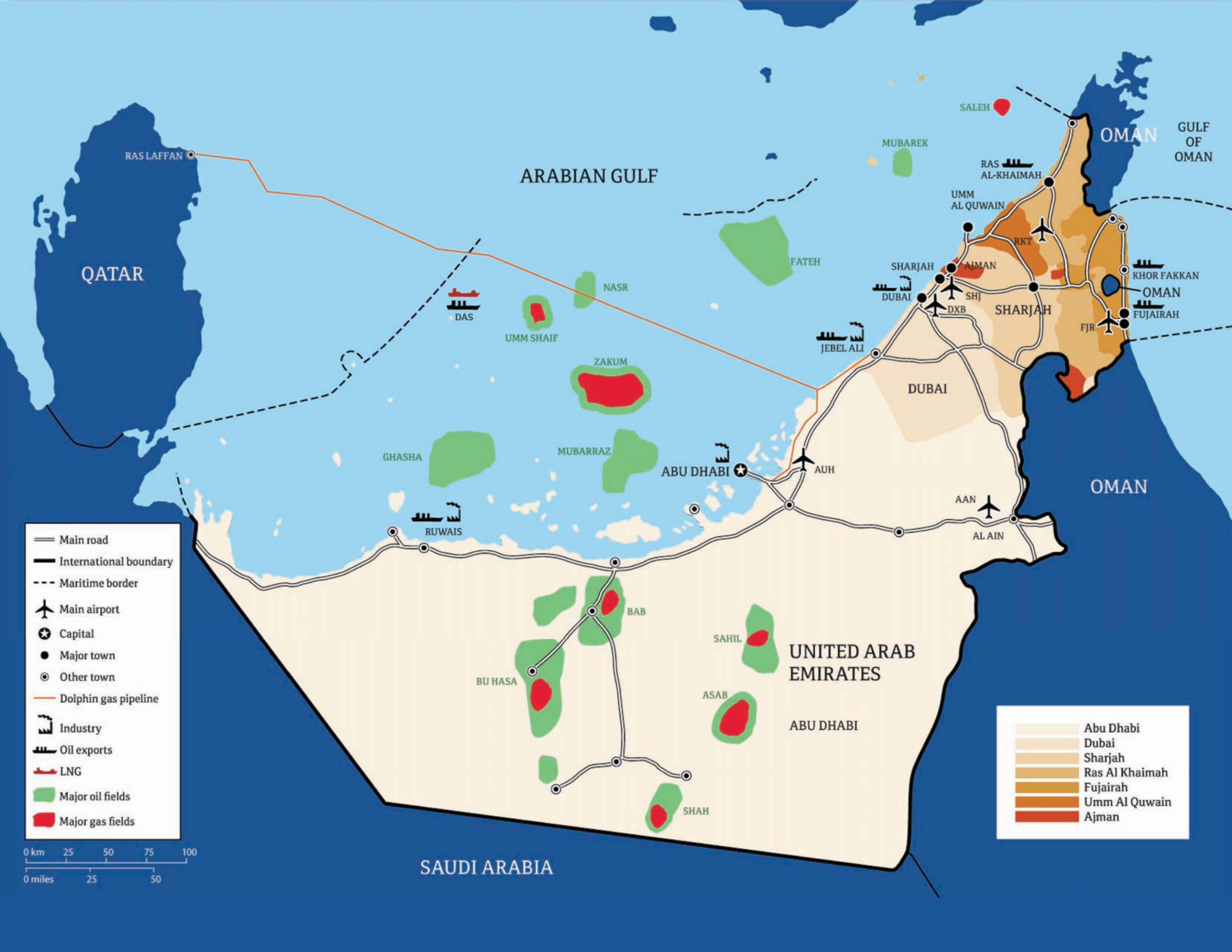
UAE Economic Insight

2012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Main road
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Other town
Dolphin gas pipeline
Industry
Oil exports
LNG
Major oil fields
Major gas fields
0 km 25 50 75 100
0 miles 25 50
Abu Dhabi
Dubai
Sharjah
Ras Al Khaimah
Fujairah
Umm Al Quwain
Ajman

Economics Team

Mohamad Moabi
Assistant General Manager
+974 4440 7660
mohamad.moabi@qnb.com.qa

Roy Thomas
Senior Economist
+974 4497 5927
roy.thomas@qnb.com.qa

Justin Alexander
Senior Economist
+974 4497 5926
justin.alexander@qnb.com.qa

Rory Fyfe
Economist
+974 4497 5929
rory.fyfe@qnb.com.qa

Minko Markovski
Economist
+974 4497 5928
minko.markovski@qnb.com.qa

Hamda Al-Thani
Economist
+974 4497 5930
hamda.althani@qnb.com.qa

2012-13 Outlook Summary

- The UAE is one of the *most diversified economies in the GCC,* with the services sector accounting for 44% of overall GDP in 2011. The share of oil and gas sector is expected to fall to 35% of GDP by 2013 as the non-oil sector drives UAE's overall real GDP growth by a moderate 2.7% in 2012-13.
- Dubai has been at the forefront of UAE's diversification, transforming itself into a *regional hub for business, finance, trade and tourism*—these services-oriented sectors will be key to driving non-oil growth in 2012-13.
- Abu Dhabi holds the bulk of hydrocarbons reserves but production will remain flat in 2012-13 owing to OPEC caps on oil output and with *no planned oil or gas capacity expansions coming on-stream until 2018,* leading to a marginal growth of 0.7% in this sector in 2012-13.
- Nonetheless, *higher oil prices will act as a key incentive for the Abu Dhabi government's investment* into non-oil industries, which will produce a strong growth of 4.7% in this sector in 2012-13, being buoyed by increasing infrastructure expenditures.
- The booming economy drew in large numbers of foreign workers up to 2008 but population growth has moderated subsequently—we expect it to stabilise at 2.9% in 2012-13 bringing the *total population close to 9m*.
- *Inflation is expected to be low at 1.1%* in 2012-13 as oversupply in the real estate sector depresses rental prices, which will be counterbalanced by small increases in food, transport and communication prices as a result of high oil prices.
- Fiscal revenue is mainly derived from hydrocarbon exports and is expected to be broadly constant in 2012-13 due to forecasted flat oil prices. Despite consolidating spending by Dubai, the *fiscal surplus will contract as Abu Dhabi further raises spending on wages and infrastructure*.
- The UAE is over-banked and has a high concentration of leading local banks. Nonetheless, the *banking system is well capitalised* to counter external shocks, and is only moderately exposed to Europe.
- The Dubai and Abu Dhabi *stock markets* together currently constitute the largest exchange in the GCC. Rising retail investor interest coupled with a possible upgrade to MSCI emerging market status could boost the markets going forward.
- Finally, UAE's business environment is improving as it ranks *fifth globally in terms of trading across borders* and 33rd overall in the World Bank's Doing Business Index.

Contents

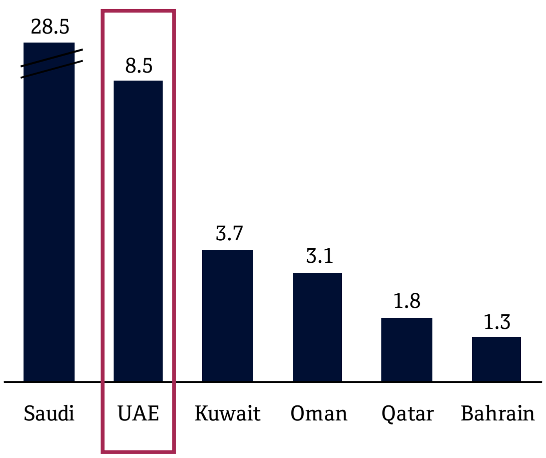
1. Overview and Demographics

A. Overview

The UAE is a **federation** of seven individual emirates: **Abu Dhabi**, **Ajman**, **Dubai**, **Fujairah**, **Ras Al-Khaimah**, **Sharjah, and Umm Al-Quwain**. It has the second largest population in the GCC, estimated to have reached 8.5m[1] in 2011 (Fig 1.1), which accounts for 18% of the total GCC population.

Fig 1.1: GCC Population (2011)

(m, nationals and expatriates)



Source: National statistical authorities, NBS, IMF, QNB Group estimates

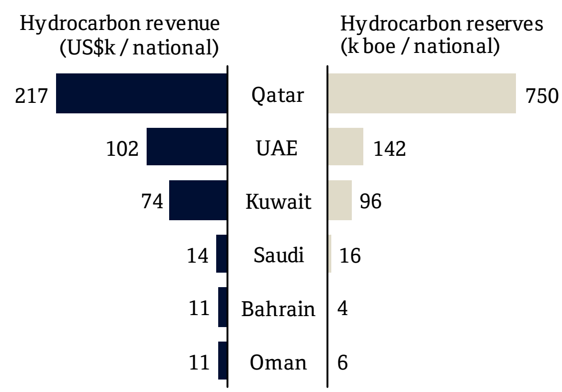
Abu Dhabi is the largest emirate, by area, wealth and population. It accounts for around 87% of the UAE's land area and 60% of its GDP. Dubai is the second largest emirate, with around 30% of total GDP.

The UAE has one of the most diversified economies in the GCC

The UAE's hydrocarbon reserves have provided a solid foundation for the country's development. However, with oil and gas resources being concentrated in Abu Dhabi, the other emirates have had to look at services and industry to boost their GDP. This involved initiatives aimed at attracting foreign investment, such as a business-friendly environment, along with a focus on trade, tourism, logistics, and manufacturing sectors. These factors have led to the **non-oil sector** in the UAE accounting for 62% of overall GDP in 2011, the highest in the region after Bahrain. The services sector alone accounted for 44% of overall GDP in 2011.

The UAE is endowed with massive natural resource reserves. In 2011, the UAE had the seventh largest oil reserves in the world, at 98bn barrels (b), and the seventh largest gas reserves, at 213trn cubic feet (cf). This provides the relatively small national population with enormous wealth. The UAE's oil and gas reserves per national are the second largest in the GCC (Fig 1.2), at around 142,000 barrels of oil equivalent (boe).

Fig 1.2: GCC Oil and Gas Wealth (2011)



Source: BP, IMF, QNB Group estimates

The governments of the various emirates in the federation are looking through long-term plans to diversify their economies. Abu Dhabi is aiming at diversifying through a long-term vision.

The Abu Dhabi Economic Vision 2030 has been developed around four key pillars

The **Abu Dhabi Economic Vision 2030** sets targets for the government and outlines an economic strategy, identifying key resources to be developed and core policy reforms to be implemented. The government has identified key pillars that will form the basis of the emirate's social, political and economic future:

- Economic development
- Social and human resources development
- Infrastructure development
- Environmental sustainability

The Abu Dhabi Economic Vision 2030 is implemented through shorter-term five-year economic plans, which will provide a focused framework to realise the long-term vision and measure progress.

[1] The UAE did not conduct a planned census in 2010, but the National Bureau of Statistics (NBS) did substantially revise upwards its 2010 population estimate to 8.3m from 4.1m in 2005. The estimation methodology was based on the 2005 census, addition of natural increase and net migration. The new figure estimates the growth rate since the 2005 census at around 20% p.a.

The oil sector has historically accounted for the bulk of Abu Dhabi's economy. **Diversification** is a key objective of the Abu Dhabi Economic Vision 2030, which includes ambitious targets for the development of the non-oil sector (Table 1.1). It seeks to encourage local enterprise, innovation and investment in downstream oil and gas activities. Other important areas will be to improve the efficiency and quality of the labour market and the financial sector.

The government also plans to transform its spending and investment pattern. Budget allocations for economic development will increase by more than five-fold in the coming ten years, with the objective to increase the share of non-oil GDP from 41% in 2005-07 to 64% by 2030.

Table 1.1: Abu Dhabi Development Targets

	(2005-2007)	Target (2015)	Target (2020)	Target (2030)
Real GDP growth Y-o-Y	16.4%	7.0%	6.0%	6.0%
Non-oil Real growth Y-o-Y	11.8%	9.5%	7.5%	7.5%
Non-oil GDP as % of Total GDP	41%	50%	56%	64%
WB Doing Business Ranking	77	43	22	20
WEF Global Competitiveness Ranking	31	25	19	17

Source: Abu Dhabi Economic Vision 2030

Investment in **human capital** is a critical factor in achieving Abu Dhabi's economic targets through higher productivity, full employment and increased participation of nationals in the economy. Abu Dhabi aims to improve education standards and create a skilled national workforce. It is also looking at doubling the number of those in the national workforce with university or equivalent degrees to provide the economy with the necessary skills for diversification.

Several strategic aims outlined in the Abu Dhabi Economic Vision 2030 vision are replicated amongst the other emirates. However, due to its high levels of oil and gas contribution to GDP, Abu Dhabi currently puts more of an emphasis on diversification away from oil and gas than the other emirates. Dubai has a model built around creating a favourable business environment that attracts foreign businesses and workers. Many of the other emirates aim to follow Dubai's model, which has the services and industry as key economic growth drivers.

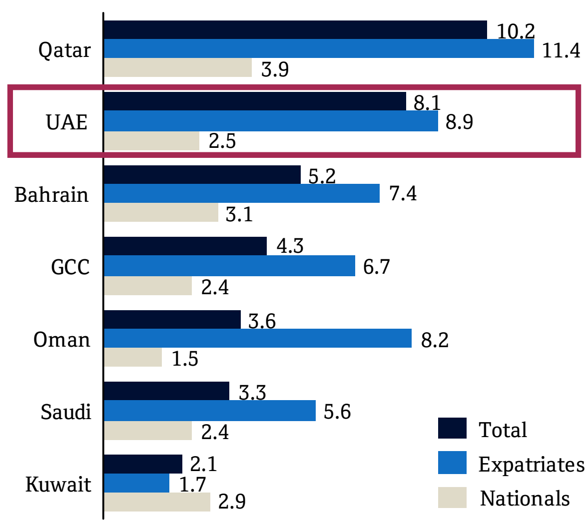
B. Demographics

Population

The UAE population grew at an average of 15.0% between 2005-10

The UAE's **total population** reached **8.3m** in mid-2010, according to estimates[2] from the NBS. The population witnessed a high growth of 15.0% during 2005-10 with particularly strong growth during 2005-08 at 25.3%[3]. It however slowed to 1.2% in 2009-10. The population increase has been driven by employment requirements, brought about by successful foreign investment initiatives in various sector of the economy. Strong economic growth added a further impetus, as has the oil and real estate boom in 2005-08. The downturn in the aftermath of the global financial crisis in 2009-10 led to a slowdown in population growth. Nonetheless, the UAE still had the second highest overall population growth among the GCC countries in 2007-11 (Fig 1.3).

Fig 1.3: GCC Population Growth (2007-11)
(% CAGR)



Source: National statistical agencies, QNB Group estimates

After a slowdown in 2009-10 population growth is picking up

QNB Group estimates that the population growth rate increased to 3.3% in 2011, from 0.8% in 2010. It is estimated to rise further to 3.5% in 2012, mainly due to a recovery in business and consumer sentiment, which

[2] The exponential growth model was used in estimating the population. The methodology is based on the 2005 census and the addition of natural population increase and net migration.

[3] This is the compounded annual growth rate (CAGR), which is a geometric mean. In general, unless otherwise specified, all multi-year growth rates mentioned in this report will be CAGRs, rather than arithmetic means.

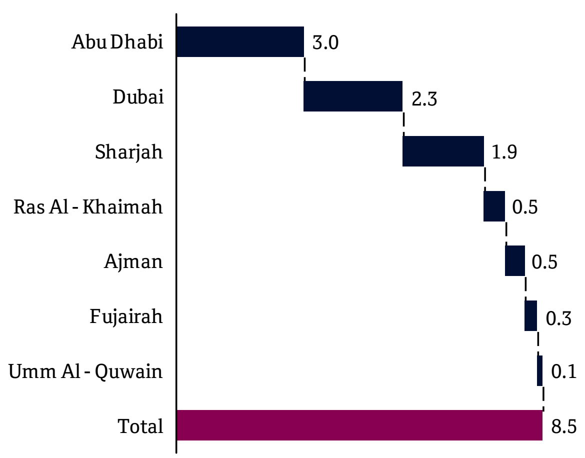
will boost economic activity and growth. Additionally, sustained high oil and gas prices will drive growth and government expenditure, creating more jobs.

QNB Group forecasts that there will be a slight slowdown in population growth to 2.8% in 2013, as we are expecting a small drop in oil prices in 2012, leading to the slowdown in population growth in 2013. This effect is compounded by the fact that lower oil prices also lead to lower government expenditure.

Abu Dhabi and Dubai account for 62% of the total population

Abu Dhabi has the largest population among the individual emirates, accounting for 35% of the total (Fig 1.4). Dubai has the second largest population. Emirati nationals[4] accounted for 11% of the total population in 2011. In recent years, Abu Dhabi's population has grown more rapidly than Dubai's (7.0% from 2007-11, compared with 2.9% in Dubai) as its oil-dominated economy has benefited from high oil prices and diversification efforts, which has led to more jobs.

Fig 1.4: Population by Emirates (2011)
(m)



Source: NBS, QNB Group analysis

Population growth has also been strong in Sharjah (9.5% during 2007-11) and in some smaller emirates as they have expanded from a lower base as gains from UAE's economic boom have trickled down to them. Lower housing costs and proximity to Dubai have also attracted residents who work in Dubai to reside in Sharjah and Ajman.

[4] Based on NBS 2010 population estimates. The UAE has the lowest level of national population as a percentage of overall population in the GCC at 11%, compared to a high of 68% in Saudi Arabia and a GCC average of 53%. The UAE has successfully followed an open development model designed to attract foreign capital, companies and workers. Additionally, high levels of investment in economic development have drawn in large numbers of low- and high-skilled expatriate workers to carry out the required work.

A more recent phenomenon has been a reverse migration to Dubai. The downturn in Dubai coupled along with employment opportunities in Abu Dhabi has led many workers to reside in Dubai at more competitive housing costs while working in Abu Dhabi.

Labour force

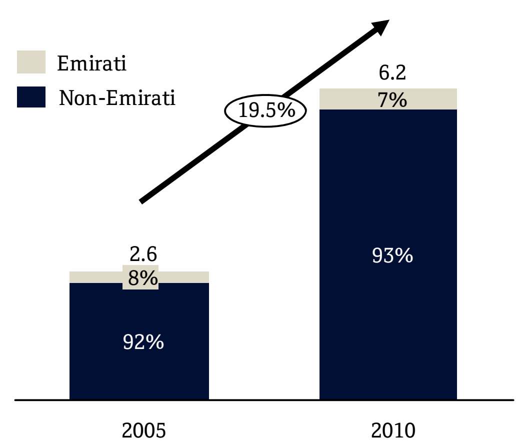
The labour force has more than doubled between 2005-10 to reach 6.2m

On the basis of a labour force survey carried out by the NBS in 2009 and its estimates for the total population, QNB Group estimates that the labour force grew at a CAGR of 19.5% from 2.6m in 2005 to 6.2m in 2010 (Fig 1.5).

Population growth was driven by the large inflow of expatriate workers as the economy expanded. The expatriate workforce accounted for an estimated 93% of the total workforce in 2010.

The Emirati labour force has doubled in six years and could be linked to a combination of factors such as: new young entrants, more government employment and emiratisation[5] efforts. The Emirati participation in the labour force is concentrated in the public sector with 85% of employed nationals working in federal and local government. The participation of nationals in the private sector is only 7.4% of those employed. This is similar to other GCC countries where public sector employment is preferred by nationals over the private sector.

Fig 1.5: Labour Force by Nationality (2005-10)
(m, % share and CAGR shown)



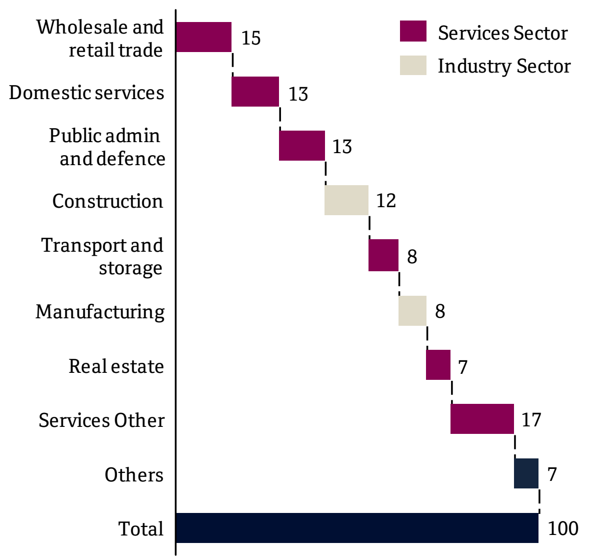
Source: NBS, QNB Group analysis

[5] Efforts by the government to increase the contribution of qualified Emiratis to the labour force. In some instances it could mean a directive by the government to companies and institutions to have a minimum employment percentage of locals.

The services sector is the principal employer accounting for 73% of the total workforce

The private economy accounts for 72% of employment in the UAE. By economic sector, the vast majority of jobs (73%) are in the services sector, which at an emirate level reaches as high as 82% for Dubai. Wholesale and retail trade, domestic services and public administration and defence are the most important sub-sectors in this category (Fig 1.6).

Fig 1.6: Labour Force by Economic Sector (2009)
(% share of total)



Source: NBS, QNB Group analysis

Construction is also a major employer accounting for a 12% share of total employment. Although the oil and gas sector contributes to a significant share of GDP, its labour force participation is small, given that it is capital intensive in nature.

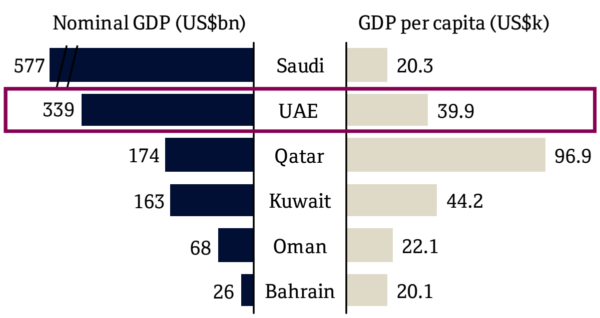
2. GDP

A. Nominal GDP

The UAE has the second largest economy in the GCC and is also one of the most diversified

The UAE has the second largest economy in the GCC, representing 25% of the total GDP of the GCC. Nominal GDP reached US$339bn in 2011 (Fig 2.1).

Fig 2.1: GDP in the GCC (2011)



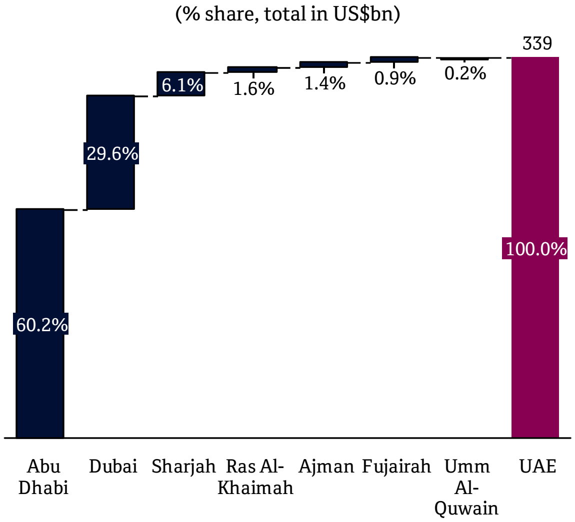
Source: National statistical authorities, IMF, QNB Group estimates

It also has the region's third highest GDP per capita, estimated at US$39,932 in 2011.

