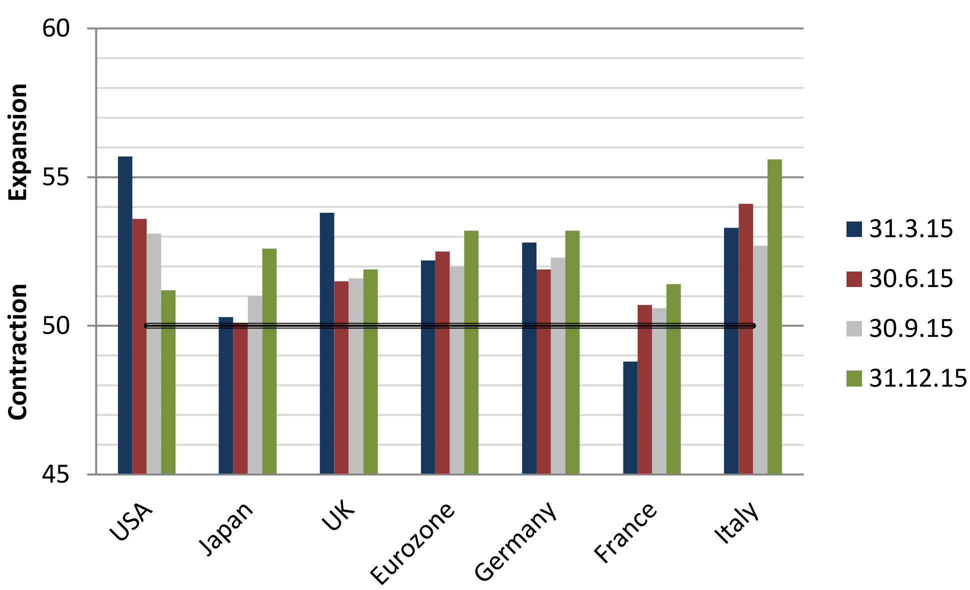
The fourth quarter 2015 was dominated by an event capital markets had been waiting for: The first policy rate rise in the U.S. since almost a decade. For the US monetary authorities this was a very difficult decision, especially with the experience of the 'taper tantrum' of 2013 in mind. Even with US unemployment rate on a downward path, reaching almost 5% by the end of the year, concerns about low inflation and weak global growth, particularly in emerging countries, were overshadowing the decision. Additionally, it was not completely clear how financial markets would take this decision as it is evident that monetary support was a critical element of stock market gains in recent years.

Otherwise, the existing ghosts of a slowdown in growth rates in the developing world were still omnipresent in the fourth quarter, whereas a vicious circle became apparent. Slow growth especially in China weakened commodity prices, hurting commodity dependent economies which led to further growth downgrades in the emerging market space.

1. Global Economy and Capital Markets

Economic activity in the developed world as measured by purchasing manager indices shows that Anglo-Saxon countries, i.e., the US and the UK have seen deteriorating PMI figures, while the Eurozone and Japan witnessed an improvement throughout the year.

Figure 1.1. PMI levels

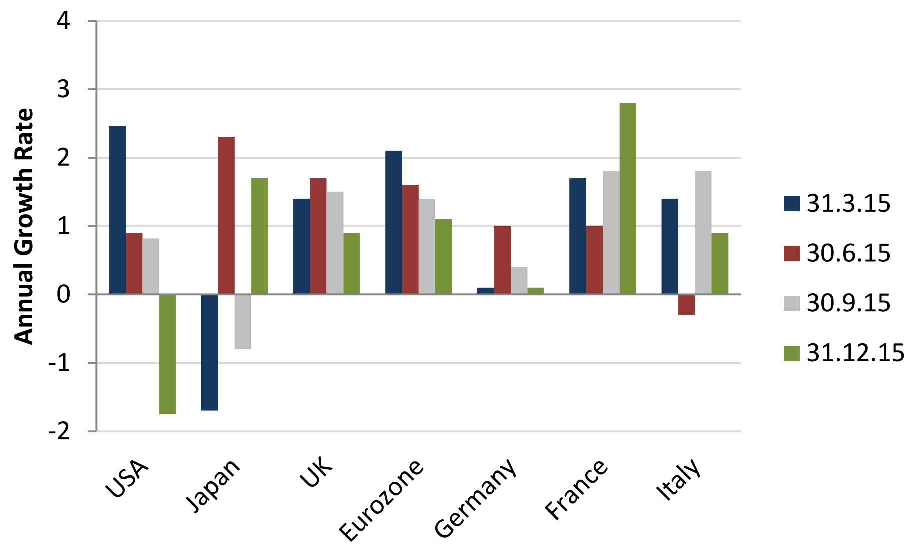


Source: Bloomberg

The US saw a decline in their PMI levels from almost 56 to 51, while the UK PMI declined from 54 to below 52. In contrast, Japan's PMI level was at 50.3 at the end of the first quarter 2015 and ended the year at 52.6. Also, the Eurozone notched up from 52.2 at end of the first quarter of 2015 to 53.2 at the end of the year. A PMI reading above 50 indicates expansion.

A similar picture appears when looking at the industrial production growth figures.

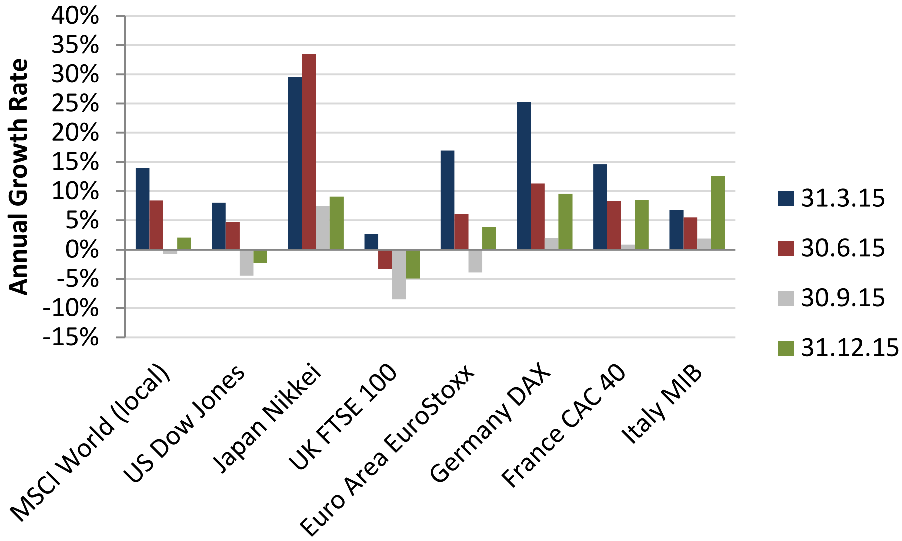
Figure 1.2. Industrial production



Source: Bloomberg

Industrial production growth figures show a deceleration in the US and in the UK, while Japan ended the year higher in terms of annual growth rates. In contrast to the PMI figures however, industrial production growth steadily decelerated in the Eurozone. The US started the year with an annual growth rate of 2.5% and ended the year with a decline of 1.7% in its industrial production. Japan experienced a negative growth rate of 1.7% but ended the year on a positive note (1.6%).

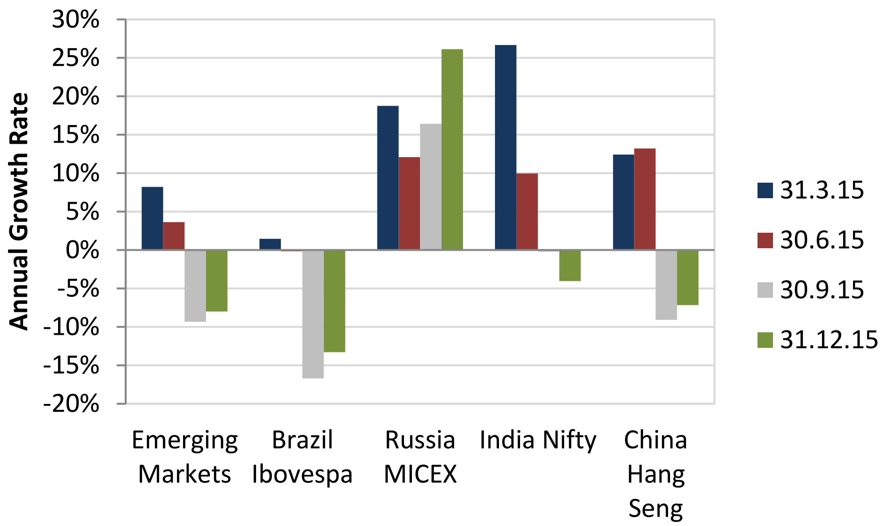
Figure 1.3. Annual percentage change of equity indices (local) in developed economies



Source: Bloomberg

All developed equity markets in our analysis, with the exception of Italy, displayed lower annual growth rates in the fourth quarter than in the first quarter of 2015. While the first quarter was dominated by the European Central Bank and its monthly purchase of securities to support the ailing European economies, the highlight of the fourth quarter was the Federal Reserve Bank which started to raise rates for the first time in almost 10 years and therefore removed an important plank of capital market support.

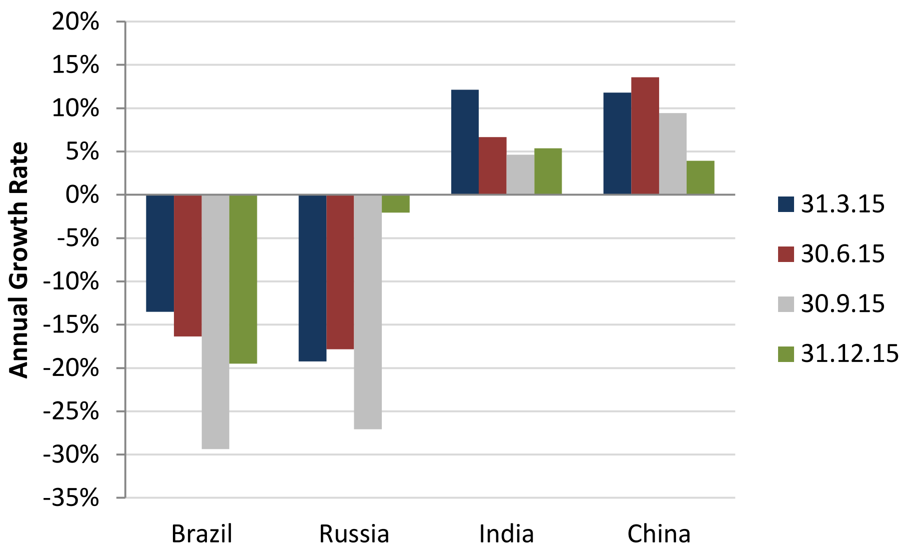
Figure 1.4. Annual stock market index percent changes in BRIC countries (local)



Source: Bloomberg.

Equity markets were all lower on an annual basis for the BRIC countries with the exception of Russia whose market has already fallen drastically in the wake of lower oil prices in late 2014. One of the major themes for the fourth quarter was the weakening of the Chinese economy which has also adversely impacted the commodity space.

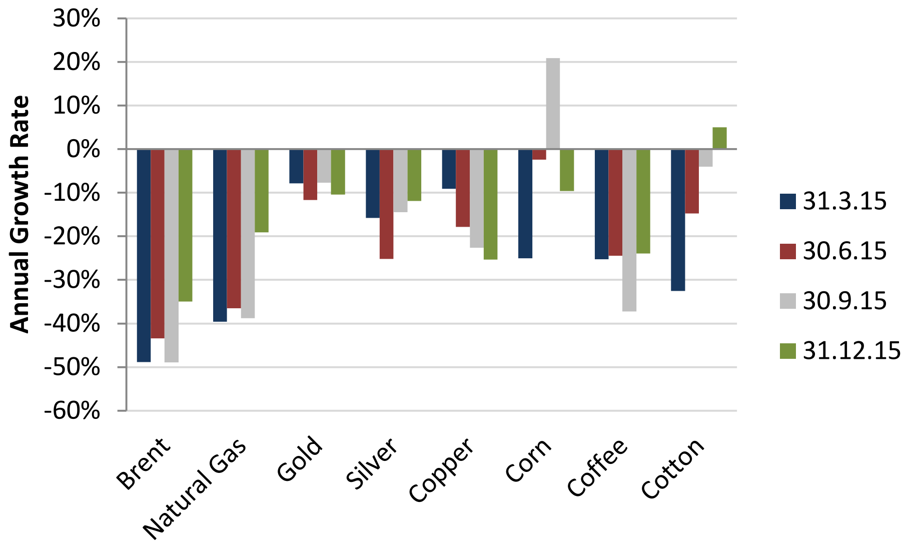
Figure 1.5. Annual percent changes in BRIC real effective exchange rates



Source: Bloomberg

With the exception of Brazil, all BRIC countries saw an annual appreciation of their real effective exchange rate in the fourth quarter. While Brazil and Russia suffered in some quarters double-digit declines on account of nominal depreciation, China and India maintained throughout the year annual appreciation of the real exchanges rates, mostly on account of higher relative inflation. China experienced nominal depreciation on account of capital outflow, supported by various measures in order to support its export sector.

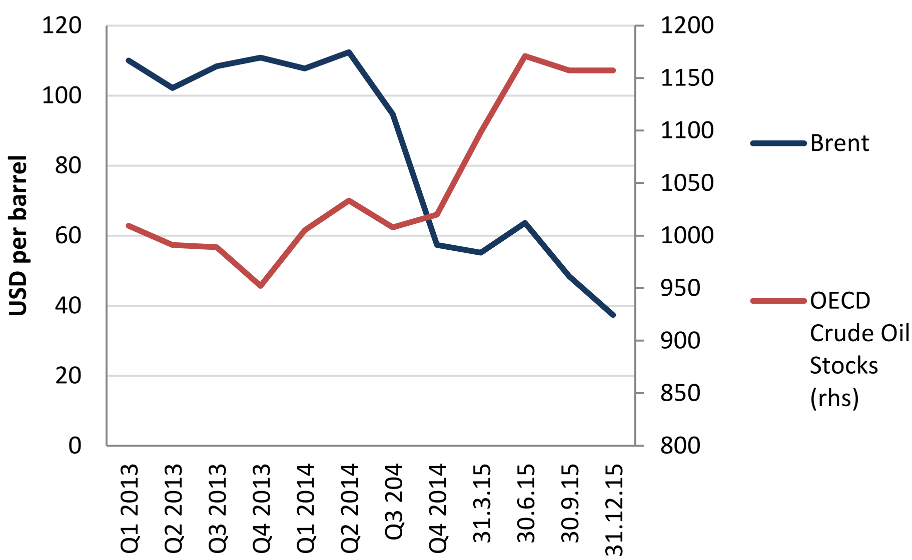
Figure 1.6. Selected commodity price levels annual changes (front-end futures)



Source: Bloomberg.

The fourth quarter saw a continuation of the general decline in commodity prices. On an annual basis, oil (Brent) for instance lost more than 30%. Only the cotton contract could manage to post a small improvement in the fourth quarter. The absence of any inflation scare with investors can be inferred by the fall in gold prices, which fell by an annual 10% in the fourth quarter.

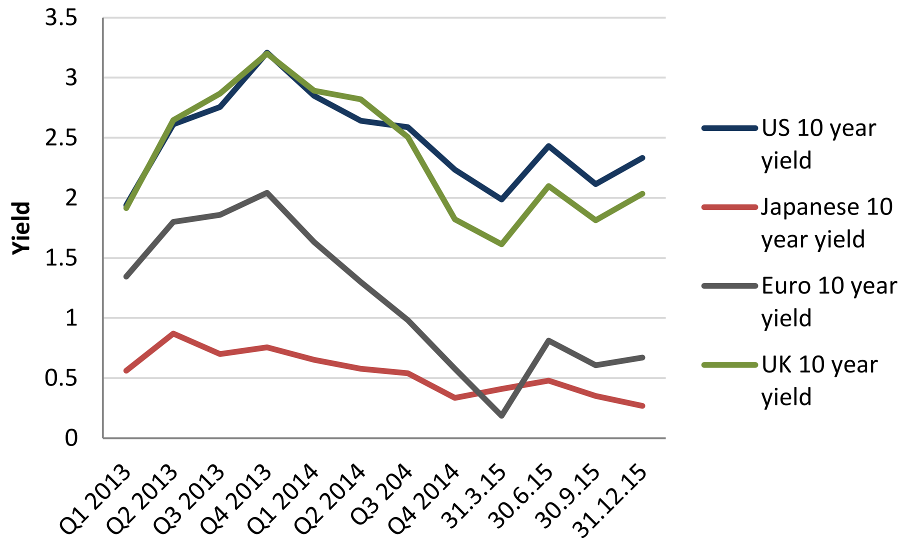
Figure 1.7. Oil price development (Brent front-end contract) and OECD oil stock



Source: Bloomberg.

The dismal development of oil prices can be partly explained by the build-up of crude oil stock piles, indicating a glut in supply. OPEC has for instance increased its production by an annual 8% in the last quarter of 2015.

