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Economics

United Arab Emirates: Weathering the Crunch

With this report, we are launching our economic coverage of the United Arab Emirates:

- We argue that the UAE's performance has been impressive and its economic outlook remains very favourable.
- The country's fiscal and external positions are strong, and we expect them to remain in large surplus over the medium term.
- Market liquidity and domestic credit have been growing at a fast pace, but recent signs seem to indicate that market liquidity has dropped sharply.
- UAE banks remain profitable and generally well capitalised, despite the rapid increase in the size of their balance sheets.
- The large premium currently attributed to Abu Dhabi's sovereign default risk is not supported by economic fundamentals.
- The government's recent corporate investigations could have long-term benefits.
- The current policy of pegging the dirham to the US dollar continues to serve the country well.
- The UAE's vulnerability to external shocks is limited, in our view.

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Key Points

The UAE's performance has been impressive and its economic outlook remains very favourable. Although the pace of economic growth may slow down slightly over the next two years, we still project that the UAE will grow at a healthy pace of about 6% in 2009. We also project that CPI inflation will peak at around 12% this year, before declining to about 9.7% in 2009.

The fiscal and external positions are strong and expected to remain in large surplus over the medium term. We estimate that the government's fiscal accounts would remain balanced even if oil prices were to drop to around US$25/barrel, and that its current account would remain in surplus even if oil prices were to drop to around US$35/barrel.

Market liquidity and domestic credit have been growing at a very fast pace, but the momentum may have started to turn. Rapid growth and negative real interest rates led to a surge in domestic credit, which was financed by a large increase in both broad money and foreign borrowing by banks. However, recent signs seem to indicate that market liquidity has dropped sharply as a result of the recent reversal of speculative inflows and the tightness in international debt markets. Nevertheless, the potential systemic risks of a liquidity crunch are largely mitigated by the government's ability to inject additional liquidity into the system should this become necessary.

Despite the rapid increase in the size of their balance sheets, UAE banks remain profitable and generally well capitalised. Based on existing market evidence, and pending additional information on the exposure of UAE banks to troubled assets, we do not believe that the financial system is currently vulnerable to a systemic liquidity shock. However, the provision of more timely, detailed and comprehensive data is crucial during these times of high uncertainty.

The large premium recently attributed to Abu Dhabi's sovereign default risk is not supported by economic fundamentals. Given Abu Dhabi's substantial official foreign assets and abundant oil resources, it is not at all clear why the CDS spread on the emirate's sovereign debt would be priced so high.

The government's recent corporate investigations could have long-term benefits. Besides setting the standards for proper corporate governance, these investigations could serve as a springboard for the implementation of a broader structural reform agenda.

The current policy of pegging the dirham to the US dollar continues to serve the country well. We maintain that the dollar peg has not been the main driver of inflation in the UAE, and that changing the current exchange rate policy may have costly implications. The economic costs of greater policy flexibility seem to far outweigh its potential benefits at the present time.

The UAE's vulnerability to an external shock is limited. The country's fiscal and external balances would remain in surplus even if oil prices were to drop by 60-70% from their current levels. Moreover, downside risks related to a sharp economic slowdown are substantially reduced by the possibility of government intervention. Barring that, a mild slowdown in the UAE's rapid rate of growth may actually help to reduce current inflationary pressures.

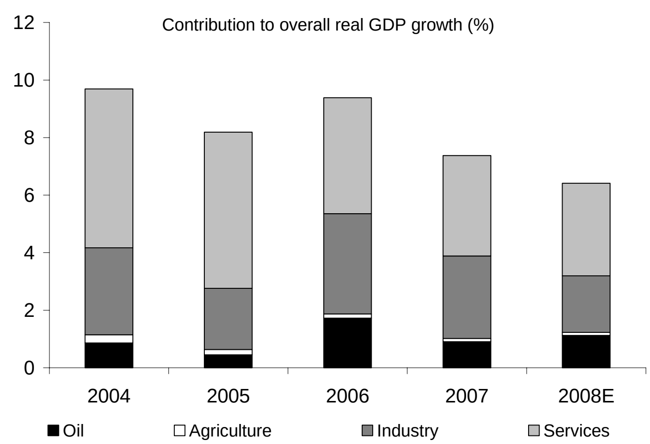
Growth and Prices

The UAE's economic performance over the past five years has certainly been impressive. Buoyed by higher oil prices and increasing domestic investment, its economy has grown at an average annual real rate of about 9% since 2003. The country has also become increasingly diversified, with a thriving private sector and a greater role for non-oil industries. Moreover, the UAE has made substantial strides in solidifying its role as a regional business hub through the implementation of market-friendly policies geared towards economic diversification and sustainable growth. As a result, GDP per capita has increased by about 130% since 2003, reaching an estimated US$57,000 in 2008.

Economic growth continues to be strong. Real output grew by 7.4% in 2007 as a result of higher hydrocarbon prices and a continued strengthening in the non-oil sector (see Exhibit 1). Although the value of total crude oil output is estimated to have increased by about US$9 billion in 2007, the non-hydrocarbon sector was the main driver of economic growth. In fact, the latter grew at an inflation-adjusted rate of about 9% and contributed around 88% of overall growth, with manufacturing, construction and trade services all growing at double-digit rates. Domestic expenditures also expanded at a healthy pace in 2007, with total investment estimated to have increased by 17% to around US$39 billion.

