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Quarterly Economic Review

Third quarter 2018

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Executive Summary

According to the International Monetary Fund's (IMF) October 2018 World Economic Outlook (WEO), global growth was revised downward to 3.7% for 2018 and 2019, reflecting the rising risks of trade wars and financial vulnerabilities in Emerging Markets. Growth in the US is expected to reach 3% this year as investments and government spending are growing steadily. Other developed countries' growth prospects were also revised downward due to increased uncertainties related to the impact of the trade wars and Brexit for the UK. In Emerging Economies, growth remained resilient at 4.7%, albeit serious pressures continue on some countries facing weakening currencies, imported inflation and capital outflows. The main risks going forward seem to be: (1)Uncertainty about trade wars which may end up compromising the rule-based world trade order, and (2) Rising vulnerabilities in some Emerging Economies facing debt overhang and weakening currencies.

Meanwhile, the Personal Consumption Expenditure (PCE) inflation edged up in the US in line with the Fed's target, which explains the decision to raise the policy rate in September and the Fed's commitment for further rate hikes. In Japan, however, inflation decreased to well below BOJ's target, which reinforces market expectations that the BoJ will have no choice but to cut its inflation forecasts in the coming period. And, the yield on US Treasuries reached new heights by the end of 2018 Q3 in line with the recent hikes in US interest rates.

In the UAE, the quarterly Augmented Economic Composite Indicator of Non-Oil activities, constructed by CBUAE, showed a resilient non-hydrocarbon sector in the third quarter of 2018. The resiliency owes mainly to the recovery in oil prices, supporting fiscal policy and resilient tourism and related activities. Moreover, CPI inflation eased as the impact of VAT and other excise taxes faded while inflation of Non-Tradables moderated as result of continued decline in housing cost. Job creation slowed down, reflecting the slowdown in the economy during the first two quarters of the year.

The UAE banking sector developments in the third quarter of 2018 showed continued growth in deposits, mainly boosted by the increase in Government deposits, in tandem with sufficient liquidity and resilient non-oil activity. This allowed banks to extend credit, particularly to the private sector in line with the improvements in the non-oil activities, thereby boosting private sector credit growth.

The Central Bank's balance sheet exhibited a decline in 2018 Q3, as evident by the decrease in Cash and Bank Balances. On the liabilities' side, the decline took place for Required Reserves, Certificates of Deposits and Currency Issued. Nonetheless, the balance of Certificates of Deposits (CDs) issued by CBUAE and purchased by banks remains high, indicating sufficient liquidity in the banking system. As for the EIBOR, it fluctuated around a slight upward trend in 2018 Q3, while the Spread EIBOR vs. US LIBOR decreased in September, as the latter increased in line with the Fed's decision to increase its policy rate.

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Chapter 1. International Economic Developments

The IMF revised global growth downward to 3.7% in 2018. In the Euro Area, growth is moderating due to fiscal challenges in Italy and the looming risks of trade wars. The lingering uncertainty over Brexit negatively affected the economic performance in the UK. Emerging Economies' growth outlook was also revised downward but remained resilient, thanks to recovery in some resource-rich countries benefiting from higher commodity prices. Inflation of Personal Consumption Expenditures (PCE) reached the Fed's target in the US, which explains the decision in September to raise the Fed's policy rate; the US Treasury yields continued to rise in tandem.

I.1 Global Economic Growth:
According to the International Monetary Fund's (IMF) October 2018 *World Economic Outlook* (WEO), global growth projection for both 2018 and 2019 was revised downward to 3.7%; i.e., 0.2 percentage points below April's projections. The downward revision was mainly due to risks from trade wars, regional disturbances, increasing commodity prices for importing countries, and rising vulnerabilities. Growth in Emerging Market and Developing Economies was also revised downward by 0.2 percentage points; but, it remains at 4.7% for both 2018 and 2019. The main source of the downward revision is attributed to the trade tariffs levied on China and other economies in emerging Asia, and increasing oil prices, which deteriorated the terms of trade and increased the import energy bill for some large economies like China and India.

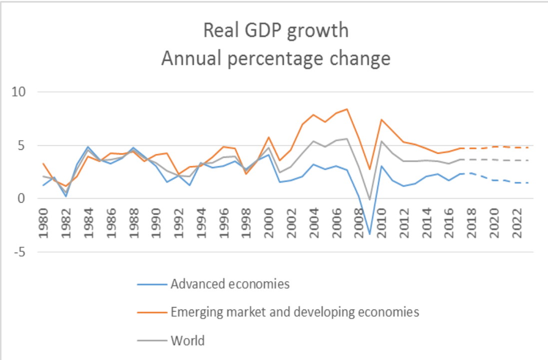
Table. 1.1 Y-o-Y Real GDP growth in Advanced Countries

	2016	2017	2018		
			Q1	Q2	Q3
USA	1.5	2.3	2.2	4.2	3.5
Euro Area	1.8	2.3	2.3	2.2	1.7
France	1.2	1.8	2.1	1.7	2.2
Germany	1.9	2.5	2.0	1.9	
UK	1.9	1.8	1.2	1.3	
Japan	0.9	1.7	1.0	1.3	0.4
China	6.7	6.9	6.8	6.5	6.5

Source: US data: BEA, Euro Area: Eurostat, France: INSEE, Germany: Federal Statistical office, UK: Office for National Statistics, Japan: Cabinet Office.

The outlook for the US growth remained robust, increasing Y-o-Y by 3.5% in the third quarter of 2018 (see table 1.1). The main drivers behind growth are the surge in inventory investment and solid government spending. Business investment, however, slowed down reflecting a weakening effect of tax cuts that was more evident during the first half of the year. By the end of 2018, the US economy is expected to achieve or even exceed 3% growth, bolstering the Fed's drive to further increase its policy rate at the FOMC meeting in December and beyond.

Figure 1.1. Real GDP growth for selected group of economies



Source: IMF

In the UK, the Bank of England lowered its growth forecast from 1.4% to 1.3% in 2018 and from 1.8% to 1.7% in 2019. The downward revision follows the worsening situation in the labor market where the number of active people claiming unemployment benefits increased to reach 943,000 in September.

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For the **Euro zone,** growth was revised downward from 2.3% in 2018 Q1 to 2.2% in Q2 and to 1.7% in Q3 due to uncertainties following the deterioration of Italy's fiscal position. The escalating trade tension between the US and China—the latter being the major destination for European machine parts and cars—negatively affected growth prospects in the Euro zone. Further, Germany's real growth remained below 2% owing to the softening in the performance of the car industry, while France managed to increase its Y-o-Y growth from 1.7% in Q2 to 2.2% in Q3 due to increasing households' consumption among others.

Rising concerns about trade wars continue to affect global growth prospects. During the third quarter, the US Administration declared that more tariffs are needed to protect intellectual property of US business and to reduce the US trade deficit with China. As a result, a 25% tariff was imposed by the US in August on additional $16 billion worth of imports from China, followed by a third round of tariffs on additional $200 billion on 24 September. As a response, China responded with a sequence of tariffs on $16 billion in August and $60 billion in September affecting imports of US goods. Meanwhile, the effect of tariffs imposed during the first half of the year started to affect the global growth; accordingly, the IMF revised the global growth outlook downward in its October 2018 World Economic Outlook issue.

In Japan, Y-o-Y GDP growth was 0.4% in 2018 Q3, down from 1.3% in Q2 mainly due to disruption from natural disasters, which hampered exports and consumption. Therefore, the Japanese growth for 2018 as a whole may be lower than the 1.1% forecast by the IMF last October. Moreover, according to the Bank of Japan's quarterly Tankan Business Survey, sentiment among large manufacturers fell in the third quarter of 2018 for the third straight period, with the index dropping from 21 in Q2 to 19 in Q3—the positive reading means optimists outnumber pessimists.

Growth projections for Emerging Economies were also revised downward, albeit growth remains at 4.7%, both in 2018 and 2019, thanks to higher growth in some commodity exporting countries as well as resilient export prospects for some others. The slowdown in Q3 is due to serious pressures observed in some countries where currencies weakened, in tandem with inflation and debt overhang; and outflows continued on the back of further worsening outlook.

China's annual real GDP growth was below expectations, at 6.5% in 2018 Q3, as the government is trying to restrain borrowing of state owned enterprises and the rising concerns from the country's trade war with the US. Industrial production of September grew at 5.8% compared to the previous year. Meanwhile, retail sales grew by 9.2%, 0.2% above expectations. The growth of the Chinese economy remains stable despite the above listed challenges.

For India, the economy is expected to grow by 7.3% for 2018, according to the IMF, making it the highest growth performer among emerging economies. Nonetheless, there is a noticeable slowdown in Q3 and the Consumer Confidence Index published by the Reserve Bank of India fell from 98.3 in June to 94.8 in September.

In the region of the Middle East, North Africa, Afghanistan, and Pakistan (MENAP)[1], as defined by the IMF, economic growth is up from 2.2% in 2017 to 2.7% in 2018 owing mainly to higher oil prices favoring resource-rich countries.

In the GCC, real non-oil GDP growth continues to improve in 2018 on the back of recovery in oil prices and a more gradual pace of fiscal consolidation. The Saudi growth advanced from 1.2% in Q1 of 2018 to 1.6% in Q2 of 2018. According to the IMF, growth is projected to be at 2.2% in 2018, thanks to higher oil prices and supporting fiscal policy undertaken by the government to further diversify the economy and implement its Vision 2030. The PMI in the non-oil private

[1] MENAP oil exporters: Algeria, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Yemen. MENAP oil importers: Afghanistan, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Sudan, Syria, and Tunisia.

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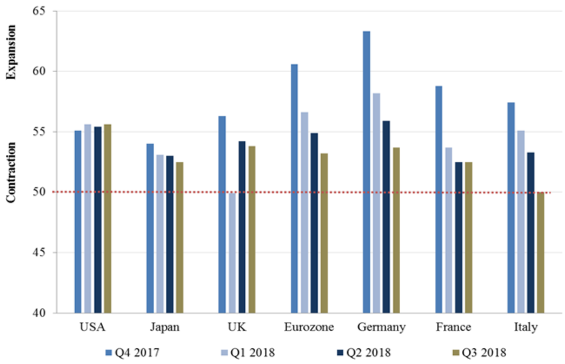
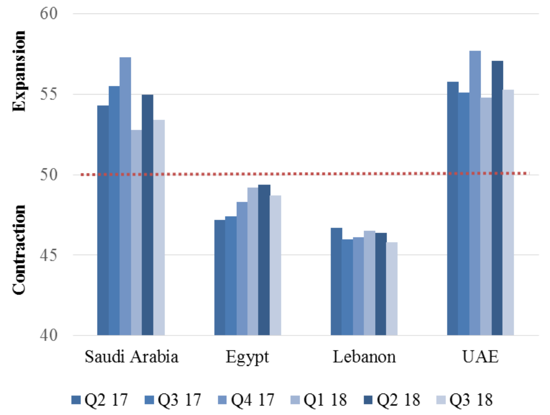
sector averaged 54.5 in Q3 from 53.2 in Q2 of 2018.

Figure 1.2. PMI Levels for Selected Countries



Source: Bloomberg

Figure 1.3. PMI levels for selected MENA countries



Source: Bloomberg

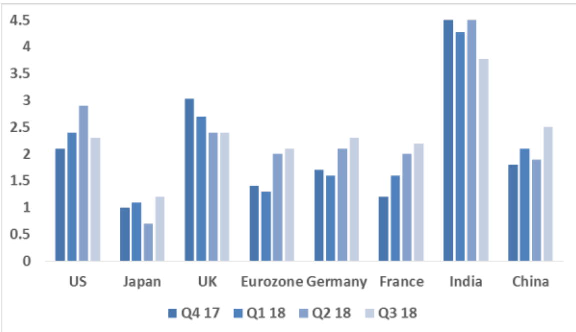
I.2 Inflation:

In the US, the core PCE inflation (The Fed's official target for inflation) reached 2% Y-o-Y at the end of Q3, up from 1.9% at the end of Q2. While the consumer CPI inflation reached 2.3% at the end of Q3 2018, compared to 2.9% at the end of the previous quarter. It is the lowest inflation rate since February, mainly due to the slowdown in gas prices and a moderate increase in fuel and shelter costs. Prices of gasoline slowed down by 9.1%, while prices of fuel decreased by 23.4% at the end of the third month of Q3. Meanwhile, the core CPI inflation (excluding volatile food and energy prices) has reached 2.2% as unemployment rates are evaluated at low multi-decade records. Price pressures may increase further in the coming period as import prices rise in the US due to the tariffs imposed by the Trump Administration.

As the commodity prices continue to increase, inflation is expected to rise this year across both advanced and emerging markets. For instance, Japan Y-o-Y CPI inflation increased to 1.2% at the end of the third quarter compared to 0.7% for the previous period. Eurozone's inflation increased by 0.1 percentage point to 2.1%. China's CPI increased to a seven-month high to reach 2.5%, matching market consensus (see figure 1.4).

In the MENA region, higher oil prices generally led to higher inflation given the importance of energy and transportation costs in the CPI basket. According to the Arab Monetary Fund's (AMF), *Arab Economies Outlook* September report, inflation in the region is expected to reach 11.4% for 2018 and 8.3% for 2019. For GCC countries, inflation is expected in the range of 3% and 1% for 2018 and 2019 respectively. Whereas inflation for major oil-exporting Arab countries—excluding GCC—is expected to reach 7.6% for 2018 and 6% for 2019. Finally, for oil-importing countries' inflation, is expected to reach 11.4% in 2018.

Figure 1.4. Year-on-Year Consumer Price Change for Selected Developed and Emerging Economies (%)



Source: Bloomberg

I.3 Prices of commodity and precious metals

The third quarter witnessed a continuation of the general mixed movements in commodity prices since the previous quarter. Prices of Brent crude oil decreased slightly during the beginning of the third quarter owing to worries about ongoing global trade disputes that could slowdown global growth, lower oil demand and appreciate the US dollar. Compared to the third quarter of 2017, Brent prices increased by 44%.

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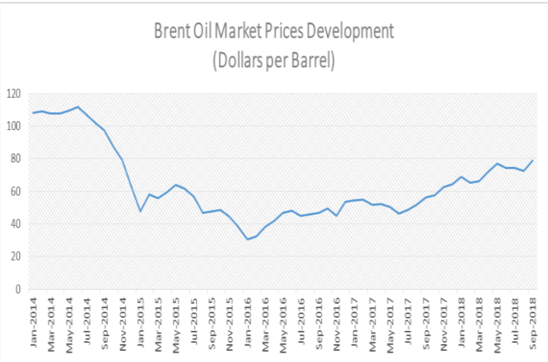
On average, Brent prices decreased to 72 dollars per barrel in August, compared to 74.25 dollars per barrel in July, before jumping to almost 79 dollars per barrel in September.

Concerning global oil demand, it is expected to grow by 1.62 million barrels per day in 2018, reaching 98.82 million barrels per day. According to OPEC's October *Monthly Oil Market Report*. For 2019, global oil demand was revised downward by 20 mb/d, reflecting less optimistic economic projections for the year. Besides, non-OPEC oil supply growth is estimated to reach 2.22 mb/d, where the major countries driving this growth are the US, Canada, Kazakhstan, and Brazil. The 2019 non-OPEC supply is forecasted to average 61.89 mb/d for the year.

World annual consumption has increased, compared to the second quarter, by 1.2% reaching 100.61 mb/d. Annual consumption for both the US and Europe slightly increased indicating improved economic activity; however, China's consumption fell by 2% during the same period (Table 1.2).

Meanwhile, a stronger dollar and stagnant investor demand continued to push the metal prices down throughout the third quarter. Compared to the third quarter of 2017, silver price fell by 12% this quarter. Further, gold price also decreased by 7% during the third quarter despite market volatility and high inflation. Whereas, natural gas price remained stable during this quarter.

Figure 1.5. Brent Crude Oil Market Prices Development



Source: EIA.

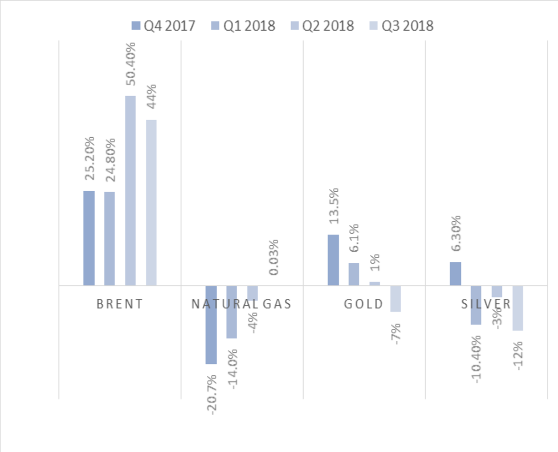
Table. 1.2 Annual Consumption in major economies

In million barrels per day

Country	2016	2017	2018			2019
			Q1	Q2	Q3	
China	12.8	13.4	13.8	14.0	13.7	14.3
U.S.	19.7	20.4	20.2	20.3	20.5	20.6
Europe	14.0	14.3	14.1	14.2	14.6	14.4
World	96.9	98.6	99.3	99.5	100.6	101.3

Source: Short-Term Energy Outlook, October 2018.

Figure 1.6. Selected commodity price levels (Y-o-Y, % change)



Source: Bloomberg, EIA.

I.4 Policy Interest Rates:

As the global growth momentum continues to gain strength, policy normalization has come into focus. The Federal Reserve (Fed) continued during the third quarter, ahead of its peers, on the pace of policy normalization. The Fed's Open Market Committee (FOMC) decided on its September 25th meeting to increase its benchmark by a quarter percentage point to the range 2-2.25 percent (Figure 1.7). Furthermore, data support improved economic outlook in the US, which would support the Fed to persist on the course of increasing the Federal Funds Rate (FFR). Most Fed officials predict interest rates to reach above 3 percent by the second half of 2019.

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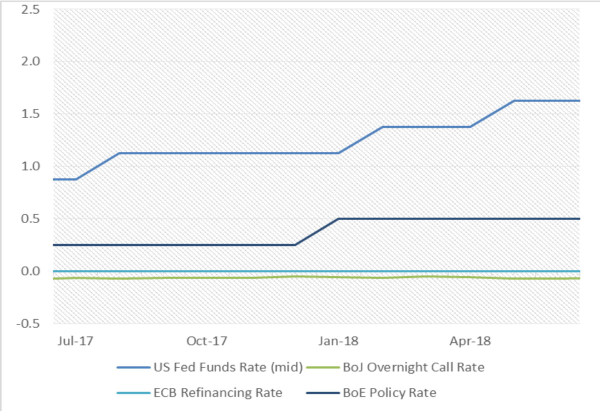
Figure 1.7. The Policy Interest Rates for Selected Advanced Countries



Source: Bloomberg

Meanwhile, during the third quarter of 2018, the European Central Bank's Governing Council maintained unchanged the policy interest rates on refinancing operations, the marginal lending facility and the deposit facility, at 0.00%, 0.25%, and -0.40%, respectively, in line with market expectations. The Governing Council reiterated that the monthly pace of the net asset purchases would be reduced to €15 billion from September to December 2018. The ECB expects key interest rates to remain unchanged at least through the summer of 2019.

During its September 19th meeting, the Bank of Japan kept its short-term interest rate unchanged at -0.1 percent while targeting the 10-year Japanese government bond yield at around zero, emphasizing healthy economic activity despite trade tensions.

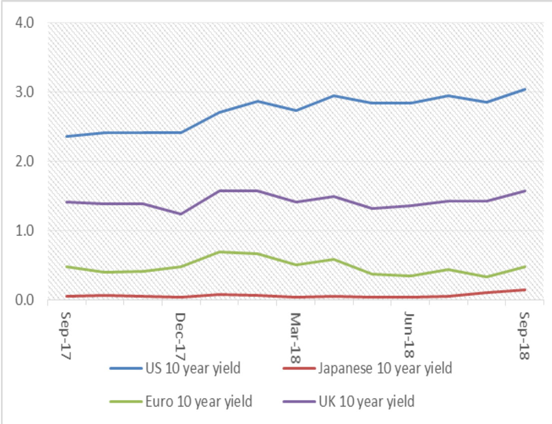
Government Bond yields:

The yield on 10-year US Treasury reached new highs of 3.04% at the end of September compared to 2.95% at the end of April, on the back of increasing trade tensions between China and the US and in line with rising policy rates and inflationary expectations. During mid-September, the yield on the benchmark rose by five basis points as the US administration announced 10 percent tariffs on about $200 billion worth of imports from China.