Figure 1.8. a. 10-year government bond yields (%)

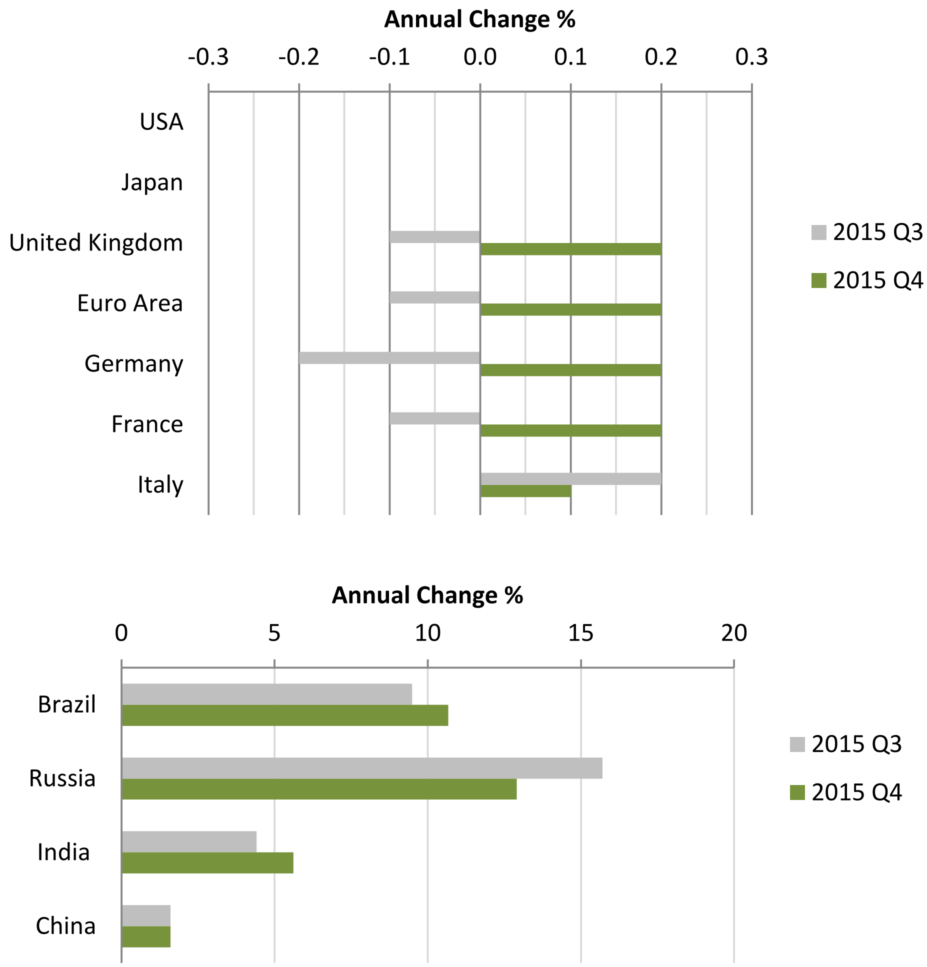


Source: Bloomberg.

With the exception of Japan, 10-year yields in the three main developed government bond markets edged up in the fourth quarter of 2015, mainly driven by the decision of the Fed to increase the policy rates. For Europe, the slight improvement in the economic outlook was one reason why the 10-year government yield increased from 0.6% to 0.67%.

The charts below on consumer prices continue to show the marked difference between the developed and the developing world, whereas the developed world is struggling with near zero inflation rates, while the developing world sees higher single to double-digit inflation rates with the exception of China. In Brazil, the devaluation of its currency in the fourth quarter of 2015 was the driving force of this development.

Figure 1.8. b. Year-on-Year consumer price change in the developed & developing worlds

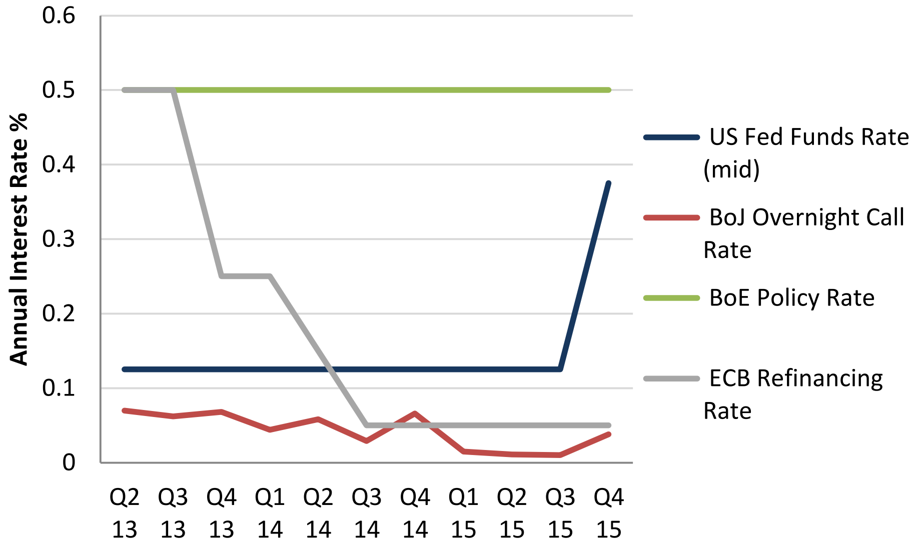


Source: Bloomberg.

In terms of monetary policy, the fourth quarter of 2015 will be remembered where the US Federal Reserve eventually raised its policy rate by a quarter of a percentage point. This move represents the first interest rate hike in almost a decade and is likely to augur a tightening cycle which will last well into 2016. All the other monetary authorities of the developed world kept their interest rate policy at historically low levels.

Within the BRIC economies, only India and China lowered their policy rates to support growth, while Russia and Brazil kept them steady in order to support their currencies.

Figure 1.9. Policy rates of developed countries

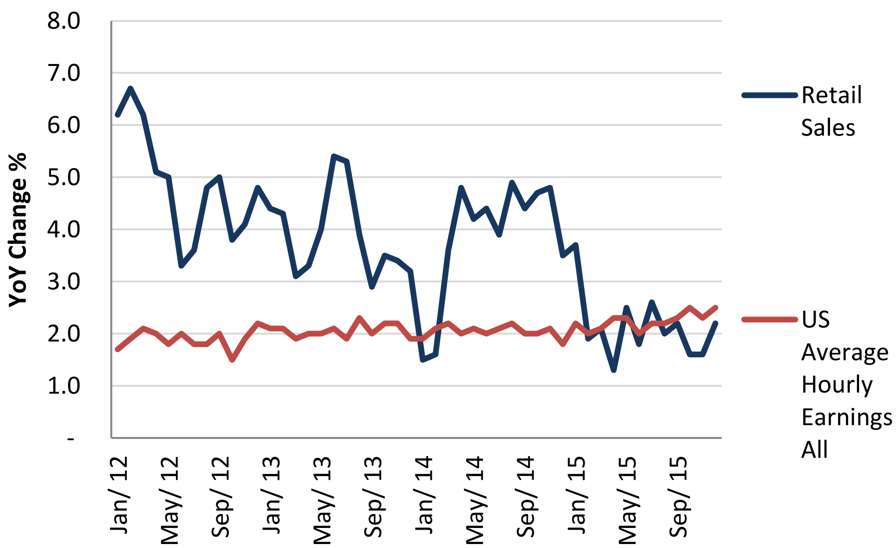


Source: Bloomberg.

2. United States

One of the weak points of the US economy is private consumption. Retail sales growth has been more than halved since 2012 and has reached an annual growth rate of 2.2% at the end of the fourth quarter of 2015.

Figure 1.10. US retail sales growth and hourly wages % (yoy)

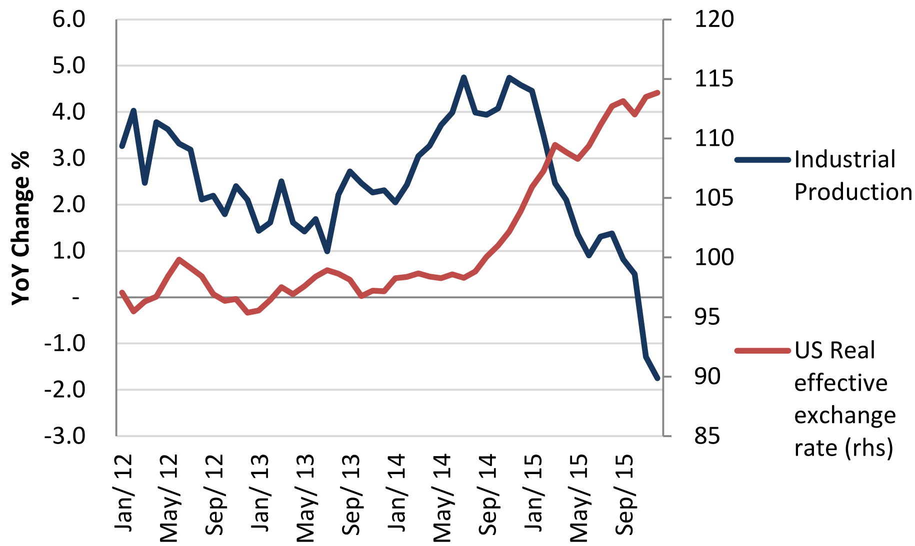


Source: Bloomberg.

One of the main reasons is the fact that hourly wage growth has not been picking up in recent years and has been humming at around 2% annual growth for years.

Looking at industrial production growth, the situation appears to be more striking. On an annual basis, industrial production in the US declined by 1.75%. One of the reasons may be seen in the broad-based appreciation of the USD, which diminished the competitiveness of US exports.

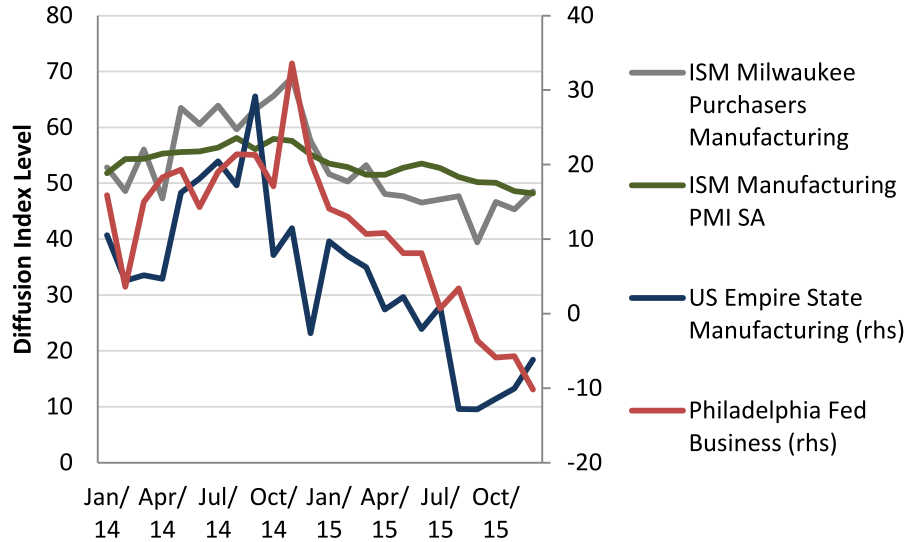
Figure 1.11. US industrial production and US real effective exchange rate



Source: Bloomberg

Other indicators such as the various regional PMI indicators also paint a general picture of a slowing US economy. The fall of the Philadelphia Fed Business survey is the most remarkable one.

Figure 1.12. Various US PMI indicators

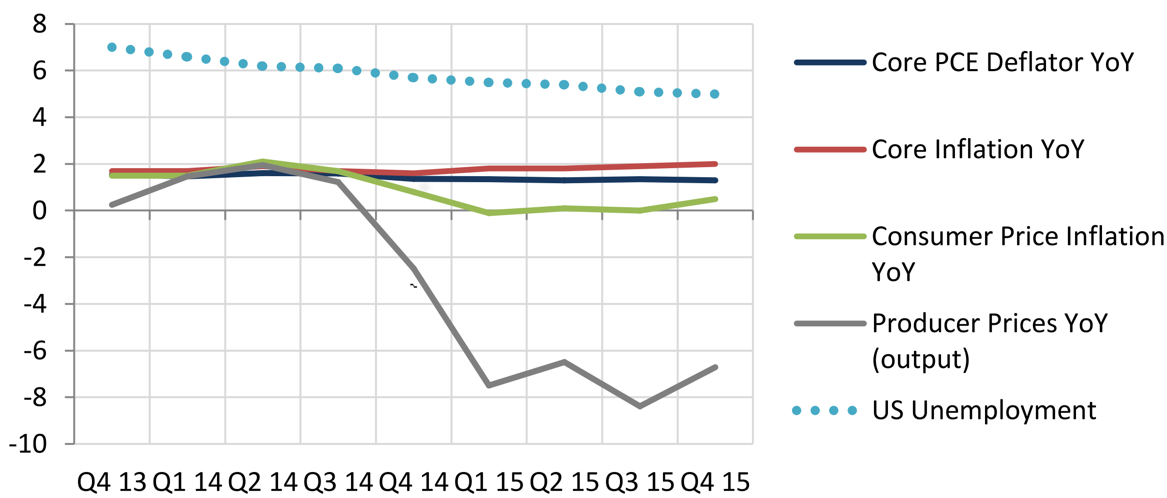


Source: Bloomberg

Only the New York state Centered Empire Manufacturing index saw an improvement in the fourth quarter of 2015, however after having fallen from over 60 to 10 within a couple of months.

The fourth quarter saw the first increase in the policy rate by the Federal Reserve Bank in years. The US monetary authority is basing its judgment on the development of consumer prices in the U.S. The Fed targets core indicators – excluding more erratic items such as food and energy – such as the core deflator for PCE (private consumption expenditures).

Figure 1.13. Various inflation indicators and the unemployment rate in the US (%)



Source: Bloomberg.

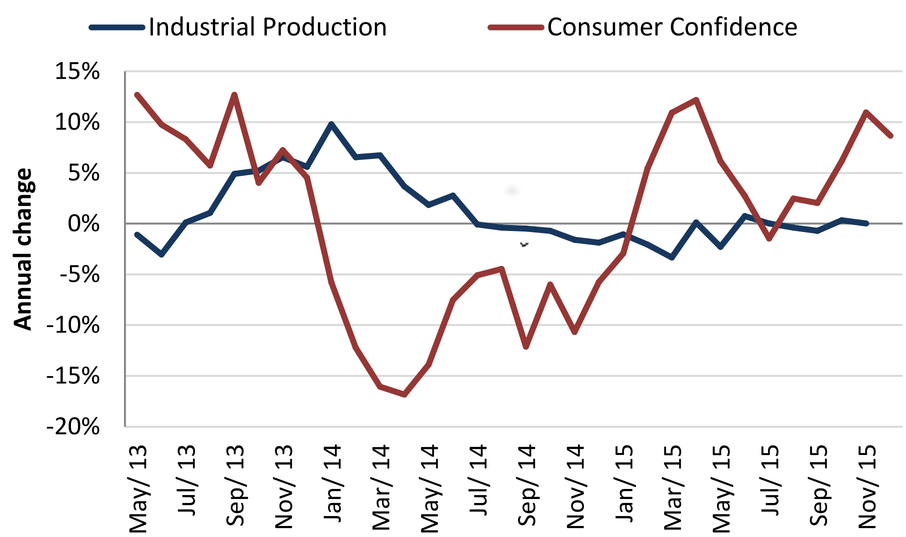
While consumer prices – which are most commonly calculated as annual growth figures - are starting to edge up due to the vanishing of the positive oil price effect, core inflation has now reached the 2% threshold, which is the target level of the Federal Reserve, albeit for the PCE deflator.

The reduction in the US unemployment figure which has now reached 5% is an indication that factor markets are getting tighter. However employment figures are lagging indicators, meaning they represent developments which have occurred already 2-3 quarters ago. More immediate indicators such as PMI figures have deteriorated recently, pointing towards a slowdown of the US economy.

3. Japan

Japan 3rd quarter GDP revision upgraded the economic outlook for the rest of the year. However, there are a variety of weaknesses. Industrial production growth has stalled in the last months of the 4th quarter, while consumer confidence slowed in December to 8.6%.

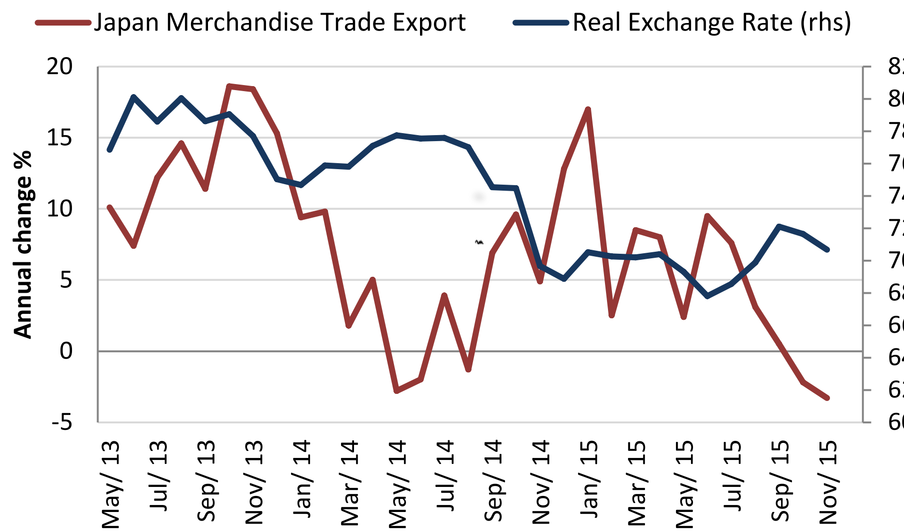
Figure 1.14. Japan industrial production and consumer confidence (y-o-y change)



Source: Bloomberg.

Moreover, annual export growth is declining rapidly, falling by 3% in November, after a fall of 2% in October 2015. This comes at a slight surprise as the real effective exchange rate has fallen steadily in recent months in support of export growth.

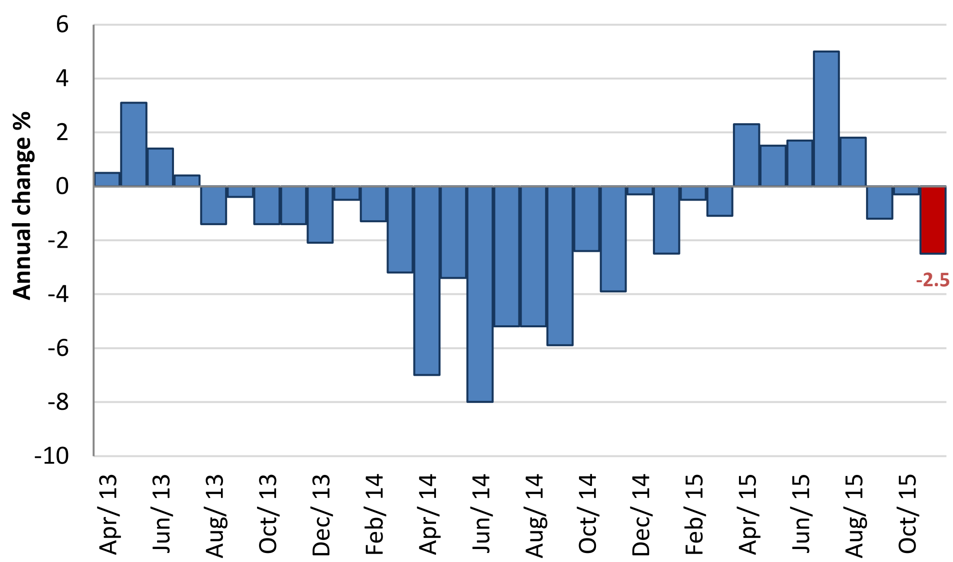
Figure 1.15. Japanese trade export and real effective exchange rate



Source: Bloomberg.

