



مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.

Quarterly Economic Review

2016 Q2

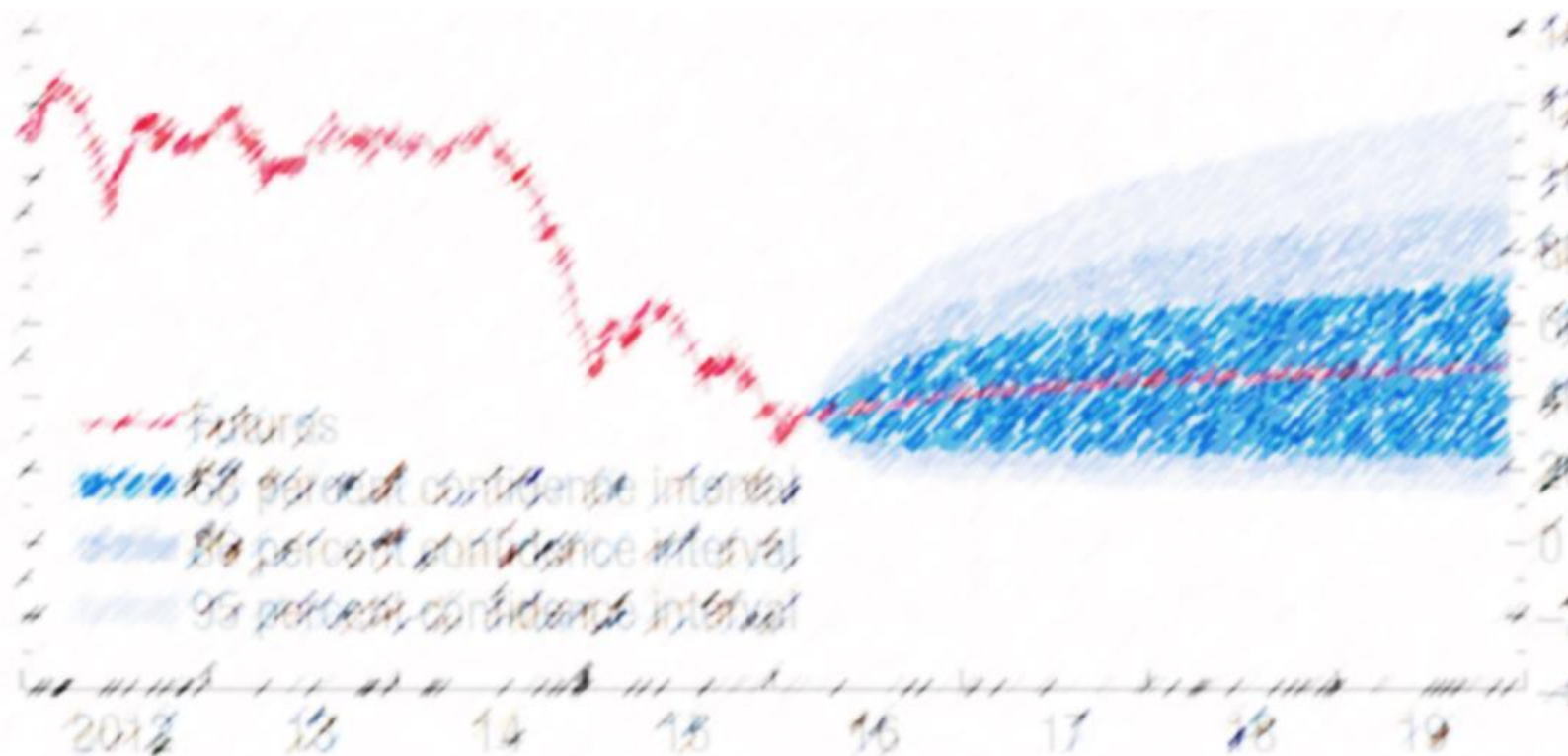


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Executive Summary

At the international level, in the US, the monthly rate of job creation over the last two months of 2016 Q2 remained below the five year monthly average. The Fed didn't take any action on rates hike following uncertainty about the global economy in the wake of the Brexit vote and awaiting more solid data from the U.S. Leading indicators on the whole remained mixed. Industrial production and durable goods orders continued to fall, although retail sales held up better.

The ECB expanded its Quantitative Easing program to include corporate bonds for the first time during 2016 Q2. Lower yields have forced investors to take on greater risk to meet income requirements, although the potential for capital losses remain high. Despite ECB buying corporate and government bonds in order to push interest rates down, the stimulus package has not paid off yet to stimulate borrowing activity outside Germany and France and inflation still remains low.

Weak global demand, spillovers from the low oil price environment and challenging domestic conditions continued to weigh on economic activity in the MENA region though some tentative signs of improvement have since emerged.

At the domestic level, based on revised new figures of growth in 2015 and revised projections of the global economy, the Central Bank of the UAE has revised its estimate 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 updated its econometric model to project economic growth for both oil and non-oil activities over a period of two years.

In this context, the growth of GDP in the UAE is expected to slow to 2.3% in 2016, lower than the initial April's projection of 2.8%, driven mainly by the continued fiscal consolidation and the slowdown of the main UAE trading partners. In fact, non-oil GDP growth is projected to slow down to 2.7% in 2016, while oil GDP growth is forecast to increase by 1.4% in 2016, given the projected increase in oil production.

The decreasing trend of inflation continued for the third consecutive quarter. The average Consumer Price Index (CPI) increased by 1.7% in the second quarter of 2016 against an increase of 2.1% during the previous quarter.

Also, CPI inflation (Y-on-Y) slowed down to 2.1% in first quarter of 2016, due mainly to a slowdown in Housing despite higher imported inflation, on account of dirham depreciation.

As regards banking activity, customer deposits declined by 0.6% compared to the end of March 2016, with the decline in GREs and Non-Banking Financial Institutions deposits by 16.5% and 17.7% respectively, reinforcing the chute in resident deposits by 0.7%. Domestic credit continued to grow nonetheless by 1.6% in 2016 Q2 and 6.8% Y-o-Y, reflecting the adequate liquidity situation at banks and the resiliency of non-oil activities.

Chapter 1. International Economic Developments

In the US, the economic environment was sluggish in the second quarter of 2016, with doubtful results in several areas of the economy. Elsewhere, economic growth continued to lag as a result of several factors. In Europe, the risks posed by the Brexit was a major concern, and the region is suffering from low demand despite the European Central Bank's (ECB) aggressive asset purchase program. China's policymakers are attempting to engineer a soft economic shift oriented towards reviving domestic demand while also navigating stock, bond, and currency markets.

For the second quarter of 2016, the GDP figures releases for the US and the Eurozone disappointed, in terms of growth expectations, while the UK, notwithstanding Brexit concern, and China performed well.

GDP in the US increased at an annual rate of 1.1% in 2016 Q2 compared to the 0.8% for the first quarter of 2016. The increase in real GDP in the second quarter reflected positive contributions from personal consumption expenditures (PCE) and exports that were partly offset by negative contributions from private inventory investment, nonresidential fixed investment, residential fixed investment, and state and local government spending. The decrease in imports helped support the growth momentum.

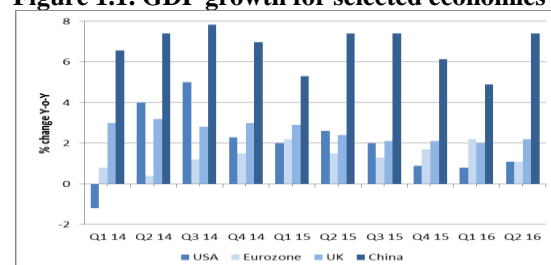
In the Eurozone the 2016 Q2 growth was of 1.1% annualized, down from 2.2% in Q1, suggesting that the economy has lost some momentum: industrial production contracted in May and economic sentiment decreased in June. Most importantly, the UK's vote to leave the EU has dramatically increased downside risks for the Eurozone economy. The vote had ramifications for the bloc's trading patterns, financials and political stability, while some of the economic consequences were immediate—financial markets have experienced heightened volatility.

The UK's economy grew by 2.2% Y-o-Y in 2016 Q2, higher than the expansion of 2% in 2016 Q1 and better than market expectations, despite the fears of Brexit. Industrial production rebounded and posted the biggest gain since 1999, boosted by mining, quarrying and manufacturing while services growth slowed and construction shrank for the second quarter.

The Chinese economy was able to keep up its momentum in 2016 Q2, growing at 7.4% Y-o-Y

due to continued policy support. While retail sales suggested that private consumption was broadly stable in Q2, investment among state-sponsored companies soared in the same period, which partially compensated for poor dynamics in investment from private firms. Moreover, a large trade surplus in 2016 Q2 mainly due to a weakening yuan has likely improved the contribution from the external sector to overall growth.

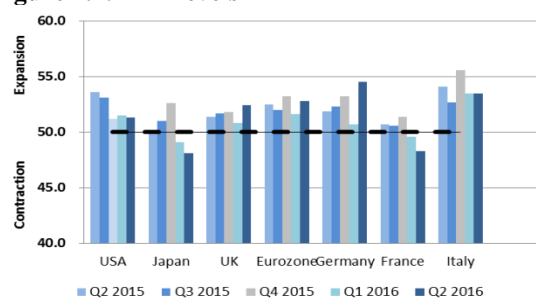
Figure 1.1. GDP growth for selected economies



Source: Bloomberg

Economic activity in the developed world as measured by the Purchasing Management Index (PMI) shows that in the US, Japan and France it has seen a deterioration in 2016 Q2, while in the other countries shown in Figure 1.2 it has experienced an improvement compared to quarter one 2016, except for Italy, where it remained unchanged.

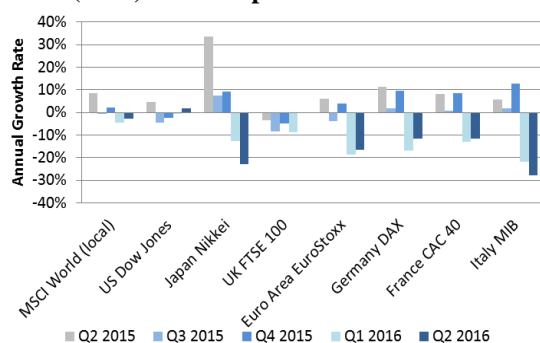
Figure 1.2. PMI levels



Source: Bloomberg

The US saw a marginal deterioration in their PMI levels from 51.5 to 51.3, while the UK PMI improved from 50.8 to 52.4. In contrast, Japan's PMI level was at 49.1 at the end of 2016 Q1 and ended the second quarter of 2016 at 48.1, which is below the 50 mark and is a sign of contraction. On the other hand, the Eurozone notched up from 51.6 at end of the 2016 Q1 to 52.8 at the end of quarter two 2016. A PMI reading above 50 indicates expansion.

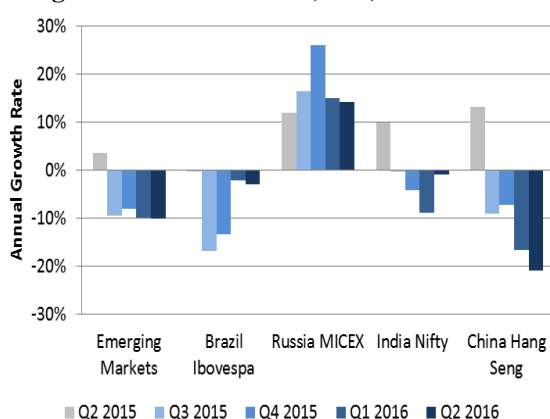
Figure 1.3. Annual percentage change of equity indices (local) in developed economies



Source: Bloomberg

All developed equity markets in the analysis, experienced negative annual returns during the second quarter of 2016, with exception of the US Dow Jones, which grew by 1.8%.

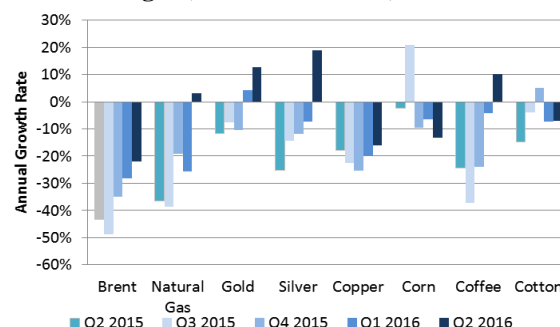
Figure 1.4. Annual stock market index percent changes in BRIC countries (local)



Source: Bloomberg

Similarly, equity markets all have had a negative return on an annual basis for the BRIC, except for Russia, in the second quarter of 2016.

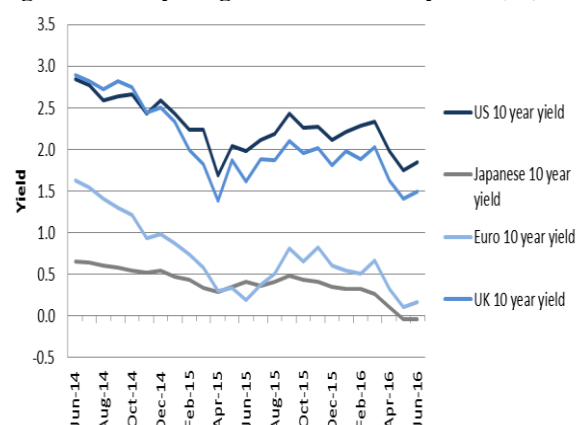
Figure 1.5. Selected commodity price levels annual changes (front-end futures)



Source: Bloomberg

The second quarter of 2016 saw a continuation of the general decline in commodity prices. On an annual basis, oil (Brent) for instance lost 21.9%. However the natural gas, gold, silver and coffee contracts managed to post improvement in the second quarter of 3.3%, 12.8%, 18.9% and 10.3% respectively.

Figure 1.6. 10-year government bond yields (%)



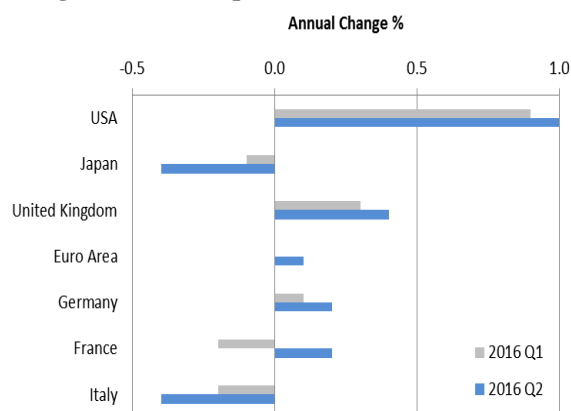
Source: Bloomberg

All of the 10-year yields in the four main developed government bond markets fell down in the second quarter of 2016, mainly driven by the uncertainty around the Brexit referendum, whether U.S. employment growth could stall and whether the Fed would pursue further interest rate hikes in the near future. For Europe, the continuing quantitative easing was the main reason for the 10-year government yield's reduction from 0.16% in 2016 Q1 to -0.13% at the end of June 2016.

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, the developing world experienced higher inflation

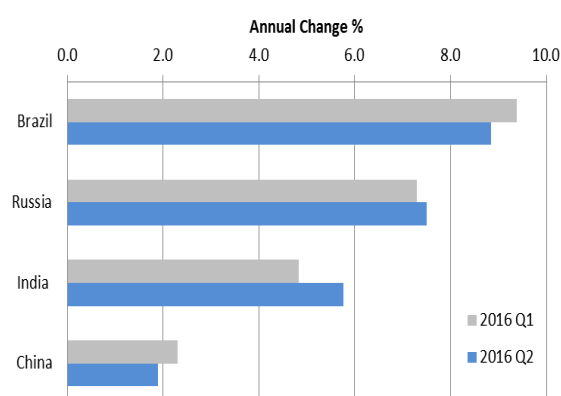
rates with the exception of China. In Brazil, the continued devaluation of its currency in the second quarter of 2016 was the driving force of high inflation.

Figure 1.7. Year-on-Year consumer price change in the developed economies



Source: Bloomberg

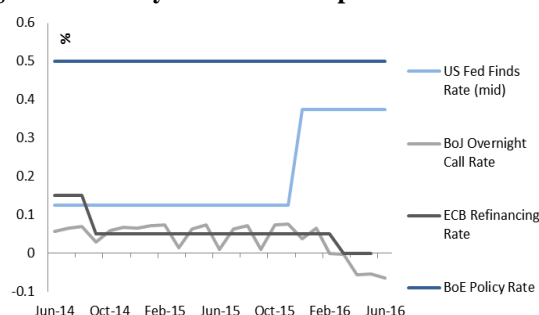
Figure 1.8 Year-on-Year consumer price change in emerging economies



Source: Bloomberg

In terms of monetary policy, the second quarter of 2016 will be remembered with the postponement of the US Federal Reserve rate hike following the historic vote on Brexit in the U.K. The period was also marked by the ECB's decision to continue its quantitative easing, increasing also the amount of assets to purchase. In this second quarter, the Bank of Japan has decreased the overnight call rate from -0.002% at the end of 2016 Q1 to -0.046%.

Figure 1.9. Policy rates of developed countries



Source: Bloomberg

MENA economies have become increasingly dependent on foreign borrowing since oil revenues began to fall. Therefore, rising volatility in the financial markets due to mounting economic and political uncertainty is having an impact on borrowing conditions. This situation may also delay international bond issuances in the region as appetite for riskier assets will diminish in the wake of rising risk aversion. On the flip side, a cloudy global outlook has the potential to force the United States Federal Reserve to postpone its tightening cycle, thereby improving liquidity and financing conditions in the region.

Another significant contagion channel for the MENA economies will be through heightened volatility in the oil market. The possibility of a significant slowdown in the European Union will add downward pressure on oil prices due to reduced demand from one of the world's key crude importers. Moreover, uncertainty will hasten investors to flee to safe-haven holdings including the U.S. dollar and other commodities such as gold. This move will exert further downward pressure on crude prices.

Chapter 2: Domestic Economic Developments

Despite the rebound of oil prices in the second quarter of 2016, growth is revised downward on account of revised GDP data for 2015 and new projections for growth in major trading partners. CPI inflation continued its downward trend on account of further decline in housing prices. Evidence of improvement of economic sentiment is reflected by a reduction in the volatility in financial markets, notable rebound in stock market indexes and tightening in the spreads of Credit Default Swaps.

2.1 Economic Activity and Growth

The second quarter of 2016 witnessed a turning point for the slope of the oil price curve since the third quarter of 2015 (see figure 2.1.a). In fact, the average Brent price for the second quarter was around \$46, displaying an improvement of 33.7% compared to the previous quarter (\$34.4 on average), though the oil price average is 26% less than the 2015's second quarter price. For the UAE Oil Sector, the decline of oil prices in 2015 was offset partially by the increase of produced quantity. Thus, real oil GDP growth was around 5% according to the last revision for 2015 (see Box 1).