The UK 10-year bond yield rose to the highest level, 1.7%, since more than two years amid growing optimism regarding the conclusion of a Brexit deal.

Meanwhile, the Japanese 10-year government bond yield inched to 0.15%, reaching fresh two years high.

Figure 1.8. The 10-year government bond yields for selected countries (%)



Source: Bloomberg

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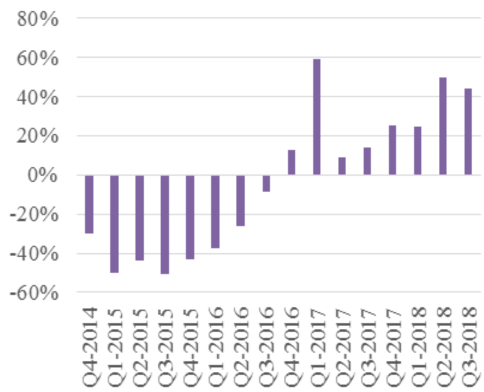
Chapter 2: Domestic Economic Developments

According to the quarterly Augmented Economic Composite Indicator of non-oil activity for the UAE, the pace of economic growth started to pick up in the third quarter of 2018 backed by the recovery in oil production and prices, supporting fiscal measures, and an improved market sentiment in the private sector. Meanwhile, CPI inflation rates rose slightly from the previous quarter following the increase in tradable prices. In parallel, inflation rates in the non-tradable sector slowed down, reflecting the continued decline in housing and CPI inflation.

2.1. Economic Activity and Growth

The continued expansion in the global economy, led by the growth rate in the US, partially contributed to the rise in oil prices in international markets Y-o-Y by 44.4%; reaching $75.22 per barrel in Q3 2018 (see Figure 2.1.a). Higher oil prices were also driven by growing concerns over global oil supply shortages from several regions and by higher geopolitical tensions.

Figure 2.1.a Brent crude oil prices (%, Y-o-Y)



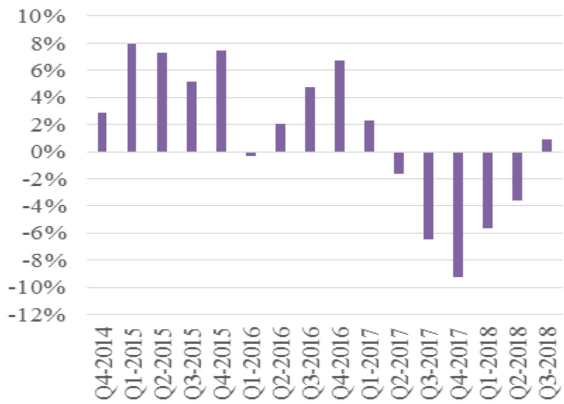
Source: EIA

Furthermore, UAE oil production increased as OPEC members agreed to a balanced and stable global oil market to compensate for the loss of Iranian exports, in anticipation of prospective sanctions, on the heels of tight supply, in conformity to the OPEC initial agreement to limit production that took effect in January 2017 among OPEC members and Russia. The pickup in global demand pressured oil prices against the backdrop of tight supply.

The direct and indirect effects of the commitment to raise oil production in the UAE have weighed positively on UAE real growth rates.

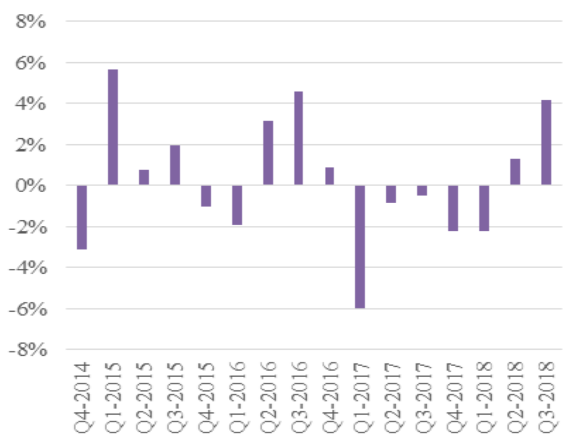
Real growth in the UAE—proxied by the CBUAE quarterly Augmented Economic Composite Index (AECI)—showed an increase of 3.1% in Q3 2018 Y-o-Y compared to a moderate 2.1% increase in the previous quarter (For AECI Methodology please refer to box 1 of Q2 report). Real oil GDP increased Y-o-Y by 2.7% in Q3 2018 compared to a decline of 0.6% in Q2 2018.

Figure 2.1.b UAE's Oil Production Growth (%, Y-o-Y)



Source: EIA and Bloomberg

Figure 2.1.c UAE's Oil Production Growth (%, Q-o-Q)



Source: EIA and Bloomberg

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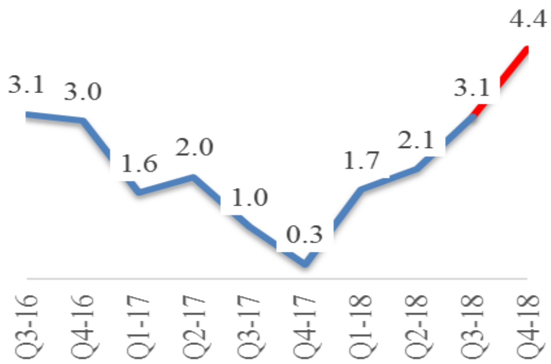
Further, the non-oil real GDP remained robust and growth stood Y-o-Y at 3.3% in both Q2 2018 and Q3 2018 following a 3.2% increase in Q1 2018. The recovery of the growth momentum also manifests through a set of economic sentiment indicators: (i) a stronger Purchasing Managers' Index (PMI), which reached 54.4 in September 2018; (ii) the dynamics of Dubai Economic Tracker (DET), which highlights a competitive market environment as it stabilized at 55.1 in September 2018; (iii) the announced Federal government stimulus packages, see Box 1; (iv) the adopted measures related to granting visas to investors and professionals, see Box 1; and (v) the increase of private credit, particularly to corporates (see Chapter 3) at the end of September 2018.

Figure 2.1.d Overall Augmented Economic Composite Indicator (%, Y-o-Y)



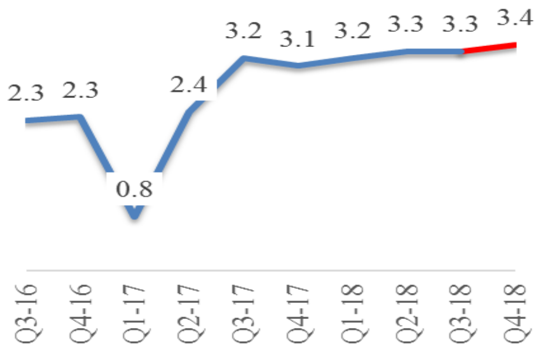
Source: CBUAE

Based on the AECI index dynamics, overall RGDP growth is projected to register Y-o-Y 4.4% in Q4 2018 supported by a 6.7% growth in the oil sector, due to a production base effect and higher price levels, and a 3.4% increase in the non-oil sector in the same quarter. Accordingly, overall real GDP growth is projected to reach 2.8% in 2018 driven by a growth of 1.7% and 3.3% in the oil and non-oil sectors, respectively.

Furthermore, growth projections for 2019 show that economic activity will improve in the non-oil sector due to expected higher oil prices, more oil production, and the effects of the announced fiscal stimulus packages, underpinned by the strong fundamentals.

Overall, real GDP is expected to grow by 4.2% in 2019 as oil and non-oil sectors are projected to grow by 5.2% and 3.7%, respectively. Box 2 illustrates the projections of the CBUAE for output growth and inflation. Box 3 illustrates recent developments in the real estate sector in the Emirates of Abu Dhabi and Dubai while Box 4 Illustrates UAE competitive rankings.

Figure 2.1.e Non-Oil Augmented Economic Composite Indicator (%, Y-o-Y)



Source: CBUAE

Box 1: Planned Fiscal Stimulus Packages by the Government and Selected GREs in the UAE

In support of projections of higher non-energy growth in 2018 and 2019 are planned additional stimulus packages put forward by the Federal and Local Governments and selected GREs. This box provides an overview of the announced stimulus packages by the Abu Dhabi government, Dubai government, and a new initiative to increase In-Country Value (ICV) of the total spending by the Abu Dhabi National Oil Company (ADNOC).

During the first half of the year, the federal government announced new measures of relaxing foreign ownership requirements and the introduction of ten-year visas to stimulate the private sector and promote tourism. The new visa system, which benefits all foreigners in the UAE, offers up to a 10- year visa for experts in medical, research, and technical fields. Furthermore, foreign students will have the option to obtain a 10-year visa and up to 2 years training following the completion of their studies. Job seekers are also included in the new regulation and will be able to obtain 6-month visa. As a result, working capital will increase and non-residents will have more opportunities for them and their families in the UAE. In addition, the government also stated a landmark law allowing foreign investors to own 100% of companies in the UAE, which will increase foreign direct investment (FDI), boosting the non-oil sector.

Abu Dhabi 50 billion stimulus package

The government of Abu Dhabi approved on the 6th of June 2018 50 billion AED (13.6 billion USD) economic stimulus package, as well as 10 economic initiatives to ease the cost of doing business and to accelerate the non-oil GDP of the emirate over the next three years. According to a report published by the government of Abu Dhabi, the package includes 10 economic initiatives aimed to help generate more business activity, enhance the economic environment in support of higher share of private sector economic activity and address the structural bottlenecks.

The initiatives include a plan that covers increased spending on infrastructure and legislative projects, supporting SMEs, and industrial and social projects. As part of the plan, the government plans to increase employment by creating 10,000 jobs for Emiratis in the private and public sectors over the next five years.

Higher employment target is aligned with steps to boost the competitiveness of SMEs on the local and regional levels. In addition, a new regulation was issued to exempt all new licenses from the requirement of having a physical space for two years, and permitting permanent home licenses, as well as the implementation of instant licensing systems in most commercial licenses types. The stimulus package also includes directives to accelerate the settlement of due payments on contracts for suppliers from the private sector, and to review all fines for the healthcare and education sectors. The collective measures are aimed at easing the cost of starting and doing business in the Emirate of Abu Dhabi.

To facilitate implementation and coordination of the stimulus package, the government ordered the establishment of the Abu Dhabi Accelerators and Advanced Industries Council, "Ghadan" to attract and support value-added investment and technologies that would predict and lead the development of Abu Dhabi's economy on the local and regional stages.

Finally, the government stressed on the importance of supporting the development of the local economy by launching policies that would promote partnership between the public and private sectors to accelerate active collaboration between the two sectors.

Dubai fiscal stimulus initiatives

The government of Dubai announced several initiatives to stimulate growth focusing on reducing costs of key industries for Dubai such as aviation, real estate, and education. At the core of the cost reduction is reducing the cost of doing business and lowering taxes to help foster additional spending by the private sector, instead of increasing government budget spending. The initiatives include cutting fees imposed by the Dubai Government on municipality for commercial entities by 50%, cancelling 19 fees related to the aviation industry and aircraft landing permits, waiving 4% overdue property registration fees imposed by the Dubai Land Department, and immediate freeze on tuition fees of all private schools in Dubai for 2018-2019.

ADNOC In-Country Value Initiative

The Abu Dhabi National Oil Company (ADNOC) implementation of the In-Country Value (ICV) program will support the economy through diversification, building more industrial clusters, Emiratization, and strategic localization of its supply chain. ADNOC 5-year plan will localize around 40% of the total awarded contracts, which are estimated to be USD 131 billion. The program mainly aims to create opportunities for both international and local business to further participate in ADNOC's projects and stimulate the non-oil sector. The ICV program is an extension of ADNOC 2030 smart growth strategy that aims at increasing its operational efficiency, profitability and sustainability.

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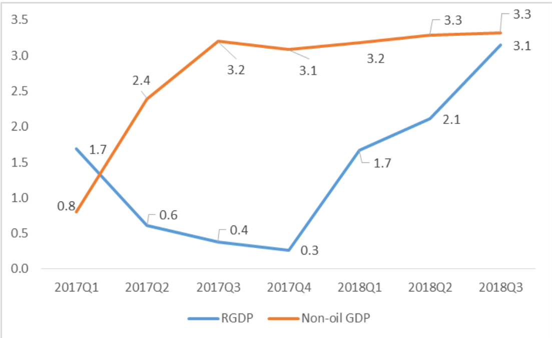
Box 2: Economic growth and inflation projections

The CBUAE uses the AECI to proxy the performance of the non-oil economy (see Box 1 in the report of the second quarter of 2018 for details on the methodology). The Central Bank continues to revise its index, based on available quarterly data at the Emirate level, and consequently updates the quarterly real growth. Based on the above, real non-oil GDP economic growth is estimated at a value of 3.3% in Q3 2018 compared to a 3.2% growth during the same period a year ago.

Accordingly, the non-oil RGDP increased annually, by 3.3% in the first three quarters of 2018, on average, compared to a 2.1% average growth during the same period a year ago.

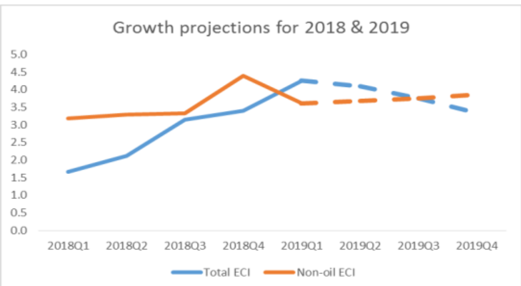
Figure 1: RGDP & non-oil GDP 2018 (y-o-y%)



Source: CBUAE

The CBUAE projects that the non-oil GDP economic growth in Q4 2018 will reach 3.4% and continue its upward trajectory in 2019, growing by 3.7% in 2019 compared to a projected growth of 3.3% in the current year. The announced fiscal stimulus packages (See Box 1) will help lift economic growth, increase consumption, revitalize the property market, and improve labor markets as the investors and consumers sentiment continues to solidify.

Figure 2: RGDP & non-oil GDP 2018 & 2019



Source: CBUAE

Hence, real GDP growth rates are projected to reach 2.8% in 2018 and 4.2% in 2019 supported by stronger fundamentals of the economy and the increase in UAE oil prices and production.

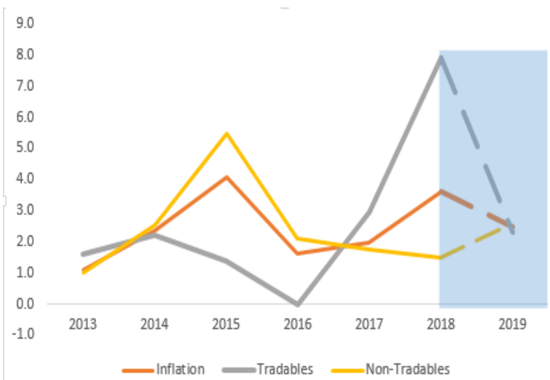
Projections of inflation

The inflation rate, measured by the Consumer Price Index (CPI), rose during the third quarter of 2018 to reach 3.6% compared to an annual increase of 3.4% in the previous quarter underpinned by the increase in oil prices in international markets. Accordingly, the price of transportation increased as the effects of fuel subsidy reforms and revenue enhancement measures adopted by the government in 2017 that imposed excise taxes on beverages and tobacco, followed by VAT taxes in the beginning of 2018.

The CBUAE projects inflation to reach Y-o-Y 3.6% in 2018 owing to an expected increase in oil and hence fuel gas prices. The sustained levels of international commodity prices will reflect on the tradable prices (projected to grow by 7.9%). However, the continued downward trajectory of the housing CPI inflation and the continued easing in labor markets for the remainder of this year will contain inflationary pressures for non-tradable goods, yielding an inflation rate of 1.5%.

As for 2019, the CBUAE projects that inflation will ease to reach 2.5%, due to some projected softening in oil prices. Prices of tradable goods and services are projected to grow at 2.3% as the VAT inflationary effect fades, whereas non-tradable price inflation would increase by 2.6% in line of projected recovery in non-energy growth and employment.

Figure 3: inflation forecasts in 2018 & 2019



Source: CBUAE

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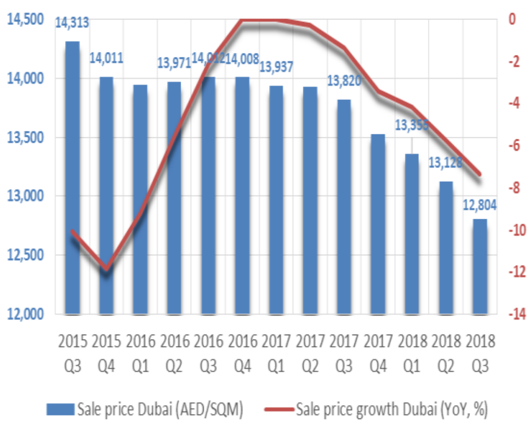
Box 3: Recent Developments in the Real Estate Market

According to recent data from REIDIN Price Index[1], the UAE residential Market continues to decline in the third quarter of 2018. In Dubai, on an annual basis the property prices decreased by 7.4% and a decline of 2.5% compared to the previous quarter was recorded with an average price of AED 12,804/m². In Abu Dhabi, the annual drop in property prices was 6.1% and 1.8% fall compared to the previous quarter as the average price reached AED 11,476/m². The rental yield, which measures the rate of income return over the cost associated with an investment property, decreased slightly in Dubai to 6.81%, as well as in Abu Dhabi by 0.1 percentage points to reach 6.77%.

Dubai residential Market

In the third quarter of 2018, real estate property price, which measures the average sample price in AED per square meter of residential properties, decreased by 7.4% Y-o-Y compared to 5.8% decline in the previous quarter (Figure 1).

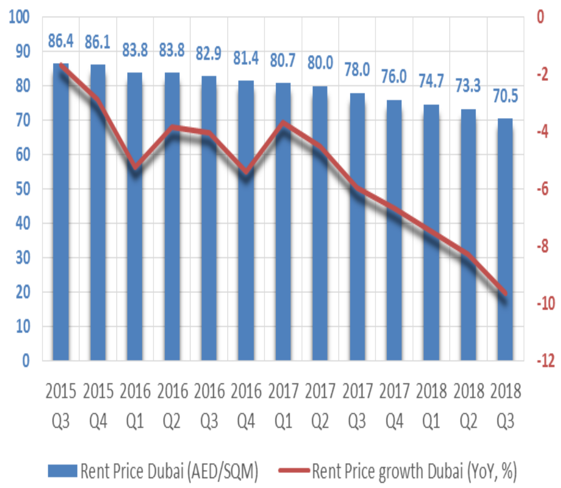
Figure 1: Dubai Residential Sale Prices



Source: REIDIN

The Dubai market continues to exhibit decline in rent (Figure 2) due to excess supply, relative to slower demand. The rent prices declined by an annual rate of 9.6% in the third quarter of 2018, following a decrease of 8.3% in the previous quarter.

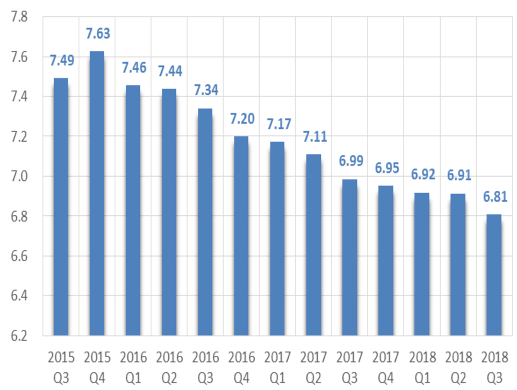
Figure 2: Dubai Residential Rent Prices



Source: REIDIN

Concerning investment in Dubai's real estate market, the rental yield has been on a downward trend since 2015 Q4 and more recently, it further declined to 6.81% (Figure 3), due to the faster decline in rents, relative to sale prices. However, the yield remains attractive for investors.