Exhibit 1

The UAE's rapid growth has been increasingly driven by the non-oil sector …

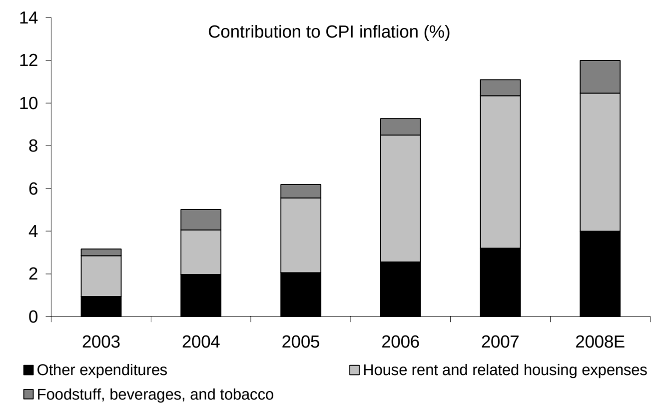


E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

However, consumer prices have continued to rise. Although strong domestic demand has partly contributed to the increase in inflationary pressures, these were also accentuated by: (i) supply bottlenecks (mainly in the housing market); (ii) sharp increases in the international prices of food and commodities; and (iii) excess domestic liquidity (see Exhibits 2 and 3). As a result, CPI inflation reached 11.1% in 2007, up from about 9.3% in 2006. Inflation has continued to be driven mainly by increases in housing rents. According to conservative official data, rental costs increased by about 50% over the past three years, while some market estimates are at least twice as high. Given that rent expenditures constitute about 36% of the current official CPI basket, we estimate that housing expenditures alone contributed close to 65% of overall inflation in 2007.

Exhibit 2

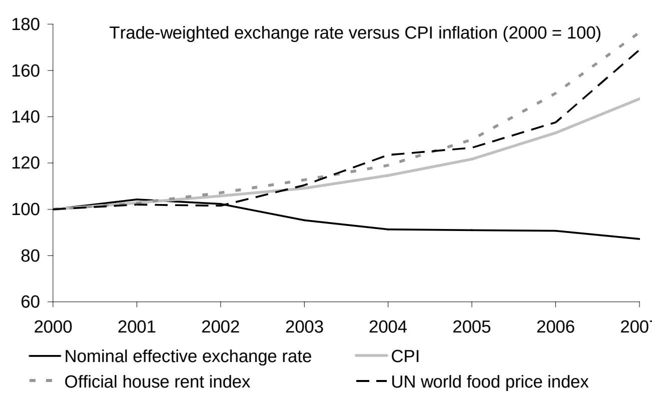
… but this has fuelled inflationary pressures, mainly stemming from sharp increases in rents …



E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

Exhibit 3

… while the relative inflationary impact of the dollar peg has not been as significant



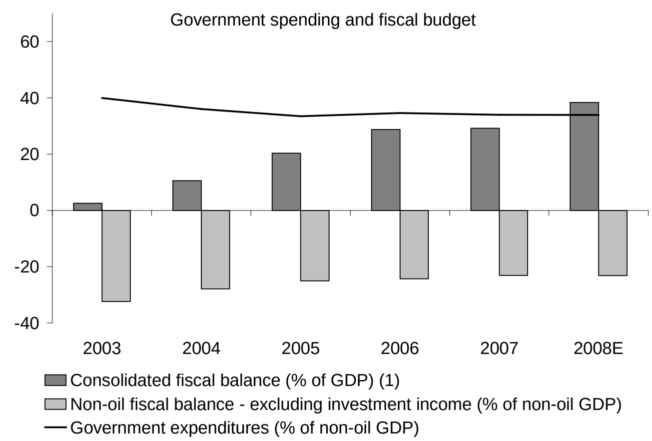
Source: UAE authorities, IMF, Bloomberg

Fiscal and External Balances

The UAE's fiscal position remains very strong. We estimate that the government's fiscal accounts would remain balanced over the medium term even if oil prices were to drop to around *US$25 per barrel*. The government's estimated total revenues for 2007 were around US$97 billion, about 74% of which came from hydrocarbons and 13% from returns on official foreign investments. As a result, the UAE's consolidated fiscal surplus stood at a significant 29% of GDP in 2007 (see Exhibit 4).

Exhibit 4

The fiscal balance continues to be in large surplus as a result of high oil prices and prudent policies



(1) Consolidated accounts of the federal government, Abu Dhabi, Dubai and Sharjah.
E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