Table 2.1 Economic Growth in the UAE (%)

	2013	2014	2015	2016 (P)	2017 (P)
Real GDP	4.7	3.1	3.8	2.3	2.4
Real Oil GDP	2.9	0.8	5.0	1.4	1.3
Real Non-Oil GDP	5.6	4.1	3.2	2.7	2.8

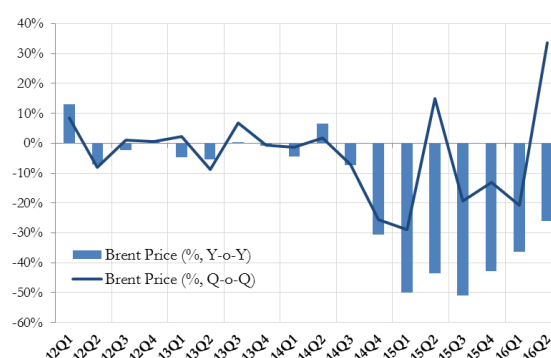
Source: Federal Competitiveness and Statistics Authority (FCSA) for 2013, 2014 and 2015, and Central Bank projections for 2016-2017.

Note: For more details concerning the Central Bank projections, see "Box: GDP forecasting model of the Central Bank of the UAE" in the Quarterly Economic Report for Q4 2015 in the CBUAE website.

Lower oil prices weighed on non-oil activity. According to the revised figures released recently, the real non-oil GDP grew by 3.2% in 2015 against a growth rate of 4.1% in 2014. This slowdown in the non-oil economic activity continued in 2016. The Economic Composite Indicator (ECI), produced by the Central Bank as a quarterly tracker of the non-oil economic activity,

registered growth of 2.4% in the second quarter against a 2.5% growth during the first quarter. Equivalently, economic activity moderated further in the second quarter in spite of the rebound in the oil price.

Figure 2.1.a. Oil Prices Development, Brent Price



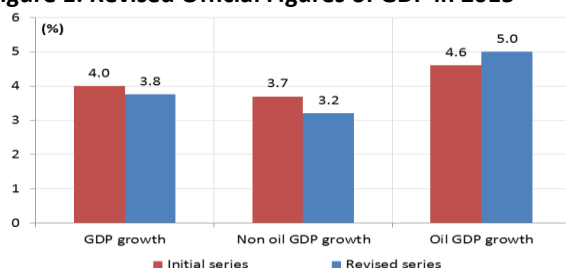
Source: IMF

The slowdown of non-oil economic activity in the second quarter of 2016 is driven by a further tightening of public capital spending due to fiscal consolidation by the government in the aftermath of continued oil price decline in 2015. In addition, weakening of the domestic demand, due to subsidies' cut and other measures, has amplified the initial adverse shock.

Box 1: Revised Official Figures of GDP projections

The Federal Competitiveness and Statistics Authority (FCSA) has released new GDP figures for 2015. The main modification concerned the real non-oil GDP growth for 2015 (from 3.7% to 3.2%), while the oil GDP growth has been raised to 5% from 4.6%. Thus, total GDP grew by 3.8%, lower than the initial estimate of 4% in 2015, according to the last FCSA updates (Figure 1).

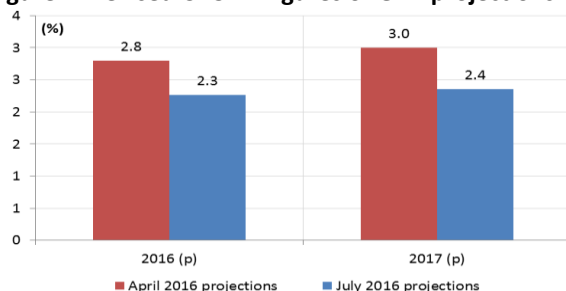
Figure 1: Revised Official Figures of GDP in 2015



Source: FCSA

For this reason, the Central Bank of the UAE (CBUAE) has revised the GDP projections¹ for 2016 and 2017 (Figure 2) in order to take into account all recent updates, especially the recent economic development of the main UAE's trading partners, as well as the modest recovery in oil prices.

Figure 2: Revised CBUAE Figures of GDP projections



Source: CBUAE

Indeed, the International Monetary Fund (IMF) cut its forecasts of global economic growth for 2016 and 2017 as the unexpected U.K. vote to leave the European Union has created a wave of uncertainty amid already-fragile business and consumer confidence. Thus, the global economy is projected to expand by 3.1% this year and 3.4% in 2017, according to the IMF.

In this context, the economic growth of the UAE's partners is expected to grow by 2.6% in 2016 and 2.7% in 2017 with

¹ For more details concerning the Central Bank projections, see "Box: GDP forecasting model of the Central Bank of the UAE" in the Quarterly Economic Report for Q4 2015 on the CBUAE website.

a 0.3 percentage point reduction for both years, according to the "Economic Partner Index" (EPI)² constructed by the CBUAE. This slowdown is likely to affect negatively the UAE's GDP growth for the coming years.

Moreover, crude oil prices have recovered from below \$30 in January per barrel to reach \$50 per barrel in June, due to tightening supply and strengthening sentiment around demand recovery. However, based on the oil futures price, persistent lower oil prices continue to pose challenge for the UAE's economy and continue to weigh on growth and fiscal policy.

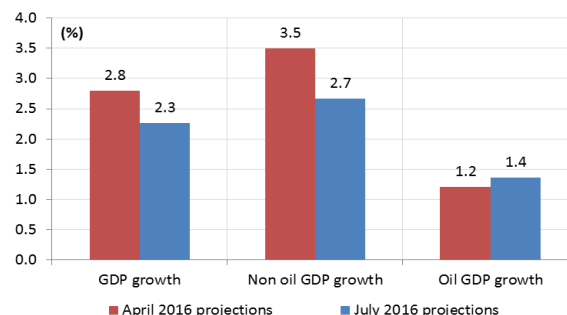
Table 1: Revised Brent price and EPI projections

	2016		2017	
	Initial	Revised	Initial	Revised
Oil Brent futures price	40	45.3	46.3	52.6
Economic Partner Index	2.9	2.6	3.0	2.7

Source: IMF, CBUAE

In this context, the growth of GDP in the UAE is expected to slow to 2.3% in 2016 (Figure 2), lower than the initial April's projection of 2.8%, driven mainly by the continued fiscal consolidation and the slowdown of the main UAE trading partners. In fact, non-oil GDP growth is projected to slow down to 2.7% in 2016, while oil GDP growth is forecast to increase by 1.4% in 2016 (Figure 3), given the projected increase in oil production.

Figure 3: Revised CBUAE Figures of non-oil GDP and oil GDP projections for 2016



Source: CBUAE

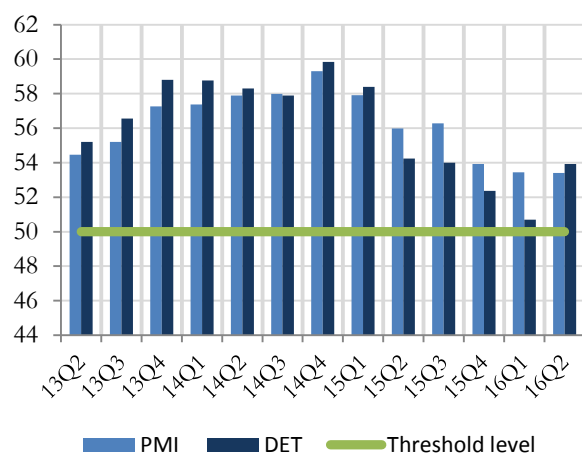
² Economic Partner Index (EPI) is a weighted average of the main UAE's economic partners' for non-energy exports GDP growth. The EPI is highly correlated with the UAE non-oil GDP, given the close economic relationships between those countries, such as trading, tourism and FDI.

Despite increased pressures, the private sector has shown positive signals during the second quarter and continued to expand according to the latest survey of purchasing managers. The average Purchasing Managers' Index (PMI) is around 53.4 in the second quarter, stabilizing at its level in the first quarter (see Figure 2.1.b).

On the other hand, the Dubai Economic Tracker (DET) has improved significantly during the second quarter. It jumped on average from 50.7 in the first quarter to 53.9 in the second quarter on account of an increased hiring trend in some industries and a sharp rise in output and new work. Monster's Employment Index showed an upward movement in job listings in the UAE up by 10% in June compared to the same month last year, on account of an increase of job openings in some industries such as Tourism and Travel in Dubai, where the employment rate improved during the second quarter (see Box 2).

2020 would continue to weigh on economic sentiment and growth prospects positively.

Figure 2.1.b Purchasing Managers' Index (PMI) and Dubai Economic Tracker (DET)



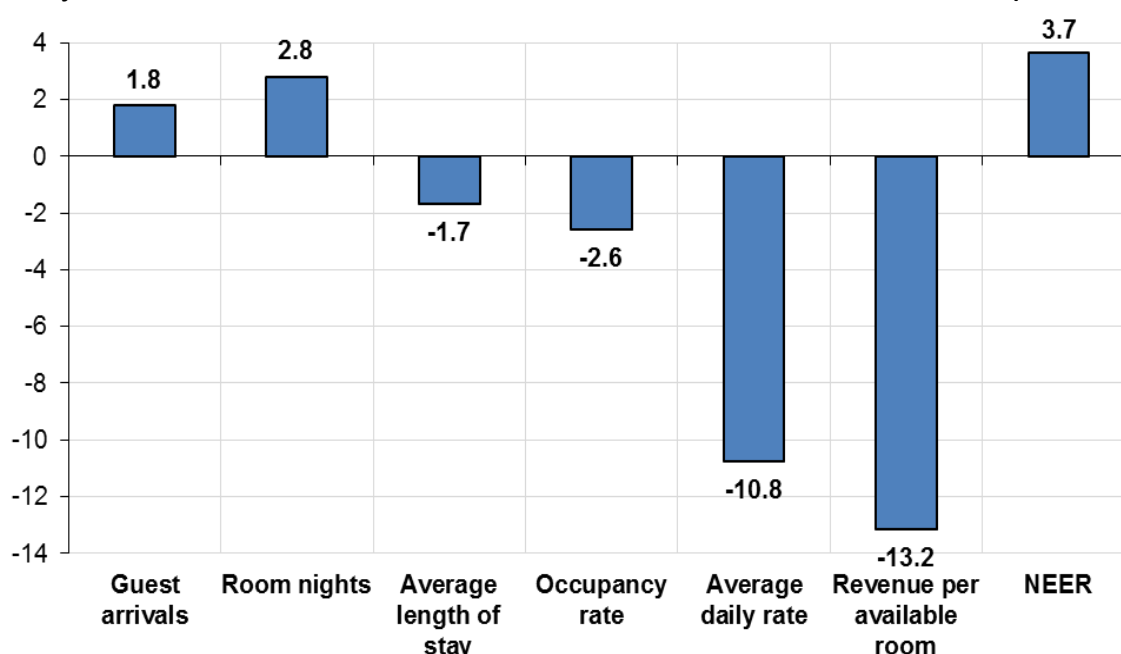
Source: Markit & Emirates NBD

Overall, the aggregate quarterly Economic Composite Index showed a continuous slowdown of the non-oil activity during the second quarter. It grew by 2.7% against a growth rate of 2.9% during the previous quarter. Given these developments during the first half of the year, the Central Bank's forecast for the economic growth will be lowered to 2.3% for 2016 instead of 2.8% previously forecast. The downgrade was partly due to the depressing effect that the Brexit might have on global economic growth and possible spillover effects on the region (see Box 3). However, increased projects spending for initiatives such as Dubai's Expo

Box 2: Exchange Rate Appreciation and Tourism Activity in the UAE

The Figure below tracks the effect of the dirham appreciation on UAE tourism for the first six months of 2016 compared to 2015 based on data from Dubai and Abu Dhabi emirates which contribute the largest shares of the total aggregate. Figure 1 illustrates an increasing trend in attracting international visitors, the number of which has increased by 1.8% in the first half of 2016 compared to the same period in 2015. However, reduction is recorded in the average daily rate or the revenue per available room by 10.8% and 13.2% respectively (average prices of the two emirates) which resulted in an increase in occupied room nights by 2.8%. More specifically, the appreciation of the dirham in nominal effective terms by 3.7% on a yearly basis is correlated with increasing trend of guest arrivals, although the average hotel occupancy slightly decreased by 2.6% for H1 2016 compared to 2015.

Figure 1. Major combined Indicators of Dubai and Abu Dhabi inbound tourism H1 2016-15 (% difference)

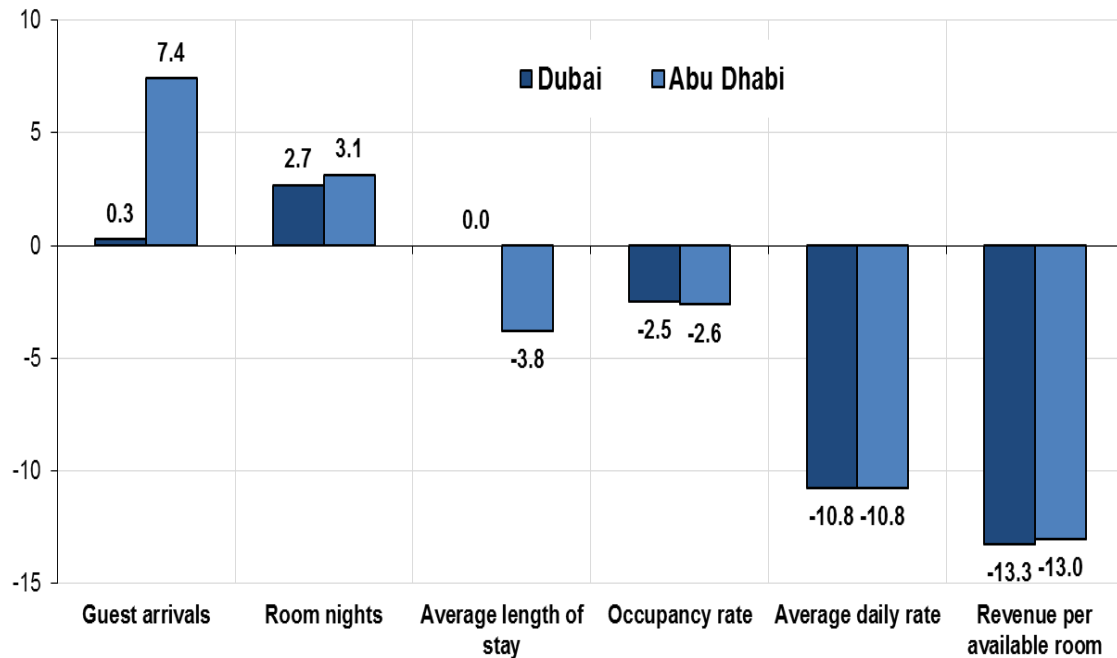


Source: Abu Dhabi Tourism and Culture Authority, Dubai Tourism Authority

Specifically, for the Dubai emirate an increasing trend is recorded in attracting international visitors, the number of which increased by 0.3% in the first half of 2016 compared to the same period of 2015. However, reduction is recorded in the average daily rate or the revenue per available room by 10.8% and 13.3% respectively which resulted in an increase in occupied room nights by 2.7%. However, the average hotel occupancy rate slightly decreased to 78% from 80% for H1 2016 compared to 2015.

The effect of dirham appreciation on tourism in the Abu Dhabi emirate depicts similar pattern, although with notable increase in guest arrivals (7.4%) in the first half of 2016 compared to the same period in 2015. However, the lower average room rate (a 10.8% decrease) resulted in a 7.9% decrease in total revenue for the first half of 2016 compared to the same period of 2015.

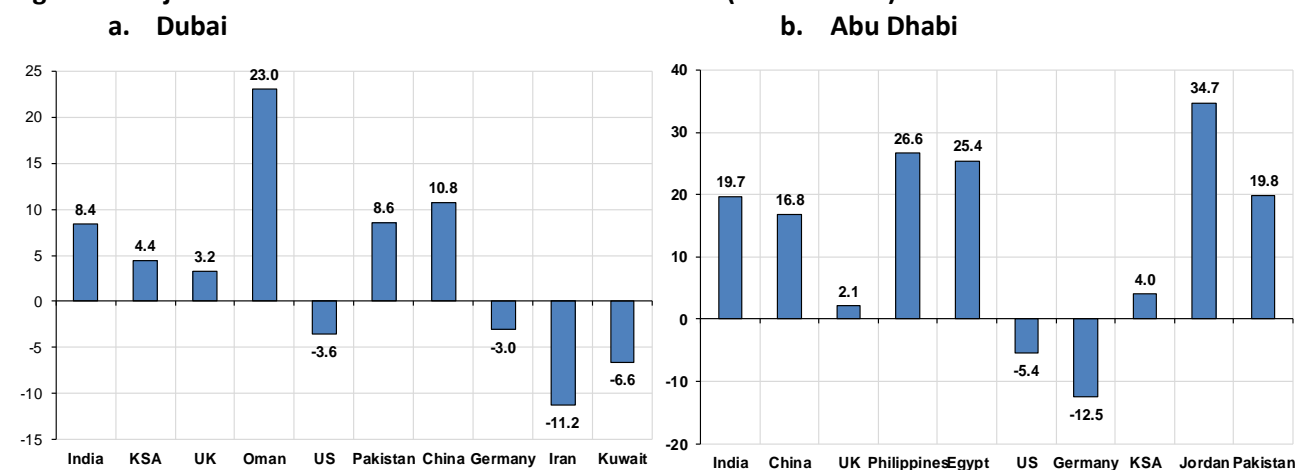
Figure 2. Major Indicators of Dubai and Abu Dhabi inbound tourism H1 2016-15 (% difference)



Source: Abu Dhabi Tourism and Culture Authority, Dubai Tourism Authority

Most of the major countries that are the markets of inbound tourism to Dubai show increase in the arrivals of tourists, except from Germany, Iran and Kuwait. Nonetheless, the vast majority of tourists originate from GCC countries and the MENA region (24% and 11% respectively) while Western Europe and America account for 22% and 6% of inbound tourism. Finally, 17% of inbound tourism comes from the region of South Asia. Across the major markets of inbound tourism for the Abu Dhabi Emirate all countries recorded increase in guest arrivals apart from Germany (-12.5%) and the US (-5.4%). The largest increase in guest arrivals was recorded from Jordan (34.5%), Philippines (26.6%) and Egypt (25.4%).

Figure 3. Major markets of inbound tourism H1 2016-2015 (% difference)



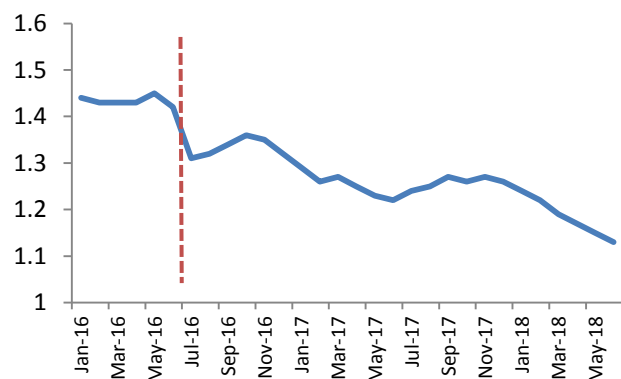
Source: Abu Dhabi Tourism and Culture Authority

Box 3: Possible Brexit Effects on the Gulf

In a historic referendum on June 23, the United Kingdom voted by 51.9% to leave the European Union. The UK exit from the EU –Brexit– is predicted to have major short and long-term implications on the global and the British economies. On the night of the result, the sterling pound depreciated by 8.76% to reach a 31-year low against the US dollar, London Stock Exchange (FTSE100) fell by 3.15% and Brent oil prices dropped from \$50.9 to \$48.4.