Figure 3: Dubai rental yield (%)



Source: REIDIN

Abu Dhabi residential Market

For Abu Dhabi, the REIDIN Price Index exhibited a continued fall in residential property prices, albeit at a more moderate rate of 6.1% Y-o-Y in the 2018 Q3 following a decrease of 6.9% in the previous quarter (Figure 4).

[1] REIDIN 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.

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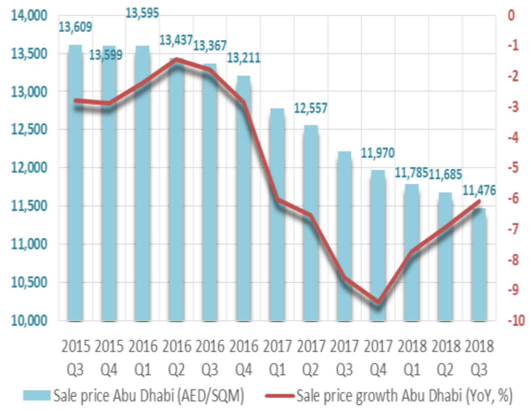
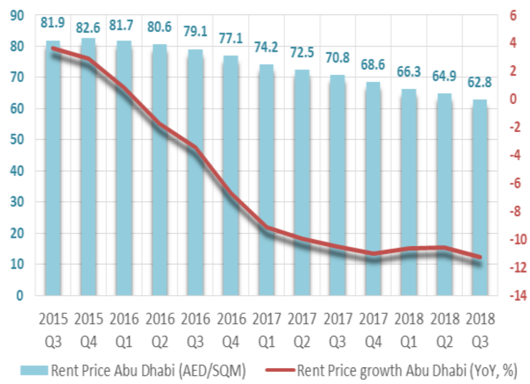
Figure 4: Abu Dhabi Residential Prices



Source: REIDIN

As for the rental market, the rent values in Abu Dhabi continued to decline by an annual rate of 11.3% on average in the third quarter of 2018, after a reduction of 10.6% in the previous quarter. This trend is reflecting the impact of softer job market, which continues to weigh in on demand in the housing market (Figure 5).

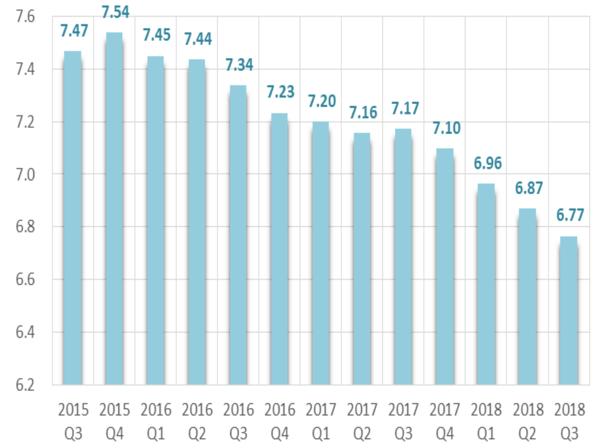
Figure 5: Abu Dhabi Residential Rent Prices



Source: REIDIN

Concerning the rental yield, Abu Dhabi registered a yield of 6.77% for 2018 Q3, wich reflects a marginal decline of 0.1 precentage points from the previous quarter (Figure 6). The observed pattern in rental yield reflects a constant pace of decline in rent along with continued decline in demand with the moderate growth of the job market indicators, which has weighed in adversely on the investment sentiment in properties.

Figure 6: Abu Dhabi rental yield (%)



Source: REIDIN

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Box 4: The UAE Ranking in Ease of Doing Business and Global Competiveness

International rankings are published on a regular basis to establish the relative position of countries in competitiveness. In what follows, Section I presents UAE performance in *Ease of Doing Business* Ranking published by the World Bank. Section II is a comparison between the UAE and other GCC countries in *Global competiveness* Index published by the World Economic Forum. Section III presents the UAE performance in the main pillars. Section IV presents the remaining challenges for the UAE.

I. Ease of Doing Business Ranking

According to the *Ease of Doing Business 2019 report*, published by the World Bank, the UAE ranking improved from 21 worldwide in the 2018 report to the 11th rank out of 190 countries in the 2019 report. The UAE topped GCC countries followed by Bahrain (62), Oman (78), Qatar (83), Saudi Arabia (92), and Kuwait (97). The factors that improved the UAE ranking are: (1) Starting a business, where the country improved from 51 in 2018 report to 25 in the 2019 report. (2) Getting electricity, where the country stayed 1st worldwide in 2018 and 2019. (3) Registering property, where the country improved from 10 to 7, (4) Getting credit, where the country improved from 90 to 44, and (5) Enforcing contracts, where the country improved from 12 in the 2018 report to 9 in 2019 report.

Table 1. GCC countries rankings in *Ease e of doing business*

Country	2015	2016	2017	2018	2019
UAE	22	31	26	21	11
Qatar	50	68	83	83	83
Saudi Arabia	49	82	94	92	92
Oman	66	70	66	71	78
Bahrain	53	65	63	66	62
Kuwait	86	101	102	96	97

Source: World Economic Forum

II. UAE/GCC Ranking in the *Global Competiveness Index*

As regards the *Global Competiveness* Index for 2018 published by the World Economic Forum, the UAE ranked first among the GCC countries, maintaining the rank of 27 out of 140 countries followed by Qatar (30), Saudi Arabia (39), Oman (47), Bahrain (50), and Kuwait (54) (see table 2).

Table 2. GCC countries rankings in 2018 Global Competitiveness Index

Country	2017	2018
UAE	27	27
Qatar	32	30
Saudi Arabia	41	39
Oman	61	47
Bahrain	46	50
Kuwait	56	54

Source: World Economic Forum 2018

III. UAE Performance

The UAE Global Competitiveness ranking in 2018 is supported by rankings in the following sub-categories: (1) Macroeconomic Stability where the UAE ranked first worldwide (2) ICT Adoption where the UAE ranked 6th, which focuses on the use of internet and mobile telephony, (3) Product Market Efficiency, where the UAE ranked 11 in the pillars which focus on the distortive effect of taxes and subsidies, competition, and prevalence of non-tariff barriers, (4) Infrastructure where the UAE ranked 15th, thanks to the Quality of Roads where it ranked 9th and Efficiency of Air Transport Services where it ranked 7th, (5) Institutions where the UAE ranked 19th, thanks to Low Burden of Government Regulation where the UAE ranked 3rd and the Future Orientation of Government where it ranked 4th.

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IV. Remaining Challenges

The most challenging pillars for the UAE going forward should focus on: (1) Scientific Publications where the UAE ranked 63rd, (2) Non-Performing Loans, where the UAE ranked 74th, (3) the Cost of Starting a Business, where the UAE ranked 89, (4) the Insolvency Recovery Rate, where the UAE ranked 90th , (5) Workers' Rights where the UAE ranked 116th , (6) Female Participation in the Labor Force where the UAE ranked 117th, and (7) the Credit Gap where the UAE ranked 118th. The latter is computed as the difference between the latest domestic credit to the private sector (as percentage of GDP) and its trend.

Table 4: GCC countries performance in 2018 Global Competitiveness Index

Pillars	UAE	Qatar	Saudi Arabia	Bahrain	Kuwait	Oman
Institutions	19	31	39	42	57	36
Infrastructure	15	26	40	30	61	24
Technological readiness/ICT adoption	6	9	54	38	62	61
Macroeconomic Stability	1	40	1	119	1	58
Health	79	40	64	74	38	65
Skills	53	38	30	28	79	36
Product Market	11	25	32	28	69	33
Labour Market	42	54	102	46	120	93
Financial System	31	34	45	33	48	56
Market size	28	51	17	90	54	62
Business Dynamism	33	40	114	54	96	52
Innovation Capability	35	37	41	72	103	86

Source: World Economic Forum

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2.2 Consumer Price Index and Inflation

Headline inflation, measured by the Consumer Price Index (CPI), rose Y-o-Y by 3.6% in the third quarter of 2018 compared to a 3.4% increase in Q2 2018. The level of inflation remained higher than in 2017 due to the effects of VAT implementation and other excise taxes on Tobacco and Alcohol beverages that were introduced by the end of 2017 (see table 2.2).

Table 2.2. UAE CPI inflation (%, Y-o-Y)

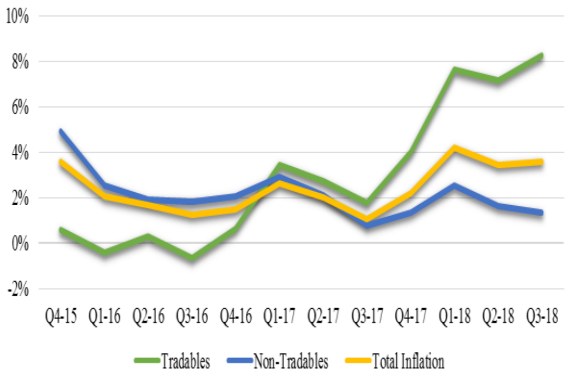
	Weight	Y-o-Y			
	%	Q4-17	Q1-18	Q2-18	Q3-18
Total Inflation	100	2.2%	4.2%	3.4%	3.6%
Tradables	34	4.0%	7.6%	7.1%	8.2%
Food and soft drinks	14.3	2.5%	6.2%	3.4%	2.9%
Beverages and tobacco	0.3	70.2%	84.2%	84.1%	86.5%
Textiles, clothing and footwear	3.2	0.7%	8.6%	14.0%	20.0%
Furniture and household goods	5.6	0.4%	4.2%	4.6%	5.3%
Transportation	7.3	6.2%	10.7%	11.3%	15.7%
Miscellaneous goods and services	3.2	9.1%	5.0%	4.8%	2.7%
Non-Tradables	64	1.3%	2.6%	1.7%	1.3%
Housing	34.1	0.2%	-0.7%	-2.5%	-4.0%
Medical care	1.4	0.4%	0.0%	0.1%	-0.1%
Transportation	7.3	6.2%	10.7%	11.3%	15.7%
Communications	5.4	-0.9%	3.2%	3.8%	3.7%
Recreation and culture	3.2	-5.5%	6.9%	9.4%	10.5%
Education	7.7	3.6%	4.7%	4.6%	4.8%
Restaurants and hotels	4	0.6%	9.1%	6.7%	7.4%
Miscellaneous goods and services	3.2	9.1%	5.0%	4.8%	2.7%

Source: Federal Competitiveness and Statistics Authority (FCSA).

Prices of tradables, which account for around 34% of the consumption basket, were the main contributor to the increase in headline inflation in Q3 2018 as it increased Y-o-Y by 8.2% compared to an increase of 7.1% in the second quarter of 2018.

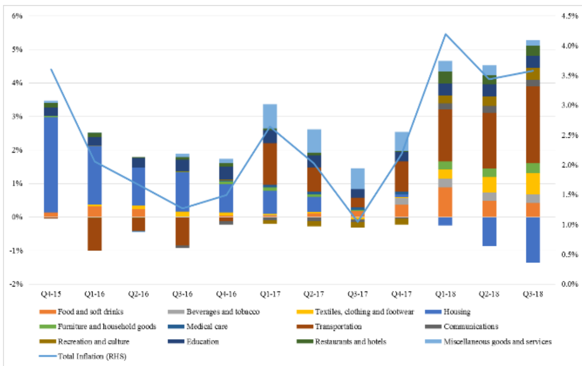
The rise in prices of tradables was boosted by the pickup in Transportation prices Y-o-Y by 15.7% in Q3 2018 compared to 11.7% increase in the previous quarter. Higher transportation price inflation is consistent with the rise of oil prices in international markets and fiscal reforms implemented by the government in August 2015, which removed energy subsidy and aligned domestic retail Oil prices to international levels.

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



Source: Federal Competitiveness and Statistics Authority (FCSA).

Figure 2.2.b. Contribution of different sub-components to the total CPI inflation (%, Y-o-Y)



Source: Federal Competitiveness and Statistics Authority (FCSA).

Furthermore, inflation of Textiles, clothing & footwear along with prices of furniture and household goods (both add up to 26% of Tradables) accelerated Y-o-Y in Q3 2018 by 20% and 5.3%, respectively, compared to 14.0% and 4.6% increase in Q2 2018, respectively. Moreover, prices of food and soft drinks softened as it increased Y-o-Y by 2.9% in Q3 2018 compared to a rise of 3.4% in the previous quarter.

On the other hand, prices of non-tradables (which account for 66% of the consumption basket) are slowing down as it increased Y-o-Y by 1.3% in Q3 2018 compared to a 1.7% rise in

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the previous quarter. The easing was a result of the continued decline in housing, electricity, gas and water prices Y-o-Y by 4.0% compared to a similar decline of 2.5% in the previous quarter.

The rent of residential and retail units has declined by 11.3% and 9.6%, respectively, in Abu Dhabi and Dubai in the third quarter of 2018 compared to a similar decline of 10.6% and 8.3%, respectively.

Other CPI sub-groups continued on an upward trend during Q3 2018. Recreation and culture, Restaurants and hotels, and Education rose Y-o-Y by 10.5%, 7.4% and 4.8%, respectively, compared to an increase of 9.4%, 6.7% and 4.6%, respectively, during the second quarter of 2018.

Inflation, excluding housing and transportation, rose in the third quarter of 2018 to reach Y-o-Y 5.7% from a 5.5% increase in the previous quarter, mainly due to the increase in the prices of tradables.

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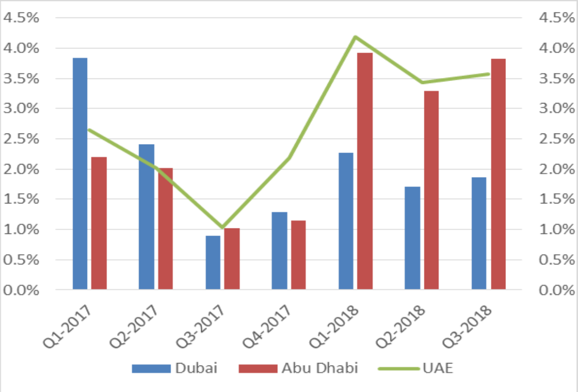
Box 5: Inflation in the UAE: Comparison By Emirate

Administrative measures have significantly influenced inflation rates in the UAE. The implementation of excise taxes on tobacco and beverages along with the VAT tax at the beginning of January 2018 have put inflation on an upward path since Q4 2017. However, inflationary pressures are mitigated by the decline in housing prices since Q1 2018.

Figure 1. Quarterly Y-o-Y Headline Inflation in the UAE and the Emirates of Abu Dhabi and Dubai



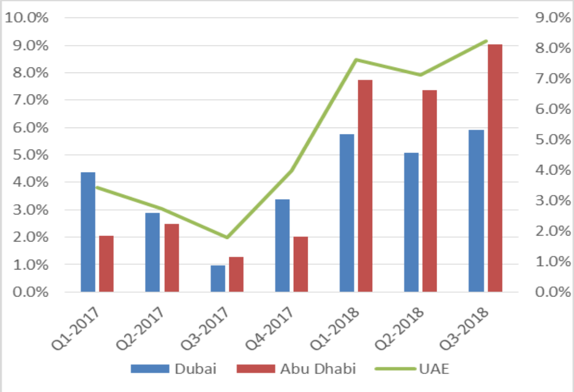
Source: FCSA. SCAD, DSC and Central Bank of the UAE

The inflation rate in the UAE reached Y-o-Y 3.6% in Q3 2018 compared to 3.4% in the previous quarter. On the Emirate level, inflation registered an increase Y-o-Y of 3.8% and 1.9% in Abu Dhabi and Dubai, respectively compared to 3.3% and 1.7% in the previous quarter (see Figure 1). The pickup in inflation was due to a rise in the prices of tradables by 9.0% and 5.9% in Abu Dhabi and Dubai, respectively. Transportation was heavily affected by the increase in oil prices Y-o-Y by 44.4% to USD 75.2 per barrel in Q3 2018 from USD 61.5 per barrel in the previous quarter, which inflated the price of domestic fuel derivatives that adjusted to the international price.

On the other hand, prices of clothing and footwear increased in the UAE Y-o-Y to 20% in Q3 2018 compared to an increase of 14% in the previous quarter. This increase was driven by the increase in the price of these items in Abu Dhabi during the same period Y-o-Y by 29.1%. In contrast, prices in Dubai declined by 3.7%.

Meanwhile, prices of tobacco products increased Y-o-Y by 86.5% in Q3 2018 compared to a similar increase of 84.1% in the previous quarter. Also, tobacco prices increased by 102.9% in Abu Dhabi and 78.5% in Dubai during the same period compared to 100.5% and 73.4% in the previous quarter due to the introduction of excise tax in October 2017 at the rate of 100 percent.

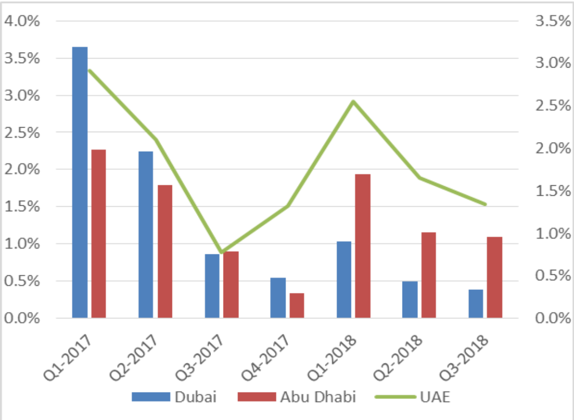
Figure 2. Quarterly Y-o-Y Tradeable Inflation in the UAE and the Emirates of Abu Dhabi and Dubai



Source: FCSA. SCAD, DSC and Central Bank of the UAE

Non-tradables' price inflation started to ease during the third quarter of 2018 affected by the continued decline in housing inflation. Non-tradable inflation reached Y-o-Y 1.3% in Q3 2018 compared to 1.7% in the previous quarter. Similarly, non-tradable inflation eased to 1.1% and 0.4% in Abu Dhabi and Dubai during the same period, down from 1.2% and 0.5% during the previous quarter, respectively (Figure 3).

Figure 3. Quarterly Y-o-Y Non-Tradeable Inflation in the UAE and the Emirates of Abu Dhabi and Dubai



Source: FCSA. SCAD, DSC and Central Bank of the UAE

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The decline in the housing component of the CPI basket was one of the main drivers for the ease in non-tradable inflation as it decreased Y-o-Y by 4.0% in Q3 2018 compared to 2.5% decline in the previous quarter. At the Emirate level, housing inflation declined Y-o-Y by 4.0% and 3.6% in Abu Dhabi and Dubai, compared to a decline of 3.8% and 2.3% in Q2 2018.

In contrast, “recreation and culture” and “restaurants and hotels” prices increased Y-o-Y by 10.5% and 7.4% in the UAE compared to a similar increase of 9.4% and 6.7% in Q2 2018. In Abu Dhabi, recreation and culture and restaurants and hotels prices increased Y-o-Y by 13.3% and 5.1%, whereas in Dubai they registered an increase of 5.4% and 11.0%, respectively.

As to the difference across Emirates compared to UAE-wide inflation, the difference in inflation could be mainly explained by the weights the Statistical Authorities are attributing to the categories of the CPI basket (Table 1). For instance, a category such as Transportation with a big weight in the tradeable inflation has a much lower weight in Dubai than in Abu Dhabi or for the UAE-wide CPI basket. Similarly, in Dubai, the Housing category has a much bigger weight, than in Abu Dhabi and UAE-wide. Hence, both tradable and non-tradable inflation are lower in Dubai, compared to Abu Dhabi and UAE-wide inflation.

