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PANORAMA

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UNITED ARAB EMIRATES: A NEW ERA OF SLOWER GROWTH

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By Seltem IYIGUN, Coface Mediterranean & Africa economist

The United Arab Emirates (UAE)' economy is of the most diversified within the Gulf region. This diversification has become especially important since mid 2014, with plunging oil prices. Only 30% of GDP and nearly 20% of exports came from hydrocarbon revenues in 2015. This relatively high level of economic diversification has made the country less vulnerable to the shock in oil prices. Diversification efforts have helped the UAE to build up solid financial buffers that allow the government to continue supporting the economy's non hydrocarbon activities. Nevertheless, this situation does not make the country totally immune from the fall in energy prices, as two thirds of its fiscal revenues come from hydrocarbons. The government has thus decided to implement fiscal consolidation and to withdraw some energy subsidies. Coupled with less accommodative monetary policy on the back of the tighter US Fed policy, this fiscal consolidation could reduce the pace of growth of private consumption the leading force of economic growth in the UAE. The first chapter of this panorama focuses on the impacts of economic diversification on growth performance.

Nevertheless, the government is expected to continue spending on non hydrocarbon activities, which will support the economy. The UAE remains a very attractive economy for international investors. Its favourable business environment benefits from high productivity, excellent infrastructures, strong connections to international markets and a dynamic private sector.

These are the keystones supporting the development of sectors such as retail and tourism – on which this panorama will focus in the second chapter. Yet some challenges remain. Tighter liquidity conditions and higher costs are narrowing profit margins in the retail sector. In the tourism sector, lower energy prices and the depreciation of the Russian rouble and the euro against the dollar (to which the dirham is pegged) are putting pressure on corporate performance.

Coface has increased the risk level of the automotive sector from moderate to high, while the textile clothing, retail and agrofood sectors have been raised from medium to high risk levels.
The question of the sustainability of the currency peg system used in the Gulf countries will be addressed at the end of the first chapter

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1 ECONOMIC DIVERSIFICATION: A BUFFER AGAINST LOWER ENERGY PRICES

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Although the hydrocarbon sector remains the backbone of the UAE's economy, the large contribution made by non hydrocarbon activities to gross domestic product is mitigating the effects of lower energy prices on economic growth.

Growth sustained by non oil sectors

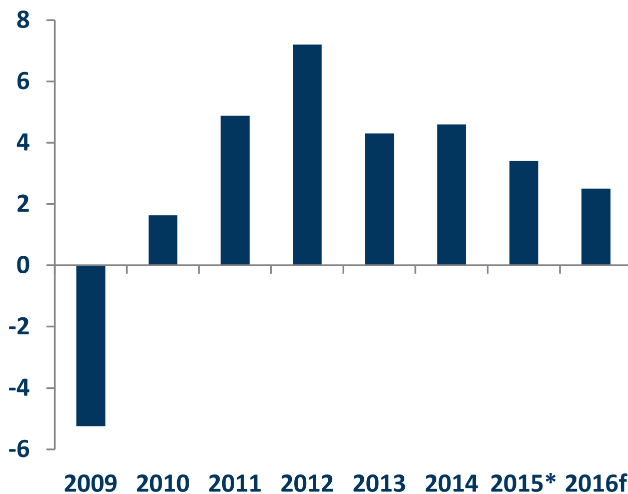
The UAE is one of the most diversified in the Gulf region. Over several decades, the country has invested in infrastructures, transportation, financial services, trade and construction, in order to increase the level of diversification in the economy. As a result, the share of non hydrocarbon sectors in GDP has increased to around 75%, as of 2015 up from around 65% in the mid 2000s.

Safe haven status, political stability and a resilient financial system have helped the UAE to limit the negative effects of lower energy prices. In fact, a permanent 10 USD drop in oil prices would reduce the UAE's national output level by 1.5 percentage points after 5 years, according to the IMF[1]. Economic diversification has sustained non oil growth. The latest Emirates NDB report on the UAE's PMI (which tracks business conditions based on variables such as output, new orders and, employment). came in at 54.5 in March continuing an expansion since January, when it hit an almost four year low. It should be noted, however, that despite the improvement in non oil private sector performance, the average PMI in the first quarter of 2016 stood at 53.4. This signals a slight deterioration from the level of 54.8 recorded in the last quarter of 2015, mainly due to weak global economic growth.

The real estate sector constitutes one of the main pillars of the UAE government's diversification strategy. In Dubai, preparations for World Expo 2020 are acting as a catalyst for growth in the construction sector. In 2013, after winning the right to host the event, Dubai said it would earmark more than US$7 billion for infrastructure projects, as the exhibition requires the construction of roads, airports and bridges. In December 2015, Dubai approved the budget for 2016. The budget includes a 12% increase in spending, for investment in infrastructure to sustain economic growth. Dubai's ruler, Sheikh Mohammed Bin Rashid Al Maktoum, has approved government spending of 46.1 billion dirhams (12.6 billion USD, equivalent to around 10% of GDP). This represents a rise of 11.9% compared to the previous year. Spending on infrastructure, transport and economic development would account for 36% of the full budget. The government is pushing forward key infrastructure projects. Contracts for the expansion of Al Maktoum International Airport at Dubai South began being awarded in October 2015. The Dubai Creek Harbour development project is continuing, while Abu Dhabi is constructing the emirate's largest chemicals manufacturing centre, in Al Ghabria.

