United Arab Emirates

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Economic & Financial Review

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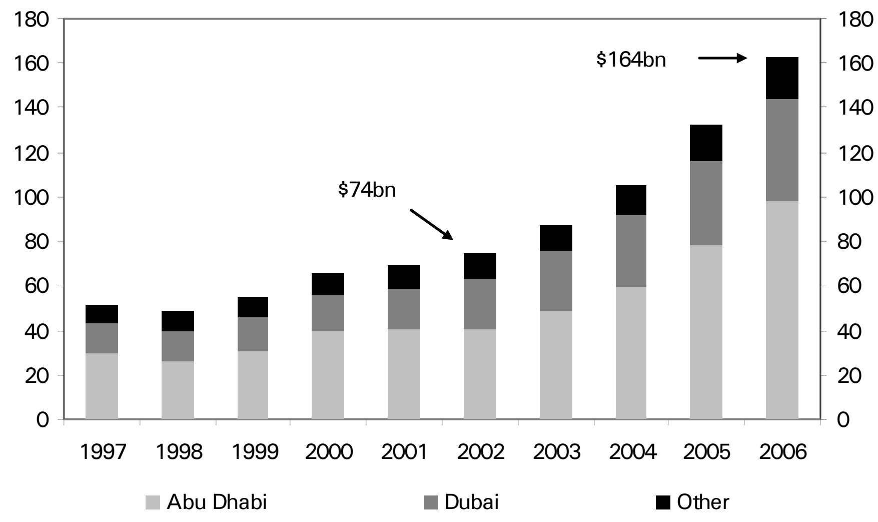
Background & Outlook

The economic boom in the United Arab Emirates, one of the Gulf region's most dynamic economies, is now in its fifth consecutive year and is cementing the country's reputation as a model for development in the GCC region as a whole. Between 2002 and 2006, the UAE economy more than doubled in size, with nominal growth averaging 22% per annum.

Graph 1: Gross Domestic Product

(Billion $)



Source: Ministry of Economy (www.economy.ae).
Note: Preliminary estimates for 2005 and 2006.

As with other Gulf economies, rising oil prices and higher oil production have played a key role in boosting economic growth. However, unlike neighboring countries, the non-oil sector has enjoyed a pivotal role, contributing around half of the total increase in gross domestic product (GDP) since 2002. Real economic growth, which excludes the direct impact of changes in oil prices, has averaged 9.8% per annum, one of the fastest rates in the region and putting the pace of development on a par with that seen in China. Indeed, the UAE's economy may have reached a point of critical mass, whereby oil revenues can be used to support, rather than drive, economic development.

We expect this remarkable performance to continue in the near future and the economy to double in size again by 2012 on the back of massive investment plans, which could ease the supply-side bottlenecks and inflationary pressures that have built up over the past two years. Inflation, as measured by the consumer price index, has accelerated from 2.9% in 2002 to 9.3% in 2006, largely because of pressures in the housing market, where increases in supply (in Dubai and Abu Dhabi) have not kept pace with demand. The depreciation of the dollar-pegged UAE dirham against other major currencies has also contributed to inflationary pressures, as has the rising cost of construction materials. The International Monetary Fund

(IMF) though expects inflation to moderate to 8% in 2007. Even so, it is widely believed that the official rate of inflation understates the true rate, which could be as high as 20%.

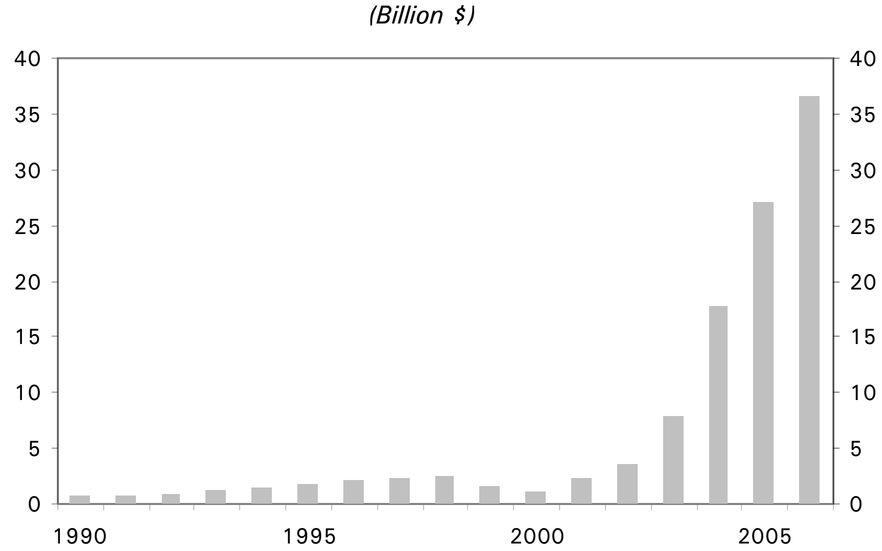
Combined with a shortage of construction materials and skilled engineers, mounting costs reportedly put a dent in construction project activity in 2006 and are now the cause of extensions to project timelines. In total, an estimated $500 billion is expected to be spent over the next five years on over 400 new ventures, in addition to the 300 or so projects, worth an estimated $110 billion, currently underway. These investments are expected to have a strong multiplier effect on the economy due to their focus on non-tradable sectors, such as real estate, which typically have a low import component. As such, we expect investment to continue to play an important role in economic growth. By contrast, the relative importance of net exports could decline.

Despite the rapid development of the non-oil sector, oil and gas remain central to the UAE economy, and the Federation is endowed with around one fifth of the world's proved crude reserves, 94% of which are in Abu Dhabi. The policy of economic diversification, clearly visible in the dramatic physical changes throughout the country, did not happen by chance, but has been part of government strategy since the founding of the Federation in 1971. The governments of each emirate have played a key role in the process.

One aspect of economic diversification has been the broadening of the government's income streams. A portion of successive oil windfalls has been re-invested through government-owned investment arms, the largest being Abu Dhabi Investment Authority (ADIA). According to a 2007 report by the McKinsey Global Institute, ADIA had $500 - 900 billion worth of assets under its management in 2006, offering the government large, but off-budget, income returns. Other money has been channeled back into the economy through government spending at the federal and emirate level, as well as through newly established public enterprises such as Mubadala, Nakheel, Emaar and TAQA.

There have also been efforts to promote private sector activity through privatization and partnership arrangements. The introduction of free zones, the removal of barriers to trade and other restrictions on foreign ownership, as well as the creation of a relatively liberal business environment have also been an integral part of the government's strategy. The private sector's share of non-oil GDP increased accordingly from 58% in 2000 to 63% in 2004, before the rise in oil revenues pushed it back down to 61% in 2006. Meanwhile, private sector investment, including foreign investment, has accounted for over half of all project activity since 2003. According to United Nations Conference on Trade and Development (UNCTAD), the stock of Foreign Direct Investment (FDI) in the UAE surged to $37 billion in 2006, up from $1 billion in 2000, and the country ranked 23rd in the world in terms of its FDI potential. The government's privatization program has also had a positive impact on local stock markets as the newly privatized firms were listed. Overall, however, the relationship between the private and public sectors is blurred, with government-run entities or state officials heavily involved in many development projects.

Graph 2: Stock of Foreign Direct Investment in the UAE



Source: *UNCTAD.*

The development of the UAE's role as a retail, financial and trading hub – while taken for granted now – was, in fact, the third stage of the government's development plan. The first stage involved developing partnerships with international oil companies to increase hydrocarbon reserves and production capacities. The second focused on upgrading the entire oil and gas value chain and beefing up oil or energy related industries such as petrochemicals, fertilizers and aluminum. But the emergence of Dubai as a modern, progressive commercial city has eclipsed the role of oil in the public's imagination. Dubai is now among the fastest growing cities in the world with an average GDP growth rate of 15% over the period 2000-2006.

In 2006, a new generation of rulers took charge in Dubai and Abu Dhabi, bringing a new dynamism to the diversification strategy but also placing more emphasis on efficiency, transparency, and integration at the federal level. The new ruler of Dubai and Prime Minister of the UAE, HE Sheikh Mohammed bin Rashid Al Maktoum, launched a three year government restructuring program with the aim of enhancing government productivity to ensure improvement in the provision of government services to both the populace and visitors, while at the same time broadening the base of the economy and promoting the role of the private sector.

With the new generation of rulers, the mindset has also shifted towards bridging income disparities among the seven emirates by developing them along the 'Dubai model'. Even Abu Dhabi, the wealthiest emirate by far, is launching plans to develop its islands as residential and tourist destinations, establishing energy intensive and capital intensive industries (including the world's largest aluminum smelter), nurturing high-tech sectors such as aerospace components, and recently venturing into renewable energy.

The plethora of seemingly similar projects has raised concerns over potential overcapacity and, ultimately, competition amongst the emirates. However, in some areas development is being coordinated. Companies from Dubai and Abu Dhabi are now jointly developing a $6 billion aluminum smelter – the largest in the world – while last year a Dubai government-backed firm won a $2 billion contract to manage the new Khalifa port in Abu Dhabi, due to be operational in 2010. Both deals are being hailed as significant steps towards greater co-operation between the two emirates.

There are, however, challenges from within. One is the need to ensure a continued flow of expatriates and foreign investment into the country to sustain certain elements of the economic model, including relatively inexpensive low-skilled labor and the development of a skills-base in targeted sectors. This requires not only a liberal business environment, but also the maintenance of conditions that have made the UAE an attractive and affordable habitat for expatriates. The latter, however, is currently under threat from the rising cost of living, and recent price and rent caps seem to have had limited success in curbing inflationary pressures. Unless structural changes take place on the supply side, high inflation is in danger of becoming entrenched in public expectations, thus making it more difficult to remove from the system. Additionally, company and competition laws, which would raise foreign ownership limits to 100%, abolish monopolistic practices and improve corporate governance, have been much delayed, though are scheduled to be ratified soon.

The local stock markets – the Abu Dhabi Stock Exchange and Dubai Financial Market – recorded a sharp correction in 2006, with the MSCI UAE index shedding 43% from its peak in September 2005 through the end of 2006. The correction does not appear to have had a significant impact on the economy, although slower credit growth and losses in related non-interest income did dent growth in earnings in the banking sector. Local stock markets have not yet recovered their previous year losses, though some observers suggest that prices may be past the trough and the recovery phase has started. This, combined with a strong rally in October, attractive valuations, a rebound in corporate earnings in the first half of 2007, and strong economic fundamentals, bodes well for local stock markets going forward. Nonetheless, interim corrections cannot be ruled out, especially after the recent sharp gains recorded within a short period of time.

There are, however, a number of other risks to the overall economic outlook, including a slowdown in the global economy that sends oil prices sharply lower, and geopolitical events including ongoing instability in Iraq. Also significant is the impact of the UAE's fast-rising corporate debt: excluding government and consumption loans, domestic debt was up 38% in 2006 following growth of 48% and 24% in 2005 and 2004, respectively, and rose a further 11% during the first half of 2007. Rising debt will need to be closely monitored with attention to corporate governance and risk management practices. Meanwhile, there is also a risk to investor and corporate confidence from a downturn in the real estate market.

1. Macroeconomic Performance

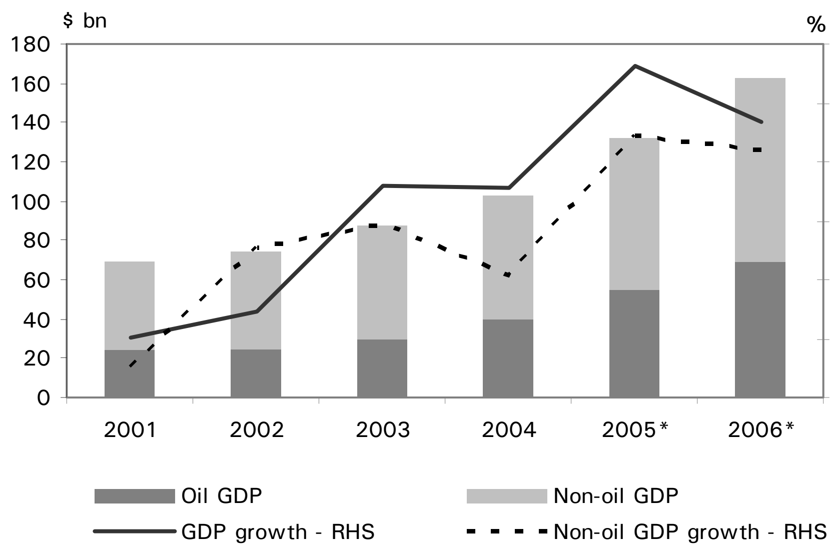
The UAE is the Gulf region's second largest economy, around half the size of Saudi Arabia but 75% larger than the region's next biggest economy, Kuwait. Although still small by international standards, its economy is less than 1% the size of Japan's, success in developing various non-oil sectors and the pursuit of an aggressive economic reform agenda have significantly enhanced its international profile. While service sector focused Dubai has become the 'international face' of the UAE, most of the country's income is still generated by the neighboring emirate of Abu Dhabi, where the country's massive oil reserves are located. The pace of economic expansion has been impressive, but is still not fully indicative of pioneering nature of the country's rapid modernization. Economic growth averaged 8.5% in real terms between 2002 and 2006 and nominal GDP per capita stood at $33,397 in 2006, the second highest in the region behind Qatar. The International Monetary Fund forecasts real growth to range between 7-8% in 2007 and 2008.