Table 1. Weights assigned for the different categories per Statistic Authority

CPI Main Groups	UAE	Abu Dhabi	Dubai
Food and Beverages	14.3%	12.3%	13.1%
Tobacco	0.3%	0.2%	0.4%
Textiles, Clothing and Footwear	3.2%	5.4%	2.0%
Housing, Water, Electricity, Gas	34.1%	31.2%	43.6%
Furniture and Household Goods	5.6%	7.2%	3.8%
Medical Care	1.4%	1.6%	0.8%
Transportation	14.6%	14.7%	10.6%
Communications	5.4%	5.0%	5.2%
Recreation and Culture	3.2%	4.8%	2.3%
Education	7.7%	6.9%	8.5%
Restaurants and Hotels	4.0%	3.8%	4.0%
Miscellaneous Goods and Services	6.3%	7.0%	5.6%

Source: FCSA. SCAD and DSC

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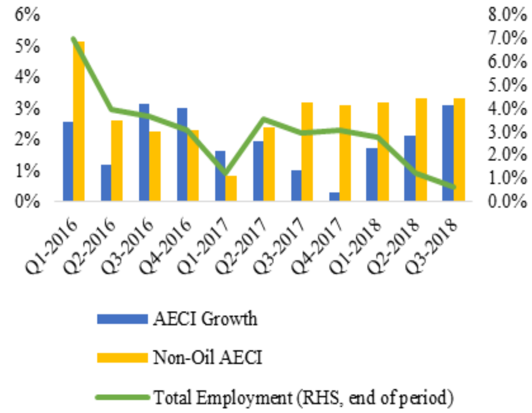
2.3 Employment and labor market dynamics

The cyclicality in the labor market, coupled with the effects of the slowdown in the economy during the first two quarters of 2018 are still weighing on the labor market. Employment eased in Q3 2018 Y-o-Y; moderately growing by 0.6% compared to a growth of 1.2% in Q2 2018. Accordingly, employment increased by 1.6% during the first three quarters, on average, compared to a 2.6% increase during the same period of 2017.

Figure 2.3.a. Employment growth and economic activity in the UAE (%, Y-o-Y)

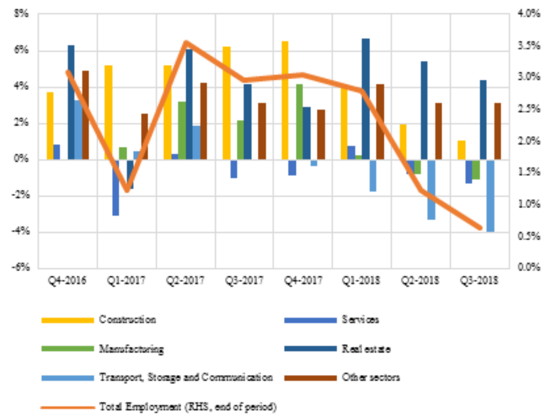


Source: Ministry of Human Resources and Emiratization

Slower employment growth was mainly driven by the services sector (employing more than 20% of total employment), which decreased by 1.3% in Q3 2018, followed by manufacturing and transport, storage & communication sectors, which declined by 1.1% and 4.0%, respectively.

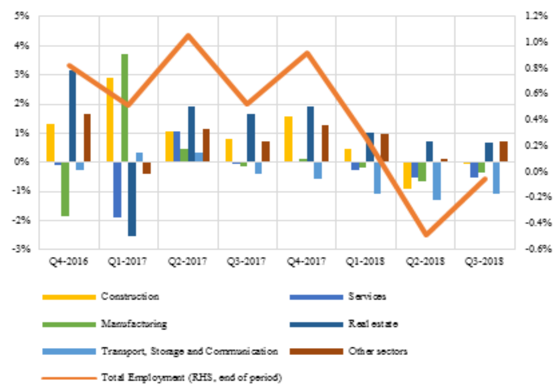
Employment in the construction sector, which accounts for around 30% of total employment in the UAE, moderated on a downward pace as it increased jobs by 1.0%. Employment growth in the real estate and other sectors reached 4.4% and 3.1%, respectively.

Figure 2.3.b. Employment growth by sector (%, Y-o-Y, end of period)



Source: Ministry of Human Resources and Emiratization

Figure 2.3.c. Employment growth by sector (%, Q-o-Q, end of period)



Source: Ministry of Human Resources and Emiratization

Comparing the third quarter with the previous quarter, data reveal that the easing in labor market employment is continuing as employment growth declined Q-o-Q by 0.1% compared to a decrease of 0.5% in the previous quarter. The decline included all sectors, except for real estate and other sectors, which registered a growth rate Q-o-Q of 0.7%, same as in the previous quarter. Transport, Storage and communications registered the largest decline of Q-o-Q of 1.1% compared to a slightly higher decline of 1.3% in the previous quarter. The construction sector decreased Q-o-Q only by 0.1% compared to a Q-o-Q decline of 0.9% in the previous quarter.

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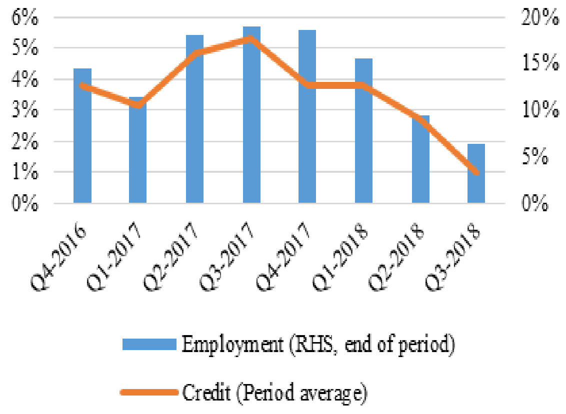
The ease in the labor market during Q3 2018 took its toll on credit growth as it increased Q-o-Q by 0.7% compared to a rise of 0.9% in Q2 2018. The services, manufacturing and transport, storage & communication sectors led the declaration in the labor market as they decreased Q-o-Q by 0.5%, 0.4% and 1.1%, respectively. This decrease was reflected on credit extended to transport, storage & communication, trade, construction and real estate, and electricity, gas and water sectors, which decreased Q-o-Q by 8.5%, 2.7%, 0.5% and 4.2%, respectively.

Figure 2.3.d Employment and domestic credit developments in the Construction and Real-Estate sector (%, Y-o-Y)



Source: Ministry of Human Resources and Emiratization & CBUAE

The construction and real estate sectors together absorb around 46.0% of the labor force in the UAE. Employment in both sectors eased to 1.9% Y-o-Y in the third quarter of 2018, against a 2.8% increase in the previous quarter. Consistently, credit to both sectors eased to 3.3% Y-o-Y in Q3 2018 compared to a rise of 9.0% in the previous quarter (see Figure 2.3.d).

Box 6 illustrates the developments in the labor market by Emirate.

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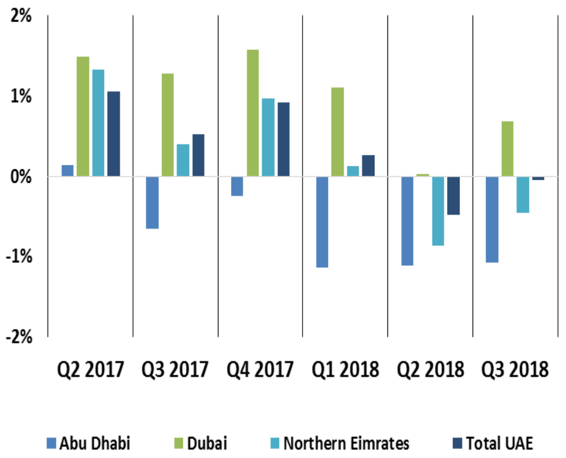
Box 6: Developments in the Labor Markets in the UAE

The labor market in the UAE can be divided into three categories based on geographical distribution: Abu Dhabi, Dubai and Northern Emirates. Data from the Ministry of Human Resources and Emiratization show that the total employment in the UAE was 5,025 thousands, of which 27.5% are based in Abu Dhabi, 51.3% are in Dubai and around 21.2% are based in the Northern Emirates.

Figure 1. Employment change (%, Q-o-Q)



Source: Ministry of Human Resources and Emiratization.

The Emirate of Dubai was the main driver for growth in the labor market during 2017 and in the first three quarters of 2018 with an average quarterly growth rate of 0.8%. The Emirate of Dubai created 45.9 thousand new jobs in the first three quarters with a growth rate of 1.8% compared to the end of 2017. However, employment growth rates in the Emirate started to pick up in the third quarter of 2018, reaching Q-o-Q growth around 0.7% compared to 0.03% in Q2 2018 as shown in Figure 1.

In contrast, the Emirate of Abu Dhabi had an average drop in employment growth during the first three quarters of 2018 by 3.3% compared to a 0.7% growth during the same period in the previous year. However, the decline in employment growth started to soften as it reached Q-o-Q decline of 1.07% in Q3 2013 compared to a decline of 1.11% and 1.13% increase during Q1 and Q2 of 2018, respectively, thereby shedding 46.8 thousand jobs during the first three quarters of 2018.

Figure 2. Employment change by sector (%, Q-o-Q)

Source: Ministry of Human Resources and Emiratization.

Similarly, in the Northern Emirates, employment decreased Q-o-Q by 0.46% in Q3 2018 compared to a decline of 0.86% in the previous quarter. Accordingly, employment growth rates in the UAE remained virtually stable with a decline Q-o-Q of 0.05% in Q3 of 2018, similar to the previous quarter.

On a sectoral level (see Figure 2), the construction, services and the real estate sectors account for 67.9% of the total employment. The growth rates of employment in the construction and the services sectors declined Q-o-Q by 0.1% and 0.5%, respectively, whereas the real estate sector witnessed an increase of 0.68% in Q3 of 2018.

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2.4 Exchange Rate Fluctuations

On a quarterly basis, the AED has appreciated against the currencies of top 10 non-dollarized import and non-oil export partners, due to the strengthening of the US dollar, by 3.08% and 3.79%, respectively. Similarly, Y-o-Y the AED appreciated against top 10 non-dollarized import and non-oil export partners by 3.08% and 7.11%, respectively.

Table 2.3.a. AED appreciation against currencies of top Non-Dollarized import partners (%, Y-o-Y)

Imports	Share of total imports	Q-o-Q		Y-o-Y	
		Q2 2018	Q3-2018	Q2 2018	Q3-2018
China	**18.72**	0.34	6.70	-6.91	2.14
India	**7.85**	4.03	4.70	3.90	9.09
Japan	**5.43**	0.78	2.17	-1.74	0.46
Germany	**4.61**	3.16	2.44	-7.69	1.02
South Korea	**3.09**	0.75	3.75	-4.44	-1.02
Turkey	**2.95**	14.57	29.87	22.17	61.64
Italy	**2.64**	3.16	2.44	-7.69	1.02
UK	**2.63**	2.35	4.29	-5.92	0.40
France	**2.44**	3.16	2.44	-7.69	1.02
Switzerland	**1.96**	3.94	-0.16	0.04	2.19
Weighted Average	**52.32**	1.32	3.08	-1.46	3.08

Source: Data on Import shares (weights) are provided by the Federal Competitiveness and Statistics Authority (FCSA) for 2017. Data for the bilateral exchange rates are the quarterly average observations, recorded and displayed by Bloomberg.

On the imports side, the AED has appreciated in the third quarter of 2018 against its top 10 Non-Dollarized import partners, which account for 52.3% of the total imports, to reach 3.08% Q-o-Q (see Table 3.2.a.), compared to an appreciation of 1.32% in the previous quarter. Further, the AED gained more momentum against emerging market economies' currencies, which depreciated more sharply during the third quarter.

Bilateral exchange rates show that the AED appreciated mainly against the Chinese Yuan (China has the largest weight in the import basket, around 18.7%) by Q-o-Q 6.7%. Furthermore, the Turkish lira continued to depreciate against the AED Q-o-Q by 29.87%, at a faster pace compared to the previous period.

Moreover, the AED appreciated against the Indian Rupee (4.7%), the Japanese Yen (2.17%), the Euro (2.44%), and the Sterling pound (4.29%). However, the AED depreciated against the Swiss Franc Q-o-Q by 0.16% compared to an appreciation of 3.94% in the previous quarter.

Table 2.3.b. AED appreciation against currencies of top Non-Dollarized partners for Non-Oil Exports (%, Y-o-Y)

Exports	Share of total exports	Q-o-Q		Y-o-Y	
		Q2 2018	Q3-2018	Q2 2018	Q3-2018
India	**10.65**	4.03	4.70	3.90	9.09
Turkey	**9.14**	14.57	29.87	22.17	61.64
Iraq	**4.68**	0.54	0.04	0.25	1.50
Kuwait	**3.52**	0.34	6.70	-6.91	2.14
China	**3.10**	1.20	2.49	-4.13	0.53
Singapore	**3.03**	0.75	3.75	-4.44	-1.02
South Korea	**2.53**	3.94	-0.16	0.04	2.19
Switzerland	**2.04**	5.01	6.08	11.43	17.58
Pakistan	**1.74**	3.16	2.44	-7.69	1.02
Netherlands	**1.67**	0.78	2.17	-1.74	0.46
Weighted Average	**45.77**	2.09	3.79	2.05	7.11

Source: Data on Import shares (weights) are provided by the Federal Competitiveness and Statistics Authority (FCSA) for 2017. Data for the bilateral exchange rates are the quarterly average observations, recorded and displayed by Bloomberg.

As for non-oil exports, the AED appreciated Q-o-Q by 3.79% against the currencies of the top 10 Non-Dollarized exports' partners (see Table 2.3.b.) compared to a Q-o-Q appreciation of 2.09% during the previous quarter. The appreciation was mainly due to the AED gains against the Indian Rupee and the Turkish Lira.[2]

Furthermore, the AED gained against other currencies of the main trading partners. It appreciated against the Chinese Yuan, the Singapore dollar (2.49 %,), and the Pakistani rupee (6.08%).

[2] India and Turkey account for 19.8% of the total exports of the UAE.

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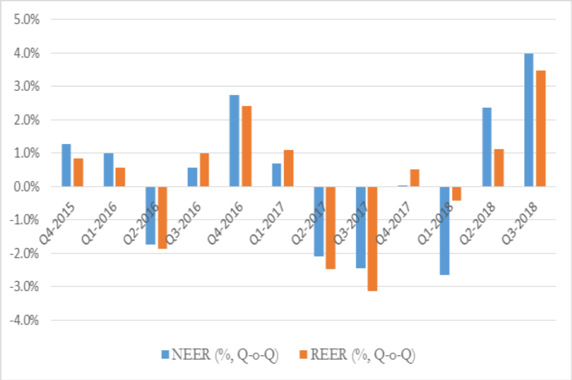
Accounting for all of the UAE's major trading partners, the Nominal Effective Exchange Rate (NEER) has displayed the same pattern as the weighted change of the AED against major import and Non-Oil export partners. In particular, the average NEER jumped by 4.0% in the third quarter of 2018, compared to a similar increase of 2.4% in the previous quarter (see Figure 2.4.a.).

Figure 2.4.a Nominal and Real Effective Exchange rates developments (%, Q-o-Q)



Source: Bank for International Settlement (BIS)

In real terms, the Real Effective Exchange Rate (REER), which takes into account the inflation differential between the UAE and its trading partners, increased by 3.6% in the third quarter of 2018 compared to a milder increase of 1.1% in the previous quarter, reflecting reduction in inflation in major trading partners.

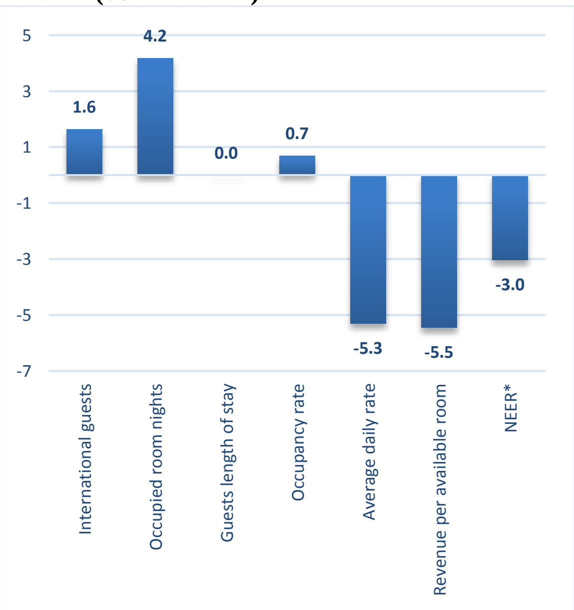
Box 7 assesses the impact of exchange rate on the indicators of the tourism industry, while Box 8 presents the developments in the outward remittances and the effects of developments in the exchange rate on bilateral flows.

Box 7: Tourism Activity in the UAE

This box focuses on the effect of the change of bilateral exchange rates of the AED on tourists to the Emirates of Dubai and Abu Dhabi, the two major tourist destinations in the UAE that contribute the largest shares of the total aggregates during January-August 2018 compared to the same period of the previous year.

The combined number of international tourists in the Emirates of Abu Dhabi and Dubai in the period of January-August 2018 increased by 1.6% compared to the same period in 2017 (Figure 1). This increase signaled a rebound by the two emirates in attracting international visitors after a seasonal slowdown in tourism during the month of Ramadan. As a result, the occupied room nights and occupancy rate for January-August 2018 increased by 4.2% and 0.7%, respectively, compared to the same period in 2017. Meanwhile, the average daily rate and the revenue per available room decreased by 5.3% and 5.5%, respectively, compared to the same period last year, due to continuous discounts offered by hotels in the two emirates.

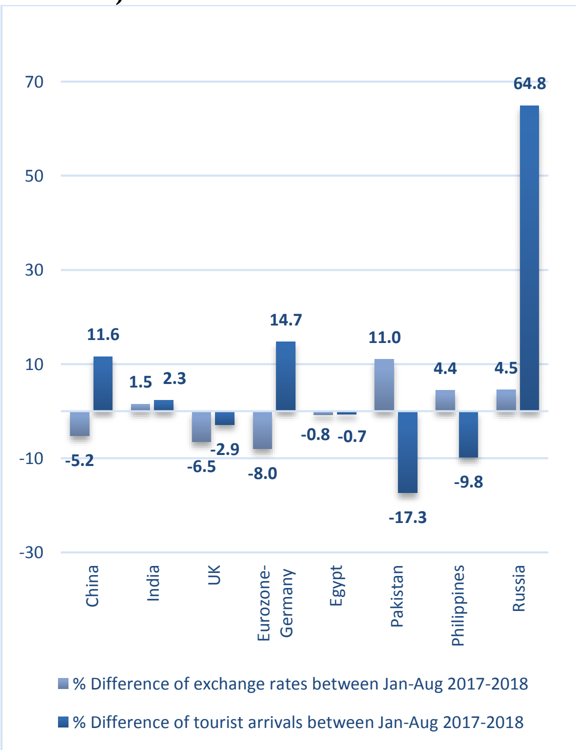
Figure 1: Major combined indicators of Dubai & Abu Dhabi inbound tourism January-August 2018-17 (% difference)



Source: Dubai Corporation of Tourism and Commerce Marketing, Abu Dhabi Tourism & Culture Authority, Bank for International Settlements
*nominal effective exchange rate

Figure 2 shows the effect of the bilateral exchange rate movements (average) on tourism between January-August 2018 and the same period of 2017. Among the international visitors, incoming tourists from Russia significantly increased (64.8%) following the easing of visa rules, despite depreciation of the ruble relative to the AED. Moreover, tourists from China and Germany recorded increase of 11.6% and 14.7%, respectively, in line with appreciation of their currencies relative to the AED. The incoming tourists from India increased at a slower pace by 2.3% following small appreciation of the AED relative to the rupee. The incoming tourists from the UK and Egypt, however, recorded a decrease despite the appreciation of their currencies relative to the AED. Tourists from Pakistan and Philippines recorded significant decrease possibly due to the appreciation of the AED relative to their respective currencies.