Although the outlook for construction remains positive, the wider economic slowdown is weighing on the sector. The residential market across the UAE remained lower than in recent years, as a total of 7,800 residential units were delivered in Dubai during 2015 compared with the scheduled delivery of 25,000 units estimated by developers at the start of 2015[2]. The delay in project delivery times was a similar trend seen in Abu Dhabi, where only 1,000 units were delivered. This was mainly due to lower levels of sales. Many projects witnessed delays in deliveries in Dubai and Abu Dhabi, the two driving forces of the UAE's economy, with many expected supplies for 2015 pushed to 2016 and 2017. As concerns the commercial property market, the demand for single owned Grade A offices in both emirates remained strong in 2015 , but the interest in secondary locations remained low, due to subdued

Chart 1: UAE real growth rate (%)



Sources: Coface, IMF
*Central Bank of the UAE

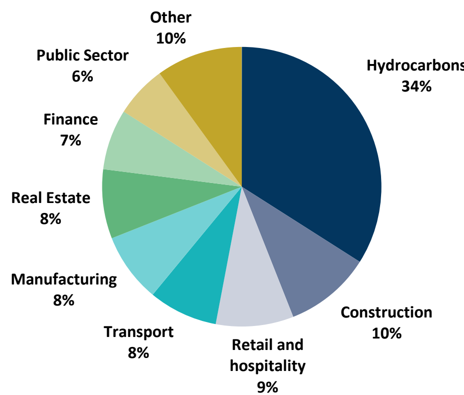
"Spending on infrastructure, transport and economic development would account for 36% of the full budget"

1 UAE, 2015 Article IV Consultation, August 2015, IMF
2 The UAE Real Estate Market 2015: A year In Review, JLL, 2016

commercial activity and corporate aversion to risk, following lower energy prices.
In line with the growing construction sector, metals will also see a rise in demand over the upcoming period. With domestic production struggling to meet the rising demand for metal, due to large construction projects, the country is likely to become a large importer of steel.

"Strong transportation and logistical services, coupled with the UAE's central geographic position between the East and West, are sustaining its status as a springboard for investors who want to reach the African continent"

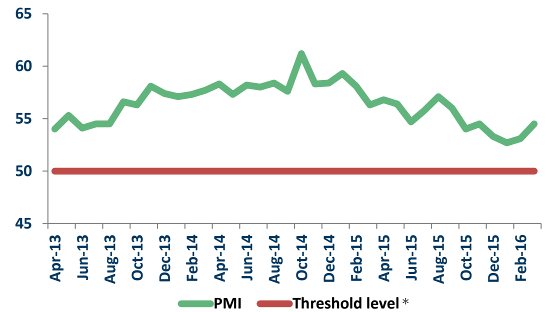
Chart 2: UAE GDP by Sector (2014)



Source: BMI

This forms another part of the country's economic diversification strategy. Despite lower energy prices, Abu Dhabi and Dubai will continue to invest in infrastructure projects which could also attract private developers to the area. With this in mind, Dubai Expo-2020 stands to be an important catalyst for investment. Dubai Electricity and Water Authority (Dewa) announced three major power expansion projects in March 2014, worth 5.4 billion USD[3]. In November 2014, it initiated a 17.7 million USD project to boost water supplies. The UAE rail system, with its budget of 25 billion, has also been approved for construction.
The trade sector is another important pillar in the UAE's economic diversification strategy. The Federation has positioned itself as a regional hub for trade and is continuing to invest in free zones, infrastructure projects and logistical developments. Free trade zones attract foreign investors by offering full ownership and tax exemptions. There are over 20,000 companies established in 21 free zones around the UAE. Huge investments in infrastructures have resulted in modern ports and airports that are among the most attractive gateways in the GCC region. Dubai's ports alone handle close to 55% of cross GCC trade .The UAE has five major international airports. Besides Dubai and Abu Dhabi, the country has Ras Al Khaimah airport in the north of the country and two

Chart 3: Non hydrocarbon activity in the UAE



Source: Reuters
*Threshold level for PMI: A PMI of more than 50 represents expansion in the manufacturing sector, while a reading under 50 indicates a contraction. A reading at 50 indicates no change.