The **non-oil sector** dominates the economy, accounting for 62% of the UAE's total GDP in 2011 as efforts to diversify have been successful. Nominal GDP grew by an estimated 19% in 2011, supported by higher oil prices.

Abu Dhabi makes the largest contribution to the UAE's GDP, accounting for 60.2% of overall nominal GDP (Fig 2.2).

Fig 2.2: GDP Share by Emirate (2011)
(% share, total in US$bn)



Source: NBS, IMF, QNB Group estimates

The services sector accounted for an average of 48% of UAE GDP from 2007-11, with the oil and gas sector accounting for 33%, the non-oil industry sector accounting for 22%, and agriculture accounting for 1%. Meanwhile, imputed bank service charges[6] deducted an average of 4% from GDP during this period.

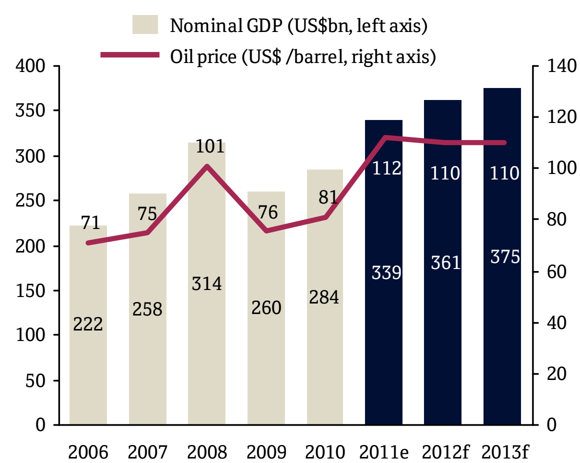
The UAE witnessed a golden decade of economic development during 1999-2008

The UAE economy witnessed a period of rapid economic growth during 1999-2008. The nominal GDP growth rate averaged 21% during that period, one of the highest in the region and globally. The economy contracted by 17% in nominal terms in 2009 owing to the global financial crisis, the decline in oil prices and the Dubai property market correction. The UAE economy has since recovered with nominal GDP increasing by 9% in 2010 and 19% in 2011, largely due to rising oil prices.

GDP growth in 2012 will be driven by the expansion of the services and industry sectors

As oil prices are expected to decline marginally in 2012 to US$110/b, we forecast that nominal GDP growth in 2012 will be subdued at 6.7% (Fig 2.3), with growth being mainly driven by the services and industry sectors. GDP growth in 2013 is forecast at 3.8%. The widening eurozone debt crisis and global economic slowdown are expected to pose further downside risks to the economy.

Fig 2.3: Nominal GDP and Oil Prices (2006-13)



Source: NBS, IMF, QNB Group forecasts

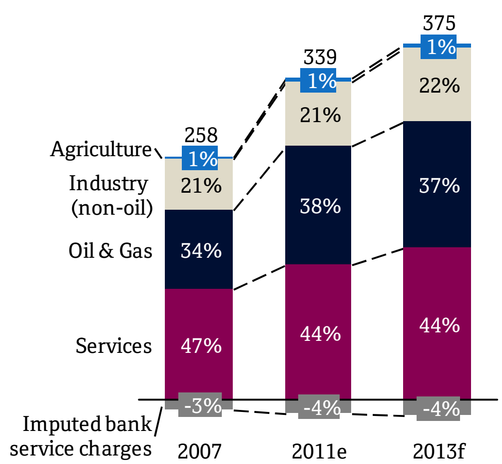
[6] Imputed bank service charges are defined as the difference between the interest received from borrowers and the interest paid to depositors. The value of imputed banks services are deducted from sectors according to the distribution of loans used by the sectors. As such, it is sometimes difficult to assign it to a particular sector and is usually deducted from the services sector in some countries or from the overall GDP in countries like the UAE.

B. Economic Structure

The services sector is expected to remain the largest contributor to overall GDP

The **services sector** dominates the UAE economy and accounted for 44% of overall GDP in 2011 (Fig 2.4).

Fig 2.4: GDP by Main Economic Sectors (2007-13)
(US$bn, % share of total)



Source: NBS, QNB Group forecast

The services sector has grown at 5.0% from 2007-11. The services sector will continue to form the largest portion of GDP and we forecast that it will grow by a further 6.0% in 2012 and by 5.4% in 2013. The underlying drivers for growth in this sector are expected to come from the increasing population, oil prices and government expenditure.

The **oil and gas sector** forms the second largest component of GDP and its share averaged 33% over 2007-11. Its share in nominal GDP has declined from a high of 63% in 1980, to 46% in 1990, and to just 31% in 2010. We forecast a marginal growth in 2012 as the OPEC quotas are eased, while flat prices will result in stagnation for 2013.

The **industry sector** forms the final core component of the overall GDP. The major individual contributors within the industry sector in 2011 were construction (51%) and manufacturing (40%). We forecast a nominal growth of 7.9% in 2012-13, due to a direct and lagged effect of oil prices in driving this sector, coupled along with government expenditure.

The opening up of the economy has made the UAE a global trading hub

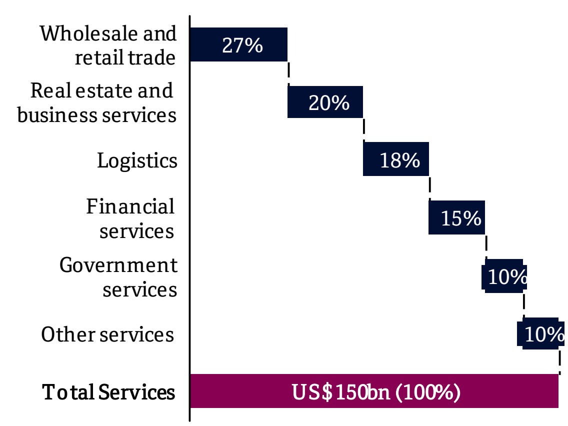
The diversification of the UAE's economy away from oil has been a key part of the country's overall economic strategy. In 1975, the oil sector accounted for 66% of overall GDP, with the services sector accounting for 21% and the industry for 13%. During the early eighties the non-oil sector had overtaken the oil sector. By the early nineties the services sector was the largest contributor to GDP.

The economic diversification strategy for the UAE was partly reinforced by dwindling oil resources in Dubai and the other emirates, where declining production inspired a new economic development strategy based around a business friendly environment, services and trade.

Trade will continue to be a major driver of growth in the coming years

The economic diversification strategy included the establishment of various free trade zones. This led to rapid growth in the wholesale and retail trade sector, which is the largest sub-component of the services sector (Fig 2.5). It grew at an average annual rate of 18% for the period 2001-10.

Fig 2.5: Breakdown of Services Sector GDP (2011)
(% share of total)



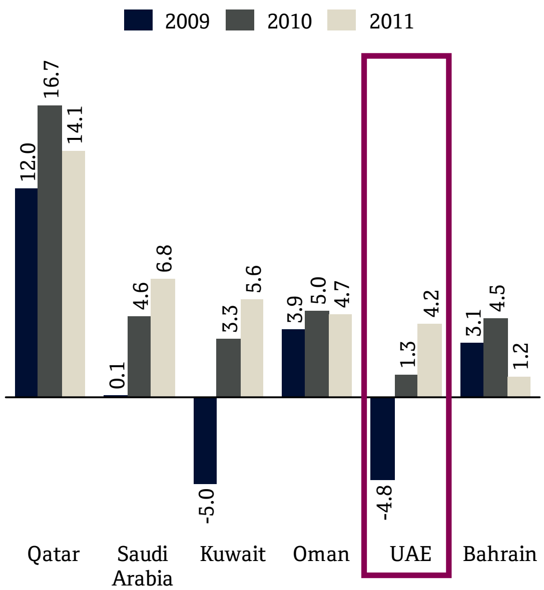
Source: NBS, QNB Group analysis

C. Real GDP

Real estate has had a major impact on UAE real GDP

During the period 2000-08, a period of strong economic growth across the region, the UAE's real GDP grew at a CAGR of 4.8%. Among the GCC economies, the UAE along with Kuwait witnessed a contraction in 2009 (Fig 2.6).

Fig 2.6: Comparison of Real GDP Growth in the GCC (2009-11)
(% change)



Source: NBS, IMF, QNB Group analysis

In 2009, GCC economies were affected by the global financial crisis and lower oil prices. The UAE real GDP contracted by 4.8% in 2009 as the economy was hard hit by the crash in the real estate market in Dubai.

The **oil sector** in the UAE has been constrained by OPEC's[7] production quotas and targets, which reduced overall production targets from 2.5m b/d in 2007 to 2.2m b/d in 2009. This factor along with lower oil prices in late 2008 and 2009 resulted in the oil sector GDP contracting in real terms by 1.1% during 2007-11.

The combination of the real estate crash and lower oil prices led to a broad slowdown in the UAE economy. As demand fell, wholesale and retail trade dropped by 8.0% in 2009.

The financial services sector component of real GDP also suffered, growing by only a marginal 0.7% in 2009, as banks were heavily impacted by the asset devaluation in the property sector.

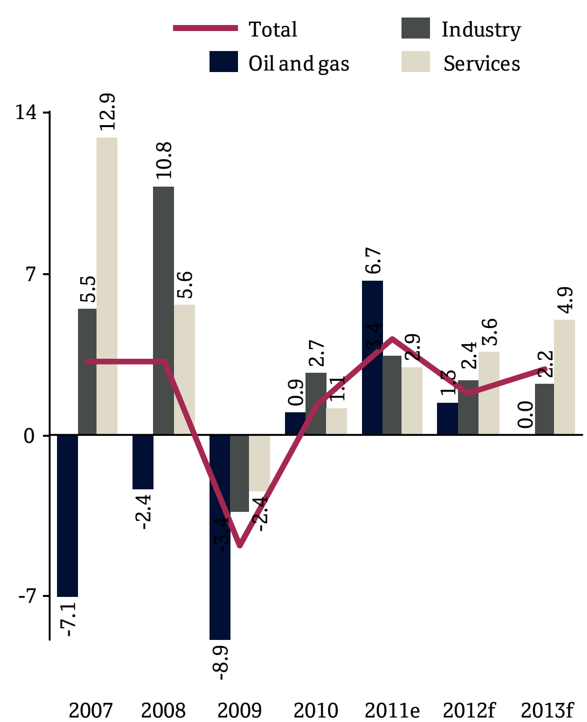
In 2010, the economy started to recover with a real GDP growth rate of 1.3%, as the construction and tourism sectors recovered. Infrastructural development also continued to grow with strong government support. The financial services sector remained weak due to the increasing levels of non-performing loans arising from exposures to the real estate sector and some government related entities (GRE's). This resulted in banks' asset devaluation and constrained overall lending.

In 2011, preliminary estimates from the Ministry of Economy show a continued recovery, with an overall real GDP growth of 4.2%. The momentum for this robust growth can be attributed to the high oil prices and overall expansion in the non-oil sectors, notably tourism. There was also a 3% increase in the industry sector as construction and manufacturing picked up.

Real GDP is forecasted to grow by 2.6% in 2012 and by 2.8% in 2013

We are forecasting a real GDP growth of 2.6% in 2012 and a growth of 2.8% in 2013 (Fig 2.7). The main drivers of this growth will be the services and industry sectors, as trade and government services continue to grow at a swift pace. The real estate and business services component is forecasted to make a recovery by 2.2% in 2012-13 as business confidence increases and lending grows.

Fig 2.7: Real GDP Growth by Sectors (2007-13)
(% change)



Source: NBS, IMF, QNB Group forecasts

[7] The Organisation of Petroleum Exporting Countries (OPEC) is a grouping of 12 oil-exporting countries. It aims to coordinate policies between its member states in order to stabilise oil markets and to ensure a steady income for oil-producing nations, secure supply to oil-consuming countries, and a fair return for investors in the oil sector. OPEC accounts for over 40% of world production and is therefore able to influence global oil markets by coordinating production adjustments and setting production targets for its members.

3. GDP by Sector

Services (Section A) is the largest component of nominal GDP, accounting for 44% of overall GDP in 2011 (Fig 3.1). Wholesale and retail trade make up the largest sub-component of this sector, followed by real estate and business services.

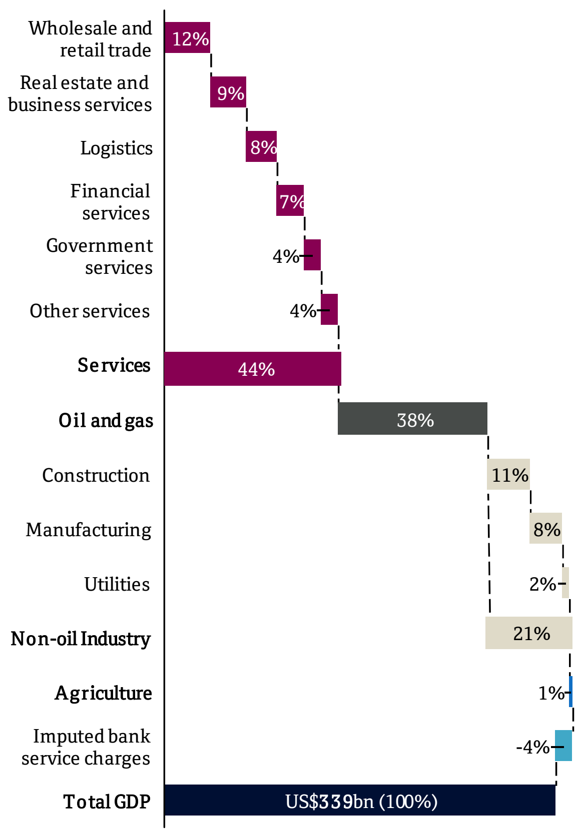
Oil and gas (Section B) accounted for 38% of GDP in 2011. It mainly includes crude oil production.

Non-oil Industry (Section C) formed 21% of GDP in 2011. It consists of construction, manufacturing and utilities. The construction sector has witnessed significant growth and forms the largest sub-sector.

Agriculture only accounts for a small proportion of GDP, which has declined from 2.2% in 2002 to 0.7% in 2011.

Imputed bank service charges[8] are deducted from the overall GDP for the UAE.

Fig 3.1: GDP by Economic Sectors (2011)
(US$bn and % share shown)



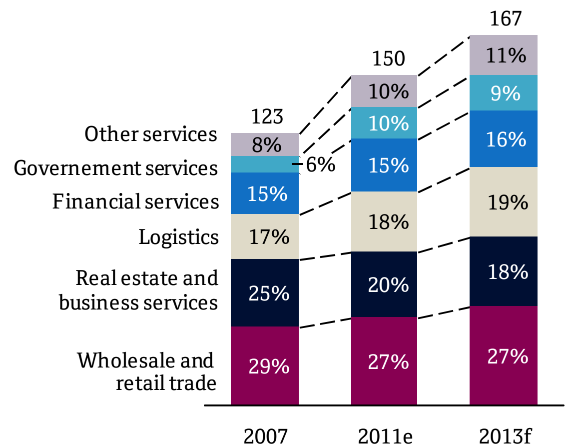
Source: NBS estimates, QNB Group analysis

[8] Imputed bank service charges are defined as the difference between the interest received from borrowers and the interest paid to depositors. The value of imputed banks services are deducted from sectors according to the distribution of loans used by the sectors. As such, it may be assigned to different sectors. It is usually deducted from the services sector in some countries or from the overall GDP in other countries such as the UAE.

A. Services

The services sector overtook the oil and gas sector in 1993 to become the largest contributor to overall GDP, as successful government initiatives to develop the non-oil economy took hold. It has been growing rapidly since then (Fig 3.2). The services sector is vital to the economy, accounting for 73% of the total workforce. QNB Group forecasts that real growth in the services sector will be 4.3% in 2012 and 3.3% in 2013.

Fig 3.2: UAE Services Sector Nominal GDP[9] (2007-13)
(US$bn and % share)



Source: NBS, QNB Group forecast

The diversification of the UAE economy has been primarily derived from emirates with small or declining oil resources, which has led to the rapid growth of their respective services sectors. A key example of this is the emirate of Dubai, which is currently the largest contributor to the services sector, accounting for around 46% of the overall services GDP. The individual break-up of Dubai's services sector (Fig 3.3) is reflected in UAE's overall make-up of services sector GDP. The emirate of Abu Dhabi is the other major contributor to the services sector, taking around 39% share of the overall sector.

Wholesale and retail trade is the largest contributor and a key driver for growth

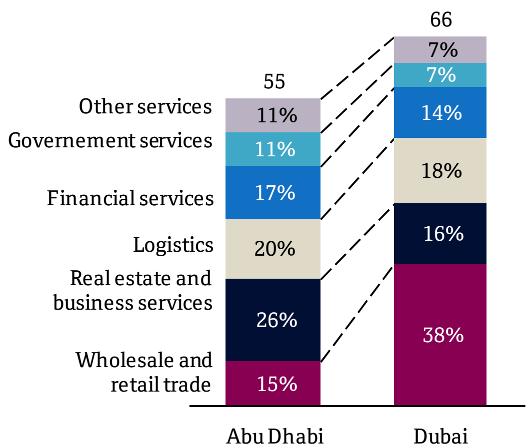
Wholesale and retail trade has more than tripled since 2001 to become the largest contributor to UAE's services sector. This sector witnessed a rapid nominal growth of 13.8% from 2003-07, and a more gradual growth of 2.6%

[9] Imputed bank service charges are usually deducted from GDP and some countries, including Qatar and Saudi Arabia in the GCC deduct them from the services sector. It is deducted from overall GDP for the UAE.

from 2007-11. The slowdown in growth has been caused by the knock-on effect from the global financial crisis and the crash in the Dubai property market, which led to reduced consumer spending. This sector has started picking up from 2010 and grew in real terms by 2.8% in 2011. We expect this sector to continue growing by a further 3.5% in 2012 and by 2.1% in 2013, as confidence grows and retail spending gathers pace.

Fig 3.3: Services Sector Nominal GDP (2010)

(US$bn and % share)



Source: NBS, QNB Group analysis

The **Real estate** sector is the second largest component of the services sector. The sector experienced strong nominal growth during 2003-07 at 20.7%, as property prices soared. Subsequently there was a contraction of 0.2% from 2007-11, with the downturn in the real estate market, especially in Dubai. Substantial borrowing by some government related entities (GREs) in the real estate sector, combined with the price correction in the real estate market, resulted in maturity mismatches and a debt standstill. The drop was significant in 2009, when it went down in real terms by 13.2%. The situation began to ease out in 2011 with a contraction by only 0.7%. We expect a good recovery in the real estate sector in 2012 with real growth of 2.1% and 2.3% in 2013, as demand picks up and the credit markets open up.

The **Logistics** sector (transport, storage and communications) has continued to gain in importance and has increased its share in the services sector to 18% in 2011 from 16% in 2007. This sector was minimally affected by the global financial crisis and had a real growth of 3.8% during 2007-11. The development of the **free zones** in the UAE has been one of the main reasons for the strong growth in this sector. The UAE has been very effective and successful in attracting foreign direct investment through the various free zones that have been established.

Free Zones

The concept of free zones in the UAE evolved from the need to attract foreign investment into sectors other than oil and gas. The UAE has 39 free zones, including some of the largest in the world, with nine more in the pipeline. The free zones have been very successful in attracting foreign investment and technological expertise, establishing a solid foundation for a non-oil economy and helping to make the UAE a hub for global trade and re-exports. Dubai and Sharjah have created the most successful free zones and the other Emirates are attempting to follow in their footsteps.

The **Jebel Ali Free Zone** (JAFZA) was the first free zone established in the UAE in 1980 and has been enormously successful. The number of companies established in JAFZA has grown from 19 in 1985 to over 6,400 in 2010. It has generated over 160,000 jobs and accounts for more than 50% of Dubai's total exports, while attracting 20% of all FDI into the UAE. JAFZA ranks among the world's largest free zones, spread over an area of 48km^2.

There are many reasons for JAFZA's success. It is extremely well located between Jebel Ali Port, one of the world's largest seaports, and the Al Maktoum International Airport, among the global top 10 largest cargo airports. JAFZA is also well positioned on a global level on a crossroads between markets in the Middle East, Asia, Eastern Europe and Africa. The standard of the facilities in JAFZA is very high, setting JAFZA apart from other free zones. Facilities include readily-available modern warehouses, office space of various kinds and sizes, and plots of land for large-scale operations such as manufacturing and extensive warehousing. JAFZA also has a wide range of commercial incentives, including 100% foreign ownership, no corporate or income taxes for a period of 50 years, exemption from local labour restrictions, full repatriation of profits and capital, and no foreign currency restrictions.

Hamriyah Free Zone in Sharjah was established in 1995 and provides an attractive investment environment and high-quality infrastructure. It permits the free movement of capital and full exemption from taxes on products and customs duties on materials imported. This free zone has provided great opportunities for small- and medium- scale industries and is fast becoming one of the cornerstones of the UAE's industrial development.

Dubai International Financial Centre (DIFC)

The success of the financial services sector in the UAE has been in large part thanks to the establishment of financial free zones. International financial services companies were attracted to the UAE through initiatives such as the **DIFC**, a financial free zone that has helped to establish the UAE as a regional and global financial centre.

The DIFC is a strategically located onshore financial centre with a developed financial infrastructure. The DIFC allows for the establishment of 100% foreign owned companies, whether as a branch of an already existing foreign company or as a 100% incorporated company within the DIFC. Furthermore, the companies undertaking the financial services will not be subject to the laws and regulations of the UAE Central Bank regulations.

It also offers a wholesale platform for investment banks and financial intermediaries looking to establish operations in underwriting, mergers and acquisitions advisory, venture capital, private equity, private banking, trade finance and brokerage services. It also has a comprehensive legal framework modelled on financial legislation in London and New York, providing companies with the confidence that they have a sound, stable and secure platform for their business.

One of the key subsidiaries of the DIFC was the Dubai International Financial Exchange (DIFX), a financial exchange that opened in September 2005 but was rebranded as NASDAQ Dubai in 2008.

The DIFC has been extremely successful attracting financial services companies from around the world. The number of active companies at the DIFC has grown almost 50 times from 19 in 2004 to 861 as at March 2012. The DIFC attracted 700 more workers in 2011 and the total employees reached 12,000.

The UAE has the largest financial services sector by value in the region

The UAE has the largest **financial services** sector in the GCC, accounting for a third of the regional total. The sector had witnessed a strong growth in real terms of 22.2% from 2003-07 as economic activity was vibrant and various initiatives such as the **DIFC** further opened up the economy and attracted foreign investment.

The financial services sector has been impacted in recent years by property related lending

The **financial services** sector has been constrained in recent years, however, it was still able to grow in real terms by 2.8% during 2007-11. The pressures brought about by the Dubai real estate market led to several GRE's and other private companies to restructure their loans. As a result, banks reduced their lending as non-performing loans (NPLs) increased from 2.9% of total loans in 2007 to 6.2% in 2011.

Government services has been one of the fastest growing sub-sectors in services and grew in real terms by 13.3% during 2007-11. This sub-sector has increased its share in the services sector to 10% from 6% in 2007 as government spending and allocations increased. We forecast a growth of 6.8% in 2012 and 4.5% in 2013 for this sector, as committed long-term spending is maintained to comply with each emirate respective long-term development visions.