Figure 2. Guest arrivals and exchange rate on selected countries January-August 2018-17 (% difference)

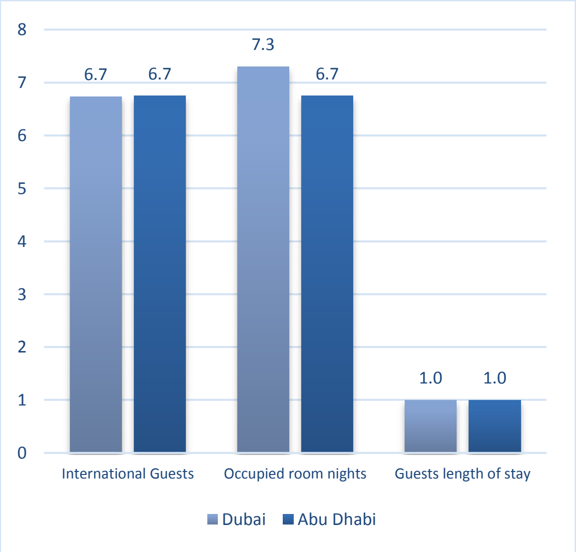


Source: Dubai Corporation of Tourism and Commerce Marketing, Abu Dhabi Tourism & Culture Authority, Bloomberg

In Figure 3, the data for the Dubai emirate indicate that the number of international visitors, compared to December 2017 (YTD), increased by 6.7%. Occupied room nights and guests length of stay YTD increased by 7.3% and 1.0%, respectively.

International visitors to the Emirate of Abu Dhabi, compared to December 2017 (YTD), during January-August 2018 increased by 6.7%. As in the case for Dubai, occupied room nights and guests length of stay YTD also increased by 6.7% and 1.0%, respectively.

Figure 3: Major indicators of Dubai & Abu Dhabi inbound tourism January-August 2018 (% difference YTD)



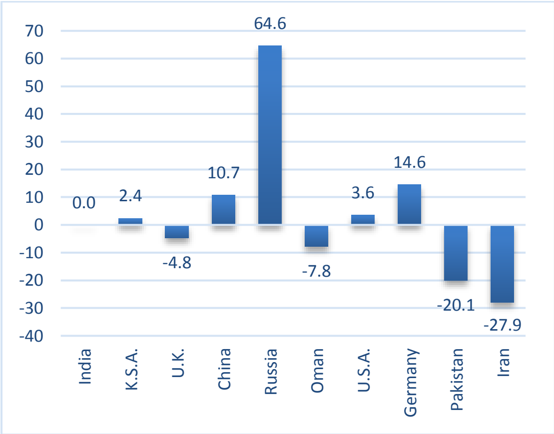
Source: Dubai Corporation of Tourism and Commerce Marketing, Abu Dhabi Tourism & Culture Authority

Countries that are the major markets for inbound tourism to Dubai show increase in the arrivals of tourists with the highest increase recorded for Russia (64.6%), Germany (14.6%), and China (10.7%). The vast majority of tourists to Dubai originate from GCC countries and the MENA region (29% combined, 19% and 10%, respectively), while Western Europe and North America cover 21% and 6% of inbound tourism. Finally, 11% of inbound tourism comes from the region of South Asia.

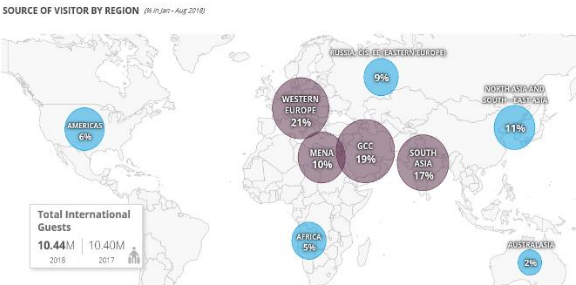
For the Abu Dhabi Emirate, most of the countries that are major markets of inbound tourism recorded increase in guest arrivals, except for Philippines that slightly decreased, most likely due to the depreciation of their currency relative to the AED.

Figure 4. Major markets of inbound tourism January-August 2018-17 (% difference)

a. Dubai

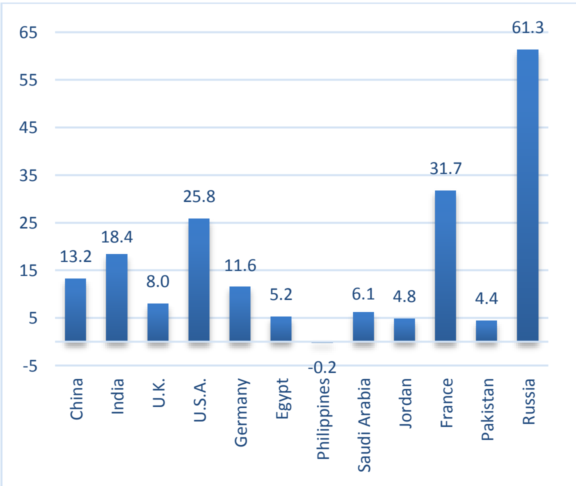


Source: Dubai Corporation of Tourism and Commerce Marketing



Source: Dubai Corporation of Tourism and Commerce Marketing

b. Abu Dhabi



Source: Abu Dhabi Tourism & Culture Authority

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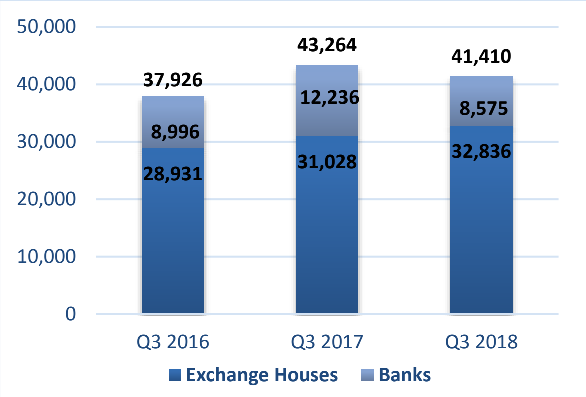
Box 8: Outward Personal Remittances from the UAE

The outward personal remittances[3] in the period of July-September 2018 recorded at AED 41.4 billion, a decrease of 4.3% or AED 1.9 billion compared to the same period of 2017 (AED 43.3 billion) (Figure 1). During the third quarter of 2018, the outward personal remittances that were settled through the exchange houses recorded AED 32.8 billion (5.8% or AED 1.8 billion increase compared to the same period of 2017).

Meanwhile, the outward personal remittances that were settled through the banks decreased from AED 12.2 billion in the third quarter of 2018 to AED 8.6 billion in the same period of 2017 (decreased by 29.9% or AED 3.7 billion).

Figure 1. Evolution of outward personal remittances settled through Banks and Exchange houses in the UAE July-September 2016-2018 (AED Millions)

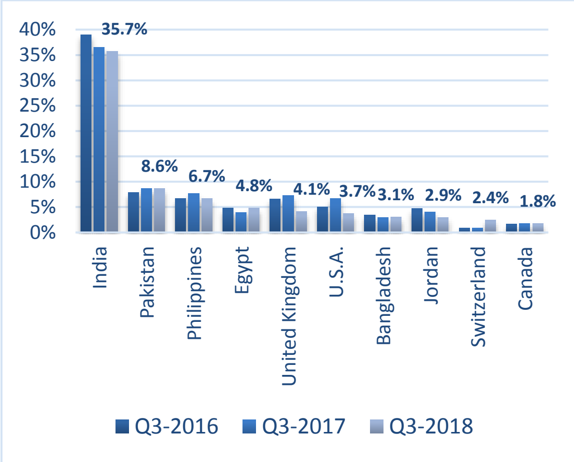


Source: CBUAE, Banking Supervision Department

The most important destination country for outward personal remittances during the period of July-September 2018 was India accounting for 35.7% of the total outflows (Figure 2). This high share is in accordance with the significant share of expats from India working in the UAE.

According to available statistics, dated October 2008 from the Federal Competitiveness and Statistics Authority, 82.7% of the employees in the UAE originated from Asian Non-Arab Countries, which include India. The next five most important countries in the share of outflows of personal remittances were Pakistan (8.6%), Philippines (6.7%), Egypt (4.8%) and the United Kingdom (4.1%) (Figure 2).

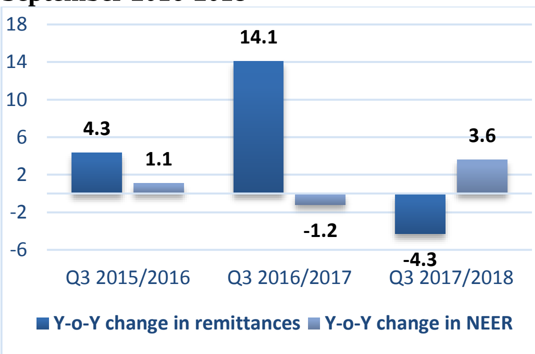
Figure 2. Share of the major countries for outward personal remittances during July-September 2016-2018 (percentage of total, exchange houses and banks)



Source: CBUAE, Banking Supervision Department

Despite the appreciation of the nominal effective exchange rate of the AED by 3.6% compared to the average for the third quarter of 2017, outward personal remittances decreased in Q3 2018 (Figure 3).

Figure 3. Percentage change of total outward personal remittances versus the percentage change of nominal effective exchange rate, July-September 2016-2018



Source: CBUAE, Banking Supervision Department; Bank of International Settlements.

[3] The data capture the outward personal remittances reported from the exchange houses and the banks to the CBUAE's Banking Supervision Department (BSD).

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2.5 Consolidated Fiscal Stance

Recent increases in oil prices during the second quarter of 2018 by 44.4%, and ongoing fiscal reforms to diversify sources of non-energy revenues contributed to an increase in total government revenues Y-o-Y by 8.1%. In particular, tax and other revenues grew by 13.8% and 4.5%, respectively. On the expenditure side, total expenses as well as capital spending, measured by the net acquisition of non-financial assets, declined Y-o-Y by 4.3% in Q2 2018. As a result, the Net Operating Balance, which is a summary measure of the sustainability of the government finances, reached AED 21.7 billion in Q2 2018 compared to AED 11.8 billion in the previous quarter (see table 2.5).

2.5.1 Revenues

Revenues increased during Q2 2018 Y-o-Y by 8.1% compared to a rise of 3.5% in the previous quarter. This increase came as a result of the increase in Taxes with the oil price (primarily royalties on oil companies) as they rose Y-o-Y by 13.8% compared to a decline of 5.4% in the first quarter. Furthermore, other revenues rose Y-o-Y by 4.5% in Q2 2018 compared to an increase of 12.4% in Q1 2018.

2.5.2 Expenditures

On the expenditures side, total expenses declined Y-o-Y by 4.3% in Q2 2018 compared to a rise of 9.5% in the previous quarter. The decline in expenses came as a result of the decline in compensation of employees (representing 20.9% of total expenses in 2017, on average) Y-o-Y by 0.3% compared to a rise of 21.7% in Q1 2018. In addition, the use of goods and services (representing a share of 25.6% of total expenses in 2017, on average) declined Y-o-Y by 57.0% compared to a significant increase of 157.0% in Q1 2018. High swings in this component can be attributed to the structure of payments schedule to suppliers.

Moreover, subsidies, grants, and consumption of fixed capital declined Y-o-Y by 23.9%, 62.7% and 28.4% in Q2 2018, respectively, compared to a rise of 15.9%, 15.6% and a decline of 13.1% in the previous quarter.

Similarly, capital spending, measured by the net acquisition of non-financial assets, continued its decline for the sixth consecutive quarter. It fell Y-o-Y by 0.5% in the second quarter of 2018, compared to a decline of 56.0% in the previous quarter.

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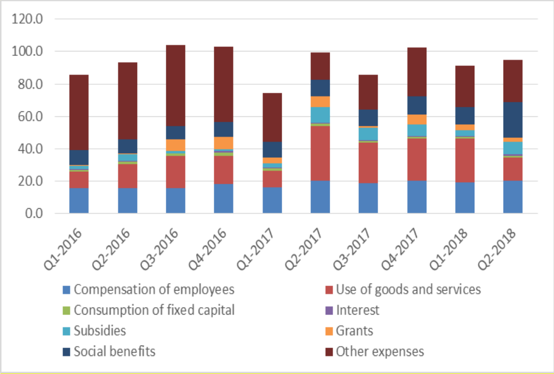
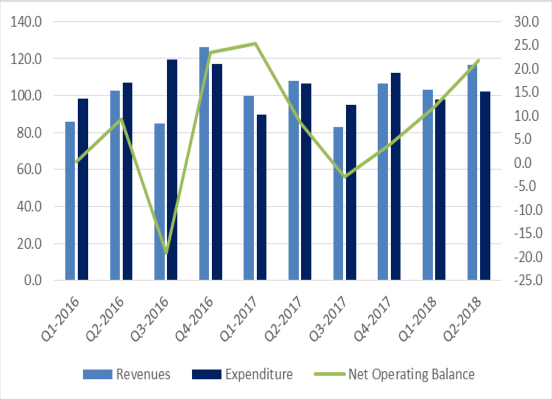
Government Finances

2.5.a. General government revenues (Billions of AEDs)

2.5.b. General government expenditures (Billions of AEDs)



2.5.c. Fiscal Stance (Billions of AEDs)



2.5.d. Developments in the Subsidies & transfers to GREs (Billions of AEDs)

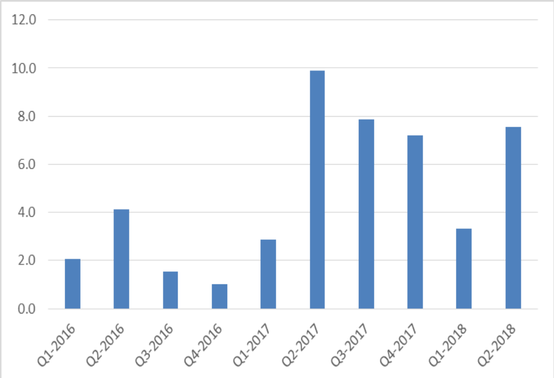


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Table. 2.5. Consolidated Government Finances

Consolidated	2016				2017				2018		2017 (% Y-o-Y)				2018 (% Y-o-Y)	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2
Net Operating Balance	**0.1**	**9.3**	**-19.2**	**23.4**	**25.4**	**8.6**	**-3.0**	**3.7**	**11.8**	**21.7**	-----	-----	-----	-----	-----	-----
Revenues (a)	**85.7**	**102.7**	**84.9**	**126.5**	**99.6**	**107.9**	**82.8**	**106.3**	**103.1**	**116.7**	**16.2%**	**5.1%**	**-2.5%**	**-15.9%**	**3.5%**	**8.1%**
Taxes	21.1	26.0	28.9	32.7	49.2	40.0	32.4	40.3	46.5	45.5	133.1%	53.7%	12.0%	23.3%	-5.4%	13.8%
Social contributions	1.5	1.2	1.2	0.9	1.2	1.1	1.3	1.1	1.3	1.3	-18.0%	-9.4%	8.3%	27.7%	3.9%	24.3%
Other revenues	63.1	75.5	54.8	92.9	49.2	66.8	49.1	64.9	55.3	69.9	-22.1%	-11.4%	-10.5%	-30.1%	12.4%	4.5%
Expenditure (b)	**98.3**	**107.0**	**119.6**	**117.1**	**89.5**	**106.4**	**95.2**	**112.5**	**98.0**	**102.0**	**-9.0%**	**-0.6%**	**-20.4%**	**-3.9%**	**9.5%**	**-4.1%**
Expense	**85.5**	**93.4**	**104.2**	**103.0**	**74.2**	**99.3**	**85.8**	**102.6**	**91.3**	**95.0**	**-13.3%**	**6.3%**	**-17.7%**	**-0.4%**	**23.0%**	**-4.3%**
Compensation of employees	15.5	15.8	15.8	18.2	15.9	20.1	18.8	20.4	19.3	20.1	2.1%	27.6%	19.4%	12.1%	21.7%	-0.3%
Use of goods and services	10.4	14.8	19.9	17.1	10.5	33.7	24.9	25.7	27.0	14.5	1.0%	127.2%	25.0%	50.4%	157.0%	-57.0%
Consumption of fixed capital	1.1	1.5	1.2	2.1	1.3	1.4	1.0	1.4	1.1	1.0	11.7%	-6.1%	-13.9%	-35.2%	-13.1%	-28.4%
Interest	0.2	0.4	0.3	1.0	0.5	0.6	0.3	0.5	0.5	1.1	103.8%	42.6%	-4.6%	-48.0%	-2.4%	85.1%
Subsidies	2.1	4.1	1.6	1.0	2.9	9.9	7.9	7.2	3.3	7.5	38.4%	139.3%	406.3%	605.6%	15.9%	-23.9%
Grants	0.5	0.5	6.9	8.0	3.3	6.7	1.2	6.1	3.8	2.5	625.6%	1169.8%	-82.9%	-23.9%	15.6%	-62.7%
Social benefits	9.3	8.4	8.5	9.0	9.8	10.1	10.3	10.9	10.5	22.1	4.6%	19.4%	21.8%	20.4%	7.5%	119.6%
Other expenses	46.3	47.8	50.1	46.6	30.1	16.8	21.4	30.5	25.6	26.1	-35.1%	-64.9%	-57.2%	-34.6%	-14.7%	55.5%
Net acquisition of non-financial assets	12.8	13.6	15.4	14.1	15.3	7.1	9.5	9.9	6.7	7.0	19.5%	-48.1%	-38.6%	-29.9%	-56.0%	-0.5%

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

- Other Revenues covers: Property income (interest, dividends, rent), Sales of goods and services (including administrative fees), Fines and penalties and other revenues not elsewhere classified. Effective 2016Q1, the Emirate of Abu Dhabi has added some transfers of important investment authorities from financing accounts to revenues, included in the distributed profit computation.
- Subsidies include social and price subsidies as well as transfers to GREs.
- Other expenses include the payments of Abu Dhabi made on behalf of the Federal Government.
- Grants include current or capital transfers from the Government to other Government units, international organizations or foreign Governments, excluding transfers between Federal and Local Governments.

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Chapter 3. Banking and Financial Developments

In the third quarter of 2018, deposits continued to grow, mainly boosted by the increase in Government Deposits. Credit to private sector also picked up in tandem with improved growth outlook in non-oil activities. Financial Soundness Indicators (FSIs) remained sound.

3.1 Banking Structure

The 22 national banks have decreased the number of branches to 751 at the end of 2018 Q3 compared to 755 at the end of 2018 Q2. The number of foreign banks and their branches has remained unchanged at 27 and 81, respectively during 2018 Q3. The total number of employees of all banks has increased by 346 in the third quarter of 2018 to 35,791.

3.1.1. Banks' Deposits

Total Customer Deposits at banks increased in the third quarter of 2018 by AED 43.9bn. The Resident Deposits in 2018 Q3 Y-o-Y is essentially due to the steady rise in all components. Government sector deposits increased by 42.1%, GREs' deposits by 5.3% and Private sector deposits by 1.8%. The Non-Resident deposits rose by 9.1% Y-o-Y during the third quarter of 2018, with their share in total deposits increasing from the previous quarter to 12.4%.

Deposits by the type of banks, i.e., Conventional vs. Islamic banks, represent respectively 76.8% and 23.2% of total deposits. Figures 3.1.1.a and 3.1.1.b, and Table 3.1.1.b show that in the third quarter of 2018 there is an increase in Islamic banks' deposits by 2.1% while for Conventional banks they grew by 2.8%. On a Y-o-Y basis, the increase of Islamic banks' deposits has reached 6.5%, while for the Conventional banks it was at 8.9%. Looking at the subcategories, the growth in Islamic banks Y-o-Y in the third quarter is stronger in the NBFIs and for the Non-resident deposits, while Conventional banks were dominating for the deposits of the Government, the GREs and the Private sectors.