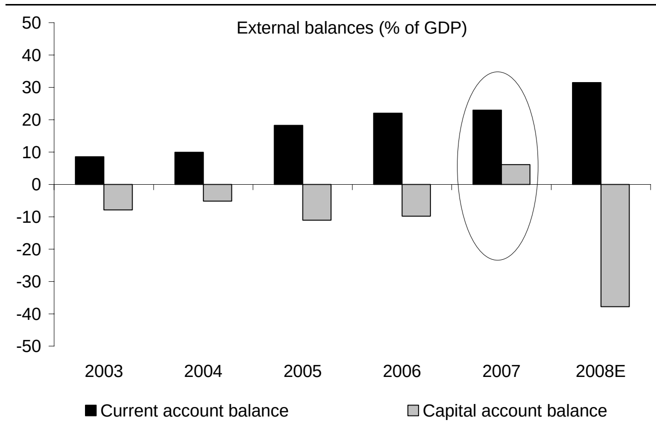
Despite the substantial inflows from oil, however, the government continues to maintain a generally prudent fiscal stance. In fact, overall government expenditures – excluding those of quasi-public entities – as a percentage of non-oil GDP have gone down from 40% in 2003 to around 34% in 2007. The emirate of Abu Dhabi accounts for the largest share of all fiscal revenues; this is to be expected, given that it produces 95% of the UAE's oil and therefore receives most of the revenues from hydrocarbon exports. Moreover, Abu Dhabi has long followed an investment policy based on transferring all of its fiscal surpluses, as well as the profits of the Abu Dhabi National Oil Company, to its investment authority (which, in turn, has tended to invest them abroad). During times of low oil prices, such as during the late 1990s, this process was reversed and the emirate had to draw down on its foreign investments to finance domestic expenditures. Given the UAE's limited short-term absorptive capacity, this policy has largely succeeded in shielding the UAE economy from the impact of volatile oil markets. It may have also helped to ensure a degree of intergenerational equity in the distribution of oil wealth.

However, as a substantial share of oil revenues was being channelled abroad, domestic companies, including large quasi-publics, have had to rely on external financing to fund their rapid growth. Although this may have increased their incentive to invest in economically viable projects, it has also increased their exposure to foreign debt markets.

The UAE's external balance continues to be in large surplus. The strong growth in exports more than offset the increase in imports, and contributed to an estimated current account surplus of about 23% to GDP in 2007 (see Exhibits 5 and 6).

Exhibit 5

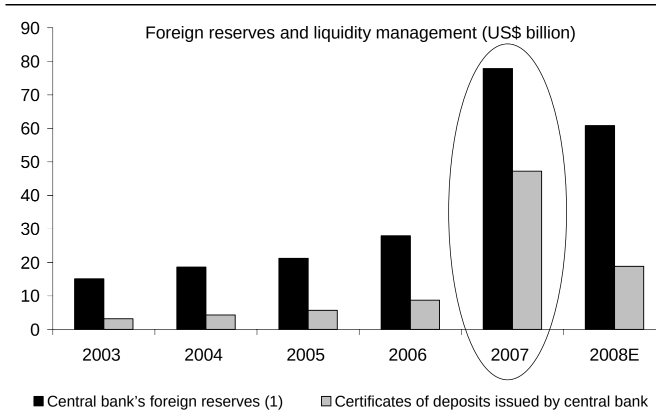
External balances are strong, but the recent speculative inflows will reverse



E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

Exhibit 6

Excess liquidity resulting from these large inflows was partly sterilized

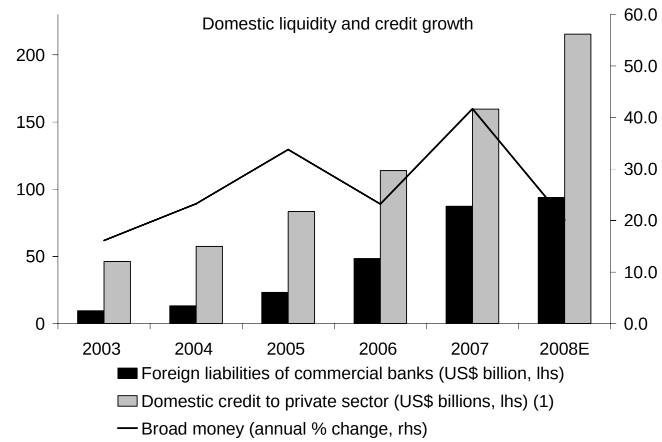


(1) Does not include sovereign wealth fund assets.
E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

Hydrocarbon exports constituted around 73% of the country's total exports (excluding re-exports), and generated about US$80 billion in revenues. In view of the expected expansion in oil production capacity and the increasing share of non-oil exports, we expect the current account balance to remain positive in the near term even if the oil price dropped to around *US$35 per barrel*. Moreover, the government continued to invest a large part of these oil revenues abroad, as evidenced by the increase in estimated official outflows from US$40 billion in 2006 to about US$54 billion in 2007. It is notable that as a result of substantial speculative inflows, the UAE registered a surplus in both its current and capital (financial) accounts during 2007. As the monetary authorities intervened to counter the pressure on the currency peg, their foreign reserves increased by about 180%, with most of this accumulation occurring during 4Q07. Although the UAE does not have any outstanding sovereign foreign debt, the foreign liabilities of UAE companies have grown substantially over time. Data reported by the Bank for International Settlements show that, as of March 2008, international loans extended to non-bank domestic entities were valued at around US$51 billion, or about 20% of GDP (see Exhibit 8). Moreover, total foreign liabilities, which include those of the banking sector, reached 67% of GDP in 2007. Although these liabilities are more than offset by the UAE's massive stock of official foreign assets, this level of exposure to international credit markets increases the likelihood that the international credit crunch may have a dampening effect on growth in the non-oil sector.