Gross Domestic Product

The UAE economy had another strong year in 2006 with GDP expanding 23% in nominal terms to reach $163.2 billion. This impressive performance came on the heels of 28% growth in 2005 due to a slower rise in the average price of crude oil compared to the previous year. Measured in real terms, however, GDP growth accelerated to 9.4%, underpinned by increases in oil production and massive investment outlays. The economy demonstrated some resilience, too. The stock market correction of 2006 did not appear to have any significant impact on the wider economy.

Graph 3: Oil versus Non-Oil GDP

(in current prices)



Source: Ministry of Economy (www.economy.ae).
*Note: * Preliminary estimates.*

The economy has witnessed rapid growth of 22% per year, on average, since 2003, largely on the back of rising oil prices and, in the last two years, at an accelerating pace. Real growth has also been equally impressive, averaging 9.8% per year in the four years to 2006, with the non-oil sector rising at an even faster 11.3%. The non-oil sector has no doubt benefited from high oil prices that are in turn supporting government spending, upon which many non-oil activities depend. It has also benefited from a robust increase in private consumption fuelled, not least, by high population growth rates, and from massive foreign and private investments.

Despite the non-oil sector's rapid expansion in recent years, its share of nominal GDP has dropped from 68% in 2002 to 58% in 2006. Its contribution to the economy is nonetheless significant compared to that of other oil-exporting economies, reflecting the success of the UAE's diversification strategy.

The private sector's contribution to the non-oil sector is also relatively high compared to that in peer countries, and increased to 61% of non-oil GDP in 2006 from 58% in 2001. This share, however, needs to be interpreted with caution as the borders between private and public activity are blurred by government officials' ownership stakes in various large private conglomerates.

Table 1: Gross Domestic Product

(in current prices)

	Million $			% Change		
	2004	2005*	2006*	2004	2005*	2006*
Oil sector	39,471	54,408	69,004	31.9	37.8	26.8
Crude oil & natural gas	33,563	47,160	60,836	33.8	40.5	29.0
Oil refining & gas liquification	5,908	7,248	8,168	22.3	22.7	12.7
Non-oil sector	65,782	77,794	94,163	14.0	18.3	21.0
Government & public sector	24,553	29,235	36,988	10.0	19.1	26.5
Private sector	41,229	48,559	57,175	16.5	17.8	17.7
GDP (at basic prices)	**105,253**	**132,202**	**163,167**	**20.1**	**25.6**	**23.4**

Source: Ministry of Economy (www.economy.ae).
*Notes: * Preliminary estimates.*

As a result of rapid growth in GDP, average income levels in the UAE have been transformed. Per capita GDP rose 20% in 2006 to $38,934 against $32,534 in 2005 and $22,382 in 2002. Likewise, per capita disposable incomes increased 24% to $34,192 in 2006 against $28,351 in 2005 and $18,402 in 2002. According to these figures, the UAE is the second richest country in the region in per capita terms and in a strong position worldwide.

Abu Dhabi, the largest of the seven emirates making up the UAE, and the epicenter of its oil wealth, generates 60% of the economy's output. Growth in Abu Dhabi is so far mainly oil-based and therefore reflects changes in oil prices and production levels. Going forward, however, the emirate is undertaking an aggressive diversification strategy by expanding its manufacturing and tourism base. Dubai is the second largest of the emirates and contributes to about 30% of the UAE's economy. With its oil reserves almost entirely eroded, growth in Dubai is being driven by its vibrant services sector. The five other northern emirates account for the residual 10% of the UAE's economy. Nonetheless, economic activity in these emirates is gaining pace, notably in Sharjah and Ras Al Khaymah where diversification strategies along the lines of Dubai are taking shape.

Expenditures on GDP

On the expenditures side, domestic demand was the main driver of economic growth in 2006, increasing 20% on 2005. The main causes were rapid growth in private consumption and private investment. Private consumption, the largest component of domestic demand, contributed $73.3 billion and expanded by 15%. This was down from growth of 17% in 2005.

Private investments witnessed the most remarkable change in 2006, leaping by a massive 60% and contributing around one-quarter of the growth of the economy overall. Seventy percent of investment expenditure took place in the non-tradable sector, which typically has a strong multiplier effect on GDP due to its low import component. In comparison, growth in government and public investments slowed down, dropping 3.3% in total after a negligible increase the previous year.

Net exports increased 37% in 2006 to reach $38.6 billion, contributing to around one-third to GDP growth overall. Growth in net exports was less dramatic than in 2005 reflecting a smaller increase in oil prices during the year.

Table 2: Gross Domestic Product Breakdown by Expenditure

(in current prices)

	Million $			% Change		
	2004	2005*	2006*	2004	2005*	2006*
Domestic demand	90,786	105,374	126,250	18.4	16.1	19.8
Final consumption	67,434	78,275	91,488	20.5	16.1	16.9
Public consumption	13,302	14,698	16,514	6.1	10.5	12.4
Private consumption	54,132	63,577	73,277	24.7	17.4	15.3
Gross fixed capital formation	22,125	25,541	32,948	11.1	15.4	29.0
Government investment	4,765	3,678	3,268	8.5	-22.8	-11.2
Public investment	7,732	8,852	8,852	17.1	14.5	0.0
Private investment	9,628	13,010	20,828	8.9	35.1	60.1
Variation in the inventory	1,227	1,559	1,814	52.7	27.1	16.4
Net exports of goods and services	15,540	28,209	38,615	30.9	81.5	36.9
Net indirect taxes	-1,075	-1,381	-1,697	16.2	28.5	22.9
GDP (at basic prices)	**105,251**	**132,202**	**163,167**	**20.1**	**25.6**	**23.4**

Source: Central Bank of the UAE (www.centralbank.ae).
*Notes: * Preliminary estimates.*

Inflation

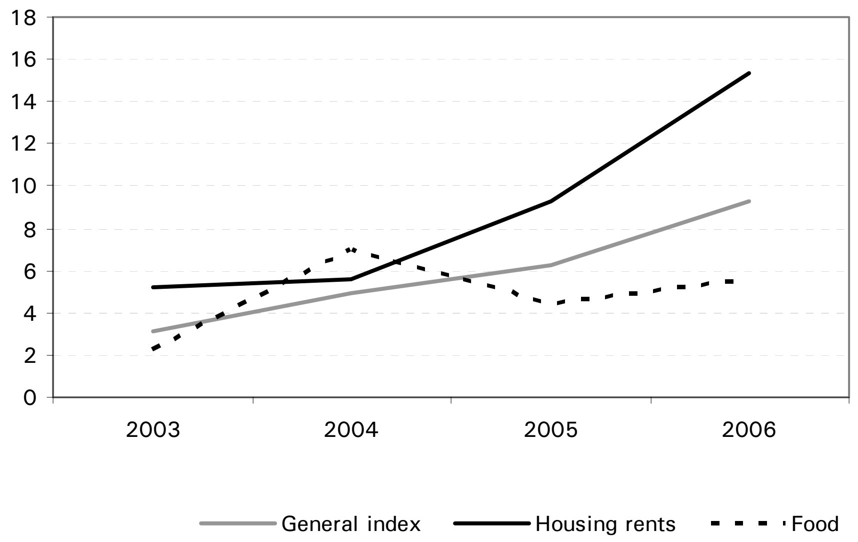
A sustained period of strong growth in domestic demand has seen an increase in inflationary pressures. In 2006, consumer price inflation accelerated to 9.3%, up from 6% the previous year. However, the consumer price basket only reflects spending patterns of nationals residing in Abu Dhabi as per a household expenditures survey from 2000.

Independent estimates pin inflation significantly higher - in double digits - particularly in the emirate of Dubai where rent increases have been large.

Increases in residential rents have been the main driver of consumer price inflation during the last two years, increasing 15.4% in 2006 after a 9.3% increase in 2005. Delays in the completion of key projects including Discovery Gardens, the Jumeirah Beach Residence, International City and the Mohammed Bin Rashid Housing program had kept the supply of residential units tight in 2006, allowing landlords to raise rents well above the government-imposed cap on rent increases.

Graph 4: Consumer Price Inflation

(year-on-year percent change)



Source: Ministry of Economy (www.economy.ae).

Inflationary pressures have also been evident in other non-tradeable components of the consumer basket. For example, prices in the transport and communication sector increased 9.5% in 2006. Prices of tradeable goods have also increased, reflecting cost increases, buoyant domestic demand and other factors. Fuel prices, for example, rose after the government implemented a 30% hike in September 2005, while food prices have increased reflecting rises in the international prices of agricultural commodities, magnified locally by the weakness of the dollar-linked dirham. Rising inflation has led to upward pressure on local wages. Public sector wages have been increased three times over the past 24 months, by a cumulative 60% for UAE nationals.

Table 3: Consumer Price Index

	CPI			Change (% yoy)		
	2004	2005	2006	2004	2005	2006
Food, beverages, and tobacco	112.0	117.0	123.5	7.0	4.5	5.6
Clothing, textile & footwear	112.0	114.8	119.2	5.1	2.5	3.8
Housing rents & related house items	119.0	130.1	150.1	5.6	9.3	15.4
Furniture & related items	106.9	110.5	113.2	2.4	3.4	2.4
Medical care & health services	117.0	123.4	127.5	1.5	5.5	3.3
Transport & communication	111.5	116.6	127.7	4.6	4.6	9.5
Education & recreational	117.1	121.7	124.6	2.1	3.9	2.4
Miscellaneous goods & services	111.1	117.8	125.0	6.9	6.0	6.1
General	**114.5**	**121.7**	**133.0**	**4.9**	**6.3**	**9.3**

Source: Ministry of Economy (www.economy.ae).

2. Oil and Gas Sector

The oil and gas sector occupies a central position in the UAE's economy, constituting half the Federation's export receipts and 60% of its consolidated fiscal revenues despite efforts in recent years to diversify the country's export base and sources of government revenues.

Higher prices and production levels since 2003 have raised the sector's contribution to the economy from 32% in 2002 to 42% in 2006. The sector's indirect contribution has increased, too, through its role in financing public expenditures, on which a number of non-oil activities depend, and in providing cheap gas feedstock to supply key industries. Additionally, hydrocarbon revenues have financed the government's accumulation of foreign assets, which are estimated to be worth well over $500 billion. Oil also underpins the massive balance sheets of government-owned conglomerates such as Mubadala, Dubai Aluminum (DUBAL), Nakheel, Emirates Airlines and Abu Dhabi National Energy (TAQA).

The UAE's total oil and gas reserves, estimated at 98 billion barrels of crude oil and over 6 trillion cubic meters (tcm) of gas, has doubled in the last two decades supported by continuous exploration and improved technology. Its oil reserves are the fifth largest in the world. Abu Dhabi is the centre of this wealth, while reserves in other emirates have dwindled.

Along with its proven reserves, the federation has built up its production capacity, which stands today at 3 million barrels a day (mbd) of crude oil and 4.6 billion cubic feet a day (bcfd) of gas. Refinery capacity has also expanded and is now 466,000 barrels per day (b/d). However, domestic consumption has been rising faster with oil consumption estimated to have reached 14% of production capacity in 2006 (against 10% in 2000 and 5% historically), while domestic gas consumption reached 68% of production capacity (versus 54% in 2000). Recognizing the importance of meeting fast-rising local and external demand, the UAE is implementing a $50 billion expansion plan to raise production capacity to 4 mbd of crude oil and 6.5 bcfd of gas by 2012.