The policy rate in the UK was expected to drop, but on July 14, the Bank of England (BOE) kept it at 0.5%, with some discussion of a possible rate reduction to additionally stimulate the economy. In addition, three major credit rating agencies have downgraded the credit rating of the UK and have warned against further downgrading. According to the Economic Forecast Agency (EFA), the sterling might further drop against the US dollar until 2018 (See Figure 1). In addition, the US Federal reserve (FED) was expected to raise its interest rates in a few months, but Brexit could lead to its postponement. UK's shadowy stance towards the EU, its trade agreements and investment policies will likely create an atmosphere of global economic uncertainty in the next few years.

Figure 1: GBP-USD Exchange Rate (Jan. 2016 - June 2018)



Source: Economic Forecast Agency

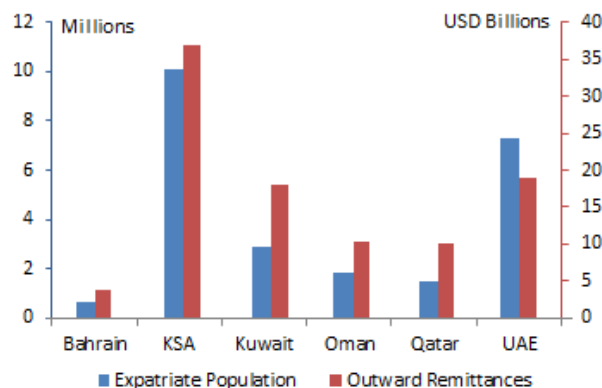
Brexit could have possible lasting effects on European and developing economies and might have some, but a limited impact on the Gulf Cooperation Council (GCC). Changes to the global economy caused by Brexit could affect the GCC economy through several channels.

There is a currency peg that maintains the exchange rates between the US dollar and most of the GCC currencies. As the sterling continues its drop against the USD, it could depreciate further as well against GCC currencies, after reaching an all-time low on June 24. In addition, continued volatility of oil prices might shrink GCC oil revenues and encourage governments to accelerate their economic diversification strategies in order to reduce their dependency on the oil sector.

More specifically, there is a remarkable interconnectedness between the UK and the GCC economies. Some of the long-existing channels of interaction include expatriate workforce, real estate, trade and tourism as well as mutual investments through foreign direct investment (FDI) and sovereign wealth funds (SWFs). The analysis of these transmission channels allows us to better understand how Brexit could affect the GCC economy.

There is a considerable proportion of expatriate workforce in the Gulf, for which remittances could be affected after Brexit. Due to its relative stability and economic prosperity, many expatriates come to the GCC to work, save and send their money back home. Expatriates account for nearly 48.1% of the GCC population, reaching 88.5% in the UAE. World Bank data indicate that remittances from the six GCC countries have reached \$98bn in 2014. Three out of the top ten remittance senders in the world were from GCC countries: Saudi Arabia came 2nd with \$36.9bn per year, the UAE was 4th with \$19bn and \$18.1bn put Kuwait in the 7th place. Brexit could further depreciate currencies like the sterling, the euro and the Philippine peso. The high expatriate population in the GCC coupled with recent appreciation of the US dollar and pegged currencies in the region could lead to a surge in remittances outflows (See Figure 2).

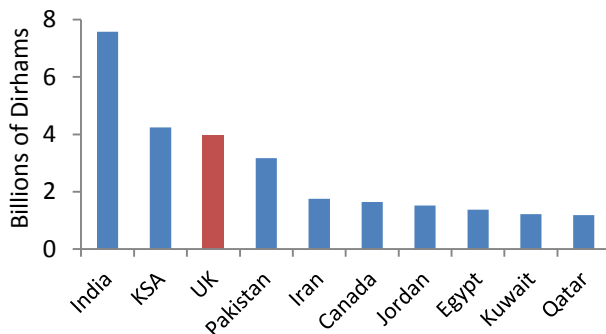
Figure 2: Expatriate Population & Outward Remittances in GCC



Sources: World Bank 2014, Gulf Research Center (2010-2015)

UK investments in the GCC real estate markets are huge and vice versa. Dubai Land Department (DLD) data show that British expatriates were the second foreign top property buyers in Dubai with purchases that are worth AED 10bn in 2015 and AED 3.97bn in the first half of 2016 (See Figure 3). On the other hand, GCC developers invest \$15bn annually in real estate overseas, with London being their most favorable city. UK property sales to Emirati investors, for example, accounted for more than 20% of the market in 2015, as reported by Chesterton's, a London-based property specialist. Due to their unstable financial security, UK citizens might reduce their demand for housing in the GCC, but GCC citizens are expected to capitalize on lower prices in the UK to buy real estate in the short run.

Figure 3: Real Estate in Dubai – 2016/H1

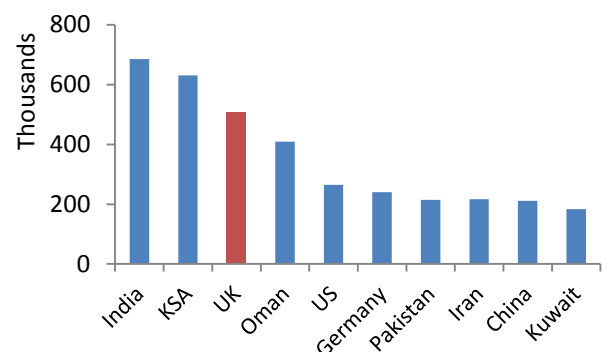


Source: Dubai Land Department

GCC-UK tourism is prosperous, but Brexit could alter its structure. In 2015, the UK was one of the top five

tourist sources in GCC; 1.2 million British tourists travelled to the UAE, forming 8.4% of the guest arrivals and 9% of total tourist expenditure. Out of the 1.2 million, Abu Dhabi and Dubai alone hosted 740,000 British tourists (See Figure 4). In the same year, the International Passenger Survey (IPS) revealed that more than 720,000 tourists from the GCC travelled to the UK and spent \$2.3bn. Holidays in the GCC will become less affordable for the UK citizens as a result of their weakened purchasing power, but GCC citizens are expected to take advantage of the lower GBP-USD exchange rates to spend their vacations in the UK.

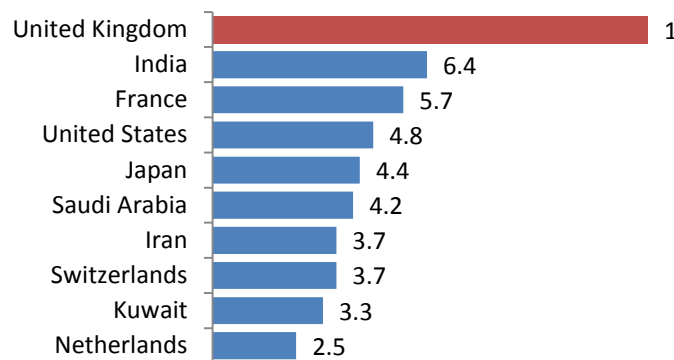
Figure 4: Tourists in Dubai - 2015



Source: Dubai Tourism Authority

Mutual investments are considerable between the GCC and the UK. The UAE Federal Competitiveness and Statistics Authority (FCSA) showed that the UK FDI formed the biggest share in the UAE, reaching 13.3% in 2013 (See Figure 5). Moreover, the UK Office of National Statistics reported that FDI from the Middle East were worth £6.3bn in 2014. The International Sovereign Wealth Funds Institute indicates that the GCC SWFs play a major role in the UK economy. To list some examples, Qatar Investment Authority (QIA) has a minimum of \$7bn worth of equities traded in London Stock Exchange (FTSE100), Kuwait Investment Authority (KIA) has invested \$24bn in the UK and Abu Dhabi Investment Authority (ADIA) has a 15% stake in Gatwick Airport. After Brexit, the volume of UK FDI in the GCC is likely to go down as higher operating costs might discourage British companies from investing overseas. On the other side, the downgrading of the credit rating of the UK indicates that its investment atmosphere will be much riskier and could decrease FDI from the GCC, notwithstanding the depreciation of the pound.

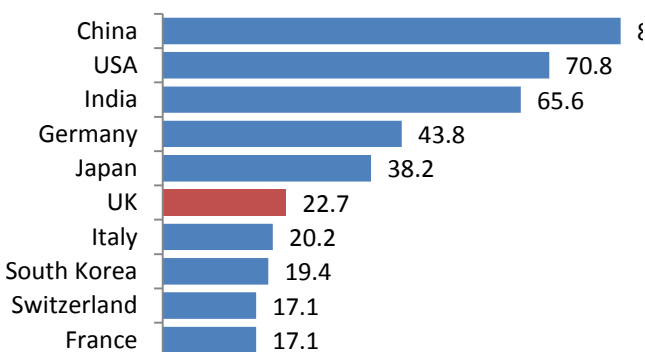
Figure 5: FDI in UAE - 2013 (as % of total FDI)



Source: UAE Federal Competitiveness and Statistics Authority

The UK is a main trade partner with the GCC. In fact, the UK is the 6th biggest import partner of the UAE (see Figure 6), and the UAE is the UK's largest export partner in the GCC. The UK government considers the UAE to be the "entry route" to other GCC markets; over 5000 British companies, 700 commercial agencies and 4700 British brands have invested in the Gulf. The main imported products from the UK are machinery, sound recorders, reproducers and vehicles. In the short run, the GCC could capitalize on the cheaper cost and seek to increase imports from the UK.

Figure 6: UAE Imports - 2015 (In billions of Dirhams)



Source: UAE Federal Competitiveness and Statistics Authority

In 2015, 3.35% of the UK's total imports were from the UAE, which were worth \$10.5bn. Exports to the UK were mainly petroleum and related products, which represented 2.55%. Other non-oil exports like metals, pearls and stones formed 0.8%. However, exports to the UK might go down on account of higher

appreciation of the GCC currencies, relative to the sterling pound.

Finally, a positive impact of Brexit will give the UK more flexibility to negotiate for bilateral trade deals. Uncertainty about accessing the single European market will persuade UK investors to carry out a more assertive trade policy outside of the EU. Hence, their plan to increase UK-GCC bilateral trade to £25bn in 2020 could be more feasible.

2.2 Consumer Price Index and Inflation

The decreasing trend of inflation continued for the third consecutive quarter. The average Consumer Price Index (CPI) increased by 1.7% in the second quarter of 2016 against an increase of 2.1% during the previous quarter (see Table 2.2). Although average prices increased at a slower pace, the end-of-period prices increased by 1.8% (against a 1.4% increase in March), in line with the end-of-period improvement of the domestic demand reflected by the DET as documented in the previous section.

Prices of non-tradables remain the major driver of consumer prices trend. Non-tradable goods constitute 66% of a standard consumption basket in the UAE, where housing and related facilities (water, electricity and Gas) represent 39% of the total basket (see Figure 2.2a). Prices of non-tradables rose by 2% in the second quarter, less than a 2.9% growth in the previous quarter, with a contribution of 1.4% to the total inflation. Housing costs increased by 3.3%, the lowest reading since the fourth quarter of 2014 (4.9%), with a contribution of 1.3% to total inflation (see Figure 2.2.b). Villas and apartments Rents have declined on average by 0.5% in Abu Dhabi during the second quarter as low oil prices and job losses in the oil and gas and construction sectors have impacted demand negatively. On the supply side, in the second quarter, approximately 570 residential units have been completed in investment zones of Abu Dhabi and around 3100 are set to enter the market during the second half of the year. These developments pushed housing prices down and reduced landlords' negotiation power. Similarly, apartments and villas rents in Dubai declined on average by 0.7% and 1% due to a significant increase of supply. Approximately 2,800 residential units have been completed in the second quarter of 2016 and around 34.5k units are scheduled to enter the market in the second half of 2016 (see Box 4).

Transportation costs that account for 10% of the consumption basket continued their decline for the third consecutive quarter. Transport costs dropped further by 2.7% in the second quarter against 6.7% decline in the first quarter. After the energy subsidies' removal, the transportation cost became indexed to international retail prices of Gasoline and Diesel. The fall of oil

prices put a deflationary pressure on transportation costs and consequently, reduced total inflation by 0.27%.

Table 2.2 UAE CPI Inflation (%)

	Weight %	2015				2016	
		Q1	Q2	Q3	Q4	Q1	Q2
Total CPI Inflation	100	3.7	4.3	4.6	3.6	2.1	1.7
Total CPI Inflation (end-of-period)	100	4.3	4.2	4.3	3.6	1.4	1.8
CPI Inflation of Tradable	34	1.1	0.8	1.4	0.6	0.4	0.9
CPI Inflation of Non-tradable	66	5.1	6.2	6.3	5.2	2.9	2.0
Housing CPI inflation	39	7.7	9.6	9.4	8.3	5.1	3.3
Transportation CPI inflation	10	1.5	1.0	5.6	-0.2	-6.7	-2.7

Source: Federal Competitiveness and Statistics Authority (FCSA).

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

Besides housing prices, the price of textiles (including clothing and footwear), that account for 8% of the total basket, increased by 3.6%, against a 1.8% increase in the previous quarter, after declining on average by 1.6% in 2015.

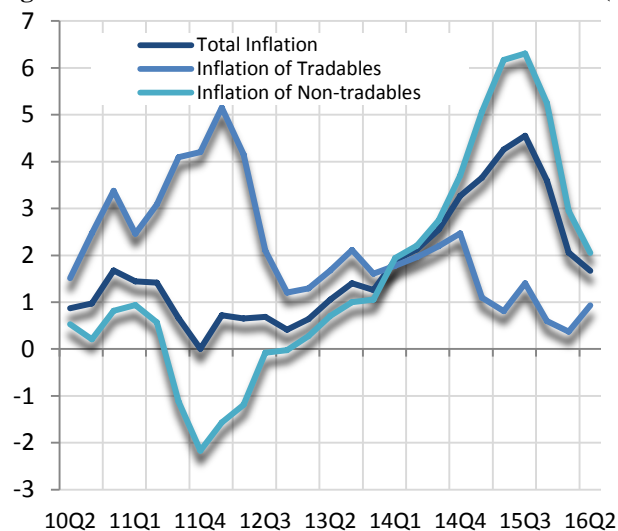
The CPI inflation for education which accounts for 4% of the consumption basket was around 3.8% in the second quarter of 2016, the highest rate since the second quarter of 2015. Average education costs displayed an increase of 3.6% for the first half of the year, on a year-on-year basis. Rising school fees in 2016 is a significant concern for expatriate households, as school vacancies fail to keep pace with population growth. Adding to the school bill, prices of textbooks and extra charges have increased.

Moreover, prices of food and soft drinks, accounting for 14% of the consumer's basket, rose by 1.6% with a contribution to the total inflation by 0.2%. The increase in prices for both consumption groups are driven by an important consumption activity and a jump of demand in June, in accordance with the holy month of Ramadan and spending for the Eid holidays. In fact, textiles and food prices increased in June by 5.1% and 1%, respectively.

Consequently, since the food and soft drinks component constitutes more than 40% of tradables in the consumption basket, the average inflation of tradables increased in the second quarter to reach 0.9%, compared to 0.4% in the previous quarter. The increase of

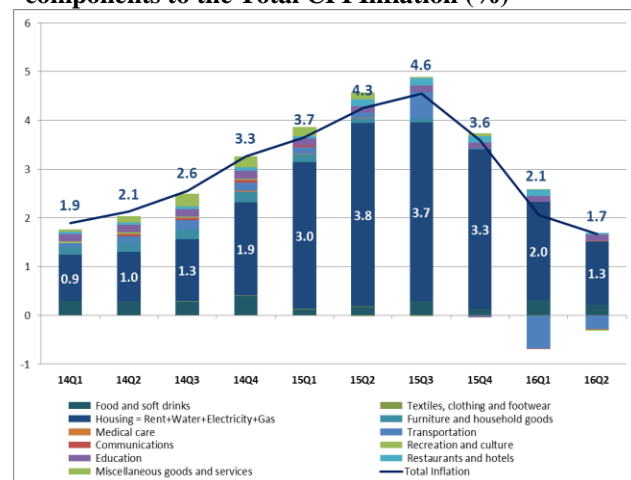
tradables' prices contributed by 0.3% to the total inflation against a contribution of 0.1% in the first quarter of 2016 and a contribution of 0.2% in the fourth quarter of 2015.

Figure 2.2.a. Tradables and Non-Tradables Inflation (%)



Source: Federal Competitiveness and Statistics Authority (FCSA).

Figure 2.2.b Contribution of different sub-components to the Total CPI Inflation (%)

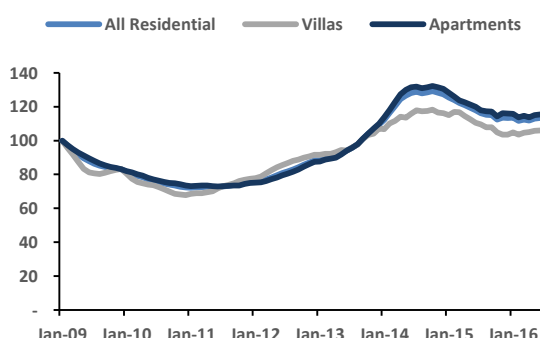


Source: Federal Competitiveness and Statistics Authority (FCSA).

Box 4: Recent Developments in the Real Estate

For the month of June, the property prices as measured by REDDIN Price Index³, for the residential segment in Dubai (comprised of both Apartments and Villas), which measures the average sample price in dirham per square meter, has increased by 0.9 points m-o-m, making it the third consecutive month of positive growth. With the performance in June, the price index exhibits a 3.8% decrease y-o-y over the whole residential segment in Dubai. The villa sector has witnessed a y-o-y drop of 4.2%, while the Apartments segment was slightly more resilient showing a 3.7% decline y-o-y (Figure 1). The trend observed during the second quarter of 2016 in Dubai points towards stabilization with a slight increase of 0.8% over the whole residential market q-o-q.

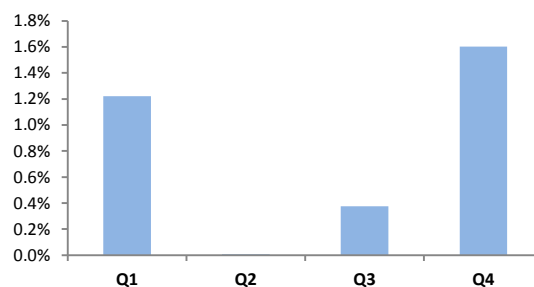
Figure 1: Dubai Residential Prices



Source: REDDIN, Central Bank of the UAE

The data are not seasonally adjusted; therefore it is worth noting the lower real estate activity during the summer season. The next few months -post the summer season, with the expected higher transaction volumes, should give a better indication on how the market progresses with the economic cycle. Over the last 5 years, the residential real estate prices have exhibited, on average, better performance during Q4 and Q1 compared to Q2 and Q3, a clear indication of the seasonality effect (Figure 2).