B. Oil and gas

Oil

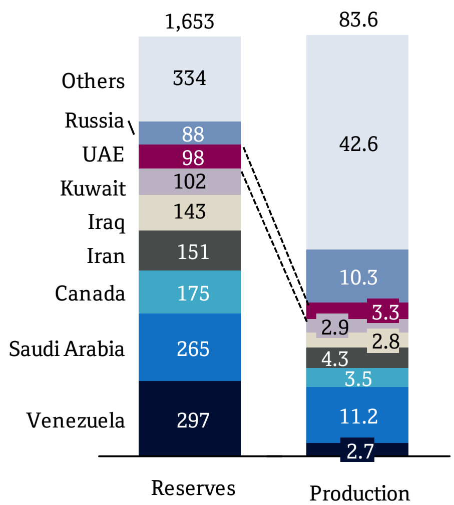
The UAE has the sixth largest proven oil reserves in the world

The UAE's proven oil reserves are 98bn barrels (Fig 3.4), which translates into the seventh largest reserves in the world and is 6% of total global oil reserves.

Saudi Arabia was the world's largest oil producer in 2011, accounting for 13% of global oil production. Saudi Arabia's production capacity is estimated by the IEA at 11.9m b/d, however, its production is restricted due to OPEC's production targets. Russia was the world's second largest oil producer in 2011 and even though it has comparatively lower oil reserves than some other countries, it is not restricted, since it is not part of the OPEC. With the rise in global oil prices and demand, Russia has been exporting most of its production to meet global demand. Venezuela on the other hand has the largest oil reserves in the world, however, production has been constrained since most of the reserves are connected to the Orinoco Belt, which are shale oil reserves that are not easily recoverable. Venezuela began including the Orinoco Belt in its official reserves in 2007 and as a consequence has revised reserves up almost three times by 2010.

Fig 3.4: World Proven Oil Reserves and Oil Production (2011)

(Reserves in bn barrels and production in m b/d)



Source: BP Statistical Review of World Energy – June 2012, QNB Group analysis

The UAE has been able to maintain its proven reserves over the past decade mainly due to enhanced oil recovery technologies. The UAE's total oil production[10] was 3.3m b/d in 2011, including crude oil, condensates and natural gas liquids (NGLs), and on that basis reserves are expected to last for 81 years (Fig 3.5). The UAE is the world's seventh largest oil producer and production equated to around 4.0% of global oil production in 2011.

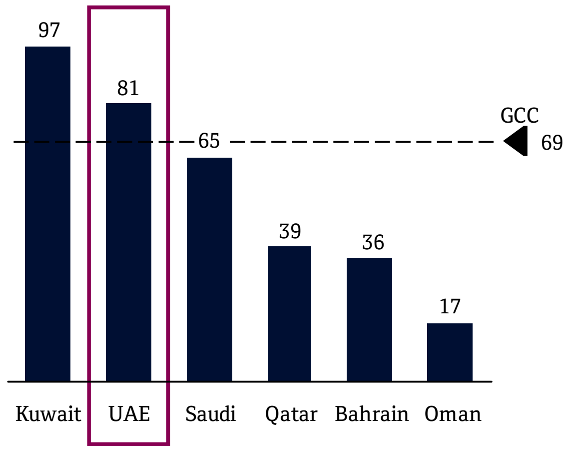
Abu Dhabi dominates UAE's oil sector accounting for 94% of total reserves

Most of the UAE's **oil reserves** and **production** are located in Abu Dhabi, with reserves estimated at 92bn barrels, accounting for 94.1% of the country's total. The remainder is located in Dubai, Sharjah and Ras Al Khaimah.

The individual emirates each have their own set of guidelines for the oil industry. In Abu Dhabi, the Supreme Petroleum Council (SPC) is in charge of overall policy making and also has management control over the state oil company, the Abu Dhabi National Oil Company (ADNOC). In Dubai, the state oil company, Dubai Petroleum Establishment, is the regulator. In Sharjah, oil policy is administered and developed by the Sharjah Petroleum Council.

Fig 3.5: GCC Oil Reserves[11]-to-Production Ratio (2011)

(Years of production at prevailing levels)



Source: BP Statistical Review of World Energy – June 2012, QNB Group estimates

A consortium of international oil companies discovered the first onshore field, Bab (Abu Dhabi), in 1960 and began production in 1962. This consortium evolved into what is now the Abu Dhabi Company for Onshore Oil Operations (ADCO). A separate consortium, the Abu Dhabi Marine Operating Company (ADMA), secured the concession[12] to develop offshore reserves, and also exported its first oil in 1962. Dubai produced its first oil in 1969.

BP, Total, Exxon and Partex were all members of the original consortiums, while the Japanese Oil Development Company (JODCO) purchased part of BP's stake in ADMA in 1972, in response to Japan's increasing dependence on Gulf oil. The ownership structure of two Abu Dhabi oil companies changed 1973, when ADNOC took stakes in them both, raising the stakes to 60% in 1974 (Fig 3.6). Finally, the Zakum Development Company (ZADCO) was founded in 1977 by ADNOC, in collaboration with JODCO, to focus on developing part of Zakum, the UAE's largest offshore field. Exxon acquired its 28% stake from ADNOC in 2006.

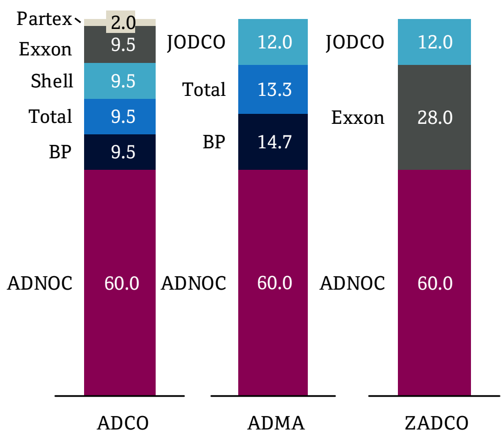
[10] Oil production as estimated by British Petroleum (BP) includes crude oil, condensates and NGLs. Crude oil production by itself was 2.565m b/d in 2011, while condensates and NGL production was 0.757m b/d.

[11] For Bahrain the reserves include its share with Saudi Arabia in the offshore Abu Safah field, which has around 5bn barrels. This has resulted in the relatively high reserves-to-production (R/P) for Bahrain.

[12] One in which a private company enters into an agreement with the government to have the exclusive right to operate, maintain and carry out investment for a given number of years.

Fig 3.6: Ownership of Main Oil Producing Companies

(% share)



Source: ADCO, ADMA, ZADCO, QNB Group analysis

Zakum is one of the world's largest oil fields with recoverable reserves of 18bn barrels

The UAE's oil production is dominated by a few giant fields, most of which have been in production for several decades. The benefit of large fields is that they minimise the need for infrastructure and maximise economies of scale, keeping down the cost of extraction. UAE's Zakum is the fifth largest oil field in the world (Table 3.1) and currently produces over 700k b/d.

Table 3.1: World's Largest Oil Fields (2010)

Field	Country	Recoverable Reserves (bn barrels)
Ghawar Field	Saudi Arabia	30
Burgan	Kuwait	22
West Qurna	Iraq	21
Safaniya	Saudi Arabia	20
Zakum	UAE	18

Source: EIA, Forbes, QNB Group analysis

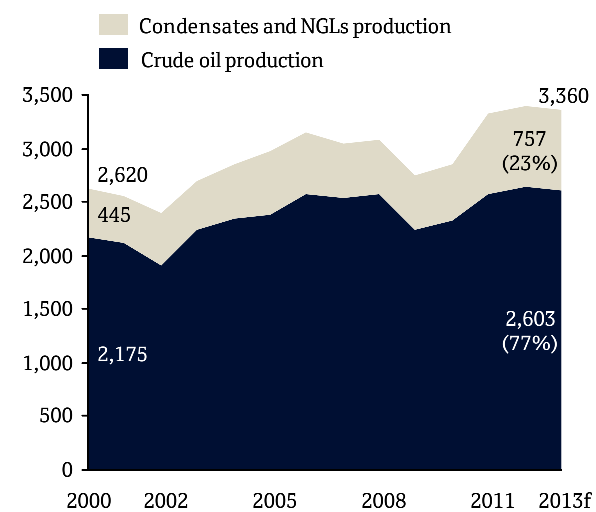
The other main fields are Bu Hasa, which produces around 600k b/d, Bab (295k b/d), Asab (220k b/d), and Unm Shaif (210k b/d).

There are plans to increase crude oil production capacity to 3.5m b/d by 2018

UAE currently produces around 2.6m b/d of crude oil. Current capacity is estimated[13] at 2.8mb/d and there are plans to increase capacity to 3.5m b/d by 2018. The additional capacity increase will come from upgrading and expanding the existing fields and infrastructure. Abu Dhabi produces the bulk of current production[14] with 2.4m b/d, while Dubai and Sharjah produce only 100k b/d and 60k b/d. We forecast that overall oil production will remain stable at around 3.4 m b/d until 2013 (Fig 3.7), as expansion programs are expected to come on-stream only by 2018.

Fig 3.7: Crude Oil, Condensates and NGL Production (2000-13)

(k b/d)



Source: Ministry of Economy, BP, QNB Group analysis and forecasts

Natural Gas

The UAE has the seventh largest proven gas reserves in the world

Gas reserves in the UAE are estimated to be at around 215trn cubic feet (Fig 3.8), which translates into the seventh largest reserves in the world and is 3% of total global gas reserves. However, the UAE's gas production is only the 18th largest in the world at 4.9bn cf/d, as most of the reserves are associated to oil fields, limiting the rate of extraction.

The US was the world's largest gas producer in 2011, accounting for 20% of global gas production, even though it has only the fifth largest gas reserves in the world. This has been driven by the high level of domestic demand and consumption. The US is the largest consumer of natural gas in the world and

[13] International Energy Agency (IEA) monthly oil market report – May 2012.

[14] Estimates from Energy Information Administration (EIA) country energy report.

consumed an average of 66.8bn cf/d of gas in 2011. Russia is the world's second largest producer and consumer of natural gas, while having the largest reserves in the world.

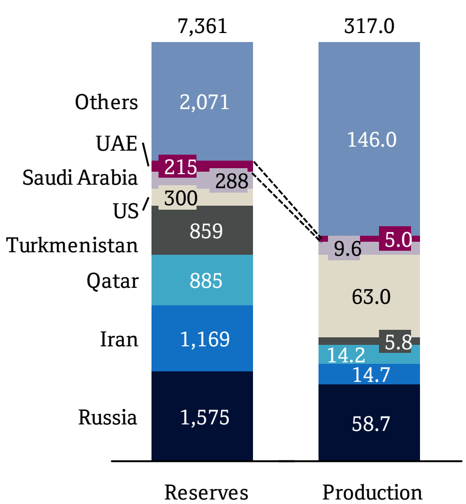
UAE has been the first GCC country to utilise its gas resources

The UAE was one of the first countries in the region to utilise its gas resources and, as early as 1977, built an LNG plant to export associated gas. However, most of the UAE's gas reserves have high sulphur content and are located offshore, making them harder and more expensive to exploit.

The UAE **gas reserves** and **production** are predominantly located in Abu Dhabi. All the associated gas used to be flared prior to the setting up of the Abu Dhabi Gas Liquefaction Company (ADGAS). The ADGAS project captured and liquefied associated gas from the Umm Shaif, Salman and Lower Zakum oil fields.

Fig 3.8: World Proven Gas Reserves and Gas Production (2011)

(Reserves in trn cf and production in bn cf/d)



Source: BP Statistical Review of World Energy – June 2012, QNB Group analysis

Total gas production increased by 4.2% over the past decade, as demand grew for power generation, industry, and to meet the needs of the oil industry for re-injection. It increased from 4.9bn cf/d in 2000 to around 7.7bn cf/d of gas in 2011 (Fig 3.9). Of total gas production, only 5bn cf/d is actually marketed, mainly because 2.2bn cf/d is re-injected into oil fields. The amount of re-injected gas has grown strongly at a rate of 10.5% over the last decade to maintain oil production at old and maturing fields, a trend that is likely to continue as the oil fields age further. Marketed gas is mainly used for power generation and industrial consumption (60%), liquefied natural gas (LNG) production (30%) and domestic/retail consumption (10%). The amount of flared gas has been reduced over the years as the infrastructure has been put in place to better utilise the country's gas resources.

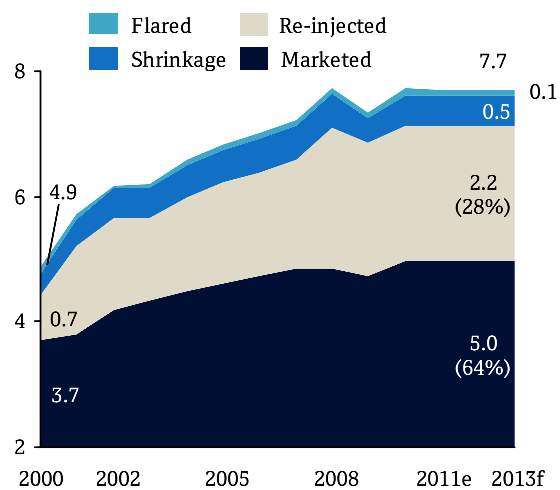
UAE currently produces around 5.6 million tons of LNG per annum

The ADGAS project to produce LNG is located on Das Island and operates a 3-train 5.6m t/y facility. Along with LNG the ADGAS plant produces small quantities of liquefied petroleum gas (LPG), pentane and sulphur.

Most of the LNG produced in the UAE is exported to Japan, under a long-term contract with the Tokyo Electric Power Company (Tepco), for 4.3m t/y, with an extended option up to 4.9m t/y. ADGAS has also signed a long-term agreement with India for 0.5m t/y. Additional short-term contracts have also been signed with customers in South Korea, Spain, Italy and Belgium.

Fig 3.9: Gas Production (2000-13)

(bn cf/d)



Source: Ministry of Economy, BP, QNB Group analysis

UAE imports gas from Qatar to meet growing domestic demand

Abu Dhabi's gas production has been insufficient to meet UAE's growing domestic demand. Even though production has increased, most of it has been locked into long-term LNG supply contracts. As an alternative source, the Dolphin project was initiated in the year 2000 to provide 2bn cf/d of piped gas to the UAE, from Qatar. A 400-km sub-sea pipeline extends from Qatar's North Field, supplying gas to Taweelah in Abu Dhabi and Jebel Ali in Dubai.

C. Non-Oil Industry

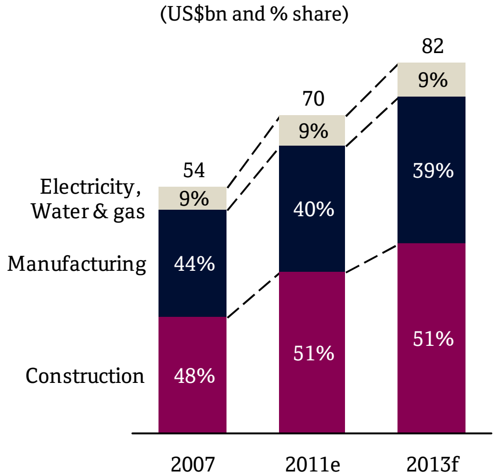
The non-oil industry consists of construction, manufacturing and utilities. The non-oil industry sector grew at a nominal rate of 6.6% and in real terms at 3.2% during 2007-11. Its contribution to UAE's overall nominal GDP stood at 21% in 2011 and amounted to US$70bn (AED258bn).

Construction sector is the largest contributor to the non-oil industry

The UAE accounts for 51% of the overall GCC construction sector. Construction forms the most important part of the non-oil industry sector in the UAE with a 51% share in 2011, up from 48% in 2007 (Fig 3.10).

Among the important drivers of economic growth in the UAE, were the active development of listed public companies, increased involvement of free zones and buoyant local stock markets, together with the launch of a number of major construction projects.

Fig 3.10: Non-Oil Industry Nominal GDP (2007-13)
(US$bn and % share)



Source: NBS, QNB Group forecast

The construction sector has been buoyed by the increasing investment in infrastructure, due to the country's positioning as an attractive tourist destination in addition to the increase in residential and non-residential units.

Projects such as the Jumeirah Beach Residences, one of the world's largest synchronised real estate developments; the Jumeirah Palm, one of the world's largest man-made islands; Aldar's massive Abu Dhabi Central Market project; Burj Khalifa, the Sheikh Zayed Grand Mosque; and mega projects such as Saadiyat Island, Al Reem, Jebel Ali Palm, Deira Palm; Al Maktoum International Airport, Dubai World Central and Dubailand, all reflect the rapid development phase of UAE's construction sector.

In the last five years, the GCC has experienced a record boom in the infrastructure sector. Construction projects in the GCC during this period exceeded US$1tn, with two-thirds of the projects being undertaken in the UAE. The construction and real estate sector in the UAE posted double-digit growth on a year-on-year basis and contributed significantly to GDP. The unprecedented growth in the UAE's construction and real estate sector was concentrated in Dubai and Abu Dhabi.

The sector's key drivers include:

- A growing expatriate population
- Ample liquidity
- A friendly regulatory environment

Moreover, as a regional hub for investments, the UAE attracts international companies to establish offices.

The free zones also acted as a major catalyst for local and foreign investment, which have included incentives such as:

- 100% foreign ownership
- Easy administrative and set-up procedures
- Exemption from import duties and taxes
- Full repatriation of capital and profits
- Subsidised water and energy prices

The construction sector in the UAE has witnessed a slowdown in recent years with a real growth of 6.9% during 2007-11, compared to 18.2% from 2003-03. The sector has been largely impacted by the effects of the global financial crisis on the financing of projects and a sharp slowdown in the real estate sector, mainly in Dubai.

The construction sector peaked in 2006 with a real growth of 36.1%, as rising real estate prices led to a huge supply of residential and commercial buildings. Dubai was a key player in the construction sector in the UAE. The diversification of Dubai's economy due to declining oil reserves and production led to growth in various economic sectors, with construction being a significant beneficiary.

Abu Dhabi is currently the largest contributor to the construction sector

Construction in Dubai was significantly impacted by the 2009 downturn. Its contribution to the UAE construction sector fell from 51% in 2001 to 28% in 2009. Abu Dhabi is currently the largest contributor to the construction sector, accounting for 65% of UAE construction GDP. Abu Dhabi's enormous oil and gas wealth enabled the sovereign to drive growth through major infrastructure development investments in the post-financial crisis period.

Abu Dhabi has been transformed into one of the world's richest locations with discovery of oil and gas in the emirate. The wealth derived from oil and gas resources has been poured into major investments aimed at spurring and maintaining development in the emirate. Further, the government of Abu Dhabi has initiated changes in its foreign ownership laws in order to encourage greater investment.

The real estate and construction sector has received the largest chunk of total investments. It is estimated that the government will spend about US$200bn on new infrastructure and development projects in the coming five years.

Another major project over the next five years will be the new Midfield Terminal at the airport in Abu Dhabi. A US$2.9bn contract for the project was signed at the end of June and completion of the project is expected in 2017.

Dubai has established itself as a global trading hub of the Middle East region. The investment initiatives, multicultural society, good infrastructure, and lifestyle have all attracted people and businesses. The boom in construction and real estate can be partly attributed to various job opportunities that have led to the influx of expatriates, which has turned the city into a hub for some of the most prolific projects in the world.

Dubai ranks fifth in the world in terms of skyscrapers

Dubai has the highest number of skyscrapers[15] in the Middle East, including the world's tallest building[16], and as at the first quarter of 2012 ranked number five in the world. Dubai has around 230 skyscrapers, which is one more than Shanghai.

Despite some delays caused by the global financial and economic crisis, there are still 52 new and upcoming hotels in Dubai, which will add over 25,000 rooms to existing capacity.

Manufacturing remains a key focus area for public investment

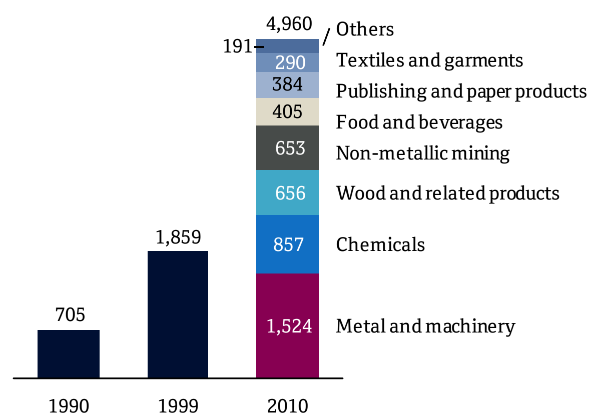
Manufacturing represented 40% of non-oil industry in 2011 (Fig 3.10). This sub-sector is mainly made up of oil refining, petrochemicals, fertilisers, metals production and other industrial sub-sectors.

Manufacturing grew in real terms at 3.0% from 2007-11. Government efforts to diversify the economy and leverage its hydrocarbon resources have led to heavy public investment into manufacturing. The sector's growth has also been boosted by rising prices for fuel, petrochemicals, fertilisers and metals.

The UAE's oil refining capacity increased from 290k b/d in 1999 to 673k b/d in 2011, which is 0.7% of the world total. UAE refines 20% of its oil production capacity. The Ruwais refinery in Abu Dhabi is the largest and has a capacity of 500k b/d. A US$10bn expansion at Ruwais currently under way will see overall oil refining capacity of UAE reach over 1m b/d by 2013.

Industrial development outside the oil sector was closely linked to the construction boom, with direct demand for building materials, and indirect demand for food processing, retail industry etc. through the large increase in population. The number of industrial establishments in the UAE has increased from 705 in 1990 to 4,960 in 2010 (Fig 3.11).

Fig 3.11: Industrial Establishments (1990-2010)



Source: Ministry of Finance and Industry, QNB Group analysis

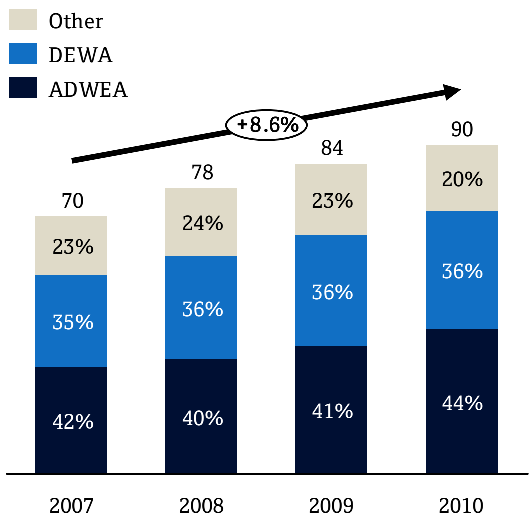
Investment in electricity capacity meets rising demand but more gas feedstock would be desirable

Electricity consumption in the UAE grew at 8.6% from 2007-10 (Fig 3.12), predominantly supplied by the Abu Dhabi Water and Electricity Authority (ADWEA) and the Dubai Electricity and Water Authority (DEWA).

15 Buildings taller than 100 metres.

16 The Burj Khalifa (828 metres),which is part of the Downtown Dubai project.

Fig 3.12: Electricity Consumption (2007-10)
(GWh)

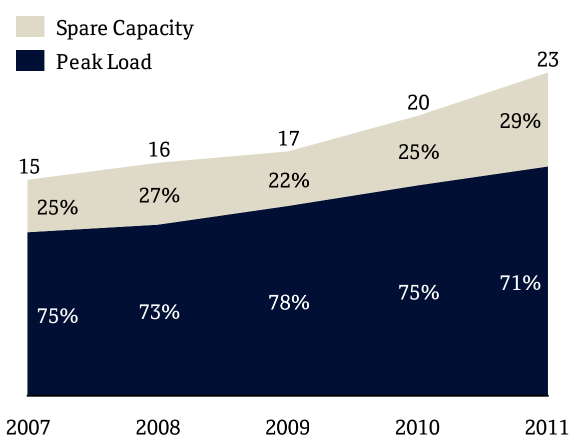


Source: ADWEA, DEWA, SEWA, FEWA, QNB Group analysis

Growth has been strongest in the emirates of Abu Dhabi (10.1%) and Dubai (9.6%), leading to these emirates taking an increasing share of consumption. Growth in electricity demand has been driven by the rapidly growing population and an expanding industrial sector. Heavy investment into economic diversification programmes have led to industry having the greatest power need, particularly in Abu Dhabi.