Table 4: Oil and Gas Production

	Production			% Change		
	2004	2005	2006	2004	2005	2006
Crude oil (thousand b/d)	**2,360**	**2,447**	**2,540**	**5.2**	**3.7**	**3.8**
Share of OPEC	8%	8%	8%			
Share of world	3%	3%	4%			
Refined products (thousand b/d)	**440**	**442**	**424**	**2.2**	**0.4**	**-4.0**
Share of OPEC	5%	5%	5%			
Share of world	1%	1%	1%			
Natural gas (million cm)	**46,290**	**47,000**	**47,400**	**3.3**	**1.5**	**0.9**
Share of OPEC	10%	9%	9%			
Share of world	2%	2%	2%			

Source: *OPEC (www.opec.org)*
Notes: *b/d is barrels a day, cm is cubic meters.*

The state-owned Abu Dhabi National Oil Company (ADNOC) controls the sector, under the auspices of the Supreme Petroleum Council. The company was set up in 1971 to engage in the exploration, drilling, production, storage, transportation, sale and export of all hydrocarbons. It includes 17 subsidiaries, including 15 ventures with international companies, which form the ADNOC group.

The largest subsidiaries are the three main oil and gas operating companies, the Abu Dhabi Company for Onshore Oil Operations (ADCO), the Abu Dhabi Marine Operating Company (ADMA-OPCO) and the Zakum Development Company (ZADCO), which together account for 75% of the Federation's oil production. There are also two natural gas processing companies (GASCO and ADGAS), five support companies providing services to the oil and gas industry, two maritime companies for crude oil, refined products and LNG (ADNAATCO, NGSCO), a refined-product distribution company (ADNOC-FOC) and two chemical and petrochemical companies (FERTIL, BOUROUGE). ADNOC keeps a foothold in the refinery and gas operations through its two fully-owned subsidiaries, the Abu Dhabi Oil Refining Company (TAKREER) and the Abu Dhabi Gas Company. ADNOC is also diversifying overseas and has bought assets in regional and global markets in upstream, downstream, and midstream areas via three of its subsidiaries, International Petroleum Investment Company (IPIC), Mubadala Group, and TAQA.

Prices and Production

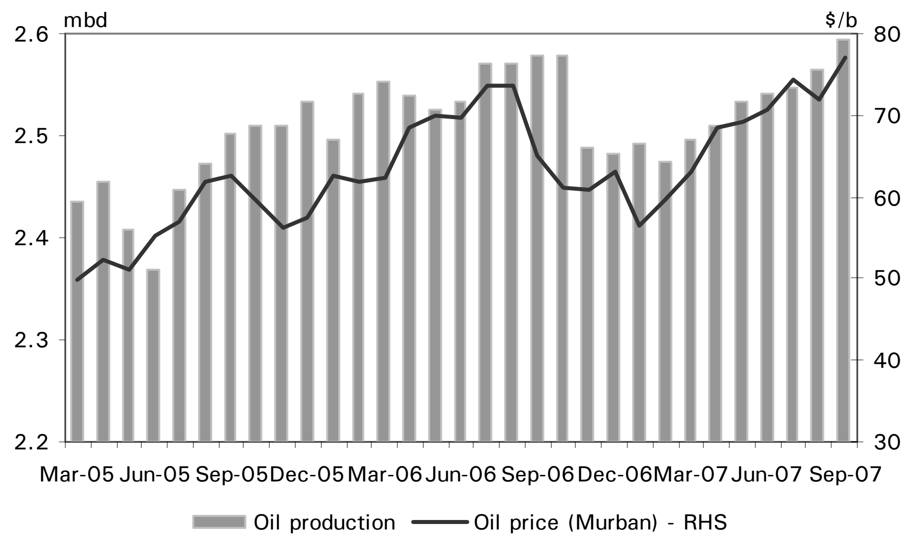
Oil prices made a strong recovery during 2007 after a sharp drop that started in August 2006 and lasted through mid-January 2007 and saw the price of the UAE benchmark crude (Murban) fall $18 to $56 per barrel (pb). By September 2007, the price of Murban crude had completely recovered and surpassed its previous peak to average $77 pb in that month and $68 pb year to date, roughly equal to that recorded in 2006.

The surge in prices during 2007 followed an increasingly tight market, largely as result of OPEC production cuts implemented in November 2006 and February 2007, but also because non-OPEC supply did not see the growth expected. According to OPEC estimates, the production of its ten effective member states averaged 26.56 mbd in the first nine months of 2007, down 1 mbd from 2006.

In line with OPEC's cuts, the UAE, a founding member of the organization, trimmed down its output by 3% in November 2006 and a further 1% in February 2007 to an average 2.48 mbd. However, responding to strong market demand, production crawled back up slowly to average 2.53 mbd year to date, barely 11 thousand mbd below 2006 average production.

The production of refined products declined 4% in 2006 to reach an average 424,000 b/d, suggesting the presence of obsolete refineries. Nonetheless, new refineries are gradually being developed in Abu Dhabi with the expansion of Ruwais and in the Jebel Ali Free Zone. The output of refined products is made up, for the large part, of Kerosene (28%), distillates (21%) and gasoline (15%).

Graph 5: Monthly Oil Prices and Production



Source: OPEC (www.opec.org).

In comparison, the level of production of natural gas has not changed much in recent years with a marketed natural gas production of 47.4 billion cm in 2006. Despite the UAE being the third largest producer of natural gas in the region, the call on its gas production is limiting its exports as demand pressures mount from domestic consumption, oil recovery and the utilities sector. The federation exported some 7 bcm of Liquefied Natural Gas (LNG) in 2006 (mainly to Japan), and 13.4 bcm of Natural Gas Liquids (NGL).

The UAE’s main export destinations are Japan and East Asia, followed by the USA (though with a much smaller quantity). Crude oil exports to Africa have declined in recent years, while those to France have increased.

Table 5: Main Export Destinations

('000 barrels/ day)

	2001	2002	2003	2004	2005	2006
Total	**1,786.7**	**1,614.0**	**2,048.0**	**2,172.0**	**2,195.0**	**2,420.3**
Japan	1,066.8	1,182.8	1,224.0	1,047.7	1,508.2	1,626.8
Other East Asia	657.2	392.2	789.0	1,089.3	631.8	724.3
Africa	37.0	26.0	28.0	30.0	41.0	34.4
France	5.1	0.0	0.0	0.0	2.6	24.5
United States	19.6	10.0	7.0	4.7	9.0	6.1
United Kingdom	0.0	0.0	0.0	0.0	1.8	3.7
Canada	0.0	0.0	0.0	0.3	0.0	0.5
Other Western Europe	1.0	3.0	0.0	0.0	0.6	0.0

Source: OPEC (www.opec.org).

Expansion Plans

The UAE has undertaken several projects intended to boost its oil and gas production capacities and upgrade refinery infrastructure to meet external, but also the fast rising domestic demand. Over the next five years, more than $50 billion in funds has been earmarked for field development projects, capacity enhancement and oil and gas pipeline networks, which should raise oil and gas production capacity a further 30% to 4 mbd and 6.5 bcfd, respectively, by 2012. Expansion plans include $10 billion already earmarked by ADNOC to raise the production capacity of Upper Zakhum, Abu Dhabi's largest oil field, from 550 b/d to 750 thousand b/d.

Expansion projects also include the $10 billion Sour Gas Development (SGD) project that aims to develop reserves on the onshore Shah and Bab fields, which should add capacity of 3 bcfd. Thirteen international companies are bidding for the SGD project, reflecting the strong appetite for this significant though costly gas reserve. There is also the Dolphin project, a $5 billion initiative that aims to transport gas from Qatar's North field by sub-sea pipeline. The project should start piping its first gas deliveries this year and deliveries are expected to reach a total of 2 bcfd by 2009. The expansion strategy also includes plans to strengthen downstream production capabilities and to enhance the value of energy exports.
But the escalating cost of production and near-term restrictions on manpower, materials and services, are likely to stretch the anticipated timeline by several years at least. Moreover, developing further fields will be more difficult as they may need more challenging recovery techniques. Nonetheless, the oil and gas sector attracts many investments, with a rising share shouldered by the private sector (almost $16.7 billion). The biggest publicly-funded project is the field development undertaken by ADCO in Qusahwira, Ruwais and Bida Al Qemzan, with a value of $1.5 billion.

Table 6: Select Oil and Gas Projects

Project Name	Value ($bn)	Project Start	Project End	Status
Adnoc - Sour Gas Development (SGD)	10.0	2007	2011	FS
Takreer - Ruwais Refinery Expansion	3.5	2008	2010	FS
Gasco - Habshan 2 - Gas Treatment Plant	2.0	2007	2010	OD
Impel - Dubai LNG Storage Hub	2.0	2008	2013	FS
Adma-Opco - Nasr Field Development	2.0	2009	2012	FS
Adgas - LNG Train 4	1.8	2007	2010	FS
Adco - 1.8 MMBPD - Development Program	1.7	2008	2012	FS
Gasco - 4th NGL Train at Ruwais	1.5	2007	2010	OD
Zadco - Umm Al Lulu Field Development	1.5	2008	2011	OD
Adco - Sahil - Asab - Shah Field Development	1.4	2008	2010	OD
IPIC - Habshan to Fujairah Crude Pipeline	1.2	2007	2010	ITB
Gasco - (ASR) - OGD III (Habshan)	1.1	2004	2007	MCA
Adma-Opco - (Umm Shaif)	1.1	2008	2010	OD
Gasco - Habshan 2 : NGL Recovery Units	1.0	2007	2010	OD
Zadco - Zakum Full Field Development	1.0	2008	2010	FS
Gasco - Ruwais Expansion	0.9	2005	2007	MCA
Adma-Opco - Umm Shaifa Gas Injection Facilities	0.9	2006	2010	MCA
Adco - Bab Compression Facilities	0.8	2007	2009	OD
Gasco - Habshan Gas Complex Expansion	0.8	2005	2008	MCA
Takreer - Aromatics Project	0.8	2009	2012	FS
Adgas - OAG Das Island Compression Facilities	0.7	2007	2009	MCA
Zadco - Umm al-Dalkh Full Field Development	0.6	2008	2011	OD
Adma-Opco - Zakum Gas Processing Facility	0.5	2007	2008	ITB
Takreer - Inter-Refinery Pipelines	0.5	2005	2007	MCA
Zadco - Satah Full Field Development	0.5	2007	2010	OD
Adgas - OAG - II - Das Island Facilities	0.5	2007	2010	OD
Adma-Opco - Infield Pipelines (Umm Shaif Field)	0.5	2007	2020	OD
Gasco - (ASR) - AGD II (Asab)	0.5	2005	2008	MCA
Adgas - OAG Offshore Subsea Gas Pipeline	0.5	2006	2009	MCA

Source: MEED Projects (www.meedprojects.com)
Notes: Project status as of June 2007. List only includes projects with an estimated cost > $500 million. MCA: Main contract awarded, ITB: invitation to bid, FS: feasibility study, OD: outline design

3. Non-Oil Sector

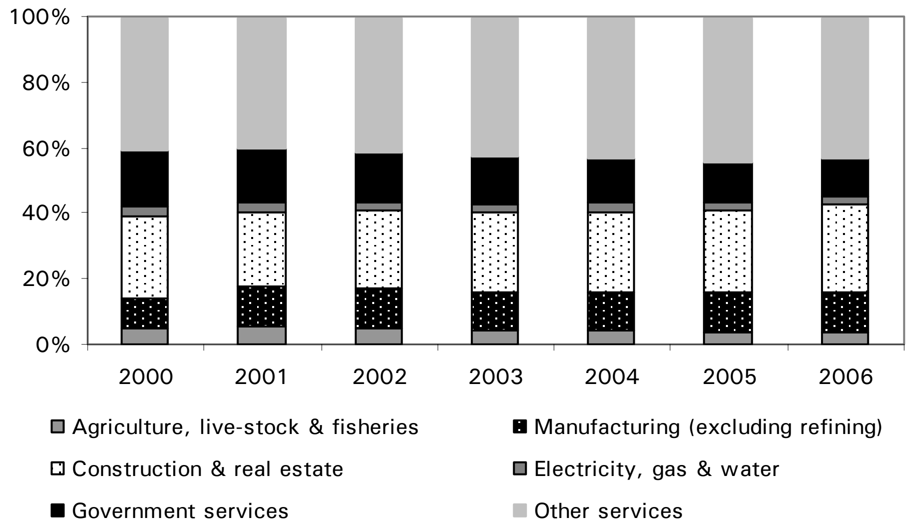
The oil and gas sector is the UAE's center of gravity, but today the prime economic contributor and main engine of economic growth is the non-oil sector. Measured in current prices, the non-oil sector’s contribution to GDP has increased from around a quarter in 1980 to 60% since 2003.