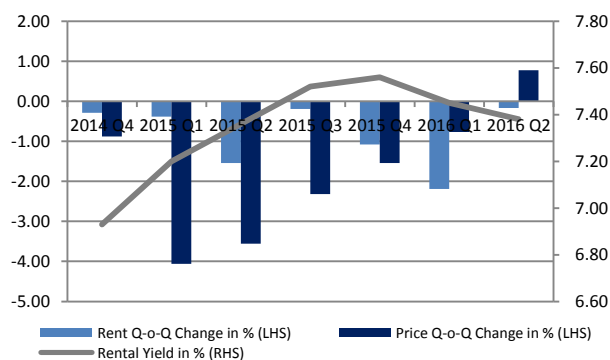
Figure 2: Five-Year Average of Quarterly Price Performance for the Residential Market in Dubai



Source: REDDIN, Central Bank of the UAE

Since the beginning of the downward cycle in mid-2014, the fall in prices has outpaced the fall in rents in Dubai, which led to an increase in rental yield from a low of 6.88% as of October 2014 (the beginning of the correction) to a high of 7.56% as of December 2015. Over the period January to June 2016, relatively stable prices coupled with a falling in rentals have led the rental yield to contract reaching 7.38% as of June 2016 (Figure 3). The pattern observed in rental yield is typical of the real estate market and is due to two main reasons. First, rent adjustments tend to lag price adjustments, leading rental yield to increase at the initial phase of the correction driven by lower prices, and then to decrease when prices start stabilizing. Second, real estate prices tend to be more speculative and sentiment driven. In contrast, rents are more a reflection of the real economy, and particularly the job market and population growth- the end-users.

Figure 3: Dubai Residential Prices



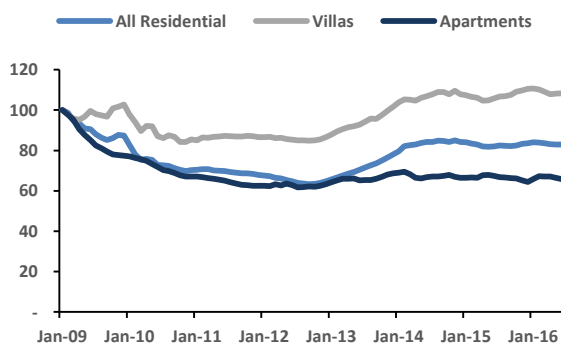
Source: REDDIN, Central Bank of the UAE

For Abu Dhabi, the residential price index has decreased by 0.01% for the month of June, which

³ REDDIN Residential Sales Price Index series are calculated on a monthly basis and cover 21 areas and 6 districts in Dubai, for Abu Dhabi, the indices cover 7 areas and 5 districts.

brings total annual change to a positive 1.1% y-o-y. However, as opposed to Dubai, the Abu Dhabi market has witnessed a decrease in both the Villas and Apartments segments for Q2 2016, recording a 0.7% and 0.9% fall in prices respectively (Figure 4).

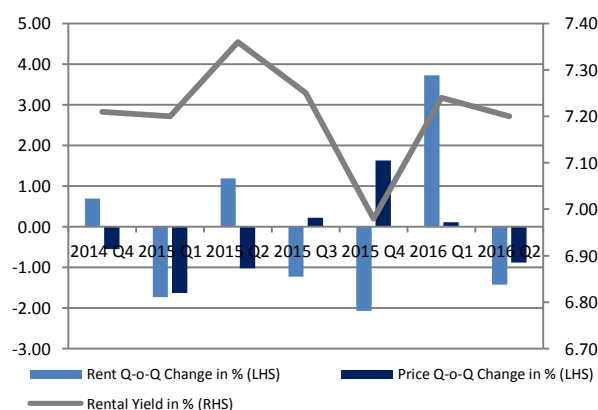
Figure 4: Abu Dhabi Residential Prices



Source: REDDIN, Central Bank of the UAE

With regards to the rental market in Abu Dhabi, the Index showed a decrease of 1.1% y-o-y for the residential segment as a whole. Q-o-q, Villas rentals were down 0.15%, compared to a decline of 1.8% for Apartments over the same period. As for the rental yield, Abu Dhabi registered a yield of 7.2% for June 2016, down from 7.24% in the previous quarter and 7.36% at the end of Q2 2015 (Figure 5), reflecting a faster pace of decline in rent relative to property values.

Figure 5: Abu Dhabi Residential Prices

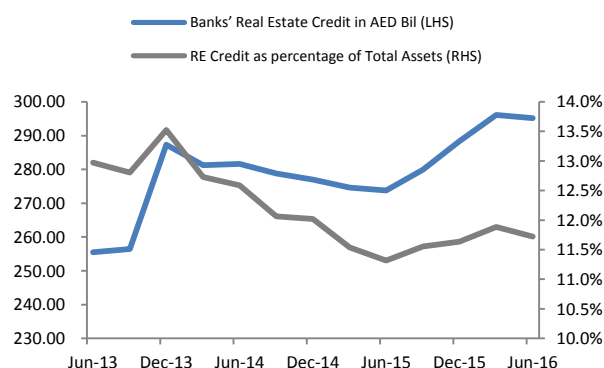


Source: REDDIN, Central Bank of the UAE

Real Estate in Abu Dhabi and Dubai, have witnessed different patterns of change in property prices over the last year. On a y-o-y basis, the change in property prices in Abu Dhabi is still positive as opposed to Dubai (1.1% vs -3.8% respectively). However, over the last quarter, the Dubai market was more resilient (-0.9% in Abu Dhabi vs 0.8% in Dubai). The rental yield in both emirates has contracted over the last few months due to the more pronounced fall in rents, but remains attractive for investors (7.2% for Abu Dhabi vs 7.38% for Dubai).

New regulations in the form of more stringent mortgage guidelines set by the central bank regarding the maximum loan to value, as well as the increase in registration fees (in Dubai), building on lessons from the 2009 crisis, have limited banking exposure to real estate (Figure 6), and by consequence speculative short term trends. The Central Bank of the UAE continues to monitor the development of the real estate market and its impact on the banking sector and the UAE economy as a whole as part of its mandate for financial stability.

Figure 6: Bank's Real Estate Exposure



Source: Central Bank of the UAE

2.3 Exchange Rate and Foreign Trade Balance

The Dirham has depreciated in the second quarter of 2016 against its trading partners. The weighted Dirham's depreciation⁴ against its top 9 non-dollarized import partners, which account altogether for 48.5% of the total imports, was around 0.87% after a continuous period of appreciation starting in the first quarter of 2015 (See Table 2.3.a). These developments are owing to the depreciation of the Dirham against all of the UAE's top 9 non-dollarized import partners. The Dirham lost more than 6% and 3% against the Japanese Yen and the South Korean Won, respectively, where Japan and South Korea account for 8.5% of UAE's total imports. In addition, it depreciated significantly against the Euro by losing 2.3% where imports from Germany, Italy and France amount to 12% of the total imports. Although the Dirham's depreciation against the Chinese Yuan and the Indian Rupee was not significant (only by 0.09% and 0.85%, respectively), the negative impact on Dirham's valuation was significant since imports stemming from the two countries altogether account for more than 22% of total imports. However, the Dirham has slightly appreciated compared to the same period of the previous year. It showed an appreciation of 0.81% against its main import partners on a year-on-year basis.

Table 2.3.a Dirham appreciation against currencies of top non-dollarized import partners

Currency	Share of UAE imports (%) 2015	% Change of Currencies per Dirham (Q4-Q3) 2015	% Change of Currencies per Dirham 2016Q1-2015Q4	% Change of Currencies per Dirham (Q2-Q1) 2016	% Change of Currencies per Dirham 2016Q2-2015Q2
Chinese Yuan	12.40	1.42	2.30	-0.09	5.35
Indian Rupee	9.70	1.42	2.38	-0.85	5.44
Germany (EUR)	6.48	1.61	-0.79	-2.28	-2.01
Japanese Yen	5.65	-0.59	-5.12	-6.29	-11.03
UK Pound	3.35	2.13	5.85	-0.09	6.85
Italy (EUR)	2.99	1.61	-0.79	-2.28	-2.01
South Korean Won	2.87	-1.07	3.65	-3.07	5.95
France (EUR)	2.53	1.61	-0.79	-2.28	-2.01
Swiss Franc	2.53	2.72	0.27	-2.25	3.21
Total	48.50				
Weighted Appreciation		0.58	0.44	-0.87	0.81

Source: Data on Imports shares (weights) are provided by the Federal Competitiveness and Statistics Authority (FCSA) for 2015. Data for the exchange rate are the quarterly average observations, recorded and displayed by Bloomberg.

For the exports side, the Dirham had also depreciated in the second quarter of 2016 against the top-9 non-dollarized non-oil export partners. Non-oil exports towards these countries account for more than 43%. The weighted Dirham's depreciation against the currencies of these trade partners was around 0.48% (See Table 2.3.b). Except for the Iraqi Dinar, the Dirham realized losses against all other non-oil export partners. Particularly, the new trend of dirham's depreciation was driven mainly by Dirham's losses against the Swiss Franc and Singaporean Dollar. Switzerland is the second top non-oil export partner to the UAE with a share of 5.6% of total non-oil exports. The Dirham lost 2.25% against the Swiss Franc in the second quarter of 2016, the first loss since the second quarter of 2015. In a similar pace, the Dirham has depreciated against the Singaporean Dollar by 3.12% and against the Euro by 2.28%. However, on a year-on-year basis, the Dirham appreciated by 1.42%.

The depreciation of the Dirham against its main trade partners in the second quarter of 2016 in nominal terms, forced a depreciation of the Real Effective Exchange Rate (REER) of the Dirham in real terms (See Figure

⁴ The weighted appreciation of the Dirham is computed using the weights of 2015.

2.3.a). The REER depreciated in the second quarter by 2% compared to the first quarter of 2015, in line with the Nominal Effective Exchange Rate's depreciation in the second quarter (-1.8% Q-o-Q) which accounts for a weighted average of bilateral exchange rate movements with respect to all trading partners. Figure 2.3.a shows a perfect co-movement of the REER and the NEER with a correlation rate of 99% from 2014 and 97% from 2011. The depreciation of the REER, while taking into account the inflation rate differential between the UAE and its trade partners, reinforces the nominal effective depreciation of the Dirham.

Notwithstanding recent depreciation, the longer span of Dirham's appreciation in nominal and real effective terms raises questions about its impact on workers' remittances in the UAE, foreign trade and the competitiveness of the non-oil sector in the UAE. The effect of the Dirhams' appreciation on the outflows of workers' remittances is discussed in the analytical box below (see Box 6).

Figure 2.3.b shows the development of weighted nominal imports change (right axis) and the weighted Dirham appreciation over time (left axis). Nominal imports increased by 2.3% in the fourth quarter of 2015 when the Dirham appreciated by 0.58% against top-9 non-dollarized import partners, hinting to cheaper imports and increasing demand. In the first quarter of 2016, nominal imports declined by 0.21%, notwithstanding a slower rate of appreciation (0.44%).

Figure 2.3.c shows the co-movement of weighted nominal non-energy exports change (right axis) and the weighted Dirham appreciation over time⁵ (left axis). The response of nominal non-energy exports to the Dirham's appreciation was not immediate since an appreciation of the Dirham in the last quarter of 2015 by 0.55% induced a decline of exports only by 0.14% while the decline was more pronounced, around 7% in the first quarter of 2016, corresponding to a smaller appreciation of the Dirham by 0.43%.

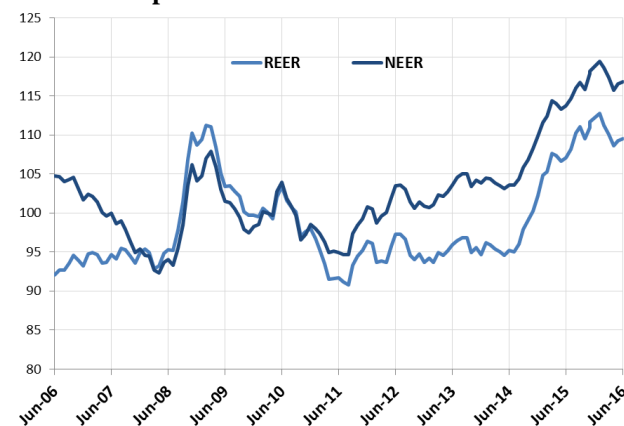
⁵ Only the top-7 non-dollarized export partners are considered because of data availability. Iraq and Kuwait were removed from the sample since nominal exports data are not available for these two countries. Pakistan was substituted by Egypt (the immediate successor to Pakistan in the non-dollarized export partners ranking) because of data unavailability.

Table.2.3.b Dirham appreciation against currencies of top non-dollarized partners for non-oil Exports

Currency	Share of UAE Exports (%) 2015	% Change of Currencies per Dirham (Q4-Q3) 2015	% Change of Currencies per Dirham 2016Q1-2015Q4	% Change of Currencies per Dirham (Q2-Q1) 2016	% Change of Currencies per Dirham 2016Q2-2015Q2
Indian Rupee	12.47	1.42	2.38	-0.85	5.44
Swiss Franc	5.64	2.72	0.27	-2.25	3.21
Iraqi Dinar	5.61	-0.66	-0.49	0.12	-1.29
Turkish Lira	5.16	1.84	1.12	-1.41	8.77
Singapore Dollar	4.26	1.17	-0.40	-3.12	1.13
Kuwaiti Dinar	4.01	0.25	-0.51	-0.04	-0.09
Chinese Yuan	2.34	1.42	2.30	-0.09	5.35
Netherlands (EUR)	1.84	1.61	-0.79	-2.28	-2.01
Pakistan	1.78	2.03	-0.16	-0.12	2.7
Total	43.11				
Weighted Appreciation		0.55	0.34	-0.48	1.42

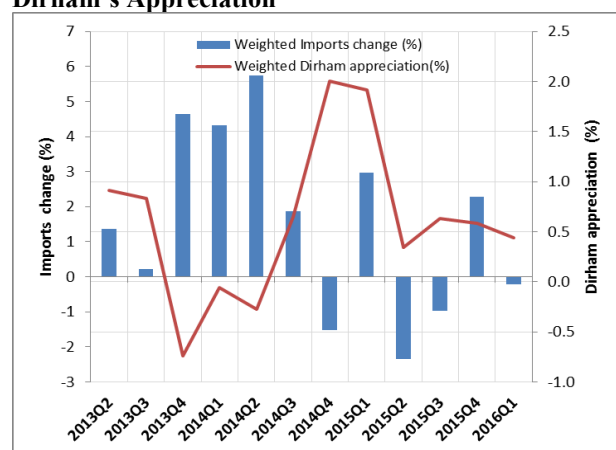
Source: Data on Exports shares (weights) are provided by the Federal Competitiveness and Statistics Authority (FCSA) for 2015. Data for the exchange rate are the quarterly average observations, recorded and displayed by Bloomberg.

Figure 2.3.a Nominal and Real Effective Exchange rates Developments



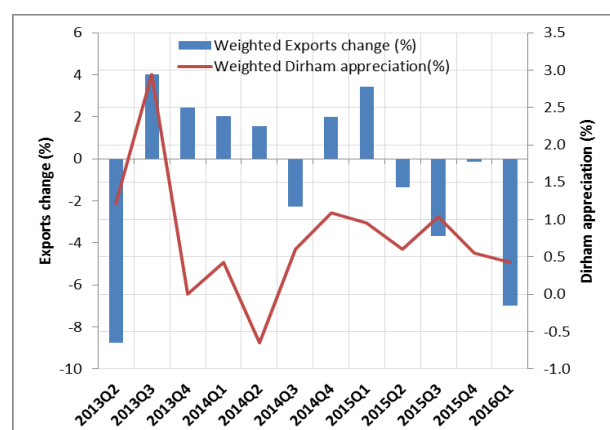
Source: Bank of International Settlement (BIS)

Figure 2.3.b Weighted Nominal Imports change for top-9 non dollarized import partners and Weighted Dirham's Appreciation



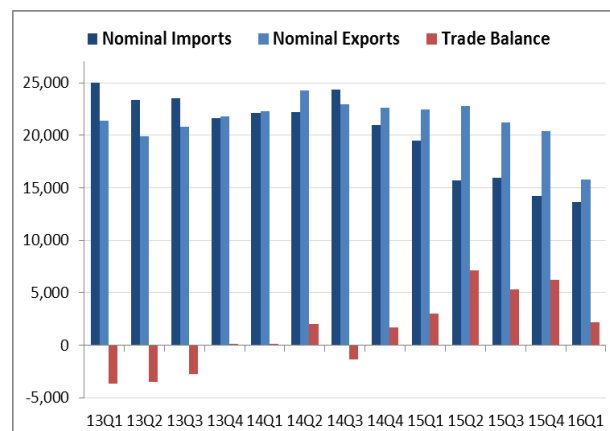
Source: Dubai Chamber and Bloomberg.

Figure 2.3.c Weighted Nominal Non-Energy Exports change for top-7 non dollarized export partners and Weighted Dirham's Appreciation



Source: Dubai Chamber and Bloomberg.

Figure 2.3.d Weighted Nominal Imports, Nominal Non-Energy Exports and Non-Energy Trade Balance



Source: Dubai Chamber

Figure 2.3.d shows the trade balance for the top-7 non-dollarized trade partners in nominal terms. Although these results do not provide a complete picture of the competitiveness in the UAE, one can get some insights regarding the impact of the Dirham appreciation on foreign trade and on the country's competitiveness. The trade balance surplus decreased significantly in the first quarter of 2016 compared to the last quarter of 2015. In fact, it fell by around 64.8%. To substantiate the impact on competitiveness, the analysis in Box 5 zeros in on bilateral exchange rate movements and implications on competitiveness using bilateral trade volumes.