Electricity generation capacity has increased quickly enough to meet rising demand. Peak load increased at 8.8% from 2007-11 while generation capacity rose at 10.5%. In Abu Dhabi and Dubai in 2011, generation capacity was 29% higher than peak demand (Fig 3.13).

Fig 3.13: Electricity Generation Capacity and Peak Load in Abu Dhabi and Dubai (2007-11)
(GW)



Source: ADWEA, DEWA, QNB Group analysis

With demand growth set to continue, the authorities need to keep investing in new capacity.

In Abu Dhabi, over 95% of power and water supply is generated by five Independent Water and Power Projects (IWPPs) and Independent Power Projects (IPPs), which, in theory, compete in a privatised market. However, the government is a major stakeholder in many power projects through ADWEA and the national oil company, TAQA. Two major projects are currently underway, which will each add 1.6 gw of generation capacity. The first is expected to be completed this year and the second in 2014. Dubai has only recently undertaken its first IPP—a US$1.5bn and 1.5 gw power station with completion scheduled for 2014. The authorities are also implementing efficiency improvements to help meet demand growth by limiting losses through the grid and improving building standards. These projects should be sufficient to meet rising demand.

Hydrocarbons are the predominant source of power in the UAE with an increasing share from natural gas. The UAE already imports 2bn cf/d of natural gas from Qatar to meet its power generation needs and also a small amount of LNG. While it is attempting to increase domestic natural gas production, it is likely to become more dependent on natural gas imports in the future.

Use of alternative energy sources for domestic needs will help support exports of oil

The UAE is investing heavily in alternative energy sources. This will limit the use of oil as a power source. It will also reduce the use of natural gas, allowing more of it to be injected into oil fields to boost oil production, helping to boost oil exports.

At the end of 2009, the Emirates Nuclear Energy Corporation awarded a US$20bn contract to a South Korean-led consortium for four **nuclear power** plants with capacity of 1.4 gw each. The first nuclear plant is expected to be in operation in around five years.

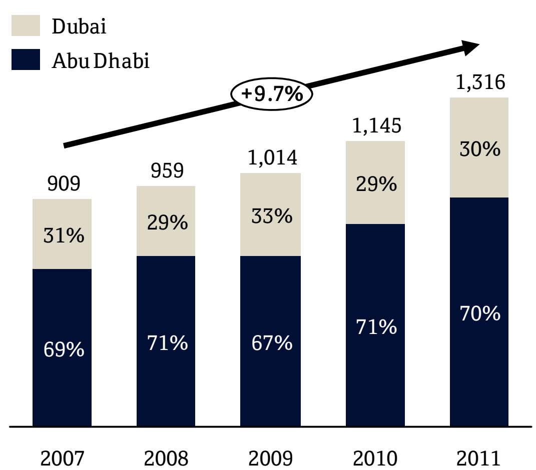
Solar power is more imminent with the first 100-mw plant (Shams 1) scheduled for completion at the end of this year and a second 100-mw (Nour 1) expected to be completed in 2013. A 100-mw **windfarm** project, building on information gathered from an existing small wind farm was announced in April 2011, but may take some years to be realised.

The **Masdar initiative**, an Abu-Dhabi backed renewable energy drive, is a lead investor in the solar power projects and aims to establish Abu Dhabi as a centre for renewable energy research and development. Construction is underway at its headline project, Masdar City, which is conceived as a futuristic city that will house 40,000 people and showcase renewable technologies.

UAE continues to invest in desalination plants to meet increasing water demand

Population growth has also driven growth in water consumption of 4.9% in Abu Dhabi in 2007-11. This has led to investment in power-hungry desalination plants to meet demand. Water production capacity in Abu Dhabi and Dubai has increased at a rate of 9.7% from 2007-11 (Fig 3.14).

Fig 3.14: Water Production Capacity in Abu Dhabi and Dubai (2007-11)
(m gallons per day, g/d)



Source: ADWEC, DEWA, QNB Group analysis

Both Emirates will continue to add to their production capacity. Abu Dhabi expects to complete an IWPP this year including 100m gallons per day of desalination capacity with other smaller desalination plants under construction in other Emirates.

Domestic prices of water and electricity are heavily subsidised, encouraging wasteful usage. Increasing prices would help tackle this issue but, this is a politically sensitive area and changes are unlikely in the near term. The authorities are currently working to increase awareness about the wastage of power and water and about the large cost of current subsidies to the government.

Petrochemicals and fertilisers expansion is limited by feedstock shortages

Petrochemicals and fertilisers are a focus of the UAE's diversification efforts. Petrochemical and fertiliser plants use derivatives of natural gas (mainly ethane) to produce a range of fertilisers, plastics and chemicals that are used in the production of a wide variety of products from plastic bags to car parts. The UAE has been investing in these sectors to add value to its raw hydrocarbon resources and provide a foundation of low-cost goods that could encourage the growth of other local industries.

The UAE petrochemical sector is almost wholly located in the Emirate of Abu Dhabi, although there is a small petrochemical facility in Dubai that produces methyl-tertiary butyl ether (MTBE), an additive for unleaded gasoline.

ADNOC has a strong involvement in the petrochemical sector as it provides the gas feedstock and has two major industrial subsidiaries located in an industrial complex in Ruwais in the Western Region:

- Ruwais Fertiliser Industries (FERTIL), which has a capacity of 1.3m t/y of ammonia[17] and 2.3m t/y of urea
- Abu Dhabi Polymers Company Limited (BOROUGE), established in 2002, which has a capacity of 2m t/y of ethylene[18] and polyethylene[19] having tripled production in 2010

BOROUGE has been successful in the global petrochemical sector with an estimated US$2.3bn of revenue in 2011. Elsewhere in the region, Saudi Basic Industries Company (SABIC), the Kingdom's largest petrochemicals producer had revenue of US$40.5bn in 2011, an 11.7% share of the global market. The only other GCC petrochemicals company with higher 2011 revenue than BOROUGE was Industries Qatar with US$4.8bn.

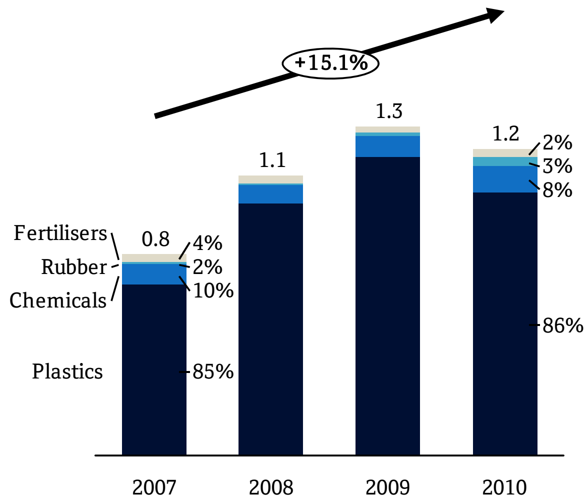
Together, these GCC companies are aggressively expanding into the global petrochemicals sector and are likely to take a growing share of the market owing to cheap feedstock, competitive pricing and proximity to fast-growing Asian markets. In the UAE, exports of petrochemicals and fertilisers have grown at 15.1% from 2007-10 (Fig 3.15).

Plastics dominated exports from the sector in 2010 with 1m tonnes exported for a value of US$1.6bn. BOROUGE is expanding production with an additional 2.5m t/y of capacity expected to come on stream in 2014 and FERTIL has plans for a further 1.2m t/y of urea by 2013.

However, further expansion of the basic petrochemical and fertiliser industries in the UAE is restricted by the availability of feedstock. The UAE is currently in need of additional gas supplies to meet its power needs (see section on electricity below) and has little spare feedstock for industry. It is investing heavily in efforts to expand its natural gas production (see the section on gas above).

[17] Ammonia is used to make urea fertilisers.
[18] Ethylene is a basic input for the chemical industry.
[19] Polyethylene is a basic input for manufacturing plastics.

Fig 3.15: Petrochemicals and Fertiliser Exports (2007-10)
(m tonnes)



Source: ADNOC, QNB Group analysis

The UAE is also investing in the petrochemicals sector abroad to support global expansion by acquiring skills, technology and production capacity. The International Petroleum Investment Company (IPIC), an Abu Dhabi investment company established to invest overseas in energy-related industries, has made major investments into global petrochemicals sector including:

- A 100% stake in Nova Chemicals, a US plastics and chemicals company
- A majority stakes in Borealis, a major Austrian-based petrochemical company—an acquisition that enabled the establishment of a petrochemicals cluster in Abu Dhabi
- A large stake in Compañia Española de Petróleos (CEPSA), a major Spanish oil and petrochemicals company

The authorities in Abu Dhabi are therefore focusing on adding further value by developing more sophisticated chemical industries. A new organisation, ChemaWEyaat, was established in 2008 and was awarded 70 km^2 of land adjacent to FERTIL and BOROUGE, on which it aims to establish a "Chemical City". The first project is a 70k b/d aromatics facility that will produce products such as benzene[20], naphtha[21] and liquefied petroleum gas (LPG)[22]. A project management contract was awarded for the project in April 2012 and it is therefore unlikely to start production for another three years.

[20] Benzene is used in the production of chemical compounds including nylon and polyester.
[21] Naphtha is a hydrocarbon used to produce fuel and used in the production of certain petrochemicals.
[22] LPG, otherwise known as propane is a fuel used in vehicles and heating appliances.

Additionally, the Abu Dhabi Basic Industries Corporation (ADBIC) was established in 2007 by the Abu Dhabi government as an industrial development and investment company to support the expansion of base metals, petrochemicals and other industries. In 2008 it launched the Abu Dhabi Polymers Park (ADPP) within the Industrial City of Abu Dhabi as an industrial zone focused on plastics. The park aims to leverage existing low-cost petrochemical production to produce higher-margin downstream plastics aimed at the construction, infrastructure, packaging and equipment manufacturing sectors. Construction of the first plant in the park began in 2009.

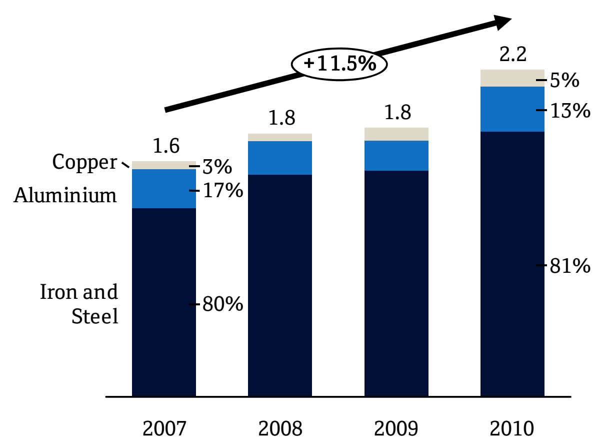
To date, the petrochemicals industry has been dominated by government companies, mainly owing to foreign ownership restrictions. ADPP aims to attract private investment to encourage the transfer of skills and technology.

Major investment is going into the expansion of metals production

Another focus of diversification is metals production. This is energy intensive and therefore enables the UAE to leverage its cheap energy resources.

Existing production enables the UAE to export significant volumes of metal overseas, which reached 2.2m tonnes in 2010 (Fig 3.16), earning US$2.0bn. This compares with 1.6m tonnes and US$1.4bn in 2007.

Fig 3.16: Exports of Metal Products (2007-10)
(m tonnes)



Source: NBS, QNB Group analysis

Emirates Steel was established in 2001 and currently produces around 2m t/y of steel products. A 3m tonne, US$4bn expansion is currently underway and is expected to start production this year with incremental increases up to full capacity over the next five years.

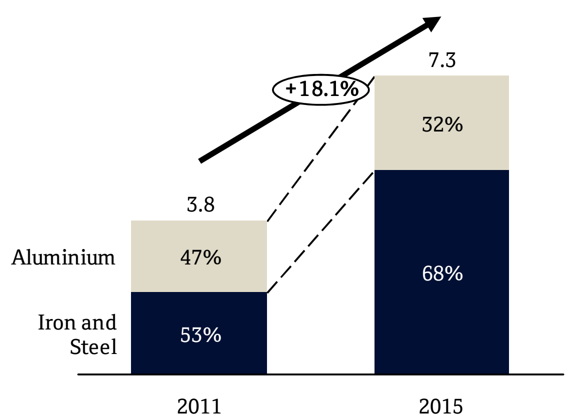
The UAE has also been investing heavily in aluminium production. Dubai Aluminium (DUBAL) was established in 1979 and now has an aluminium smelter with production of 1m t/y and casting operations with capacity of 1.3m t/y all located in Jebel Ali and powered by a 2.4 gw power station.

DUBAL has a 50% stake in Emirates Aluminium (EMAL), which established a new US$5.7bn smelter in 2010 in Abu Dhabi with production of 750k t/y. A second US$4.5bn phase of this project will increase production capacity to 1.3m t/y by 2014.

Based on current expansion plans, production of iron, steel and aluminium at major UAE production facilities will increase at 18.1% from 2011-15 (Fig 3.17).

Fig 3.17: Production of Iron, Steel and Aluminium (2011-15)

(m tonnes)



Source: DUBAL, Emirates Steel, ADBIC and QNB Group analysis

The large and growing volumes of metal production provide a solid foundation for additional downstream metals companies and to establish themselves in the UAE and opens up doors to other industries. ADBIC aims to build on existing metals production to create a cluster of metals companies in the aluminium, copper and steel sectors. It plans to provide infrastructural, legal and tax incentives as well as offering low-priced raw materials to attract investors to the sector. The sector is a driving force behind the UAE's diversification efforts.

4. External Sector

A. Balance of Payments

The **balance of payments** tracks all foreign transactions between a country and all other countries, reflecting all payments and liabilities to foreigners and from foreigners. It includes transactions between governments, consumers and businesses. The balance of payments consists of three sub-accounts: the current account, the capital account and official settlements account.

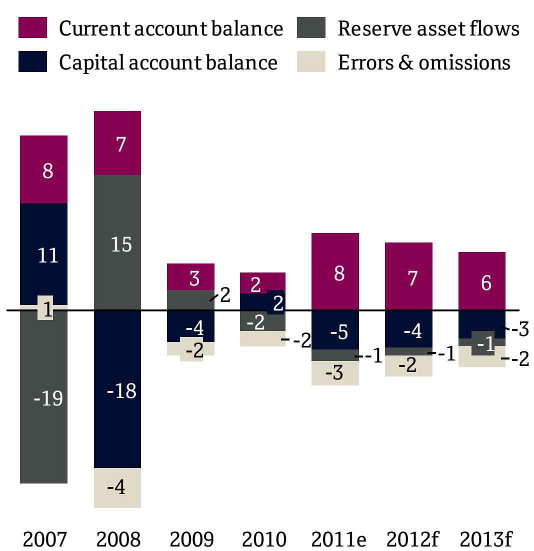
The **current account** measures the net exchange of merchandise goods, services, investment income, and unilateral transfers (regular payments that are not for exchange such as companies repatriating profits, workers remitting income and gifts).

The **capital account** mainly measures the flow of funds for the principal value of investment into a country from abroad and out of a country due to investment by citizens, businesses and governments in foreign assets. This includes investment in real assets as well as purchases of financial securities.

Changes in the **official settlements account** are usually dominated by changes in holdings of foreign currencies, but also include holdings of gold, IMF special drawing rights (SDRs), and other foreign assets held by the monetary authorities of the country. The official reserve balances can be utilized to intervene in the foreign exchange markets in an attempt to maintain exchange rate control.

Fig 4.1: Balance of Payments (2007-13)

(% of GDP, + are inflows of foreign currency, - are outflows)



Source: NBS, Central Bank of UAE, QNB Group estimates and forecasts

The balance of payments also includes **errors and omissions**. The current, capital and official settlements accounts should sum to zero. However, in practise there is usually a discrepancy owing to errors or omissions, which is offset under this category.

The UAE receives large surplus inflows of foreign currency in its current account, as a result of its hydrocarbon exports and trade flows. This surplus then flows into private and state investments abroad, resulting in net capital account outflows, and into central bank reserve assets[23] (Fig 4.1). The UAE recorded a surplus in its overall balance of payments equal to 1% of GDP in 2011. The components of the balance of payments are discussed in detail in this chapter.

Balance of payments surpluses are being used to build up foreign reserves and investments

The balance of payments surpluses represent the increase in the Central Bank of UAE **international reserves**. Reserves declined sharply from US$77bn in 2007 to US$31bn in 2008 as growing confidence from rising oil prices led UAE private and public enterprises to invest heavily abroad, resulting in an outflow of funds abroad. Since 2008, reserves have increased steadily as investment outflows have moderated.

We do not expect reserves to fall below current levels in the short-medium term. We forecast that they will increase to about US$52bn by the end of 2013. In addition to the central bank reserves, it is also estimated that the UAE has sizable holdings of foreign assets through the Abu Dhabi Investment Authority (ADIA)[24]. These serve as an additional implicit reserve. This would only need to be called upon during a period of sustained low hydrocarbon prices.

B. Current Account

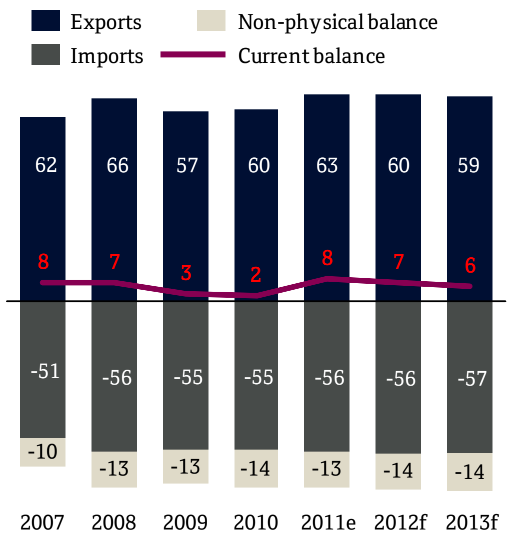
The emergence of UAE as a trading hub has resulted in a lower current account surplus

The UAE has a relatively low surplus in its current account, compared to other GCC countries, which reached an estimated US$31bn (8% of GDP) in 2011. The UAE's emergence as a trading hub for the Middle East shows substantial imports and also re-exports.

[23] A negative entry in the balance of payments means that reserves increase, while a positive entry, as in 2009, mean reserves decrease.
[24] More details about ADIA given on page 27.

However, the foreign exchange it earns from hydrocarbon exports still outweighs both payments for imports of goods and services and payments by foreign companies and workers income repatriation (Fig 4.2).

Fig 4.2: Current Account Constituents (2007-13)
(% of GDP)



Source: NBS, Central Bank of UAE, QNB Group estimates and forecasts

The current account surplus is forecast to average 7% of GDP in 2012-13

The UAE current payments are dominated by trade in physical goods, which relate to hydrocarbon exports and large quantities of imports. The UAE's emergence as an inter-regional trading hub has led to growth in imports, although this has been matched by corresponding growth in re-exports. The trade surplus averaged 18.4% of GDP in 2007-11.

In contrast, the non-physical balance, which is composed of services, income and current transfer payments, generally records a sizable deficit, averaging 12.7% of GDP in 2007-11, partly offsetting the trade surplus. This is mainly due to the freight and insurance, and also workers remittances.

In 2009-10, the UAE recorded a low current-account surplus relative to GDP at 2.7%, due to the effects of weak global trade, lower oil prices and declining overseas investment income.

The current-account surplus recovered to 8.5% of GDP in 2011 as high oil prices boosted exports. Relatively constant oil prices, averaging US$110/b in 2012-13, will keep export revenues stable as imports increase steadily as local and global economies recover. We therefore expect the surplus to fall to 7.4% of GDP in 2012 and 6.3% in 2013.

Trade Balance

UAE's trade balance has been impacted by weaker imports in consumer goods and the real estate sector

The UAE's trade balance averaged 18.4% of GDP from 2007-11. Exports and imports have fluctuated in line with oil prices and the state of the global and local economy, but have maintained relatively steady shares of GDP.

We expect the trade surplus to remain broadly constant in 2012-13 at around US$80bn, or 21% of GDP, as oil prices remain at similar levels and import growth is weak owing to continued drag on the economy from recovering real estate and construction sectors.

Imports

Imports have started to pick up again after a slight slowdown

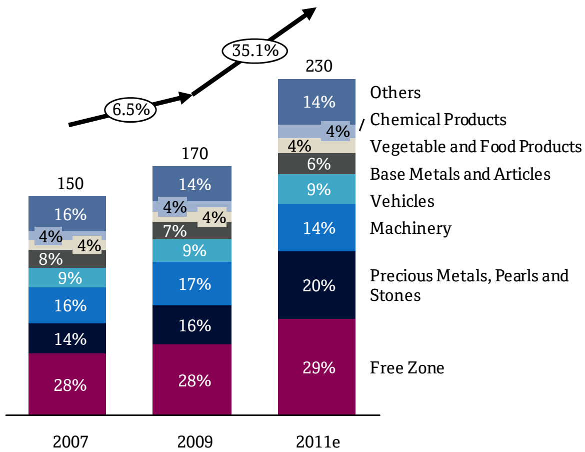
UAE's total imports averaged 55% of GDP from 2007-11, compared to an average of 39% in 2002-06. Imports grew by 11.2% from 2007-11, even as the economic downturn in 2009 saw imports drop by 15%. Imports witnessed a strong comeback with growth of 9.9% in 2010 and 23% in 2011, global trade recovered given Dubai's importance as regional trade hub and as consumer demand and real estate activity recovered.

The composition of UAE **imports** differs to other GCC countries as the largest portion of imports (29%, or US$66bn in 2011) are directed towards the Free Trade Zones. This is mainly due to the country establishing itself as a global trading and transit hub.

Limited natural resources other than hydrocarbons, means that the UAE has to import a wide range of goods. However, the UAE has a well established manufacturing base both in industrial goods and food processing, helping reduce import dependence in these areas.

The largest category of imported goods is precious metals and stones, which totalled an estimated US$47bn in 2011. Gold accounted for 48% of the total in this category, followed by diamonds with 35%, and jewellery with the remaining 17%. Increasing wealth and an expanding retail sector have boosted precious metals imports. This category has increased its share from 14% in 2007 to 20% in 2011 (Fig 4.3).

Fig 4.3: Imports[25] (2007-11)
(US$bn, CAGR shown)



Source: NBS, Central Bank of UAE and QNB Group estimates

Machinery, vehicles and iron and steel form the other major import categories. There has been a slight shrinkage in imports of base metals and machinery, which can be linked to the slowdown in the construction sector, low population growth and declining consumer confidence.

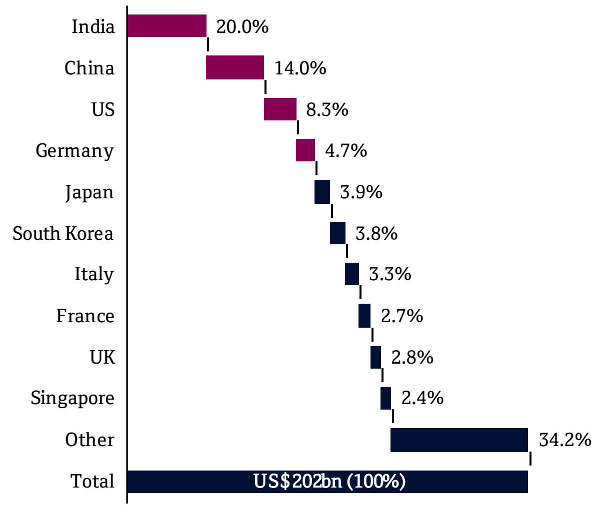
We forecast imports to grow by 5.4% in 2012 and by 3.7% in 2013 as imports of consumer goods, food and manufactured items categories will continue to be strong, well exceeding forecast population growth. Demand for metal imports will also slowly gather pace, given the pick up in construction projects.