The improvement in the production value of the non-oil sector and its performance in recent years reflect the success of the UAE’s economic diversification strategy. This strategy was based upon using hydrocarbon revenues to stimulate and support broader economic growth. Oil windfalls were channeled back into the economy through the government at the federal and emirate level, but also through giant public enterprises such as Mubadala, Nakheel, DUBAL, Emaar and TAQA.

While the public sector played a key role in developing non-oil activities, there were also efforts to promote the role of the private sector through privatization and a series of partnership arrangements. The introduction of free zones, the removal of barriers to trade and others restrictions on foreign ownership and the creation of a relatively liberal business environment were also an integral part of these efforts. The private sector's share of non-oil activities has increased accordingly from an average of 58% in 2001 to 61% in 2006. Private investments, including foreign investments, have accounted for over half the total investments in projects since 2003.

Nonetheless, the line between private and public sectors is indistinct, with government or government officials holding majority stakes in several private conglomerates. For example, the largest business conglomerate in the UAE and the Middle East, Dubai Holding, is 100% owned by HE Sheikh Mohammed bin Rashid Al Maktoum, ruler of Dubai.

Graph 6: Contributions to Non-Oil GDP



Source: Ministry of Economy (www.economy.ae).
*Note: * Preliminary figures.*

The UAE is the number one destination for investments in the region. According to the Middle East Economic Digest Projects database, 800 projects, planned or underway, have been launched since 2003 in the non-oil sector with an estimated cost of $550 billion. Roughly, a third of these projects are, however, still at an early stage of planning so part of the associated investment may not materialize. There are also 122 projects that are at a more advanced stage of planning, where for example the invitation to bid has already been released, while 364 projects are currently underway. Nonetheless, once implemented, the massive outlays on these projects are expected to have a strong multiplier effect on the economy because they are predominantly in construction or infrastructure, which typically have a low import component.

The UAE is home to the world's largest construction market with project costs estimated at $494 billion, although only $83.5 billion are underway and in the construction phase. The sector is benefiting from a plethora of announced tourism and real estate projects. Most of the activity used to be centered in Dubai which has three main property developers, Nakheel, Emaar, and Dubai Holding which together account for more than half of the emirate's total construction work. But construction activity in the other emirates, especially Abu Dhabi, is rising quickly. However, construction costs are also escalating due to local shortages of materials, in particular steel and cement, and hikes in fees of qualified contractors. This is putting a dent in project activity but is also largely a timing issue before new capacity hits the market and curtails rising costs.

Manufacturing, including petrochemicals, is also an important focal point for investment. Projects estimated at $30 billion are in the pipeline. This includes petrochemical projects estimated at $7 billion. The largest manufacturing project is the $8 billion aluminum smelter planned in Tawelleah by Emirates Aluminum (EMAL). Aluminum is the largest manufacturing industry outside the hydrocarbon sector.

Table 7: Project Activity By Sector

	Projects Completed*		Projects Underway		Advanced Stage		Early Stage Planning		Total	
	Value $bn	Count	Value $bn	Count	Value $bn	Count	Value $bn	Count	Value $bn	Count
Oil & gas	0.9	4	8.5	30	2.5	6	37.5	40	49.3	80
Non-oil	2.4	17	101.3	364	195.4	122	250.7	260	549.8	763
Construction	1.3	13	83.5	299	178.0	105	231.1	229	493.9	646
Industry	1.1	3	3.7	21	12.4	4	5.2	11	22.4	39
Power	0.1	1	8.7	27	3.5	4	10.0	11	22.3	43
Petrochemicals	0.0	0	3.6	4	0.5	2	3.0	4	7.1	10
Water & waste	0.0	0	1.8	13	1.0	7	1.4	5	4.2	25

Source: *Middle East Economic Digest (www.meedprojects.com). Project status as of June 2007.*
Notes: ** Projects completed in the last 18 months only. Projects are underway where main contract was awarded. Projects are at an advanced stage of planning when invitation to bid was released, and are at an early stage of planning when planned, under feasibility study, or in outline design.*

There are economic specializations among the different emirates: Abu Dhabi in energy-based industries; Dubai in commercial and financial services, telecommunications, tourism and trading, Sharjah in light manufacturing, and the northern emirates in agriculture, quarrying and cement manufacturing. However, the decentralized nature of the policy-making process is slowly changing this specialization as a new mindset has emerged - that of a new generation of leaders that aspires to reduce their emirate's dependency on oil by replicating the 'Dubai model'.

In the coming years, Abu Dhabi will concentrate on the development of heavy manufacturing and cultural tourism along with hydrocarbons and petrochemicals. The massive Saadiyat island project represents a move in this strategic direction. The project was initially launched 8 years ago at an estimated cost of $3.5 billion and was intended to include commodity exchanges, silos that could house grain shipped in from Australia, an information technology park and a financial hub. The new development plan is estimated at $27 billion and will focus on culture and tourism, including prestigious attractions such as the Louvre and Guggenheim museums. Abu Dhabi is also focusing on transport in terms of ports and airports, shipping companies and airlines, in order to create another major transport hub in the region.

Meanwhile, Sharjah and Ras Al-Khaima (RAK) are implementing massive tourism development plans. RAK has also launched an offshore facility, which will allow foreign investors to register offshore companies in the Ras Al-Khaimah Free Trade Zone (RAK FTZ) without the need to establish a physical presence. The RAK FTZ was modeled along the lines of the Jebel Ali Offshore Center in Dubai, which was set up in 2003 to position itself as a tax haven like the Cayman Islands, Bahamas and Liechtenstein.

The other emirates are attempting to duplicate the success story of the Jebel Ali Free Trade Zone (JAFTZ), which was established in 1985 and has since evolved to house around 3,000 companies. Dubai has established 13 free trade zones including the Dubai International Financial Center (DIFC) that focuses on various financial activities and is recognized as a leading regional financial center.

Key Non-Oil Activities

Wholesale and retail trade is the largest non-oil sub-sector, responsible for 18% of total value added by the non-oil sector. Construction, real estate and manufacturing (excluding refining) are also leading activities, each accounting for 13% of the non-oil economy. Transport and communication are next with 11%, on a par with government services, followed by financial services with 10%.

Table 8: Non-Oil Sector GDP by Economic Activity

(in current prices)

	Million $			% Change		
	2004	**2005***	**2006***	**2004**	**2005***	**2006***
Agriculture, live-stock & fisheries	2,750	3,003	3,333	10.4	9.2	11.0
Quarrying	225	250	308	8.2	11.0	23.0
Manufacturing excluding refining	7,750	9,414	11,827	16.3	21.5	25.6
Electricity gas & water	1,830	2,161	2,593	11.8	18.1	20.0
Construction	7,889	9,525	12,287	11.1	20.7	29.0
Restaurants & hotels	1,999	2,436	2,840	12.5	21.8	16.6
Wholesale, retail trade & maintenance	11,833	14,431	17,029	22.6	22.0	18.0
Transport storage & communications	7,424	8,888	10,488	10.4	19.7	18.0
Real estate & business services	8,174	9,781	12,558	18.4	19.7	28.4
Social & personal services	1,937	2,071	2,371	9.6	6.9	14.4
Financial corporation sector	6,365	7,740	9,714	17.4	21.6	25.5
Government services sector	8,839	9,458	10,626	5.6	7.0	12.4
Domestic services of household	579	649	715	3.0	12.0	10.3
Less: Imputed Bank Services	*1,814*	*2,014*	*2,527*	*14.4*	*11.0*	*25.5*
Total non-oil sector	**65,780**	**77,794**	**94,163**	**14.0**	**18.3**	**21.0**

Source: Ministry of Economy (www.economy.ae).
*Notes: * Preliminary figures.*

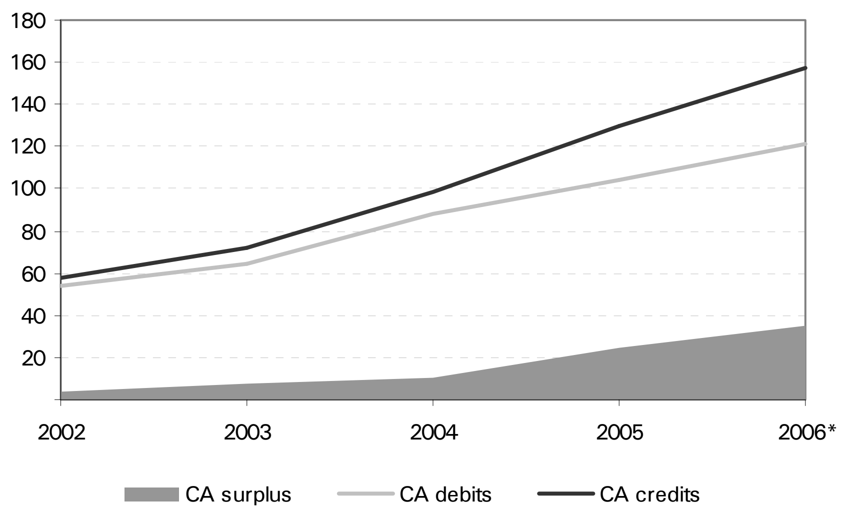
Activity in these leading sub-sectors has been brisk in the last three years, expanding at an average of 24% per annum in nominal terms on the back of buoyant domestic demand and soaring foreign investment. The availability of cheap gas feedstock and subsidized utilities were also supporting elements for the manufacturing sector. However, after adjusting for rising prices, growth in the trade and real estate sectors slowed down significantly in 2006. Government services exhibited slower average growth of 10%, reflecting smaller increases in public sector employment but also efforts to rationalize costs. Overall, the stock market correction of 2006 did not appear to have any significant impact on activity in the non-oil sector.

4. External Sector

Balance of Payments

The performance of the UAE's external sector remained strong in 2006. Preliminary estimates by the Central Bank of the UAE (CBU) showed that the current account surplus continued to widen in 2006, reaching a record $35.2 billion. Although significant, the improvement was not as dramatic as in the previous year, reflecting slower growth in exports and investment income. As a percentage of GDP, the current account surplus increased to 22% compared to 18% in 2005.

Graph 7: Current Account Surplus



(Billion $)

Source: Central Bank of the UAE (www.centralbank.ae).
*Note: *Preliminary estimates.*

The overall balance of payments (the sum of the current account, financial account and errors and omissions) registered a surplus of $6.5 billion in 2006, triple the surplus achieved the previous year. The surplus translated into a corresponding increase in the international reserves of the CBU.

Current Account

The merchandise trade balance was the main contributor to the surplus on the current account. Measured on an FOB basis, the merchandise trade surplus grew an impressive 32% in 2006 to reach $56.38 billion, which is equivalent to 35% of GDP. Exports continued to grow faster than imports despite some deceleration in the second half of the year following a drop in oil prices between August and December.

Net investment income, the second largest contributor to the current account surplus, increased 64% in 2006 to reach $4.74 billion fuelled by higher returns on investments overseas versus little growth in the profit repatriations of the international oil companies. The returns on overseas investments, which tripled in size between 2002 and 2005, continued to improve in 2006 growing 28% to reach a total of $10.6 billion. Two-thirds of these returns were attributed to public sector enterprises, excluding the Abu Dhabi Investment Authority, whose sizeable foreign holdings would probably have boosted the numbers considerably.

In the services account, receipts from services provided to non-residents reached $4.4 billion in 2006, 17% higher than in the previous year and almost double the receipts recorded in 2002. Fast growth in service receipts was led mainly by tourism, which accounted for 60% of the total though transport services were also significant contributors. Despite the rise in receipts, the deficit in the services accounts worsened in 2006 due to fast growth in all payments on services provided by non-residents.

Similarly, the deficit in the current transfers account worsened in 2006 due to rapid growth in worker remittances. The increase in the number of foreign workers in the UAE led to fast growth in such remittances, which reached $8.2 billion in 2006, double the 2002 level.