Exhibit 7

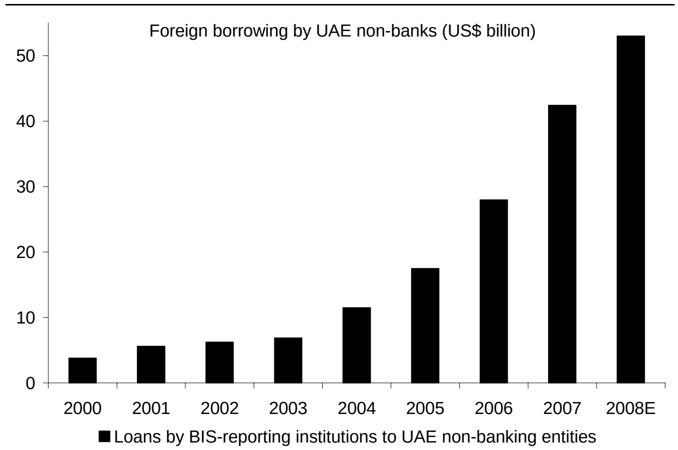
Strong credit growth was increasingly financed through foreign borrowing by banks…



(1) Includes non-bank financial institutions.
E = Morgan Stanley Research estimates
Source: UAE authorities, IMF, Morgan Stanley Research

Exhibit 8

… but financial institutions were not the only ones borrowing from abroad



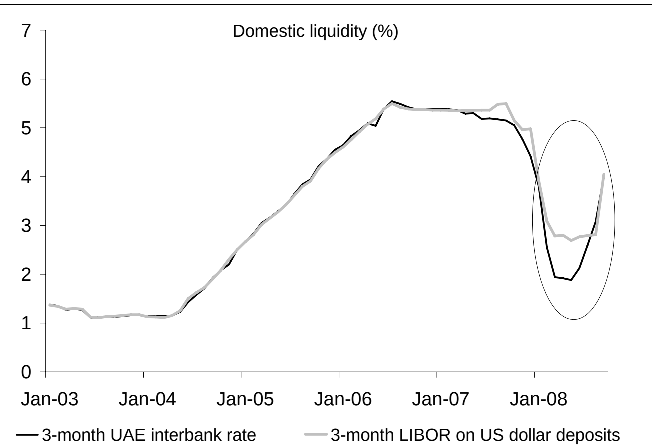
E = Morgan Stanley Research estimates
Source: BIS, Morgan Stanley Research

Money and Banking

Market liquidity and domestic credit have been growing at a very fast pace. By June 2008, the latest month for which official monetary data are available, domestic credit had grown at a rate of about 49%Y compared to its level a year earlier (see Exhibit 7 on page 5). This considerable growth was partly financed by an increase in broad money, which grew at a rate of 42%Y, about twice as fast as it had grown in 2006. Interestingly, this substantial increase in domestic liquidity was not sufficient to finance the considerable growth in domestic credit, which led banks to further increase their foreign borrowings. As of February 2008, the foreign liabilities of UAE banks had increased by 70%Y and their net foreign position registered a deficit of US$37.9 billion, down from a surplus of US$13.3 billion a year earlier. This excessive increase in credit has been mainly driven by rapid output growth and low interest rates; as of August 2008, the real interbank three-month rates stood at -8%. Given the dirham's peg to the US dollar and the UAE's open capital account, there was little that the monetary authorities could do to shore up these rates and attenuate their pro-cyclical impact. In fact, the authorities were obliged to mirror the cuts in US policy rates, which dropped by about 3.25% since September 2007. In turn, this increased market pressure for a revaluation of the dirham as speculators bet against the government's ability to maintain the dirham's peg to a depreciating currency at a time when consumer prices were rising. As a result, the monetary authorities accumulated about US$50 billion in additional foreign reserves during 2007 as they absorbed the impact of massive speculative inflows on the currency (see discussion on the exchange rate on page 10).

Exhibit 9

Tighter international liquidity may have started affecting domestic markets…



Source: UAE authorities, Haver Analytics, Bloomberg

Nevertheless, the momentum may have started to turn. Recent signs seem to indicate that market liquidity in the UAE has dropped sharply, with the 3-month interbank rate rising by about 190bp since end-June 2008 (see Exhibit 9). Moreover, the UAE Central Bank has recently announced that it stands ready to inject up to US$13.6 billion into the banking system – around 7.4% of broad money – in order to address increasing liquidity constraints within the banking sector. We believe that this liquidity squeeze may be due to two main factors:

- First, as the likelihood of a revaluation of the dirham waned over the past few months, foreign speculators were less willing to maintain their speculative positions in dirham. Consequently, the reversal of their earlier trades led to a substantial outflow of funds and to a US$15.5 billion reduction in the banking system's overall foreign assets during 1H08. In fact, the aggregate value of the Central Bank's certificates of deposits – which were primarily used to sterilise excess market liquidity – dropped by about 37% in 2Q08; further proof of capital outflows.

