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The Emirate of Dubai

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In a nutshell

- The economy of the Emirate of Dubai (Dubai), which accounts for roughly one-third of that of the United Arab Emirates (UAE), was hit by the bursting of the property bubble, a sharp fall in global oil prices, and massive declines in trade and services activities following the global financial crisis in 2009. As an economy that is highly dependent on the services sector (namely the wholesale and retail, tourism and real estate services) the prospects of Dubai's recovery hinge on the strength of global trade, a rebound in tourism activities and a pickup in the property sector. In addition, relatively strong and stable oil prices will have an indirect positive effect on Dubai through higher private consumption and investment from regional economies, particularly the Gulf Cooperation Council (GCC) and Asia.

- The property sector that was supported by favourable demographics, strong liquidity (as a result of high oil prices) and a robust tourism industry experienced a hard landing in 2009. The bursting of the property bubble hit the economy through contractions in property investments, reduction in consumer spending, and a decline in government revenue. Concerns over the prospects of the property sector are also compounded by incoming supply of properties which are expected to continue to exert downward pressure on prices. Notwithstanding that, measures implemented by Dubai's Real Estate Regulatory Agency (RERA) and the federal government to stabilise the sector have to some extent managed to restore investor confidence.

- Government revenue was adversely affected following the crisis and its growth is expected to remain below the historical average in the next few years. However, based on the expected steady (albeit slow) recovery of the global economy, it is not likely to deteriorate further. To be prudent, Dubai's government is aiming to ensure a continuous operating surplus, with current expenditure to be fully funded by non-oil revenues. The government has also gone on an austerity drive through its reductions in government-sector expenditure as well as its 21% cut in the development expenditure of 2010. Although the government's overall fiscal position is expected to be in a deficit of 2% of its gross domestic product (GDP) this year, it will likely be an improvement from the 2009 level. However, as non-tax revenue (NTR), comprising mainly fees from oil & gas as well as from property and tourism-related activities, is not expected to rebound strongly in the next few years, the budget deficit is likely to persist until 2013.

- Direct government debt has risen in 2009 but remained at a manageable level, compared with crisis-stricken economies such as Greece, Portugal, Ireland and the United States. But the Dubai government's instrumental role in restructuring the astronomical debt of Dubai World (a government-related entity) following the latter's standstill announcement in November 2009 has left many wondering about the amount of corporate debt that the government is willing to assume in the future. Following the debt crisis, Dubai's government established the Dubai Financial Support Fund with an allocation of USD20 billion sourced from the UAE central bank and Abu Dhabi. The support from Abu Dhabi reflects Dubai's strategic importance to the overall UAE economy. Dubai's government remains firm on its stance that it will only support strategic entities which, in the event of failure, would cause systemic risks to the economy.

- Dubai's long-term economic prospects remain resilient and are now more sustainable, despite a slower overall growth when compared to the period prior to the crisis. Latest projections by the government reveal that the economy will likely rebound by 2.3% in real terms in 2010, after contracting marginally in 2009. In the long term, growth will normalise to between 4% and 5% in real terms, half of the pace during the boom times under a base-case scenario, according to the officials. In terms of the government's fiscal position and based on the momentum of the UAE's economy as forecast by the International Monetary Fund (IMF), we anticipate Dubai's budget deficit to slowly decline and be eliminated in the next four years. As for inflation, it will not likely pose any threat to the economy in the medium term. The only concern at present is Dubai's property sector, which is not expected to recover too soon. Notwithstanding this, with credible measures by the RERA, the governments of Dubai and the UAE, as well as outstanding global rankings in terms of the emirate's competitiveness in the property sector and business environment as a whole, Dubai will not likely be shunned by long-term investors.

- Judging by different macroeconomic matrices, Dubai and the UAE are in favourable positions in terms of GDP per capita, population growth and global competitiveness when compared with selected countries in the GCC and Asia. They are in neutral positions in terms of variables such as inflation and current account balance, but in less-favourable positions in relation to fiscal balance, government debt and government revenue.

Introduction

Dubai is one of seven emirates comprising the Federation of the UAE. The second-largest emirate in the UAE after Abu Dhabi at 3,885 square kilometers, Dubai is located on the western coast of the UAE in the south-western part of the Arabian Gulf, at a longitude of approximately 55 degrees east and latitude 25 degrees north.

Chart 1: The map of Dubai

Source: Government of Dubai

Dubai began as a pearl diving and fishing village in the first half of the 18th century. Significant development only took place in the early part of the 19th century when members of the Bani Yas tribe migrated north from Abu Dhabi to found an independent Sheikdom in what is known as Dubai today. It became a centre for merchandise trade in later years. Upon the discovery of oil in 1966 at Fateh, 92km off Dubai’s coast, oil revenues became fundamental in the development of Dubai’s economic and social infrastructure. The discovery of oil also enabled the emirate to capitalise on the increase in Middle East business activity with the rise of oil exports. In 1971, Dubai and five other emirates, Abu Dhabi, Sharjah, Ajman, Umm Al Quwain and Fujairah, merged to form the UAE, which was joined by Ras Al Khaimah in February 1972.

Dubai’s robust economic growth through the years led to a steady rise in population. From a mere 183,187 people residing in Dubai in 1975, the population has expanded to about 1.87 million people, according to the Dubai Statistics Centre (DSC). The majority of these are non-UAE nationals, mainly from the Indian subcontinent, Europe and other Arab countries.

Law and order

The UAE Constitution provides for a two-pronged strategy for the governance of the UAE. Jurisdiction for enacting substantive legislation was confined to the federal government, and the local governments of the seven emirates were given authority over matters not falling under the purview of the federal government. Under Articles 120 and 121, the federal government takes charge of matters pertaining to foreign affairs; security and defence; nationality and immigration; education; public health; the currency (monetary and exchange-rate policy managed by the Central Bank of the UAE); postal, telephone and other communications services; air traffic control and the licensing of aircraft and other matters like labour relations; banking; the delimitation of territorial waters; and the extradition of criminals, while Article 122 empowers individual emirates to manage themselves and maintain their own competencies in certain sectors. Dubai has chosen to assume responsibility for its own education, public health and judicial systems.

The UAE is governed by three sources of law: federal laws and decrees (applicable in all emirates), local laws and decrees, and Shari'ah law. When federal legislation is non-existent on areas under federal authority, the Ruler or local government can apply individual rules, regulations and practices.

The counsel of Councils

As part of the UAE, Dubai is governed by the Supreme Council of the Rulers of all the emirates (Supreme Council), the highest federal governing body comprising the Rulers of the seven emirates; it elects from among its members a President and Vice President, who serve for a renewable five-year term. Substantive matters are decided by a majority vote of five emirates that must include Dubai and Abu Dhabi, and procedural issues are decided by a simple majority vote. The Supreme Council, vested with legislative and executive powers, ratifies federal laws and decrees, plans general policy, approves the nomination and resignation of the Prime Minister and relieves him from power upon the President's recommendation.

The Federal Council of Ministers ("the Cabinet") is the federation's executive authority that implements the Supreme Council's policy decisions and is tasked with preparing draft laws, drawing up the annual federal budget and enacting legislation regulating such aspects of the federation as foreign affairs, defence, security, the federal judicial system, federal finance and loans and civil aviation through specially created federal ministries. The Cabinet is headed by the Prime Minster and comprises the Deputy Prime Minister and other ministers. Dubai's Ruler, Sheikh Mohammed bin Rashid al-Maktoum, is the vice president and prime minister of the UAE, while Abu Dhabi's Ruler, Sheikh Khalifa bin Zayed Al Nahyan, is the president of the UAE.

The Federal National Council is a parliamentary body comprising 40 members, with each emirate contributing members according to population and size. It is tasked with examining and amending all proposed federal legislation, summoning and questioning federal ministers about ministry performance, and discussing the UAE's annual budget.

The economy

Prospects of the UAE's economy

The UAE's economy took a beating from the global recession in 2009, causing its real GDP to decline by an estimated 2.5%, according to the latest estimates by the IMF. Prior to the recession, the UAE's economy grew at an average rate of 7% between 2005 and 2008, fueled by rising oil prices and robust global trade. With the subsequent recovery in global trade and a steady rise in crude oil prices, the UAE, being the fourth-largest oil producer in the Organization of Petroleum Exporting Countries (OPEC) and the world's third-largest oil exporter, is expected to experience an economic recovery and post a 2.4% growth in 2010, followed by an expansion of 3.2% in 2011. While the economy is anticipated to go through a soft patch as a result of an expected slower growth of the global economy in the next few years, relatively strong and sustained oil prices and rising trade activities will provide important buffers against any sharp deterioration in the economy's health.

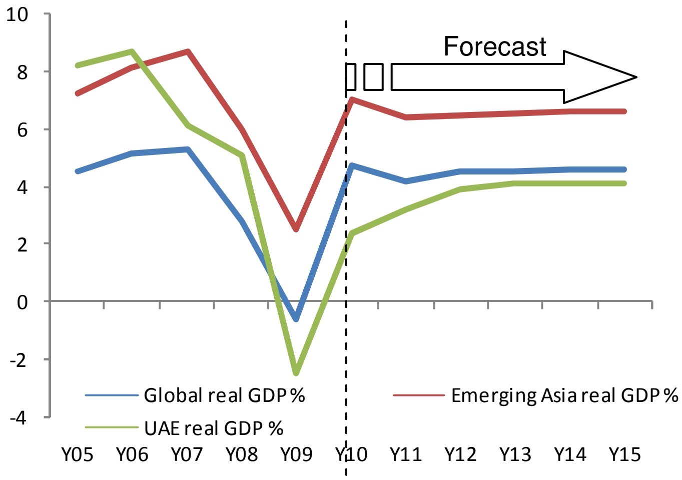
Efforts to diversify the economy have strengthened the UAE's overall macro position. Although oil & gas still makes up about 30% of its economy, other sectors (namely, manufacturing, wholesale and retail, construction, real estate and business services and transport, storage as well as communication) account for a combined 51% of the UAE's economy. Dubai, for instance, is well-known for its trade, wholesale and retail sectors as well as being a property centre of the UAE.