Table 9: Current Account Balance

	Million $			% Change		
	2004	2005	2006*	2004	2005	2006*
Current account balance	**10,674**	**24,369**	**35,156**	**49.2**	**128.3**	**44.3**
Trade balance (fob)	27,650	42,792	56,384	32.1	54.8	31.8
Total exports and re-exports (fob)	90,996	117,287	142,505	36.3	28.9	21.5
Total imports (fob)	-63,346	-74,495	-86,120	38.2	17.6	15.6
Services (net)	-12,075	-14,584	-17,770	33.3	20.8	21.8
Travel	-2,880	-2,969	-3,855	14.3	3.1	29.9
Transport	-577	-1,487	-2,202	78.8	157.8	48.0
Government services	31	30	30	4.5	-2.6	0.0
Freight and insurance	-8,650	-10,158	-11,743	38.4	17.4	15.6
Investment income (net)	155	2,886	4,738	-385.0	1759.6	64.2
Financial entitites and private non-banks	4,512	8,251	10,402	82.1	82.9	26.1
Banking system	643	1,498	2,396	42.3	132.9	60.0
Private non-banks	81	54	-163	5.7	-32.4	-400.0
Enterprises of public sector	3,788	6,698	8,169	94.3	76.8	22.0
Foreign hydrocarbon companies in UAE	-4,357	-5,364	-5,664	73.1	23.1	5.6
Transfers (net)	-5,055	-6,726	-8,196	8.4	33.0	21.9
Public transfers	-408	-511	-551	50.0	25.0	8.0
Workers transfers	-4,647	-6,215	-7,645	5.9	33.8	23.0

Source: *Central Bank of the UAE (www.centralbank.ae).*
Note: ** Preliminary estimates.*

Capital and Financial Account

Preliminary estimates of the financial account reveal a net outflow of $16 billion, 9.5% higher than in 2005 as official net financial outflows of $39.9 billion were only partially offset by private net financial inflows of $23.8 billion.

The largest private inflows were recorded in the form of non-resident deposits and other foreign liabilities of commercial banks, including borrowing from abroad to fund their asset/liability mismatches. Such large inflows translated into a $9.7 billion surplus in the net financial account of commercial banks, which in contrast ran a deficit of $3.4 billion the previous year. Similarly, the net private financial account of non-banks recorded a $11 billion surplus, which was double the previous year's level reflecting a rapid rise in corporate external indebtedness.

Meanwhile, portfolio investment inflows dropped 80% on a net basis to $1.2 billion following the stock market correction during the year. Likewise, net direct investments in the UAE fell 70% as direct investments abroad rose much faster than inward direct investments, reflecting international acquisitions by large UAE companies. Some experts also reported a slowdown in direct investments in the local real estate market, though this is difficult to confirm given the lack of detailed balance of payment aggregates.

Table 10: Capital and Financial Account

	Million $		% Change
	2005	2006*	2006*
Current account balance	**24,369**	**35,156**	**44.3**
Capital and financial account	**-14,671**	**-16,062**	**9.5**
Enterprises of private sector	15,036	23,851	58.6
Direct investment	7,150	1,914	-73.2
Outward	-3,750	-10,892	190.4
Inward	10,900	12,806	17.5
Portfolio investment	6,143	1,198	-80.5
Commercial banks	-3,403	9,684	-384.5
Portfolio investment	-2,886	-3,462	20.0
Other investment (loans, deposits)	-518	13,146	-2639.6
Private non-banks	5,146	11,055	114.8
Enterprises of public sector	-29,707	-39,913	34.4
Net errors and omissions	-7,110	-12,591	77.1
Overall balance	**2,587**	**6,504**	**151.4**

Source: *Central Bank of the UAE (www.centralbank.ae).*
Note: **Preliminary estimates.*

Balance of Trade

The merchandise trade surplus continued to widen in 2006, reaching $35.2 billion, 14% higher than the previous year. The surplus was achieved due to 21.5% growth in exports, which more than offset the 15.6% increase in imports recorded during the year. Export growth was driven by a 34% increase in crude oil exports, but non-oil exports and re-exports also grew significantly, by 18% and 16%, respectively.

Crude oil is the UAE's single largest export commodity, which on its own accounts for 41% of the Federation's total export earnings and 49% when petroleum products and gas are included. Without crude exports, the trade balance would have recorded a $23 billion deficit in 2006. High oil prices and production levels since 2003 have bolstered this commodity's dominance, even with fast rising non-oil exports and re-exports. Including petroleum products and gas, oil exports earned a total of $70.1 billion in 2006.

After oil and gas, re-exports are the UAE's second largest source of export earnings, constituting 32% of the total. At $46 billion in 2006, re-exports have almost trebled in size since 2001, although their growth has stabilized somewhat in the last two years. Re-export activity is mainly concentrated in Dubai, an emerging regional commercial hub servicing Africa, Asia and the Middle East.

Non-oil exports have also trebled in size since 2001, though from a lower base, reaching $26.4 billion and are worth 18% of the UAE's total export receipts. Non-oil exports grew 18% in 2006, after growing 27% per year between 2002 and 2005. Exports from Free Zones, mainly from Jebel Ali, drove this impressive performance, constituting 75% of non-oil exports.

Table 11: Summary of Foreign Trade

	Million $			% Change		
	2004	**2005**	**2006***	**2004**	**2005**	**2006***
Trade balance (cif)	**17,526**	**30,908**	**35,174**	**19.4**	**76.4**	**13.8**
Total exports and re-exports (fob)	90,996	117,287	142,505	36.3	28.9	21.5
Total exports of hydrocarbon	38,801	55,079	70,100	33.0	42.0	27.3
Crude oil exports	29,624	43,502	58,100	34.3	46.8	33.6
Petroleum products exports	4,423	5,800	4,900	33.6	31.1	-15.5
Gas exports	4,754	5,777	7,100	24.5	21.5	22.9
Total exports of non hydrocarbon	18,316	22,421	26,409	29.5	22.4	17.8
Free zones exports	14,319	17,407	20,500	27.2	21.6	17.8
Other exports	3,997	5,014	5,909	38.6	25.4	17.8
Re-exports	33,879	39,787	45,996	44.6	17.4	15.6
Total imports (cif)	-71,984	-84,654	-97,864	38.2	17.6	15.6
Free zones imports	55,247	-17,236	-20,806	37	-131	21
Other imports	16,737	-67,417	-77,058	42	-503	14

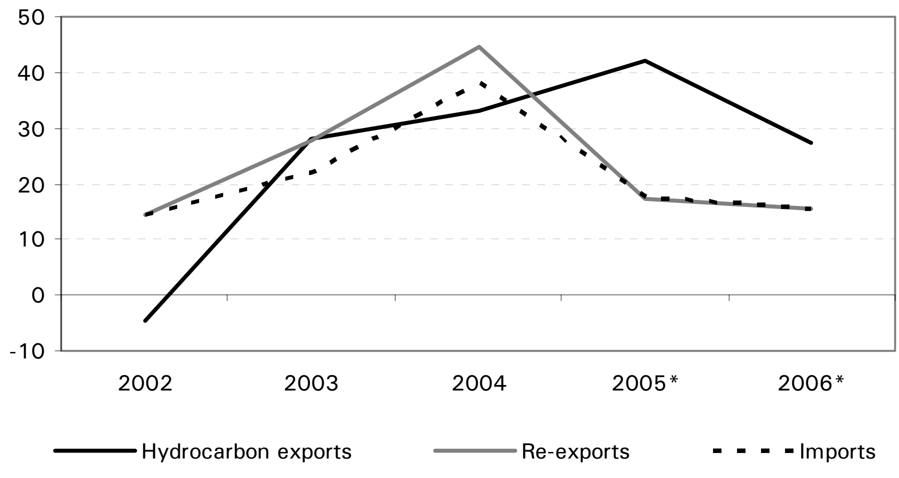
Source: *Central Bank of the UAE (www.centralbank.ae).*
Notes: ** Preliminary estimates. FOB: Freight on board. CIF: Cost, insurance, freight.*

Merchandise imports reached $97.9 billion in 2006, approaching double the merchandise import bill of 2002, fuelled by buoyant private consumption and investment spending. Rapidly rising re-export activity also contributed to rapid growth in imports. Although high, the pace of import growth decelerated in 2006, partly owing to a slowdown in the growth of re-exports. Consumer goods constituted over half the import bill, while capital goods constituted about a third.

Japan is the UAE's main trading partner, followed by the European Union and the US. Whether bilaterally or within the GCC, the UAE is negotiating trade agreements to strengthen and further develop its trade relations with the US, China, Singapore and the EU.

Graph 8: Growth in Exports and Imports

(percent change)



Source: Central Bank of the UAE (www.centralbank.ae).
*Note: * Preliminary estimates.*

5. Public Finance

Consolidated Finances

The UAE's consolidated government finances, which reflect the accounts of the federal government and those of the seven emirates, have substantially improved since 2002. The consolidated fiscal deficit dropped from $8 billion to $3 billion and $415 million in 2003 and 2004, respectively, and reversed in 2005 into a $10.5 billion surplus, its first surplus since 1979, as oil prices exceeded $60 pb and total revenues leapt 52%. With oil prices climbing further in 2006, the budget surplus almost doubled to $19.7 billion.

Rapidly rising oil and gas revenues have afforded higher expenditures at both the federal and emirate level while at the same time nourishing the reserve funds. Non-oil revenues have also contributed to the turnaround in fiscal performance, though their share of all government revenues declined from 37% in 1999 to 20% in 2006 as oil revenues surged. Taxes, mainly customs duties, accounted for 22% of all non-oil revenues and increased 25% in 2006 following a 29% drop in 2005 to reach $2.3 billion (4% of total revenues). Enterprise profits, derived mainly from government ownership in shareholding companies, accounted for 15% of non-oil revenues in 2006 and have increased significantly in the last two years, by 39% and 23% in 2005 and 2006, respectively, to reach $1.6 billion (2.8% of total revenues), reflecting the health of the local stock market and economic activity.

Other revenues, including investment income and proceeds from privatization, have had a more volatile performance, leaping in 2005 following a drop the previous year, and rising a further 18% in 2006 to $6.8 billion or 12.4% of total revenues.

Against a backdrop of rising revenues, growth in public spending accelerated as well, from an average of 5% per year between 2002 and 2005, to 18% in 2006, excluding the fiscal effects on central government finances privatizations in the water and electricity sectors.

Most of the growth in spending in the last two years has been in current expenditures, under subsidies and transfers, which have increased at an average rate of 60% per annum to constitute 23% of total spending. In comparison, the other components of current spending have increased at a more moderate 7% rate, reflecting, in part, government efforts to rationalize costs through outsourcing or transferring items off-budget. As such, the consolidated wage bill only rose 7% per annum in both 2005 and 2006 to reach $4.8 billion, as a reduction in the number of public workers, following the outsourcing of municipal services in Abu Dhabi, offset the 25% and 15% increase in the salaries paid to nationals and expatriates, respectively.

Meanwhile, capital (development) expenditures rose 19% in 2006, reversing falls in the previous two years, to reach $4.6 billion, or 13% of total spending. Nonetheless, expenditures under this chapter only constitute a portion of the massive government-led investment plans which are underway, since some of these are kept off-budget and on the books of public enterprises such as Mubadala and TAQA. The bulk of reported public capital expenditures are concentrated in real estate projects, followed by utilities (electricity, gas and water), and public services (education, health).

Table 12: Consolidated Government Finances

	Million $			% Change		
	2004	2005	2006*	2004	2005	2006*
Revenues	25,800	39,184	54,651	23.0	51.9	39.5
Tax revenues	2,605	1,854	2,312	35.8	-28.8	24.7
Oil & gas	19,965	30,327	43,980	29.2	51.9	45.0
Enterprise profits	905	1,259	1,553	13.2	39.2	23.3
Other revenues	2,326	5,744	6,806	-17.0	147.0	18.5
Expenditures	26,215	28,436	34,918	5.3	8.5	22.8
Capital	4,141	3,824	4,560	-5.1	-7.7	19.3
Current	22,051	22,942	27,418	9.1	4.0	19.5
Salaries & wages	4,255	4,535	4,837	3.1	6.6	6.7
Goods & services	6,816	6,639	7,100	5.2	-2.6	6.9
Subsidies & transfers	3,177	5,151	8,249	12.1	62.1	60.2
Other	7,803	6,617	7,231	15.2	-15.2	9.3
Loans & equity	23	1,670	2,941	-92.8	7289.2	76.1
Surplus (Deficit)	-415	10,749	19,732	-89.4	-2691.9	83.6

Source: *Central Bank of the UAE (www.centralbank.ae).*
Note: ** Preliminary estimates.*

Planned capital spending over the next five years is expected to exceed $350 billion, reflecting the authorities' commitment to re-invest oil windfalls in infrastructure and real estate projects as well as the expansion of oil and gas production capacity. This figure includes investment plans by key public enterprises Abu Dhabi National Oil Company, TAQA, Mubadala, Dubai Ports Authority and Dubai Aluminum Company (DUBAL). It is also expected that a significant part of these investment plans will be shouldered by large private sector conglomerates such as Dubai Holding.