Unemployment remains robust even after a slight increase to 3.3%, compared to 3.1% in October. Analysts are concerned that wage growth is not sufficient to maintain the economic growth momentum. Disposable income has been falling since October 2015, contracting by -2.5% in November 2015. And this is despite the fact that Japan, as a traditional oil importing country, stands to benefit from lower oil prices.

Figure 1.16. Japanese disposable income



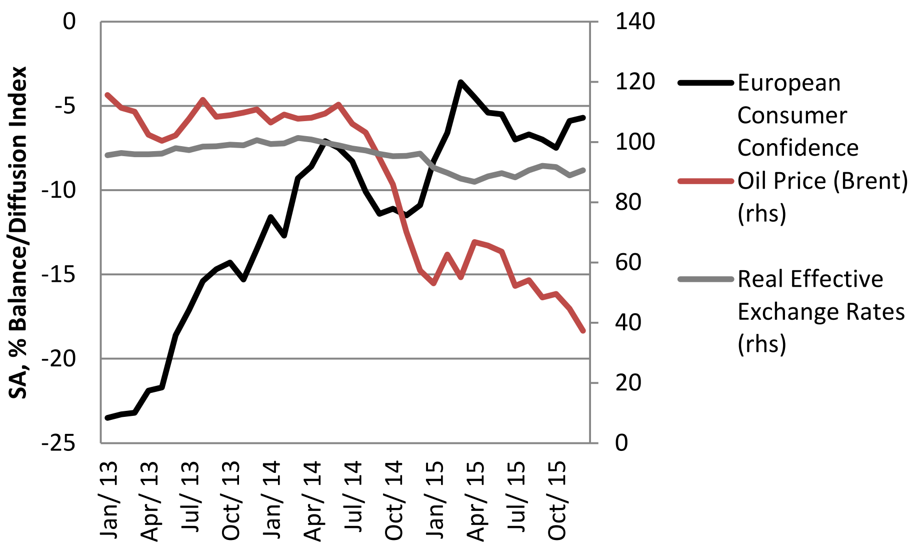
Source: Bloomberg.

4. Eurozone

The minutes of the December meeting of the European Central Bank (ECB) revealed growing dissent among policy makers regarding the strength of the economic recovery, the inflation outlook and hence the appropriate monetary policy stance.

Consumer confidence is on the rise again, partly propelled by lower oil prices, which however was mitigated by the fact that the Euro has lost part of its external value in recent months. The improvement in consumer confidence is also a result of the steady decline in the unemployment rate in the Eurozone (10.5% in November 2015).

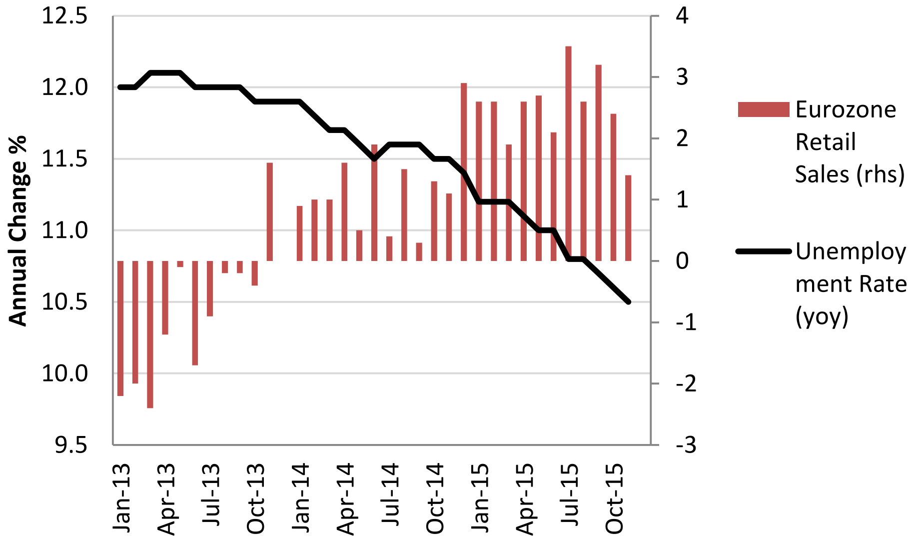
Figure 1.17. European consumer confidence, oil prices and real effective exchange rate



Source: Bloomberg.

Concurrent to the fall in the unemployment rate, retail sales have been on a steady ascent in recent years. In the last months of the year, however, the annual growth rate of retail sales slowed to 1.4%, less than half of what it was in July 2015.

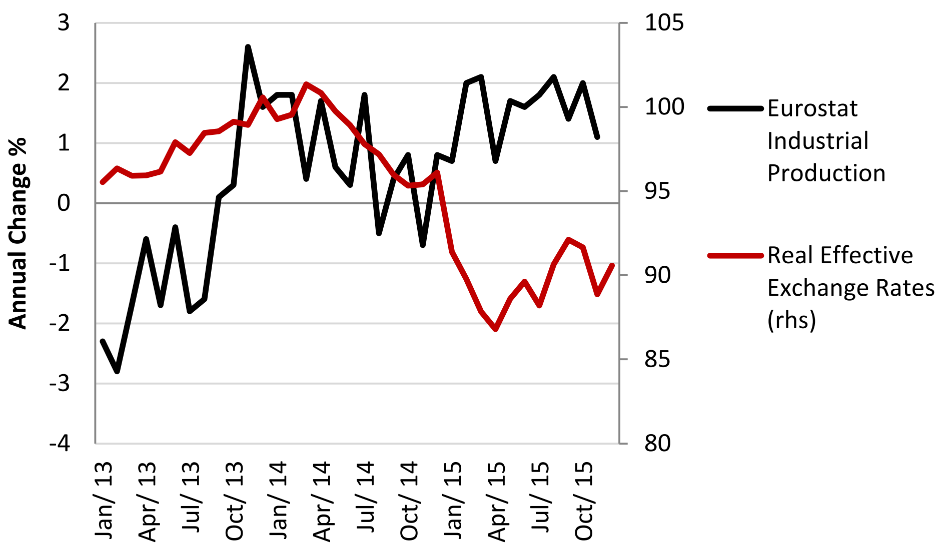
Figure 1.18. Eurozone unemployment rate and retail sales (%)



Source: Bloomberg.

In contrast, industrial production seems not to have benefitted massively from the depreciation of the Euro in recent months. It remained in a narrow band of 1-2% annual growth rate throughout 2015.

Figure 1.19. Eurozone industrial production and real effective exchange rate



Source: Bloomberg.

During the course of the fourth quarter, analysts expected the ECB to announce a widening of the quantitative easing program. However, in the beginning of December these expectations were not met. However, the Governing Council announced several additional measures.

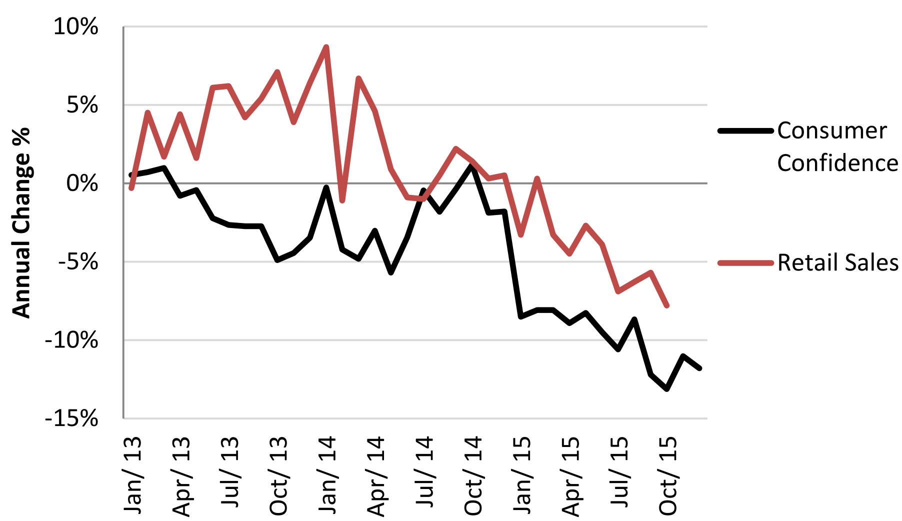
The deposit rate was reduced to -0.3% from -0.2%. Additionally, a 10 basis-point reduction on excess reserves was announced. More importantly, the duration of the quantitative buying program, where EUR 60bn of various securities are bought in the market was extended to March 2017 from September 2016. Also in terms of the scope of the program, changes were announced. Debt issued by regional and local governments will be added to the list of eligible assets. That seems unlikely to expand the universe of eligible assets significantly - national governments are much larger issuers of debt than local entities.

In this context, the ECB also indicated that the principal of maturing securities will be reinvested. That means the stock of assets will be maintained even as bonds mature, pointing to a bigger program than would otherwise be the case.

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

The fourth quarter of 2015 saw a further deterioration of major economic indicators in Brazil. Consumer confidence fell by an annual 12% in December, while retail sales reported a decline of -8% in November.

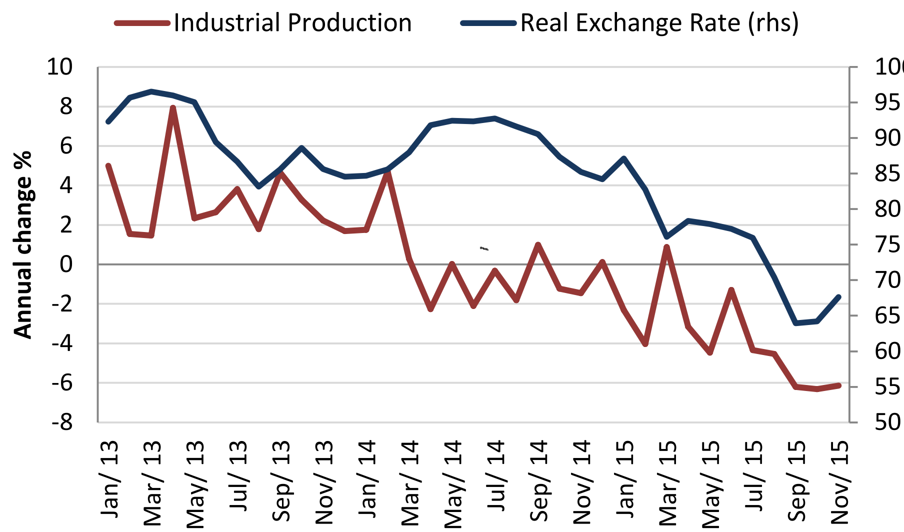
Figure 1.20. Consumer confidence and retail sales in Brazil (%)



Source: Bloomberg.

Also industrial production growth posted again a negative annual growth rate of -6.1% in November, which was the 8th consecutive annual decline. The rapid depreciation of the Real in real effective exchange terms did not stem the decline in industrial output.

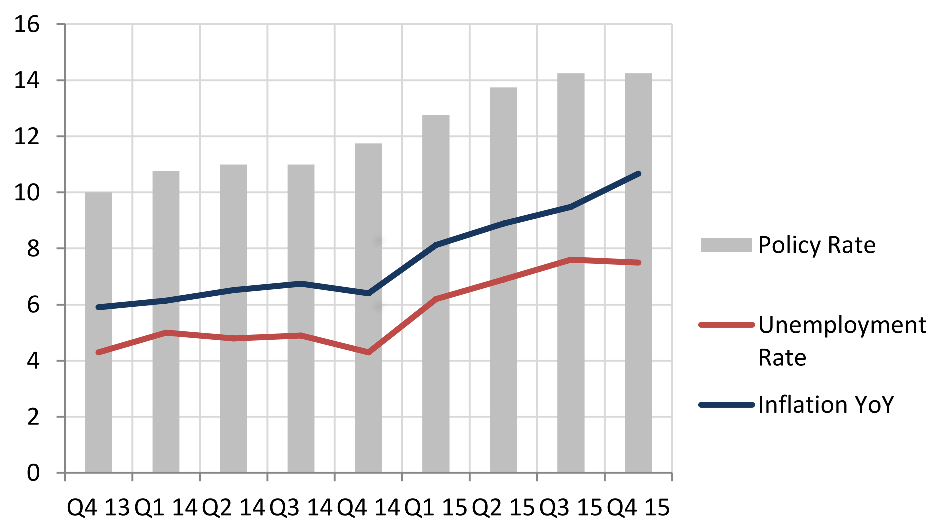
Figure 1.21. Industrial production and real effective exchange rate in Brazil



Source: Bloomberg.

The Brazilian monetary authorities kept their policy rate in the fourth quarter stable at 14.25% against the backdrop of rising inflation (10.6% at end of the year, versus 9.5 at the end of the third quarter). Unemployment stabilized in the fourth quarter at 7.5%, after having relentlessly risen in recent years.

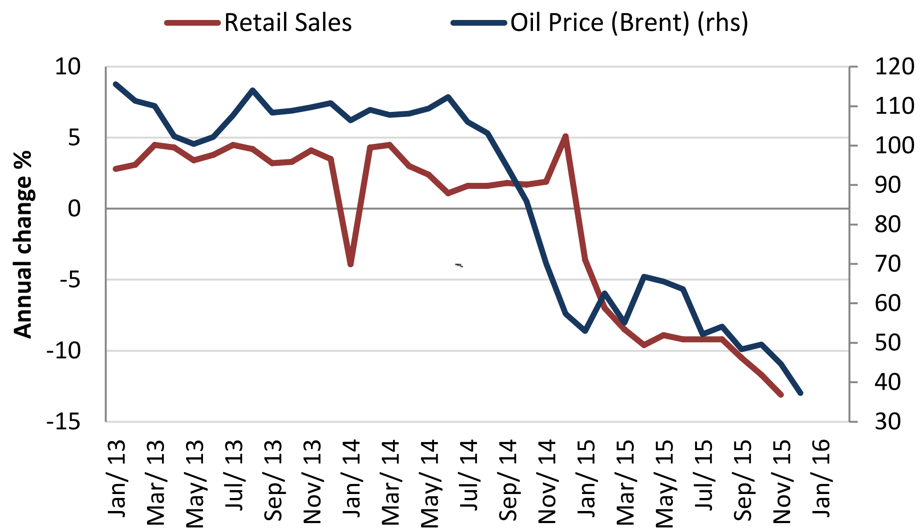
Figure 1.22. Policy rate, unemployment and inflation rate in Brazil (%)



Source: Bloomberg.

The Russian economy continues to suffer from the fall in the oil price and Western sanctions. Retail sales fell by an annualized 13% in November which marks the 11th consecutive months of negative growth rates.

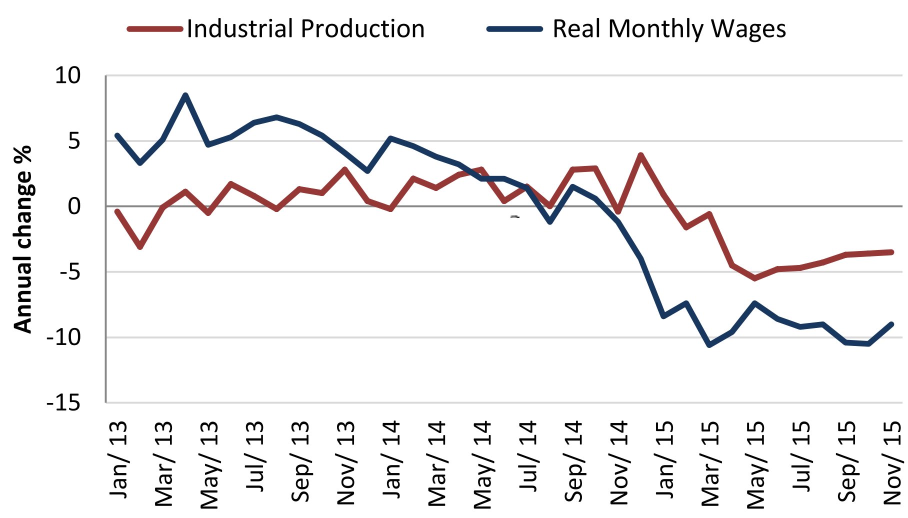
Figure 1.23. Retail sales and oil price



Source: Bloomberg.

A similar picture emerges when considering industrial production and wage growth. Both had been since the beginning of the year in negative growth territory, whereas industrial production has witnessed some kind of improvement over recent months.

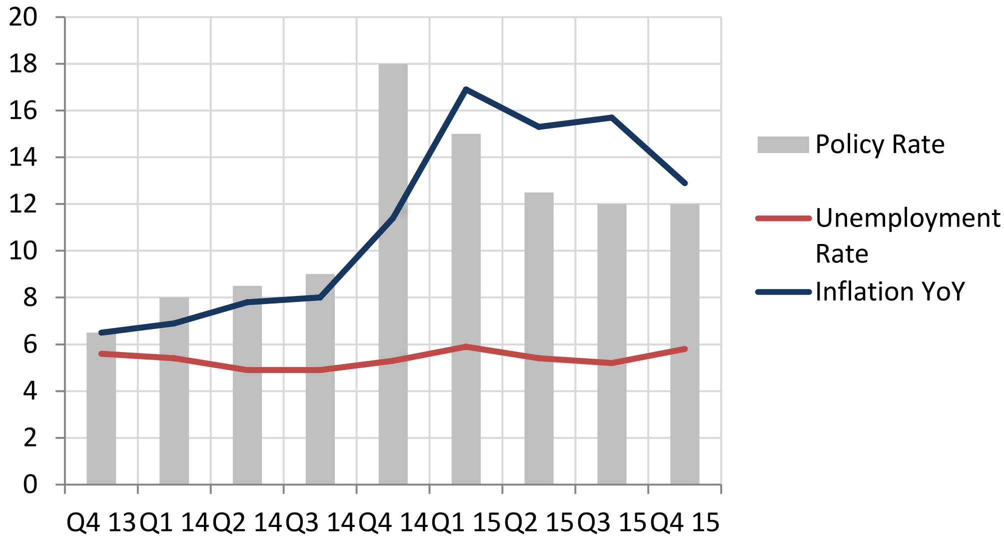
Figure 1.24. Industrial production and real wage growth in Russia



Source: Bloomberg.

Unemployment edged up slightly in the fourth quarter from 5.2% at end of September to 5.8% at end of December. Moreover, the central bank did not change the policy rate in the fourth quarter as inflation came down in order to stem the tide of capital leaving the country, thereby weakening the Rouble.