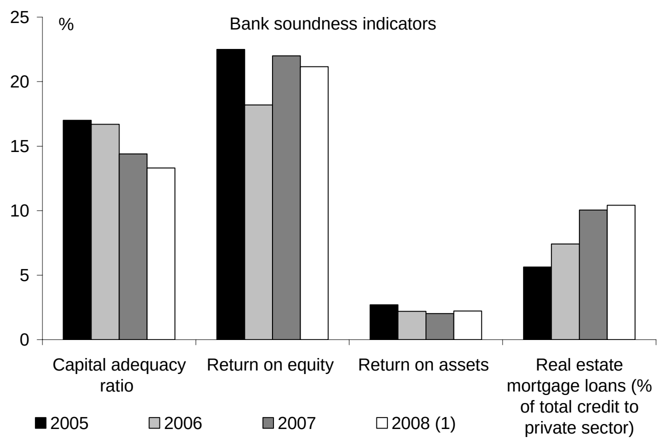
- Second, the credit crunch that has gripped global markets over the past year may have also reduced the ability of UAE banks to finance their funding needs by borrowing from abroad. Although recent data on the banking sector's foreign liabilities are not available, it would be reasonable to expect their growth to have slowed down during the last quarter, especially given the recent increase in default risk-premia and its effect on the cost of capital (see page 8).

However, it is worth noting that, as a result of the large increase in domestic liquidity during 2007, the share of government deposits to broad money dropped by close to 3.8 percentage points, to around 23%. As such, it would not be unreasonable to see the government increase its deposits in the banking system through the injection of some of its oil revenues – which are usually sterilised into foreign holdings – or through the repatriation of a small share of its official assets held abroad. Although public interference in the operations of the banking system has been historically limited, the fact that the government has a large financial stake in some of the country's biggest banking institutions may provide it with an additional impetus to alleviate any liquidity shortage. *Based on this, and pending additional information on the exposure of UAE banks to troubled financial assets, we do not believe that the banking system is currently vulnerable to a systemic liquidity shock.*

Despite the recent liquidity squeeze, the UAE banks remain profitable and generally well capitalised. In June 2008, the industry's average return on equity was around 21% and the aggregate capital adequacy ratio stood at a relatively solid 13% (see Exhibit 10). However, it should be noted that this ratio has dropped by about 3.5 percentage points over the preceding 18 months as the banks' equity base had not caught up with their rapidly expanding balance sheets. Moreover, as the real estate market in the UAE matures over the next two years, it may be necessary to evaluate the extent of the banks' exposure to this sector.

Exhibit 10

… but banks remain profitable and well-capitalized, although their real estate exposure has increased



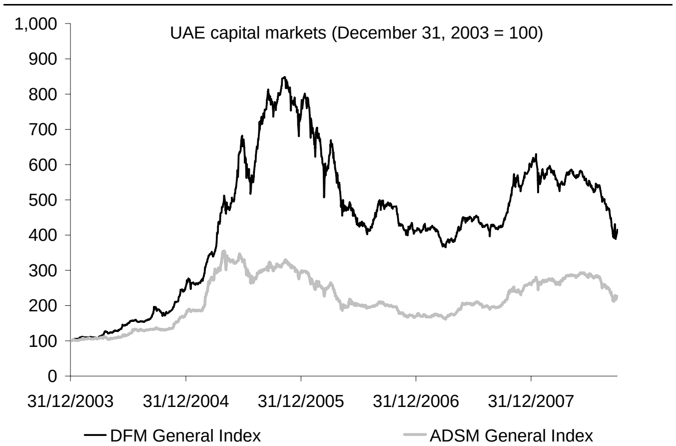
(1) 2008 data are as of June, except for the mortgage loans estimate, which is based on Morgan Stanley projections.
Source: UAE authorities, Morgan Stanley Research

Although this exercise should theoretically include an assessment of the banks' claims on quasi-public companies that are heavily involved in the real estate market, it may be difficult to carry it out, given the lack of transparency on the magnitude of this exposure. Moreover, the supervisory authorities may need to rethink the current rules governing the exposure of banks to the real estate sector, including through: (i) reconsidering the merits of the March 2007 Central Bank resolution that allowed UAE banks to establish real estate subsidiaries; and (ii) establishing clear guidelines for the classification of loans exposed to the real estate sector, some of which are currently being included in the rapidly growing class of 'personal loans for business purposes'. This said, we should be careful not to overstate the potential risks to banks from a mild correction in the real estate sector, if indeed such a correction were to materialise. In fact, it may be useful to reflect back on the stock market correction of 2005-06 and its effect on the soundness of the banking system. At the time, the UAE stock markets lost about 50% of their value over a period of less than a year. Given that a large number of speculators had relied on bank financing to leverage their positions, concerns arose about the extent of bank exposure to rapidly falling asset prices at the time. In retrospect, these fears turned out to be largely unfounded as banks' balance sheets were not significantly affected by the downturn and their NPL ratios actually improved over time. It should be stressed, however, that much of the current market anxiety around this issue could be put to rest through the provision of more timely, consistent and comprehensive data on the monetary and banking sector. Indeed, the need for greater market transparency on the part of market participants and regulators cannot be overemphasised at a time of considerable uncertainty in global financial markets.

Capital Markets

The UAE capital markets have underperformed in 2008. With the exception of a short-lived rally during 4Q07, the Abu Dhabi Securities Market (ADX) and the Dubai Financial Market (DFM) remain well below their 2005 peaks. Moreover, as of end-September, the ADX and the DFM indices were down by around 14% and 31% for the year, respectively (see Exhibit 11). Notwithstanding the most recent drops, which may have been accentuated by low seasonal liquidity, the overall poor performance of these markets is rather puzzling. After all, one would have expected that record-high oil prices, strong economic growth and healthy corporate earnings would have provided the necessary catalysts for a bull market.