Box 5: Dirham's Appreciation and Competitiveness

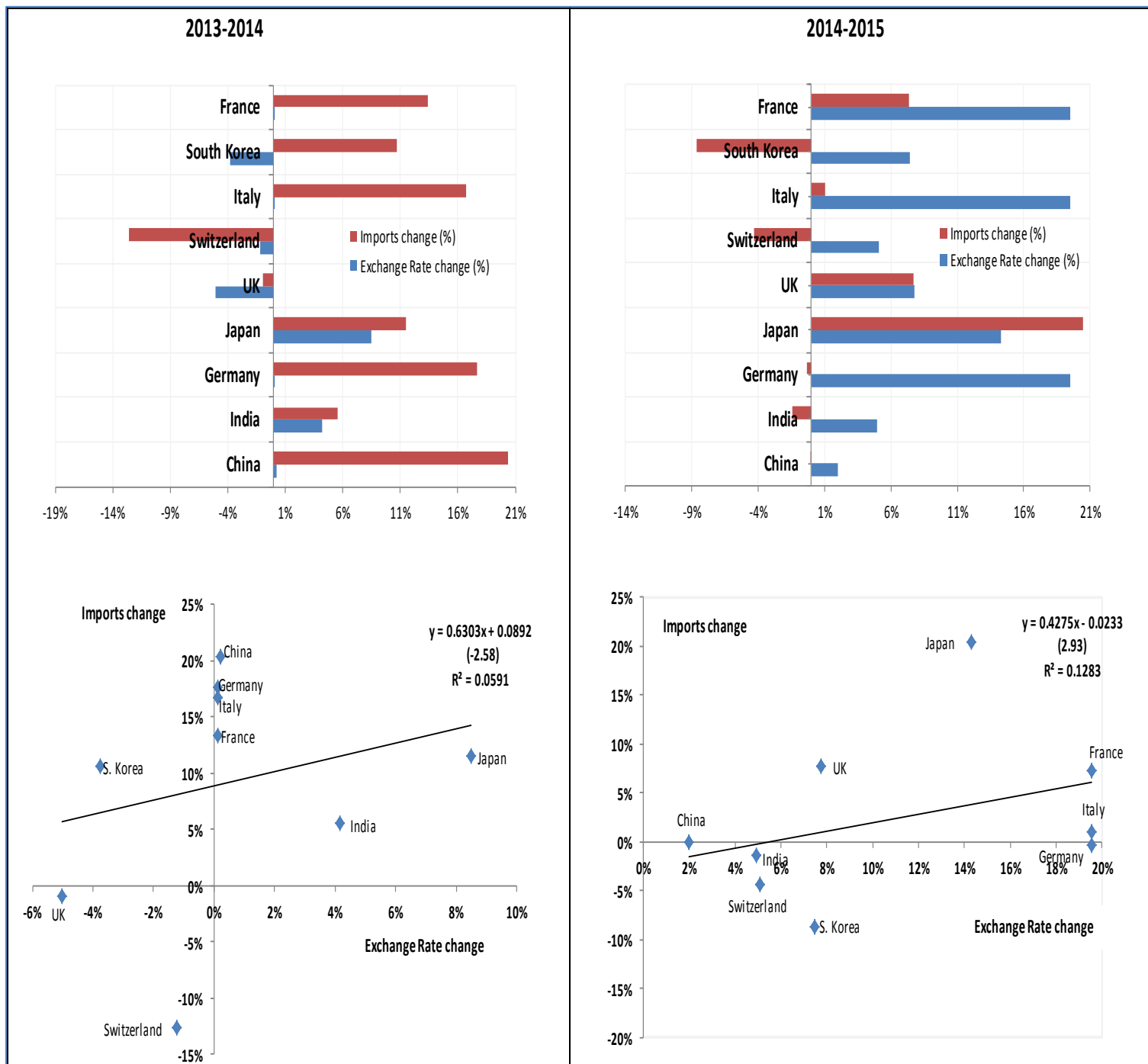
According to the previous findings, the Dirham's appreciation with respect to major currencies of trading partners is likely to render the cost of imports cheaper and decrease competitiveness of non-energy exports. In this box, the analysis focuses on the effects of the Dirham's bilateral appreciation on real imports and real non-energy exports using bilateral trade volumes for major trading partners.

As shown in Figure 1, the appreciation of the Dirham was most pronounced in 2015 as the average appreciation among the top-9 non-dollarized imports partners was around 11%, while the Dirham appreciated in 2014 only by 0.35% on average with respect to the same set of countries. This uptrend of the Dirham during the last two years was followed by an increase of real imports but at different paces; the average increase of real imports across countries in 2014 was 9% while it was around 2.4% in 2015. The slower increase in real imports in 2015 despite the faster pace of Dirham appreciation may have been affected by the slower pace of economic activity.

In 2015, the Dirham strengthened against all import-partners' currencies; the appreciation was driven mainly by a 19.5% gain against the Euro and 14.3% against the Japanese Yen. Consequently, real imports from Italy, France and Japan increased by 1.1%, 7.3% and 20.5%, respectively, while imports from Germany decreased by 0.35%. On the other hand, the Dirham's appreciation for 2014 was steered by an appreciation of 8.5% against the Japanese Yen and 4% against the Indian Rupee, and dampened by a depreciation of 5% against the GB Pound, 3.8% against the South Korean Won and 1.2% against the Swiss Franc. Consequently, the real imports from Japan and India rose by 11.5% and 5.5%, respectively. In addition, the Euro lost only 0.12% against the Dirham in 2014 and the real imports from Germany, Italy and France jumped by 17.3%, 16.7% and 13.4%. Imports from China, with the highest imports' share of 11.7% to the UAE in 2014 and 12.4% in 2015, increased by 20.4% in 2014 when the Dirham appreciated by 0.2% against the Chinese Yuan. In 2015, real imports from China remained constant despite the appreciation of the Dirham by 2% with respect to the Chinese Yuan.

Although the growth of real imports across countries is positive for both years, the correlation between the Dirham's appreciation and the real imports growth is higher in 2014, partly driven by a stronger pace of economic activity. The sensitivity of real imports growth to Dirham's appreciation is documented in figure 1 by a linear regression analysis across the sample of top-non dollarized import partners. The results show that a 1% appreciation of the Dirham in 2014 pushed up the real imports by 0.6%, while a 1% appreciation of the Dirham in 2015 increased real imports by a smaller rate of 0.4%. This difference could be explained by the slowdown in the non-oil economic activity in the UAE in 2015. In fact, the real non-oil GDP grew by 3.2% in 2015 against a growth of 4.1% in 2014. The softening of economic activity pushed the slope of the curve of real imports growth down and reduced the positive elasticity of real imports to the Dirham nominal bilateral exchange rate appreciation.

Figure 1. Real Imports change, Dirhams' Appreciation and Bilateral Competitiveness



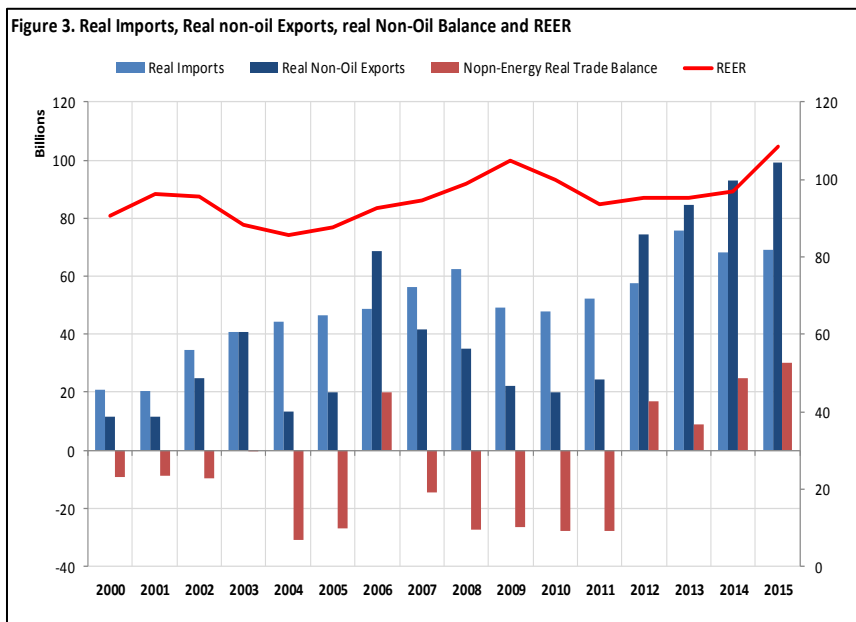
Note: All the bilateral exchange rates are nominal and expressed as **indirect** rates of exchange, i.e., one Dirham is exchanged for a fixed amount X of the foreign currency (FC); 1 AED = X FC, or equivalently, the price of the Dirham in foreign currency such that an increase denotes appreciation.

The impact of the dirham's nominal appreciation on real non-oil exports growth is documented in Figure 2. The average appreciation of the dirham against the top non-dollarized partners for non-oil exports is around 2% in 2014 and 8.4% in 2015. The average growth of real non-oil exports in 2014 was around 70% driven by an important increase of real non-oil exports to Iraq (224.6%), Switzerland (217%) and Egypt (115%) despite the weakening of the Iraqi Dinar and the Egyptian Pound against the Dirham by 0.5% and 3%, while the Dirham depreciated against the Swiss Franc by 1.2% in light of significant appreciation of the Swiss Franc.

The continued dirham appreciation weighed negatively on competitiveness and the growth of non-oil exports. Real non-oil exports declined on average by 1.7% in 2015 as real non-oil exports to Egypt and Iraq dropped by more than 76% and 16%, respectively on account of an appreciation of the Dirham against the Egyptian Pound and the Iraqi Dinar by 8.8% and 2.3%, respectively.

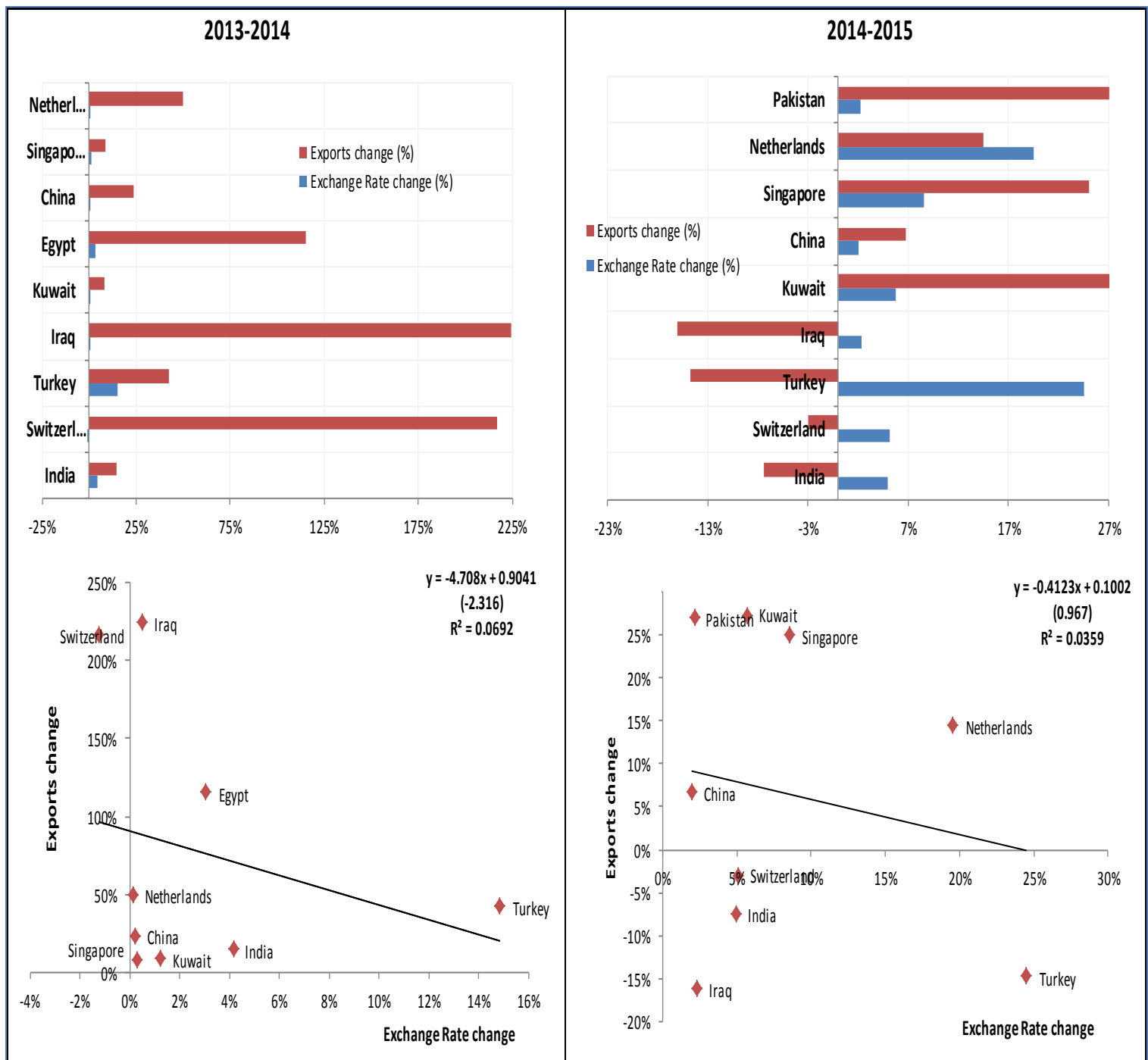
The linear regression analysis across the sample of top-non dollarized export partners sample shows also some disparities in terms of the impact of the Dirham's appreciation on the real exports growth between the two years, 2014 and 2015. Although the statistical relation between the two variables is significant and negative for both years, the impact of the dirham's appreciation on real non-oil exports is higher in 2014. An appreciation of the Dirham by 1% in 2014 induced a decline of the real non-oil exports by 4.7%, while the same level of dirham's appreciation pushed down the real non-oil exports only by 0.4% in 2015.

At the aggregate level, the dirham appreciation seems to have a positive impact on both real imports and real non-oil exports over time (See Figure 3). Consistently with the conjecture, the quantity of imported goods increased in response to a lower price of imports, with a contemporaneous correlation with the REER of 39%. On the other hand, the exported quantity of non-energy goods seemed to be more resilient to higher exports price. The contemporaneous correlation between real non-oil exports and the REER was around 38%. One would argue that real exports benefited from the resilient real economic growth of the UAE and the ability to access new markets. Consequently, the non-energy trade balance was not adversely impacted by the Dirham's appreciation.



Nonetheless, referring to the results above, the loss in terms of bilateral competitiveness is higher vis-à-vis the countries where the Dirham appreciated more. The higher is the bilateral appreciation of the Dirham relative to the currency of an export partner, the lesser is the exported quantity of non-oil goods to this country.

Figure 2. Real Non-Energy Exports change, Dirhams' Appreciation and Bilateral Competitiveness

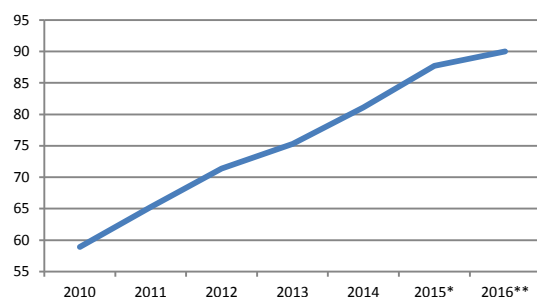


Note: All the bilateral exchange rates are nominal and expressed as **indirect** rates of exchange, i.e., one Dirham is exchanged for a fixed amount X of the foreign currency (FC); 1 AED = X FC or equivalently, the price of the Dirham in foreign currency such that an increase indicates appreciation.

Box 6: Workers' Remittances

The private transfers in the balance of payments include personal transfers (workers' remittances) and other current transfers⁶. The net payments (outflows) of workers' remittances show an increasing trend for the period 2010-2016 as depicted in the Figure 1.

Figure 1. Evolution of Net Private Transfers (in billions of Dirhams)

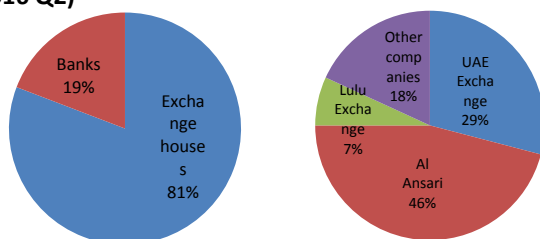


* Provisional data, ** Estimation

Source: CBUAE

For the estimation of workers' remittances in the balance of payments, information is available from the Banking Supervision Department of the central bank and included information from both the exchange houses and the banks. Major companies in the field of exchange houses that possess the largest share of transactions are Al Ansari Exchange, UAE Exchange and Lulu Exchange.

Figure 2. Share of settlement of total workers' remittances and shares of major exchange companies (2016 Q2)



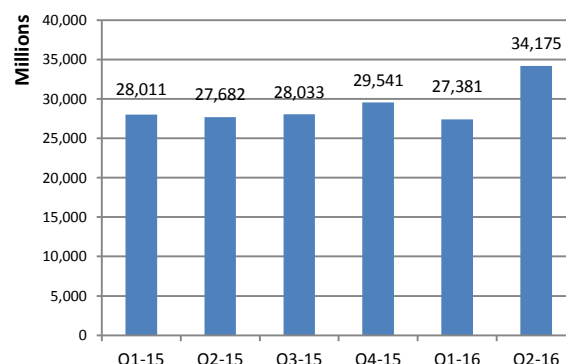
Source: CBUAE, Al Ansari Exchange, UAE Exchange, Lulu Exchange

According to the market participants' estimates, the three companies account for around 82% of the market for workers' remittances outflow from the UAE. Based on data available for the second quarter of 2016 from the Banking Supervision Department 81% of the transactions

are conducted through the exchange houses and 19% through the banks.

The Figure 3 shows the evolution of workers' remittances in the UAE from 2015 Q4 to 2016 Q2 for the sum of data reported from the exchange houses and the banks to the Banking Supervision Department. These combined recorded AED 34.2 billion net outflows in the second quarter of 2016 and 24.8% or AED 6.8 million increase compared to the first quarter of 2016 (AED 27.4 billion). The net outflows of the workers' remittances that were settled through the exchange houses only recorded AED 27.6 billion the second quarter of 2016 (19.5% or AED 4.5 billion increase compared to 2016 Q1).

Figure 3. Workers' remittances in the UAE 2015 Q4-2016 Q2

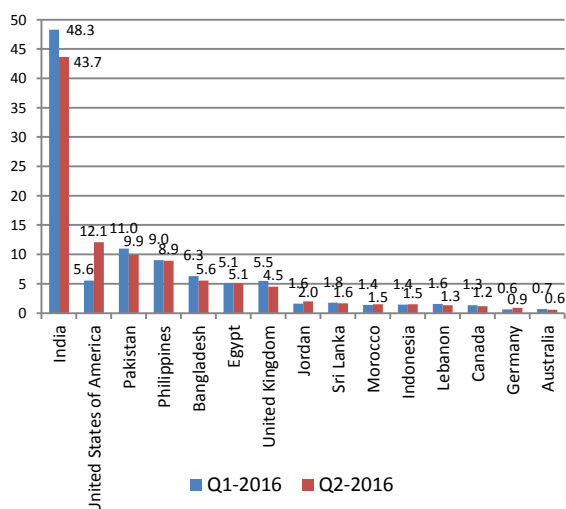


Source: CBUAE, Banking Supervision Department

The most important country of destination for workers' remittances during the second quarter of 2016 was India that accounted for almost half of the workers' remittances in accordance with the significant share of expats from India in the UAE. According to available population statistics, dated October 2008 from the Federal Competitiveness and Statistics Authority, 82.7% of the employees in the UAE belong to Asian Non-Arab Countries which include India. The next five most important countries in the share of expat workers were United States of America (12.1%), Pakistan (9.9%), Philippines (8.9%), Bangladesh (5.6%) and Egypt (5.1%).