Table 3.1.1.a. Deposits at UAE Banks

	2017		2018		
	Sep	Dec	Mar	Jun	Sep*
Bank Deposits	1595.8	1627.3	1662.4	1,684.3	1,728.2
(Q-o-Q change %)	0.4	2.0	2.2	-2.1	2.2
(Y-o-Y change %)	5.8	4.1	3.8	6.0	8.3
Resident Deposits	1407.5	1435.6	1472.9	1494.2	1522.8
(Q-o-Q change %)	-0.1	2.0	2.6	1.4	1.9
(Y-o-Y change %)	6.5	5.3	4.2	6.0	8.2
Government Sector	201.2	212.0	233.2	250.6	285.9
(Q-o-Q change %)	2.2	5.4	10.0	7.5	14.1
(Y-o-Y change %)	18.7	13.5	20.2	27.3	42.1
GREs	183.0	191.5	201.3	191.8	192.7
(Q-o-Q change %)	-3.5	4.9	5.1	-4.7	0.5
(Y-o-Y change %)	6.9	14.0	4.8	1.2	5.3
Private Sector	991.9	1001.0	1007.7	1020.4	1010.1
(Q-o-Q change %)	0.8	0.9	0.7	1.3	-1.0
(Y-o-Y change %)	3.7	2.1	0.9	3.7	1.8
NBFI	31.4	31.1	30.7	31.4	34.1
(Q-o-Q change %)	-20.1	-1.0	-1.3	2.3	8.6
(Y-o-Y change %)	27.6	10.3	7.0	-20.1	8.6
Non-Resident Deposits	188.3	191.7	189.5	190.1	205.4
(Q-o-Q change %)	4.7	1.8	-1.1	0.3	8.0
(Y-o-Y change %)	0.7	-3.7	0.3	5.7	9.1

Note: All data indicate the end-of-period values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

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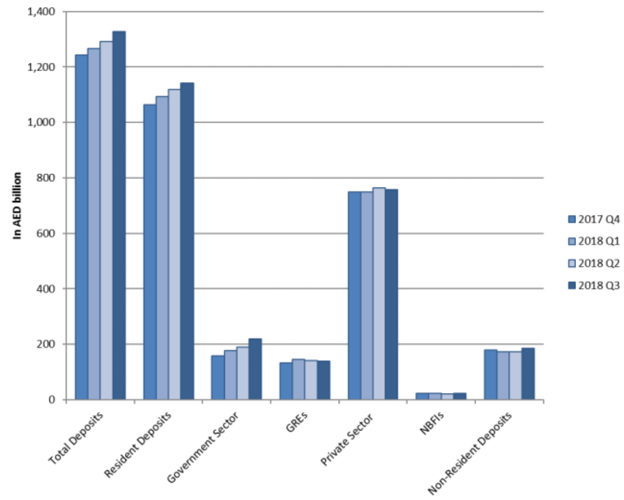
Table 3.1.1.b. Deposits at Conventional/Islamic Banks

	Conventional		Islamic	
	2018	2018	2018	2018
	Jun	Sep*	Jun	Sep*
Bank Deposits	**1291.9**	**1327.6**	**392.4**	**400.6**
(Q-o-Q change %)	2.0	2.8	-1.0	2.1
(Y-o-Y change %)	6.4	8.9	4.7	6.5
Share of Total, %	76.7	76.8	23.3	23.2
Resident Deposits	**1117.8**	**1142.0**	**376.4**	**380.8**
(Q-o-Q change %)	2.2	2.2	-0.7	1.2
(Y-o-Y change %)	6.8	9.4	3.9	4.6
Share of Total, %	74.8	75.0	25.2	25.0
Government Sector	**189.5**	**220.1**	**61.1**	**65.8**
(Q-o-Q change %)	7.2	16.1	8.3	7.7
(Y-o-Y change %)	30.2	49.5	19.3	21.9
Share of Total, %	75.6	77.0	24.4	23.0
GREs	**142.1**	**140.0**	**49.7**	**52.7**
(Q-o-Q change %)	-1.9	-1.5	-12.0	6.0
(Y-o-Y change %)	7.2	10.3	-13.0	-6.1
Share of Total, %	74.1	72.7	25.9	27.3
Private Sector	**764.7**	**758.6**	**255.7**	**251.5**
(Q-o-Q change %)	2.0	-0.8	-0.8	-1.6
(Y-o-Y change %)	4.0	1.9	2.9	1.5
Share of Total, %	74.9	75.1	25.1	24.9
NBFI	**21.5**	**23.3**	**9.9**	**10.8**
(Q-o-Q change %)	-3.2	8.4	16.5	9.1
(Y-o-Y change %)	-36.6	-7.5	83.3	74.2
Share of Total, %	68.5	68.3	31.5	31.7
Non-Resident Deposits	**174.1**	**185.6**	**16.0**	**19.8**
(Q-o-Q change %)	1.0	6.6	-7.0	23.8
(Y-o-Y change %)	4.1	5.4	28.0	62.3
Share of Total, %	91.6	90.4	8.4	9.6

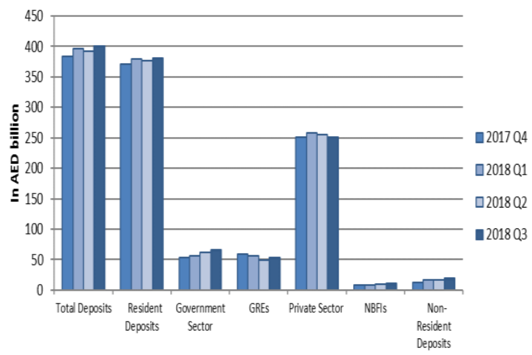
Note: All data indicate the end-of-period values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

Figure 3.1.1.a. Banking System Deposits: Conventional Banks (AED billion)



Source: CBUAE

Figure 3.1.1.b. Banking System Deposits: Islamic Banks (AED billion)



Source: CBUAE

The breakdown of National and Foreign banks in Figures 3.1.1.c and 3.1.1.d show that National banks experienced a stronger increase in deposits compared to the Foreign banks Q-o-Q and Y-o-Y in 2018 Q3. National banks' deposits grew at a rate of 9.7% Y-o-Y in contrast to the Foreign banks for which deposits dropped by 1.4%. At the end of 2018 Q3, 88.3% of the total deposits are held in National banks and 11.7% are in Foreign banks.

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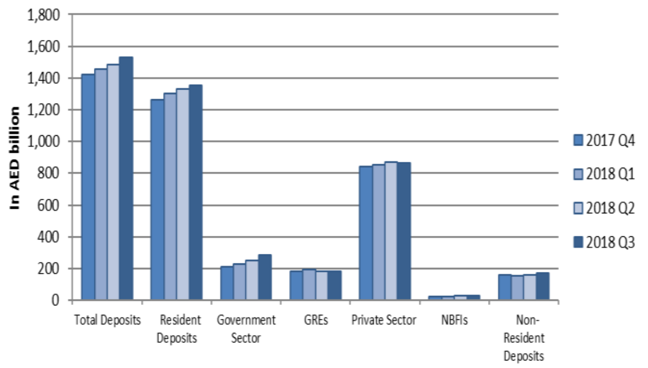
Table 3.1.1.c. Deposits at UAE National/ Foreign Banks

	National		Foreign	
	2018	2018	2018	2018
	Jun	Sep*	Jun	Sep*
Bank Deposits	**1,485.3**	**1,526.5**	**199.0**	**201.7**
(Q-o-Q change %)	1.9	2.8	-2.8	1.4
(Y-o-Y change %)	7.3	9.7	-2.7	-1.4
Share of Total, %	88.2	88.3	11.8	11.7
Resident Deposits	**1,328.4**	**1,355.5**	**165.8**	**167.3**
(Q-o-Q change %)	2.0	2.0	-2.9	0.9
(Y-o-Y change %)	7.4	9.7	-3.5	-2.5
Share of Total, %	88.9	89.0	11.1	11.0
Government Sector	**249.1**	**284.6**	**1.5**	**1.3**
(Q-o-Q change %)	8.1	14.3	-46.4	-13.3
(Y-o-Y change %)	27.7	42.7	-11.8	-27.8
Share of Total, %	99.4	99.5	0.6	0.5
GREs	**184.8**	**180.2**	**7.0**	**12.5**
(Q-o-Q change %)	-4.4	-2.5	-11.4	78.6
(Y-o-Y change %)	0.7	2.2	16.7	89.4
Share of Total, %	96.4	93.5	3.6	6.5
Private Sector	**868.3**	**862.1**	**152.1**	**148.0**
(Q-o-Q change %)	1.8	-0.7	-1.6	-2.7
(Y-o-Y change %)	5.3	3.4	-4.5	-6.3
Share of Total, %	85.1	85.3	14.9	14.7
NBFI	**26.2**	**28.6**	**5.2**	**5.5**
(Q-o-Q change %)	4.4	9.2	-7.1	5.8
(Y-o-Y change %)	-23.6	9.2	4.0	5.8
Share of Total, %	83.4	83.9	16.6	16.1
Non-Resident Deposits	**156.9**	**171.0**	**33.2**	**34.4**
(Q-o-Q change %)	0.8	9.0	-2.1	3.6
(Y-o-Y change %)	6.6	10.2	1.8	3.9
Share of Total, %	82.5	83.3	17.5	16.7

Source: CBUAE
Note: All data indicate the end-of-period values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

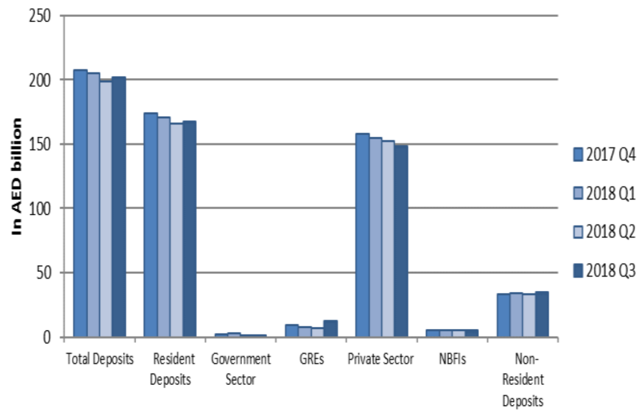
The sector registering the fastest growth in deposits in 2018 Q3 for the National banks was the Government sector, growing by 42.7% Y-o-Y owing to the improved oil price and diversifying sources of revenues for the government. For Foreign banks, in the third quarter of 2018, the breakdown shows that the biggest increase was for the GREs sector, rising by 89.4% Y-o-Y; however, its base remained relatively low with a small impact on total deposits.

Figure 3.1.1.c. Banking System Deposits: National Banks (AED billion)



Source: CBUAE

Figure 3.1.1.d. Banking System Deposits: Foreign Banks (AED billion)



Source: CBUAE

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3.1.2. Banks' Credit

Domestic Credit increased in 2018 Q3 by AED 16bn (1%), which corresponded to a growth of a 3.7% Y-o-Y. For the underlying domestic credit, there was a rise in all sectors Y-o-Y, except for GREs. Lending to the Government increased by 2.3%, Private sector by 4.8%, with lending to Private corporates and individuals growing by 6.5% and 1%, respectively. The GREs sector experienced a decline in credit by 3.8% Y-o-Y.

Table 3.1.2.a. Assets and Credit at UAE Banks

	2017		2018		
	Sep	**Dec**	**Mar**	**Jun**	**Sep***
Total Assets	**2,643.0**	**2,693.8**	**2,718.3**	**2,748.9**	**2,838.2**
(Q-o-Q change %)	0.4	2.0	0.9	1.1	3.2
(Y-o-Y change %)	4.5	4.0	3.5	4.4	7.4
Gross Credit	**1,580.0**	**1,580.3**	**1,608.1**	**1,622.3**	**1,638.3**
(Q-o-Q change %)	0.7	0.0	1.8	0.9	1.0
(Y-o-Y change %)	2.2	1.7	2.1	3.4	3.7
Domestic Credit	**1,447.0**	**1,452.7**	**1,472.8**	**1,486.6**	**1,496.4**
(Q-o-Q change %)	0.9	0.4	1.4	0.9	0.7
(Y-o-Y change %)	1.5	1.4	1.5	3.6	3.4
Government	**182.0**	**175.4**	**181.1**	**180.8**	**185.6**
(Q-o-Q change %)	2.0	-3.4	3.2	-0.2	2.7
(Y-o-Y change %)	4.3	1.7	2.3	1.6	2.3
Public Sector (GREs)	**175.0**	**172.3**	**170.2**	**168.4**	**168.7**
(Q-o-Q change %)	-2.0	-0.7	-1.2	-1.1	0.2
(Y-o-Y change %)	-6.7	-7.0	-12.7	-5.9	-3.8
Private Sector	**1,070.0**	**1,086.4**	**1,100.7**	**1,117.4**	**1,120.8**
(Q-o-Q change %)	1.1	1.4	1.3	1.5	0.3
(Y-o-Y change %)	0.4	2.9	3.9	5.6	4.7
Business & Industrial Sector Credit	**735.0**	**748.9**	**764.2**	**780.1**	**782.4**
(Q-o-Q change %)	0.8	1.8	2.0	2.1	0.3
(Y-o-Y change %)	2.0	2.6	4.5	7.1	6.5
Individual	**335.0**	**337.5**	**336.5**	**337.3**	**338.4**
(Q-o-Q change %)	1.7	0.7	-0.3	0.2	0.3
(Y-o-Y change %)	3.1	3.5	2.6	2.3	1.0
Non-Banking Financial Institutions	**21.0**	**18.6**	**20.8**	**20.0**	**21.3**
(Q-o-Q change %)	5.1	-9.3	11.8	-3.8	6.7
(Y-o-Y change %)	12.6	-2.1	4.0	2.6	1.4
Foreign Credit	**133.0**	**127.6**	**135.3**	**135.7**	**141.9**
(Q-o-Q change %)	-1.0	-4.2	6.0	0.3	4.6
(Y-o-Y change %)	10.9	5.8	8.2	1.0	6.7

Source: CBUAE
Note: All data indicate the end-of-quarter values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

Table 3.1.2.b. illustrates sectors of lending by economic activity. The split shows an increase in 2018 Q3 Y-o-Y for Agriculture (62.3%), Mining (9.7%), Manufacturing (5.7%), Construction and Real estate (3.3%), Trade (4.9%) and Financial sector (3%). In contrast, lending decreased Y-o-Y for Electricity, Gas and Water (-0.3%) and Transport, Storage and Communication (-22.4%).

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Table 3.1.2.b. Banks' credit to residents by economic activity

(End of Period , In Billions of AED)

Economic Activity	2017 Sep	2017 Dec	2018 Mar	2018 Jun	2018 Sep
Agriculture	**1.2**	**2.1**	**2.0**	**1.9**	**1.9**
(Q-o-Q change %)	7.7	77.3	-4.1	-6.2	1.8
(Y-o-Y change %)	3.9	54.8	70.0	74.0	62.3
Mining and Quarrying	**12.2**	**12.1**	**12.1**	**12.9**	**13.4**
(Q-o-Q change %)	-12.5	-0.8	-0.3	7.1	3.7
(Y-o-Y change %)	-13.1	-10.7	-36.5	-7.1	9.7
Manufacturing	**72.0**	**75.2**	**75.5**	**73.7**	**76.1**
(Q-o-Q change %)	2.4	4.5	0.4	-2.5	3.3
(Y-o-Y change %)	0.6	8.6	10.6	4.8	5.7
Electricity, Gas and Water	**17.0**	**16.7**	**18.9**	**17.7**	**17.0**
(Q-o-Q change %)	-2.6	-1.6	12.9	-6.4	-4.2
(Y-o-Y change %)	-5.2	-9.3	4.4	1.7	-0.3
Construction and Real Estate	**295.2**	**298.1**	**300.5**	**306.6**	**305.0**
(Q-o-Q change %)	5.0	1.0	0.8	2.0	-0.5
(Y-o-Y change %)	17.7	12.6	12.6	9.0	3.3
Trade	**147.7**	**152.8**	**157.1**	**159.1**	**154.9**
(Q-o-Q change %)	-1.2	3.4	2.9	1.2	-2.7
(Y-o-Y change %)	-6.7	-1.7	3.2	6.4	4.9
Transport, Storage and Communication	**63.7**	**54.9**	**52.7**	**54.0**	**49.5**
(Q-o-Q change %)	1.0	-13.8	-4.0	2.4	-8.5
(Y-o-Y change %)	1.6	-13.5	-12.7	-14.4	-22.4
Financial Institutions (Excluding Banks)	**130.3**	**127.5**	**133.6**	**129.0**	**134.2**
(Q-o-Q change %)	-6.2	-2.1	4.8	-3.5	4.1
(Y-o-Y change %)	-12.2	-12.4	-12.0	-7.2	3.0
All Others	**132.9**	**138.3**	**139.2**	**142.0**	**146.5**
(Q-o-Q change %)	5.3	4.0	0.7	2.0	3.2
(Y-o-Y change %)	9.0	10.4	7.1	12.5	10.3

Source: CBUAE
Note: All data indicate the end-of-quarter values.
***:** Preliminary figures subject to revision.

Islamic banks have a share of 20.4% in the assets and 22.6% in the gross financing of the total banking system. The breakdown of the assets and lending by Conventional and Islamic banks in Figures 3.1.2.a and 3.1.2.b indicates that Islamic banks' financing was increasing by 3.6% Y-o-Y as of 2018 Q3 due to rising in all categories, except for GREs and NBFIs, where there was a decline. In parallel, credit in Conventional banks grew by 3.7% during the same period, reflecting the increase in credit in all categories except the GREs.

Table 3.1.2.c. Assets and Credit across Conventional and Islamic Banks

	Conventional 2018 Jun	Conventional 2018 Sep*	Islamic 2018 Jun	Islamic 2018 Sep*
Total Assets	**2,183.9**	**2,259.3**	**565.0**	**578.9**
(Q-o-Q change %)	1.1	3.5	1.1	2.5
(Y-o-Y change %)	3.9	7.4	6.7	7.2
Gross Credit	**1,254.6**	**1,267.4**	**367.7**	**370.9**
(Q-o-Q change %)	0.4	1.0	2.7	0.9
(Y-o-Y change %)	2.9	3.7	5.0	3.6
Domestic Credit	**1,146.6**	**1,153.7**	**340.0**	**342.7**
(Q-o-Q change %)	0.6	0.6	2.1	0.8
(Y-o-Y change %)	3.8	3.7	3.2	2.5
Government	**169.1**	**173.1**	**11.7**	**12.5**
(Q-o-Q change %)	-0.2	2.4	0.0	6.8
(Y-o-Y change %)	0.7	1.6	18.2	12.6
Public Sector (GREs)	**135.8**	**136.0**	**32.6**	**32.7**
(Q-o-Q change %)	-1.1	0.1	-0.9	0.3
(Y-o-Y change %)	-5.7	-3.2	-6.9	-6.3
Private Sector	**825.3**	**826.8**	**292.1**	**294.0**
(Q-o-Q change %)	1.1	0.2	2.7	0.7
(Y-o-Y change %)	6.1	5.3	4.1	3.3
Business & Industrial Sector Credit	**608.4**	**619.4**	**155.8**	**163.0**
(Q-o-Q change %)	1.7	0.1	3.7	0.9
(Y-o-Y change %)	7.5	7.1	5.4	4.6
Individual	**206.7**	**207.4**	**130.6**	**131.0**
(Q-o-Q change %)	-0.6	0.3	1.6	0.3
(Y-o-Y change %)	2.3	0.5	2.4	1.8
Non-Banking Financial Institutions	**16.4**	**17.8**	**3.6**	**3.5**
(Q-o-Q change %)	-3.0	8.5	-7.7	-2.8
(Y-o-Y change %)	5.1	7.2	-7.7	-10.3
Foreign Credit	**108.0**	**113.7**	**27.7**	**28.2**
(Q-o-Q change %)	-2.0	5.3	10.4	1.8
(Y-o-Y change %)	-5.0	3.9	33.8	19.5

Source: CBUAE
Note: All data indicate the end-of-period values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

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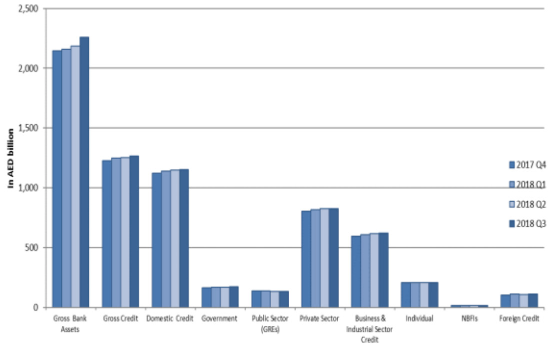
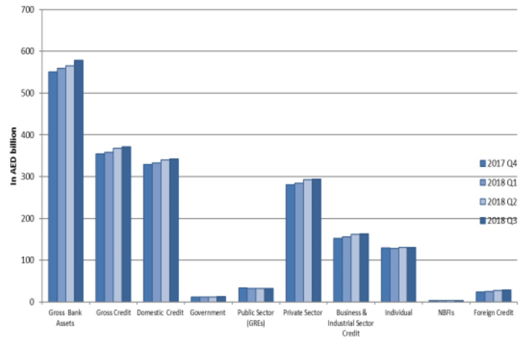
Figure 3.1.2.a. Banking System Assets and Credit: Conventional Banks (AED billion)



Source: CBUAE

Figure 3.1.2.b. Banking System Assets and Financing: Islamic Banks (AED billion)



Source: CBUAE

Foreign banks have a share of 12.8% of the system in terms of assets and 11.8% in terms of gross credit in the third quarter, a decline for both categories compared to 2018 Q2. The split of the assets and credit by national and foreign banks in Figures 3.1.2.c and 3.1.2.d indicates that National banks' assets were growing by 8.7%, while gross credit increased by 3.8% compared to a year ago as of September 2018. For the same period, Foreign banks had their assets decreasing by 0.7% and gross credit increasing by 2.6% (see Table 3.1.2.d).