Asian countries are the leading import sources, surpassing European countries

Asian countries provided 48.5% of imports in 2011. The major trading partners for the UAE are India and China, which accounted for over a third of total imports in 2011 (Fig 4.4). Their shares have been increasing steadily over the last decade. While Indian and Chinese imports have increased, Japan has declined in importance, dropping from first place in the 2000s to fifth in 2011.

The EU accounted for 21.2% of overall imports in 2011, led by Germany with 4.7% and Italy with 3.3%. The imports from other GCC countries increased by 29% in 2011 and accounted for 5.3% of total imports. The UAE pattern is also reflective for the overall GCC sources of imports, where India and China are the top trading partners.

Fig 4.4: Import Sources (2011)
(% of total imports)



Source: IMF Direction of Trade Statistics, QNB Group analysis

Imports from EU increased by 24% in 2011, however, its share in overall imports has been declining from a high of 48% in 2005, to 21% in 2011. The main reason for this fall was a decline in imports from UK.

Lower cost manufactured goods from China and food and textiles from India have driven the shift in import sources to these countries, away from Western countries that produce higher-end manufactured goods and industrial equipment.

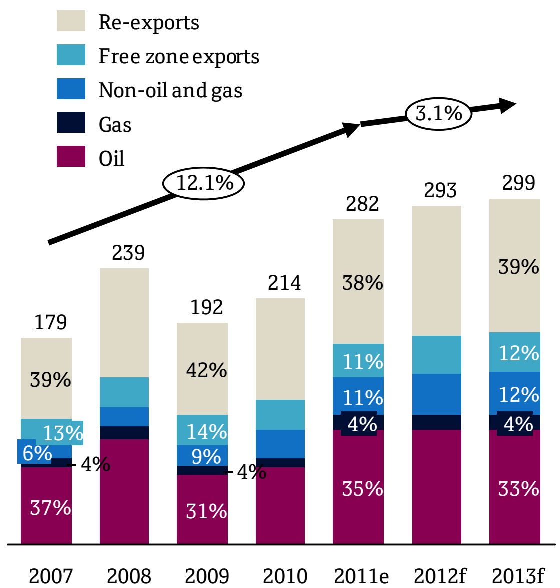
Exports

Re-exports are prominent in the UAE as it is a major regional and global trading hub

The UAE has invested heavily in infrastructure (such as ports, storage facilities, free zones and an attractive business environment) to enable it to become a global trading hub. These investments have also encouraged rapid industrialisation. This ensured a high annual export growth of 29% from 2002-06, and a 12% annual export growth from 2007-11 (Fig 4.5).

[25] Imports are shown here at their CIF (cost, insurance and freight) values. These are about 13% higher than the FOB (free on board) value of the goods themselves. Within the balance of payments, the FOB figure for imports is included in the trade balance, while the insurance and freight costs are accounted for within the services component of the non-physical payments.

Fig 4.5: Total Goods Exports (2007-13)
(US$bn, CAGR shown)



Source: NBS, Central Bank of UAE and QNB Group estimates and forecasts

Exports grew rapidly during the boom time from 2002-08

Nearly all major exports items witnessed high growth during the boom years from 2002-08. The value of **Oil**[26] exports increased by 29% from 2002-08, while gas exports went up by 22%. Rising oil prices and production coupled along with the rapid industrialisation, which included the development of free-zones were major drivers for this high growth.

Non-oil and gas exports saw a rapid growth of 38% in 2002-08, while free zone exports moved up by 21%. Non-oil and gas exports consist mainly of precious metals and stones.

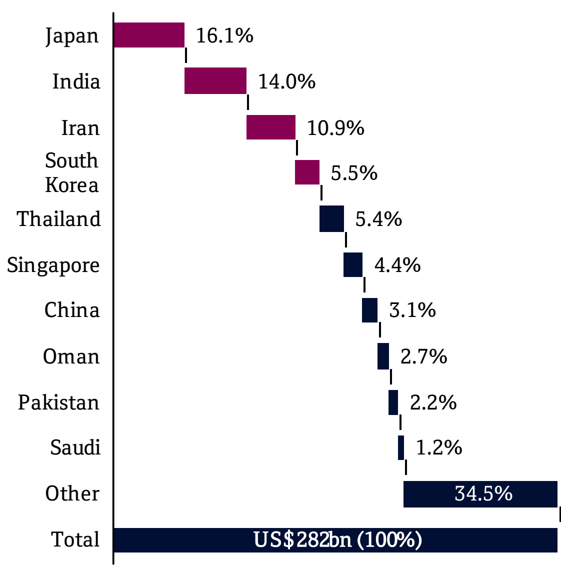
Finally, **re-exports** which has the largest share in exports grew by 31% from 2002-08. The improving facilities available for global trade led to the development of the UAE as a major centre for re-exports. The UAE alone typically accounts for 85% of the re-export value that flows through the GCC region, as it acts as a transit hub for the region due to its location and well established logistics infrastructure.

The crisis in 2009, coupled with a decline in oil prices led to a 20% fall in exports during that year. Exports have since recovered with growth of 11% in 2010 and 32% in 2011, as oil prices recovered. We are forecasting an export growth of 4.0% in 2012 and 2.1% in 2013, mainly due to an increase in free zone and other non-oil and gas exports as oil production and prices remain broadly constant.

Japan continues to be the main export market for UAE

The Asian markets continue to be main destination for exports, with Japan leading the pack (Fig 4.6).

Fig 4.6: Export Destinations (2011)
(% of total exports)



Source: IMF Direction of Trade Statistics, QNB Group analysis

Japan has been the main consumer of UAE hydrocarbons for decades, taking in 16% of total exports in 2011, although this was down from an average of 30% in the early 2000s. Likewise, South Korea, Thailand and Singapore, other industrialised Asian countries lacking domestic hydrocarbon reserves, were other major export partners in 2011.

India and China have rapidly risen in importance as export destinations, as economic growth has required them to seek new supplies of oil and gas. A decade ago China purchased less than 1% of UAE exports, and India just 2%. Now India is the second most important export market, at 14.0%, and China the seventh at 3.1%. These shares are likely to increase even further as growth in India and China continues to outperform the US and EU.

[26] Includes refined oil.

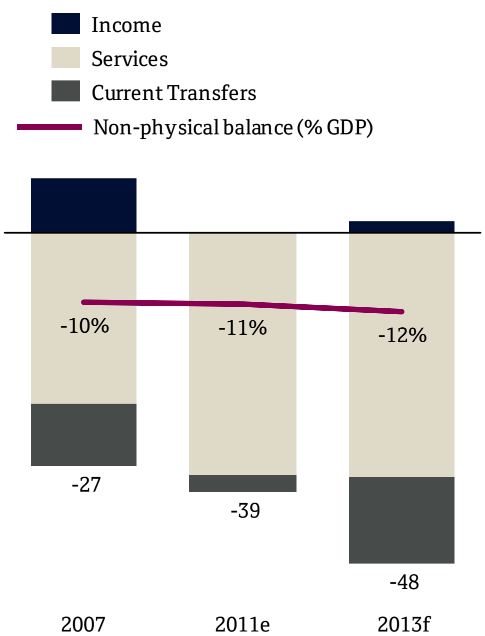
Non-Physical Balance

The UAE records annual non-physical deficits of around 12% of GDP

The UAE consistently records net deficits in its balance of non-physical payments (Fig 4.7).

The **income** balance, relates to cross-border payments of corporate profits and investment income. The UAE tends to record small surpluses in this account, largely owing to income from the investments of public enterprises overseas. This is partly offset by foreign companies operating in the hydrocarbon economies repatriating profits to their countries of origin.

Fig 4.7: Non-Physical Balances (2007-13)
(US$bn, unless indicated)



Source: Central Bank of UAE, QNB Group estimates and forecasts

The **current transfers** account is composed largely of remittances sent home by expatriate workers. Proportionally, the UAE has one of the largest expatriate workforces in the GCC. As a result, it records sizable and growing transfer deficits. Total net transfers reached a deficit of US$12.0bn in 2011 and are forecast to grow further to US$13.9bn by 2013. Remittances reached US$11.2bn in 2011, or US$2,334 per employed worker.

The **services** deficit is the most complex of the three components of non-physical payments. It includes:

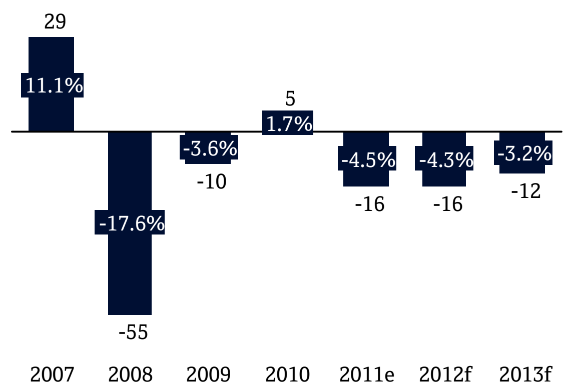
- **Transportation costs**, particularly related to hydrocarbons shipments
- **Payments abroad by tourists** and other travellers—whether by foreign visitors to the UAE or UAE residents travelling abroad
- **Foreign payments** for professional and financial services

C. Capital Account

Outflows from public sector enterprises in recent years have been significant

The capital account refers to flows of capital, or investment, in and out of the country. It tends to have significant outflows, which are largely related to public sector enterprises. In the case of the UAE, this is predominantly investments made by the state (mainly through the ADIA and other GRE's). In 2011, the net outflow of capital from the public sector amounted to US$26bn, which resulted in the overall negative balance in the capital account (Fig 4.8).

Fig 4.8: Capital Account Balance (2007-13)
(US$bn and % of GDP)



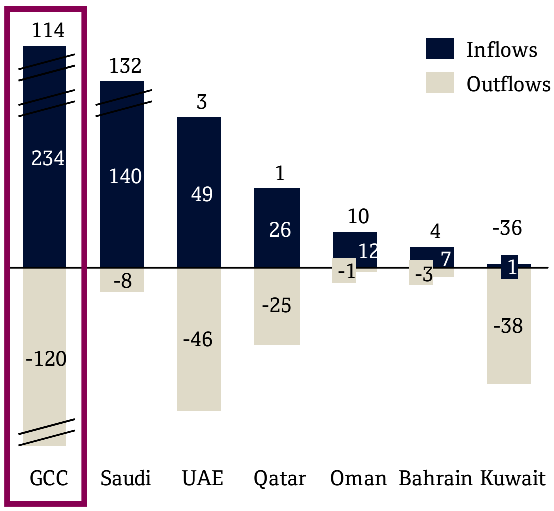
Source: Central Bank of UAE, QNB Group estimates and forecasts

However, the UAE has tended to receive sizeable inflows from private capital investments, which prior to the financial crisis reached a record of US$59bn in 2007, resulting in a overall capital account surplus in that year. The rapid growth in the real estate sector has been a major driver for attracting private capital. Private capital investments have started picking up again.

Portfolio investment is another component of the capital account. However, official statistics providing a breakdown into portfolio inflows (foreign investments in stocks and bonds listed in the UAE) and outflows (investments abroad by entities, particularly the SWF) is not available.

Direct investment, mainly foreign direct investment (FDI) has been a key to the development of the UAE as a financial and trading hub. UAE has been very successful in attracting FDI over the past decade and more, with its various foreign investment initiatives. The FDI peaked in 2007 US$14.2bn and dropped to US$4.0bn in 2009. It has picked up to US$7.7bn in 2011 and ranks second in the GCC region (Fig 4.9).

Fig 4.9: Cumulative FDI Flows (2006-10)
(US$bn)



Source: UNCTAD[27], QNB Group analysis

The UAE has the world's largest SWF with assets of US$627bn

The international reserves of UAE dropped from US$77bn in 2007 to US$32bn in 2008. It has since improved to US$46bn in 2011. However, this excludes ADIA's foreign assets. ADIA is the world's largest SWF and its total assets were estimated at US$627bn as at May 2012 by the SWF institute.

Most GCC countries have been channelling government surpluses through their respective SWF's into a wide range of investments in associates, marketable securities, and other direct investments.

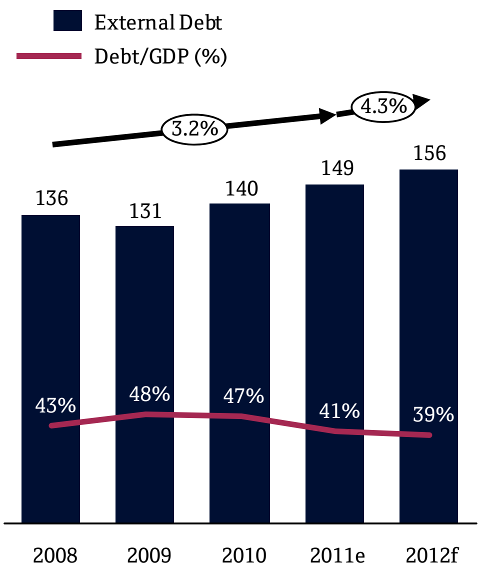
D. External debt

UAE's external debt is increasing but its share of GDP is declining

A sizable part of the debt relates to financing construction and real estate projects. **External debt** has increased in recent years, at an estimated CAGR of 3.2% in 2008-11 (Fig 4.10).

However, the IMF forecasts that growth in the debt stock will be 4.3% in 2012, slower than our nominal GDP forecast of 9.6%. Therefore, as a percentage of GDP, it is estimated that external debt will fall from 48% in 2009 to 39% in 2012. This is a very manageable and moderate level of debt by regional and international standards, and only about the half the size of the UAE's forecast export earnings in 2012.

Fig 4.10: External Debt (2008-12)
(US$bn, CAGRs shown)



Source: IMF, QNB Group estimates and forecasts (excludes bank debt)

[27] United Nations Conference on Trade and Development (UNCTAD).

5. Money and Prices

A. Currency

The US Dollar peg provides stability, but limits the monetary policy tools

The UAE Dirham (AED) has been pegged to the US Dollar at a rate of AED3.6725: US$1 since 1978. All the other GCC currencies are also pegged directly to the US Dollar (Table 5.1), with the exception of Kuwait, which is pegged to a basket of currencies that is heavily weighted in favour of the US Dollar.

Table 5.1: GCC Exchange Rates (2011)
(Local Currency per US Dollar)

Country	Local Currency per US Dollar
Bahrain	BD 0.3760
Kuwait	KD 0.2765
Oman	OR 0.3845
Qatar	QR 3.6400
Saudi Arabia	SR 3.7500
UAE	AED 3.6725

Source: Central banks and QNB Group analysis

It seems unlikely that the currency will be de-pegged or re-valued. The central bank of the UAE has made it quite clear in communications that there was no fear on the US$ peg, although it is exposed to price fluctuations as are other major global currencies. This despite the fact that the central bank foreign reserves are mainly denominated in US dollars, and that they are invested mostly in non-US assets. The peg of the UAE currency to the US dollar minimises the volatility of hydrocarbon export revenue, as oil and gas are priced in US dollars. For foreign investors, the long-term stability of the pegs removes some of the capital value risks that are usually associated with investment in countries with floating exchange rates. However, the peg limits the monetary policy tools available to the central bank of the UAE

The UAE is currently not part of the GCC monetary union

The GCC **monetary union** was established in 2009, with the signing of an agreement between Saudi Arabia, Bahrain, Kuwait and Qatar (the UAE and Oman have withdrawn from the initiative). A joint GCC Monetary Council was established in Riyadh in 2010 as the first step towards monetary union and a single currency.

It is likely that a GCC currency would initially be pegged to the US dollar with the local currencies that are already dollar pegged being converted to the new GCC currency at equivalent weights, leading to no underlying change in the value of their currencies.

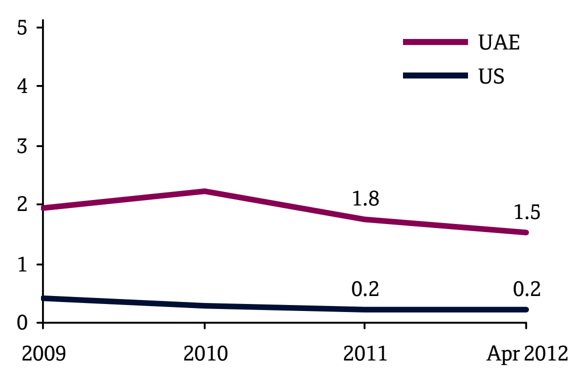
The GCC monetary union project has been largely modelled on the Euro. The sovereign debt issues currently being faced in the Eurozone have highlighted some of the problems with currency unions. This may cause GCC policy makers to re-evaluate whether the efficiency and stability gains of creating a single currency outweigh the possible disadvantages, making the timeline unclear.

B. Money Supply and Policy Tools

UAE rates are likely to remain low until 2014, taking their lead from the US Federal Reserve

The US dollar peg in the UAE requires the central bank to keep its interest rates broadly in line with US rates. This is necessary to deter major speculative capital flows seeking to arbitrage any interest-rate differentials. Interbank rates are therefore closely related to interbank rates in the US (Fig 5.1).

Fig 5.1: Average Three-Month Interbank Rates (2007-11)
(% 3-month rates, annualised)



Source: Central Bank of UAE, US Federal Reserve and QNB Group analysis

In recent years the UAE interbank rates have not been tracking rates in the US as closely as in the past. They have averaged a premium of 1.5 percentage points to US rates in 2009-12. The central bank of UAE does not need to cut rates as aggressively as the Federal Reserve because:

- Ultra-low rates were not so necessary to stimulate borrowing and economic activity in the UAE as they were in the US in 2009-11
- Inflation is more of a concern in the UAE
- The prevailing premium has not encouraged excessive inflows of capital

The Emirates Interbank Offered Rate (EIBOR) was introduced in October 2009 and stood averaged 1.5% up to April 2012. The US Federal Reserve has cut its benchmark federal funds rate from 5.25% at the end of 2006 to 0.00-0.25% at the end of 2008, which has influenced rate movements in the UAE.

In January 2012, the Federal Reserve announced that US policy rates would remain at their current low levels until late 2014. Therefore, UAE interest rates are also likely to remain at historically low levels throughout our 2012-13 forecast period.

As the central bank is bound to US interest rate policy it tends to employ alternative monetary policy tools. These tools include:

- **Reserve requirements** for banks
- **Lending limits**, such as caps related to salary multiples for customers and loan to deposit ratios for banks
- **Open market operations**, such as certificates of deposits, debt issuance and repo and reverse repo transactions
- **Lending rate caps** for banks.

Economic diversification, rising oil prices and credit growth have boosted liquidity

Liquidity as measured through broad **money supply**[28] (M2) in the UAE grew at a rate of 9.9% from 2007-11 to reach US$225bn (Fig 5.2), or 62% of GDP in 2011.

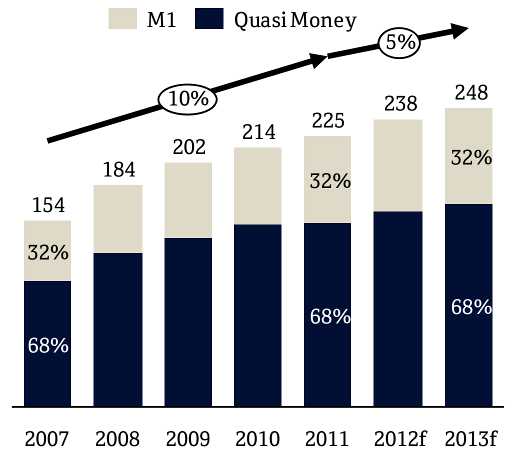
Quasi money increased by 10.0% from 2007-11 to reach US$153bn, as medium-long term local currency deposits went up by 9.3%, and foreign currency deposits gained by 12.2%.

Narrow money supply (M1) increased by an equally strong 9.8% from 2007-11 to reach US$72bn. The main underlying factors for the growth were a 9.3% increase in short-term monetary deposits, and a 12.5% rise in the currency in circulation.

The strong growth in money supply is mainly a result of the oil-fuelled economic and real estate boom during the 2000s combined with strong growth in domestic credit.

[28] The sum of narrow money (M1) and Quasi-money. Quasi-money refers to assets that are easily convertible into cash, such as money market accounts and bank deposits. M1 refers to the actual notes and coins in circulation and current accounts.

Fig 5.2: Money Supply (2007-13)
(US$bn, CAGR shown)



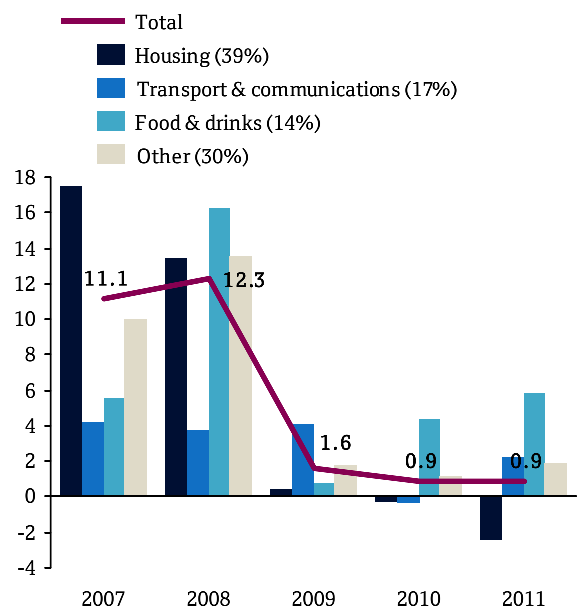
Source: Central Bank of UAE, QNB Group forecasts

C. Inflation

Falling rents have held down inflation since 2009 due to an oversupply in real estate

Inflation in the UAE has been historically low from 1998-2003, averaging 2.4%, but then increased to an average of 8.8% in 2004-08. Consumer price index (CPI) inflation in the UAE peaked in 2008 at 12.3%, driven primarily by rising housing costs and food prices (Fig 5.3).

Fig 5.3: CPI (2007-11)
(% change, weights of components indicated in legend)



Source: NBS and QNB Group analysis

Inflation was driven higher by economic growth, the real estate boom, high oil prices and strong government spending, all of which increased domestic demand and drove up rents.

The UAE is also heavily dependent on imports of food and other goods and is therefore affected by imported inflation as international commodity prices rise. Since the financial crisis, falling rents and fuel subsidies have kept CPI inflation low at an average of 1.1% in 2009-11.

Rental price fluctuations have driven the increase and subsequent contraction in the CPI

Housing (rent, fuel and energy) has the strongest weighting in UAE's CPI basket, accounting for 39% of the index. Inflation in this component was faster than most of the other categories in 2004-09, at a rate of 10%. During UAE's real estate boom, especially in Dubai, rental prices rose rapidly.

Rent was also the key driver for low inflation in 2010-11, as the housing index contracted by 0.3% in 2010 and by 2.4% in 2011.

The second most heavily weighted category in the CPI is **transport and communications**, representing 17% of the overall index. Price changes in this component have been more moderate, only rising at a rate of 5.1% in 2004-09 and contracting by 0.4% in 2010. This category is dominated by automotive costs and the cost of mobile phones. The prices of these items tend to be less elastic than other basic goods.