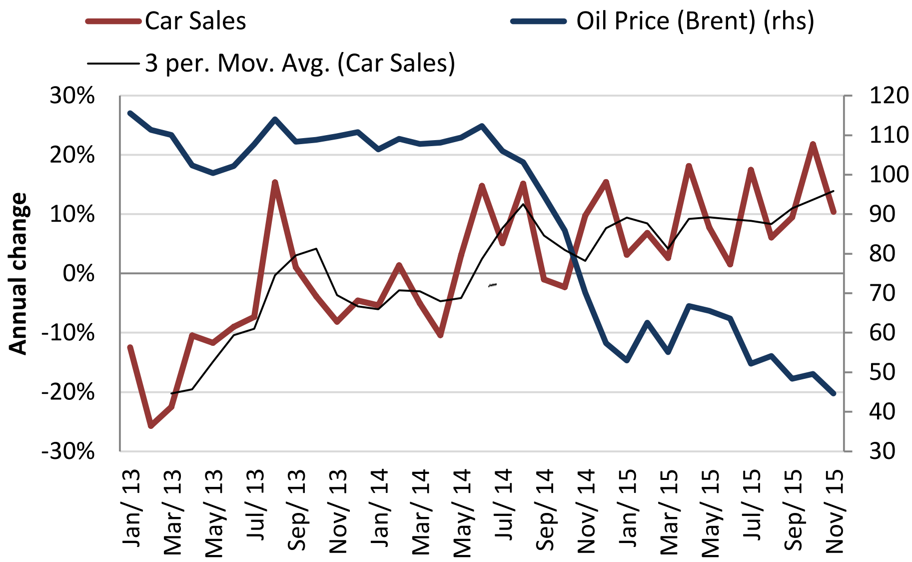
Figure 1.25. Policy, unemployment & inflation rates in Russia (%)



Source: Bloomberg.

India is lacking timely household spending data. However, car sales are considered big ticket items which reflect nicely the state of consumer confidence. Car sales have risen by 12% year on year in December, painting a positive picture on India's economy. India is said to have benefitted significantly from the fall in oil prices.

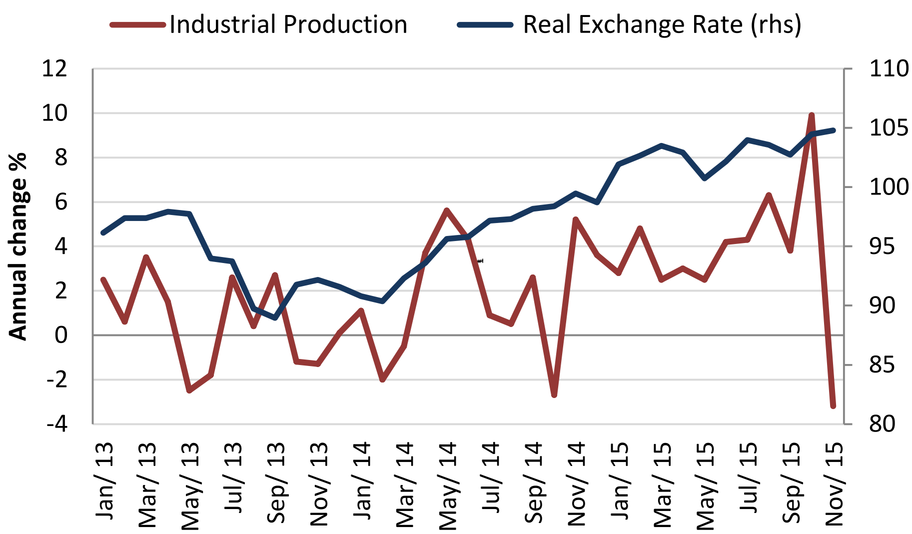
Figure 1.26. Car sales growth and oil prices in India



Source: Bloomberg.

Similar to car sales, industrial production increased steadily in 2015. The reported decline in the annual growth rate of -3.2% in November 2015 is partly due to a base effect, as industrial production jumped by over 5% in November 2014. The improvement happened against the backdrop of a steadily rising Rupee which started in summer 2013, mostly on account of higher relative inflation.

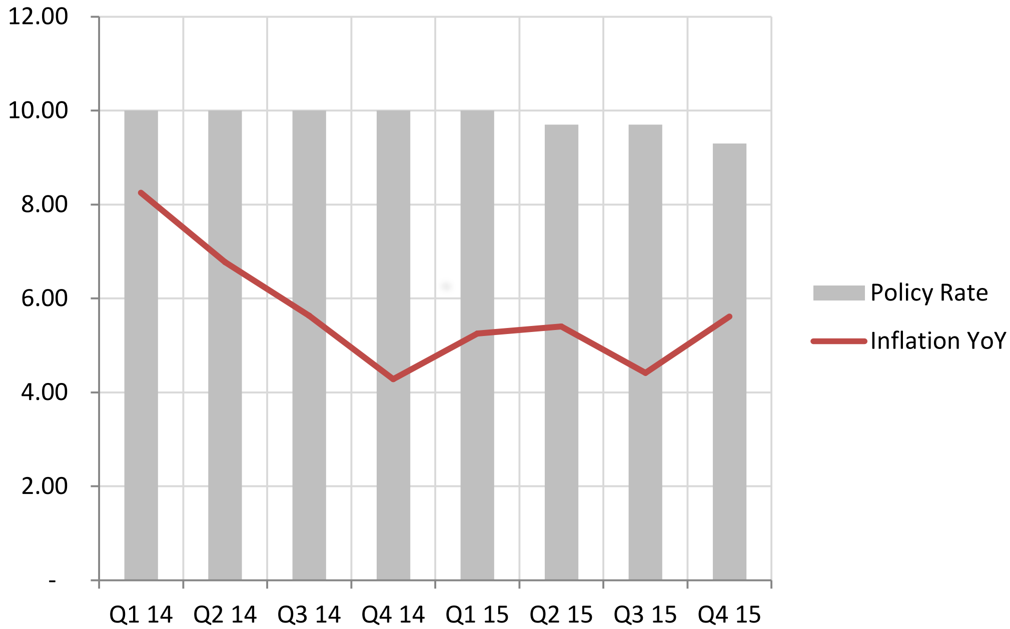
Figure 1.27. Industrial production and the real effective exchange rate in India



Source: Bloomberg.

As a result of the benign economic conditions, India's inflation rate edged up in the fourth quarter of 2015 to 5.6% compared to 4.4% at the end of the third quarter. The increase is due to the fading of a "large" favorable year-over-year comparison for food prices. Yet deficient rainfall for this year's southwest monsoon, a shortfall that was more geographically widespread than last year, may compound the upward pressure on food prices. At the moment the monetary authorities seem to be undisturbed by this development and have lowered the base rate by 40bp to 9.3% compared to the third quarter. However, the Reserve Bank of India has set itself an inflation target of 6% and if this is being breached, further reductions in the policy rate are unlikely.

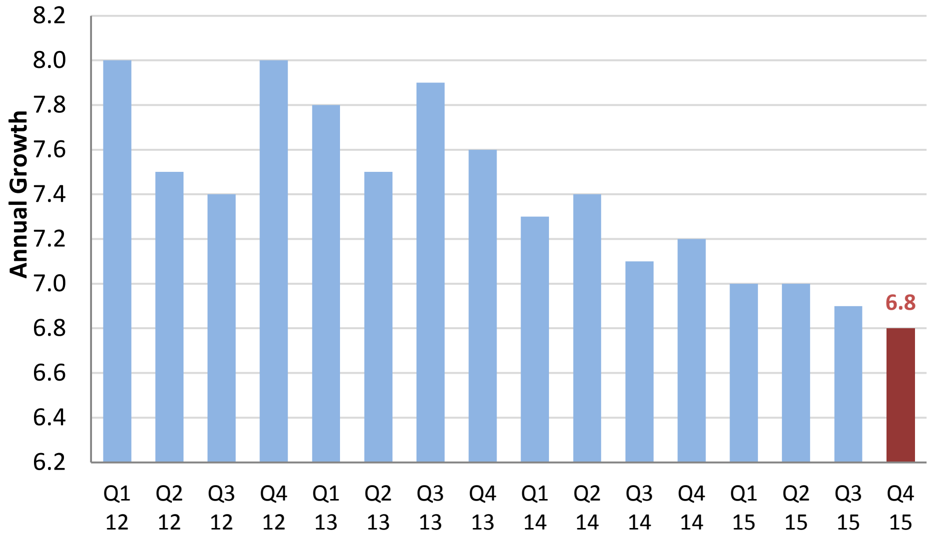
Figure 1.28. Policy and inflation rate in India (%)



Source: Bloomberg.

China was the first country in our analysis which was able to publish GDP figures for the fourth quarter 2015. On an annual basis China grew by 6.8% according to official figures. This marks one of the lowest growth rates in years.

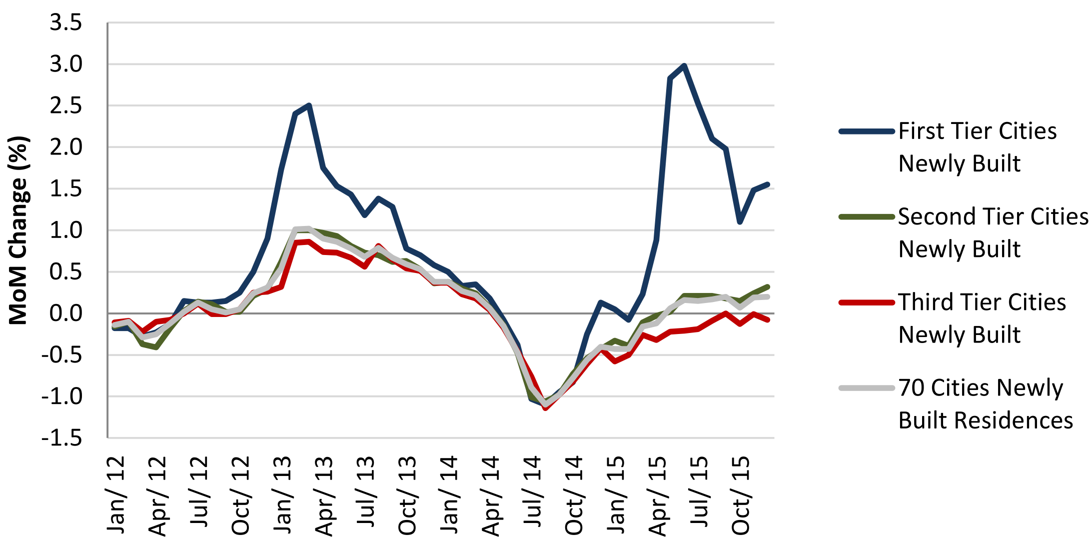
Figure 1.29. Annual GDP growth in China (%)



Source: Bloomberg.

In the first half of 2015, the fast growing equity market boosted GDP by adding to financial-sector output. In the second half of 2015, the boom decelerated markedly. With trading volume sharply down, financial-sector output growth fell to 12.9% year on year in the fourth quarter, down from a peak of 19.2% in the second quarter. Growth in construction accelerated to 7.3% year on year, up from 5.8% in the third quarter, offsetting that drag. That likely reflects more infrastructure building as public spending surged. The acceleration of government activity was also felt on urban property prices.

Figure 1.30. Urban property prices in China (%)

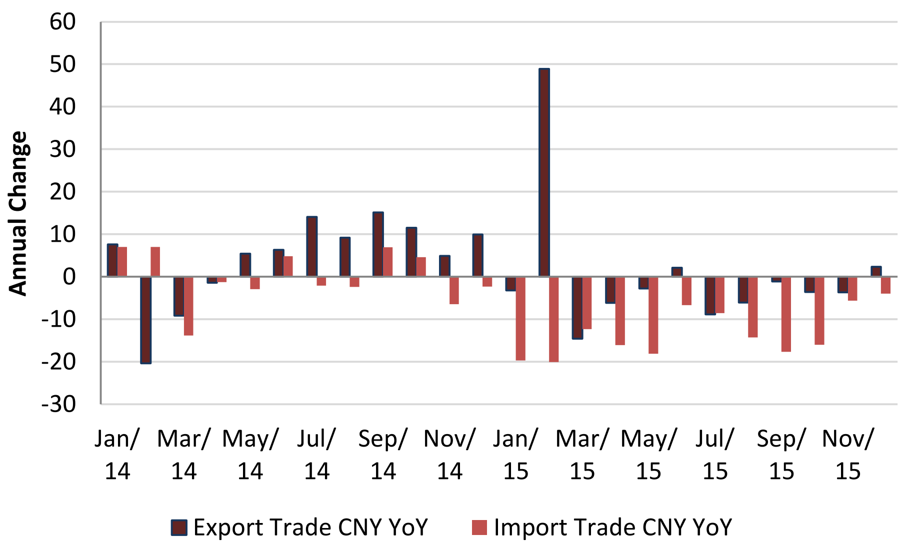


Source: Bloomberg.

“Other services,” which include output from the public sector, also added positively to growth. Growth in this category accelerated to 9.9% year on year, up from 9.5% in the third quarter, as higher public spending boosted output at hospitals and schools. The large share that “other services” has in the economy means that even moderate acceleration has a significant impact. Fourth-quarter GDP growth at 6.8% year on year was barely down from 6.9% in the third quarter and kept growth for the year as a whole in line with the Premier Li Keqiang’s target of “approximately 7%.”

The weakening economic momentum was also reflected in a slowdown in trade volumes.

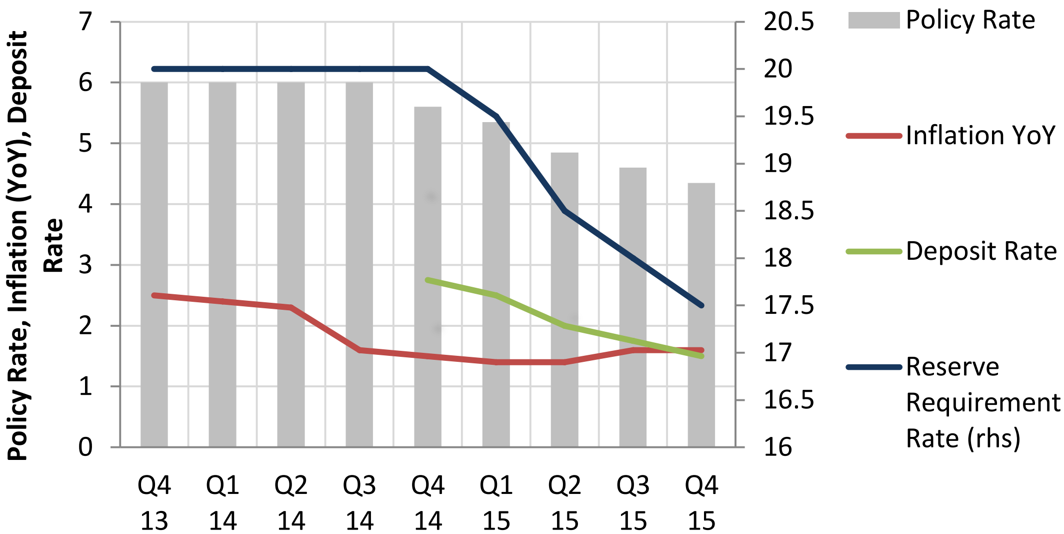
Figure 1.31. Exports and Imports growth in CNY in China (%)



Source: Bloomberg.

China’s authorities have reacted to the slowdown in its economy by lowering their policy rate to 4.35% in the fourth quarter from a level of 4.6% in the third quarter of 2015. Also the deposit rate was lowered by 25bp to 1.5% in the fourth quarter in line with a reduction in the reserve requirement to 17.5% down from 18% in the third quarter. Concurrent with the observation of a slowdown in the economy, annual inflation remained at 1.6% in the fourth quarter, unchanged from the third quarter 2015.

Figure 1.32. 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 investor confidence, while security is impacting the economic situation in post-revolutionary Egypt and Tunisia, nonetheless these countries as well as other oil importers are benefiting from lower oil prices.

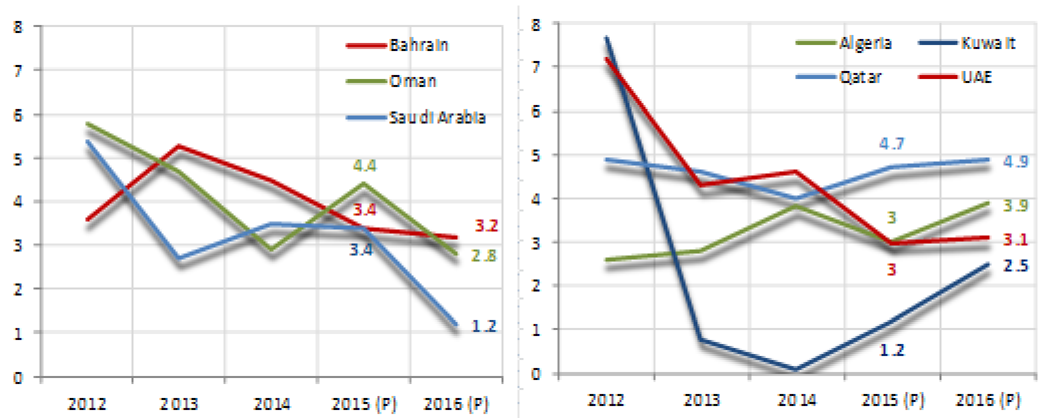
Overall, according to the IMF revised projections of last October, the MENA growth this year will continue to be modest in 2015.

6.1 Oil-exporting countries

Economic Growth

The slowdown in the GCC region is due mainly to the fact that the slump in oil prices turned out to be in 2015 Q4 more pronounced and more persistent than previously expected. As a result, the fall in government revenues forced the authorities to initiate fiscal consolidation, combined with a tightening liquidity situation which is likely to have decelerated growth in most GCC countries.

Figure 1.33. Real GDP Growth for Oil-exporting countries



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

Inflation

Inflation in oil-exporting countries is moderating; due to decelerating prices of food and other imported goods and services on account of the appreciating U.S. dollar to which most of these countries peg their currencies. The exception in the UAE could be explained by the increase in the price of housing and non-tradable inflation in general (see table 1.1.a).

Table 1.1.a. Inflation in the GCC countries (%)

	2014	2015 (Estimates)	2016 (projections)
Saudi Arabia	2.7	2.2	2.3
Bahrain	2.7	1.9	2.1
Kuwait	2.9	3.3	3.3
Oman	1.0	0.0	2.0
Qatar	3.3	1.6	2.3
UAE	2.3	4.1	3.0

Source: Official data, IMF Regional Economic Outlook-October 2015 and CBUAE estimates.