Other aspects of the UAE's economy remain favourable. The inflation rate, which climbed to an average of 9.7% between 2005 and 2008 following sharp increases in property and oil prices, fell drastically to 1.2% in 2009 due to the recession and the bursting of the property bubble in Dubai. Going forward, in the absence of significant cost-push and demand-pull inflation, the UAE's consumer prices are expected to move within the range of 2%-4% between 2011 and 2015.

The external sector remains resilient, as the UAE benefits from strong oil prices, similar to before the global crisis. Its current account of the balance of payments registered an average surplus of USD25.2 billion per year between 2005 and 2008 (13.9% of GDP). Going forward, while the average surplus is expected to decline to USD19 billion per annum (6.3% of GDP) under the IMF's base-case scenario, such forecasts may be surpassed if oil prices remain strong and global trade continues to recover in the next few years.

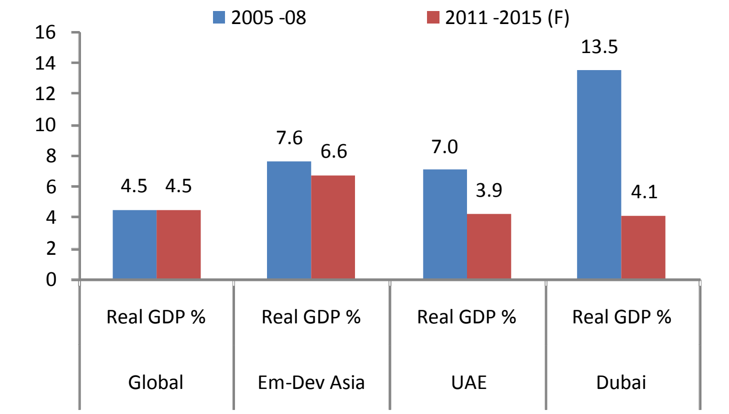
The UAE's fixed exchange rate with the USD at United Arab Emirates Dirham (AED) 3.6725 per USD is seen as a major contributor to the stable trade performance in past years. While concerns have emerged over the peg regime following the precipitous decline in the value of the greenback that is causing large capital outflows, it is also regarded as an important tool in providing stability to external trade and overall macro balances. We do not anticipate any changes in this fixed exchange-rate regime in the foreseeable future.

Chart 2: GDP growth (%)



Source: IMF

Chart 3: GDP growth trajectory (%)

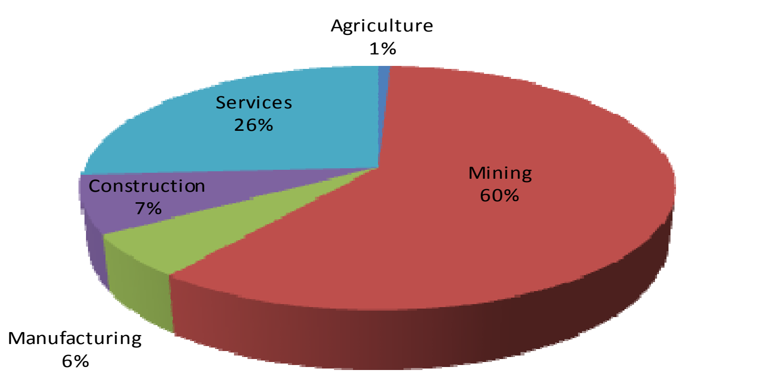


Sources: IMF & MARC Economic Research
Note: F = Forecast

Structure of Dubai's economy

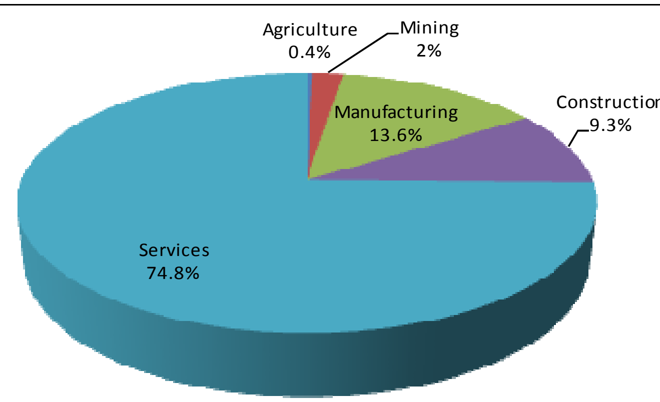
Dubai's economy is the second-largest contributor to the UAE, and, unlike Abu Dhabi, the emirate is largely dependent on the services and trade sectors. The services sector accounted for a hefty 75% of Dubai's GDP in 2008. Further inspection of the figures revealed that the wholesale & retail (WS&R) and real estate & business services (RE&BS) sectors are the major drivers of the economy, with a combined contribution of roughly 53% of GDP. Oil & gas, on the other hand, accounts for a mere 2% of GDP. This is in contrast with Abu Dhabi, which accounts for 60% of the UAE's economy and is largely dependent on the oil industry (constituting 60% of its economy in 2008). Abu Dhabi, however, is often considered as Dubai's "big brother", especially after the former provided critical support to the latter during the crisis last year. With regards to long-term strategies, Dubai is concentrating its resources on developing its services sector, particularly those which are wholesale-, retail- and business-related, while Abu Dhabi is focusing on developing heavy manufacturing industries. Both emirates complement each other in terms of their roles in the economy of the UAE.

Chart 4: Abu Dhabi's economic structure in 2008



Source: CEIC

Chart 5: Dubai's economic structure in 2008

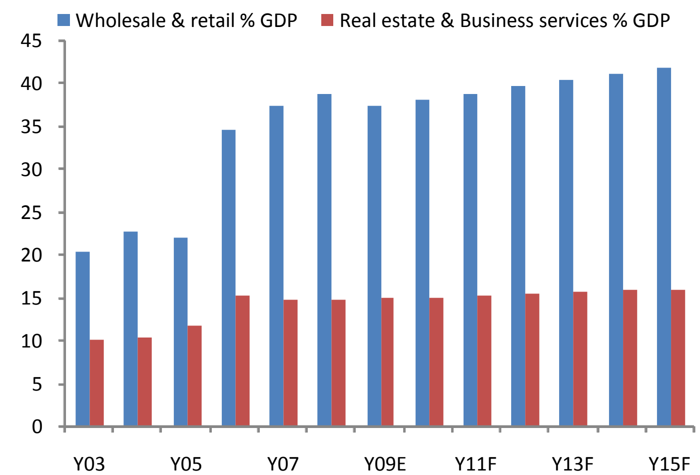


Source: CEIC

Dubai's high dependency on real estate-related activities is the primary reason for the anticipated moderation in its growth in the next few years. Notwithstanding this, the relatively steady and strong prices of oil will ensure positive prospects for wholesale, retail and tourism activities which, taken as a whole, are expected to offset the decline in activities related to the real-estate sector. This is particularly true, as demand for such services is highly dependent on consumers and businesses around the GCC region which are largely driven by oil dollars.

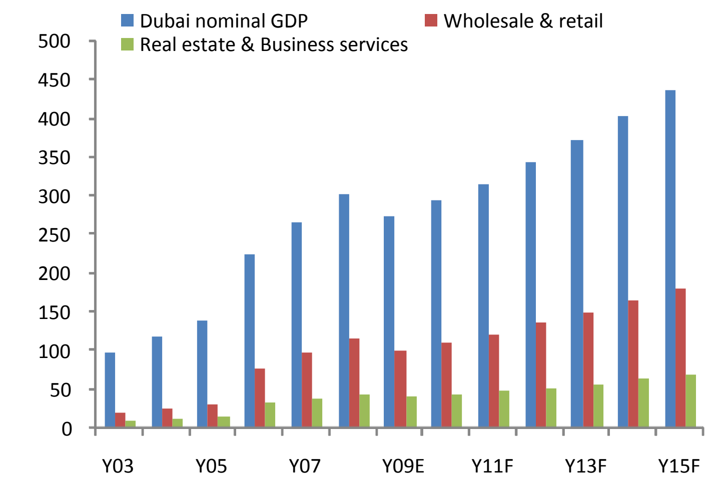
Another important contributor to Dubai's economic growth is the tourism and hotel-related industry which accounts for an estimated 19% of its economy. The sector has been adversely affected by the global recession, as evidenced by the decline in the hotel occupancy rate to 69.8% in 2009, far below its historical average of 82.6%. However, one should bear in mind that the historical average has been somewhat skewed by the extremely high rates recorded during the boom time prior to the crisis. The outlook, however, is more encouraging now as the recovery in the global economy and a sustained rise in oil prices begin to lure more tourists from the GCC and other regions to Dubai. This is reflected in the rebound of the hotel occupancy rate to 71.7% and the increase in new guest arrivals by 9% year-on-year in the first half of 2010.