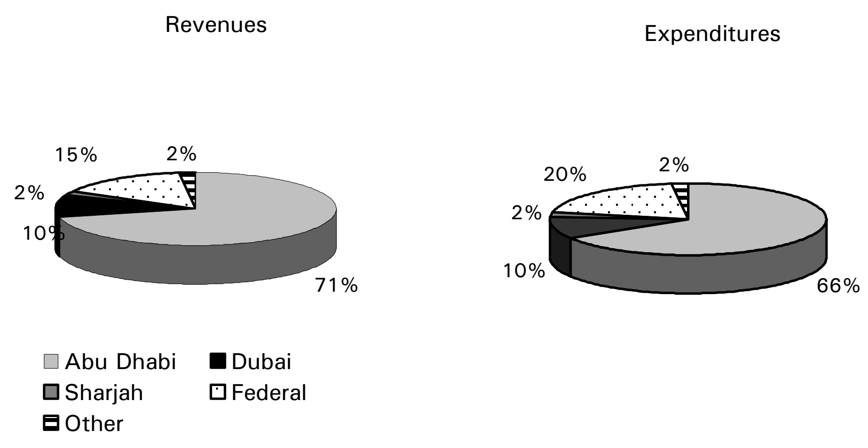
Federal versus Emirate-Level Budgets

Expenditures at the federal level constitute only 20% of consolidated expenditures. Moreover, to keep the federal budget balanced, federal expenditures are determined by revenues, which in turn depend upon the contributions from the individual emirates. Each emirate is constitutionally required to contribute around 50% of its revenues to the federal government, but in practice only Dubai and Abu Dhabi make any contributions.

The federal budget is mainly allocated to defense spending and expenditures in the northern emirates, with development expenditures only constituting 5% of the total. The latest available figures show that actual federal spending in 2005 was $6.3 billion, of which only 5% or $329 million were spent on capital projects. In 2007, the federal government announced that it intends to spend a much more significant 22% share of its budget on capital projects, a planned $7.7 billion. This is only a fraction of the budgets of Abu Dhabi and Dubai for this year.

Abu Dhabi, the center of the UAE's oil wealth, accounts for the bulk of consolidated fiscal expenditures (66%) and consolidated revenues (71%). Oil windfalls have underpinned a rapid increase in Abu Dhabi's total revenues since 2002, while expenditures rose by only 8% per annum, resulting in an accumulated budget surplus estimated at around $18 billion. This surplus was reportedly channeled to Abu Dhabi's reserve funds, which also receive a significant portion of its sizeable investment income.

Graph 9: Contributions to the Consolidated Finances



Sources: Ministry of Economy (www.economy.ae), IMF (www.imf.org).
*Note: * Preliminary estimates.*

Dubai accounts for around 10% of the UAE's consolidated fiscal expenditures and revenues. Roughly 80% of this emirate's revenue is non-tax based, derived from the oil and gas sector, enterprise profits (including DUBAL, Emirates Airlines, Jebel Ali and other shareholding companies) and investment income. The rapid increase in Dubai's total revenue since 2002 has been accompanied by a modest increase in expenditures. Accumulated surpluses over the last three years have amounted to an estimated $1.6 billion.

Sharjah, the third largest emirate, accounts for around 2% of consolidated government expenditures. The total revenue of the government of Sharjah has increased significantly since 2002. Although the bulk of this emirate's revenue is generated from the hydrocarbons sector, non-hydrocarbon revenues have increased significantly since 2001 due to the diversification policy adopted by Sharjah. In fact, in 2004 and 2005, hydrocarbon and non-hydrocarbon revenues were almost equal. Since the increase in Sharjah's total revenue was matched by an equal increase on the expenditures side, the overall balance of this emirate's budget did not increase as it did in Dubai and Abu Dhabi. It was nonetheless slightly positive and accumulated surpluses over the last three years are estimated at $100 million. The other emirates generally maintain balanced budgets.

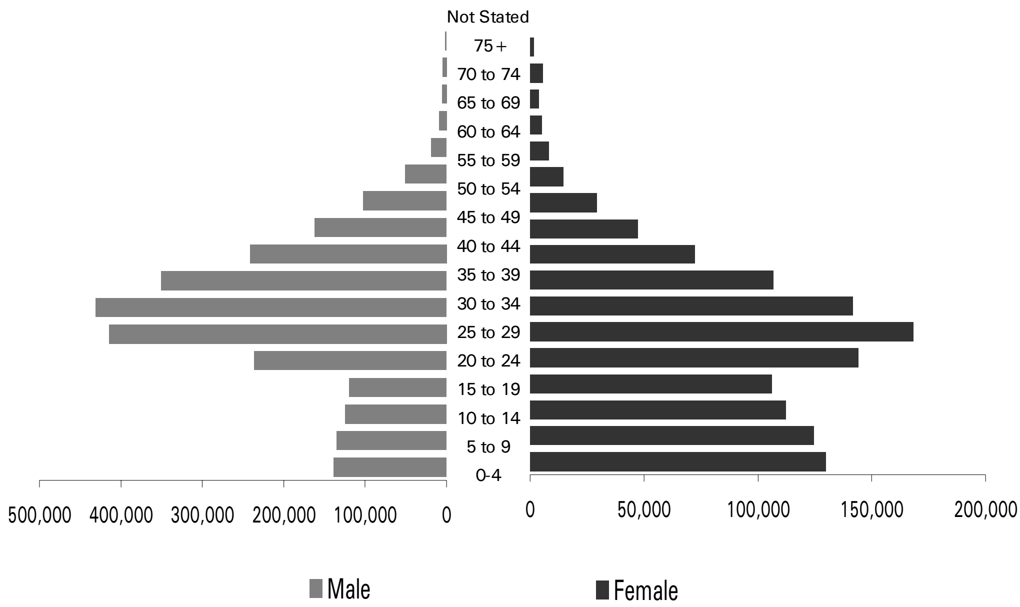
6. Population and Labor Force

The Ministry of Economy (MOE) estimated population growth at 3% in 2006, slower than the 9% growth reported in 2005 and the 5.5% average annual increase between 1995 and 2005. The MOE bases its growth figures on population censuses it carries out every decade. The last one, conducted on December 6th 2005, had revealed a total population of 4.1 million including 336 thousand non-nationals who were not present in the UAE or who had an invalid residency permit at the time of the census fieldwork period. There is a suspicion, however, that because of the way in which the census was carried out, the official numbers may have understated the recent growth in the country's population.

Nevertheless, the Federation still has one of the fastest growing populations in the world, resulting from the large inflow of expatriate workers and from the relatively high prevailing fertility rate, especially among nationals. The increased inflow of expatriates is also reflected in the gender distribution of the populace. The 2005 census showed that males constituted 67.5% of the total population. The census also showed that the local Emirati population constituted 20.1% of the total population with 51.1% of nationals below the age of 20 years. In comparison, this age group only constituted 20% of the expatriate population while 48.8% were 25 to 40 years old.

Census figures also revealed that 31.5% of nationals have a high school degree and only 11% hold a university degree with a rising share of Emirati women receiving higher education. In comparison, a third of expatriates have not completed high school but have had some schooling, and 18% hold a university or professional degree. Illiteracy is high in the UAE, reaching 9% for both nationals and expatriates. Illiteracy is more entrenched among Emirati women and expatriate men.

Graph 10: Demographic Pyramid – Census 2005



Source: Ministry of Economy (www.economy.ae).

Abu Dhabi is the most highly populated emirate with 34.3% of the census population followed by Dubai with 31.8%. Over the last decade, the emirate of Sharjah exhibited the fastest population growth of 6.1%, followed by Dubai (5.7%) and Ajman (4.6%).

Labor Force

The growing influx of expatriate labor, together with a rising participation rate amongst women, has translated into a rapidly growing labor force. The latest MOE estimates reveal that the total number of workers (excluding defense personnel) increased 8.4% in 2006, following a 6.7% growth in 2005 and 5.3% in 2004, to reach 2.84 million. This meant that average growth in the workforce was higher than population growth, resulting in a rise in the total participation rate, which increased from 61% in 2001 to an estimated 67% in 2006. Moreover, the pace of growth in the number of workers was also on average higher than the growth in the adult population, contributing to a drop in the unemployment rate to below 6%.

The data also showed that 23% of all workers were employed in the construction sector while the wholesale/retail and the manufacturing sectors employed 18% and 13%, respectively. The oil industry, on the other hand, employed only 1% of the federation's workers. According to latest MOE estimates, the unemployment rate amongst nationals is around 14%, much higher than that of the population as a whole. The rate is also rising because of the difficulty in matching local skills with employment requirements, wage expectations, and a preference to work in the public sector. Another key factor is the female participation rate which has been increasing over the years. Census data showed that women accounted for 13% of the economically active population among nationals in 1995, up from 6% in 1985.

The Emiratization policy, enacted in 2004 in select sectors, is intended to provide more job opportunities for nationals. Training services and career counseling programs are available. The National Human Resource Development and Employment Authority (TANMIA), a federal government independent authority, was also established to reduce unemployment.

Table 14: Workers by Economic Activity

	Thousand			% Change		
	2004	**2005**	**2006***	**2004**	**2005**	**2006***
Agriculture, live stock & fishing	169	191	193	1.3	13.4	1.0
Mining & quarrying	36	38	39	8.1	7.7	1.6
Manufacturing industries	319	333	362	6.8	4.3	8.6
Electricity, gas & water	29	34	34	1.7	17.4	0.8
Construction	498	529	647	5.2	6.2	22.3
Wholesale, retail trade & repairing services	479	497	519	6.3	3.9	4.3
Restaurants & hotels	110	115	124	11.6	5.0	7.4
Transports, storage & communication	148	161	174	3.7	9.0	8.3
Real Estate & business services	74	77	84	10.0	4.4	8.9
Social & personal services	107	114	121	7.4	6.4	6.6
The financial corporations sector	27	31	37	2.4	13.7	19.0
Government services sector	265	283	284	5.8	7.0	0.4
Domestic services of household	200	220	226	0.3	10.0	2.4
Total	**2,459**	**2,624**	**2,844**	**5.3**	**6.7**	**8.4**

Source: Ministry of Economy (www.economy.ae).
Note: Not including defense personnel.

7. Money and Banking

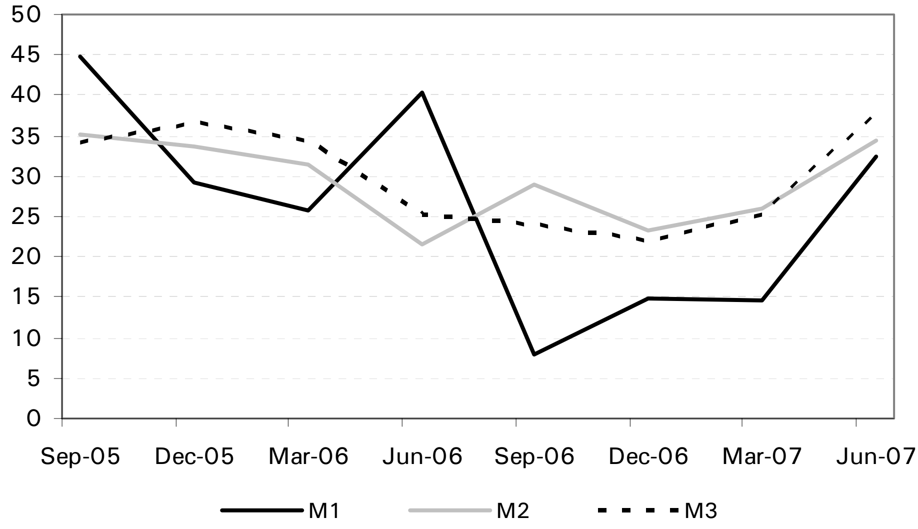
Monetary Developments

Monetary aggregates have witnessed accelerated growth in tandem with the rapid expansion in economic activity. Domestic liquidity, defined as broad money (M2), expanded by $20.5 billion in 2006 to reach $108.7 billion, an increase of 23% against 34% growth recorded the previous year. The trend continued in the first half of 2007 (1H07) with M2 expanding by a further 19% thus lifting the year-on-year increase to 34%.