Stock Markets

On the back of persistent low oil prices, diminishing government expenditures, and global economic slowdown and market uncertainty, GCC stock markets continued their slump during the fourth quarter of 2015, which was particularly pronounced for Dubai Financial Market (-12.3%), Qatar (-9%) and Oman and Saudi Arabia (-6.6%).

Table 1.1.b. Stock Market Share Prices change in GCC countries (%)

	2015 Q4	
	Quarterly	Y-o-Y
Saudi Arabia	-6.6	-17.1
Bahrain	-2.3	-12.3
Kuwait	-3.4	-16.5
Oman	-6.6	-14.8
Qatar	-9.0	-15.1
UAE		
- **ADSM**	-4.3	-4.9
- **DFM**	-12.3	-16.5

Source: Bloomberg.

6.2 Oil-importing countries

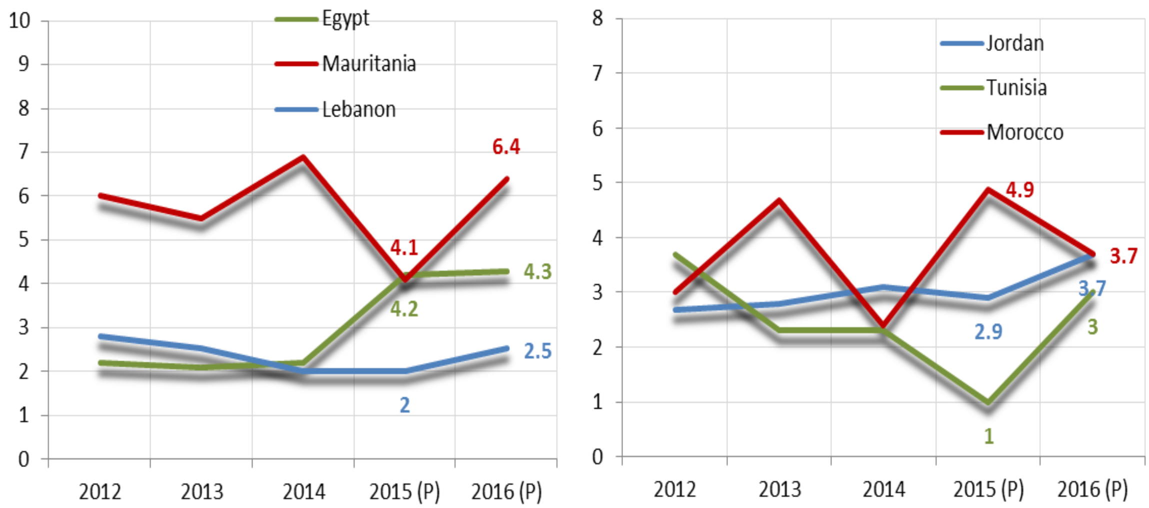
Economic Growth

Recovery in some 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. Progress toward political stability, economic reforms, and low oil prices 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. In addition, supply-side bottlenecks and strong currency valuations continue to hamper competitiveness and productivity growth. Therefore, unemployment remains high and large swathes of the population do not benefit from growth, notably in remote areas.

Oil-importing countries continue also to suffer in 2015 from reduction in exports, tourism receipts, and remittances due to anemic growth in the Euro Area and slowdown in the GCC region. The start of normalization of U.S. monetary policy in December, moreover, sparked more financial market volatility, and tightening financing. In this challenging environment, stepping up the reform momentum is imperative for oil-importers, as they can also take advantage of low inflation and better fiscal situation.

Figure 1.34. Real GDP Growth for Oil-importing countries



Source: IMF, Regional Economic Outlook-October 2015

Inflation

In 2015, persistently large negative output gaps and low food prices reduced inflation by almost 3 percentage points to 6.6% — 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. Moreover, the pass-through of lower international oil and other import prices remains weak, owing to remaining subsidies and/or low competition, which leads to little near-term benefits for firms' production costs and household incomes, in most of the countries.

Table 1.1.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 estimates

Stock markets

Share prices continue their decline in most oil importing countries in 2015 Q4, consistent with the global capital market slump, except for Jordan where stock prices recovered by 4.5%, during this period.

Table 1.1.d. Stock Market Share Prices change for some MENA oil-importing countries (%)

	2015 Q4	
	Quarterly Change	**Y-o-Y**
Egypt	-3.5	-24.4
Jordan	4.5	-1.3
Morocco	-2.6	-7.5
Tunisia	-4.4	-0.9

Source: Bloomberg.

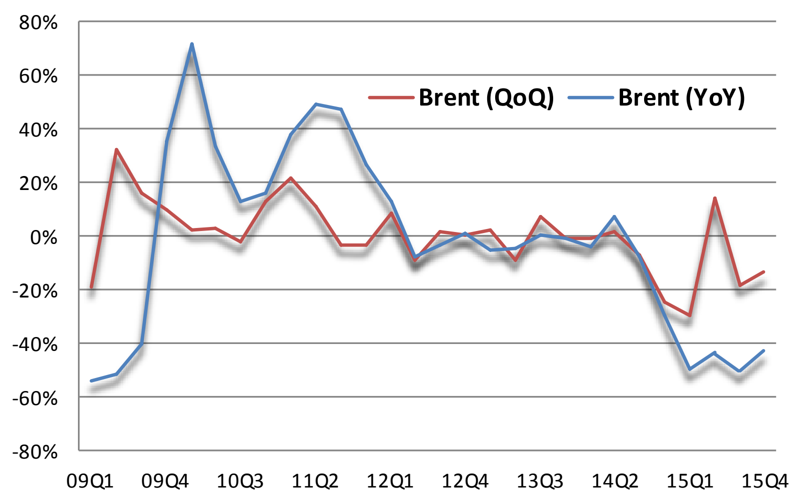
Chapter 2: Domestic Economic Developments

Dipping oil prices led to the start of fiscal consolidation, which in tandem with global slowdown and tumbling securities markets led to softening credit activities in the fourth quarter of 2015 and lower economic growth, despite some resiliency in non-oil activities.

2.1 Economic Activity and Growth

According to the Central Bank forecasts, the real GDP of the UAE is estimated to expand by 3.1% in 2015, following an average of 4.8% growth achieved during the period 2000 – 2014 (see Table 2.1). The slowdown in 2015 is due to the decline in oil-GDP growth which represents more than 35% of total GDP, mostly linked to the fall in oil prices. The oil-GDP slowed down from 4% in 2014 to 2.2% in 2015, in line with a persistent drop in oil price. In fact, the Brent price decreased on average by 43%, in 2015 Q4, compared to the same period of the previous year (see Figure 2.1).

Figure 2.1 Oil price change (%)



Source: FRED

The growth in 2015 is mainly due to the resilience of the non-oil activities, which are expected to grow by 3.7%. These developments are in line with the purchasing managers' index (PMI) results. The average PMI for 2015 Q4 was 53.9, well below the 59.3 average recorded in 2014 Q4, and also lower than the average PMI for 2015 Q3, indicating that the growth momentum slowed in the fourth quarter of 2015.

Table 2.1. Economic Growth in the UAE (%)

	2013	2014	2015 (estimates)	2016 (projections)	2017 (projections)
Total GDP annual growth rate	4.3	4.6	3.1	3.0	2.9
Oil GDP annual growth rate	2.9	4.0	2.2	2.1	2.6
Non-Oil GDP annual growth rate	5.0	4.8	3.7	3.4	3.2

Source: National Bureau of Statistics for 2013 and 2014, and Central Bank estimates and projections for 2015-17.

Box: GDP forecasting model of the Central Bank of the UAE

Forecasting and assessing the future state of the economy are crucial components of the decision-making process in central banks. Policy makers must know what the future is likely to be, in order to make the right decision in the right moment. Better forecast performance for macroeconomic variables will lead to better decisions.

In the UAE, official data on most economic variables are obtained from different sources, with different frequencies. Moreover, the UAE GDP, the main measure of the economic activity, is available only on an annual basis with a considerable publication delay. For these reasons, having an early estimate and an accurate forecast for the GDP are essential ingredients for the Central Bank of the UAE for policy analysis purposes.

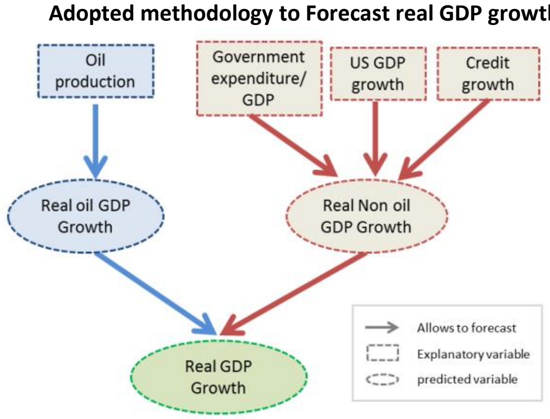
Methodology description

To this end, we developed a forecasting framework to estimate the real GDP growth of the UAE for the current year (2015) and to predict it for the next two years (2016 and 2017). This approach is based on a simple and intuitive principle that explains UAE GDP as a function of the relevant determinants which reflect the economic activity.

The model adopted is a structural representation that captures key relationships in the UAE economy in both oil and non-oil sectors. Given the importance of the oil sector and its implication on the UAE economy, we started by constructing two separate models in order to forecast the real non-oil GDP growth and the real oil GDP growth, and then we used the predicted results in a third small model to forecast the real GDP of the whole economy (see figure below).

This model is an automatic, judgment free, process that can be updated with recent information releases. It provides a timely estimation and an accurate forecast of the economic activity of the UAE.

Adopted methodology to Forecast real GDP growth



Key variables and relationships

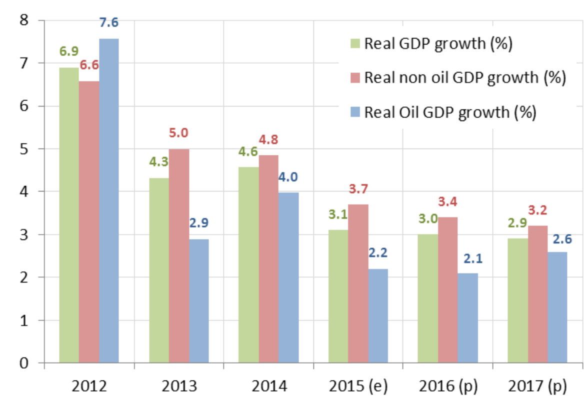
Each of the two GDP components is modeled as a function of a limited number of explanatory variables, for which projections are obtained from reliable sources, such as official institutions in the UAE or the IMF. The structure of each equation is inspired from the economic theory, but adapted to the characteristics of the UAE economy.

The first model is for the real oil GDP growth. It is based on a simple and intuitive equation. It depends mainly on the oil production, which is taken from the OPEC. Higher oil production implies higher growth of the real oil GDP of the UAE. Concerning the second model, the real non-oil GDP is modeled as a function of the government expenditure, the US GDP growth and the credit growth. Finally, the real GDP of the whole economy is a simple equation of the two previous forecasting components.

Empirical Results

According to our model, the real GDP of the UAE is estimated to expand by 3.1% in 2015, and forecasted to grow by 3.0% and 2.9% in 2016 and 2017 respectively.

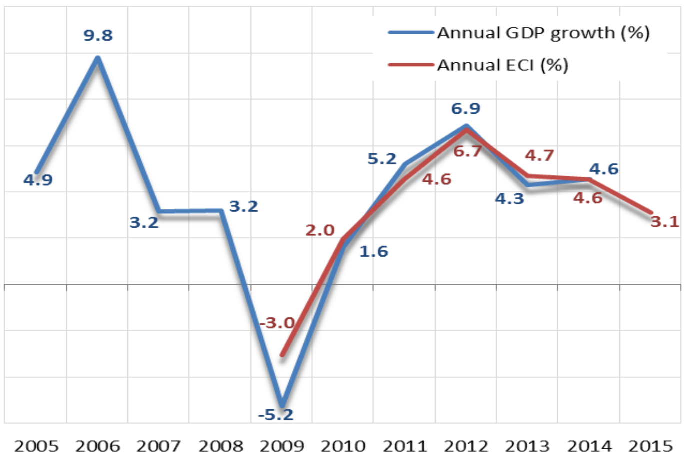
Real Economic activity growth (%)



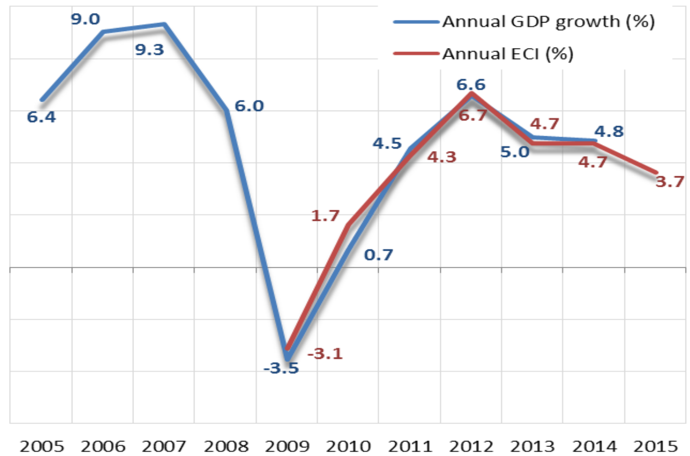
Based on the forecasting performances of this model, we believe that the methodology adopted to forecast the GDP growth is the most appropriate method, taking into consideration all available data and the lack of alternative sources for evaluating economic activity. Indeed, the utility and the quality of the results seem promising, but could be improved if more data are available in a long-enough time series for our purposes and if there is more information reflecting the development of economic activity at relatively high frequency.

Economic Activity

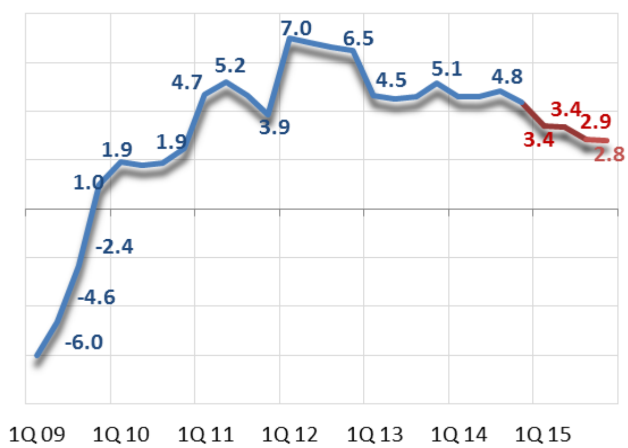
2.2. a. Total ECI annual growth (%)



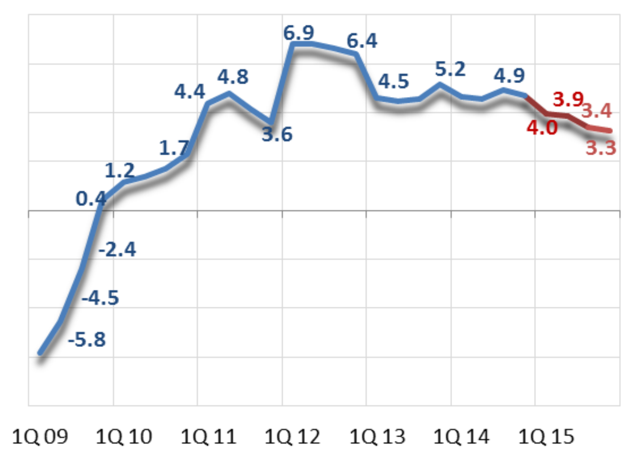
2.2.b. Non-Oil ECI annual growth (%)



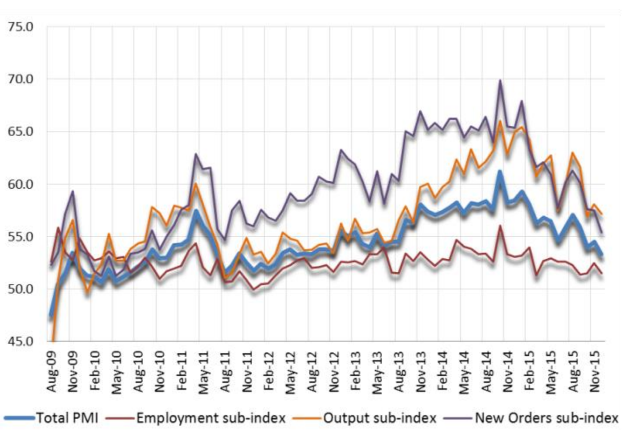
2.2.c. Total ECI quarterly growth (%)



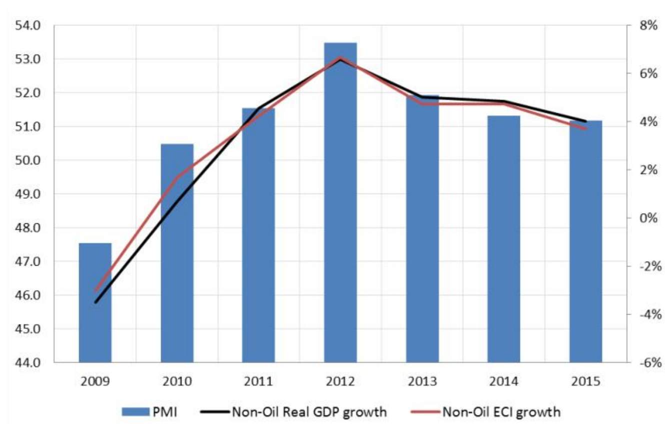
2.2.d. Non-Oil ECI quarterly growth (%)



2.2. e. PMI developments



2.2.f. Non-Oil economic activity developments



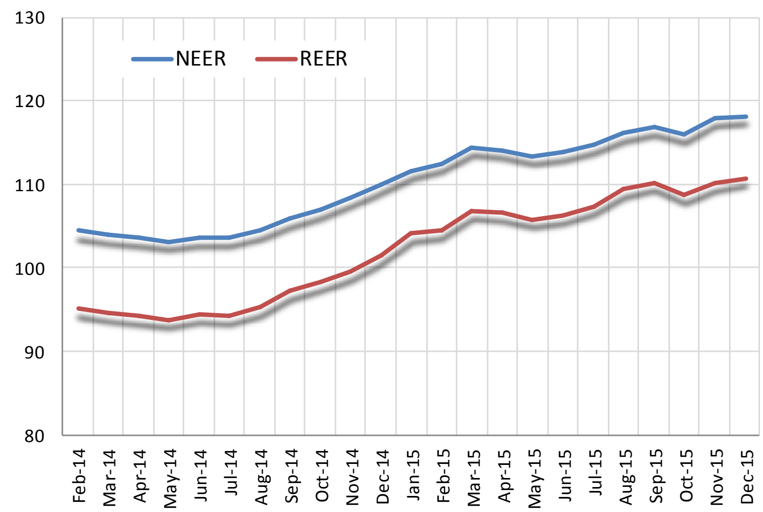
Source: Markit and CBUAE forecasting model

2.2 Exchange Rate and Foreign Trade Balance

The Dirham's appreciation continued for the fourth quarter of 2015 against its major trading partners. The weighted currency variation for the top 9 non-dollarized import partners has increased in the fourth quarter by 1.07%, against an increase by 0.64% in the third quarter (See table 2.2.a). This development is explained mainly by an important depreciation of the Chinese Yuan, the Swiss Franc and the British Pound. They lost 3%, 4% and 5.1%, respectively, against the Dirham, where China, the UK and Switzerland represent together a total of 18.6% of the imports to the UAE. This appreciation is more significant for 2015 as a whole, reaching 2.8%, due mainly to the depreciation of the euro by 11.5%, the South Korean Won by 7.5% and the Indian Rupee by 4.8%.