others located in the Fujairah and Sharjah emirates. Together they offer investors a large of choice of trade ports.
Growing trade within the GCC and with Africa are also supporting the development of the trade sector in the UAE. Gulf States are investing heavily in construction, infrastructure and the service sectors, in order to diversify their economies away from oil and gas. The latest data from Dubai Customs indicates that Dubai's trade with the GCC in the first nine months of 2015 rose 8% from the previous year. Saudi Arabia is its largest GCC trading partner, with a share of 46.6% of total trade[4].
Strong transportation and logistical services, coupled with the UAE's central geographic position between the East and West, are sustaining its status as a springboard for investors who want to reach the African continent. Telecom companies, for example, can easily ship smartphones and other technologies to the GCC, Pakistan and African countries such as Tanzania and Kenya, through the UAE's facilities in the Jebel Ali Free Zone. The UAE's largest airlines, Emirates and Etihad, have strengthened their services to Africa in recent years. According to data from the IMF, the UAE's total value of trade with Africa and the Middle East rose from 56.7 billion USD in 2010, to 82.8 billion USD in 2014. Investment ties between Africa and the UAE are also strengthening. The Federation, particularly Dubai, accounted for 6% of total capital expenditure on greenfield related FDI projects in Africa in 2014[5].
Nevertheless, weak commodity prices, tightened global financial conditions and limited external and fiscal buffers in some Sub Saharan Africa countries, combined with security issues, may weigh on the positive outlook that has been supporting trade volumes so far.
India, China and Japan are among the UAE's largest Asian trading partners. China and India account for nearly one quarter of total UAE trade[4]. The UAE's ambition to increase its market shares in this part of the globe, have further pushed the country in its strategy to develop itself as a trade axis.

3 United Arab Emirates Metals Report, January 2016, BMI
4 The UAE as a global trade hub, April 2016, ENBD
5 World Investment Report, 2015, UNCTAD

India is the UAE's largest non oil trade partner. Bilateral trade between the UAE and India reached 61.2 billion USD in 2014, up from 60.6 billion USD in 2010. Indian exports to the UAE accounted for 36.5 billion USD, while UAE exports to India were 24.7 billion USD. Besides trade flows, there are also investment ties between the two countries. Dubai Ports World has a growing presence in India, as it operates at Nhava Sheva International Container Terminal Private Limited, Chennai Container Terminal Private Limited and India Gateway Terminal at Cochin. RAK Ceramics, AK Ceramics, the world's largest manufacturer of ceramic and vitrified tiles, has the biggest vitrified tile manufacturing plant, located in Samalkot in Andhra Pradesh. It has a daily manufacturing capacity of 30,000 sq. m of vitrified tiles and 1,500 items of sanitary ware. Emaar MGF Land Limited is a joint venture between Emaar Properties PJSC of Dubai and MGF Developments Limited of India. It began operations in India, in early 2005. The company is involved in real estate development, with a pan India presence and operations spanning all key segments of the Indian real estate industry, namely the residential, commercial, retail and hospitality sectors. In May 2007, SmartCity signed a joint venture agreement with the Government of Kerala to develop SmartCity Kochi in India. TECOM Investments (a subsidiary of Dubai Holding, established in 2015), has created SmartCity to develop knowledge industry townships worldwide. Many large Indian companies and banks (such as Nagarjuna Construction Company Limited, Hinduja Group, Danube, Sobha Group, Indian Oil Corporation, State Bank of India, IDBI Bank, Union Bank of India and Oriental Bank of Commerce, among others) have an important presence in the UAE.

"As private consumption accounts for nearly 60% of GDP, its expansion is important for the country's economic performance"

Bilateral trade between the UAE and the Chinese mainland expanded from 27 billion USD in 2010, to almost 57.1 billion USD in 2014 equivalent to 9% of the UAE's total trade volume. Shanghai contributes to over 20% of China's total trade with the UAE. The majority of products traded between the UAE and Shanghai consist of high tech products, office machines, auto data processing equipment, clothes, mineral products and plastics.

According to Dubai Chamber (which will soon open an international office in Shanghai), China's investment in the UAE has reached nearly 2.33 billion USD and there are around 4,000 Chinese companies present, as well as more than 200,000 Chinese nationals living in the country. The number of Chinese companies registered with Dubai Chamber has jumped by 54% since 2008, to reach 2,055.

Chinese investment in the UAE has increased due to the Chinese government's "Zou Chu Qu" strategy, which aims to support the integration of Chinese enterprises into the world economy. An increasing number of Chinese companies are therefore looking for investment opportunities in the UAE, particularly in the property and manufacturing sectors. At the end of 2015, during the visit of the Crown Prince of Abu Dhabi to China, the two countries signed 9 agreements to boost economic ties. The two leaders also launched a 10 billion USD joint strategic investment fund.

The UAE's investments in China are also rising. Borouge, an Abu Dhabi National Oil Company (ADNOC) Group subsidiary, has invested almost 60 million USD in a manufacturing plant in Shanghai which has an annual capacity of 50,000 tons. The Shanghai plant manufactures resins specifically for clients in the automotive sectors. Union National Bank and National Bank of Abu Dhabi also have representative offices in Shanghai.

The UAE is also investing heavily in China's ports and other infrastructures. Dubai Ports World operates within three marine terminals in China: Qingdao, Tianjin and Yantai. Jumeirah Group, a member of Dubai Holding, is planning to expand its presence in China, with eight new hotels across the country.

The value of two way trade between Japan and the UAE rose to 48.4 billion USD in 2014, up from 34.7 billion USD in 2010. Japan's main imports from the UAE are crude oils, gases and other petroleum products, along with other products such as copper scraps, precious stones, metals and non alcoholic beverages . The UAE's main imports from Japan are motor vehicles, general machinery and electrical machinery. Exports to Japan account for 15% of the UAE's total exports.