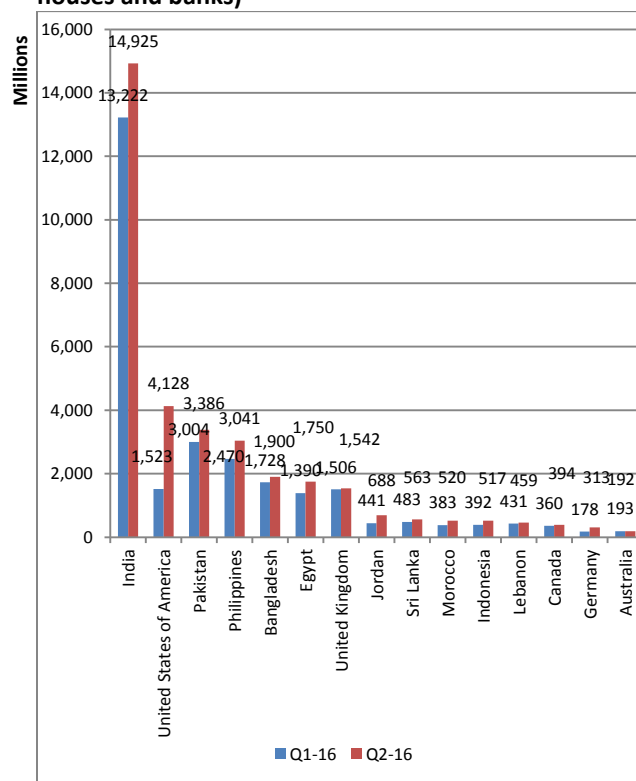
⁶ Other current transfers include, for example, current taxes on income, wealth etc., social contributions, benefits and current international cooperation. Information on other transfers is not currently available.

Figure 4. Share of the major countries for workers' remittances in 2016 Q1 and 2016 Q2 (percentage of total, exchange houses and banks)



Source: CBUAE

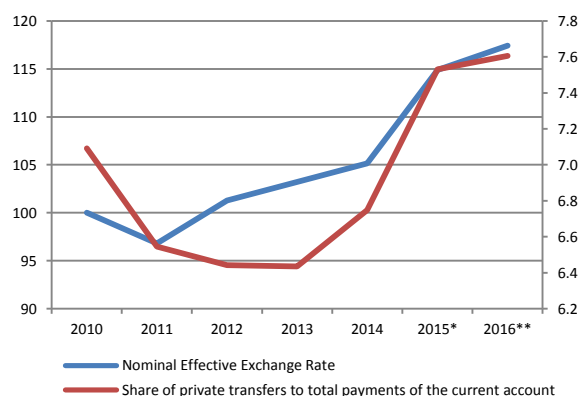
Figure 5. Countries with the highest net outflows of workers' remittances in 2016 Q1 - 2016 Q2 (exchange houses and banks)



Source: CBUAE

The total recorded workers' remittances for the first half of 2016 represents 70.2% of the total for 2015 (at AED 87.7 billion) and 68.4% for the initial projection for 2016 (estimated at AED 90 billion). Based on the net outflows recorded over the first half of the year, the projection for 2016 is likely to be revised upward. The increasing trend in the second quarter of 2016 to the total net outflows of private transfers could be attributed to the appreciation of the dirham by 12.5% on average in the nominal effective exchange rate (average of second quarter of 2016 116.4) over the second quarter of 2015 encouraging expats to transfer more savings abroad. The share of private transfers to the total payments of all components of the current account shows an increasing trend over time. The Figure 6 depicts this pattern since 2010 along with movement in the nominal effective exchange rate. Higher outflows, coupled with less oil receipts reduced the surplus of the current account balance.

Figure 6. Share of Private Transfers to the total payments of the Current Account (%) and the NEER (2010-2016)



* Provisional data, ** Estimation

Note: Annual average of NEER and average of first six months for 2016

Source: CBUAE, Bank of International Settlements

2.4 Fiscal Stance

The fiscal consolidation initiated by the government in 2015, after an important plunge of oil prices since mid-2014, was reflected by a 41% cut of expenditures in the first quarter of 2016 on a year-on-year basis (see Table 2.4).

The expenditures' decline is due to an important reduction of four main spending items during the first quarter of 2016. Interests costs and offered grants declined by 49% and 85%, respectively. In addition, social benefits were cut by more than 51%. Other expenses which cover all Abu Dhabi's transfers made on behalf of the Federal Government and accounts mainly for military expenditures, have tumbled by around 89%.

Subsidies and transfers to GREs jumped significantly during the first quarter of 2016. Given the ongoing energy-subsidy cut, this development may be due to an increase of transfers to GREs.

On the Other hand, total revenues increased by 14% during the first quarter of 2016, on a year-on-year basis. This improvement of revenues was triggered by a 37.5% increase of social contributions and an increase of others revenues. These revenues include principally the property income, sales of goods and services and fines and penalties. It is noteworthy that these revenues do not include profit transfers from the national oil company to the sovereign wealth funds, neither the government investment income.

Nonetheless, tax revenues have declined during the first quarter of 2016 by 61.5% on account of a reduction of taxes on oil companies in line with the decline in oil revenues.

Table.2.4 Consolidated Government Finances

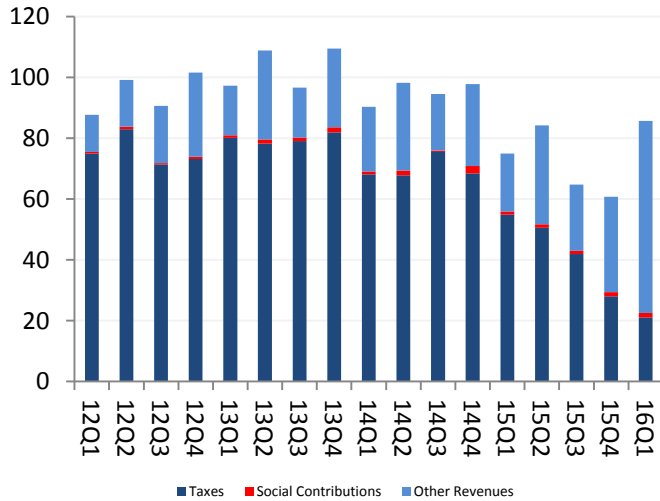
	2014					2015					2016	Change (%, Y-o-Y) 2015					Change (%, Y-o-Y) 2016
	Q1	Q2	Q3	Q4	2014	Q1	Q2	Q3	Q4	2015	Q1	Q1	Q2	Q3	Q4	Q1	
Revenues (a)	90.2	98.1	94.5	97.8	380.7	74.9	84.2	64.8	60.7	284.7	85.7	-17.0	-14.2	-31.5	-37.9	14.3	
Taxes	68.1	67.8	75.5	68.4	279.9	54.9	50.6	41.9	28.1	175.4	21.1	-19.4	-25.4	-44.5	-59.0	-61.5	
Social contributions	0.9	1.6	0.4	2.4	5.3	1.1	1.1	1.0	1.3	4.5	1.5	14.0	-27.8	172.1	-46.5	37.5	
Other revenues	21.2	28.7	18.6	26.9	95.5	19.0	32.5	21.8	31.4	104.7	63.1	-10.4	13.2	17.1	16.6	232.2	
Expenditure (b)	104.0	103.7	98.9	107.9	414.6	87.0	93.1	83.9	90.3	354.4	51.0	-16.4	-10.2	-15.2	-16.3	-41.4	
Compensation of employees	10.6	11.4	11.4	14.1	47.5	14.4	15.8	14.5	14.4	59.1	15.5	36.4	38.0	27.3	2.1	7.6	
Use of goods and services	8.9	12.1	13.8	14.7	49.5	10.5	13.5	10.8	16.3	51.0	10.4	18.3	11.5	-22.0	10.4	-0.6	
Consumption of fixed capital	0.9	0.7	1.0	1.1	3.8	0.9	1.1	0.9	1.5	4.4	1.1	0.3	48.1	-14.8	37.7	32.1	
Interest	1.0	1.0	0.9	1.2	4.1	0.5	0.5	0.6	1.3	2.9	0.2	-52.4	-49.1	-38.3	13.8	-49.0	
Subsidies	2.5	3.6	3.4	2.6	12.1	0.2	0.2	1.4	0.1	1.9	4.3	-93.1	-95.6	-58.1	-95.5	2414.7	
Grants	9.8	6.2	5.5	0.4	21.9	3.1	2.8	2.5	2.1	10.6	0.5	-67.9	-54.9	-55.1	507.3	-85.4	
Social benefits	12.6	13.8	16.1	18.8	61.4	12.9	15.2	13.5	11.6	53.2	6.3	2.2	9.5	-16.1	-38.4	-51.6	
Other expenses	52.3	41.0	37.2	43.9	174.4	39.9	35.4	33.4	37.0	145.7	4.5	-23.8	-13.6	-10.2	-15.7	-88.7	
Net acquisition of non-financial assets	5.5	13.7	9.5	11.2	39.9	4.7	8.7	6.4	5.9	25.6	8.1	-15	-36.7	-33.3	-47.2	73.8	

Source: UAE Ministry of Finance, revenues do not include ADNOC transfers and government investment income.

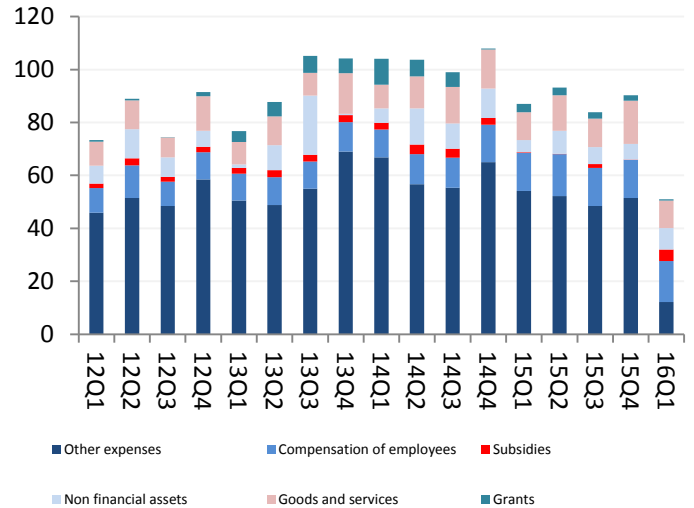
Note: All values are expressed in Billions of Dirhams.

Government Finance

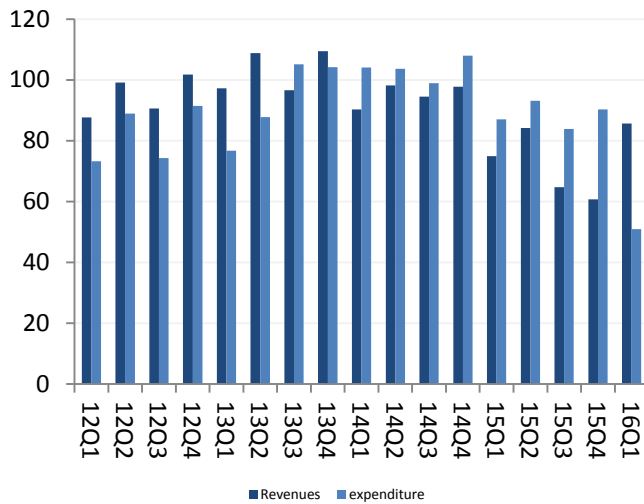
2.4. a General Government Revenues
(Billions of Dirhams)



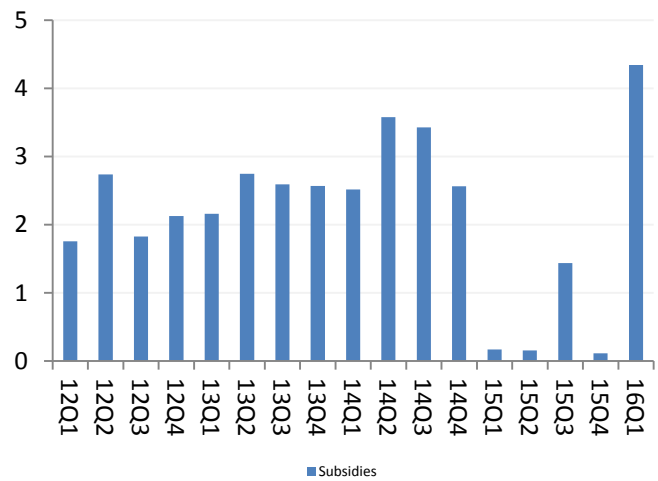
2.4.b General Government Expenditures
(Billions of Dirhams)



2.4.c Fiscal Stance
(Billions of Dirhams)



2.4.d Development in Subsidies and transfers to GREs
(Billions of Dirhams)



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

Despite the Brexit referendum results in June and the fears of potential negative spillovers on the UAE economy, the securities market recovered in the second quarter of 2016. The increase of oil prices in the second quarter (33.7% Q-o-Q) had a dominant positive impact on markets. Abu Dhabi's financial market saw its capitalization increasing by 3.6% in the second quarter of 2016 against an increase of 0.6% in the previous quarter (See Table 2.5.1). The share price index improved by 3.9% after a drop of 0.5% in the previous quarter. The recovery of Dubai's financial market is more significant where market capitalization jumped by 6.4% in the second quarter against a decline of 2.7% previously. Moreover, the share price index rose by 5.5% after a drop by 2.7% in the first quarter of 2016.

Adding to the improvement of the performance of both financial markets, the volatility⁷ of the share price indices has decreased in the second quarter. In Dubai financial market, the volatility of the share price index dropped by 43% while it fell by 14% in Abu Dhabi's securities market.

The recovery of oil prices in the second quarter of 2016 and the subsequent positive sentiment regarding the resiliency of the non-oil sector restored investors' confidence in the UAE's economic outlook and markets' potential.

Table 2.5.1 UAE – Securities Markets

		2015			2016	
		Q2	Q3	Q4	Q1	Q2
Abu Dhabi	Change of Share Price Index (%)	2.1	-0.5	-7.0	-0.5	3.9
	Change of Market Capitalization (%)	2.3	0.3	-4.9	0.6	3.6
Dubai	Change of Share Price Index (%)	10.7	-6.9	-13.5	-2.7	5.5
	Change of Market Capitalization (%)	10.4	-1.6	-10.3	-3.4	6.4

Source: UAE Securities and Commodity Authority

Note: Changes computation (Q-o-Q) is based on quarterly average of end-of-month values for the share price index and market capitalization.

2.5.2 Credit Default Swaps Premiums

The recovery of oil prices in the second quarter helped tightening in the spreads of Credit Default Swaps (CDS).

Except for DP World, the CDS spreads dropped for Sovereigns and GREs in both Abu Dhabi and Dubai. The CDS of Sovereigns fell by 6.5% and by 15% in Abu Dhabi and Dubai, respectively, in the second quarter of 2016 compared to the previous one.

The CDS of Dubai Holding decreased by 4.5%, displaying the lowest spread since the last quarter of 2015. The expectation of oil price improvements helped further tightening of CDS.

Table 2.5.2. UAE - Credit Default Swaps (CDS)

	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
Sovereigns						
Abu Dhabi	72.0	52.0	77.4	92.6	93.6	87.5
Dubai	197.4	191.4	196.9	233.7	215.0	182.5
GREs						
DP World	194.1	188.5	190.0	183.9	196.9	202.3
Dubai Holding	321.3	340.8	322.5	421.0	352.0	336.3

Source: Bloomberg.

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

⁷ The volatility is measured by the standard deviation.

Chapter3. Monetary & Banking Developments

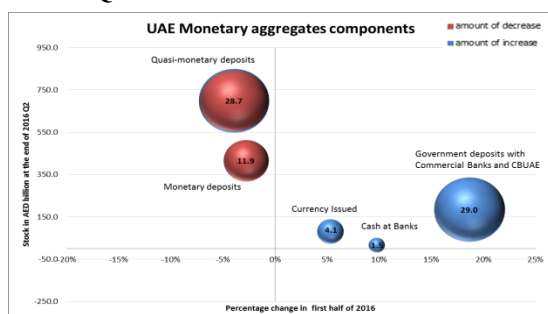
Government deposits increased in the 2nd quarter of 2016, on the heels of a decline in the previous year. However, monetary aggregates declined mainly due to the decline in private sector deposits. Banks continued to increase credit at a rate that supports growth in the non-oil activities, thereby providing the needed financing against the backdrop of deleveraging by the Government and Non-Banking Financial Institutions.

3.1 Monetary Aggregates

During 2016 Q2, Money Supply Aggregates declined by 1.9% for M1, 3.1% for M2 and by 0.7% for M3 Q-o-Q.

The main reason for the decrease in M1 in 2016 Q2 is the decline in monetary deposits by AED 9.3 billion (-2.8%) compared to the end of March 2016. The reduction in M2 is due to the decrease in Quasi-monetary deposits by AED 28.7 billion (-3.9%). Meanwhile, M3 declined to a lesser extent due to the growth in government deposits by AED 29 billion (18.7%), during this period.

Figure 3.1. UAE Monetary aggregates – year to 2016 Q2



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

3.2 Banking Activity

The 23 locally-incorporated banks have reduced the number of branches from 874 at the end of 2016 Q1 to 862 at the end of June 2016, mainly due to cost efficiency, while for the 26 foreign banks, the number of branches increased from 85 at the end of 2016 Q1 to 86 at the end of 2016 Q2.

3.2.1 Banks' Deposits

Total Customer Deposits at banks decreased in 2016 Q2 by AED 9.6 billion mainly due to the decline in Resident Deposits by AED 9.2 billion. The chute in Resident Deposits is essentially due to the decrease in GREs deposits by AED 31.8 billion

or 16.5%. However GREs deposits withdrawal was partially compensated for by the increase of Government deposits during the second quarter by AED 30.4 billion or 19.5%. In parallel, the drop in Private sector deposits and Non-Banking Financial Institutions (NBFIs) deposits by AED 2.8 billion and AED 5 billion respectively reinforced the decline in Resident Deposits by AED 9.2 billion. The falling trend was observed also in the Non-Resident Deposits, where the drop was marginal of AED 400 million.

Table 3.2.a. Deposits at UAE Banks

	2015			2016	
	Jun	Sep	Dec	March	June
Bank Deposits	1,444.3	1,436.8	1,471.6	1,502.6	1,493.0
(Q-o-Q change %)	-0.3	-0.5	2.4	2.1	-0.6
(Y-o-Y change %)	3.1	1.6	3.5	3.7	3.4
Resident Deposits	1,288.6	1,278.3	1,300.2	1,325.1	1,315.9
(Q-o-Q change %)	-1.0	-0.8	1.7	1.9	-0.7
(Y-o-Y change %)	1.7	-0.3	2.6	1.8	2.1
Government Sector	162.9	164.3	157.4	155.5	185.9
(Q-o-Q change %)	-11.4	0.9	-4.2	-1.2	19.5
(Y-o-Y change %)	-11.8	-20.8	-16.6	-15.4	14.1
GREs	184.2	173.3	190.8	193.3	161.5
(Q-o-Q change %)	-4.0	-5.9	10.1	1.3	-16.5
(Y-o-Y change %)	-3.3	-11.5	10.1	0.7	-12.3
Private Sector	907.2	911.2	923.8	948.1	945.3
(Q-o-Q change %)	2.1	0.4	1.4	2.6	-0.3
(Y-o-Y change %)	6.0	8.1	6.3	6.7	4.2
NBFI	34.3	29.5	28.1	28.2	23.2
(Q-o-Q change %)	-7.8	-14.0	-4.7	0.4	-17.7
(Y-o-Y change %)	-5.5	-17.1	-22.8	-24.2	-32.4
Non-Resident Deposits	155.7	158.5	171.5	177.5	177.1
(Q-o-Q change %)	5.2	1.8	8.2	3.5	-0.2
(Y-o-Y change %)	17.2	19.6	11.4	19.9	13.7

Source: Central Bank of the UAE

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

In the banking system, deposits by the type of banks, i.e. Conventional or Islamic, represent respectively 76.9% and 23.1% of the total deposits. It is clear from Figure 3.3, that Islamic banks' deposits are growing much faster than the conventional ones in the last quarter and on Y-o-Y basis. Total deposits grew by 1.7% and 9.4% Y-o-Y for Conventional and Islamic banks respectively. However, in the last quarter only there was a decline of 0.9% for the Conventional banks and marginal increase of 0.3% for deposits of Islamic banks.