On the non-energy exports side, the weighted average currency appreciation with respect to the top 9 non-dollarized export partners is around 0.6% in the fourth quarter of 2015%. This appreciation is due mainly to the gains realized by the Dirham against the Swiss Franc, the Chinese Yuan and the Turkish Lira (see table 2.2.b). For the year 2015 as a whole, the weighted appreciation of the Dirham reached 2.6% because of a substantial depreciation of the Turkish Lira (24.6%), the Egyptian Pound (9.5%) and the Indian Rupee (4.8%).

Figure 2.2. Real and Nominal Effective Exchange rates



Source: BIS

On the other hand, the Real Effective Exchange rate (see Figure 2.2) continues to follow its upward trend. It increased by 2.6% and 0.8% during the third and fourth quarters of 2015, respectively. All these developments do not seem to be affecting the country's competitiveness. The analysis of trade data available for the first half of the year shows an increase of the exports volume by 6.4% compared to the first half of 2014, in spite of an appreciation of the Dirham by 2.2% vis-à-vis the top 9 non-dollarized non-oil export partners during the same period.

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 (Q4–Q3) 2015	% Change of Currencies per Dirham in 2015
Chinese Yuan	11.68	-0.55	1.63	3.03	4.63
Indian Rupee	9.19	1.89	2.49	1.93	4.83
Germany (EUR)	6.09	1.65	-0.51	2.47	11.47
Japanese Yen	5.55	1.82	0.70	-1.56	0.51
UK Pound	3.53	-1.18	-1.08	5.13	5.72
Swiss Franc	3.38	-1.22	2.53	3.97	0.81
Italy (EUR)	3.09	1.65	-0.51	2.47	11.47
South Korean Won	2.95	-0.34	6.59	0.54	7.52
France (EUR)	2.54	1.65	-0.51	2.47	11.47
Total	**48.00**				
Weighted Appreciation		**0.31**	**0.64**	**1.07**	**2.81**

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 (Q4–Q3) 2015	% Change of Currencies per Dirham in 2015
Indian Rupee	14.85	1.89	2.49	1.93	4.81
Saudi Arabian Riyal	8.15	-0.07	0.00	0.11	0.01
Omani Rial	6.61	0.00	0.03	-0.03	0.00
Swiss Franc	6.34	-1.22	2.53	3.97	0.81
Turkish Lira	5.4	8.08	7.16	2.09	24.62
Iraqi Dinar	4.72	1.64	-0.28	-3.24	-2.47
Kuwaiti Dinar	4.48	1.86	0.19	0.29	3.51
Egyptian Pound	3.65	1.65	2.55	0.12	9.52
Chinese Yuan	3	-0.55	1.63	3.03	4.63
Total	**57.20**				
Weighted Appreciation		**0.84**	**1.06**	**0.61**	**2.63**

Source: Data on imports shares are provided by the Federal Competitiveness and Statistics Authority for the year 2014. Data for the exchange rate are the quarterly average of daily observations recorded and displayed by Foreign exchange.

2.3 Consumer Price Index and Inflation

The total CPI inflation has decreased during the fourth quarter of 2015 to reach on average 3.6% (see Table 2.3). The CPI inflation of non-tradables remains the main driver of the total inflation developments (see Figure 2.3.a). The non-tradable CPI has increased on average by 5.2% in the fourth quarter compared to an increase of 6.3% in the third quarter. These developments are due to the slowdown of the housing CPI inflation that constitutes the major subcomponent of a typical household consumption basket, with a weight of 39%. If the housing subcomponent is excluded, the end-of-period total CPI inflation would be 0.8% instead of 3.6% (see Figure 2.3.b).

Table 2.3
UAE – CPI Inflation (%)

	Weight %	2014	2015			
		Q4	Q1	Q2	Q3	Q4
Total CPI Inflation	100	3.3	3.7	4.3	4.6	3.6
Total CPI Inflation (end-of-period)	100	3.9	4.3	4.2	4.3	3.6
CPI Inflation of Tradables	34	2.5	1.1	0.8	1.4	0.6
CPI Inflation of Non-tradables	66	3.7	5.1	6.2	6.3	5.2
Housing CPI inflation	39	4.9	7.7	9.6	9.4	8.3
Transportation CPI inflation	10	1.8	1.5	1.0	5.6	- 0.2

Source: Federal Competitiveness and Statistics Authority.
Note: All the changes are computed on a Y-o-Y basis and based on the quarterly average CPI, unless otherwise indicated.

It is noteworthy that the inflation rate of the transportation subcomponent decreased significantly during the fourth quarter. The average transportation CPI inflation decreased from 5.6% in the third quarter to reach (-0.2%) in the fourth quarter. The positive impact of the energy-subsidy removal on inflation dissipated during the fourth quarter of the year, reducing the transportation price inflation. Moreover, the CPI inflation of ‘Food and Soft Drinks’ subcomponent which accounts for 14% of the total consumption basket, has decreased from 2% in the third quarter to 0.9% in the fourth quarter on account of further deceleration of the price of imports with further dirham appreciation.

Prices

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

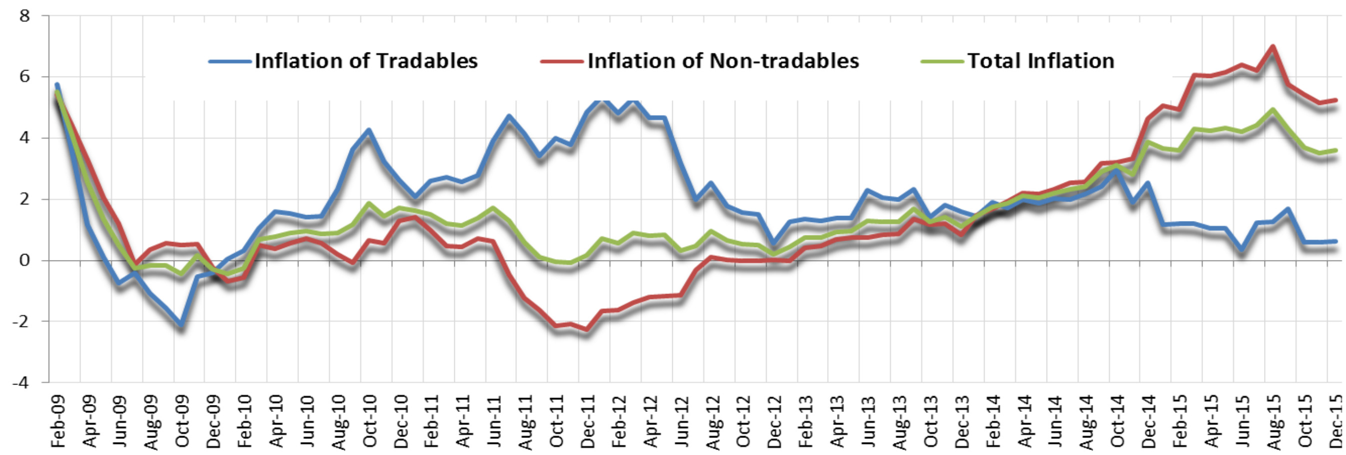


Figure 2.3.b Total CPI Inflation vs. Housing CPI inflation (monthly, yoy %)

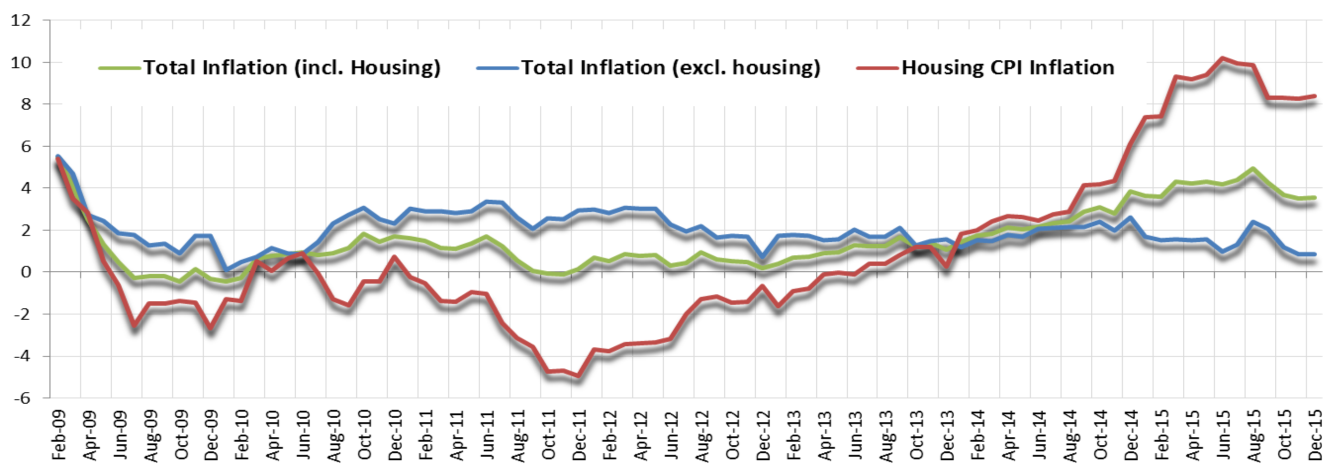
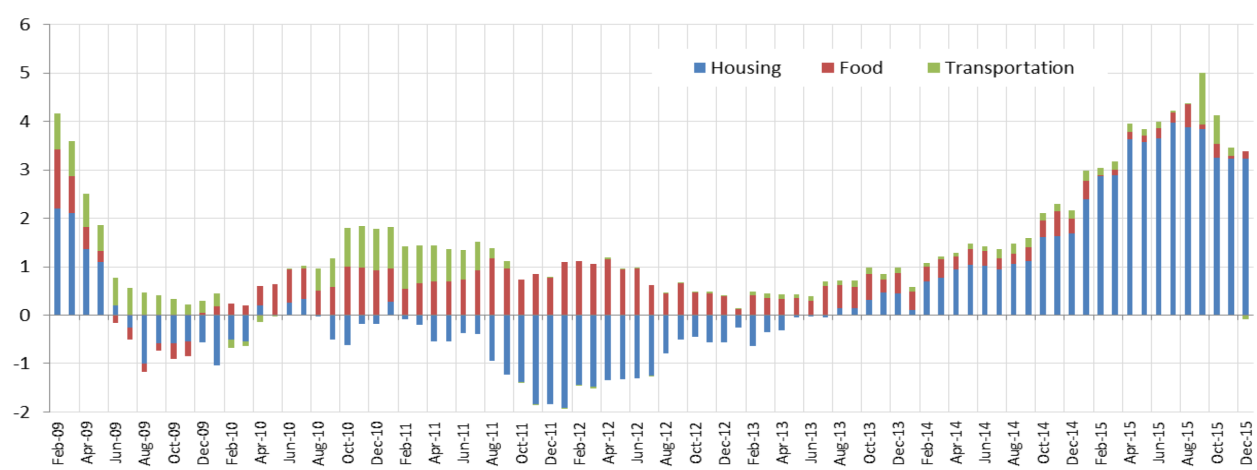


Figure 2.3.c Contribution to CPI inflation



Source: Federal Authority for Competitiveness and Statistics

2.4 Fiscal balance

The fiscal balance for the UAE deteriorated substantially during the third quarter of 2015. The general government deficit increased by 114.6% compared to the second quarter as it changed from a deficit of 8.9 AED Billions to a higher deficit of 19.1 AED billions (see table 2.4 and figure 2.4.c). It is noteworthy that this fiscal balance does not take into account the revenues generated by ADNOC transfers and government investments. This deterioration is due to a further decrease of oil revenues that is more proportional than the expenditure cut. The revenues declined by 23% compared to the second quarter, while total expenditures declined only by 9.9%.

On a year-on-year basis, the revenues decreased by 31.5% during the third quarter with an important decline of taxes by 44.5%. Although all spending items have decreased, the compensation of employees has increased by 27.3% compared to the same period of the last year. Therefore, spending cuts have been less effective in reducing the deficit.

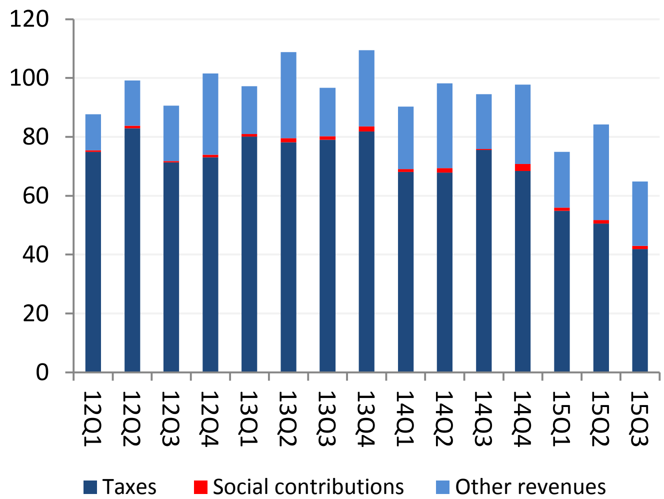
Table.2.4
Consolidated Government Finances

	2014					2015 Q1 (Actual)	2015 Q2 (Actual)	2015 Q3 (Actual)	2015* Annual (Budgeted)	% change 2015Q1-2014Q1	% change 2015Q2-2014Q2	% change 2015Q3-2014Q3	% change (Jan-Sept)2015 (Jan-Sept)2014
	Q1	Q2	Q3	Q4	2014								
Revenues (a)	**90.2**	**98.1**	**94.5**	**97.8**	**380.7**	**74.9**	**84.2**	**64.8**	**286.9**	**-17.0**	**-14.2**	**-31.5**	**-20.8**
of which:													
Taxes	68.1	67.8	75.5	68.4	279.9	54.9	50.6	41.9	188.4	-19.4	-25.4	-44.5	-30.3
Social contributions	0.9	1.6	0.4	2.4	5.3	1.1	1.1	1.0	5.5	14.0	-27.8	172.1	11.6
Expenditure (b)	**104.0**	**103.7**	**98.9**	**107.9**	**414.6**	**87.0**	**93.1**	**83.9**	**411.1**	**-16.4**	**-10.2**	**-15.2**	**-13.9**
Compensation of employees	10.6	11.4	11.4	14.1	47.5	14.4	15.8	14.5	48.6	36.4	38.0	27.3	33.8
Use of goods and services	8.9	12.1	13.8	14.7	49.5	10.5	13.5	10.8	55.3	18.3	11.5	-22.0	-0.1
Consumption of fixed capital	0.9	0.7	1.0	1.1	3.8	0.9	1.1	0.9	3.8	0.3	48.1	-14.8	7.9
Interest	1.0	1.0	0.9	1.2	4.1	0.5	0.5	0.6	3.1	-52.4	-49.1	-38.3	-46.9
Subsidies	2.5	3.6	3.4	2.6	12.1	0.2	0.2	1.4	13.0	-93.1	-95.6	-58.1	-81.4
Grants	9.8	6.2	5.5	0.4	21.9	3.1	2.8	2.5	11.3	-67.9	-54.9	-55.1	-60.9
Social benefits	12.6	13.8	16.1	18.8	61.4	12.9	15.2	13.5	56.7	2.2	9.5	-16.1	-2.3
Other expense	52.3	41.0	37.2	43.9	174.4	39.9	35.4	33.4	184.5	-23.8	-13.6	-10.2	-16.7
Net Acquisition of Nonfinancial Assets	5.5	13.7	9.5	11.2	39.9	4.7	8.7	6.4	34.8	-15	-36.7	-33.3	-31.4
Consolidated Fiscal balance (a-b)	**-13.8**	**-5.6**	**-4.4**	**-10.2**	**-34.0**	**-12.1**	**-8.9**	**-19.1**	**-124.2**	**-12.5**	**-60.3**	**-333.5**	**-68.8**

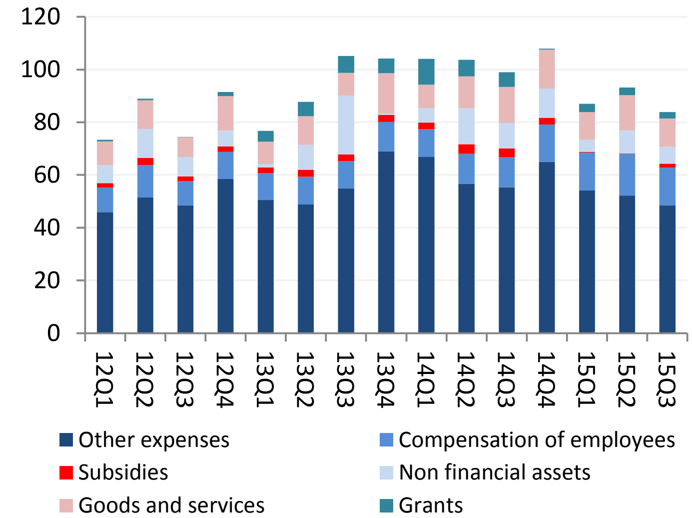
Source: UAE Ministry of Finance, revenues do not include ADNOC transfers and government investment income.
Data for 2015are projections based on the latest Regional Economic Outlook, IMF.
Note: All values are expressed in Billions of Dirhams.