Chart 6: Wholesale & retail trade and real estate & business services (% of GDP)



Sources: CEIC & MARC Economic Research
Note: F = Forecast; E = Estimate

Chart 7: Dubai's nominal GDP and wholesale & retail trade and real estate & business services (AED million)



Sources: CEIC & MARC Economic Research
Note: F = Forecast; E = Estimate

Challenging prospects for the property sector

Dubai's officials concur with the view of challenging prospects for the property sector, which was hard hit by the bursting of the property bubble. Prior to the global crisis, Dubai's real estate and property sectors were supported by some positive factors, including:

(1) Favourable demographics, where population growth has averaged approximately 7% per annum between 2003 and 2008;

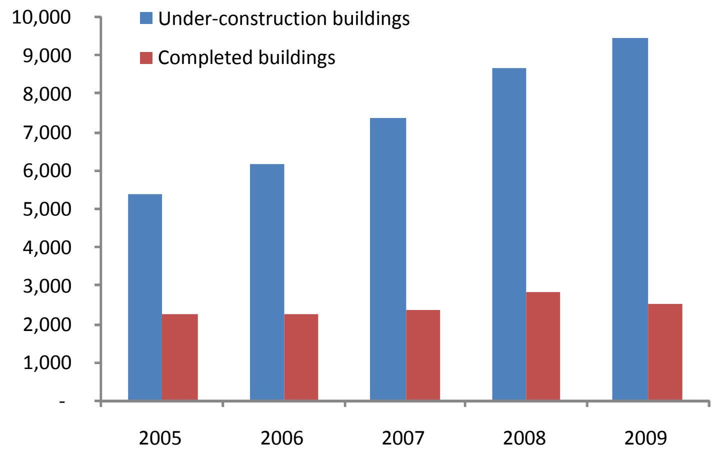
2) Strong liquidity following high oil prices that led to massive property investments by other GCC countries;

3) Robust tourism industry which induces the construction of hotels and other types of accommodations; and

4) Market-friendly policies and world-class infrastructure that make the emirate appealing to property investors.

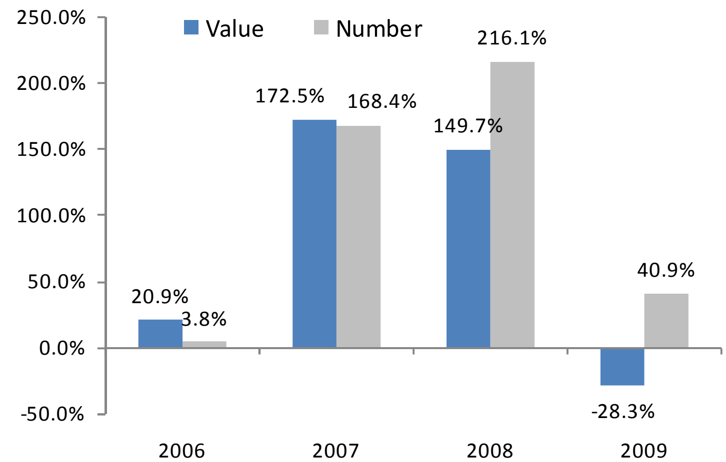
Pursuant to the collapse of Dubai's property market in the wake of the global crisis in 2009, the sector's prospects were challenged by sudden diminished demand from foreign investors and expatriates who fled the emirate. This was evidenced by lease rates for office space and new towers which continued their freefall by contracting 6% quarter-on-quarter in 3Q2010. The residential market did not perform much better – average rental rates for one-, two- and three-bedroom apartments fell by an average 13% on a quarterly basis, whilst on a yearly basis they contracted by 18%, according to a report by CB Richard Ellis. At the same time, the value of property transactions contracted by 28% in 2009 (2008: +150%) despite a 41% increase in the number of transactions. The incoming supply of properties, i.e. the number of buildings currently under construction (Chart 8), is also likely to depress rates further.

Chart 8: Under-construction and completed buildings (units)



Source: *Statistical Yearbook (2007,2008 & 2009)*, DSC

Chart 9: Real estate transactions – Sales (% change)



Source: *Statistical Yearbook (2007,2008 & 2009)*, DSC

Notwithstanding these, the long-term prospects may not seem too bleak if one were to consider the following factors:

(1) Prices have normalised and have become more affordable and sustainable for long-term investors. The collapse of property prices (which are now about half of their peak values) have driven away speculators, leaving only long-term investors in the property market. Although rental yields have moderated from the 15%-20% recorded during the heydays, they remain at a respectable and sustainable level of 8%-9%, according to the RERA.

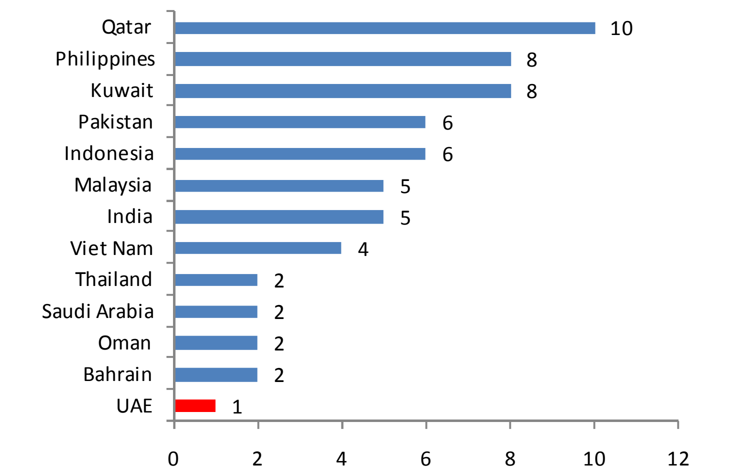
(2) Measures undertaken by the authorities to assure investors of the prospects of their property investments have been impressively effective. The transparency of information with regards to the status of each development and the market-friendly approach taken to solve customers' anxiety are indeed commendable moves that have assuaged investors' fears, giving them a heightened sense of security when investing in the emirate. At the height of the crisis, the UAE government introduced several initiatives, including extended property visas allowing homeowners the right of multiple entries into Dubai for a period not exceeding six months, to stabilise the market and restore investor confidence.

(3) Access to credit for new buyers has not been severely hampered, according to statistics provided by the Dubai Chamber of Commerce and Industry. Total credit extended to the UAE real estate sector has been rising steadily, reaching AED966.5 billion in June 2010 from AED924.4 billion in December 2008. Real-estate mortgage loans only fell slightly to AED66.3 billion in June 2010 from AED67 billion in December 2008. While it is true that banks' loan-to-value ratio has been reduced to approximately 70% (as revealed by officials), we do not see this as a major deterrent for long-term investors to invest in a locale equipped with world-class infrastructure and market-friendly business policies.

(4) Dubai's attractiveness as a centre for business and property investment is boosted by the UAE's favourable position in terms of ease of doing business. It ranked 40th out of 183 countries surveyed in the *Doing Business 2011* report that was published by the World Bank in November this year. Looking at the indicators used for the benchmarking, e.g. starting a

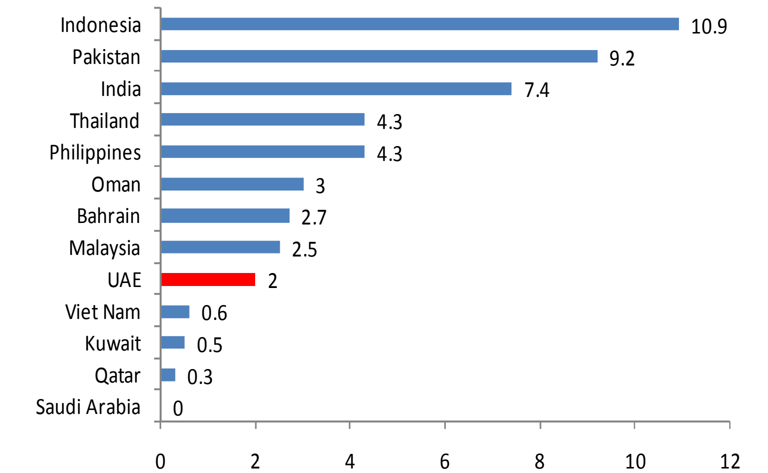
business, registering property and trading across borders, the UAE scored well, signifying the pro-business policies implemented by the authorities. For instance, it takes a mere two days to register a property in the UAE, tying it with Saudi Arabia and Thailand. In terms of trading across borders, the country climbed three places from last year to settle on the third rung, with the number of days to export goods having been reduced from 12 days in 2004 to seven days this year. Such improvements have increasingly lured foreign investors to set up shop in Dubai, thereby boosting the demand for properties.