**Table 3.2.b. Deposits at UAE
Conventional/Islamic Banks**

	Conventional		Islamic	
	2016		2016	
	March	June	March	June
Bank Deposits	1,159	1,148	344	345
(Q-o-Q change %)	1.7	-0.9	3.5	0.3
(Y-o-Y change %)	1.5	1.7	11.9	9.4
Share of Total, %	77.1	76.9	22.9	23.1
Resident Deposits	989	337	979	337
(Q-o-Q change %)	1.4	-1.0	3.4	0.1
(Y-o-Y change %)	-1.2	-0.1	11.8	9.0
Share of Total, %	74.6	74.4	25.4	25.6
Government Sector	109	137	46	49
(Q-o-Q change %)	2.2	25.2	-8.5	6.3
(Y-o-Y change %)	-22.5	19.2	7.9	2.1
Share of Total, %	70.3	73.6	29.7	26.4
GREs	135	59	112	50
(Q-o-Q change %)	-0.9	-16.7	6.7	-15.8
(Y-o-Y change %)	-5.7	-17.5	19.5	-10.2
Share of Total, %	69.6	69.3	30.4	30.7
Private Sector	720	228	710	235
(Q-o-Q change %)	1.5	-1.3	6.4	3.0
(Y-o-Y change %)	4.9	1.8	12.9	12.1
Share of Total, %	75.9	75.1	24.1	24.9
NBFI	25	20	3	3
(Q-o-Q change %)	9.7	-19.3	-38.9	-6.1
(Y-o-Y change %)	-17.5	-28.7	-52.9	-49.2
Share of Total, %	88.3	86.6	11.7	13.4
Non-Resident Deposits	170	169	7	8
(Q-o-Q change %)	3.3	-0.6	9.0	9.6
(Y-o-Y change %)	19.9	13.2	21.7	27.0
Share of Total, %	95.9	95.5	4.1	4.5

Source: Central Bank of the UAE

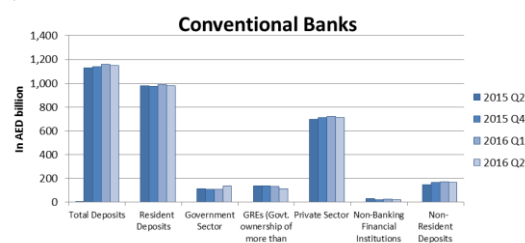
Note: All data indicate the end-of-quarter values. Values are expressed in billions of Dirhams.

While the growth in Government deposits is mainly concentrated in Conventional banks, the drop in the GREs' deposits is equally distributed between the two types of banks.

The accelerated growth of the Islamic banks' deposits is in line with the UAE's vision to become a world center for the Islamic finance.

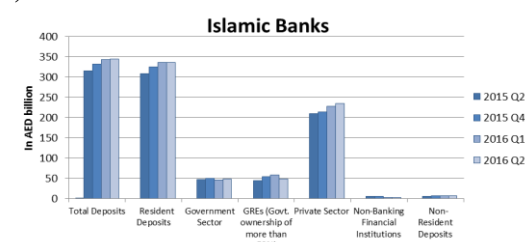
Figure 3.3. Banking System Deposits by Conventional/Islamic Banks split

a)



Source: Central Bank of the UAE

b)



Source: Central Bank of the UAE

The breakdown of Local and Foreign banks in Figure 3.4 provides a clear trend that deposits in Local banks are growing in contrast to a decline in foreign banks. At the end of 2016 Q2, 85.5% of the total deposits are in Local banks and 14.5% are in foreign banks.

For the second quarter, deposits in the Local banks grew by 0.3% with the sector growing the most being the Government (20.0%). For the Foreign banks in 2016 Q2, total deposits declined by 5.7% Q-o-Q. The breakdown shows that there was a decline in all subsectors.

Table 3.2.c. Deposits at UAE Local/Foreign Banks

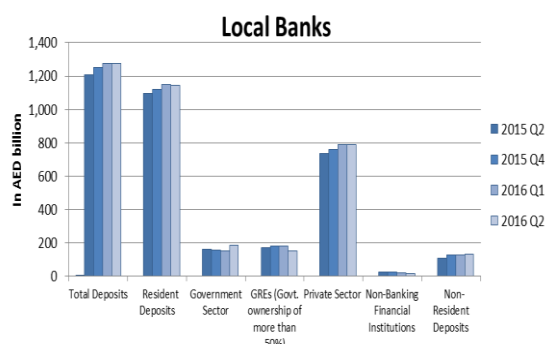
	Local		Foreign	
	2016		2016	
	March	June	March	June
Bank Deposits	1,273	1,276	230	217
(Q-o-Q change %)	1.8	0.3	3.8	-5.7
(Y-o-Y change %)	4.8	5.8	-2.3	-9.1
Share of Total, %	84.7	85.5	15.3	14.5
Resident Deposits	1,147	1,145	178	171
(Q-o-Q change %)	2.3	-0.2	-0.4	-3.7
(Y-o-Y change %)	3.5	4.4	-7.7	-11.0
Share of Total, %	86.6	87.0	13.4	13.0
Government Sector	154	185	2	1
(Q-o-Q change %)	-1.1	20.0	-11.1	-25.0
(Y-o-Y change %)	-15.4	14.2	-11.1	9.1
Share of Total, %	99.0	99.4	1.0	0.6
GREs	184	155	10	7
(Q-o-Q change %)	1.2	-15.8	4.3	-27.8
(Y-o-Y change %)	3.6	-9.9	-33.6	-44.9
Share of Total, %	95.0	95.7	5.0	4.3
Private Sector	788	788	160	158
(Q-o-Q change %)	3.5	0.0	-1.5	-1.7
(Y-o-Y change %)	9.8	7.0	-6.1	-7.8
Share of Total, %	83.1	83.3	6.9	6.7
NBFI	22	18	6	5
(Q-o-Q change %)	-6.3	-18.9	36.4	-13.3
(Y-o-Y change %)	-30.4	-33.3	13.2	-28.8
Share of Total, %	78.7	77.6	11.3	12.4
Non-Resident Deposits	126	132	52	46
(Q-o-Q change %)	-2.4	4.8	21.3	-12.3
(Y-o-Y change %)	18.9	20.2	22.4	-1.5
Share of Total, %	70.8	74.3	29.2	25.7

Source: Central Bank of the UAE

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

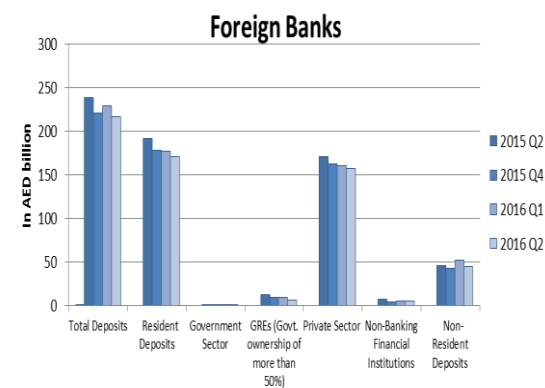
Figure 3.4. Banking System Deposits by Local/Foreign Banks split

a)



Source: Central Bank of the UAE

b)



Source: Central Bank of the UAE

3.2.2 Banks' Credit

Domestic Credit increased in 2016 Q2 by AED 21.9 billion, benefiting mainly the increase in credit to the private sector (AED 22 billion) and the government-related entities (GREs) by AED 6.9 billion. Meanwhile the Government and NBFIs were deleveraging.

Table 3.3.a.Assets and Credit at UAE Banks

	2015			2016	
	Jun	Sep	Dec	Mar	Jun
Total Assets	2,420	2,422	2,478	2,491	2,519
(Q-o-Q change %)	1.7	0.1	2.3	0.5	1.1
(Y-o-Y change %)	8.2	4.8	7.5	4.7	4.1
Gross Credit	1,447	1,479	1,485	1,518	1,543
(Q-o-Q change %)	2.6	2.2	0.4	2.2	1.7
(Y-o-Y change %)	8.8	7.0	7.8	7.6	6.7
Domestic Credit	1,336	1,366	1,381	1,404	1,426
(Q-o-Q change %)	2.5	2.3	1.1	1.7	1.6
(Y-o-Y change %)	6.5	5.9	8.1	7.7	6.8
Government	168.5	166.4	166.6	168.7	168.6
(Q-o-Q change %)	4.7	-1.3	0.1	1.3	-0.1
(Y-o-Y change %)	13.6	13.2	8.8	4.8	0.1
Public Sector (GREs)	164.6	174.0	169.8	180.8	187.7
(Q-o-Q change %)	-0.4	5.7	-2.4	5.4	3.8
(Y-o-Y change %)	1.7	7.2	2.8	8.3	12.1
Private Sector	985	1,006	1,020	1,030	1,052
(Q-o-Q change %)	2.8	2.2	1.4	1.1	2.1
(Y-o-Y change %)	7.8	4.6	8.5	7.7	7.1
Business & Industrial Sector Credit	665.2	676.3	689.3	693.5	709.7
(Q-o-Q change %)	2.6	1.7	1.9	0.9	2.3
(Y-o-Y change %)	7.7	3.3	7.7	7.3	7.1
Individual	319.3	329.7	330.7	336.1	341.9
(Q-o-Q change %)	3.1	3.3	0.3	1.6	1.7
(Y-o-Y change %)	8.1	7.5	10.3	8.5	7.1
Non-Banking Financial Institutions	18.2	19.9	24.7	25.3	18.4
(Q-o-Q change %)	-6.2	9.2	24.2	2.4	-27.3
(Y-o-Y change %)	-40.7	-0.4	27.4	30.4	1.1
Foreign Credit	110.9	112.2	103.9	113.1	117.1
(Q-o-Q change %)	4.0	1.1	-7.4	8.9	3.5
(Y-o-Y change %)	46.9	22.8	3.5	6.1	5.6
of which: Loans & Advances to Non-Residents in AED	9.9	9.6	9.2	11.2	12.8
(Q-o-Q change %)	-2.5	-2.6	-4.6	21.7	14.3
(Y-o-Y change %)	-10.8	-12.2	-9.8	10.3	29.3

Source: Central Bank of the UAE

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

Table 3.3.b.Assets and Credit at UAE Conventional/Islamic Banks

	Conventional		Islamic	
	2016		2016	
	Mar	Jun	Mar	Jun
Total Assets	2,008	2,025	483	493
(Q-o-Q change %)	-0.3	0.9	4.0	2.1
(Y-o-Y change %)	3.1	2.6	11.9	10.8
Gross Credit	1,201	1,217	316	326
(Q-o-Q change %)	1.9	1.3	3.3	3.1
(Y-o-Y change %)	6.2	5.3	13.1	12.4
Domestic Credit	1,102	1,116	302	311
(Q-o-Q change %)	1.4	1.2	2.8	2.7
(Y-o-Y change %)	6.4	5.6	13.0	11.2
Government	160	160	9	9
(Q-o-Q change %)	1.8	-0.1	-7.2	0.0
(Y-o-Y change %)	6.6	1.3	-19.6	-17.4
Public Sector (GREs)	149	155	32	33
(Q-o-Q change %)	4.3	4.3	11.5	1.6
(Y-o-Y change %)	4.2	11.3	19.9	16.5
Private Sector	772	786	257	265
(Q-o-Q change %)	0.7	1.8	2.3	3.1
(Y-o-Y change %)	5.7	5.2	15.3	13.3
Business & Industrial Sector Credit	553	565	141	144
(Q-o-Q change %)	0.8	2.2	1.1	2.7
(Y-o-Y change %)	5.5	5.2	17.5	15.2
Individual	219	221	117	121
(Q-o-Q change %)	0.5	0.8	3.7	3.5
(Y-o-Y change %)	6.3	5.0	12.8	11.0
Non-Banking Financial Institutions	21	15	4	4
(Q-o-Q change %)	3.9	-31.5	-4.8	-5.0
(Y-o-Y change %)	63.8	22.7	-37.5	-39.7
Foreign Credit	99	101	14	16
(Q-o-Q change %)	8.0	2.3	15.6	12.1
(Y-o-Y change %)	4.9	1.7	15.6	41.1

Source: Central Bank of the UAE

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

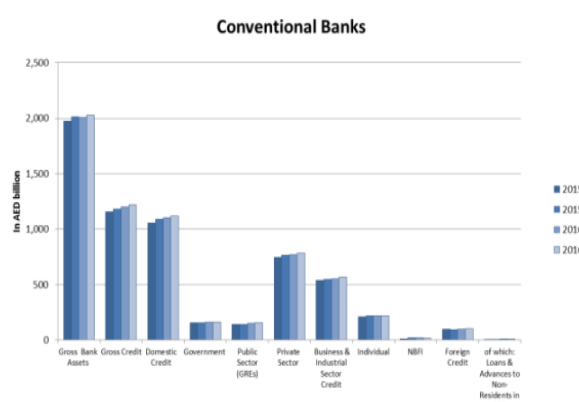
The split between Conventional and Islamic banks in Figure 3.6 indicates that the growth in Islamic financing and assets is much steeper than for the Conventional banks' loans. The share of Conventional banks' assets at the end of 2016 Q2

is 80.4% of the total, while the share of the Islamic banks assets is 19.6%.

Islamic banks had their assets growing by 2.1% in 2016 Q2, more than two folds the increase for the conventional banks. Islamic banks' financing has dominated the Conventional banks' loans in almost all subcategories, with exception of GREs and Loans and Advances to Non-residents.

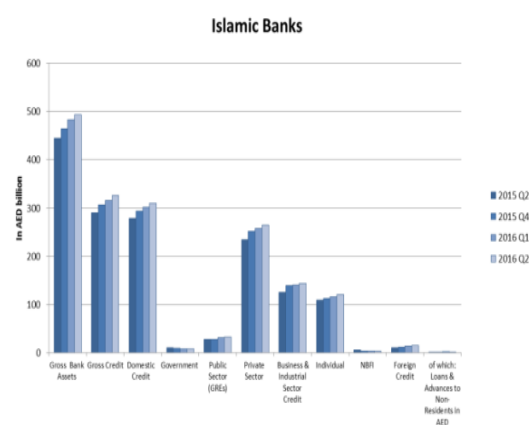
Figure 3.6. Banking System Assets and Financing by Conventional/Islamic Banks split

a)



Source: Central Bank of the UAE

b)



Source: Central Bank of the UAE

The breakdown of the assets and credit by local and foreign banks in Figure 3.7 indicates that national banks grew much quicker than the foreign banks.

Table 3.3.c.Assets and Credit at UAE Local/Foreign Banks

	Local		Foreign	
	2016		2016	
	Mar	Jun	Mar	Jun
Total Assets	2,099	2,130	392	389
(Q-o-Q change %)	0.5	1.4	0.7	-0.8
(Y-o-Y change %)	6.6	5.9	-4.6	-4.8
Gross Credit	1,307	1,337	211	207
(Q-o-Q change %)	2.5	2.3	0.5	-1.7
(Y-o-Y change %)	9.7	8.9	-3.7	-5.7
Domestic Credit	1,216	1,243	188	184
(Q-o-Q change %)	2.0	2.1	-0.3	-2.2
(Y-o-Y change %)	9.4	8.8	-2.1	-5.0
Government	162	162	7	6
(Q-o-Q change %)	1.6	0.6	-6.5	-13.9
(Y-o-Y change %)	5.7	1.2	-12.2	-23.5
Public Sector (GREs)	150	159	31	29
(Q-o-Q change %)	7.2	5.9	-2.2	-6.1
(Y-o-Y change %)	12.6	19.1	-15.0	-14.9
Private Sector	881	904	149	147
(Q-o-Q change %)	1.2	2.6	0.2	-0.9
(Y-o-Y change %)	9.0	8.8	2.1	-2.1
Business & Industrial Sector Credit	580	597	113	112
(Q-o-Q change %)	0.9	3.0	0.7	-0.9
(Y-o-Y change %)	8.3	9.1	4.7	-2.3
Individual	301	307	35	35
(Q-o-Q change %)	2.0	2.0	-1.4	-0.9
(Y-o-Y change %)	10.4	8.1	-5.6	-1.1
Non-Banking Financial Institutions	24	17	1	1
(Q-o-Q change %)	0.8	-28.6	50.0	0.0
(Y-o-Y change %)	36.2	-1.1	-29.4	50%
Foreign Credit	91	94	23	23
(Q-o-Q change %)	9.2	3.8	7.7	2.7
(Y-o-Y change %)	13.1	10.8	-15.1	38.9

Source: Central Bank of the UAE

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

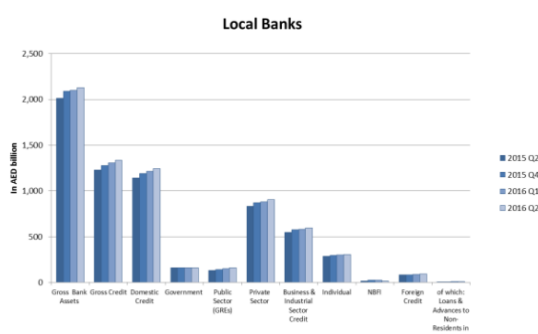
Local banks' assets have increased in 2016 Q2 by 1.4% with all of the loans asset classes growing for the period, with exception of the NBFIs that declined by 28.6% or AED 7 billion. However, assets and gross credit of Local banks represent 84.6% and 86.6% of the UAE banking system

assets and credit respectively. Assets of foreign banks declined by 0.8% with all the underlying categories declining, except for foreign credit and loans to non-residents, representing only 15.4% and 13.4% of the banking system's assets and gross credit respectively.

For the foreign banks, the asset class with the highest deleveraging percentage for the quarter was the Government at -13.9% of growth Q-o-Q with an outstanding of only AED 6 billion (3.7% of the total banks' lending to Government, i.e. 96.3% of the lending to the Government is coming from the Local banks), hence it is clear that Local banks have the monopoly in lending to this asset class.