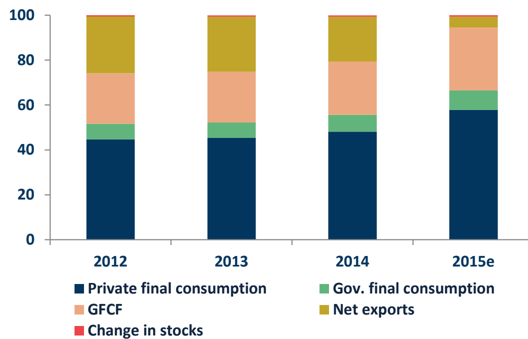
Private consumption continues to increase - but at a slower pace

Although lower oil prices dampened investor sentiment at the end of 2015, household consumption remained solid, on abundant liquidity, low interest rates and continued tourism inflows. Loans to the private sector increased by 8.5% in February 2016, compared to a year earlier. The country's economic diversification is supporting this outlook, as the slowdown in the oil sector has less impact on employment levels. The unemployment rate is expected to decline to 3.2% in 2016, down from 3.7% in 2015, according to BMI Research. Furthermore, a survey conducted by Bayt indicated that consumer confidence and consumer expectations are continuing to improve. 22% of GCC residents said that their financial condition had improved in January 2016, compared to 6 months previously. This was mainly due to 28% of respondents from Qatar and 25% from the UAE who said that their financial situations were now better[6]. As private consumption accounts for nearly 60% of GDP, its expansion is important for the country's economic performance. A risk to this outlook could

6 Middle East Consumer Confidence Index, Feb. 2016, Bayt.com

result from a more restrictive than expected monetary policy from the US Federal Reserve, as it would force the UAE central bank to push its interest rates up (due to the currency peg to the dollar). The bank already delivered a small rate hike of 0.25% in December 2015.

Chart 4: GDP by Expenditure (% of GDP)



Source: BMI

Fiscal prudence restrains pace of growth

The government has adopted measures to consolidate its fiscal position, as the country has fallen into fiscal deficit, reinforced by lower energy prices. As a result, all expenditure (except for employee compensation and the consumption of fixed capital), has decreased. In 2015, budget expenditures decreased by 14.5%, compared to to the previous year.. Subsidies fell by nearly 84%, following the implementation of subsidy reforms involving electricity and retail fuel subsidies, the latter being set in accordance with global oil price benchmarks. These reforms helped the country to save around 3% in total expenditure. Grants and social benefits also declined, down by 51.8% and 13.4% respectively in 2015, compared to the previous year.
The 37.3% fall in tax revenues in 2015 (compared to the previous year) was the main reason for the decline in budget revenues. This loss of revenues has resulted from the fall in taxes on oil companies.
The UAE budget consequently fell into negative territory in 2015 and the budget deficit reached 5.2% of GDP. By around 2018, the country is expected to introduce a value added tax (VAT). The cabinet approved a smaller federal budget for 2016, reflecting the country's aim to further cut expenditure, due to low oil prices. The consolidated budget for 2016 was set at 48.6 billion AED (13.2 billion USD) slightly smaller than the 2015 budget of 49.1 AED. Traditionally, the federal budget represents around 14% of total fiscal spending in the UAE's seven emirates.
Dubai, on the other hand, announced plans to raise state spending by 12% in its 2016 budget, as it invests in infrastructure projects to sustain economic growth. The emirate has forecast that its budget will be balanced, with no deficit this year. 36% of state spending will be allocated to wages while 45% will be spent on grants and subsidies. The government is continuing to support infrastructure projects, for which it has earmarked 14% of spending. Oil revenues will account for only 6% of total government revenue s.
This situation suggests that overall capital spending in the UAE will continue to support economic activity. Moreover, investments in domains such as tourism, infrastructure, and education are contributing to economic diversification and helping to maintain political stability.
Although this fiscal consolidation is important for long term economic sustainability, the UAE has a large financial cushion in the form of its sovereign wealth fund, which allows the country to implement consolidation plans in a gradual manner. Abu Dhabi Investment Authority's (ADIA) assets totaled 773 billion USD as of June 2015.
On the export side, although the fall in oil prices is hampering export revenues, the increase in re-export activity in line with the opening of the Iranian market would sustain exports. Although a surge in oil supply from Iran would increase the downside risks for oil prices, the removal of sanctions would create important opportunities for the UAE's exports of goods and services. According to the IMF, in 2013, exports to Iran accounted for 12% of the UAE's total non hydrocarbon exports, making it the country's second largest export destination after India. Economic diversification is working in favour of growth performance, as hydrocarbon exports accounted for only 20% of total exports in 2015. The UAE is serving as a central hub for the region's growing trade activity. The country's current account balance is thus expected to remain in positive territory in 2016, after recording a huge decrease in current account surplus in 2015. The country's safe haven status and its positive business environment are continuing to attract foreign inflows and foreign direct investments.