Government Finance

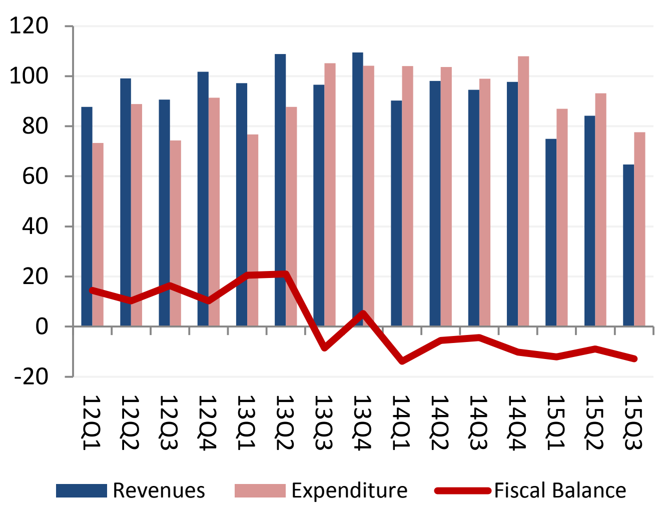
2.4. a General Government Revenues
(Billions of Dirhams)



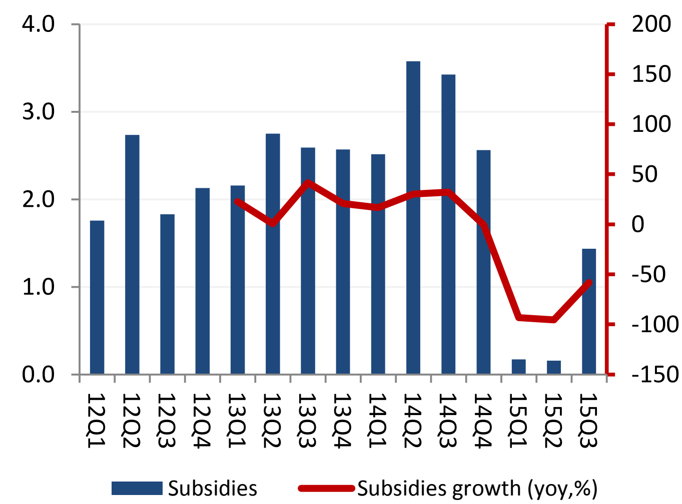
2.4.b General Government Expenditures
(Billions of Dirhams)



2.4.c Fiscal Stance
(Billions of Dirhams)



2.4.d The subsidies' development



Source: Ministry of Finance.
Note: Other expenses cover all the payments of Abu Dhabi Government 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 Price Volatility

In the fourth quarter of 2015, the decline of real estate prices in Dubai and to a lesser extent in Abu Dhabi, combined with the further drop of the oil prices in the last quarter of 2015 had a negative result on investors' confidence. The uncertainty regarding markets' development resulted in 7.2% decrease in both the Emirates Securities Market General Index and its market capitalization, with the value traded as of end of Q4 of AED 33.1bn compared with AED 42.7bn at the end of Q3.

Table 2.5.1
UAE – Securities Markets

	2014		2015			
	Q3	Q4	Q1	Q2	Q3	Q4
Change of Share Price Index (%)	15.5	-14.8	-2.3	10.1	-6.4	-7.2
Change of Market Capitalization (%)	15.6	-9.9	-0.3	10	-6.4	-7.2
Quarterly Traded Value	97.0	86.7	51.8	81.8	42.7	33.1

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

The UAE is the most diversified economy in the GCC. However, the share of oil remains quite high and the drop of the oil prices in the last quarter of 2015 have pushed CDS spreads higher for both, Emirates governments and their respective GREs. The CDS of Dubai Holding have increased by more than 30% in the fourth quarter compared to the previous quarter. In Abu Dhabi, the sovereign's CDS have increased by more than19%.

Table 2.5.2
UAE - Credit Default Swaps (CDS)

	2014				2015			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Sovereigns								
Abu Dhabi	53.0	49.5	54.5	63.5	72.0	52.0	77.4	92.6
Dubai	191.7	193.5	198.1	201.6	197.4	191.4	196.9	233.7
GREs								
DP World	148.9	151.3	145.0	212.0	194.1	188.5	190.0	183.9
Dubai Holding	287.8	282.0	316.0	330.7	321.3	340.8	322.5	421.0

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

Chapter 3. Monetary & Banking Developments

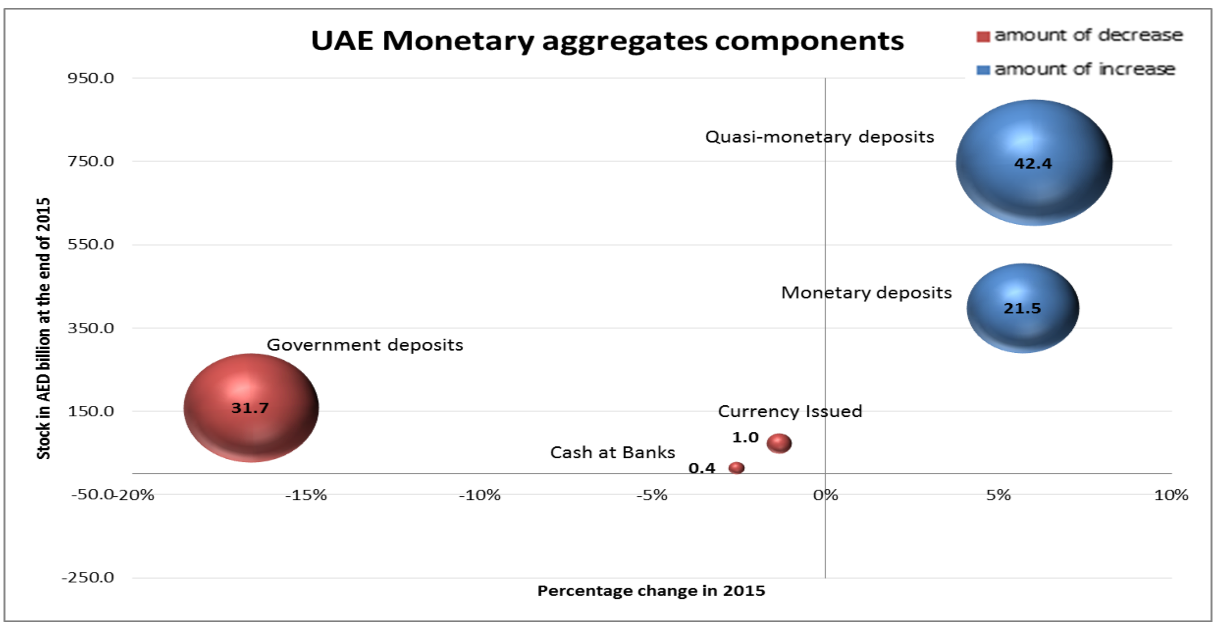
Government deposits decreased in the 4th quarter of 2015 as low oil prices persisted, which slowed down the growth of the money supply. Banks however, capitalizing on improved quality of loan portfolio were able to increase credit albeit at a moderate pace, thereby providing the non-energy sectors of the economy with the needed financing.

3.1 Monetary Aggregates

During 2015 Q4, all Money Supply Aggregates witnessed an increase for M1, M2 and M3 on Q-o-Q basis, by 0.7%, 2.4% and 1.6, and for the whole year of 2015, by 4.8%, 5.5% and 2.4%, respectively.

The main growth in M1[1] in 2015 could be explained by the increase in monetary deposits by AED 21.5bn (5.7%) to AED 457bn and marginal decrease in currency issued and cash in banks. The growth in M2[2] is due to the increase in M1 and the Quasi-monetary deposits. The aggregate grew by AED 63.3bn (5.5%) in 2015 to AED 1,204.4bn. The largest of the monetary aggregates – M3[3], experienced a lower growth - AED 31.6bn (2.4%) because of the further contraction of the government deposits, reaching AED 1,363.6bn.

Figure 3.1. UAE Monetary aggregates – 2015



Source: Central Bank of the UAE and Central Bank of the UAE analysis
Note: All data indicate the end-of-quarter values; data for December 2015 are provisional.

[1] Currency in Circulation Outside Banks (Currency Issued - Cash at banks) + Monetary Deposits (all short term deposits on which bank customer can withdraw without prior notice)
[2] M1 + Quasi-Monetary Deposits (Resident Time and Savings Deposits in Dirham + Commercial Prepayments in Dirhams + Resident Deposits in Foreign Currencies)
[3] M2 + Government Deposits

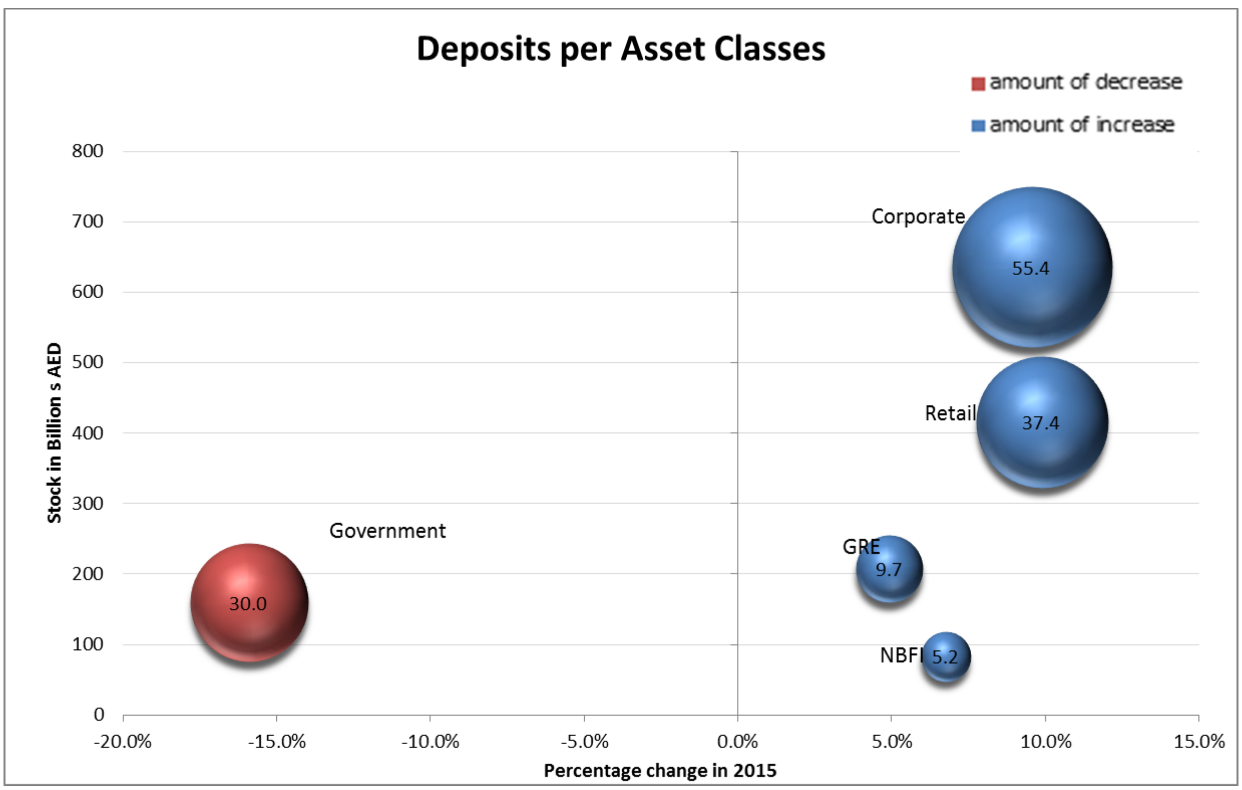
3.2 Banking Activity

The 23 locally-incorporated banks decreased their branches from 875 at the end of quarter 3 2015 to 856 at the end of December 2015, due to the higher cost efficiency requirements from the shareholders, while the 26 foreign banks from the GCC countries remained with 86 branches.

Customer Deposits at banks increased in Q4 2015 by AED 34.8bn or 2.4% only, due to the decrease in Government deposits, and despite stable growth in the other asset classes. During the same period, Non-resident Deposits increased by 8.2%, an increase that could be explained mainly by the UAE's ability to maintain its safe haven status in the region.

As regards to Resident Government Deposits, the decrease in October by AED 10bn was compensated by an increase roughly by the same amount in November, followed by a decrease of AED 9.5bn reaching AED 158.8bn at end of December. Accordingly, government deposits decreased by 3.3% in the last quarter of 2015.

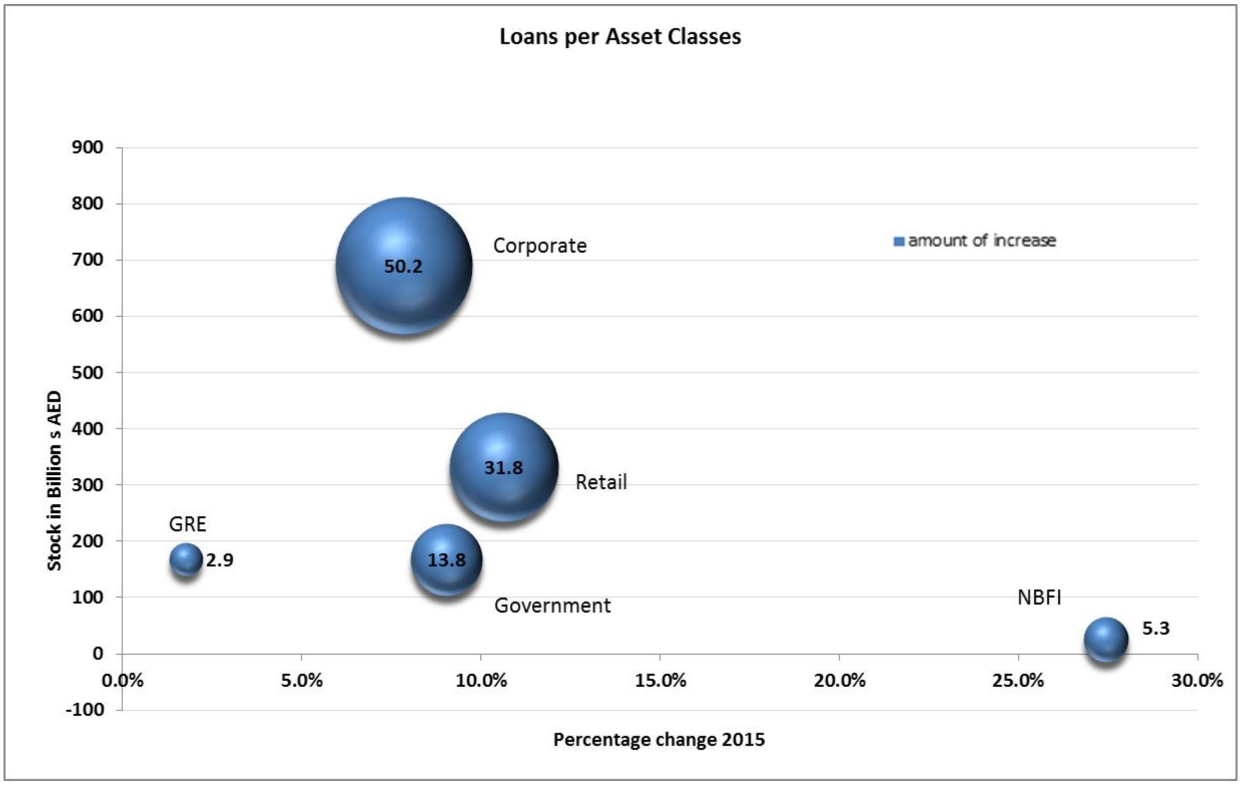
Figure 3.2.a. Deposits per asset classes – 2015



Source: Central Bank of the UAE and Central Bank of the UAE analysis
Note: All data indicate the end-of-quarter values; data for December 2015 are provisional.

Domestic Credit increased in 2015 Q4 by AED 15.3 billion, benefiting mainly the Non-banking financial institutions (NBFI) and Corporate by respectively AED 4.8bn and AED 14.1bn, whereas credit to the Government remained stable, with the government-related entities deleveraging (i.e., registering a decrease by AED 6bn). Compared with the previous quarter, however, Domestic Credit growth Q-on-Q slowed down from 2.3% in 2015 Q3 to 1.1% in 2015 Q4. According to respondents of the Central Bank "Credit Sentiment Survey" the contraction reflects "a downward trend in credit appetite" across all sectors of economic activity, with the exception of retail and wholesale trade, as well as further tightening in credit standards by banks.

Figure 3.2.b. Loans per asset classes – 2015



Source: Central Bank of the UAE and Central Bank of the UAE analysis
Note: All data indicate the end-of-quarter values; data for December 2015 are provisional.

Table 3.2.a.UAE Banking Indicators

	2014	2015			
	Q4	Q1	Q2	Q3	Q4
Total Bank Assets	**2,305**	**2,380**	**2,420**	**2,422**	**2,446**
(Growth Q-o-Q % change)	(-0.3)	(3.3)	(1.7)	(1.1)	(2.2)
(Growth Y-o-Y % change)	(9.7)	(9.1)	(8.2)	(4.8)	(7.4)
Gross Credit*	**1,378**	**1,410**	**1,446**	**1,479**	**1,486**
(Growth Q-o-Q % change)	(-0.3)	(2.3)	(2.6)	(2.2)	(0.5)
(Growth Y-o-Y % change)	(8.0)	(8.2)	(8.8)	(7.0)	(7.8)
Domestic Credit	**1,278**	**1,304**	**1,336**	**1,366**	**1,382**
(Growth Q-o-Q % change)	(-1.0)	(2.0)	(2.5)	(2.3)	(1.1)
(Growth Y-o-Y % change)	(6.2)	(6.5)	(6.5)	(5.9)	(8.1)
Personal loans to residents	**300**	**310**	**319**	**330**	**332**
(Growth Q-o-Q % change)	(-2.3)	(3.3)	(3.1)	(3.3)	(0.6)
(Growth Y-o-Y % change)	(7.0)	(8.1)	(8.1)	(7.5)	(10.6)
Customers' deposits at banks	**1,421**	**1,449**	**1,444**	**1,437**	**1,472**
(Growth Q-o-Q % change)	(0.5)	(2.0)	(-0.3)	(-0.5)	(2.4)
(Growth Y-o-Y % change)	(11.1)	(8.8)	(3.1)	(1.6)	(3.5)

Source: Central Bank of the UAE

Note: All data indicate the end-of-quarter values; data for December 2015 are provisional. Values are expressed in billions of Dirhams.