Chart 10: Registering property – number of procedures



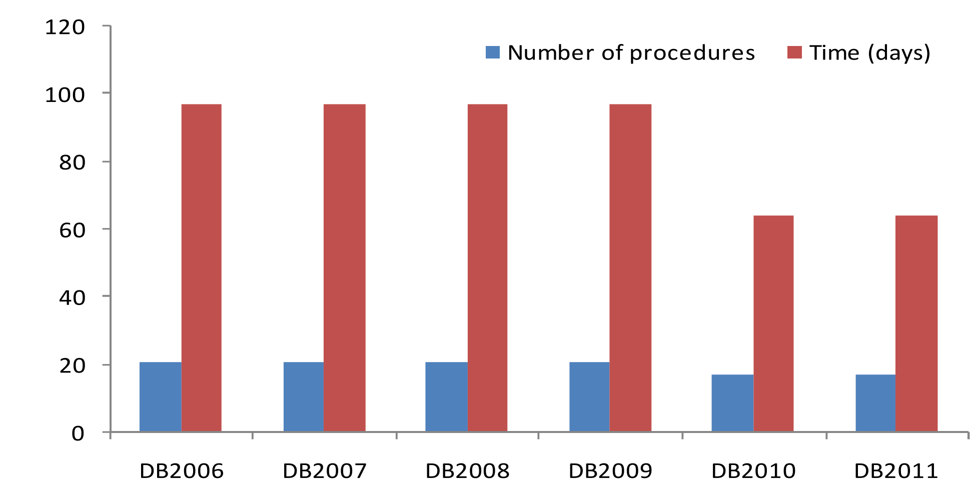
Source: *Doing Business 2011*, The World Bank

Chart 11: Registering property – cost (% of property value)



Source: *Doing Business 2011*, The World Bank

Chart 12: Dealing with construction permits (UAE) – number of procedures and time (days)



Source: *Doing Business 2011*, The World Bank

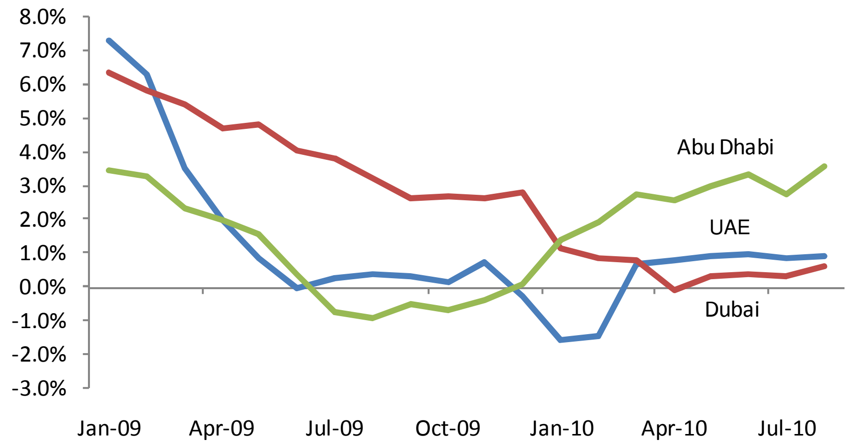
Inflationary pressures dissipated

The consumer price index (CPI) inflation, which surged to 10.8% in 2008, fell to 4% in 2009 and to 0.6% in the first eight months of 2010 as a result of the recession and the bursting of the property bubble. The sharp decline in the CPI reflects the high weightage of housing, water, electricity, gas and other fuels (about 43.7% of the index) which experienced a precipitous decline in 2009. In addition, imported inflation has diminished, consistent with the low inflationary environment in the global economy.

According to officials, excluding rentals and property prices, Dubai's cost of living is somewhat affordable as it has not increased dramatically in the past few years. In addition, salary and wage increases managed to offset the rising cost of living for the man in the street. For instance, officials stated that the salary of a new graduate in the government sector is typically within the range of AED12,000-14,000 per month, while those in the military and police force can command higher salaries of roughly AED24,000 per month, sufficient to fund a comfortable lifestyle in a metropolitan city like Dubai.

Going forward, with tepid increases in rentals and property prices as well as reduced imported inflation, we do not foresee any significant inflationary pressures in Dubai's economy.

Chart 13: Consumer price indices



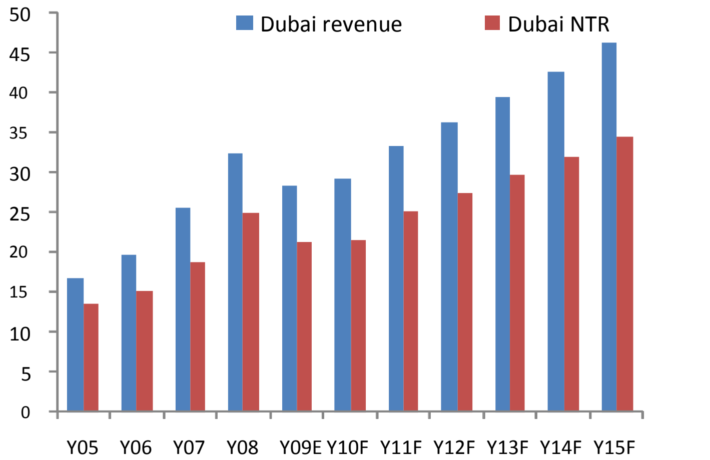
Source: CEIC

Fiscal balance still under pressure, but unlikely to deteriorate further

Judging by the composition of tax revenues, Dubai's financial position is expected to improve steadily (albeit slowly) in the next few years, as the emirate is largely dependent on its services sector for revenues. The good news is that the possibility of further deterioration in its fiscal position is rather limited due to greater efficiency in tax collections, a continued operating surplus and a likelihood of a decline in development expenditure post-mega projects.

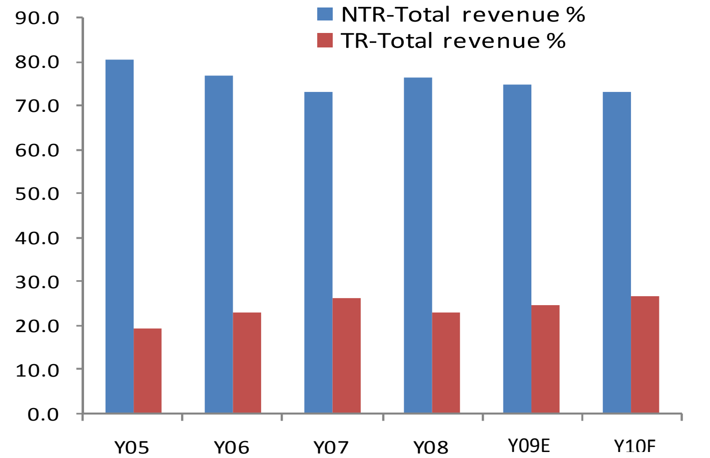
Dubai's NTR, a major component of the emirate's income, accounting for 75% of total revenue, is mainly comprised of fees from oil & gas, real-estate and tourism-related activities as well as from enterprise profits. The category denoted as "other" in the NTR that includes fees on land transfers, mortgages, immigration and visa issuances, hotel taxes and transport fees, has become more important in recent years, accounting for 75% of the NTR in 2009 (up from 41.9% in 2005). Such improvements signify the greater significance of property and tourism-related activities for Dubai's economy in the past few years. Given such observations, and the fact that the property-related sector will not likely experience a speedy recovery to its level prior to the crisis, Dubai's revenue growth is not envisaged to be as robust as before the crisis in the next few years.

Chart 14: Dubai's total revenue and non-tax revenue (AED billion)



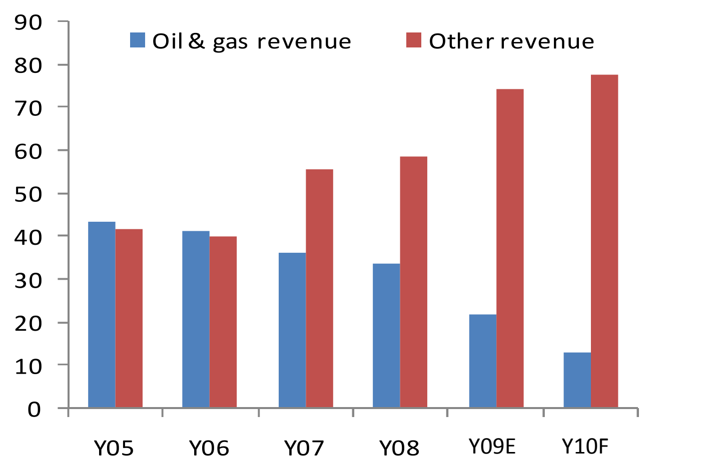
Sources: Dubai Department of Finance (DOF) & MARC Economic Research
Note: F = Forecast; E = Estimate

Chart 15: Non-tax revenue and tax revenue (% of total revenue)



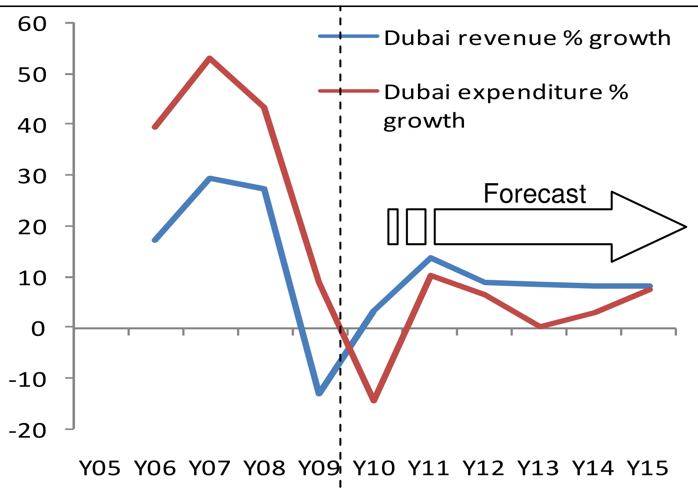
Sources: Dubai Department of Finance (DOF) & MARC Economic Research
Note: F = Forecast; E = Estimate

Chart 16: Oil & gas revenue and other revenue (% of non-tax revenue)