The **food and drinks** component of CPI was also an important factor driving inflation. It has the third strongest weighting in the CPI basket, accounting for 14%. Inflation in this sector was 6.6% in 2004-09 and continued its upward trend in 2010 by 4.5% and by 5.9% in 2011. The majority of goods in this category are imported into UAE and inflation has therefore been driven by rising international food prices.

The six smaller categories omitted from Fig 5.3 are:

- Textiles, clothing, and footwear (7.6% of the index)
- Education, recreation, and culture (7.1%)
- Miscellaneous goods and services (5.3%)
- Restaurants and cafes (4.4%)
- Furniture and household goods (4.2%)
- Medical care and medical services (1.1%)

We forecast overall inflation of 1.1% in 2012-13

We expect rising food prices and transport and communication costs, to counterbalance a marginal decline in housing costs. This will lead to inflation of around 1.0% in 2012 and 1.2% in 2013.

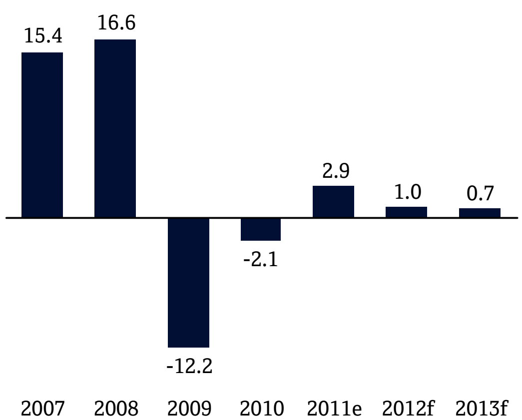
6. Public Finance

Each Emirate within the UAE has its own budget. There is also an official federal budget, which accounts for about 25% of revenue and expenditure. Abu Dhabi covers most of the federal budget, of which defence is an important part, and Dubai is the only other Emirate that contributes, accounting for 3% of federal budget revenue in 2011.

The fiscal balance has recovered quickly from a large deficit in 2009

Strong oil prices in the 2000s supported growing fiscal surpluses until 2008 (Fig 6.1).

Fig 6.1: Fiscal Balances (2007-13)
(% of GDP)



Source: IMF and IMF estimates and QNB Group forecasts

The government stepped up spending to support the ailing economy in 2009 as oil prices collapsed, leading to a deficit. Economic recovery, consolidation of spending and an unwinding of government support to the economy brought the budget back to an estimated surplus by 2011.

QNB Group forecasts that the fiscal surplus will average 1.2% of GDP in 2012-13. With oil prices expected to remain flat at US$110/b in 2012 and 2013, we expect that the surplus will be at 1.4% of GDP in 2012 and at 1.0% in 2013. Although Dubai is consolidating its government spending, the expansionary stance in Abu Dhabi and the potential that GREs may require further support, will restrict the surpluses in 2012-13.

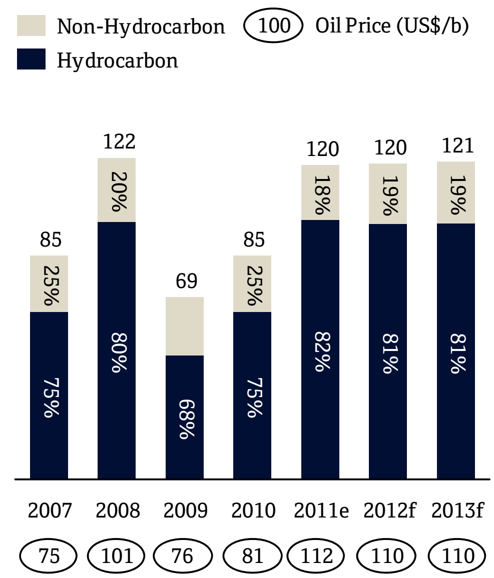
It should be noted that official data underestimates the true strength of UAE public finances as some of Abu Dhabi's oil revenue is paid straight into reserve accounts and is excluded from revenue. Additionally, income from sovereign wealth funds with large investments abroad is not included in the budget.

A. Revenue

Oil and gas income accounts for the largest portion of government revenue

Total UAE budget revenue amounted to US$120bn (AED440bn) in 2011, or 33% of GDP. Oil and gas revenue tends to account for the largest share of budget revenue, averaging 76% in 2007-11. UAE budget revenue has therefore fluctuated in line with changes in oil prices (Fig 6.2).

Fig 6.2: Budget Revenue (2007-13)
(US$bn)



Source: IMF and QNB Group forecasts

As oil prices have risen, the share of non-hydrocarbon revenue in total revenue has contracted from a high of 32% in 2009 to 18% in 2011. In recent years, the bulk of non-hydrocarbon revenue (US$6.9bn in 2010, the last year for which a break down is available) has been derived from fees and charges for government services. Investment income has declined from a peak of US$8.4bn in 2007 to US$3.6bn in 2010 as the performance of the world's major financial markets weakened during that period.

QNB Group expects total revenue to fractionally decline by 0.2% to US$119.5bn in 2012 as UAE oil prices move downward to US$110/b, even as a continued economic recovery supports non-hydrocarbon revenue. In 2013, we are expecting prices to remain at an average of US$110/b, however, a slight increase in oil production along with non-hydrocarbon revenue will drive revenue higher to US$120.1bn.

B. Expenditure

Strong government support following the financial crisis boosted spending

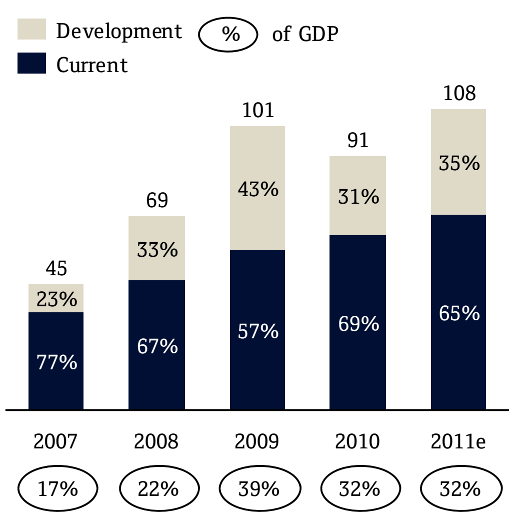
During 2009, the global financial crisis, lower oil prices and the bursting of the Dubai property bubble led to a sharp slowdown in economic growth, strains in the banking system and the debt restructuring of GREs.

Authorities responded promptly and extensively to these events, supporting the banking sector with emergency liquidity facilities, deposit guarantees, recapitalisations and other measures. Spending on strategic infrastructure projects was also ramped up, particularly in Abu Dhabi, to provide support to the construction sector. In addition, the UAE authorities contributed US$20bn to support Dubai's GREs in 2009.

These supportive measures led to a 47% increase in government expenditure in 2009 to US$101bn (Fig 6.3), or 39% of GDP.

Fig 6.3: Government Expenditure (2007-11)

(US$bn)



Source: UAE authorities, IMF and QNB Group analysis

The increase in development spending in 2008-09 was substantial, more than quadrupling in two years from US$10.4bn in 2007 to US$23bn in 2008 and US$44bn in 2009. This increase was mainly related to higher spending in Abu Dhabi on infrastructure, real estate, hospitality, manufacturing, and supporting services, providing a considerable boost to the non-oil economy, particularly the construction, real estate and banking sectors. Dubai also continued ongoing work on major infrastructure projects, including the metro, airport and road projects during this period.

Dubai is focusing on consolidating spending while Abu Dhabi budgets remain expansionary

Spending fell back towards more normal levels in 2010 (31% of GDP) and the government is currently consolidating its spending, albeit gradually to avoid damaging growth. Development expenditure was cut back 37% in 2010.

Consolidation has been particularly strong in Dubai, the IMF projects that Dubai government spending will fall from 7.2% of GDP[29] in 2009 to 5.4% in 2012. In nominal terms, the Dubai government aims to cut spending by 20-25% in 2012-13, with most of the cuts coming in 2013.

In Abu Dhabi on the other hand, the government plans to implement major increases in capital spending with a focus on boosting non-oil sectors, particularly culture and tourism, health, infrastructure and renewable energy projects. A federal salary hike has also been implemented, which will predominantly be covered by the Abu Dhabi budget. However, "Other" expenditures, mainly subsidies and transfers, are expected to fall leading to a moderate consolidation of overall expenditure.

QNB Group forecasts small increases in spending in 2012-13, although as a percentage of GDP we expect spending will fall to 29.3% in 2012-13 from 30.1% in 2011. The key drivers of the forecast are:

- Additional support to GREs in the Abu Dhabi and Dubai has tended to be forthcoming, for example US$10bn was provided to Aldar, Abu Dhabi's largest real estate company, in 2011
- The likely extension of strong governmental support to the rest of the economy, particularly in Abu Dhabi

The UAE will need to consolidate expenditure in the medium term. The expansionary fiscal position has increased the oil price needed to balance the budget from US$23/b in 2008 to almost US$100/b in 2012, based on QNB Group's analysis. Unless oil prices

[29] The IMF measures Dubai's government spending as a percentage of the GDP of Dubai and the Northern Emirates, owing to availability of data. The GDP of these Emirates is small in relation to Dubai and it would not have a significant impact on the numbers.

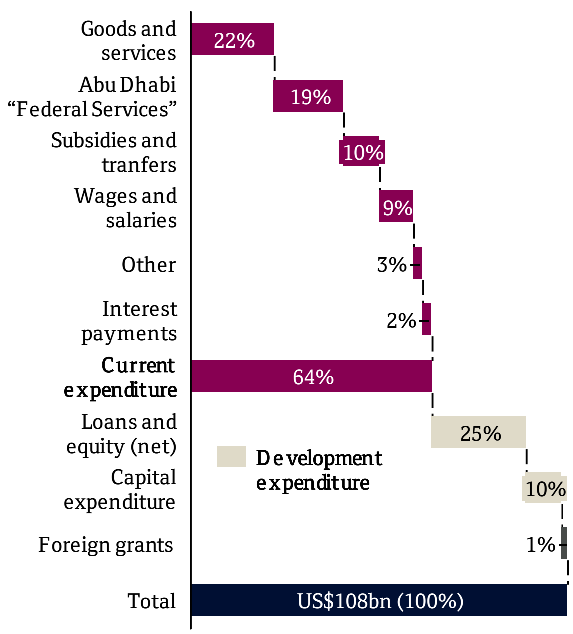
continue to rise there is little room for further expansion of expenditure and more conservative budgeting may be necessary in case of a collapse in oil prices.

Budget funding for development projects has shifted to loans and equity

The data for the consolidated government accounts of the UAE is provided by federal government and individual emirates. It includes the largest Emirates (Abu Dhabi, Dubai and Sharjah), which account for over 99% of government expenditure in the UAE.

Expenditure can be broadly broken down into current and development expenditure. Current expenditure is mainly wages, government services and other ongoing obligations (Fig 6.4), which accounted for an estimated 64% of spending in 2011. Development expenditure consists of direct project spending and indirect loans and investments in companies that are involved in large projects.

Fig 6.4: Government Expenditure Components (2011)
(US$bn and % share of total expenditure)



Source: QNB Group estimates

Current expenditure has increased steadily, growing 9.1% in 2010 and 11.5% in 2011, well below growth of 15.6% during the boom years 2002-08. It has fallen as a percentage of GDP from 21.1% in 2010 to 19.3% in 2011 as the Emirates have reigned in spending. Taken together, all government goods, services and salaries account for 79% of current spending.

Overall, 35% of the budget went towards development projects. Development spending increased by 34% to US$38bn in 2011 as Abu Dhabi boosted spending on projects. Loans and equity have grown dramatically in the budget as a means of financing projects, accounting for 72% of contributions to projects in 2010, up from zero in 2003. This should make the budget more sustainable in the long term.

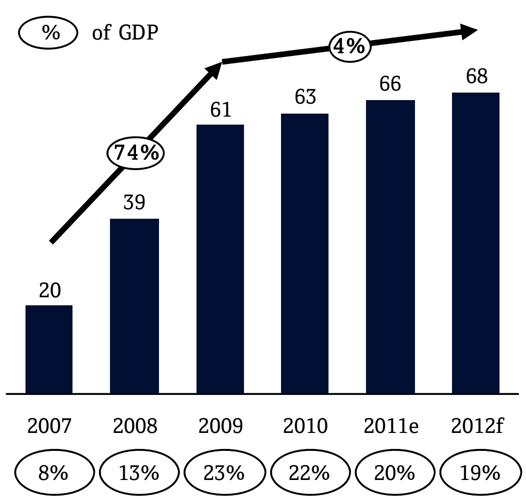
C. Public Debt

GRE debt and refinancing needs could lead to more government support in the short term

The UAE's central government debt rose at 47% per year from US$3bn in 2001 to US$61bn in 2009, increasing its share of GDP from 2.7% to 22%. The Emirates borrowed heavily to finance booming real estate and infrastructure projects as well as to support the economy and distressed companies in the aftermath of the global financial crisis.

The expansion of central government debt has levelled off since 2009 (Fig 6.5) and is expected to reach US$68bn this year.

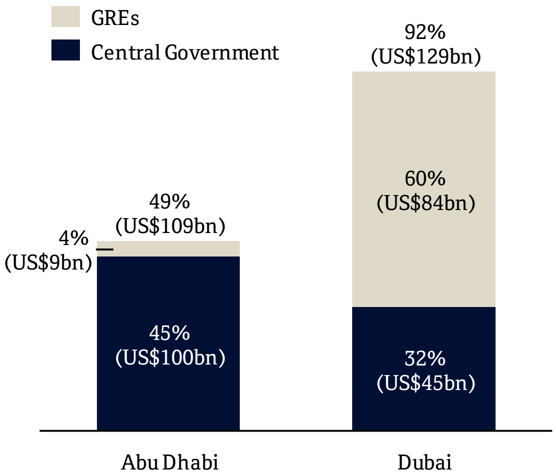
Fig 6.5: Central Government Debt (2007-12)
(US$bn, CAGR shown)



Source: IMF and QNB Group analysis

Including GRE debt and guarantees, UAE total public debt amounted to US$185bn in 2011, according to the IMF, representing 51% of GDP. This level of debt to GDP is well below many advanced economies (Japan 233%, US 100% and Germany 83%, for example) and is generally regarded as manageable.

Fig 6.6: Government-Related Debt (2011)
(% of GDP and US$bn)



Source: IMF and QNB Group analysis

Furthermore, UAE's debt is concentrated in Dubai and large amounts of debt are maturing in the near future. On average in 2013-15, US$9bn of Dubai government and GRE debt is maturing each year. Dubai's total central government and government-related debt is US$129bn, or 92% of Dubai's GDP (Fig 6.6), and US$22bn matures in 2014 alone. The restructuring of Dubai World debt has helped improve Dubai's financial position.

Total government-related debt in Abu Dhabi is US$108bn, but this is a more comfortable 49% of Abu Dhabi's GDP. However, refinancing needs of US$17bn are expected in 2012 with similar levels in 2013 and 2014. With high volatility and uncertainty in financial markets and the retrenchment of European banks, there is some risk that Abu Dhabi will need to provide further support to its GREs.

In 2009 when Dubai's debt crisis was at its peak, the Abu Dhabi government lent US$3.3bn to help support GREs in Dubai. A further US$3bn was provided in 2010 and US$2.7bn in 2011. However, no further support is expected to be provided in 2012.

7. Banking Sector

A. Overview

The UAE is over-banked and would benefit from consolidation

Currently 51 commercial banks operate in the UAE:

- 23 national banks
- 28 foreign banks

The number of UAE banks relative to inhabitants is the highest in the GCC.

Additionally, there are 160 financial institutions in the UAE, mainly:

- Representative offices of foreign banks
- Finance companies
- Specialised banks and investment banks
- Consultancies

The sector is over-banked with some banks undercapitalised. Therefore, consolidation has the potential to provide greater scale that could be a driver for growth, positively impacting the sector.

There are previous examples of consolidation:

- Emirates Bank International merged with National Bank of Dubai to form Emirates NBD (ENBD) in 2010
- ENBD then took over Dubai Bank in October 2011

Going forward, Dubai Bank and Emirates Islamic Bank, which are Islamic banking subsidiaries of ENBD, are likely to merge soon.

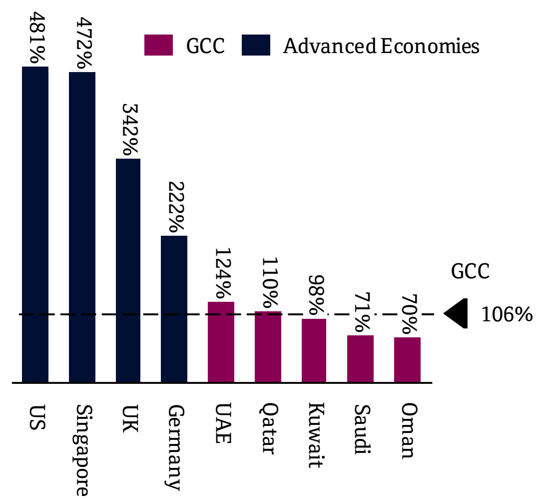
Assets to GDP are high for the region but still low compared with advanced economies

The UAE banking assets to GDP, which provide a measure of the importance of the sector to the overall economy, is higher than in most of the GCC, but still low compared to advanced economies that are considered major global financial centres (Fig 7.1).

The higher assets to GDP in advanced economies are a result of more sophisticated banking systems. This suggests that there is room for asset growth in the UAE over the long term through developing the sophistication of the banking sector. However, significant asset growth is unlikely in the short term as GREs will need further de-leveraging.

Fig 7.1: Total Banking Assets to GDP (2011)

(Total Assets as % of GDP)



Source: Central banks and QNB Group analysis

B. Structure

Islamic banks have outperformed conventional banks following the financial crisis

As with the rest of the GCC, restrictions on foreign ownership ensure that local banks dominate the sector, accounting for 80% of assets in 2011.

The local banks include 15 conventional banks and eight Islamic banks. Overall, 15.6% of the banking sector assets are held by Islamic banks, up from 9% in 2003 owing to the rapid growth and demand for Islamic finance. In addition to Islamic banks, most local conventional commercial banks and some of the foreign banks (such as the UAE operations of HSBC and Standard Chartered) have Islamic windows. This increases the share of Islamic assets in total assets to around 38%.

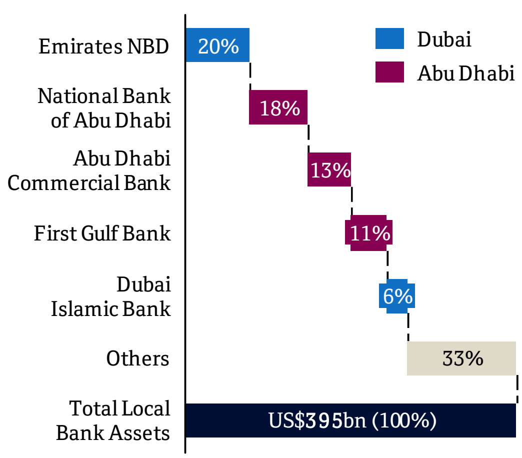
Concentration of the leading banks by assets and emirate is high

The sector is highly concentrated with the top five banks accounting for 68% of assets (Fig 7.2):

- ENBD was established with the aim of becoming a regional banking giant that could compete internationally. It was the second largest bank in the MENA region as at March-end 2012 with overall assets of US$80.8bn, behind QNB Group with US$85.5bn

- National Bank of Abu Dhabi (NBAD) is 70.5% owned by the Government of Abu Dhabi via the Abu Dhabi Investment Council. It has the largest international presence among UAE banks
- Abu Dhabi Commercial Bank (ADCB) has been suffering from poor asset quality and is struggling to maintain its share of loans, though it has enjoyed lower loan losses in 2011
- First Gulf Bank (FGB) is majority-owned (67%) by the ruling family of Abu Dhabi. It leverages its shareholder strength and has historically benefited from large deposit flows and infrastructure project financing from the Abu Dhabi government
- Dubai Islamic bank is the other major player in UAE and was more exposed than most other banks to the Dubai commercial real estate market (in terms of loans, investments and associates), which has led to weak asset growth for the bank

Fig 7.2: Local Banks by Assets (2011)
(% of total)



Source: Bankscope and QNB Group analysis

Foreign banks account for 20% of total banking assets in the UAE. Some of the main foreign banks are Barclays Bank, BNP Paribas, Citibank, HSBC, Royal Bank of Scotland and Standard Chartered.

Abu Dhabi accounts for 55% of total local banking assets, while Dubai accounts for 37%. As the UAE's economic wealth is mainly derived from Abu Dhabi and Dubai, which account for around 90% of GDP between them, most financial activity is concentrated within the major banks in these emirates.

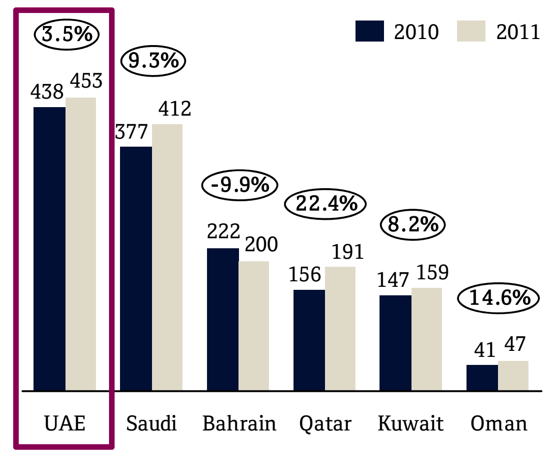
Sharjah has four banks that account for 4% of local bank assets, leaving the remaining four emirates with 4% of assets. The share of banking assets broadly reflects the share of GDP of each emirate.

C. Performance

The UAE has the largest share of GCC assets but growth was impacted by the financial crisis

With total banking assets at US$453bn in 2011, the UAE has the largest banking sector in the GCC. However, all other GCC banking sectors are expanding substantially faster, with the exception of Bahrain (Fig 7.3).

Fig 7.3: GCC Banking Assets (2010-11)
(US$bn)



Source: GCC Central Banks and QNB Group analysis

Slower asset growth in the UAE compared with its neighbours has mainly been a consequence of the UAE's high degree of integration and exposure to global financial developments[30]. This resulted in the global financial crisis having a greater impact on the UAE than other countries in the region.

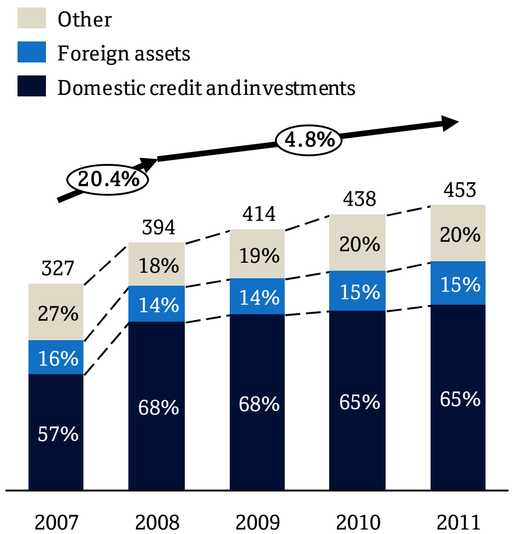
The impact of the global financial crisis can be seen in the marked slowdown in asset growth from 2008, which slowed from 32% in 2003-08 to 4.8% in 2008-11 (Fig 7.4).