Islamic banks continued to thrive with their assets increasing by 2.7%, in 2015 Q4, reaching AED 464bn, with their share in total assets increasing to 19%. Meanwhile, their financing increased by 2.3%, reaching AED 307 billion, or 22.2% of Domestic Credit.

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

	2014	2015			
	Q4	Q1	Q2	Q3	Q4
Assets	405	432	445	452	464
Percent of total banking assets	17.6	18.2	18.4	18.7	19.0
Islamic financing	266	280	290	300	307
Percent of Domestic Credit	20.8	21.5	21.7	22.0	22.2

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 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 Q3 and 2015 Q4, well below its peak level of 7% in 2014 Q4. Meanwhile, bank specific provisions for NPLs increased from AED 72.6bn at the end of June to AED 72.8 billion at the end of December, 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 Q3, which is well above the regulatory requirements set by the Central Bank (12% and 8%, respectively).

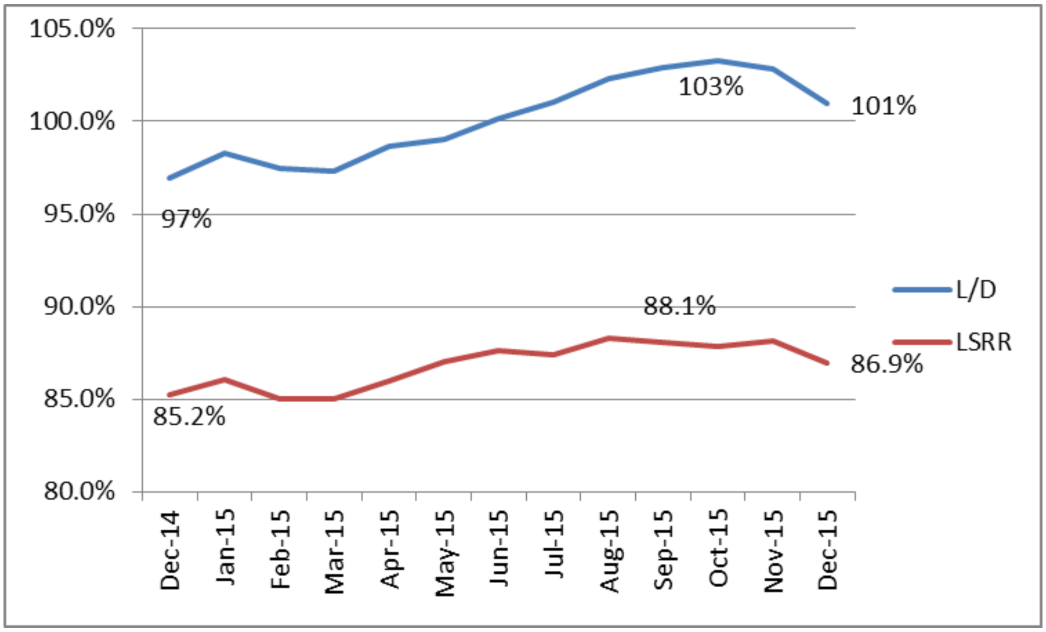
To capture the composite effects of changes in loans and deposits, two key ratios related to the funding of the banks are considered for the last quarter: the Loan-to-Deposit[4] (L/D) ratio and the Lending to the Stable Resources Ratio[5] (LSRR).

L/D has moved from 103% at end of Q3 to 101% in Q4. Consistently, LSRR declined by 1.2 percentage points to the level of 86.9% during the last quarter of the year. This implies that the growth of deposits and stable resources has outpaced the growth of credit in the last quarter of 2015. This is consistent with faster growth in deposits in Q4 and slower growth of credit in Q4, compared to Q3.

[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)

Figure 3.2.c. Indicators of lending relative to the source of funding – 2015



Source: Central Bank of the UAE and Central Bank of the UAE analysis
Note: All data indicate the end-of-quarter values; data for December 2015 are provisional.

Meanwhile, liquid assets which include reserve requirements, certificates of deposits 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 increased from 14.2% at the end of September 2015 to 17.4% at the end of December. The increase is attributed to the increase mainly in free and other account balances (excess unremunerated reserves) at the Central Bank, which more than doubled, from AED 17.7bn in Q3 to AED 36.4bn at the end of the year, and banks' investments in Central Bank CDs which increased by 43.5% from AED 97.3bn to AED 139.7bn in December. The increase in both categories is due to some banks having increased those two components of assets with the Central Bank, as previously their shares of liquid assets to total assets were lower than the threshold established by the Central Bank at 10%.

Table 3.3. Financial Soundness Indicators in the UAE (%)

Indicators	2014			2015			
	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Lending to Stable Resources Ratio[6]	84.5	86.0	85.2	85.0	87.6	88.1	86.9
Ratio of Non-performing loans	8.6	8.3	7.0	6.6	6.3	6.3	6.3
Capital Adequacy Ratio (CAR) of which:	18.2	18.3	18.2	18.2	18.3	18.3	18.3
Tier 1 Capital	16.0	16.3	16.2	16.2	16.5	16.5	16.6
The Liquid Assets Ratio (LAR)	15.57	15.09	15.67	14.74	14.3	14.2	17.4

Source: Central Bank of the UAE.
Note: All data indicate the end-of-quarter values; data for December 2015 are provisional.

Overall the banking sector in the UAE, based on indicators in 2015, remains well capitalised with the average CAR (18.3% at the end of Q4, unchanged since Q3) largely exceeding the CBUAE minimum requirement of 12% and for the Tier 1 capital (16.6% at the end of Q4, 0.1 percentage points higher compared to the end of the previous quarter) also exceeding the minimum threshold established by the central bank at 8%. Even though there were some signs of liquidity squeeze in 2015, the system remains highly liquid, as judged by the ratio of liquid assets to total assets and the share of credit to stable resources as well as banks' assets at the central bank that could be tapped for additional liquidity. Further, indicators of financial soundness continue to bode well for the ability of the banks to support growth of credit while adhering to the guidelines of financial stability, with a very low level of NPLs. Hence, the overall outlook of the banking system remains positive in 2016.

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

Chapter 4. Central Bank Financial Position & Reserve Management

The Central Bank balance sheet exhibited a significant increase in 2015 Q4, reflecting higher banks' liquid assets and more investments abroad.

4.1 Central Bank Balance Sheet

On the liabilities side, "Current Accounts and Deposits" of banks at the Central Bank increased by AED 24.3 billion, during 2015 Q4, while banks' holdings of "Certificates of Deposit" issued by the Central Bank increased by AED 42.4 billion, reaching AED 139.8 billion at the end of December 2015. This exceptional increase was due to the fact that some banks decided to increase their holdings of CDs at the end of December to meet the required Liquidity Ratio of 10% imposed by the Central Bank. Meanwhile, "Currency Issued" increased by AED 2.5 billion.

The total assets of the Central Bank increased by 21.5% during 2015 Q4, reaching AED 393 billion, with the above-indicated increase in liabilities as the main driver. On the assets side, "Held-to-Maturity Foreign Securities" increased by AED 57.4 billion, as new investments were made to replace the securities that came to maturity by end of the third quarter.

Moreover, "Cash and Bank Balances" increased by AED 11.7 billion, during 2015 Q4 as the Central Bank invested in "Bank Balances" which are mostly Nostro Accounts that provide interest, while withdrawal from Central Bank's deposits at banks abroad amounted to AED 1.9 billion, during the same period.

Table 4.1. Central Bank Balance Sheet In Millions of Dirhams

	2014	2015			
	Q4	**Q1**	**Q2**	**Q3**	**Q4**
Assets					
Gold Bullion	-	-	347	664	934
Cash & Bank Balances	42,001	42,409	40,708	66,883	78,611
Deposits	76,917	70,057	92,880	98,241	96,362
CDs Under Repo	-	6,000	-	-	-
Liquidity Support Facility	321	321	321	228	228
Held-To-Maturity Foreign Securities	157,753	159,947	145,574	107,078	164,495
Held-To-Maturity Bonds Issued by MOF & Dubai Government:	49,443	49,443	49,443	49,231	49,231
Available-for-sale foreign Investments	378	378	368	362	361
Advances to Government	2,500	2,500	-	850	2,500
Available-for-sale foreign securities	-	-	-	-	74
Derivative Assets	7,530	955	1066	47	334
Other Assets	7,996	447	469	462	445
Property and Equipment’s	79	78	85	78	79
Total Assets	**344,918**	**332,535**	**331,260**	**324,126**	**393,660**
Off Balance Sheet Commitments	**134,105**	**145,303**	**119,150**	**115,166**	**199,681**
Liabilities					
Current Accounts & Deposits	142,168	129,404	135,394	132,727	157,031
Certificates of Deposit	99,534	111,759	101,335	97,365	139,773
Currency Issued	74,472	69,353	72,549	71,047	73,522
Derivative Liabilities	-	381	771	1,256	1,310
Other Liabilities	1,683	1,810	1399	1,931	2,275
Total Liabilities	**317,857**	**312,707**	**311,448**	**304,327**	**373,910**
Authorized Issued & Fully Paid Capital	2,500	2,500	2,500	2,500	2,500
Fair Value Reserve	-11	-11	-21	-26	-29
Gold Revaluation Reserve				-12	-60
General Reserve	16,080	17,339	17,339	17,339	17,339
Retained Earnings	962	-	-	-	-
Total Liabilities & Capital	**337,388**	**332,535**	**331,260**	**324,126**	**339,660**
Off Balance Sheet Commitments related to foreign exchange fluctuations	**134,105**	**145,303**	**119,150**	**115,166**	**199,681**

Source: Financial Control Division, Central Bank of the UAE.
Note: End-of-quarter data.

4.2 Central Bank Financial Results

The Central Bank's balance of foreign currency assets, i.e., including USD 10 billion Dubai Government bonds, increased by 24.4%, from AED 303.8 billion at the end of September to AED 377.8 billion at end of December, with the increase in liabilities being the main driver, and the investment abroad, mainly in "Held-to –Maturity Securities" and "Bank Balances" which are Nostro Accounts that mostly provide interest (details in Table 4.2).

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

In billions of Dirhams

End of Quarter	2014	2015			
	Q4	Q1	Q2	Q3	Q4
Total Foreign Currency Assets	320.6	306.0	311.3	303.8	377.8
Central Bank's Investments Abroad In Highly Rated Securities, Government Bonds And Treasury Bills	157.8	159.9	145.6	107.1	164.5
Deposit Account and Cash with Banks Abroad	115.4	105.5	124.6	156.4	171.8
Central Bank's Investment In Local Government Bonds	36.7	36.7	36.7	36.7	36.7
Other Foreign Assets	10.7	3.9	4.4	3.6	4.8

Source: Central Bank of the UAE

4.3 Interest Rates

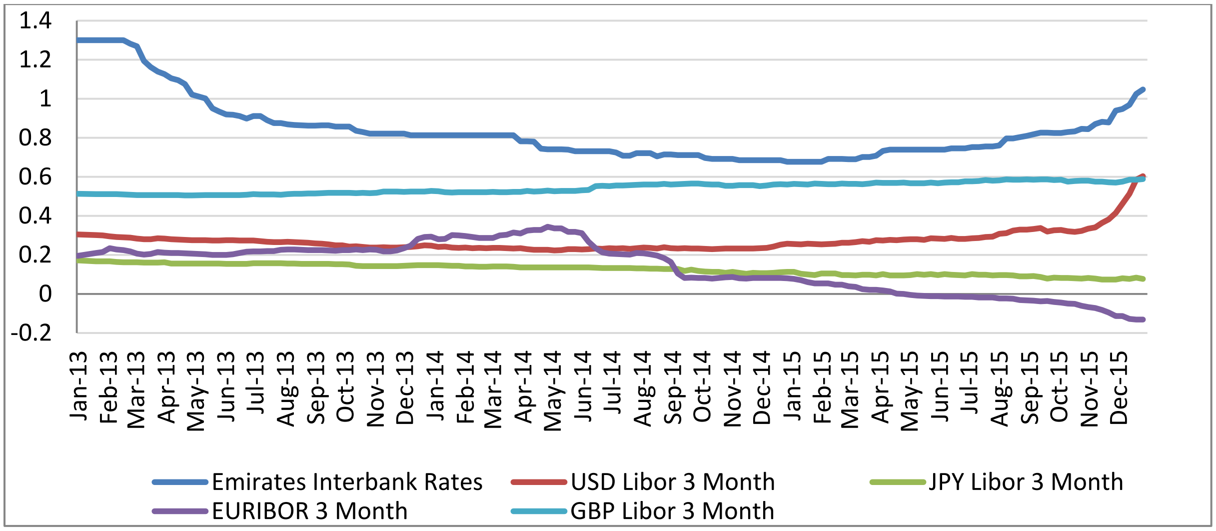
The fixed peg of the exchange rate of the Dirham to the US dollar means that the CBUAE has to peg its policy rate to the direction of the interest policy in the U.S. as well. Therefore, following the Federal Open Market Committee decision on 16 December 2015 to increase its target Federal Funds rate by 25 basis points, the Central Bank of the UAE announced its decision on December 17 to raise its interest rates applied to the Certificates of Deposits it issues to banks, in line with the increase on the US dollar. It is also worth-noting in this regard that the CBUAE uses monetary tools at its disposal to manage liquidity in the banking system, with a goal to strike a balance between supporting credit growth and stemming the risks to financial stability, while maintaining its continued commitment to the fixed peg regime.

4.3.1 Short-term interest rates

In line with the interest rate policy change, 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 12 basis points in the fourth quarter, thereby reducing the spread over the 3-month USD Libor rate from 49 bps at the end of September to 46 bps at the end of December.

Meanwhile, the 3-month USD Libor increased by 21 basis points during 2015 Q4 in line with the above-indicated FOMC decision to increase its target policy rate by 25 basis points. The Euro 3-month Libor rate continued its retreat in the fourth quarter, reflecting the tepid economic conditions in the Eurozone. On the other hand, the European Central Bank (ECB) remains committed to quantitative easing to help support sluggish growth in the Euro area.

Figure 4.3.1. 3-month Libor Rates (%)



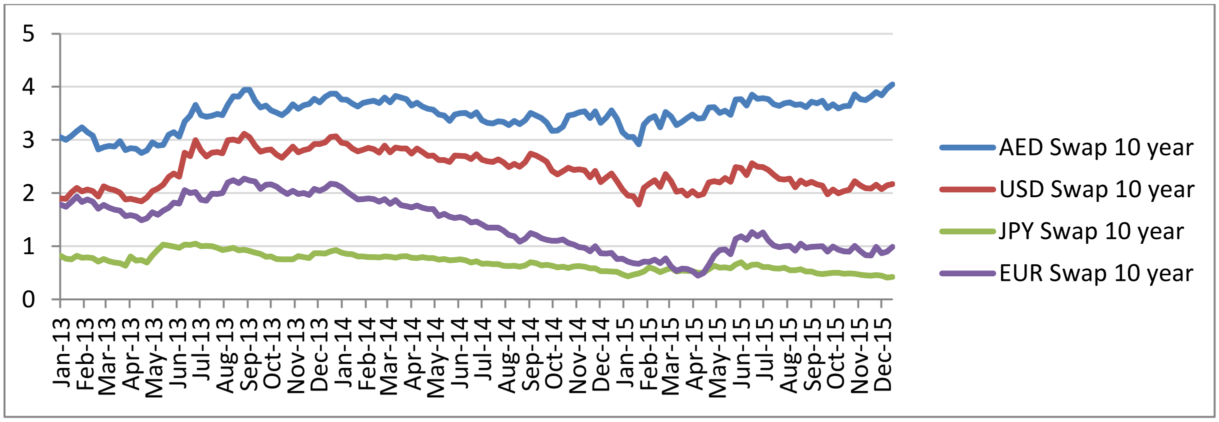
Source: Bloomberg

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. Interest rate swaps often exchange a fixed payment for a floating payment that is linked to an interest rate, most often the LIBOR. The AED 10-year swap rate increased from 3.69% at the end of September 2015 to 3.94% at end of December, i.e., an increase by 25 bps in consistency with the targeted increase in the policy rate in the U.S. However, the USD 10-year swap rate fluctuated during this period, decreasing by 15bps in October as the widely expected rise in the Fed Funds rate did not materialize, subsequently increasing by 10bps in November and 2bps in December, following the historic FOMC decision on December 16.

The spread between the AED 10-year swap and the USD 10-year swap increased steadily during this period, from 1.52 percentage points at the end of September to 1.61pps at the end of October, to 1.65pps at the end of November, and to 1.80pps at the end of December, reflecting developments in the Dirham 12-month Forward rate. The steady increase reflects an ever higher risk premium, as investors became averse to the potential adverse impact of low oil prices, particularly falling government revenues and the impending fiscal consolidation.

Figure 4.3.2. 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 at a rate set by the Central Bank. The system was revamped in 2007 with the move to a new auction system, where the CBUAE determines issuance by setting a cut-off interest rate for bids posted by banks, while Islamic CDs were introduced in 2010 to allow Islamic banks to better manage their excess liquidity, putting them on equal footing with conventional banks.

4.6 Banks' Excess 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 17.7 billion at the end of September to AED 36.4 billion at the end of December, while Certificates of Deposits held by banks increased by AED 42.3 billion, as indicated above (cf. Table 4.1).

Total banks' liquidity, including reserves requirements and highly-rated government and public sector debt, increased from AED 280.1 billion at the end of September to AED 351.2 at the end of December, i.e., 25.4% increase, due to the increase in CDs by AED 42.3 billion and AED 18.7 billion increase in banks' current account at the Central Bank. Excess liquidity indicates sufficient liquidity in the banking system as the few banks that tapped CBUAE's facilities to borrow Dirhams during this period, namely through the Interim Marginal Lending facility, the Collateralized Murabaha Facility, and the CDs Repo Facility tapped small amounts of liquidity.

4.7 Reserves Management

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

CBUAE's reserves are managed with a goal to strike a balance between guaranteeing a reasonable return on investments, 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 December 2015 comprise AED 171.8 billion Deposit Account and Cash with Banks Abroad and AED 164.5 billion Central Banks's Investments Abroad in Highly Rated Securities, Government Bonds and Treasury Bills, in addition to other foreign currency assets, amounting to AED 4.8 billion, which brings total foreign reserves to AED 341.1 billion, excluding USD 10 billion Dubai Government Bonds.