Strong, sustained growth in domestic liquidity took place despite a steep increase in banks' foreign liabilities, which was only partially offset by their continued accumulation of foreign assets and thus resulted in a significant drop in their net foreign asset position (NFA). Another significant net outflow was recorded under 'other net domestic assets', reflecting unaccounted for private outflows from the system. These net outflows slowed the growth in liquidity, which, nonetheless, remained rapid and consistent with the current economic expansion. Liquidity growth has stayed well above the growth of non-oil GDP, a likely signal of inflationary pressure.

Graph 11: Monetary Aggregates (M1, M2, M3)

(year-on-year percent change)



Source: Central Bank of the UAE (www.centralbank.ae).

Credit extended to the private sector was the main driver of growth in domestic liquidity in 2006 and 1H07. M2 growth was also supported by a continuous improvement in the Central Bank's Net Foreign Assets (NFA), which reached $43 billion by the end of June 2007. This was a 73% increase on 1H06, reflecting net capital inflows, asset revaluations and income accumulation in the Central Bank's foreign assets portfolio.

The appetite for credit continued to be driven mainly by personal loans, which constituted a quarter of total outstanding credit. Initial public offerings (IPO) were a major driver of the growth in personal lending. This is most starkly evident in the surge in personal lending for business purposes (up 50%) in the first quarter of 2006, coinciding with the subscriptions in two mega-IPOs, namely, Emirates Integrated Telecommunications Co. (*du*) and Tamweel, which were oversubscribed by 167 times and 484 times, respectively. The *du* IPO received applications of AED 405 billion, around 68% of the UAE’s 2006 GDP.

Growth in personal loans for business purposes was, nonetheless, much less dramatic in 2006 and 2007 than in the previous two years due to a decline in lending for the purchase of securities. There was also weaker growth in credit extended to trade activities, which increased 9% against an average of 20% per year since 2003 and turned slightly negative in 1H07.

Non-residents were dynamic contributors to the growth in credit in 2006, recording a significant increase of $5.9 billion which constituted 12% of outstanding credit. In 1H07 $1.4 billion worth of new credit facilities were awarded to non-residents, roughly 9% of total new facilities.

Table 15: Monetary Survey

(million $ at end of period)

	Dec 2004	Dec 2005	Dec 2006	June 2006	June 2007
Domestic liquidity (M2)	65,961	88,241	108,725	96,351	129,440
Money (M1)	22,006	28,441	32,680	30,861	40,855
Currency outside banks	4,296	4,771	5,946	5,176	6,335
Monetary deposits	17,710	23,670	26,734	25,685	34,520
Quasi-money	43,955	59,800	76,045	65,491	88,585
FC deposits	17,017	20,096	26,224	22,097	27,869
Dirham deposits	26,938	39,703	49,821	43,394	60,716
Foreign assets (net)	39,568	45,424	42,378	41,107	48,519
Central Bank NFA	18,515	20,969	27,606	24,930	43,076
Central bank foreign assets	18,665	21,280	27,958	25,260	43,442
Central bank foreign liabilities	-149	-311	-352	-330	-367
Commercial banks NFA	21,052	24,456	14,772	16,178	5,444
Commercial banks foreign assets	34,338	47,659	63,155	49,018	64,740
Commercial banks foreign liabilities	-13,286	-23,204	-48,383	-32,840	-59,296
Domestic assets (net)	26,393	42,817	66,347	55,244	80,921
Net claims on government	-8,521	-12,888	-14,127	-10,390	-16,504
Credit to government	8,337	11,978	15,103	12,031	17,512
Government deposits	-16,858	-24,866	-29,230	-22,422	-34,016
Claims on official entities	3,781	6,752	8,986	8,219	8,392
Claims on private sector	55,764	79,048	105,048	90,657	118,325
Claims on non-bank financial insts	1,800	4,151	8,812	5,268	11,652
Other items (net)	-26,431	-34,246	-42,372	-38,509	-40,944
Broader money (M3)	82,819	113,106	137,955	118,773	163,456

Source: Central Bank of the UAE (www.centralbank.ae).
Note: NFA is net foreign assets.

Table 16: Credit by Economic Activity

(million $ at end of period)

	Dec 2004	Dec 2005	Dec 2006	June 2006	June 2007
Total domestic credit	67,244	96,158	129,111	109,181	144,296
Agriculture	235	260	382	275	376
Mining and quarrying	733	1,011	1,582	1,058	1,198
Manufacturing	3,704	4,850	6,606	6,105	8,048
Electricity, gas & water	2,478	2,868	3,020	2,700	2,556
Construction	8,627	11,408	14,798	12,798	16,657
Trade	18,925	23,170	25,225	23,474	24,866
Transport, storage & communication	1,861	2,914	5,287	4,079	5,473
Financial institutions	953	2,035	5,063	2,515	7,145
Government	7,947	10,703	13,039	10,389	14,968
Personal loans for business purposes	9,672	19,185	23,956	21,471	27,381
Personal loans for consumption purposes	6,554	7,422	8,511	7,851	10,020
All others	5,557	10,330	21,643	16,467	25,607
Credit to non-residents	10,828	11,369	17,226	14,528	18,581
Total credit	**78,072**	**107,527**	**146,338**	**123,709**	**162,877**

Source: Central Bank of the UAE (www.centralbank.ae).

Credit to financial institutions, which also showed a steep increase, added $3 billion to new credit facilities in 2006, and another $2 billion in 1H07, increasing its share in total credit from 2% at the end of 2005 to 4% by June 2007. The construction sector, which accounted for 11% of total outstanding balances, maintained strong growth, albeit decelerating from 32% in 2005 to 30% in 2006 and an annualized 25% in 1H07..

The distribution of credit according to type of facility showed that the increase in credit in 2006 mainly occurred in loans, advances and overdrafts, which rose $34.4 billion or 43% to $132.8 billion. In contrast, their increase during 1H07 was a smaller 9%. Meanwhile, real estate mortgage loans witnessed a steep rise during 2006 of 80% or $3.8 billion, but their share of total credit remained a meager 6%. However, their share improved in 1H07 to almost 8%, following another 47% increase.

Overall, credit expansion outpaced deposit growth resulting in an increase in the loan-to-deposit ratio for the banking sector. The trend reversed slightly in 1H07, following a weakening of credit growth, with total credit expanding 12% on a half yearly basis while deposits rose 17%.

The rise in credit facilities and foreign assets in 2006 resulted in a significant expansion in bank assets. The aggregate assets of banks (including foreign and national banks) rose $58.8 billion or 36% to reach $224.5 billion, against a 41% increase the previous year. Over half of this expansion was a result of the rapid growth in domestic credit. Foreign assets contributed another quarter, rising 33% in 2006 to reach 28% of total assets. Domestic investments and deposits with the Central Bank also saw a steep rise during the year.

In 1H07, bank assets rose a further 17% to reach $273 billion or 167% of 2006 GDP. Growth in bank assets over this period was also driven by credit facilities as well as a significant leap in bank deposits at the Central Bank, while growth in foreign assets remained almost negligible.

Broadly speaking, the stock market correction did not significantly affect bank assets nor did it materially affect their quality. This is primarily due to the salary assignment feature that characterizes most personal lending, as well as the fact that margin lending is primarily offered to high net worth individuals and adequate collateral is required.

On the liabilities side, private deposits increased 23% to reach $102.8 billion in 2006 while government deposits grew 18% to $25.5 billion. Growth in private deposits was slower than in 2005 as banks resorted to wholesale funding to finance credit expansion. This was also reflected in the sharp increase in foreign liabilities, which reached $48.4 billion or 21% of total liabilities, up from 11% in 2004. Meanwhile, capital and reserves increased 33% to maintain their average share of liabilities at 12%. These trends continued in 1H07 as private deposits rose 20% in six months and 35% year-on-year to reach $123 billion, while government deposits and foreign liabilities rose 20% and 23%, respectively.

Table 17: Aggregate Balance Sheet of Banks

(million $ at end of period)

	Dec			June	
	2004	2005	2006	2006	2007
Total assets	**122,463**	**173,727**	**234,057**	**194,121**	**272,995**
Cash	739	956	1,360	946	1,270
Deposits with CB	9,748	11,838	15,907	15,779	31,208
Due from resident banks	4,642	7,996	9,474	7,086	9,913
Foreign assets	34,338	47,659	63,155	48,938	64,740
Credit facilities	67,244	96,158	129,112	109,003	144,295
Claims on government	7,947	10,703	13,039	10,372	14,968
Claims on official entities	3,398	6,332	8,581	7,852	7,242
Claims on private sector	54,946	77,088	102,429	88,269	114,940
Claims on other financial institutions	953	2,035	5,063	2,511	7,145
Domestic investments	2,735	5,227	8,745	6,736	11,463
Other assets	3,017	3,893	6,304	5,633	10,106
Total Liabilities	**122,463**	**173,727**	**234,057**	**194,121**	**272,995**
Monetary deposits	17,710	23,670	26,734	25,643	34,520
Qasi-monetary deposits	43,955	59,800	76,045	65,384	88,585
Government deposits	13,962	21,560	25,509	19,267	30,613
Foreign liabilities	13,286	23,204	48,383	32,786	59,296
Government lending funds	5	5	4	5	4
Due to central banks	5	57	46	962	1,179
Capital & reserves	14,285	21,275	28,343	25,517	31,870
Due to resident banks	5,339	8,113	10,455	8,279	10,833
Other liabilities	13,917	16,044	18,538	16,279	16,095

Source: Central Bank of the UAE (www.centralbank.ae).

The government is a major player in the Federation's banking sector. Government deposits as a share of total deposits have been relatively stable in the past few years, ranging between 23% and 25%. There is tough competition among banks for large corporate and government deposits, which do not come very cheaply. On the lending side, claims on the public sector as a share of total claims have gradually increased, reflecting the government-led development policy under way in the UAE. However, exposure to the government varies widely across banks.

Interest Rates

The Central Bank of the UAE (CBU) aims to control domestic liquidity while maintaining the exchange rate peg to the dollar. It uses money market operations, mainly through certificates of deposits (CDs), to mop up excess liquidity and shadow the US Federal Reserve's interest rate moves closely, while maintaining a narrow differential.

This policy served the CBU well during 2006 as the rate hikes by the US Federal Reserve allowed it to pursue a tighter monetary policy, which was appropriate in the face of the rapid increase in credit. However, it proved a bit challenging in 2007 when, in September, the US Federal Reserve cut its Fed Funds rate by 50 bps following the summer sub-prime credit crisis. The CBU responded by cutting its benchmark rate on three-month CDs by only 25 bps, to 4.7%, out of concern that this could fuel further expansion in lending and consequently the money supply, thus, feeding inflationary pressures further.

The recent drop in interest rates is likely to reverse the tightening in spreads between bank lending and deposit rates witnessed between 2004 and June 2007. The effects of a tighter monetary policy in 2006 were felt in interest rate structures and average rates on credit facilities, with business loans registering the largest increase, rising from an average of 5.9% in 2004 to 7.9% in 2006. Interest rates on personal loans remained higher, averaging 11.6% in 2006. However, interest rates on customer deposits saw larger increases over the same period, with rates on three-month deposits rising from an average of 1.0% to 4.2% in 2006, while twelve-month deposits rose slightly less to 4.4%.

Excess Liquidity in the UAE market became a real problem for the CBU in 2007. With limited flexibility in the use of interest rates as a monetary policy tool, due to the pegged exchange rate, the CBU had to resort to mopping up excess liquidity by issuing CDs. During 1H07, a staggering $13.8 billion worth of CDs were issued, compared to $3 billion in 2006 as a whole, with the total outstanding reaching $23 billion. With liquidity kept in check by CBU intervention, the three-month inter-bank rate remained almost unchanged from its December 2006 level, down only 4 bps to 5.2%. Meanwhile, interest rates on business loans dropped in 1H07 a full percentage point to 6.9%, while personal loan rates witnessed a small change, rising slightly up to 11.6%. In contrast, deposit rates changed only slightly.

Exchange Rate Trends

Since 2002 the UAE dirham has been pegged to the US dollar at an official rate of AED 3.6725 per dollar and, as such, its value has remained relatively stable against all other GCC currencies. However, the value of the dirham has trended lower with the dollar, depreciating by a cumulative 24% against the British pound, 20% against the Swiss franc and 29% against the euro between 2002 and June 2007. Despite the nominal depreciation, the real effective exchange rate, as estimated by the World Bank, reportedly increased in 2005 and 2006 owing to an acceleration in the UAE's inflation rate.