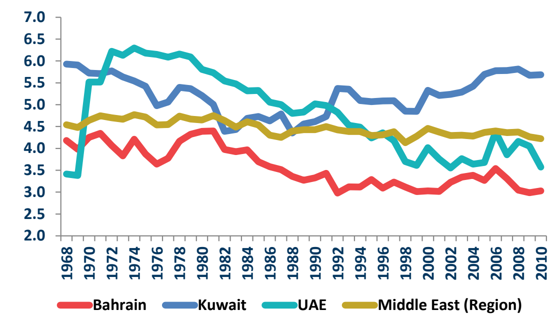
"The removal of sanctions in Iran would create important opportunities for the UAE's exports of goods and services exports, although it would weigh on energy prices"

However there are still downside risks for non hydrocarbon exports, mainly due to the slowdown in China which is weighing on commodity prices. In 2014, 35% of the UAE's non hydrocarbon exports comprised precious metal exports, while 22% were base metal exports. In this context, the opening of Iran could represent some challenges for the UAE. Oil exports averaged 1.4 million barrels in the first quarter of 2016, according to import statistics from countries accepting Iranian crude oil. This amount is expected to rise in line with new oil capacity, due to the removal of sanctions[7]. In an environment where the recovery of world trade volumes is weak, this

7 Iran oil&gas report, Q3 2016, BMI

additional supply in the oil market may lead to more price falls. This situation would weigh further on the UAE's fiscal balance and slow down the economy, eroding its efforts in diversification.
Imports will increase at a slower rate, but will remain buoyant, thanks to the appreciation of the US dollar to which the Emirati dirham is pegged.
According to the preliminary estimates of the UAE Central Bank[8], the country's current account surplus plunged significantly in 2015, to 79.3 billion AED (5.8% of GDP), down from 215.7 billion in 2014 (14.6% of GDP). This was due to the slump in oil prices. Exports of hydrocarbons, of which 77% are crude oil exports, decreased by 43% during 2015. This was partially compensated by an increase of 9% in non hydrocarbon exports. Adding re-export activities to this, total exports decreased by 9.3% in 2015. Total imports increased by 17.9 billion AED, dragging down the trade balance surplus from 313.8 billion AED in 2014, to 170.2 billion AED in 2015 (12.5% of GDP).
Lower energy prices, which created a wealth effect for travellers, helped the country to enjoy higher tourism revenues. With the increase in international arrivals, the country had a net travel inflow of 3.3 billion AED in 2015, compared to a net outflow of 1.7 billion AED in 2014.
The financial account deficit was lower, however, mainly due to huge inflows in private capital. Bank borrowing was the main source of these inflows in 2015, reflecting confidence in the stability of the country's financial system. Foreign direct investments rose by 5% in 2015, compared to the previous year. The overall balance of payments surplus rose by 66.1% in 2015, compared with 2014, as economic diversification, political stability and the resilience of the banking sector attracted investors to the UAE. The current account balance surplus should be lower in 2016 but with the slight recovery in oil prices, the surplus could increase again in 2017.

Chart 5: Export diversification index*



Source: IMF
* Higher values indicate lower diversification.

GCC currency peg: how sustainable?

Within a currency peg system, a country pegs its currency within margins of 31 percent, or less, to another currency[9]. GCC countries have pegged their currencies to the US dollar since the mid 1980s. This system has helped to keep inflationary pressures under control and provided credibility to the monetary policies of these countries. It has also aided external stability, as most exports and external assets are denominated in US dollars.

However, plunging energy prices and the appreciation of the US dollar have put the viability of the currency peg system in emerging countries, especially in oil exporting Gulf countries, into question.

The debate on this subject, earlier this year, mainly concerned Saudi Arabia. The largest economy in the region, it is highly dependent on oil revenues to balance its finances and oil recorded its biggest two year loss on record in 2015, due to the global supply glut. The Kingdom, which needed oil prices at 94.8 USD per barrel in 2015 to balance its budget, drained around 115 billion USD from its foreign reserves. According to data from the Saudi Arabian Monetary Agency, Saudi Arabia's foreign assets have fallen by a further 24.5 billion USD since the beginning of 2016, down to 584.4 billion USD in February.

The strengthening of the US dollar puts appreciation pressures on GCC currencies because of the currency peg. According to the IIF[10], the observed real effective exchange rate indicated that GCC currencies were 12% above their estimated equilibrium level, suggesting that they are deviating from levels justified by economic fundamentals.

The Gulf States are expected to have a combined fiscal deficit of around 137 billion USD in 2016[11]. At first sight, this may seem to justify devaluation, as it would boost oil revenues in local currencies and narrow deficits. However, despite the efforts made in economic diversification, around 60% of the GCC's total

8 Annual report, 2015, CBUAE
9 De Facto Classification of Exchange Rate Regimes and Monetary Policy Framework, July 2006, IMF
10 GCC: Dollar Pegs Will be Maintained, March 2016, IIF
11 Regional Economic Outlook: Middle East and Central Asia, April 2016, IMF

fiscal revenues still come from oil. Depegging would also increase the uncertainty surrounding prices of imported goods' prices to the region, which would increase inflationary pressures. The import and export volume elasticities of oil exporting countries are, in fact, very low and are more affected by the government spending than by import prices[8]. The majority of imports comprise transport and machinery goods, as the GCC States are investing heavily to support economic growth and employment. This strategy is also important to avoid social turbulence.
In this sense, the choice by GCC governments to adopt fiscal consolidation as a means of reducing budgets and external deficits, rather than depegging, is more effective, as import demand in oil exporters does not vary systematically with real exchange rate changes[12].