The global financial crisis impacted the UAE in a number of ways that have undermined asset growth within its banking sector:

- Tighter international liquidity led to fewer stable source of funding being available in the UAE
- The world growth slowdown, weaker trade and lower oil prices that followed the crisis led to a sharp economic slowdown in the UAE and burst its real estate bubble
- The collapse of the real estate sector and continued oversupply has kept prices more than 60% below their 2008 level. However, there are signs that the residential real estate prices in Dubai have started to rebound

[30] IMF UAE Selected Issues and Statistical Appendix report, June 2012.

Fig 7.4: Total Banking Sector Assets (2007-11)
(US$bn, CAGRs shown)



Source: Central Banks and QNB Group analysis

Exposure to indebted real estate companies and GREs have led to a focus on de-leveraging

UAE banks lent heavily to real estate companies and GREs, which have also been negatively impacted by the real estate collapse:

- Of the 26 companies in the real estate sector, seven have operating losses or cannot service their debt.
- Major GREs have restructured their debt or are in the process of doing so, including US$25bn of Dubai World debt and US$10bn of Dubai Holding.

The banking sector has therefore suffered from rising non-performing loans (NPLs), higher provisions and funding constraints. This acts as a significant drag on the sector— banks have become risk averse and have focused on de-leveraging and lower-risk business. As a result lending has suffered and domestic credit has almost stagnated since 2008.

Real estate exposure is concentrated in Dubai and Islamic banks

The real estate sector was hit hardest in Dubai with GREs and banks also impacted more than in other Emirates. Islamic banks are more exposed to real estate than conventional banks and way Islamic real estate loans were structured also led to them being harder hit[31].

[31] Islamic borrowers only start to pay profit and principal on their debt once the property has been completed. The collapse in real estate prices means that many borrowers may no longer want to complete purchases on delayed projects now that property prices are lower than the agreed purchase price in Islamic financing structures.

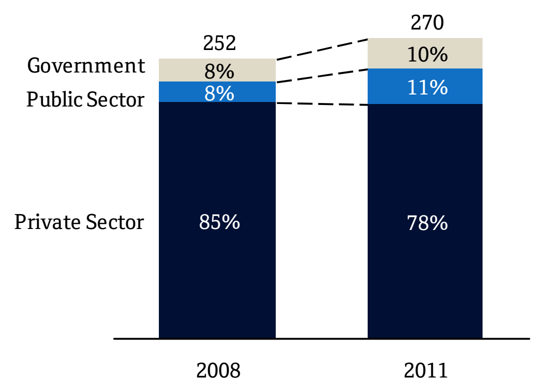
In terms of foreign assets, credit to non-residents and amounts due from foreign banks have increased at 8.8% and 15.3% respectively. While UAE banks have been forced to retrench in their domestic market, some appear to have focused on lending abroad to boost their asset growth.

The "Other" assets category includes elements such as receivable accrued interest, sundry debtors, inventories and the positive fair value of derivatives. These categories have boosted other assets, which have grown at 9.2% since 2008.

Growing risk aversion led to a cutback in lending to the private sector

The stagnation in domestic credit has mainly impacted the private sector, which takes the largest share of loans. Lending to the private sector fell at a rate of 3.1% from 2008-11 (Fig 7.5). However, this is also impacted by higher balance sheet provisions.

Fig 7.5: Loans, Advances and Overdrafts to Residents (2008-11)
(US$bn)



Source: Central Bank of UAE and QNB Group analysis

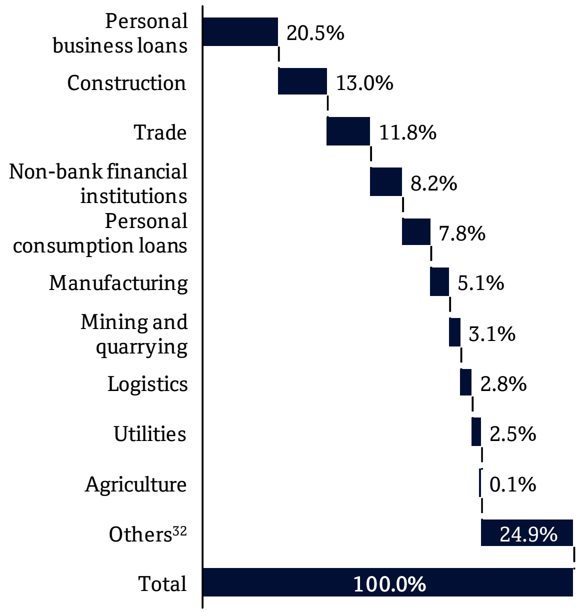
Strong government backing for GREs led to the private sector being perceived as more risky. As banks became more risk averse following the financial crisis, they cut lending to the private sector.

The private sector also retrenched as the outlook deteriorated with consumers and businesses borrowing less—the largest category of loans is Personal and Business loans (Fig 4.6).

Lending to the government and the public sector grew from 2008-11. The government has borrowed to finance fiscal deficits in 2009 and 2010 owing to lower oil revenue and higher spending, including spending to support GREs. There has been a build up of debt in the public sector owing to a reduction in the capacity of GREs to repay debt and GRE restructurings.

Fig 7.6: Non-Government Credit to Residents by Sector (2011)

(% share)

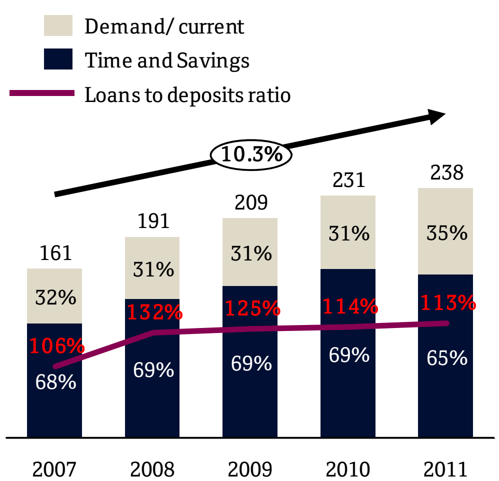


Source: Central Bank of UAE and QNB Group analysis

Deposit levels provide insufficient liquidity with Dubai facing long-term funding constraints

Fig 7.7: Deposits by Maturity[33] (2007-11)

(US$bn, CAGR shown)



Source: Central Bank of the UAE and QNB Group analysis

32 Includes loans to the services sector and non-profit institutions.

33 Excludes interbank deposits, government deposits and commercial prepayments.

Deposit growth has been steady at 11.4% over the last five years (Fig 7.7), supported by a growing population and economy.

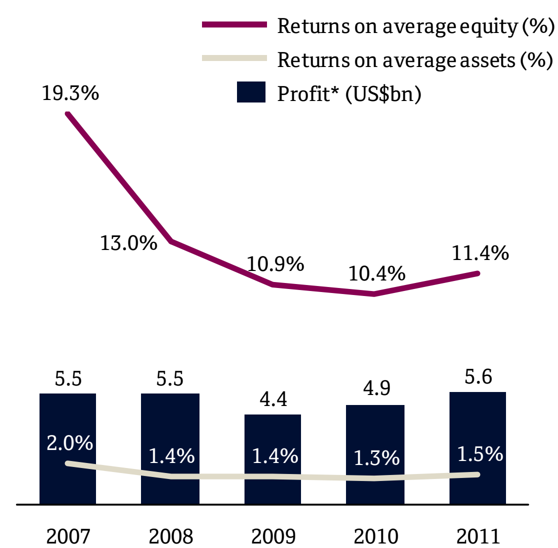
The federal government guaranteed bank deposits in September 2008, helping to minimise withdrawals during the global financial crisis. The government also provides a large and relatively stable source of deposits. Including the government, total deposits were US$288bn in 2011. Since 2008, government deposits have fallen slightly as more cash has been utilised for spending. Meanwhile, private sector and GRE deposits have risen as they have retained more cash.

Loans growth has outstripped deposits growth which has brought the ratio of loans to deposits up from 106% in 2007 to 113% in 2011. Overall deposit growth is insufficient to meet the liquidity requirements of the banking system, with Dubai banks having had some difficulty raising long-term funding owing to less liquid global markets and perceived problems with Dubai's GREs, which constrains lending[34]. Just over 50% of deposits mature within three months while loans and assets tend to have a longer maturity.

Profits and returns are recovering from their low levels due to impact of the financial crisis

UAE banks reported profits of US$5.6bn in 2011, a 13.9% increase on the profits recorded in 2010[35], consolidating the recovery from the 2009 trough in profits (Fig 7.8).

Fig 7.8: Banking Sector Profits and Returns (2007-11)



Source: Bankscope, IMF and QNB Group analysis, *Profits exclude two small banks that have not reported results in some years

34 Fitch UAE Banking Report, December 2011.

35 Profits exclude two small banks that have not reported results in 2011.

Following the financial crisis, bank profits were impacted by higher provisions for NPLs and by de-leveraging. Lower profits and the injection of capital into banks by the authorities in 2009-10 led to lower returns on average equity. De-leveraging meant that returns on average assets fell less dramatically.

However, in 2011, returns on equity and assets reverted to an upward trajectory as banks became more profitable. Business growth in the UAE remained slow in 2011, but banks benefited from lower funding costs as global interest rates fell. Net interest income also increased as deposits (shorter maturities) responded faster to lower rates than loans (longer maturities). Profitability was also boosted in 2011 by one-off gains from the sale of subsidiaries by Abu Dhabi Commercial Bank (40% stake in RHB) and ENBD (50% stake in Network International).

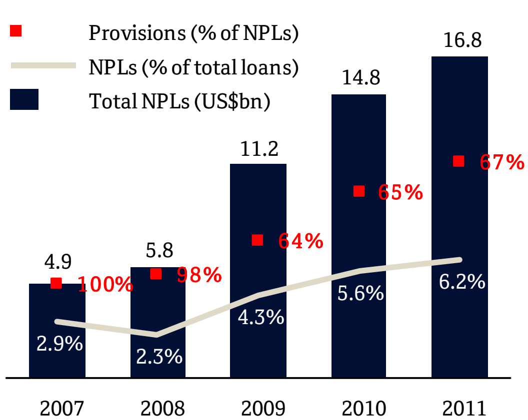
D. Risks and Regulation

NPLs have increased mainly due to large exposures to the real estate sector

NPLs have risen sharply since 2007 (Fig 7.9) as:

- Banks were heavily exposed to real estate companies, which have faced difficulty servicing their debt
- GRE restructuring and other debt issues have led to impaired loans
- Economic weakness has increased NPLs amongst companies in the broader economy
- A deteriorating job market has led to job losses and higher consumer NPLs, particularly for expatriates

Fig 7.9: NPLs and Provisions (2007-11)
(US$bn)



Source: IMF and QNB Group analysis

The restructuring of GREs has driven up NPLs as debt repayments have been put on standstill. These issues are concentrated in Dubai. The US$25bn Dubai World restructuring was concluded in mid-2011 and the US$10bn restructuring of the debt of Dubai Holding[36] is expected to be completed in 2012.

The rise in NPLs has also led to an increase in the provision level, although the coverage ratio has still fallen from 100% in 2007 to 67% in 2011.

Banks remain well capitalised, profitable and not excessively leveraged

The outlook for NPLs is uninspiring. A recovery in the real estate sector, the broader economy and the jobs market would help reduce NPLs. However, commercial real estate prices are still falling and the market is considered oversupplied.

Despite rising NPLs, the banking sector is well capitalised and profitable and lending is not excessive:

- The Capital Adequacy Ratio (CAR) is at 21% (up from 13.0% in 2007) for regulatory capital versus an official minimum of 12%
- The CAR is 15.3% for Tier 1 capital (13% for Dubai banks) versus a regulatory minimum of 8%
- All the local banks that have reported results were profitable in 2011 and in the first quarter of 2012
- Profits at the 20 local banks that have reported results were up 12.7% in 2011 to US$5.6bn
- Stress tests indicate that the banking system as a whole has adequate liquidity and capital buffers to withstand substantial shocks[37]
- Total lending, including loans abroad, is comfortable at 93% of total deposits

Authorities have taken proactive measures to ensure stability in the banking sector

The relatively healthy state of the UAE banking sector, despite the shock it has suffered, is mainly owing to a strong support from the authorities following the global financial crisis.

The federal government injected US$15.8bn of capital into banks, increasing the CAR by five percentage points and also provided substantial term deposits that were converted into capital.

The central bank has limited dividend distribution at banks since 2009 to further strengthen their resilience. This helped ensure that the UAE banking sector

[36] Moodys Banking System Outlook, November 2011.
[37] IMF UAE Selected Issues and Statistical Appendix report, June 2012.

remained well capitalised and supported a recovery in asset and profit growth.

The authorities also provided strong backing to the banking sector. The central bank deployed bank liquidity support facilities and the federal government guaranteed bank deposits and interbank loans from September 2008.

Regulators have been proactive in ensuring adherence with Basel guidelines. Along with Saudi Arabia, the UAE was the first GCC country to begin implementing Basel II. They are now the most advanced in implementing these guidelines and stand ready to integrate further requirements.

The authorities have also introduced new limits to ensure that banking sector risks are contained. In April 2012, large exposure limits were lowered for most categories, including individual local governments and GREs (to 25% of capital base) and new aggregate sector limits were introduced for all individual governments and GREs (to 100% of capital base).

In addition, the authorities took monetary and fiscal steps to support the banking sector and the broader economy. Interest rates were lowered by the central bank and spending on strategic infrastructure projects was increased, mainly in Abu Dhabi. The authorities (mainly Abu Dhabi) borrowed externally to help stabilise UAE international reserves.

Abu Dhabi authorities provided strong support to overly indebted Emirates and GREs. They injected equity into GREs, increased lending to them, and provided US$20bn to the Government of Dubai to finance the needs of Dubai's GREs and to establish the Dubai Financial Support Fund. A standstill and restructuring of Dubai World debt was also implemented.

The authorities also resolved issues at Dubai Bank by supporting a takeover by ENBD—the Ministry of Finance deposited US$0.8bn with ENBD in connection with this transaction and the Government of Dubai guaranteed existing assets, though this has created US$0.3bn in intangibles for ENBD and had a negative impact on its capital ratios.

In April 2012, the central bank of the UAE issued guidelines to all banks regarding large exposure limits. The federal government and their non-commercial activities were exempt from the limits. Some of the highlights of the new rules based on the type of borrower are as follows:

- UAE Local Governments and their non-commercial entities – The new individual limits are 25% of capital base from no limits previously.
- A single borrower or a group of related borrowers – The new limits are 25%, with a maximum 10% funded exposure, from the earlier limit of 7%.
- Bank's subsidiaries and affiliates – The individual limit is now 10% and aggregate limit is 25%, from the earlier 20% and 60% respectively.

8. Equity Market

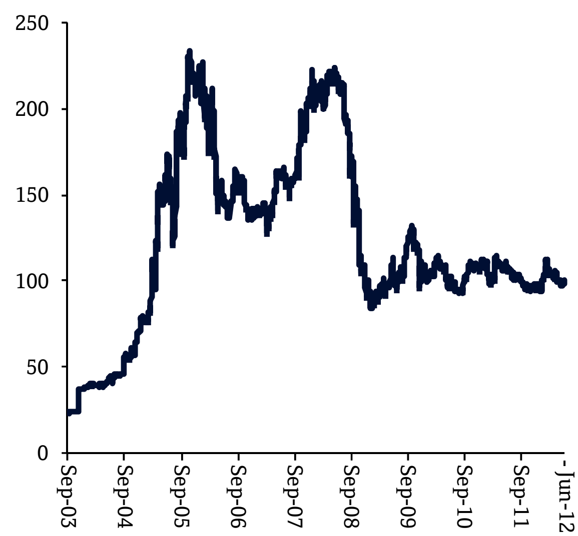
The UAE stock market has two primary exchanges located in Dubai and Abu Dhabi

The Dubai Financial Market (DFM) and the Abu Dhabi Securities Exchange (ADX) together constitute the UAE stock market. Equities listed on a third exchange, NASDAQ Dubai, were operationally consolidated into the DFM in July 2010 after the DFM bought a majority stake (67%) in NASDAQ Dubai in May 2010. The DFM and the ADX together form the third largest market in the GCC, behind Saudi Arabia and Qatar. Their combined market capitalisation was US$98bn as of June 30, 2012, equivalent to 14% of total regional capitalisation of US$697bn[38].

Market capitalisation has been volatile and has undergone boom and bust cycles

The total equity market capitalisation of the UAE grew by approximately 18% from September 2003 to June 2012 to reach US$98bn. However, the growth of the market has not followed a constant trend (Fig 8.1).

Fig 8.1: Market Capitalisation (2003-June 2012)
(US$bn)



Source: Bloomberg and QNB Financial Services (QNBFS) analysis

The initial rise from 2001 to mid-2006 was driven by speculation by retail investors, which was partially funded through borrowings. Increasing foreign participation (several companies allow a maximum 49% ownership by foreigners) coincided with high levels of domestic investor interest in the UAE. Furthermore, rapid economic growth and an improving outlook also had a positive effect on investor sentiment. The combination of these factors led to excessive valuations and a peak in market capitalisation, which reached US$224bn in late-2005. However, a subsequent crash by 42% in 2006 led to a decline in market capitalisation to US$136bn by late-2006.

Market capitalisation recovered through 2007 and most of 2008. In late 2007, DP World was brought public raising almost US$5bn in the UAE's largest ever IPO. However, the global financial crisis in late 2008, coupled with the bursting of a real estate bubble in Dubai, which seeped into Abu Dhabi's real estate market, weighed on the markets. Sentiment was also impacted by low oil prices, which fell sharply during the fourth quarter of 2008. Furthermore, Dubai's GREs' debt problems also roiled investors. Post the 2008 downturn, UAE's market capitalisation has been range bound within US$80bn to US$135bn.

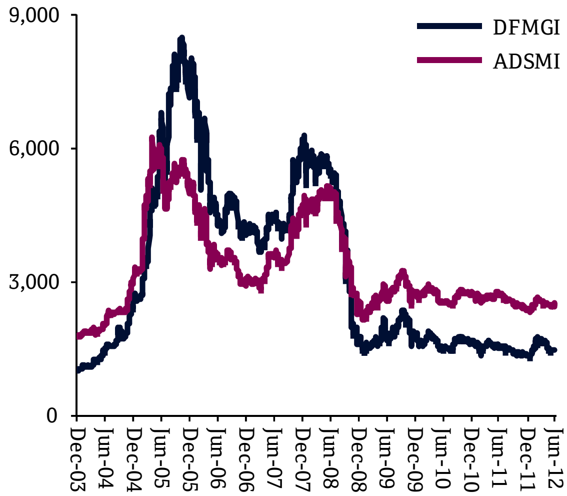
The Dubai stock market index has historically tended to be more volatile than Abu Dhabi

The Dubai Financial Market General Index (DFMGI) is the Dubai bourse's primary index. This free-float market capitalisation weighted-price index comprises of 31 companies, whose primary listings debuted on the DFM on or after January 2004. There are around 61 equities listed on the DFM as of June 2012, including some dual listings. The Abu Dhabi Securities Market General Index (ADSMI) is Abu Dhabi's primary stock market index and consists of all 67 equities trading on the ADX, including dual-listed stocks.

In 2004 and 2005, DFMGI was the star performer in the region. However, the dual crashes of 2006 and 2008 have taken some of the speculative steam out of the market. Over the last three years (2009-11), the index has oscillated in a relatively tighter band compared to 2004-08. On the other hand, the ADSMI has been relatively less volatile (Fig 8.2).

[38] This figure is from Bloomberg. The market capitalisation does not include exchange traded funds (ETFs) and global depositary receipts (GDRs). It includes only actively traded, primary securities on the country's exchanges to avoid double counting. Therefore, the market capitalisation figure amounts to less than the sum of the stock exchange market capitalisation data.

Fig 8.2: DFMGI and ADSMI (2003-June 2012)
(Index)



Source: Bloomberg and QNBFS analysis

The DFMGI declined by 17.0% in 2011 (Table 8.1), with only the Bahraini index posting a worse performance (down 20%) in the region. The ADSMI fared better, declining by 11.7% in 2011. The UAE's perception as a regional safe haven did little to help the markets as real estate issues and GRE debt concerns unnerved investors.

Table 8.1: DFM and ADX Performances Versus GCC Index (2005-12)

	DFMGI Index	ADSMI Index	S&P GCC Comp. Index
2005	189.6%	67.0%	103.9%
2006	-43.3%	-41.5%	-40.2%
2007	43.7%	51.7%	35.3%
2008	-72.4%	-47.5%	-55.3%
2009	10.2%	14.8%	14.1%
2010	-9.6%	-0.9%	12.8%
2011	-17.0%	-11.7%	-8.2%
YTD (June 2012)	7.3%	1.9%	1.0%

Source: Bloomberg and QNBFS analysis

After a strong start to 2012, the UAE markets have surrendered some gains

In 2012, the DFMGI and ADSMI got off to strong starts shrugging off their 2011 losses. In fact, the DFMGI in the first three months of the year was up as much as 29.6%. Concurrently, the ADSMI also appreciated by 9.9% in the first three months of 2012. We believe the relative underperformance seen in 2011 along with increasing retail interest led to the strong rally experienced in early 2012.

Global economic issues have deflated the rally in the previous two months, with the DFMGI losing some momentum. However, the index is still up around 7.3% (as of June 30, 2012) and is the best performing GCC index this year. The ADSMI has followed suit, correcting in line with other global and regional indices and is now up 1.9% (as of June 30, 2012).

The UAE bourses did not receive upgrades to MSCI Emerging Market status in June

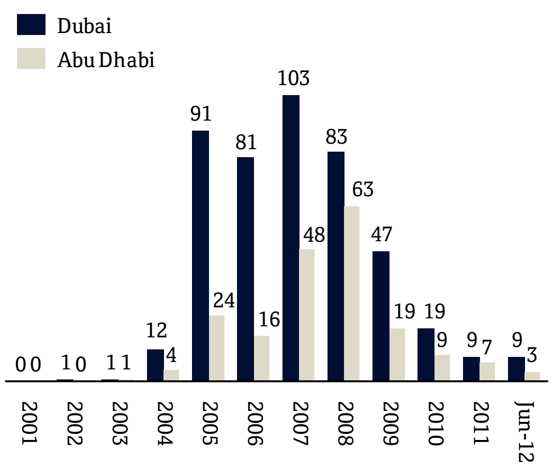
In the latest MSCI review in June 2012, the UAE bourse was not upgraded to Emerging Market (EM) status as expected. The next review is in June 2013. MSCI said that it "will maintain the MSCI UAE Index in Frontier Markets as no enhancements with respect to the operational issues mentioned in the last review are expected to be implemented in the United Arab Emirates before 2013." At present, none of the GCC nations have MSCI-EM status, and only Egypt and Morocco are included from the broader MENA region.

In 2011, the UAE rolled out its delivery versus payment model of trade settlements as per international standards. Over time, this new framework should reassure institutional investors that their assets will be fully safeguarded and is a key criterion in a potential upgrade to EM status. The UAE's stock market regulator for the DFM and ADX, the Emirates Securities and Commodities Authority (SCA), has also published draft regulations on securities borrowing and lending (SBL) and short selling. However, implementation is yet to take place.

Trading values have improved on the DFM in 2012 but remain subdued on the ADX

Overall, the value of trading on the DFM and ADX rose rapidly during 2001-08 (Fig 8.3).