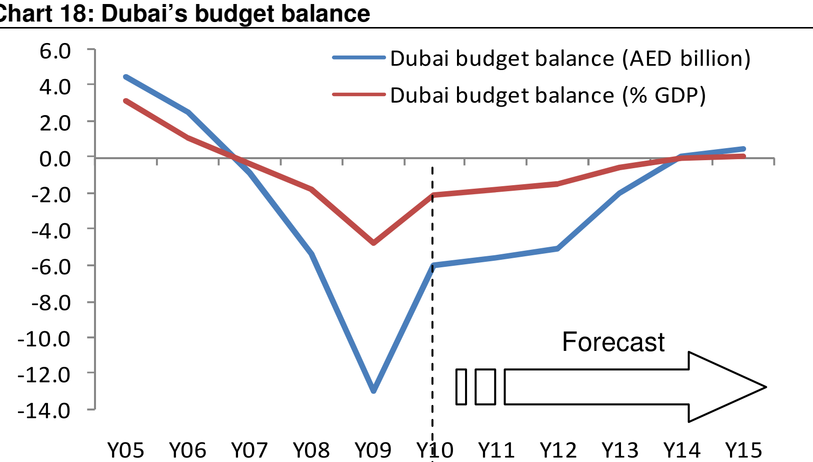
Sources: Dubai Department of Finance (DOF) & MARC Economic Research
Note: F = Forecast; E = Estimate

Chart 17: Dubai's revenue and expenditure growth (%)



Sources: Dubai Department of Finance (DOF) & MARC Economic Research

Chart 18: Dubai's budget balance



Sources: Dubai Department of Finance (DOF) & MARC Economic Research

Notwithstanding the above, there exist several positive attributes that need to be considered in evaluating the prospects of the financial position of the government of Dubai (GD):

(1) Although the emirate's fiscal balance is expected to remain in deficit in 2010, its revenue is anticipated to continue exceeding current expenditure, as in previous years. Officials stressed that it is the government's policy to ensure that current expenditure will not be funded by non-current revenues. Between 2006 and 2009, Dubai's total revenue was on average AED7 billion more than its yearly current expenditure. This means that development expenditure is only funded by oil & gas revenues and borrowings.

(2) The GD is taking serious steps to raise its efficiency in tax collection. There is now increased coordination in the collection of rental taxes compared with before the crisis. At the same time, the GD, in its worst-case scenario, can always opt to open up new channels through introducing new taxes if it deems it necessary, although officials have stated that such ideas have not been discussed at length just yet.

(3) The austerity measures implemented following the global recession last year prove that the GD is capable and willing to address the deficit problem through better coordination of its various departments. In an effort to cap operating expenditure, each government department has been tasked with cutting its spending by 15% through such efforts as allowing only a minimal increase in wages and salaries.

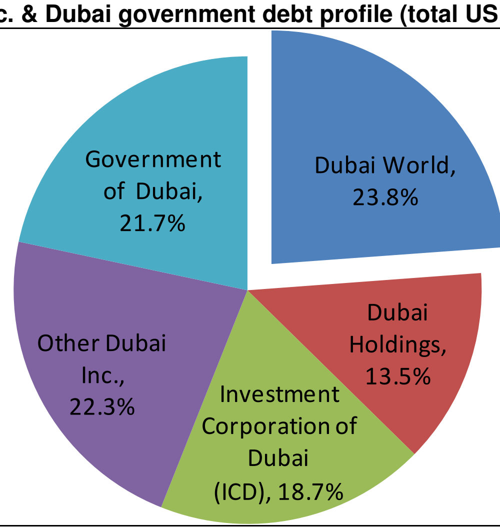
(4) Development expenditure is likely to moderate significantly after the completion of ongoing mega projects, namely the Dubai Metro railway project and the Dubai International Airport Phase II Expansion Project. This can be seen from the government's projection of a decline in development and total expenditure by 21% and 14.5% respectively in 2010.

As a result of the above measures, the government is expecting the budget deficit to contract significantly from AED12.9 billion in 2009 (4.8% of estimated GDP) to AED5.9 billion (2% of estimated GDP) in 2010. In the next five years, based on the IMF's latest scenario for the UAE's economy, we anticipate Dubai's deficit to steadily improve and be eliminated in 2014, before turning to a surplus in 2015.

Government debt remains manageable

The level of direct government debt stood at AED105.47 billion (USD28.7 billion, approximately 38% of GDP) in 2009, about two-thirds of the international threshold. The highly publicised debt of Dubai World, amounting to AED95.4 billion (USD26 billion), has been successfully restructured by the government following its standstill announcement in November 2009.

Chart 19: Dubai Inc. & Dubai government debt profile (total USD109 billion)



Source: IMF

Consequent to the sudden surge in debt incurred by Dubai Inc. in the wake of the global crisis, the government set up the Dubai Financial Support Fund (Support Fund) with a total allocation of USD20 billion, of which USD10 billion was sourced from the UAE's central bank, with the rest from Abu Dhabi. Officials stated that while there are no explicit guarantees provided to any corporate entity, the GD is committed to providing sufficient support to strategic corporations that may, in the event of an operational downturn, cause a systemic failure to the economy. In such an event, the GD will not only extend financial support, but also its involvement in the restructuring of the corporation to ensure the success of the restructuring. In other viable non-strategic entities, the GD will offer support via either financial means or regulations to enhance the ease of doing business.

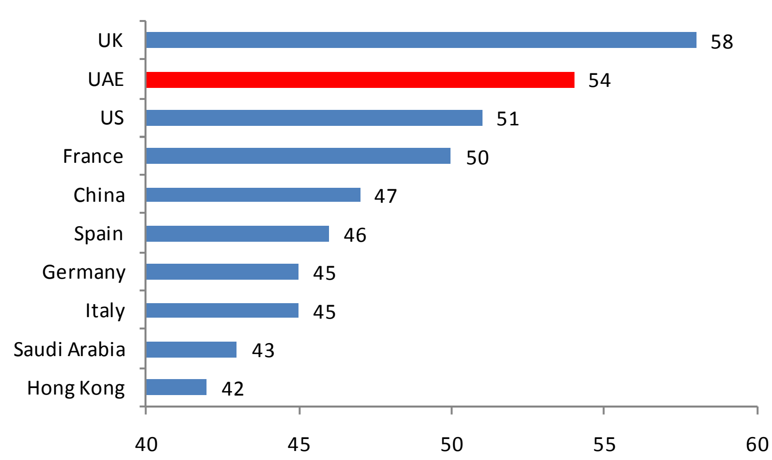
Dubai's government debt level looks manageable as it is still below the international threshold of 60% of GDP in 2009. Including the AED13.83 billion in guarantees that it provides in relation to the financial obligations of Dubai Electricity & Water Authority (DEWA) and the AED9.6 billion guarantee exposure to the DURL Consortium with respect to Dubai Metro, the total debt level will amount to AED128.9 billion, approximately 47% of the estimated 2009 nominal GDP. Even adding other contingent liabilities, our rating team estimates the total debt to be AED143.6 billion (53% of our estimated 2009 nominal GDP). This compares favourably with the debt levels of other countries which have recently experienced severe crisis, such as Greece (115.1%), Portugal (76.8%) and Ireland (64%). Even the US, which went through a property-market meltdown in 2009, has a debt ratio of 84.3%.

Competitiveness is among the highest

The authorities' laborious efforts to create a market-friendly business environment in the UAE have not been in vain. In *The Global Competitiveness Report 2010-2011* by the World Economic Forum, the UAE featured among the top 10 of 139 countries in such indicators as quality of port infrastructure (8th), ease of access to loans (8th), FDI and technology transfer (6th), firm-level technology absorption (5th), flexibility of wage determination (7th), and government procurement of advanced technology (3rd), among others.

The government's drive to position the country as a shopping haven has also paid off handsomely, with 54% of all international retailers setting up shop in the nation - second only to the United Kingdom which has 58% of these retailing powerhouses, according to CB Richard Ellis' *How Global is the Business of Retail?* report. Together, these findings point to the illustrious success of the authorities in shaping the UAE into a shining beacon of a pro-business nation in the region.

Chart 20: Percentage of international retailers present in the economy



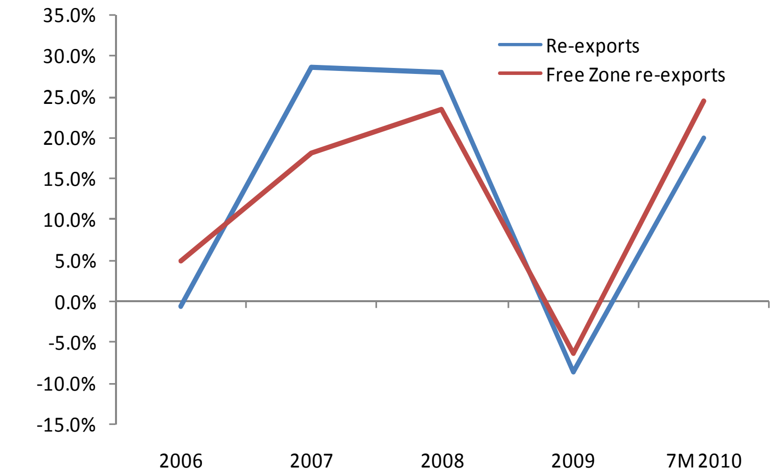
Source: *How Global is the Business of Retail?* (2010), CB Richard Ellis

Overall medium- and long-term prospects of Dubai's economy

According to officials, Dubai's real GDP, estimated to have contracted in 2009, is anticipated to rebound and register a 2.3% growth in 2010 (our projection: +2.6%) owing to steady recoveries in trade, logistics and other services sectors, according to the DSC. It is also envisaged that growth in the next few years will converge towards its long-term trajectory, which could be one-third to half of the growth rates registered during the boom period.