On the other hand, uncertainty surrounding import prices as a result of depegging, would create additional inflationary pressures. The spike in inflation could damage investors' confidence and the business environment, which would result in capital outflows.

The strength of GCC countries, while backing their currency pegs, was a result of their financial buffers and low debt structures. However, according to the IMF, total government gross debt in for the GCC countries is forecast to jump to 23.4% of GDP in 2016, up from 9% in 2014. As these fiscal deficits are mainly financed by draining funds from currency reserves, gross official reserves declined to 689 billion USD (equivalent of 11.4 months of imports) in 2016, down from 903.1 billion USD in 2014 (equivalent of 15.1 months of imports)[9]. Saudi Arabia (with 612 billion USD in its reserves as of 2015) could easily defend its currency peg. Qatar, Kuwait and the UAE would also be able to manage their pegging systems, on the back of their huge reserves and strong finances. The Gulf States have started to tap international markets to meet their growing financing needs. According to NBAD estimates[13], in 2015, international borrowing by GCC sovereign and corporate issuers (through bonds, sukuk and syndicated loans) stood at around 90 billion USD. The market is expected to grow further in 2016. Total bond issuance in the MENA region jumped by 67% to 105.7 billion USD in 2015, compared to the previous year.
Saudi Arabian authorities have announced that the country is preparing for a sale and is to start a two or three year program. The Kingdom has resumed the issuing of domestic bonds for the first time since 2007. In mid January 2016, the emirate of Sharjah raised 500 million USD in Islamic bonds. The governments of Bahrain, Kuwait Projects Co and the Jeddah based Islamic Development Bank subsequently followed suit.

Chart 6: Impact of currency depreciation on trade volumes

	"Impact of 10% Depreciation (percent volume changes)"	
	Imports	Exports
Oil Exporters	0	0
Nonoil Countries	-6.6	6.7
Advanced Countries	-9.2	7.1

Sources: IIF, IMF, Consultative Group on Exchange Rate Issues (CGER), Hakura and Billmeier, IMF WP/08/216

However, the financial situation for Bahrain and Oman appears to be more difficult. They require oil prices of 95.1 USD and 73.1 USD per barrel, respectively, in order to balance their budgets. Coface forecasts that the budget deficit to GDP ratio in Oman will widen to 20% in 2016, up from 17.7% in 2015, as the authorities are likely to extend their expansionist budget policy, which will further increase public deficit. In Bahrain, the budget deficit should edge down to 13.9% of GDP, from 14.2% in 2015. Both countries benefit from financial aid from GCC countries in order to back their economies. There is also a political alliance between Saudi Arabia and Bahrain, which the latter may be able to count on should the currency peg collapse. However this automatic backing may not be the case for Oman.

So far, GCC governments appear to be committed to maintaining the pegging system, as they can manage deficits through their large financial assets and low debt ratios. However, the pegs will continue to be questioned, as long as oil prices remain low.

12 Trade Elasticities in the Middle East and Central Asia: What is the Role of Oil?, 2008, IMF
13 Gulf sovereign bond issues to surge as governments plug deficits, January 2016, Reuters

UAE macro indicators

	2014	2015	2016f
GDP (%)	4.0%	3.4%	2.7%
Current acc. bal. (1)	14.6%	5.8%	1.2%
Budget balance (1)	-2.3%	-5.2%	-4.5%
Public debt (1)	15.7%	19.4 %	18.5%
CPI (yearly average)	2.3%	4.1%	4.5%

(1) % of GDP
Source: Official statistics, IMF, Coface

2 SECTOR BAROMETER

This section will focus on retail and tourism sectors in the UAE. Retail and wholesale trade account for more than 11% of the country's GDP and close to 30% of Dubai's GDP[14]. The UAE is one of the region's retail centres. Retail, as tourism, is an important pillar of the UAE's economic diversification. The UAE has also been successful in establishing itself as a tourism hub in the Middle East. This has helped the country to compensate for falling revenues from the oil sector. According to the World Travel and Tourism Council, the direct contribution of travel and tourism to GDP stood at 64.9 billion dirhams (4.2% of total GDP) in 2015 and is forecast to rise by 4.2% in 2016.
Coface assesses the risks related to sectors based on indicators such as production, demand, corporate profits, exports, growth potential and the payment experiences of Coface entities. The sector risk assessment is divided into four risk categories: moderate, medium, high and very high.
The risk levels for agrofood, retail and textiles & clothing were revised up to high risk, from medium risk. The risk level for the automotive sector has been raised to high risk, from moderate. A common challenge for these sectors is related to the country's tighter financial conditions. Banks are more selective when granting loans and they are reluctant to extend credit facilities for traders, following the increase in bankruptcies in 2015. This situation is harmful to the financial structures of most traders and small manufacturers, due to difficulties in cash flow management when banks stop funding. Profit margins have become extremely narrow.