Fig 8.3: Traded Value of Stock Exchanges (2001-June 2012)
(US$bn)



Source: Bloomberg and QNBFS analysis

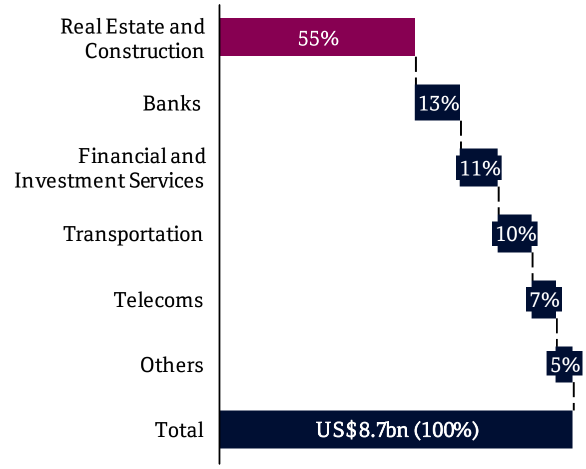
Despite the stock market crash in 2006, traded value remained strong during 2007-08. However, post 2008 total equity traded value has declined significantly.

This can be attributed to multiple reasons. First and foremost was the declining confidence in financial markets globally after the 2008 financial crisis. Another factor was that the majority of listed companies primarily represented the banking and real estate sectors and their related entities. The trading environment was further impacted by tightening credit from banks. Banks were focusing on strengthening their financial positions and improving asset quality through writing off debts secured by assets whose values had deteriorated significantly. Finally, the decrease in trading values was also due to the lower level of stock prices relative to previous years.

In 2011, the value of trading on the DFM fell 54% to US$8.7bn, which was a fraction compared to an average of approximately US$90bn during 2005-08. On the sector level, the **real estate** and **construction** sectors accounted for the majority of the traded value (US$4.8bn) followed by **banks** (Fig 8.4).

Traded value on the DFM has recovered thus far in 2012. As of June 30, 2012, the total traded value was roughly US$8.8bn (101% of 2011). However, after reaching a high of US$2.6bn for the month of March, it has fallen off in line with decline in the index.

Fig 8.4: DFM Traded Value by Sector (2011)
(US$bn and % share)



Source: Bloomberg and QNBFS analysis

In 2011, the value of trading on the ADX fell 28% to US$6.8bn. On the sector level, the **real estate** sector again accounted for the majority of the traded value (US$2.3bn) followed by **banks** (Fig 8.5).

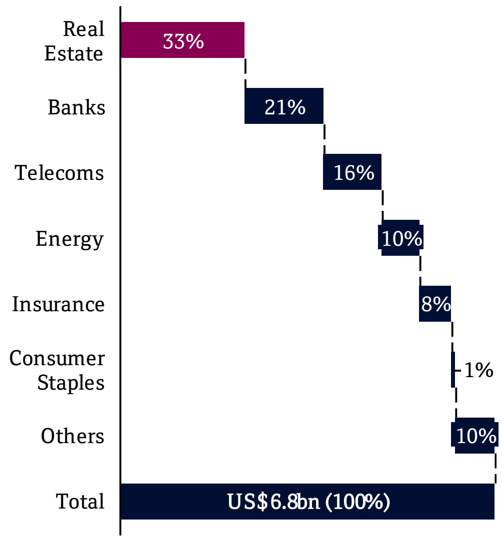
As of June 30, 2012, the total traded value on the ADX stands at US$3.3bn (49% of 2011). Similar to the DFM, the Abu Dhabi market also experienced improving trading values in the early part of 2012 before tapering off in the second quarter of 2012.

Markets remain dominated by retail and local investors

The presence of retail investors in the market has been declining but still remains dominant. In 2005, retail investors were responsible for 86% of the total traded value on the DFM exchange. However, this figure declined to 73% in 2011 and was 79% in first two months of 2012, the latest period for which data was available.

Foreign (non-UAE) investor participation has increased from just 22% in 2005 to 47% in 2011 as the Dubai stock market continues to appeal to foreign retail investors. Similarly, institutional activity is fairly limited on the ADX, making up 28% and 25%, respectively, of the total traded value in 2011 and thus far this year (as of June 30, 2012). Foreign (non-UAE) participation on the Abu Dhabi bourse was 34% in 2011 as some companies, such as Etisalat, which made up 16% of the total value traded, are restricted to only UAE nationals.

Fig 8.5: ADSMI Traded Value by Sector (2011)
(US$bn and % share)



Source: Bloomberg and QNBFS analysis

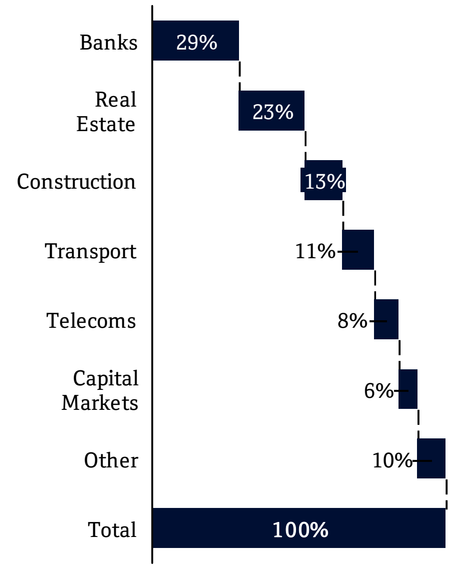
Despite increasing institutional investor participation, their presence remains limited in comparison to large mature bourses, such as New York and London, where institutional investors make up over 80% of the traded value. While restrictions on foreign investments could be one of the factors in limiting institutional presence, we note several of the better-known equities currently allow the maximum limit of foreign ownership[39]. For DFM-listed equities, we suspect still subdued profitability (low ROEs) of real estate and construction stocks have deterred institutional appetite.

UAE stock markets have had a strong start to 2012 with most sectors posting gains

On the DFM, most of the sector indices are up thus far this year, except the DFM Bank Sector Index, which is down 8.2% driven by a 34% decline in Mashreqbank. Investors should be cognizant that Mashreqbank is a very thinly traded stock.

The leading company by market capitalisation (actively traded) on the DFM is Emaar Properties. Of the largest ten companies, four are bank stocks (Emirates NBD, Mashreq Bank, Dubai Islamic Bank and Commercial Bank of Dubai). The remaining six are Emaar Properties, Emirates Integrated Communication (Du), Dubai Financial Market, Arabtec Holding, Air Arabia and Aramex.

Fig 8.6: DFMGI Sector Weights (June 2012)



Source: Bloomberg and QNBFS analysis

The five best performing (total return) stocks were:

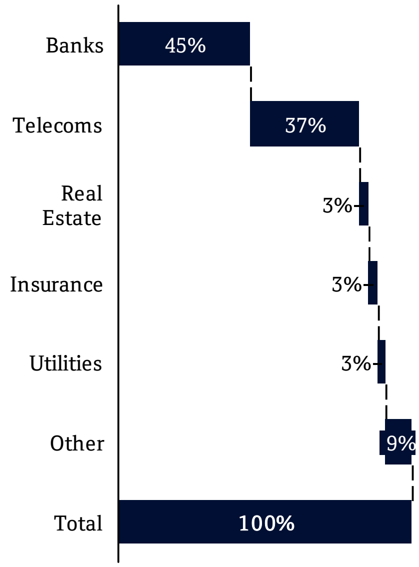
- Tabreed (+137.90%)
- Dubai Islamic Insurance (+123.00%)
- Tamweel (+98.73%)
- Arabtec Holding (+88.89%)
- Union Properties (+61.43%)

Source: Bloomberg (as of June 30, 2012)

On the ADX, most of the sector indices are positive thus far this year. The leading company by market capitalisation (actively traded) on the ADX is Etisalat. Of the largest ten companies: Seven are bank stocks (National Bank of Abu Dhabi, First Gulf Bank, Abu Dhabi Commercial Bank, Abu Dhabi Islamic Bank, Union National Bank, National Bank of Ras Al Khaimah and United Arab Bank). The remaining three are Etisalat, Abu Dhabi National Energy (Taqa) and Aldar Properties.

[39] Several companies listed on the DFM and the ADX can offer maximum foreign ownerships of up to 49% if they chose to do so. Foreign ownership restrictions are greater in certain sectors, such as insurance and finance companies, which have ceilings of 25% and 40%, respectively.

Fig 8.7: ADSMI Sector Weights (June 2012)



Source: Bloomberg and QNBFS analysis

The five best performing (total return) stocks were:

- Al Khazna Insurance (+70.15%)
- Gulf Cement (+56.34%)
- Eshraq Properties (+52.17%)
- Abu Dhabi Commercial Bank (+27.37%)
- Aldar Properties (+25.60%)

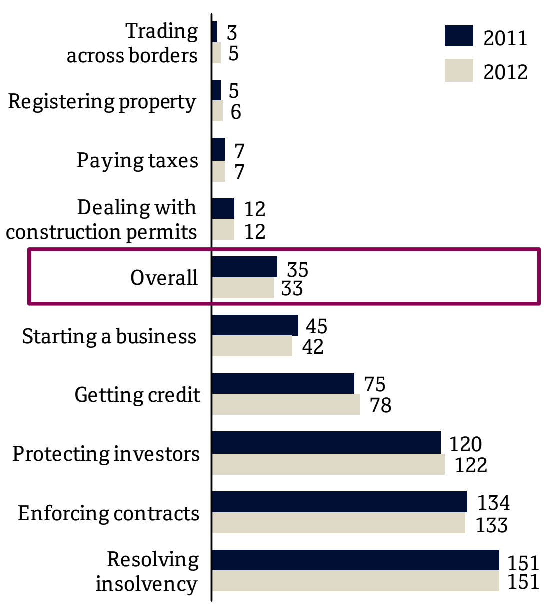
Source: Bloomberg (as of June 30, 2012)

9. Business Environment

UAE's business environment ranks second among the GCC countries, after Saudi Arabia

The UAE ranked **33rd out of 183** economies in the World Bank's (WB) Doing Business 2012 report (Fig 9.1). It progressed two places on the previous year, and ranks second among the GCC countries (after Saudi Arabia at 12th). In comparison with the wider MENA region, the UAE is second again, ahead of all other non-GCC countries.

Fig 9.1: World Bank Doing Business Ranks (2012)
(UAE rank out of 183)



Source: WB Doing Business Report and QNB Group analysis

There were two major reforms that pushed the UAE up the rankings in the 2012 report. Firstly, the ease of starting a business was improved by merging trade license filing requirements with the Department for Economic Development and the Dubai Chamber of Commerce and Industry. Secondly, a new law established a credit bureau under the supervision of the Central Bank, improving the score for the UAE's credit information systems.

Low tax structures are a strong support to the business environment

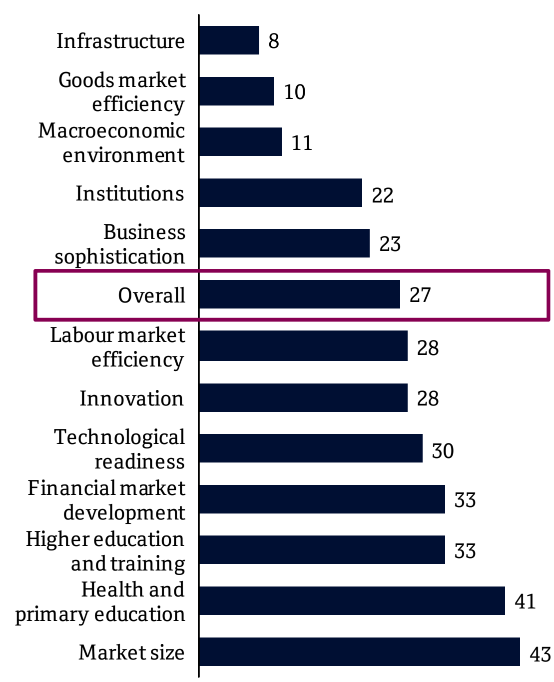
The strong business environment in the UAE is supported by low tax structures—the only significant taxes are import duties, which is at a flat rate of 5%. As part of a recommendation by the IMF, the UAE is considering the introduction of a value added tax as part of a coordinated GCC initiative, as well as general income and corporate taxes. However, these are unlikely to happen for some years, and even then only at low rates.

The impact of the economic crisis has implications for competitiveness

In the World Economic Forum's (WEF) 2011-12 Global Competitiveness Report, the UAE ranked **27th out of 142**, two places below the previous year, but still 3rd in the GCC after Qatar (14th) and Saudi Arabia (17th).

The country's overall competitiveness reflects the high quality of its infrastructure, an efficient operating environment and strong economic fundamentals (Fig 9.2).

Fig 9.2: Competitiveness Ranks by Category (2011-12)
(UAE rank out of 142)



Source: WEF Global Competitiveness Report 2011-12

Historically, the ranking for institutions has benefited from improving trust in politicians and high government efficiency, but this ranking has deteriorated owing to the severity of the country's economic crisis.

The WEF argues that following the crisis the UAE needs to reorient its development model to enhance competitiveness through structural reforms that will reduce the risk of asset bubbles, making development more stable. Priorities in this context should include further investment to boost health and educational outcomes.

10. Qatar-UAE Trade

The UAE has a trade deficit of US$2.7bn with Qatar and total trade is US$5.9bn

Bilateral trade between Qatar and UAE totalled US$5.88bn in 2010 (Fig 10.1), equivalent to about 6.3% of total trade for Qatar and 1.5% for the UAE.

Fig 10.1: Qatar-UAE Trade (2004-10)
(US$bn)

Source: Qatar Statistics Authority

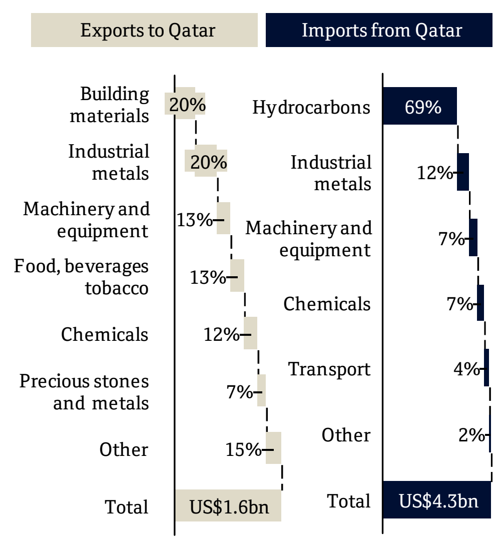
Since 2008, the UAE has developed a trade deficit with Qatar, which reached US$2.7bn in 2010, mainly as a result of new pipeline gas imports from Qatar. For this reason, hydrocarbons account for the largest proportion of imports from Qatar (Fig 10.2). Meanwhile, UAE exports to Qatar have fallen from a peak of US$1.8bn in 2008 to US$1.6bn in 2010.

Both the UAE and Qatar have invested heavily in the petrochemical and fertiliser industries, producing a range of chemicals, plastic and rubber products as well as fertilisers. These products accounted for 8.1% of total trade between the countries.

Exports from the UAE to Qatar are mainly to supply construction

The key exports to Qatar from the UAE are more diversified than Qatar's to the UAE. This includes building materials, industrial metals and machinery and equipment. Building materials include gravel, stone, plaster and cement, all core inputs for construction. Industrial Metals mainly include iron and steel for piping and scaffolding, aluminium and copper for wiring. Machinery and Equipment mainly consists of basic products for installing electrical systems, air conditioning units and parts, fridges/freezers and water coolers. Oil well drilling equipment is also important to this category, accounting for 23%.

Fig 10.2: Qatar-UAE Trade by Commodity (2010)



Source: QSA and QNB Group analysis, *We have included Fertiliser, Plastics and Rubber in the Chemicals category to fully capture the trade related to expanding petrochemical and fertiliser industries.

UAE banks and other companies are active in Qatar and vice versa

Qatari banks have a presence in the UAE through QNB's associate - Commercial Bank International, Commercialbank's associate – United Arab Bank, and a branch and representative offices of Doha Bank. Conversely, a number of major UAE banks have a presence in Qatar though the Qatar Financial Centre, including Emirates NBD, First Gulf Bank, Union National Bank and Abu Dhabi Islamic Bank.

Outside the banking sector, Al Habtoor Group of the UAE has a significant presence in Qatar in the real estate sector, hotels, and shopping malls. Another UAE company, Al Futtaim Real Estate, is involved in the construction of Festival City, a US$1.7bn "mega-mall" with entertainment, retail, hospitality and commercial facilities to the north of central Doha.

Key Macroeconomic Indicators

	2007	2008	2009	2010	2011	2012	2013
Population							
Total (m)	6.22	8.07	8.20	8.26	8.48	8.72	8.97
Growth (%)	24.1	29.8	1.6	0.8	2.6	2.8	2.9
GDP							
Nominal GDP (US$bn)	257.9	314.5	259.7	283.9	338.7	361.2	374.9
Growth (%)	16.2	21.9	-17.4	9.3	19.3	6.7	3.8
Oil & gas sector (% of GDP)	33.8	37.0	26.4	30.9	38.4	38.4	37.0
Real GDP growth (%)	3.2%	3.2%	-4.8%	1.3%	4.2%	2.6%	2.8%
Oil & gas growth (%)	-7.1%	-2.4%	-8.9%	0.9%	6.7%	1.3%	0.0%
Other sectors growth (%)	9.3%	6.0%	-2.9%	1.4%	3.1%	3.1%	4.0%
Fiscal indicators (% of GDP)							
Revenue	33.1	38.9	26.7	30.0	35.3	33.2	32.1
(US$bn)	85.3	122.4	69.4	85.3	119.7	119.9	120.3
Expenditure	17.7	22.3	39.4	32.3	32.3	31.6	31.0
(US$bn)	45.7	70.2	102.4	91.7	109.2	114.2	116.2
Balance	15.4	16.6	-12.7	-2.2	3.1	1.6	1.1
(US$bn)	39.7	52.3	-32.9	-6.4	10.5	5.8	4.1
Public debt	28.7	46.0	86.1	82.0	71.8	69.2	70.3
Current account (% of GDP)							
Balance	7.6	7.1	3.0	2.6	9.1	7.9	6.6
(US$bn)	19.6	22.3	7.8	7.2	30.7	28.6	24.7
Trade balance	18.0	20.0	16.2	17.3	23.5	22.2	20.9
Exports	69.3	76.1	73.8	75.2	83.2	81.3	79.9
Imports	-51.2	-56.1	-57.6	-58.0	-59.7	-59.0	-59.0
Services balance	-10.1	-10.8	-10.5	-10.7	-10.9	-10.7	-10.6
Current transfers balance	-3.6	-3.4	-3.9	-4.0	-3.6	-3.7	-3.7
International reserves	29.9	10.0	13.5	14.7	13.7	13.8	14.1
External Debt	50.3	43.2	48.4	47.2	41.0	39.0	39.5
Industry indicators							
Oil production (k b/d)	2,529	2,572	2,242	2,324	2,565	2,600	2,600
Oil export price (US$/barrel, weighted)	75.1	100.5	75.9	80.7	112.1	110.0	110.0
Gas production (bn cu ft/day)	4.9	4.9	4.7	5.0	5.0	5.0	5.0
Monetary indicators (% change)							
Consumer price inflation	11.1	12.3	1.6	0.9	0.9	1.0	1.2
Food	5.6	16.3	0.8	4.5	5.9	3.3	3.3
Housing	17.5	13.4	0.4	-0.3	-2.4	-0.7	-0.7
Broad money growth	41.7	19.2	9.8	6.2	5.0	4.8	4.5

Source: NBS, various ministries, Central Bank of UAE, IMF, QNB Group estimates and forecasts

Editorial closing date: 30th June 2012

Table of Charts

QNB Group International Network

QNB International Branches and Representative Offices:

United Kingdom
51 Grosvenor Street,
London W1K 3HH
Tel: +44 207 647 2600
Fax: +44 207 647 2647
QNBLondon@qnb.com.qa

France
65 Avenue d'lena
75116 Paris
Tel: +33 1 53 23 0077
Fax: +33 1 53 23 0070
QNBParis@qnb.com.qa

Kuwait
Al-Arabia Tower, Ahmad Al-Jaber Street. Sharq Area
P.O. Box: 583
Dasman 15456 Kuwait
Tel:+965 2226 7023
Fax: +965 2226 7031
QNBKuwait@qnb.com.qa

Lebanon
Ahmad Shawki Street, Capital Plaza Building
Mina El Hosan, Solidere, Beirut
Tel: +961 1 762 222
Fax: +961 1 377 177
QNBLebanon@qnb.com.qa

Mauritania
Al-Khaima City Center
10, Rue Mamadou Konate
Tel: +222 4524 9651
Fax: +222 4524 9655
QNBMauritania@qnb.com.qa

Oman
Qatar National Bank Building
MBD Area - Matarah
opposite to Central Bank of Oman
P.O. Box: 4050
Postal Code: 112, Ruwi
Tel: +968 24783555
Fax: +968 24779233
QNBOman@qnb.com.qa

Sudan
Africa Road – Amarat Street No. 9
P.O. Box: 8134
Tel: +249 183-480000
Fax: +249 183-486666
QNBSudan@qnb.com.qa

South Sudan
Juba
P.O. Box: 587
QNBSouthSudan@qnb.com.qa

Singapore
One Temasek Avenue
22-03 Millenia Tower
Singapore 039192
Tel: +65 6499 0866
Fax: +65 6884 9679
QNBSingapore@qnb.com.qa

Yemen
Qatar National Bank Building
Al-Zubairi Street
P.O. Box: 4310 Sana'a -Yemen
Tel: +967 1 517517
Fax: +967 1 517666
QNBYemen@qnb.com.qa

Iran
Representative Office
6th floor Navak Building
Unit 14 Africa Tehran - Iran
Tel: +98 21 88 889 814
Fax: +98 21 88 889 824
QNBIran@qnb.com.qa

Libya
Representative Office
Burj Al Fatah – 19th Floor
P.O. Box: 91351 Tripoli - Libya
Tel: +218 213362131 / 2
Fax: +218 213362134
QNBLibya@qnb.com.qa

QNB Group International Network

QNB Subsidiary / Associates:

Iraq
Mansour Bank
Associate Company
P.O. Box: 3162
Al Alawiya Post Office
Al Wihda District Baghdad - Iraq
Tel: +964 1 7175586
Fax: +964 1 7175514

Jordan
The Housing Bank for Trade
and Finance (HBTF)
Associate Company
P.O. Box: 7693
Postal Code 11118 Amman - Jordan
Tel: +962 6 5200400
Fax: +962 6 5678121

Qatar
Al Jazeera Finance Company
Associate Company
P.O. Box: 22310 Doha - Qatar
Tel: +974 44682812
Fax: +974 44682616

Switzerland
QNB - Switzerland
Subsidiary
3 Rue des Alpes, P.O. Box: 1785, 1211
Genève -1 Mont Blanc
Tel: +41 22 907 70 70
Fax: +41 22 907 70 71

Syria
QNB - Syria
Subsidiary
Baghdad Street
P.O. Box: 33000 Damascus
Tel: +963 11 2290 1000
Fax: +963 11 44 32221

Tunisia
Tunisian Qatari Bank
Associate Company
Rue de la cité des sciences
B.P 320 – 1080 Tunis Cedex
Tel: +216 71713555
Fax: +216 71713111
www.tqb.com.tn

UAE
Commercial Bank International p.s.c
Associate Company
P.O. Box: 4449, Dubai, Al Riqqa Street, Deira
Tel: +971 04 2275265
Fax: +971 04 2279038

Indonesia
QNB Kesawan
Subsidiary
Jl. Hayam Wuruk No. 33
Jakarta Pusat 10120 - Indonesia
Tel: +62 213 508 888
Fax: +62 2134 832 739
www.bankkesawan.co.id

Qatar National Bank SAQ
P.O. Box 1000
Doha, Qatar

Tel: (+974) 4440 7407
Fax: (+974) 4441 3753

qnb.com.qa