Exhibit 11
Stock markets have performed poorly in 2008 …



Source: Bloomberg

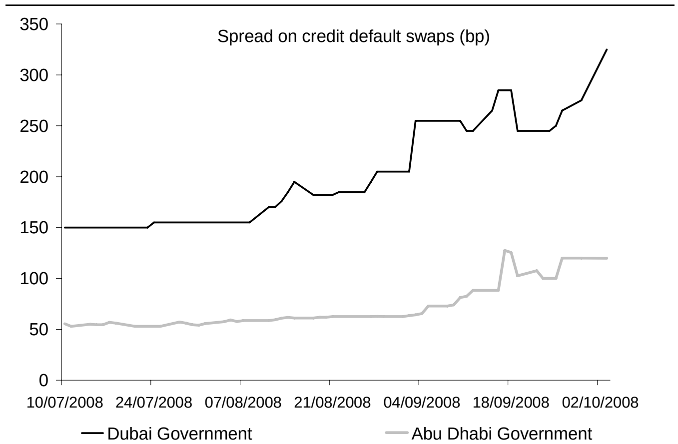
Unfortunately, it seems that these positive fundamentals may have been overshadowed by a number of dampening factors, including:

- A diversion of investments towards the real estate sector following the 2006 correction;
- The global credit crunch, which has led some foreign investors to liquidate their positions and repatriate their funds;
- Anxiety about the potential exposure of the UAE to developments in international debt markets;
- Recent government probes into the activities of some of Dubai's most high-profile companies (discussed on page 9);
- An apprehension towards financial markets in general, given the current excess volatility in global financial markets.

Moreover, anecdotal evidence suggests that the UAE's large government funds have so far resisted the pressure to directly intervene in domestic capital markets. Despite its immediate benefits, there are substantial economic costs associated with such a public intervention; not the least of which would be the moral hazard effects of an implicit government support of stock market performance. If policy measures are indeed warranted, they could focus on increasing market transparency and encouraging the participation of large institutional investors. Indeed, one the main contributors to high market volatility has been the predominance of retail investors, which by some estimates account for about 70% of total market activity in the UAE.

Recently, the risk-premium on debt issued by the UAE's sovereign and quasi-public entities increased sharply. Credit default swaps (CDS) written on five-year sovereign debt issued by the emirates of Abu Dhabi and Dubai are currently trading at a spread of about 120bp and 325bp, respectively – almost twice their levels two months ago (see Exhibit 12). Moreover, the spread on some of Dubai's quasi-public entities has also shot up to about 500bp for certain maturities. In view of the recent news about corruption probes in Dubai and possible price stabilisation in its real estate sector – to which many of the quasi-public companies are exposed – the increase in its default-risk premium was to be expected. However, the magnitude of this increase may have been exaggerated, given that, to date, there has been no evidence of actual corporate losses or defaults resulting from these risks.

Exhibit 12
… and credit risk premiums have increased



Source: Bloomberg

The substantial premium attributed to Abu Dhabi's sovereign default risk is not supported by economic fundamentals. Abu Dhabi is by far the richest emirate in the UAE. In terms of oil wealth, we estimate that the emirate's annual revenues from hydrocarbon will exceed US$90 billion in 2008, which is more than 90 times the entire value of its outstanding sovereign debt. Moreover, Abu Dhabi possesses substantial official foreign assets, which, according to a recent IMF report, could be in the range of US$500-900 billion. These foreign assets belong to the emirate itself and not to the federal government. If we were to conservatively assume that the lower estimated funds (US$500 billion) were exclusively invested in risk-free assets, this would still return a non-trivial annual investment income of about US$15 billion, or around 10% of the UAE's non-oil GDP. Moreover, it would be reasonable to assume that the negative impact that declining global capital markets may have had on the stock of official foreign assets has been mitigated to some extent by the sharp increase in oil revenues during 2008. In light of this, and given Abu Dhabi's track record of fiscal prudence, it is not at all clear why the CDS spread on the emirate's sovereign debt would be priced considerably higher than those of other sovereigns with equal or lower credit ratings.

The government's recent corporate investigations could have long-term benefits. The authorities have recently launched a series of probes into illicit activities that have involved some of Dubai's most prominent companies. Although these investigations may have generated a certain degree of market uncertainty, their long-term value in setting the standards for proper corporate governance cannot be overstated. Moreover, these actions could well be used as a springboard for the implementation of a broader structural reform agenda which would include: (i) fostering a greater degree of transparency within the private and public sectors; (ii) updating the UAE's regulatory framework, including through the modernisation of corporate, securities and labour laws; and (iii) further facilitating the conduct of business by streamlining official processes. In the meantime, greater transparency on the part of the authorities with regard to these ongoing investigations would go a long way towards reducing market anxiety, in our view.

Exchange Rate Policy

The current policy of pegging the dirham to the US dollar has generally served the country well. Despite the constraints that it has placed on monetary policy, we believe that the currency peg has generally been a source of stability for an economy that is heavily reliant on export revenues from a highly volatile resource. An extended discussion of the UAE's optimal exchange rate policy is not within the scope of this note. However, and at the risk of over-simplifying the debate about the dirham's peg, we would like to note that the criticism against the current exchange policy has mainly revolved around two interrelated arguments. The first, partly outlined already, has focused on the potential inflationary impact of maintaining the peg to the US dollar at a time when the UAE and the US seem to be at different stages of their economic cycles. Greater monetary independence, it is argued, would allow for a more restrictive policy, which could, in turn, help to cool down the economy at a time of rising domestic prices. A second conjecture has been that the policy of pegging the dirham to a currency that has depreciated by about 15% over the past two years has led to a substantial increase in the price of imported goods and contributed to higher inflation. Although both of these arguments are certainly not without merit, the degree to which they have factored into the rapid build-up in domestic prices is not self-evident. As argued below, the evidence seems to indicate that their effect on inflation has been secondary to other factors that are not directly affected by exchange rate fluctuations.