Sector Risk Assessment

Sectors	UAE	Middle East+Turkey
Agrofood	High Risk	Medium Risk
Automotive	High Risk	Medium Risk
Chemicals	High Risk	High Risk
Construction	High Risk	High Risk
Energy	High Risk	High Risk
ICT	Medium Risk	Medium Risk
Metals	Very High Risk	Very High Risk
Paper-Wood	Medium Risk	Medium Risk
Pharmaceuticals	Low Risk	Low Risk
Retail	High Risk	Medium Risk
Textile-clothing	High Risk	Medium Risk
Transportation	Medium Risk	Medium Risk

Source: Coface

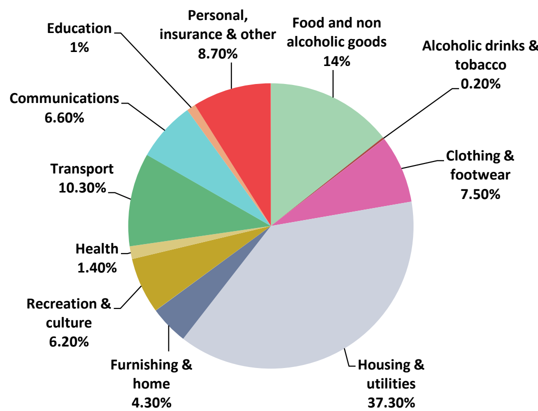
Low Risk Medium Risk High Risk Very High Risk

UAE's retail sector: Funding issues continue, saturation is a problem

Investing in service sectors, such as retail, is an important pillar in the UAE's economic diversification strategy to support economic growth. Higher per capita income perspectives in the upcoming period could encourage greater consumer spending and stem the uncertainties due to the oil sector. An important factor supporting the retail sector is the non existence of value added taxes and sales taxes.
According to Dubai Chamber, retail sales in the UAE reached 173 billion AED in 2014, a growth of more than 6% compared to 2013. This is said to be the equivalent of more than 20,000 retail sales per capita, over the year. Total household spending is forecast to reach 267.1 billion AED (72.8 billion USD) in 2016, up from an estimated 241.8 billion AED in 2015. This growth has been supported by high levels of disposable income and a large consumer base of wealthy local residents, expatriates and tourists[15]. The retail industry currently attracts 23% of total foreign direct investment inflows to the UAE. Despite its saturation, the retail sector still offers investment opportunities, encouraged by the country's robust infrastructure, advanced environment and mega development projects. The UAE is therefore ranked 7th in the 2015 Global Retail Development index (GRDI). This is the second highest rating in the Middle East and North Africa (MENA) region, after Qatar, which is ranked 4th. The UAE's attraction as a regional retail shopping center earned it US based brands Victoria's Secret, Cheesecake Factory, and IHOP in 2012, through franchise agreements.
Housing and utility spending accounts for around 38% of total household budgets. For the low income bracket, housing costs, especially rents, represent the heaviest burden. However, a large number of Emiratis are provided with free, or subsidised, housing by the government. There is also demand from expatriate workers in the housing market, as the UAE continues to be a very attractive location due to its positive business environment, economic opportunities and political stability.

14 Dubai Chamber analysis, April 11, 2016
15 UAE retail report, April 2016, BMI

Chart 7: Retail sector spending, % of total (2016)



Source: BMI

The second largest sub category in the total retail sector, in terms of spending, is food and non alcoholic drinks, estimated to account for 14% total retail spending in 201614. International and domestic hypermarkets, such as Carrefour, Geant and LuLu are dominatinge the market. Spending on food and non alcoholic drinks is expected to increase by 10.8% in 2016, compared to 2015, to reach 10.2 billion USD. Factors for this growth include evolving nutritional tastes, the rise in per capita income and higher demand for healthy food.
Transport, which represents 10.3% of total spending, is mainly allocated to existing transportation options. However, many households have more than one car, as the transportation sector has still has some way to go in terms of development. Public transport in Dubai is expected to represent 30% of all travel movements by 2030 . RATP, the French state owned public transport operator, has signed a partnership (through RATP Dev, its international subsidiary), with Zain Capital LLC, a subsidiary of the Lakhraim Business Group. The joint venture has been created to provide new transportation systems for the UAE.

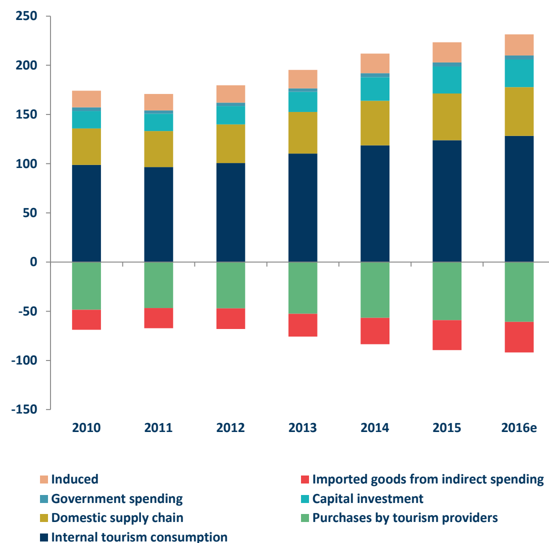
"Given the oil dependent and highly cyclical nature of the region's economies, this situation could weigh on consumer spending"