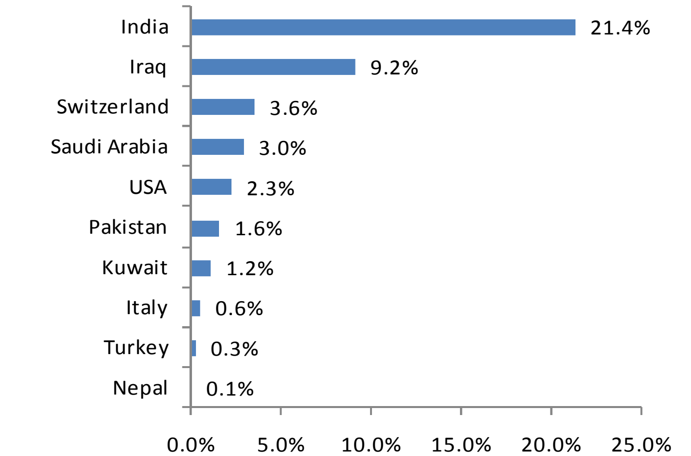
Signs of recovery that have emerged include a convincing rebound in re-exports, which expanded by 20% in the first seven months of 2010 compared with the previous corresponding period, and a surge in trade through the Free Zones (areas where companies are legally treated as foreign companies or companies operating outside the UAE, and are allowed 100% ownership, 100% repatriation of capital and profits, no minimum capital investment, no corporate or personal tax and no need for a local partner) by 24.4% over the same period. It was also reported that total volume of exports surged 38% over the same period. The promising trade prospects are based on the premise that Dubai's major trading partners are emerging Asia and GCC countries which have not been severely affected by the slowdown in the Group of 3 (G3) economies.

Chart 21: Dubai's external trade growth (%)



Sources: DSC & MARC Economic Research

Chart 22: Dubai's major trading partners in 2009 (% of total re-exports)



Sources: DSC & MARC Economic Research

According to officials, the stronger-than-expected rebound will largely be attributed to a significant recovery in trade and logistic activities, better business environment and stronger foreign investments. For instance, Dubai's WS&R sector will still likely grow at an average nominal pace of 10.2% in the next five years based on our estimates, while the RE&BS will register an average growth of 9.5%, close to a double-digit growth rate, despite moderating in pace from the years prior to the crisis. Based on the IMF's assumption that the UAE's real GDP will expand at an average of 3.9% between 2011 and 2015, we envision Dubai's economic trajectory to be somewhat lower but at a more sustainable level than during the boom times, with real GDP growth averaging circa 4% to 5% between 2011 and 2015, in line with officials' long-term growth projection of roughly 4%.

The positive outlook for Dubai's economic growth in the long term is supported by the following factors:

(1) Improved global trade conditions coupled with growing intraregional trade and greater exposure to emerging Asian economies (particularly China and India) that will likely keep Dubai's economy humming in the next several years. Dubai's trade and logistic sectors will likely benefit from a sharp rebound in emerging and developing Asian economies which are expected to grow by an average of 6.6% between 2011 and 2015;

(2) Rising investments following a surge in capital flows due to global excess liquidity resulting from loose monetary policies in the major economies. Foreign investors who shun these

economies due to bleak economic prospects and low returns will find Dubai an attractive investment target in comparison due to the emirate's excellent infrastructure, its economy's openness as well as favourable tax policies;

(3) Effective counter-cyclical measures will likely continue to be implemented by the local and federal governments on both the monetary and fiscal fronts in the event of a relapse in the global economy. These measures were undertaken at the height of the recent recession where the government proactively addressed problems to avoid a prolonged downturn;

(4) Better coordination among policymakers of all emirates through the establishment of the Supreme Fiscal Council in 2007 with regards to fiscal counter-cyclical policies which have become a significant tool in the absence of a flexible exchange-rate regime in the UAE. Being one of the two most important emirates (second only to Abu Dhabi) in terms of contributions to the UAE economy, Dubai's development will continue to be the focus of the federal government;

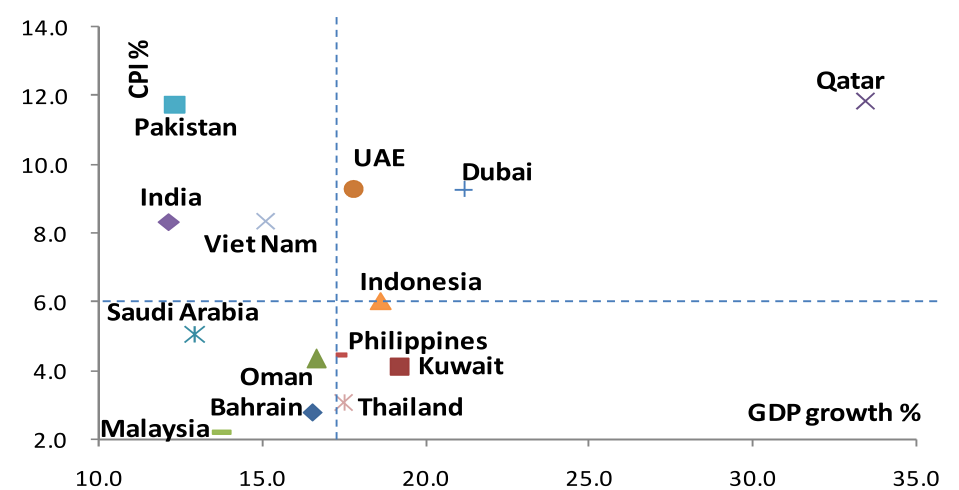
(5) Dubai's long-term plan to continue diversifying its economy, as spelled out in the Dubai Strategic Plan, remains intact despite some fine-tunings that are needed following the eruption of the global crisis and the bursting of the property bubble. Dubai's strategy, focusing primarily on the services sector, complements Abu Dhabi's Economic Vision 2030 that will see the latter's government concentrating on expanding the heavy manufacturing sector. Indeed, these complementary roles have strengthened the cohesiveness of their economies.

Comparison of critical macro matrices

In our macro matrices used to gauge sovereign risks, we plotted different economic variables to define the four quadrants. We observed the following for Dubai:

- For the nominal GDP growth-CPI matrix, Dubai is in the group of countries with high growth and high inflation in the past five years, the same quadrant as Qatar and the UAE. The burst in the property bubble that led to a significant decline in inflation will likely shift Dubai to the same group as Malaysia, Saudi Arabia, Bahrain and Oman in the next few years.

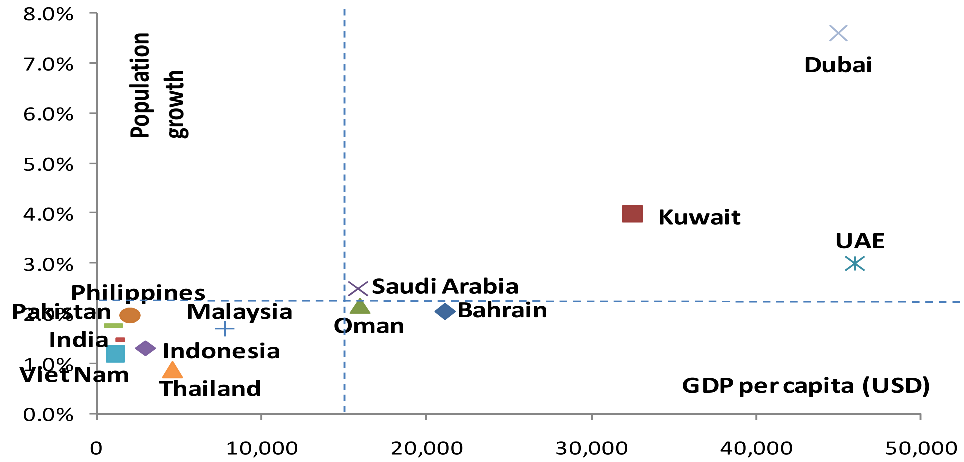
Chart 23: Nominal GDP growth (X-axis) vs. CPI (Y-axis) (five-year median)



Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research
(Note: Dotted lines denote averages of the five-year medians)

- The GDP per capita-population growth matrix indicates that Dubai is in the favourable quadrant, in the same group as such countries as Kuwait, Saudi Arabia and the UAE. Dubai's position ranks favourably even when compared with other GCC countries in this quadrant with GDP per capita at USD44,993 in 2008, and population growth of approximately 7.6% per annum.