In terms of domestic credit, all sectors for the National banks were growing in 2018 Q3 Y-o-Y except GREs, while for the Foreign banks, all asset classes were declining except for Government and Private corporates.

Credit to non-residents was growing for the Foreign banks by 24.3% Y-o-Y as of September 2018, while for the National banks it increased by 2.8%.

To shed more light on the allocation of the National banks assets abroad, Box 9 below provides details about the Cross Border Exposure of UAE National Banks and Foreign Currency denominations of lending to Non-Residents.

Table 3.1.2.d. Assets and Credit at UAE National/Foreign Banks

	National		Foreign	
	2018 Jun	2018 Sep*	2018 Jun	2018 Sep*
Total Assets	**2,391.7**	**2,473.8**	**357.2**	**364.4**
(Q-o-Q change %)	1.5	3.4	-1.6	2.0
(Y-o-Y change %)	5.5	8.7	-2.0	-0.7
Gross Credit	**1,426.8**	**1,445.7**	**195.5**	**192.6**
(Q-o-Q change %)	1.0	1.3	-0.2	-1.5
(Y-o-Y change %)	3.3	3.8	4.1	2.6
Domestic Credit	**1,320.6**	**1,334.0**	**166.0**	**162.4**
(Q-o-Q change %)	1.1	1.0	-0.1	-2.2
(Y-o-Y change %)	3.9	3.9	1.2	-0.7
Government	**174.4**	**178.7**	**6.4**	**6.9**
(Q-o-Q change %)	-0.2	2.5	1.6	7.8
(Y-o-Y change %)	0.9	1.3	28.0	35.3
Public Sector (GREs)	**149.7**	**152.0**	**18.7**	**16.7**
(Q-o-Q change %)	0.0	1.5	-8.8	-10.7
(Y-o-Y change %)	-4.2	-1.3	-17.6	-22.0
Private Sector	**977.3**	**982.8**	**140.1**	**138.0**
(Q-o-Q change %)	1.6	0.6	1.1	-1.5
(Y-o-Y change %)	5.8	5.1	4.4	2.4
Business & Industrial Sector Credit	**671.9**	**676.0**	**108.2**	**106.4**
(Q-o-Q change %)	2.2	0.6	1.5	-1.7
(Y-o-Y change %)	7.2	7.0	6.0	3.4
Individual	**305.4**	**306.8**	**31.9**	**31.6**
(Q-o-Q change %)	0.3	0.5	-0.3	-0.9
(Y-o-Y change %)	2.7	1.2	-0.6	-0.9
Non-Banking Financial Institutions	**19.2**	**20.5**	**0.8**	**0.8**
(Q-o-Q change %)	-4.0	6.8	0.0	0.0
(Y-o-Y change %)	10.3	12.0	-61.9	-63.6
Foreign Credit	**106.2**	**111.7**	**29.5**	**30.2**
(Q-o-Q change %)	0.5	5.2	-0.3	2.4
(Y-o-Y change %)	-4.0	2.8	23.9	24.3

Source: CBUAE
Note: All data indicate the end-of-period values. Values are expressed in billions of Dirhams.
***:** Preliminary figures subject to revision.

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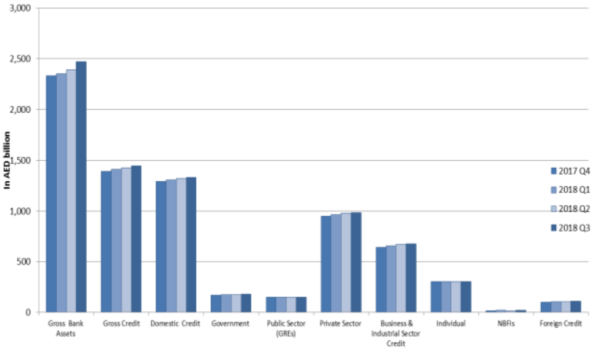
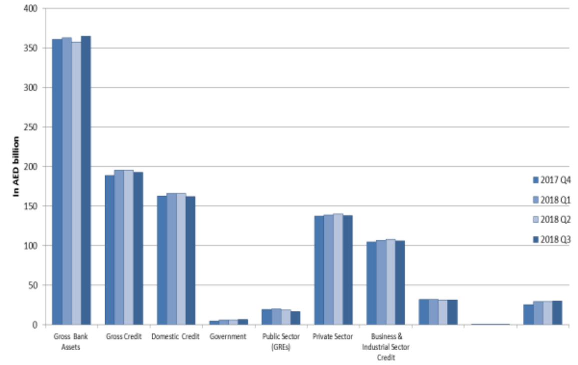
Figure 3.1.2.c. Banking System Assets and Financing: National Banks (AED billion)



Source: CBUAE

Figure 3.1.2.d. Banking System Assets and Financing: Foreign Banks (AED billion)



Source: CBUAE

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Box 9: Cross Border Assets' Exposure of UAE National Banks to Non-Residents and Foreign Currency Denominations

The UAE banking system is the largest in terms of assets in the MENA region. As of September 2018, the outstanding amount of assets is at AED 2,838bn[4]. As of end of the third quarter 2018, UAE banks, excluding branches and affiliates abroad, have a total of AED 693.1bn in foreign assets, AED 575.3bn for national banks and AED 117.8bn for foreign banks.

The analysis is focusing on the exposure of UAE national banks to non-residents. First, is the allocation of the foreign assets per asset category, followed by the top ten countries of exposure and the currency denomination of lending to non-residents.

Foreign Assets' Class Exposure of UAE National Banks

The foreign assets of national banks increased by 10.1% Q-o-Q as at the end of 2018 Q3 and by 22.2% through September 2018. The asset classes of exposure are split as per the categories in Table 1. The three major categories as of September 2018 are securities with an outstanding amount of AED 147.4bn, due from other banks at AED 133.2bn and Due from Head office & branches at AED 132.4bn that rose by 1.4%, 9% and 26.6% Q-o-Q respectively and by 8%, 12% and 60% year-to-date. (Table 1).

Table 1: UAE National Banks' Foreign Assets' Class Exposure (in AED bn)

	Dec 17	Jun 18	Sep 18
Due from HO & branches	82.8	104.6	132.4
Due from other banks	118.9	122.2	133.2
Securities	136.5	145.3	147.4
Loans	101.7	106.2	111.7
Other assets	38.3	44.2	50.4
Total	478.3	522.5	575.1

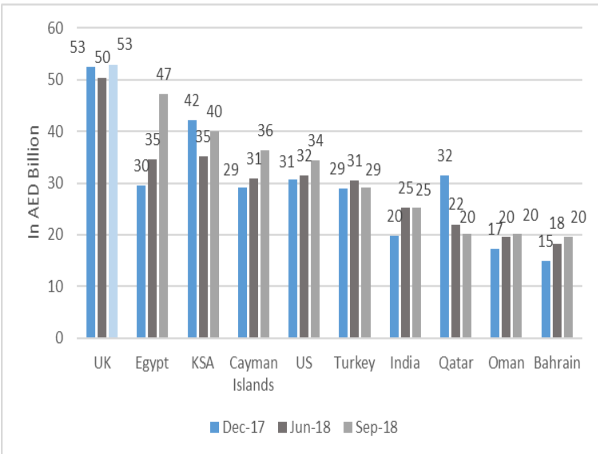
Source: Central Bank of the UAE

UAE National Banks' Top 10 Countries for Cross Border Exposure

As of September 2018, the biggest exposure of UAE banks abroad, including branches and affiliates, was in the UK at AED 53bn, followed by AED 47.2bn in Egypt and by AED 40bn in Saudi Arabia. The three countries in the top 10 foreign exposures that experienced the highest increase Q-o-Q were Egypt by AED 12.6bn (36.5%), Cayman Islands by AED 5.4bn (17.3%) and Saudi Arabia by AED 4.9bn (14.1%).The top 3 countries with the largest increase year-to-date were led by Egypt by AED 17.7bn (60%), Cayman Islands by AED 7.2bn (17.3%) and India by AED 5.4bn (27.1%).

On the other hand, a decline Q-o-Q as of September 2018 was observed for Qatar by AED 1.8bn (8.3%) and Turkey by AED 1.3bn (4.3%). Year-to-September 2018 the exposure to Qatar declined by AED 11.3bn (35.9%) while exposure to Saudi Arabia declined by AED 2.1bn (4.9%) (Figure 1).

Figure 1: Top 10 Foreign Country Exposures for UAE national banks (in AED bn)



Source: Central Bank of the UAE

[4] Excluding branches and affiliates abroad.

Currency Denomination of UAE Banks' Assets in Foreign Currency

The main foreign currency assets of the total foreign currency denomination of UAE banks remains in USD, which stood at 79.9% at the end of the third quarter of 2018 of the total foreign assets. The second most important foreign currency denomination is in Euro as of September 2018 (9.3% of the total foreign currency exposure). The third, fourth and fifth currency denominations are in Saudi Riyal, Japanese Yen and Pound Sterling (Table 2).

Table 2: Share of Assets in Foreign Currencies of Total UAE Banks' Exposure in Foreign Currencies

	Dec-17	Jun-18	Sep-18
US Dollar	84.7%	83.4%	79.9%
Euro	8.5%	9.8%	9.3%
Saudi Riyal	1.7%	1.6%	1.4%
Japanese Yen	1.2%	1.0%	1.2%
Pound Sterling	1.2%	1.5%	0.8%
Kuwaiti Dinar	0.1%	0.3%	0.3%
Chinese Yuan	0.1%	0.1%	0.3%
Qatari Riyal	0.4%	0.4%	0.3%
Swiss Franc	0.1%	0.2%	0.1%
Bahraini Dinar	0.1%	0.2%	0.1%
Other Foreign currencies	1.8%	1.5%	6.1%

Source: Central Bank of the UAE

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3.1.3. Financial Soundness Indicators

The overall soundness of the banking sector remained positive during the third quarter of 2018.

As of 2017 Q4, the Central Bank of the UAE started reporting the quality of the capital in line with Basel III framework[5]. Banks operating in the UAE remain profitable and well capitalized, with the Capital Adequacy Ratio (CAR) at 18.2%, Tier 1 Capital Adequacy at 16.8% and Common Equity Tier 1 (CET) at 14.9%, which are well above the regulatory requirements set by the Central Bank.

The Loans to Deposits (L/D) ratio for the whole banking system declined from 96.3% in June 2018 to 94.8% at the end of 2018 Q3, a level which is also lower than the 99% in 2017 Q3, mainly due to the higher growth in deposits compared to lending.

Looking at the breakdown between Conventional and Islamic banks, the L/D ratio is respectively 95.5% and 92.6%, decreasing by 1.6 percentage points from the previous quarter for the Conventional banks, and by 1.1 percentage points for the Islamic banks.

Loans to Deposits ratio for Conventional banks in September 2018 has improved compared to a year ago when it was 100.2%. For Islamic banks' L/D has also decreased from 95.2% in September 2017. On the other hand, National banks have L/D ratio of 94.7% (with a decline of 1.4 percentage points compared to June 2018), while the ratio for Foreign banks is 95.5%, lower than the 98.2% at the end of 2018 Q2.

Meanwhile, liquid assets, which include required reserves mandated by the Central Bank, certificates of deposits held by banks at the Central Bank, in addition to zero-risk weighted government bonds and public sector debt and cash at banks, as a ratio of total assets moved from 16.8% at the end of June 2018 to 16.1% at the end of 2018 Q3. This level of liquid assets still constitute a significant buffer as it is higher than the 10% minimum required by the Central Bank.

The level of total liquid assets at banks as of the end of 2018 Q3 remains at AED 372.2bn, AED 4.3bn lower than at the end of 2018 Q2, registering a decline of 1.1% in the third quarter of 2018, explaining the decrease in the Liquid Assets Ratio (LAR). On a Y-o-Y basis, total liquid assets at banks decreased also by AED 4.3bn, registering the same fall as Q-o-Q. In addition, looking at the split between Islamic, Conventional, National and Foreign banks, data show that for all segments the LARs decreased during 2018 Q3, except for Islamic banks where it remained unchanged. On a Y-o-Y basis, LAR has declined for all types of banks, except for the Islamic segment where it increased by 0.9 percentage points.

Box 10 below analyzes the impact of the most recent US monetary policy tightening on the UAE banks' deposit and lending rates, as well as the interest rate margin.

Table 3.1.3.a. Financial Soundness Indicators in the UAE (in %, unless otherwise Indicated)

Total system	2017	2018		
	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio	84.5	84.2	83.8	82.3
The Liquid Assets Ratio (LAR)	18.3	17.4	16.8	16.1
Capital Adequacy Ratio (CAR)	18.1	17.5	18.1	18.2
Tier 1 Capital	16.6	16	16.6	16.8
CET 1	14.6	13.9	14.6	14.9

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

Table 3.1.3.b. Financial Soundness Indicators in the UAE for Conventional Banks (in %, unless otherwise indicated)

Conventional	2017	2018		
	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio	84.9	84.8	84.4	82.8
The Liquid Assets Ratio (LAR)	17.7	16.2	15.9	15.2
Capital Adequacy Ratio (CAR)	18.5	18.0	18.2	18.4
Tier 1 Capital	16.9	16.4	16.7	17.0
CET 1	15.4	14.7	15.1	15.4

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

[5] Please refer to the 2017 Central Bank of the UAE Annual Report (page 66, Box 1) for details.

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Table 3.1.3.c. Financial Soundness Indicators in the UAE for Islamic Banks (in %, unless otherwise indicated)

Islamic	2017	2018		
	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio	83.1	82.1	81.6	80.8
The Liquid Assets Ratio (LAR)	20	20.2	18.7	18.7
Capital Adequacy Ratio (CAR)	16.4	15.8	17.5	17.5
Tier 1 Capital	15.3	14.6	16.3	16.3
CET 1	11.4	10.9	12.6	12.8

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

Table 3.1.3.d. Financial Soundness Indicators in the UAE for Foreign Banks (in %, unless otherwise indicated)

Foreign	2017	2018		
	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio	74.6	76.6	77.2	75.4
The Liquid Assets Ratio (LAR)	26.3	23	22.4	21.7
Capital Adequacy Ratio (CAR)	21.3	20.9	20.7	20.4
Tier 1 Capital	18.9	18.7	18.6	18.4
CET 1	18.9	18.7	18.6	18.4

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

Table 3.1.3.d. Financial Soundness Indicators in the UAE for National Banks (in %, unless otherwise indicated)

National	2017	2018		
	Q4	Q1	Q2	Q3
Lending to Stable Resources Ratio	86.1	85.3	84.7	83.3
The Liquid Assets Ratio (LAR)	17.1	16.6	15.9	15.3
Capital Adequacy Ratio (CAR)	17.7	17.1	17.7	17.9
Tier 1 Capital	16.3	15.6	16.4	16.6
CET 1	14.0	13.3	14	14.4

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

Box 10: Impact of Changes in the US Federal Funds Rate on Lending and Deposits Interests Rates and Banks' Interest Margin

Against the backdrop of continued solid data of economic activity in the U.S. and the pickup of inflation[6], the Federal Reserve has announced eight interest rate hikes, by 25bps each, since December 2015. The underlying effect of these policy announcements on domestic interest rates is straightforward given continued commitment to the stability of the exchange rate peg. Indeed the policy rate has been aligned with the direction of adjustment in the Federal Fund Rate (FFR) (see Chapter 4).

Due to the peg of the AED to the USD, the Central Bank of the UAE (CBUAE) has mirrored all the recent hikes made on the FFR to the interest rates applied to the issuance of its certificates of Deposits (CDs) and the Repo Rate applicable to lending short-term liquidity against CDs' holdings by banks. The continued commitment to align the policy rate in the UAE to the direction of monetary policy in the US motivates the interest in analyzing the impact on the market deposit and lending interest rates of the UAE banks.

The degree of interest rate pass-through to market rates in the UAE remains unknown due to excess liquidity in the banking system. This box aims to quantify the impact of recent changes of the US FFR, which have reached 2-2.25% in September 2018, on the effective system-wide lending and deposit interest rates in the UAE banks and implicitly on their interest rate margin. This will shed some light on the cost borne by banks versus the amount passed through to borrowers.

The analysis employs the lending and deposit interest rates as aggregates (i.e., abstracting from the interest rate distribution across maturities for deposit and asset classes). In particular, we consider the income and expense as shares of total loans and total deposits, respectively, as reported in the assets and liabilities sides of the balance sheet of the banking system.

The empirical model evaluates the contemporaneous response of effective domestic interest rates following an adjustment to the FFR in addition to its impact in the subsequent months up to one year following the announced rate hike by the FED.

We adopt a Vector Autoregressive model with Exogenous Variable (VAR-X) model with the endogenous variables being: effective Interest on Loans (IL), effective Interest on Deposits (ID), PMI (Purchasing Managers' Index) growth for the UAE (PMIUAE), and the CPI inflation (PI); while the exogenous variable is FFR. The sample covers the period from November 2013 to August 2018 using monthly observations[7].

The estimated model is represented as follows:

$$y_t = \mathrm{C} + \sum_{i=1}^{n} A_i\, y_{t-i} + \sum_{i=0}^{q} B_i\, FFR_{t-i} + \varepsilon_t,$$

where $y_t = [IL_t, ID_t, PMI_t, PI_t]'$ and the vector of errors $\varepsilon_t \overset{iid}{\rightarrow} N(0, \Sigma)$. The selected lag structure indicates that the model should be a VAR-X(1). The output for the VAR-X is presented below in Table 1:

Table 1. Output of the VAR-X model

	Interest on Loans	Interest on Deposits
Interest loans lag1	0.215653*	-0.062789
Interest deposit lag1	-0.653068**	0.481369***
inflation lag1	-0.085459	0.000967
PMI growth lag1	-0.006335	0.005362
FFR	0.428705***	0.218629***
constant	0.042506***	0.006425**
***significant at 1%, **significant at 5%, * significant at 10%		

[6] In 2018 Q3 GDP grew by 3.5% Y-o-Y and as of end of September 2018 Core CPI inflation and Core PCE Price Index rose by 2.2% and 2% Y-o-Y respectively, unemployment rate reached 3.7% with the initial jobless claims, hourly earnings, nonfarm payrolls remaining unchanged.

[7] The choice of the period under consideration is due to the change in variables' definition and statistics collected from the commercial banks in the UAE by CBUAE.

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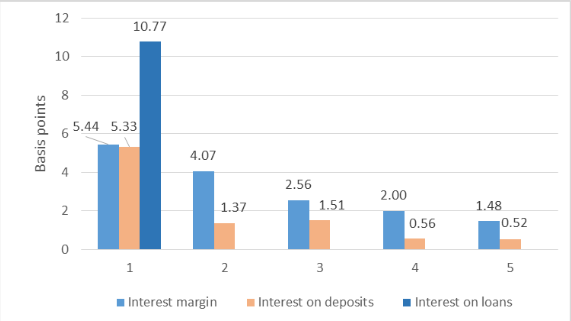
The impulse-response functions, after a single period shock from the exogenous variable FFR by 25 bps (basis points), on IL, ID and Interest Margin (IM) are represented below in Figure 1. The values show the cumulative positive impact over the current period and four months following the increase in the policy rate. This is the time span over which the impulse response continues to show positive reaction in the deposit rate, Adjustment in the deposit rate appears to be more gradual and persistent in contrast to the larger and short adjustment to the lending rate during the month of the rate hike.