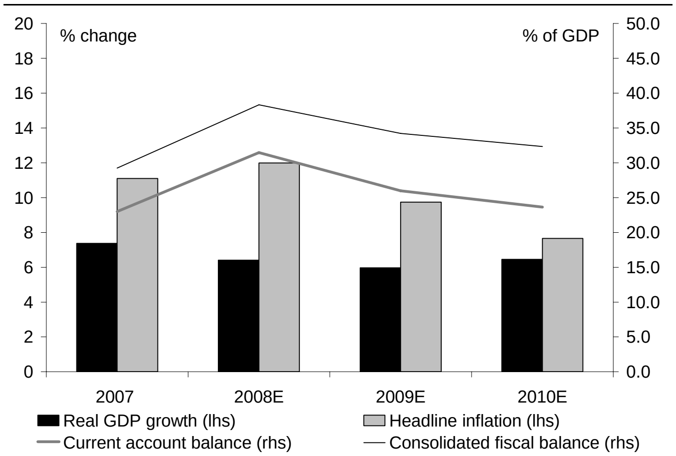
The dollar peg has not been the main driver of inflation. We maintain that inflation in the UAE has essentially been driven by sharp increases in rents and, to a lesser extent, by higher international prices of food and commodities (see Exhibits 2 and 3). Together, these two factors – which have little to do with the dirham's peg to the dollar – have accounted for over 70% of CPI increases over the past two years. It may be argued that lower interest rates – resulting from the authorities' need to mirror the Federal Reserve's expansionary monetary policy – have been partly responsible for the increase in property prices. Nevertheless, we should keep in mind that it is changes in rents, and not real estate prices, which directly impact household expenditures and are ultimately reflected in the CPI. Moreover, the relationship between property prices and rental values is not a straightforward one, as is evident by the declining rental yields in certain emirates. Rents in the UAE have been mostly driven by the strong demand for housing, which in turn has been bolstered by the large inflow of expatriates, not by low interest rates. Further, it is not evident that the dirham's peg to a depreciating dollar has been the main factor behind the rise in the price of imported goods. Whereas the UAE's nominal, trade-adjusted (effective) exchange rate has depreciated by about 9% since 2003, the estimated index of tradable goods (mostly imported) has increased by about 26%. This leads us to believe that the exchange rate effect has not been the main factor behind the increase in the domestic price of imported goods. Instead, import price inflation may be more significantly attributed to: (i) an increase in the international prices of goods (such as in the case of food and commodities); (ii) rising shipping costs; and (iii) wider premiums charged by domestic wholesalers and retailers (partly as a reflection of higher commercial rents). Moreover, the effectiveness of any revaluation will depend on the extent to which the resultant exchange rate effects are passed on to final consumers in the form of lower-priced imported goods. Anecdotal evidence suggests that these pass-through effects may not be very significant.

Changing the current exchange rate policy may have costly implications. Although a revaluation may not significantly help to ease inflationary pressures, it will surely lead to a further appreciation in the real exchange rate, which will in turn have an immediate, negative impact on the international competitiveness of the non-oil sector. Further, we believe that a change in the existing exchange rate policy – either through a one-time revaluation or the re-pegging to a basket of currencies – would signal to the market that additional revaluations may be forthcoming, which is likely to reignite market speculation against the dirham. Such an outcome is certainly possible, given the substantial appreciation that may be required to rebalance the UAE's large external surpluses. We believe that the cost of such a disruption to the financial system is not justified at the current juncture, especially given the recent appreciation in the US dollar. Therefore, we are for the maintenance of the status quo, at least until the establishment of the GCC monetary union. In other words, we believe that the economic costs of greater policy flexibility seem to far outweigh its potential benefits, at the present time.

Looking Forward

The future economic outlook continues to be very favourable. Although the pace of economic growth may slightly slow down over the near term, we still project that the UAE will grow at a healthy pace of about 6% in 2009. This is based on our projection that global liquidity constraints are likely to have a mild dampening effect on domestic demand, thereby slowing down growth in the non-oil sector to about 7% by 2009. However, this is expected to be partially offset by an average annual increase of 4.5% in oil production, as total capacity is ramped up to about 3.5 million barrels per day over the next five years. Against this backdrop, we project that CPI inflation will peak at around 12% this year before declining to about 9.7% in 2009. These inflation estimates are based on our assumptions that: (i) rent pressures will gradually decrease starting in 2H08 as an estimated 150-200,000 housing units come online by 2010, most of them in Dubai; (ii) international food prices, which had increased by more than 80% since 2005, continue their recent downward trend; and (iii) tighter credit markets will lead to the phasing of domestic projects and the stabilisation of domestic demand growth.