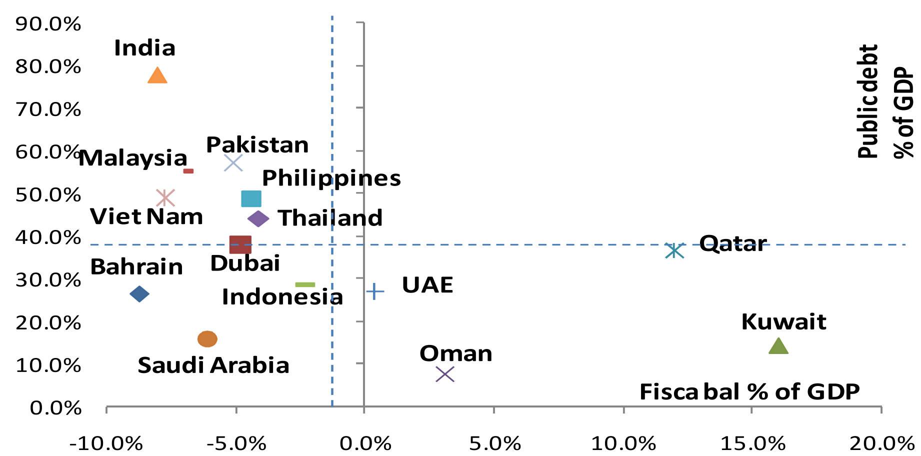
Chart 24: GDP per capita (X-axis) and population growth (Y-axis) (five-year median)



Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research
(Note: Dotted lines denote averages of the five-year medians)

- For the fiscal balance-public debt matrix, Dubai is in a less-favourable quadrant alongside countries such as India, Pakistan, Malaysia, Thailand, Vietnam and the Philippines, with the most favourable countries being Oman, Qatar, Kuwait and the UAE. Its public debt position is somewhat near the average level, but its budgetary position is less favourable than countries such as Oman, Qatar and Kuwait.

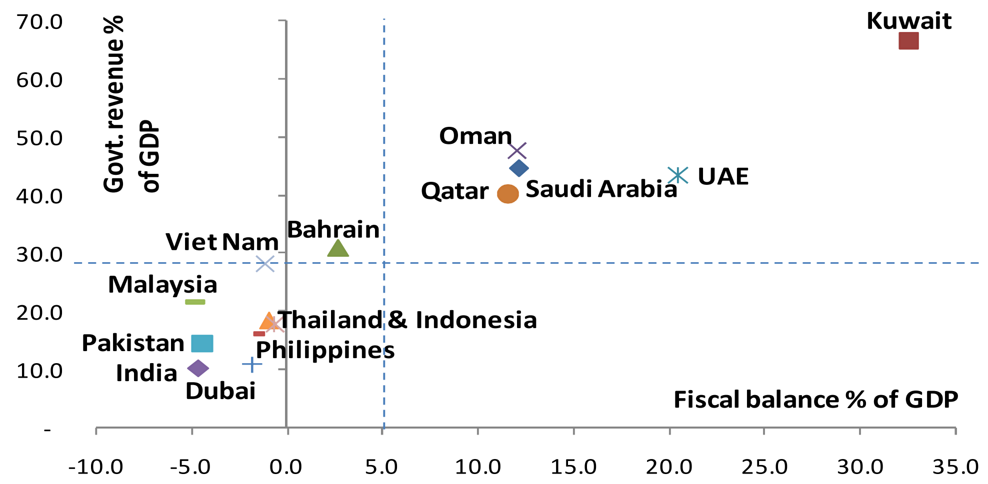
Chart 25: Fiscal balance % of GDP (X-axis) and public debt % of GDP (Y-axis) in 2009



Sources: IMF, Asian Development Bank, MARC Economic Research
(Note: Dotted lines denote averages of the 13 countries in 2009)

- The fiscal balance-government revenue matrix shows Dubai is in the same quadrant as Malaysia, India, Pakistan, the Philippines, Thailand and Indonesia. It compares less favourably with Saudi Arabia, Qatar, Kuwait, Oman and the UAE due to smaller government revenue as a percentage of GDP that comes as a result of the government's policy of not imposing various taxes such as the real property gains tax (RPGT), income and corporate taxes.

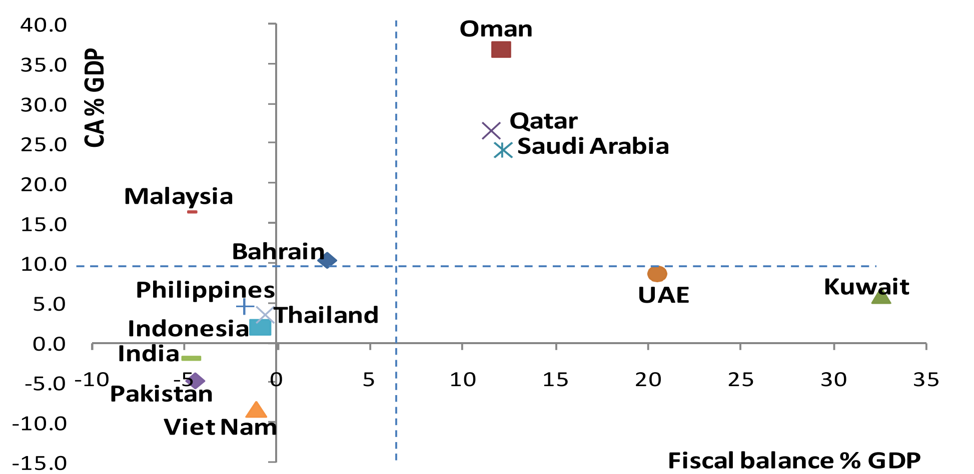
Chart 26: Fiscal balance % of GDP (X-axis) and government revenue % of GDP (Y-axis) (five-year median)



Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research
(Note: Dotted lines denote averages of the five-year medians)

- The fiscal balance and current account matrix reveals that the UAE is in the middle in terms of ranking, somewhere between the favourable group (consisting of countries such as Qatar, Saudi Arabia and Oman) and the unfavourable group (comprising countries such as Thailand, the Philippines, Indonesia, India, Pakistan, and Viet Nam).

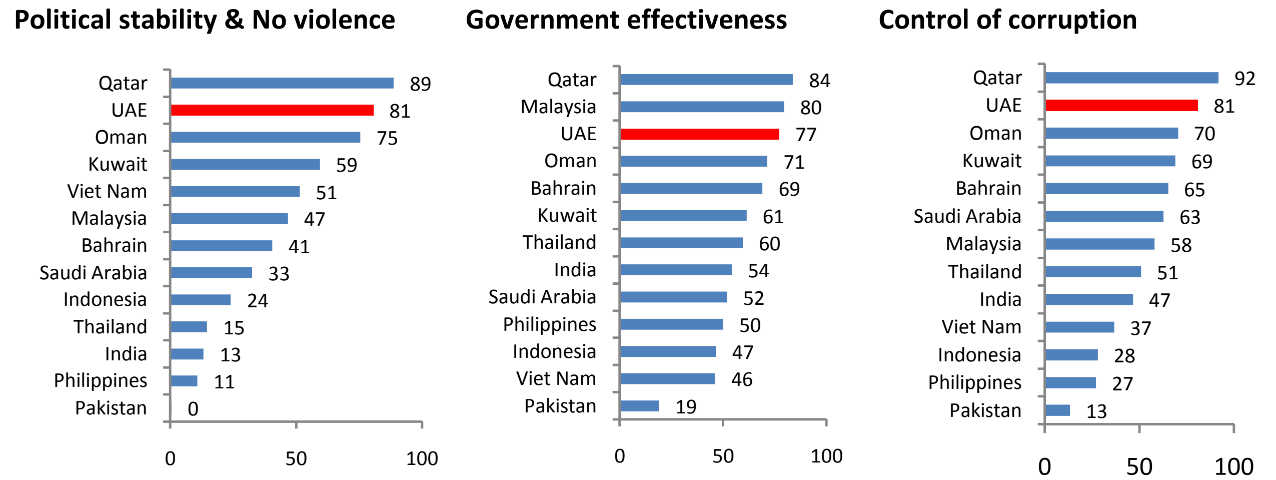
Chart 27: Fiscal balance % of GDP (X-axis) and current account balance % of GDP (Y-axis) (five-year median)



Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research
(Note: Dotted lines denote averages of the five-year medians)

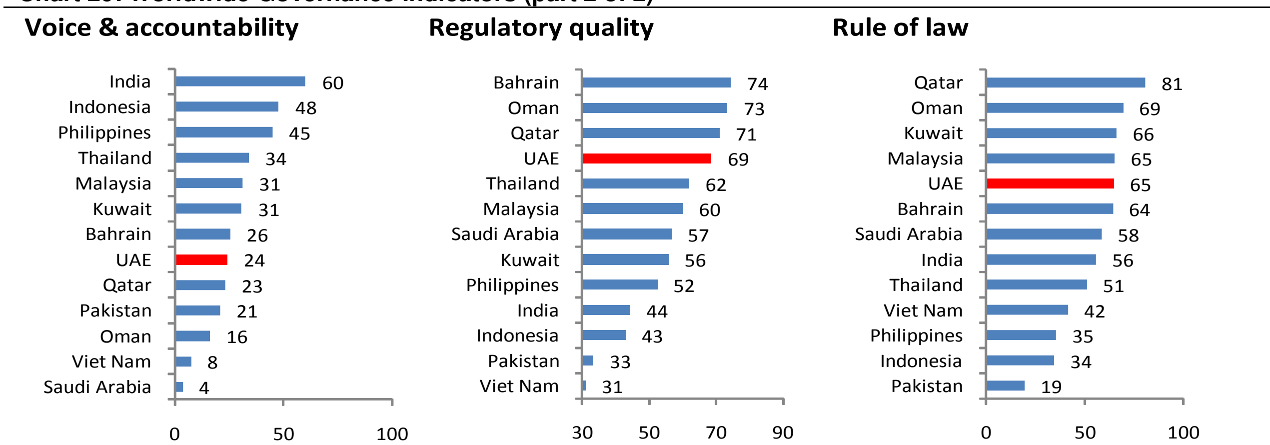
- In terms of political stability, government effectiveness and corruption, the UAE ranks favourably compared with other countries in our sample, as reflected in the Worldwide Governance Indicators produced by the World Bank that covers the six dimensions of political stability & absence of violence, government effectiveness, control of corruption, voice & accountability, regulatory quality, and rule of law. The UAE has done well on various fronts, most notably in politics, government effectiveness and corruption, boding well for attracting direct investments as businesses can operate in an environment conducive for business.