Figure 1. Effect on the interest rates on loans, deposits and the interest rate margin from a single period adjustment by 25 basis points of the FFR



Source: Central Bank of the UAE

The impact on IL is positive in the period of the increase. This means a temporary increase of 10.77 bps in the lending rate during the month of the policy rate hike of 25 basis points[8]. Similarly, the effect on the interest on deposits is positive during the period of a hike of the FFR. This means a temporary increase of 5.33 bps basis points during the month of the policy rate hike by 25 basis point. However, the positive effect on the deposit rate persists for 5 months following the policy rate hike.

Given the initial larger effect on the lending rate, compared to the deposit rate, the interest margin, which is the difference between the interest rates on loans and deposits, increases by 5.44 basis points in the month of the policy rate hike. Subsequently, the interest rate margin decreases on further slower adjustments of the deposit rate over a duration of 4 months till it reaches1.48 basis points in the fifth month following the rate hike.

In conclusion, the pass-through of the FFR is incomplete—around 43 percent and 21 percent on the market interest rates for loans and deposits, respectively for every 25 basis points increase in the policy rate during the month of the announcement.

It is important to mention that this result is based on aggregated banking data and estimates could vary across individual banks based on the specifics of their balance sheets.

[8] In the following periods the impact of FFR on lending rate turns to be statistically insignificant.

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3.2 Financial developments

3.2.1. Share Price Movement

Higher oil prices gave more confidence to investors, with a significant increase of share price indices of the Abu Dhabi securities markets. However, in Dubai the share price index lost value. The market capitalization on Dubai Financial Market (DFM) and Abu Dhabi Securities Exchange (ADX) experienced the same trend as the share price indices—i.e., rising for ADX and declining for DFM.

On the ADX, the average Share Price Index increased by 6.8% in the third quarter of 2018 Q-o-Q and by 10% Y-o-Y after a rise by 0.4% Q-o-Q and 3.4% Y-o-Y in the second quarter of 2018. The market capitalization moved from a decline of -2.1% Q-o-Q and an increase of 6.9% Y-o-Y in 2018 Q2 to a hike by 4.6 % Q-o-Q, while rising by 12.1% Y-o-Y during 2018 Q3 (see Table 3.2.1).

The average Share Price Index in Dubai fell by 2.5% Q-o-Q and 20.3% Y-o-Y in the third quarter of 2018. The market capitalization declined by 1.2% during the same quarter Q-o-Q and by 0.6% Y-o-Y against a decrease by 3.6% Q-o-Q and a rise by 6.3% Y-o-Y in 2018 Q2.

Table 3.2.1. UAE – Securities Markets

			2017		2018		
			Q3	Q4	Q1	Q2	Q3
Abu Dhabi	Change of Share Price Index (%)	Q-o-Q	0.4	-3.5	6.4	0.4	6.8
		Y-to-Date	2.1	-1.5	2.6	6.8	14.1
		Y-o-Y	-0.7	-1.5	1.8	3.4	10
	Change of Market Capitalization (%)	Q-o-Q	-0.3	0.4	9.2	-2.1	4.6
		Y-to-Date	-0.4	-0.1	9.2	6.8	11.7
		Y-o-Y	-3.4	-0.1	7.6	6.9	12.1
Dubai	Change of Share Price Index (%)	Q-o-Q	6.8	-3.8	-6.5	-9.2	-2.5
		Y-to-Date	6.0	2.0	-10.0	-15.1	-17.2
		Y-o-Y	3.6	2.0	-9.4	-12.8	-20.3
	Change of Market Capitalization (%)	Q-o-Q	5.7	2.4	1.9	-3.6	-1.2
		Y-to-Date	15.8	18.5	1.9	-1.8	-2.9
		Y-o-Y	12.0	18.5	1.7	6.3	-0.6

Source: Abu Dhabi Securities Exchange and Dubai Financial Market
Note: Changes computation (Q-o-Q) is based on quarterly average of end-of-month values for the share price index and market capitalization.

3.2.2. Credit Default Swaps Premiums

The default risk premium for the Emirate of Abu Dhabi remains at a low level, which decreased in 2018 Q3, after a slight increase in 2018 Q2. In the Emirate of Dubai, it moved upwards compared to the previous quarter (see Figure 3.2.1).

Figure 3.2.1. UAE – Sovereign Credit Default Swaps (CDS)

	2017				2018		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Emirate of Abu Dhabi	51.1	43.8	57.3	62.9	56.2	63.7	62.9
Emirate of Dubai	128.6	114.0	121.4	130.6	106.8	116.1	124.4

Source: Bloomberg.
Note: All quarterly data are the average of each quarter. Premiums are expressed in basis points.

Despite the recent increase for Dubai, CDS levels remained very low, in historical terms, which reflect the recent firming up of oil prices and continued progress on fiscal reforms and debt sustainability.

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Chapter 4. Monetary Developments and The Central Bank's Financial Position

Monetary aggregates exhibited a mixed behavior in 2018 Q3 following some decline in Cash and Bank Balances that was dominated by continuous increase of Government Deposits. On the Liabilities' side of the Central Bank's balance sheet, a decrease took place for Required Reserves, Certificates of Deposits and Currency Issued. Concerning EIBOR, it fluctuated around a slight upward trend in 2018 Q3, while the Spread EIBOR vs. US LIBOR decreased in September, as the latter increased in line with the Fed's decision to increase its policy rate. The Spread of the 10-year Swap rates for the Dirham vs. USD increased.

4.1 Monetary Aggregates

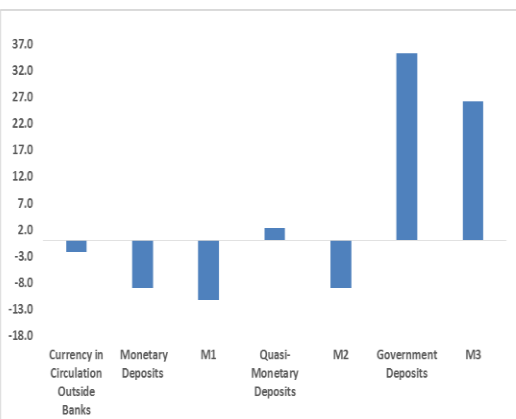
During 2018 Q3, M1 decreased by 3.1% to reach AED 484.2 billion at the end of September compared to end of the previous quarter. The decrease was due to the fall in Monetary Deposits by AED 9.1 billion, reaching AED 415.3 billion, and the fall in Currency in Circulation by AED 2.2 billion reaching AED 68.9 billion.

Money supply M2 decreased by 2.3% to reach AED 1291.1 billion, due to the above-indicated decrease in M1 despite the increase in Quasi-Monetary deposits by AED 2.3 billion, reaching AED 806.9 billion.

Meanwhile, M3 increased by 0.7% to reach AED 1,579.8 billion, due to an increase in Government deposits by AED 35.2 billion, which reached AED 288.7 billion.

Figure 4.1 Change in Monetary aggregates in 2018 Q3

In billions of Dirhams



Source: Central Bank of the UAE

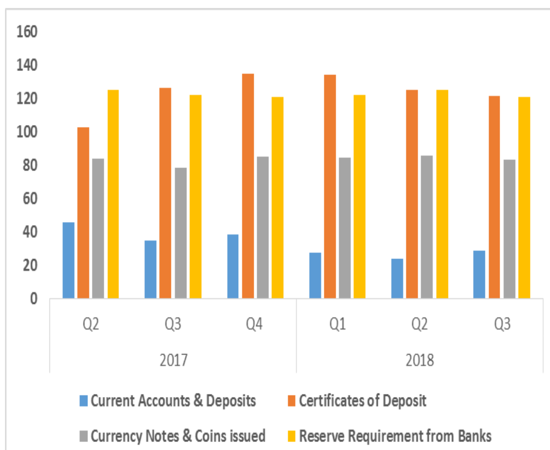
4.2 Central Bank Balance Sheet

Changes in the Central Bank balance sheet are triggered by the liquidity position in the banking system, reflecting developments in the oil price and foreign currency flows, in tandem with the change in assets at banks operating in the UAE. During 2018 Q3, total assets of the Central Bank decreased by 1.6% (AED 6 billion) to reach AED 380.1 billion, due mainly to a decrease in Cash and Bank Balances by AED 9.6 billion.

On the liabilities side, a decrease was recorded in Required Reserves by AED 4.2 billion and in Currency Issued by AED 2.9 billion, while Certificates of Deposits (CDs) issued by CBUAE and purchased by banks decreased by 3.8 billion. Nonetheless, the balance of CDs at banks remained in the amounts of AED 121.4 billion at end of September, which boosts the ELAR above the regulatory requirement by CBUAE.

Figure 4.2 Central Bank Liabilities

In billions of Dirhams



Source: Central Bank of the UAE

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Table 4.1 Central Bank Balance Sheet

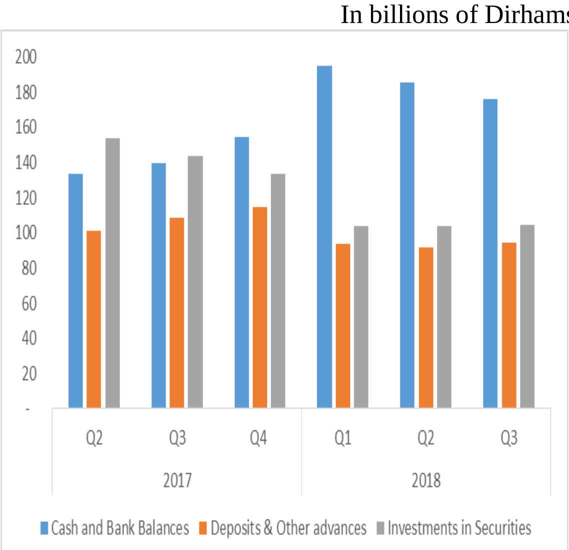
In billions of Dirhams

	2017		2018		
	Q3	**Q4**	**Q1**	**Q2**	**Q3**
Total Assets, Of which:	**396.1**	**404.9**	**395.6**	**386.1**	**380.1**
Cash and Bank Balances	140.0	154.2	195.2	185.6	176.0
Deposits & Other advances	108,.3	115.2	93.6	91.8	91.6
Investments in Securities(1)	143.5	133.7	104.2	104.2	104.2
Gold Bullion	1.1	1.2	1.2	1.1	1.1
Total Liabilities, Of which:	**375.5**	**384.3**	**373.6**	**364.1**	**359.0**
Current Accounts & Deposits	35.0	38.6	27.7	24.3	28.8
Reserve Requirement from Banks	122.1	121.2	122.0	125.1	120.9
Certificates of Deposit	127.0	135.1	134.3	125.2	121.4
Currency Notes & Coins issued	78.3	85.4	84.7	86.1	83.2

Source: Financial Control Division, Central Bank of the UAE
(1) Including Held-to-Maturity foreign securities and Securities of Ministry of Finance and Dubai Government

Figure 4.3 Central Bank Assets

In billions of Dirhams



Source: Financial Control Division, Central Bank of the UAE

4.3 Central Bank Foreign Assets

As shown in Table 4.2, the balance of foreign assets decreased from AED 331.1 billion at end of 2018 Q2 to AED 327.3 billion at end of 2018 Q3, due to a fall in Current Account Balances & Deposits with Banks Abroad by AED 5.4 billion.

Table 4.2 Central Bank's Foreign Assets

In billions of Dirhams

	2017		2018		
	Q3	**Q4**	**Q1**	**Q2**	**Q3**
Total Foreign Assets*	344.1	347.7	336.3	331.1	327.3
Foreign Securities	94.3	84.5	55.2	55.2	55.2
Current Account Balances & Deposit with Banks Abroad	241.5	256.6	271.2	260.5	255.1
Other Foreign Assets	8.3	6.6	9.9	15.4	17.0

Source: Central Bank of the UAE, end of quarter data
*Excluding IMF Reserve Position and SDR Holdings

4.4. International Reserves Position

The credibility of the fixed peg arrangement requires the Central Bank to hold sufficient foreign currency reserves. To this end, Article 63 of Decretal Federal Law No. 10 of 2018 regarding the Central Bank and Organization of Financial Institutions and Activities, states that market value of balance of Foreign Reserves "*shall not, at any time, be less than solvency seventy percent (70%) of the value of the monetary base*." Article 62 of the sad Law defines Reserves of Foreign Assets as follows:

(1) *Gold bullion and other precious metals.*
(2) *Cash, deposits and other monetary and payment instruments denominated in foreign currencies, freely convertible in global markets.*
(3) *Securities denominated in foreign currencies and issued or guaranteed by foreign governments and their related companies, entities, institutions, and agencies, or by international monetary and financial institutions, or by multinational corporations, and are tradable in global markets.*

Table 4.3 reports the International Reserves Position of the Central Bank, which decreased from AED 333.6 billion at the end of 2018 Q2 to AED 329.8 at end of 2018 Q3. As a ratio of the monetary base, however, the International Reserves Position increased during this period, from 94.3% to 94.9%, i.e., higher than the above-indicated minimum cover ratio, which supports the robustness of the fixed exchange rate peg.

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Table 4.3 International Reserves

In billions of Dirhams

	2017		2018		
	Q3	Q4	Q1	Q2	Q3
1. International Reserve Position*	**347.0**	**350.3**	**339.0**	**333.6**	**329.8**
Of which					
− Current Account Balances & Deposits with Banks Abroad	241.5	256.6	271.2	260.5	255.06
− Foreign Securities	94.3	84.5	55.2	55.2	55.2
− IMF Reserves Position + SDR Holdings	2.8	2.6	2.7	2.6	2.5
2. Monetary Base	**358.7**	**377.4**	**365.2**	**353.9**	**347.7**
Of which					
− Currency Issued	78.3	85.4	84.7	86.1	83.2
− Reserve Requirements	122.4	121.4	122.0	125.1	120.9
− Banks & OFCs Current Accounts at CBUAE	31.4	35.5	24.2	17.5	22.2
Ratio (1/2)	**96.7%**	**92.8%**	**92.8%**	**94.3%**	**94.9%**

Source: Central Bank of the UAE, end of quarter data
* Gross International Reserves including IMF Reserve Position and SDR Holdings

4.5 Developments in Banks' Liquidity at the CBUAE

Banks' liquid assets at the Central Bank are composed mainly of their current accounts at the Central Bank, required reserves, and the balance of certificates of deposits held by banks. These assets decreased from AED 376.5 billion at the end of 2018 Q2 to AED 372.2 billion at the end of 2018 Q3, i.e., by AED 4.3 billion, mainly due to a decrease in Required Reserves by AED 3.6 billion, in addition to the above-indicated decline in CDs. Nonetheless, liquidity at banks remained sufficient, as the Eligible Liquid Assets Ratio (ELAR) remained at 16.1%, above the regulatory requirement of CBUAE.

4.6 Interest Rates

The fixed peg of the exchange rate of the Dirham to the US dollar means that the CBUAE has to adjust its policy rate to changes in the interest rate policy in the U.S. Therefore, the Central Bank of the UAE announced an increase in interest rates applied to its Certificates of Deposits, in line with the Fed's decision to increase its target Federal Funds rate in September by 25 basis points to reach 2–2.25% range. Similarly, the Repo Rate applicable to banks' borrowing of short-term liquidity from the Central Bank against their holding of CDs, has been increased by 25 basis points.

4.6.a Short-term interest rates

The Emirates Interbank Offer Rate (EIBOR) comprises the daily quotes of the largest banks operating in the country, based on the interest rate at which banks offer to lend unsecured funds to other banks in the Dirham wholesale money market. New "Regulations on Interbank Rate Submissions by EIBOR Panel Banks" were issued on 25 March 2018, in line with the recommendations of the International Organization of Securities Commissions (IOSCO), with the aim to enhance governance, standardization and transparency in the rate-setting process at Panel Banks.

The main requirements of the new regulations are: (i) EIBOR Panel Banks are to rely, as much as possible, on the use of available transaction data from the day before, otherwise they need to base their estimates based on unsecured interbank transaction of greater than AED 20 million, unsecured wholesale deposits of greater than AED 20 million from GREs, corporates and NBFIs, and internally developed expert judgment; and (ii) Panel Banks are required to appoint an independent auditor from a panel of audit firms nominated by the CBUAE.

During 2018 Q3, EIBOR 3-month fluctuated around a slight upward trend and an average of 2.5%. Nevertheless, the rate did not increase at the end of September, reflecting sufficient liquidity in the UAE banking system. Meanwhile, the 3-month LIBOR on the U.S. dollar fluctuated during July and August, then it increased in September in line with the Fed's decision to increase its policy rate.

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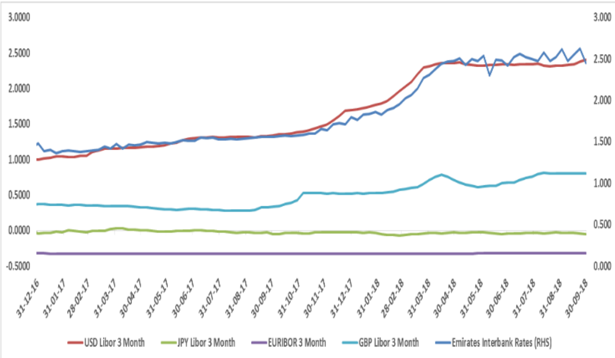
Figure 4.4.a Benchmark rates (3-month) for the Dirham and key other currencies (%)



Source: Bloomberg

The 3-month GBP increased by about 10 basis points during 2018 Q3, in line with the increase in the policy rate of the Bank of England, increasing BREXIT uncertainties and rising inflation in the UK. The LIBOR rates on the Euro and the Japanese Yen remained in negative territory in consistency with the directions of monetary policy adopted by the respective central banks.

Concerning the Spread EIBOR vis-à-vis the USD LIBOR (3 –month), it increased from an average of 17 basis points in July to 19 basis points in August, before decreasing to 15 basis points in September due to the above-indicated increase in the LIBOR on USD, on the one hand, and the excess liquidity in the banking system in the UAE on the other hand. Indeed, the correlation coefficient in Q3 between the Spread and the change in excess liquidity in the UAE is -0.82, implying tighter spread with more excess liquidity.

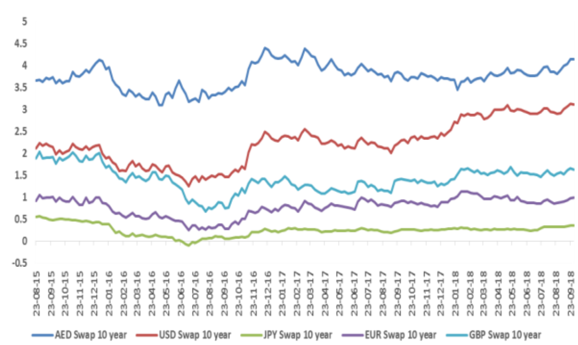
Figure 4.4.b Dirham Spread vs. USD LIBOR (3 month, %)

Source: Bloomberg

4.6.b Long-term swap rates

Given the absence of a government bond market in local currency in the UAE, awaiting the issuance of Federal Debt instruments per the newly issued Debt Law No. (9) for 2018, the swap market reflects the yields of long-term securities [(9)]. As shown in Figure 4.6.a, the 10-year swap rates for the Dirham increased from 3.8% in early July to 4% in August, and to 4.14% in the second half of September. The above-indicated increase in the Dirham 10-year swap rate led to an increase in the Spread vis-à-vis the US dollar Swap rate (Figure 4.5.b), which rose from an average of 89 basis points in July to 93 basis points in August and to 100 basis points in September.

Figure 4.5.a 10-year swap rates (%)



Source: Bloomberg

(1) By definition, interest rate swaps correspond to an exchange of a fixed rate for a floating payment that is linked to an interest rate, most often the London Interbank Offer Rate (LIBOR).

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Figure 4.5.b Spread 10-year Dirham Swap vs. USD Swap (%)

Source: Bloomberg