Exhibit 13
The UAE's economic outlook remains very favourable



E = Morgan Stanley Research estimates
Source: BIS, Morgan Stanley Research

The UAE's systemic vulnerability to external shocks is relatively limited. Notwithstanding the geopolitical risks, we see two main potential sources of external instability facing the UAE: (i) the risk of an adverse movement in the oil market; and (ii) the possibility of a prolonged period of low international liquidity. As mentioned above, the country's external and fiscal balances are expected to remain in surplus over the near term, even if current oil prices were to drop by 60-70%. Additionally, the government's fiscal rectitude during times of high oil prices will likely mitigate the second-round effects of a drop in oil prices on domestic demand, as the funding for public investment programmes would only be marginally affected. As such, we believe that the strong fundamentals of the UAE economy will allow it to weather oil market volatility over the medium term. Conversely, the economic impact of a prolonged weakness in international credit markets may be more relevant due to the greater reliance of UAE institutions on foreign leverage to finance their growth. Our near-term projections already incorporate the likelihood of a slowdown in domestic credit growth. This said, we believe that the downside risk of a sharp economic slowdown is substantially reduced by the possibility of direct government intervention should conditions deteriorate significantly. Given the size of official foreign assets and the annual surplus from oil, such an intervention could be quite significant. However, it is equally important to point out that a mild slowdown in the UAE's rapid rate of growth may actually be welcomed. Liquidity constraints could lead to a reconsideration of over-ambitious projects and the phasing of others over a longer period of time; which would in turn ease the demand for domestic resources and further reduce inflationary pressures. Overall, we believe that the UAE is in a strong position to overcome the challenges that it may face over the medium term, be they domestic or foreign, and we expect it to continue building on its impressive track record of growth and diversification.

Exhibit 14

United Arab Emirates – Selected Economic Indicators

	2005	2006	2007	2008E	2009E	2010E
Output and prices						
Nominal GDP (in billions of U.S. dollars)	133.0	163.3	192.8	270.4	267.5	284.8
Real GDP (percent change)	8.2	9.4	7.4	6.4	6.0	6.5
Real oil and gas GDP (percent change)	1.6	6.5	3.5	4.5	4.5	4.5
Real non-oil GDP (percent change)	10.8	10.4	8.7	7.1	6.4	7.1
CPI inflation (percent change)	6.2	9.3	11.1	12.0	9.7	7.7
Government finances						
Revenue (percent of GDP)	41.7	50.4	50.5	56.4	54.3	53.5
Expenditure and net lending (percent of GDP)	21.4	21.7	21.3	18.1	20.1	21.1
Budget balance (percent of GDP)	20.3	28.8	29.2	38.3	34.2	32.3
Non-oil budget balance (excluding invesment income) 1/	-25.0	-24.3	-23.1	-23.2	-23.2	-23.3
Gross government debt (percent of GDP)	9.3	10.1	10.5	9.0	10.4	11.0
Monetary sector						
Broad money (percent change)	33.8	23.2	41.7	20.1	9.7	8.8
Net foreign assets (percent change)	14.8	-6.7	3.1	-66.2	17.8	6.6
Net domestic assets (percent change)	62.2	54.9	66.3	54.3	9.0	9.0
Credit to private sector (percent change)	44.5	36.9	40.1	35.0	10.0	10.0
Interest rate (3-month interbank), in percent 2/	4.55	5.39	4.42	4.00	…	…
Real interest rates, in percent 3/	-1.54	-3.55	-6.01	-7.14	…	…
External sector						
Exports of goods (billions of US dollars)	117.2	142.6	157.6	235.0	225.7	236.8
Of which: Oil and gas (billions of US dollars)	55.0	70.2	80.1	141.0	120.9	118.9
Imports of goods (billions of US dollars)	-74.5	-86.1	-92.4	-113.5	-126.4	-142.3
Current account balance (billions of US dollars)	24.3	35.9	44.4	85.1	69.5	67.3
Current account balance (in percent of GDP)	18.3	22.0	23.0	31.5	26.0	23.6
Gross official reserves (billions of US dollars) 4/	21.3	28.0	77.9	60.8	61.2	63.2
Total external debt (billions of US dollars) 5/	30.8	47.0	67.5	54.5	51.3	48.0
Memorandum items:						
Crude oil production (in millions of barrels per day)	2.38	2.57	2.66	2.78	2.90	3.04
GDP per Capita (in U.S. dollars)	32,392	38,614	42,988	56,784	53,454	53,788
Poputation (Millions)	4.1	4.2	4.5	4.8	5.0	5.3
Average exchange rate (AED per dollar)	3.6725	3.6725	3.6725	3.6725	3.6725	3.6725
Real effective exchange rate (percent change)	2.52	5.40	1.93	…	…	…
Stock market indices (End of year values) 2/						
Abdu Dhabi Securities Market index	5203.0	2999.7	4551.8	3981.6	…	…
Dubai Financial Market index	7426.4	4127.3	5932.0	4151.8	…	…

1/ In percent of non-oil GDP.
2/ 2008 figures are as of end-September, 2008.
3/ 3-month interbank rates adjusted for CPI inflation
4/ Central bank reserves which do not include foreign assets held by sovereign wealth funds.
5/ Mostly foreign liabilities of U.A.E. commercial banks and other non-bank institutions that are more than offset by the country's foreign assets.

Source: UAE authorities, IMF, Morgan Stanley Research; E = Morgan Stanley Research estimates

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