Chart 28: Worldwide Governance Indicators (part 1 of 2)



Source: World Bank (higher values denote better governance)

Chart 29: Worldwide Governance Indicators (part 2 of 2)



Source: World Bank

Table 1: Summary of economic variables of quadrants in above matrices

Matrix	Dubai's/UAE's position	Countries in similar quadrant
Nominal GDP growth versus CPI	Dubai is in a *neutral* quadrant with high 5-year median growth of 21.2% and high 5-year median inflation of 9.3%	Qatar, Indonesia and the UAE
GDP per capita versus population growth	Dubai is in a *favourable* quadrant with high 5-year median GDP per capita of USD44,993 and high 5-year median population growth of 7.6%	Kuwait, Saudi Arabia and the UAE
Fiscal balance versus public debt	Dubai is in a *less-favourable* quadrant with fiscal balance as a percentage of GDP at -4.8% and public debt-to-GDP ratio at 38% in 2009	Thailand, Vietnam, Malaysia, Pakistan, the Philippines and India
Fiscal balance versus government revenue	Dubai is in a *less-favourable* quadrant with fiscal balance as a percentage of GDP at a 5-year median of -1.8% and government revenue to GDP at a 5-year median of 10.8%	Malaysia, Pakistan, India, Thailand, Indonesia and the Philippines
Fiscal balance versus current account balance	The UAE is in a *neutral* quadrant with fiscal balance as a percentage of GDP at a 5-year median of 20.5% and current account balance to GDP at a 5-year median of 8.6%	Kuwait
Political stability versus government effectiveness	Dubai is in a *favourable* position with 5 out of 6 indicators above the median	na

Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research

Risk factors

- **Fiscal balance could suffer imbalance if property-market rout recurs**

  The uncertainties prevailing in the developed world's growth might cause investors' risk aversion to heighten, presenting downside risks to Dubai's real estate market. The government's fiscal balance would be adversely affected should the property market experience another downturn. Additionally, the total number of projects undergoing construction has increased from 7,343 units in 2007 to 9,427 units in 2009 (of which almost 79% or 7,419 units comprise high-end villas and residential complexes), bringing about the possibility of an oversupply situation that can further depress rental rates and property prices, and ultimately detract from government revenue in the form of reduced assessment rates.

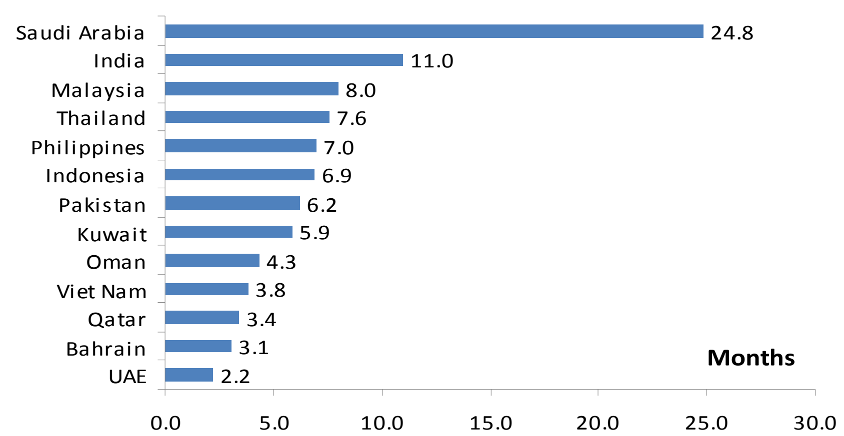
- **High volatility in capital flows for the UAE**

  Historically, capital movements have been rather volatile for the UAE as a whole. Indeed, the country's capital account shifted from -9.2% of GDP in 2006 to +13.9% of GDP in 2007 and back to -21.7% of GDP in 2008. High volatility in capital movements have been the result of (1) speculation on a possible dismantling of its currency peg; (2) the country's sensitivity to changes in oil prices that affect overall macro performance; (3) its significant dependency on trade, especially on re-exports (especially so for Dubai). Such high volatility can be disruptive for the financial markets, especially at a time when the world economy is flushed with liquidity following quantitative-easing policies in developed countries such as the US and Japan.

- **Fixed exchange rate strains reserves, puts fiscal policy at the forefront**

Although the UAE's fixed exchange-rate regime prevents the country from experiencing high volatility in exchange-rate movements, it is also a factor that leads to a drain in foreign reserves. Latest statistics reveal that the UAE's five-year median reserves-to-import ratio stands at 2.2 months, below the international standard of three months. In the event of massive outflows, reserves will decline. The fixed exchange rate is also a factor behind the ineffectiveness of monetary measures as a counter-cyclical policy, making fiscal policies the only way to prevent the economy from crumbling under downward pressure. So far, however, the implementation of fiscal measures has not been impeded by cumbersome processes and bureaucracy. In addition, we concur with the IMF assessment that the "level of the exchange rate suggests that the UAE Dirham is broadly in line with fundamentals," based on the level of current account balance of the country.

Chart 30: International reserve assets-to-import ratio (five-year median)



Sources: IMF, Asian Development Bank, CEIC & MARC Economic Research

- **The importance of oil prices for the economy**

Oil prices remain important not only for the UAE's economy, but also for Dubai, despite the latter's economic growth being relatively independent from oil output. Dubai's dependency on favourable oil prices comes from two angles: (1) revenues for Abu Dhabi and the UAE as a whole which in turn can be used to support Dubai in an event of an economic crisis for the latter; and (2) revenues for other GCC countries which are spent on Dubai's services sector, such as wholesale, retail and even real estate. As such, any weaknesses in the global economy that affects oil prices will likely detract from Dubai's economic growth through these indirect channels.

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Appendix

Dubai Economic Statistics

	2005	2006*	2007	2008	2009	2010
National Account (Growth)						
Nominal Gross Domestic Product (GDP)	18.4%	na	18.3%	14.2%	(9.5%)[1]	7.6%[1]
Agriculture, Livestock and Fishery	na	na	5.1%	5.7%	na	na
Mining and Quarrying	na	na	-16.0%	6.2%	na	na
Manufacturing	36.9%	na	10.2%	10.9%	na	na
Construction	22.2%	na	33.5%	20.4%	na	na
Services	na	na	19.6%	14.1%	na	na
Government Finances (AED Billion)						
Revenue	16.9	19.8	25.6	32.6	28.4[2]	29.4[2]
Expenditure	12.4	17.3	26.5	38.0	41.4[2]	35.4[2]
Overall balance	4.5	2.5	(0.9)	(5.4)	(12.9)[2]	(5.9)[2]
Overall balance % of GDP	3.2%	1.1%	(0.3%)	(1.8%)	(4.8%)[1]	(2.0%)[2]
Balance of Payments (UAE)						
Current account % of GDP	17.7%	20.6%	9.5%	8.8%	3.2%	7.3%[3]
Capital & financial account % of GDP	-10.6%	-9.2%	13.9%	-21.7%	0.9%	na
Overall BOP % of GDP	1.9%	3.7%	24.2%	-18.4%	-2.5%	na
Inflation & Monetary Indicators						
Consumer Price Index (Dubai)	na	na	na	10.8%	4.0%	0.6%[4]
Consumer Price Index (UAE)	6.2%	9.3%	11.1%	12.3%	1.6%	0.2%[4]
Loan growth (UAE)	43.3%	32.6%	27.9%	39.4%	2.0%	(1.7%)[5]
3-month interbank rate (UAE)	na	5.53%	4.58%	4.31%	1.89%	2.14%[6]
External debt % of GDP (UAE)	30.6%	49.2%	62.7%	52.0%	56.3%	56.4%[7]
Other Indicators						
Abu Dhabi Securities Exchange Index	5,203.0	3,136.0	4,551.8	2,390.0	2,743.6	2751.0[8]
% increase / decrease	na	-39.7%	45.1%	-47.5%	14.8%	0.3%
Dubai Financial Market Index	na	4,127.3	5,932.0	1,636.3	1,803.6	1693.3[8]
% increase / decrease	na	na	43.7%	-72.4%	10.2%	-6.1%
Exchange rate (AED per USD)	$ 3.6725	$ 3.6725	$ 3.6725	$ 3.6725	$ 3.6725	$ 3.6725

Sources: Dubai Department of Finance (DOF), CEIC, IMF, MARC Economic Research, Dubai Statistics Centre (DSC) Bloomberg & Global Investment House

* Prior to 2006, Dubai's GDP was calculated on the basis of statistical sampling. A new and more accurate methodology was implemented during 2006 with the result that GDP statistics for 2005 are not directly comparable with GDP statistics for subsequent years.

[1]: MARC Economic Research

[2]: Dubai 2010 Budget

[3]: IMF forecast

[4]: first eight months of 2010

[5]: as of July 2010

[6]: Bloomberg, as at November 13, 2010

[7]: IMF

[8]: as at November 8, 2010

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