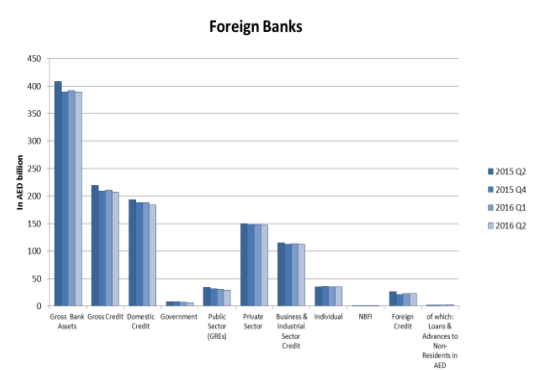
Figure 3.7. Banking System Assets and Credit by Local/Foreign Banks split

a)



Source: Central Bank of the UAE

b)



Source: Central Bank of the UAE

Table 3.4. Banks' credit to residents by economic activity

(End of Period, In Billions of AED)

Economic Activity	2015			2016	
	Jun	Sep	Dec	Mar	Jun
Agriculture	1.2	1.3	1.6	1.3	1.2
(Q-o-Q change %)	-22.7	1.7	20.5	-19.1	-4.9
(Y-o-Y change %)	-20.8	-41.7	-42.2	-23.3	-5.7
Mining and Quarrying	10.5	11.1	11.9	11.7	12.4
(Q-o-Q change %)	-2.6	5.9	7.7	-1.8	6.2
(Y-o-Y change %)	17.6	10.8	29.9	9.0	18.9
Manufacturing	71.2	72.2	69.1	72.2	71.4
(Q-o-Q change %)	7.1	1.4	-4.3	4.5	-1.2
(Y-o-Y change %)	7.4	17.6	6.1	8.7	0.3
Electricity, Gas and Water	22.5	20.7	20.5	18.6	18.6
(Q-o-Q change %)	21.0	-7.8	-1.2	-9.4	0.2
(Y-o-Y change %)	11.3	8.0	8.2	-0.1	-17.3
Construction and Real Estate	216.2	223.6	235.0	241.8	242.4
(Q-o-Q change %)	2.6	3.5	5.1	2.9	0.2
(Y-o-Y change %)	4.1	5.7	10.6	14.8	12.1
Trade	164.9	164.8	161.7	160.7	160.7
(Q-o-Q change %)	2.7	0.0	-1.9	-0.6	0.0
(Y-o-Y change %)	10.5	5.3	3.8	0.2	-2.5
Transport, Storage and Communication	60.8	58.8	59.2	62.5	64.0
(Q-o-Q change %)	2.2	-3.3	0.6	5.6	2.4
(Y-o-Y change %)	11.9	5.4	4.7	5.0	5.1
Financial Institutions (Excluding Banks)	128.2	135.5	135.6	139.6	144.9
(Q-o-Q change %)	-3.7	5.7	0.1	2.9	3.8
(Y-o-Y change %)	5.2	4.4	2.9	4.8	13.0
All Others	111.9	113.0	112.7	113.1	120.6
(Q-o-Q change %)	2.5	1.0	-0.3	0.4	6.7
(Y-o-Y change %)	-1.1	-3.6	17.1	3.6	7.8

Source: Central Bank of the UAE

Note: All data indicate the end-of-quarter values.

Banks' lending by economic activity shows an increase in the second quarter of 2016 for Mining and Quarrying (6.2%), Electricity, Gas and Water (0.2%), Construction and Real Estate (0.2%), Transport, Storage and Communication (2.4%) and Financial Institutions (3.8%). The sectors in which there is a decrease in credit, during the same period, are Agriculture (-4.9%) and Manufacturing (-1.2%). In the Trade sector there was no change in credit.

3.3 Financial Soundness Indicators

The overall outlook regarding the soundness of the banking sector remains positive during the second quarter of 2016.

The ratio of non-performing loans (NPLs) marginally declined to 6.3% at the end of 2016 Q2 from 6.4% at the end of 2016 Q1. Meanwhile, banks' specific provisions for NPLs increased from AED 74.4 billion to AED 75.6 billion, thereby ensuring that NPLs are fully provisioned. Nonetheless, banks do not want to write off bad loans, implying that the NPL ratio could decrease below what is reported.

Banks operating in the UAE remain highly capitalized, with the capital adequacy ratio of banks reaching 18.4% (16.8% for Tier1 capital) in 2016 Q2, which is well above the regulatory requirements set by the Central Bank (12% and 8%, respectively), with Conventional banks being better capitalized compared to the Islamic ones (CAR of 18.9% vs. 16.5% and Tier 1 capital 17.0% vs. 15.9% respectively). Foreign banks have better capitalization than the Local banks (20.7% vs. 18.1% for CAR and Tier 1 capital of 17.7% vs. 16.6% respectively).

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

L/D ratio for the overall banking system has moved from 101.7% at the end of March to 103.4% at the end of 2016 Q2, which is mainly due to the decline in Deposits and marginal increase in Loans. Looking at the breakdown between Conventional and Islamic banks, the L/D ratio is respectively 106% and 94.6%. On the other hand, Local banks have L/D ratio of 104.7%, while the ratio for Foreign banks is 95.5%.

LSRR increased from 86.8% to 87.7%, reflecting slower increase in stable resources compared to the robust credit growth at banks. However, Foreign banks have a lower level than the National banks by about 10 percentage points, while Islamic and Conventional banks have comparable LSRR.

Meanwhile, liquid assets which include reserve requirements mandated by the Central Bank, 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 increased from 15.6% at the end

of March 2016 to 16% at the end of 2016 Q2. The level of total liquid assets at the end of 2016 Q2 remains higher than the levels observed at the end of 2016 Q1.

Table 3.5.a Financial Soundness Indicators in the UAE (in %, unless otherwise indicated)

	2015		2016	
	Q2	Q4	Q1	Q2
Lending to Stable Resources Ratio	88.1	87.3	87.2	88.1
The Liquid Assets Ratio (LAR)	13.7	17.5	14.9	15.8
Capital Adequacy Ratio (CAR)	18.8	18.9	18.7	18.9
of which:				
Tier 1 Capital	16.7	16.9	16.7	17.0

Source: Central Bank of the UAE.

Note: All data indicate the end-of-quarter values

Table 3.5.b Financial Soundness Indicators in the UAE for Conventional Banks (in %, unless otherwise indicated)

	2015			2016	
	Q2	Q3	Q4	Q1	Q2
Lending to Stable Resources Ratio⁸	87.6	88.1	87.1	86.8	87.7
Ratio of Non-performing loans	6.3	6.3	6.3	6.4	6.3
The Liquid Assets Ratio (LAR)	14.3	14.2	17.4	15.6	16.0
Capital Adequacy Ratio (CAR)	18.3	18.3	18.3	18.0	18.4
of which:					
Tier 1 Capital	16.5	16.5	16.6	16.3	16.8

Source: Central Bank of the UAE.

Note: All data indicate the end-of-quarter values.

Table 3.5.c Financial Soundness Indicators in the UAE for Islamic Banks (in %, unless otherwise indicated)

	2015		2016	
	Q2	Q4	Q1	Q2
Lending to Stable Resources Ratio	85.4	86.1	85.4	86.4
The Liquid Assets Ratio (LAR)	16.5	17.0	18.8	17.0
Capital Adequacy Ratio (CAR)	15.9	15.6	15.4	16.5
of which:				
Tier 1 Capital	15.1	14.9	14.7	15.9

Source: Central Bank of the UAE.

Note: All data indicate the end-of-quarter values.

⁸ Net Lending + Net Financial Guarantees+ Stand-by Letters of Credit+ Interbank Placements (3 months and more)/ (Net Free Capital Funds+ Other Stable Resources).

Table 3.5.d Financial Soundness Indicators in the UAE for Local Banks (in %, unless otherwise indicated)

	2015		2016	
	Q2	Q4	Q1	Q2
Lending to Stable Resources Ratio	77.8	78.6	76.2	78.8
The Liquid Assets Ratio (LAR)	21.1	22.2	22.8	24.0
Capital Adequacy Ratio (CAR) of which:	18.9	20.2	20.7	20.7
Tier 1 Capital	15.9	17.1	17.6	17.7

Source: Central Bank of the UAE.

Note: All data indicate the end-of-quarter values.

Table 3.5.e Financial Soundness Indicators in the UAE for Foreign Banks (in %, unless otherwise indicated)

	2015		2016	
	Q2	Q4	Q1	Q2
Lending to Stable Resources Ratio	89.6	88.6	88.9	89.3
The Liquid Assets Ratio (LAR)	12.8	16.5	14.2	14.6
Capital Adequacy Ratio (CAR) of which:	18.2	18.0	17.6	18.1
Tier 1 Capital	16.5	16.5	16.1	16.6

Source: Central Bank of the UAE.

Note: All data indicate the end-of-quarter values.

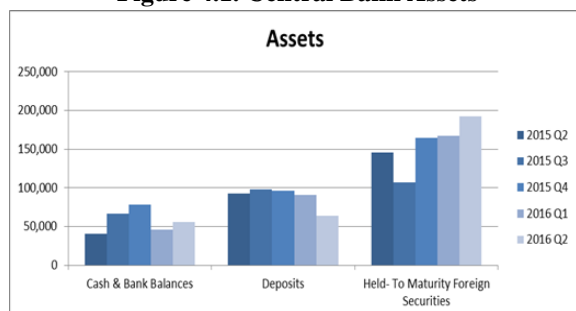
Chapter 4. Central Bank Financial Position & Reserve Management

The Central Bank balance sheet exhibited an increase in 2016 Q2, triggered by increases on the liabilities side, namely an increase in required reserves, currency issued and derivative liabilities. Meanwhile, assets were reallocated to “Cash and Bank Balances” abroad or invested in “Held-To-Maturity Foreign Securities” to strike a better balance between return and liquidity.

4.1 Central Bank Balance Sheet

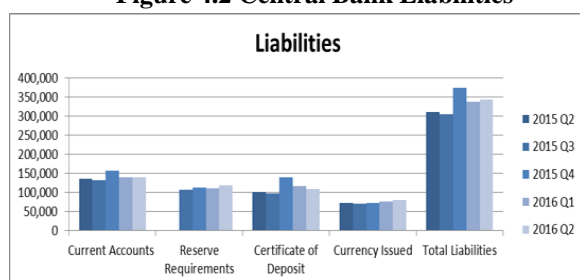
The Central Bank balance sheet is mainly triggered by changes on the liabilities’ side. Total liabilities increased by 1.7% in 2016 Q2 on account of an increase in “Currency Issued” by AED 4.1 billion in the month of June, when *Zakat*, the Islamic donation, is collected by the UAE Zakat Fund. In addition, an increase in “Derivative Liabilities” by AED 7.2 billion reinforced the increase in liabilities. The latter corresponds to a revaluation impact on Open Swap Contracts due to an appreciation of the Japanese Yen, the currency in which some liabilities are denominated, during this period. Meanwhile, banks’ holding of “Certificates of Deposit” (CDs) issued by the Central Bank decreased by AED 7.3 billion.

Figure 4.1. Central Bank Assets



Source: Central Bank of the UAE

Figure 4.2 Central Bank Liabilities



Source: Central Bank of the UAE

The total assets of the Central Bank increased during 2016 Q2 by AED 6.1 billion, reaching AED 364.7 billion, with the above-indicated increase in liabilities as the main driver. A drawing on deposits at banks abroad took place in the amount of AED 26.6 billion, which allowed for an increase in “Cash and Bank Balances” by AED 9.6 billion and an increase in investments in “Held-To-Maturity Foreign Securities” in the amount of AED 24.7 billion, both of which have a better return.

Table 4.1. Central Bank Balance Sheet

In Millions of Dirhams

	2015			2016	
	Q2	Q3	Q4	Q1	Q2
Assets					
Gold Bullion	347	664	934	1,085	1,164
Cash & Bank Balances	40,708	66,883	78,611	46,029	55,656
Deposits	92,880	98,241	96,362	90,434	63,850
CDs Under Repo	-	-	-	-	-
Liquidity Support Facility	321	228	228	214	214
Held-To-Maturity Foreign Securities	145,574	107,078	164,495	167,508	192,094
Held-To-Maturity Bonds Issued by MOF & Dubai Government:	49,443	49,231	49,231	49,198	49,198
Available-for-sale foreign Investments	368	362	361	356	372
Advances to Government	-	850	2,500	2,500	-
Available-for-sale foreign securities	-	-	74	75	76
Derivative Assets	1066	47	334	175	151
Other Assets	469	462	445	437	401
Property and Equipment's	85	78	79	113	103
Total Assets	331,260	324,126	393,660	358,675	364,748
Off Balance Sheet Commitments	119,150	115,166	199,681	198,254	262,631
Liabilities					
Current Accounts & Deposits	135,394	132,727	157,031	140,363	140,351
- Of which:					
Reserve Requirements	109,300	107,700	112,900	110,300	118,100
Banks' Current Account	17,300	17,700	36,400	25,100	17,800
Certificates of Deposit	101,335	97,365	139,773	116,393	109,083
Currency Issued	72,549	71,047	73,522	77,208	81,317
Derivative Liabilities	771	1,256	1,310	4,468	11,684
Other Liabilities	1399	1,931	2,275	1,177	1,853
Total Liabilities	311,448	304,327	373,910	338,611	344,287
Authorized Issued & Fully Paid Capital	2,500	2,500	2,500	2,500	2,500
Fair Value Reserve	-21	-26	-29	-33	-15
Gold Revaluation Reserve		-12	-60	85	165
General Reserve	17,339	17,339	17,339	17,812	17,812
Retained Earnings		-	-	-	-
Total Liabilities & Capital	331,260	324,126	393,660	358,975	364,748
Off Balance Sheet Commitments related to foreign exchange fluctuations	119,150	115,166	199,681	198,254	262,631

Source: Financial Control Division, Central Bank of the UAE

4.2 Central Bank Foreign Assets

The Central Bank's balance of foreign assets increased from AED 306.2 billion at the end of 2016 Q1 to AED 314.1 billion at end of 2016 Q2 (2.6%), with the increase in liabilities being the main

driver. The increase was mainly due to the above-indicated rise in “Held-To-Maturity Foreign Securities” while “Current Account Balances & Deposits with Banks Abroad” fell by AED 15.9 billion.

Table 4.2. Central Bank's Foreign Assets

	In billions of Dirhams				
	2015			2016	
	Q2	Q3	Q4	Q1	Q2
Total Foreign Assets	274.6	267.1	341.1	306.2	314.1
Held-To-Maturity Securities	145.6	107.1	164.5	167.5	192.1
Current Account Balances & Deposit with Banks Abroad	124.6	156.4	171.8	132.8	116.9
Other Foreign Assets	4.4	3.7	4.8	5.9	5.1

Source: Central Bank of the UAE, end of quarter data

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. Therefore, the CBUAE policy rate was maintained during 2016 H1 in line with the Federal Reserve’s decision to postpone the planned increase in its policy rate following the Brexit vote in the UK. It is also worth noting 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

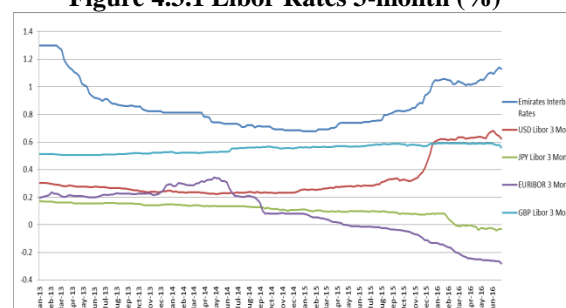
Figure 4.3.1 shows the 3-month Emirates Interbank Offer Rate (Eibor), which comprises the daily quotes of the largest banks operating in the country, and published by the Central Bank of the UAE. Eibor was reformulated in 2016 Q2 to include the cost of attracting deposits from larger clients, thereby better reflecting the true cost of funds for banks.

Following the fluctuation during 2016 Q1, Eibor slightly increased during 2016 Q2 due to increased attraction to potential rate hike in the US. Similarly, the 3-month USD Libor rate showed some increase during this period in light of the renewed commitment by the Federal Reserve in the US for further rate hikes.

The 3-month Libor rate in the Euro Area and in Japan however continued their decline during 2016 Q2, reflecting the tepid economic conditions and

heightened uncertainty about the success of the European Central Bank (ECB) and the Bank of Japan (BOJ) in their policies of Quantitative Easing and the absence of supportive fiscal policy and/or structural reforms. Moreover, Brexit is leaving no choice to the Bank of England but to adopt more monetary easing to counter the recessionary impact, thereby increasing the prospect of further divergence relative to the U.S interest rate policy where economic activity has been expanding and job gains have been on an upward trend.⁽¹⁾

Figure 4.3.1 Libor Rates 3-month (%)



Source: Bloomberg

4.3.2 Long-term swap rates

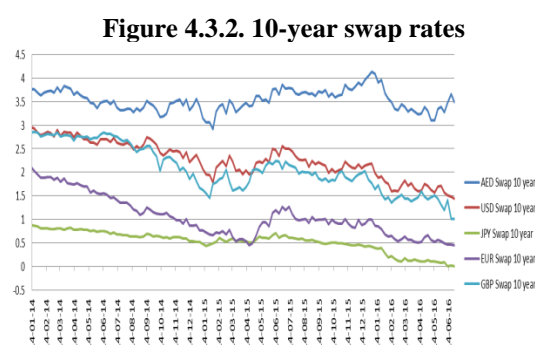
Given the absence of a deep and liquid government bond market in the UAE, the swap market is the only way to get an idea about yields at longer maturities. Interest rate swaps correspond to an exchange of a fixed payment for a floating payment that is linked to an interest rate, most often the LIBOR. As shown in Figure 4.3.2, the AED 10-year swap rate fluctuated during 2016 Q2 around an average of 3.3%, with a trough of 3.1% in the first half of May, linked to recovering oil prices during this period. The Dirham swap rate increased afterwards, peaking at 3.66% in the third week of June; this may indicate a higher risk premium as investors in the UAE became averse to the potential adverse effect of low oil prices, which reached an average of \$47.5 per barrel during 2016 Q2 and increased attraction to potential rate hike in the US. However, rating agencies remained positive about the UAE during this period.

Moody’s reported positively on the *gradual* fiscal consolidation in the Emirate of Abu Dhabi which is expected to boost confidence in the resilience of the non-oil activities, while Fitch reported on the sale of \$27 billion worth of Sovereign Wealth Fund assets that provided additional revenues to the government to

⁽¹⁾ See Federal Reserve Press Release, 27 July 2016.

finance the deficit gap. Ultimately, the Dirham swap rate decreased during the last week of June.

Meanwhile, the USD 10-year swap rate continued its retreat along with the swap rates for the Euro and JPY, on the back of the Federal Reserve's postponement of a policy rate increase and the ECB and BOJ renewed commitments to more monetary easing. With regards to the Brexit's impact, the 10-year Swap rate on the British Pound lost 30 basis points on the day of the announcement and an additional 25 basis points in the week that followed (Graph 4.3.2).



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 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

Banks' current account at the Central Bank decreased during 2016 Q2 by AED 7.3 billion while Certificates of Deposit held by banks decreased also by the same amount, i.e., a total decline by AED 14.6 billion. Total liquid assets of banks increased, however, from AED 319.8 billion at the end of 2016 Q1 to AED 326.4 at the end of 2016 Q2. This was due mostly to the an increase in liquid assets held by banks, but not part of the CB's balance sheet, namely highly rated government and public sector debt by AED 9.8 billion (AED 8.2 billion increase in local government zero-risk weighted securities, and AED 1.6 billion increase in public sector entities debt rated A+ and above). Additionally, there was an increase in required reserves held by banks at the CB by AED 7.8 billion, which was mainly due to the fact that reserve requirements at the end of 2016 Q2 are calculated based on customer deposits held in mid-April.

As a result, the Liquid Assets Ratio increased from 15.6% at the end of 2016 Q1 to 16.0% at the end of 2016 Q2, which is a testament to satisfactory liquidity in the banking system. Therefore, few banks tapped CBUAE's facilities to borrow Dirhams during 2016 Q2, namely through 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 Operations and Reserve 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.