The main strengths of the UAE's retail sector are its lack of VAT, the competitive and attractive environment for retailers, tourism inflows related to the country's safe haven position within the region, high per capita income, the rising population and solid public spending in retail infrastructures.
There are still challenges, however, for the retail sector. The rising cost of rents is narrowing retail profit margins and a continued decline in oil prices could destabilise retail investments in the long term.
Another key challenge is related to tighter funding conditions. Banks are facing deteriorating liquidity conditions and dollar shortages, as government deposits in the banking system have dropped following the fall in oil prices. As this liquidity problem is impacting many markets simultaneously, funding costs are rising, forcing banks to offer higher rates on deposits. These rising costs for banks are forcing them to be more selective while granting loans and funding is becoming more expensive for businesses including those in the retail sector. Profit margins are thus being negatively affected. Further liquidity problems during the second half of the year, following the tightening of the Federal Reserve's monetary policy, could aggravate funding issues for retailers.
In addition, there is a possibility that the government could introduce VAT in 2018, in line with tighter fiscal policies resulting from weak oil prices. The IMF suggests a 5% sales tax, which would increase costs for retailers. Given the oil dependent and highly cyclical nature of the region's economies, this situation could weigh on consumer spending. A continued decline in oil prices would also destabilise the dynamics of the retail sector in the long run.
Another risk is related to the strong expansion of the retail sector in recent years, which has resulted in the saturation of the market. This intense competition is another factor weighing on profit margins, which needs to be taken into consideration.
The federal nature of the country can also represent challenges for retail companies, due to the various business regulations that can differ across the emirates.

Tourism

The UAE's tourism sectors relies on a range of activities including shopping, desert adventures and balloon tours, sports, culture, marine tourism and medical tourism. Dubai and Abu Dhabi are the two most attractive destinations for tourists and their luxury hotels offer a number of hotel based attractions. The government is also making efforts to promote other emirates, such as Sharjah. The country's political stability, in contrast to that of the surrounding region, is another advantage for tourism.
Tourism is an important source of foreign currency for the UAE. According to the World Travel & Tourism Council's benchmark report in 2015, visitor spending in 2014 totaled 23.5 billion USD the equivalent of 60% of all service exports and 5.4% of all exports including goods and services. In 2015, visitors spent nearly 26 billion USD. This is forecast to increase by 3.3% in 2016, as the UAE is expected to attract more than 15 million foreign visitors. Dubai's government aims to attract 20 million international visitors per year (according to Dubai's Tourism Vision for 2020, which was approved in May 2013).

Chart 8: Total contribution of travel & tourism to the UAE's GDP (AED bn, real 2015 prices)



Source: WTTC

The government's support for the tourism sector is crucial for its development. In order to support the growth of mid range hotels, the government has decided to waive the 10% municipality fee, for an initial period of 4 years from the date of granting construction permits. The waiver applies to properties with construction beginning between 2013 and 2017. Tourism investments are expected to rise by 2.8%, to reach 28.2 billion AED in 2016, according to media reports citing the Minister of Economy, Sultan bin Saeed Al Mansouri. Abu Dhabi officials recently announced that a 231 million USD tourist and entertainment investment, by developers Al Barakah International Investments, has been confirmed. Abu Dhabi Airport Company (ADAC), a public joint stock company, wholly owned by the Abu Dhabi Government, has initiated a vast expansion project for Abu Dhabi airport's Midfield Terminal Building. When completed, the airport is expected to be one of the largest airports in the world. Its capacity is projected to leap from 60 million, to 90 million passengers per year, by 2018.

Nevertheless, challenges remain for the tourism sector. During the first two months of 2016, hotel occupancies remained almost flat in Dubai, compared with a year earlier, at 84%. Increased competition and the strength of the dollar pulled down average daily room rates from 272 USD, to 237 USD during the period[16]. In Abu Dhabi, occupancy rates declined by 2% in the first two months of 2016 compared to a year earlier, despite a 10% increase in guest arrivals[17]. This is a partial indication of the impact of increased competition. Total revenues for hotel establishments decreased by 9% in January-February 2016, while room revenues and food & beverage revenues decreased by 14% and 4%, respectively.

"The country's political stability, in contrast to that of the surrounding region, is another advantage for tourism"

Furthermore, the arrival of new tourists cannot be guaranteed under the current circumstances of the global economy. Lower energy prices, along with the depreciation of the Russian rouble and euro against the dollar, are making the UAE a more expensive destination for Russian and European visitors. This is putting pressure on corporate performance in the hospitality sector. In addition, regional political instability may discourage some tourists from travelling to this part of the world.

The struggling recovery in the global economy has also had negative impacts on the tourism sector, as leisure tourists have less disposable income to spend on travel, while companies are restraining business trips in order to reduce budgets. This has also contributed to a reduction in the average length of stay by visitors.

16 Dubai Real Estate Market Overview, Q1 2016, JLL
17 Monthly Hotel Establishment Report, Feb. 2016, Abu Dhabi TCA

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