Table 18: Average Exchange Rates

(dirham per unit of foreign currency, period average)

	2003	2004	2005	2006	Jun-07
US Dollar	3.67	3.67	3.67	3.67	3.67
Euro	4.15	4.57	4.58	4.61	4.93
Pound Sterling	6.00	6.65	6.69	6.77	7.29
Swiss Franc	2.73	2.94	2.95	2.93	2.97
Japanese Yen	0.03	0.03	0.03	0.03	0.03
Kuwait Dinar	12.32	12.46	12.58	12.65	12.75

Source: Central Bank of the UAE (www.centralbank.ae).

The declining value of the dirham has undoubtedly had an impact on the domestic value of imports from non-dollar areas. However, the UAE authorities believe that the exchange rate pass-through effect on domestic inflation has been minimal. Nonetheless, the lack of flexibility in the conduct of monetary policy that a fixed exchange regime implies has given rise to speculation and debate about the necessity of abandoning the dollar-peg or revaluing the dirham. The CBU has refuted so far speculation that it would revalue the dirham or that it would change its exchange rate policy. It has also reaffirmed the government's commitment to the planned GCC currency union by 2010.

Bank Results

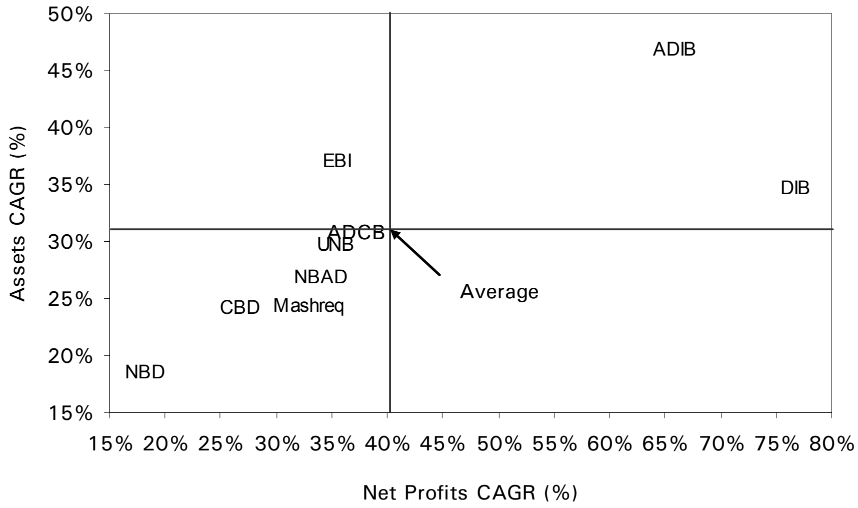
The banking sector recorded another excellent year in 2006 and in the first half of 2007. With assets of $273 billion at the end of June 2007, the banking sector in the UAE is the largest in the region. The sector comprises 47 banks, 22 of which are domestically owned while the remaining 25 are foreign. The national banks dominate the sector, accounting for the lion's share of all banking business. At the end of 2006 they accounted for 84% of all branches and 79% of total assets. Foreign banks account for a quarter of total sector deposits, a share that has changed little in recent years. Foreign banks' share of total lending dropped from 26% at the end of 2004 to 22% at the end of 2006. These shares however stand unchanged at the end of 1H07.

Compared to those in other GCC countries, the UAE's banking sector is relatively fragmented. On average, assets per bank stood at $5.1 billion at the end of 2006, compared with $14.4 billion in Saudi Arabia, which is comparable to the UAE in terms of the absolute size of the banking sector. With a population of around 4.5 million, there is one bank for every 100,000 individuals in the UAE, compared with one bank for every 1.44 million individuals in Saudi Arabia.

Owing to the large number of players, no single entity dominates the sector. Still, the five largest national banks in terms of assets accounted for 48% of overall assets and 61% of the total assets of national banks at year end 2006. Nevertheless, the merger of Emirates Bank International (EBI) and National Bank of Dubai (NBD) could radically change the banking environment. The new entity, Emirates NBD, is now not only the largest in the UAE, commanding an estimated 19% of total assets, but also the largest in the GCC.

Banks have witnessed wide differences in growth of assets and net profits over the past four years. First Gulf Bank (FGB) has been, by far, the fastest-expanding bank with assets increasing by a CAGR of 76% in the four years ending in 2006. Prior to the merger of Emirates NBD, National Bank of Abu Dhabi (NBAD) was the market leader, accounting for 16% of the top ten banks' total assets. NBAD was also the top earner, despite its earnings dipping 18% in 2006 related to weakness in regional equity markets. EBI comes first in terms of lending, with its net loans representing nearly 18% of the sample's total, closely followed by Abu Dhabi Commercial Bank (ADCB) with a 17% share.

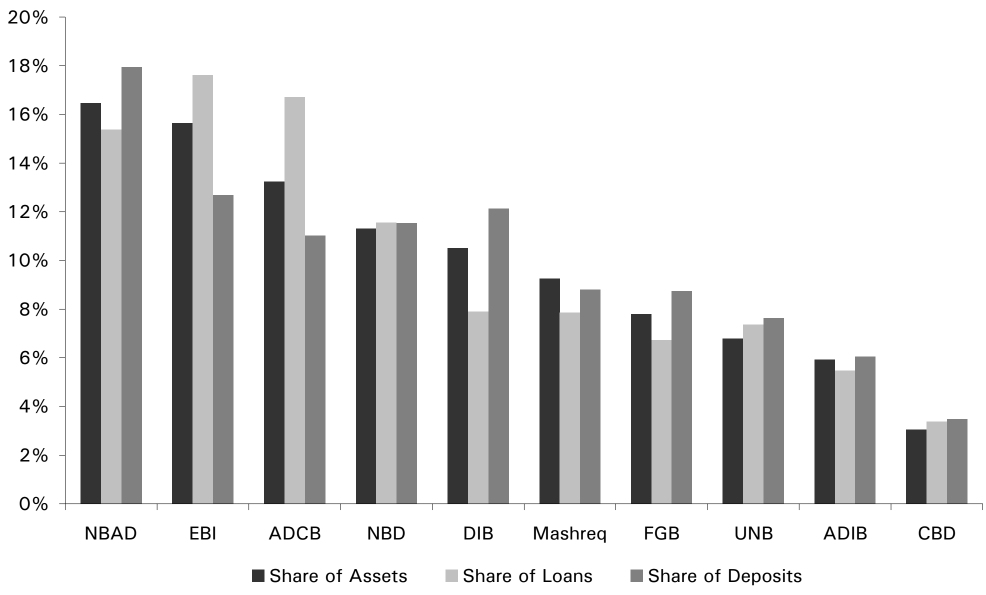
Graph 12: Growth of Assets and Net Profits – 2002-2006



Sources: Banks' financial statements and NBK MENA Capital.

Islamic banking is one of the fastest growing activities in the UAE's banking sector, reflecting very strong demand for Shaira-compliant products and services. The two Islamic banks, Dubai Islamic Bank (DIB) and Abu Dhabi Islamic Bank (ADIB), were able to grow both their assets and net profits more than the sector averages. The growth in the popularity of Islamic banking can also be seen in the number of banks that have established, or are in the process of establishing, Islamic finance subsidiaries, which will enable them to enter the Islamic market and, hence, boost and diversify earnings. Moreover, with the recent conversion of Dubai Bank into an Islamic bank, and the establishment of Al Noor Islamic Bank, the number of Islamic banks increased to six.

Graph 13: Market Shares of the Top 10 Banks - December 2006



Sources: Banks' financial statements and NBK MENA Capital.

The earnings of the 10 largest national banks (in terms of assets) increased by only 6% in 2006 after registering double-digit increases in the previous two years. Only three banks, namely ADIB, DIB, and FGB, were able to boost net profits significantly in 2006, with growth rates of 66%, 47%, and 45%, respectively. On the other hand, three of the top 10 banks, namely, NBAD, Mashreq, and United National Bank (UNB), saw their net profits decline in 2006. NBAD's net profit suffered the most, plunging 18%. The drop in earnings was related to equity market weakness, especially the decline in IPOs and investment management fees.

Net interest income showed healthy growth of 21%, 51%, and 28% in 2004, 2005, and 2006, respectively, as all banks managed to grow this source of income in a rising interest rate environment. NBAD accounted for 17% of all net interest income earned by our sampled banks in 2006. Income from fees and commissions has been volatile. After a 149% jump in 2005, income from fees and commissions was nearly flat in 2006 as lower equity market related fees were compensated by growth in income from core banking operations. Fees and commissions at the 10 largest national banks accounted for an increasing share of total operating income, rising from 19% in 2003 to 29% in 2005, but dropping to 26% in 2006. UNB and ADCB had the highest shares in 2006, at 37% and 36%, respectively, while ADIB had the lowest measure at 8%.

An improvement in performance was visible in the 1H07, with earnings rising 21% compared to 1H06, with the gain primarily registered in the second quarter. First quarter profits were affected by sharp declines in income from fees and commissions in comparison to the IPO-inflated 1Q06 figures. While the stock market correction of 2006 had an impact on earnings in 2006 and 1H07, it did not result in any significant deterioration in banks' asset quality as margin lending is offered to high net worth individuals and adequate collateral is required. The top 10 national banks have shown steadily improving asset quality in the last two years with their weighted average ratio of non-performing loans (NPLs) to gross loans (excluding the two Islamic banks due to inadequate disclosure) dropping from 3% in 2004 to 1.4% in 2006. NPLs have also dropped in absolute terms during the past two years on the back of very favorable economic conditions. Coverage, defined as the ratio of total provisions to NPLs, is adequate, with the weighted average at the largest 10 national banks (excluding the two Islamic banks) rising to 119% at the end of 2006, up from 97% two years earlier. Nevertheless, banks' ratios differed widely.

A very positive step was the launching of the credit bureau, "Emcredit", at the DIFC in November 2006. In addition, the establishment of another national credit bureau is expected in 2007. This will eventually lead to the availability of more comprehensive credit information on borrowers, which will help banks to better assess the risks they face.

As for exposure to the real estate market, concerns remain as to the potential impact on the banking sector if a correction occurs. Gauging the exact exposure of the banking sector to the real estate market is challenging given the gaps in disclosed public data, and also given the marked difference between the situation in Dubai and that of the other emirates. Still, it is expected that banks will comfortably withstand any mild correction in the real estate market.

Table 19: Financial Highlights - Top 10 National Banks

(million $)

	Assets				Loans				Deposits				Shareholders' Equity				Net Profits			
	2004	2005	2006	1H07	2004	2005	2006	1H07	2004	2005	2006	1H07	2004	2005	2006	1H07	2004	2005	2006	1H07
NBAD	15,339	23,134	27,492	33,761	9,647	14,014	15,653	17,826	10,551	16,221	19,262	21,086	1,412	1,994	2,452	2,636	310	703	573	323
EBI	10,475	16,178	26,107	31,392	7,579	11,093	17,927	21,620	5,594	5,594	5,594	16,807	1,584	2,110	2,417	2,545	265	472	514	327
ADCB	10,454	15,718	22,080	23,935	7,761	11,481	16,998	18,450	8,047	9,241	11,817	13,204	1,351	2,344	2,902	2,849	218	521	567	266
NBD	10,965	13,998	18,863	22,036	4,525	7,607	11,768	14,308	8,571	10,100	12,364	14,234	1,481	1,497	1,646	1,639	253	300	301	177
DIB	8,336	11,708	17,545	20,595	4,762	7,321	8,030	17,801	6,791	9,092	12,997	15,984	813	1,012	2,325	2,551	126	289	425	413
Mashreq	8,699	12,673	15,451	19,223	4,794	6,064	8,006	8,815	5,747	8,170	9,437	12,237	1,321	1,977	2,009	2,460	205	474	428	278
FGB	1,970	3,484	7,157	15,585	1,779	3,704	6,851	9,315	2,717	4,714	9,376	10,345	484	2,130	2,447	2,459	67	287	418	240
UNB	6,688	9,512	11,311	12,326	4,398	5,637	7,486	8,569	4,872	7,022	8,181	8,455	603	1,425	1,614	1,651	123	314	274	148
ADIB	3,455	6,042	9,882	11,204	2,101	3,638	5,565	5,905	2,606	4,910	6,487	7,650	410	549	754	1,362	33	94	155	94
CBD	2,968	4,162	5,093	6,034	2,047	2,544	3,442	4,016	2,036	2,896	3,746	4,462	564	768	1,037	1,121	96	150	164	59
Total	79,347	116,610	160,981	196,092	49,392	73,103	101,727	126,626	57,532	77,960	99,260	124,465	10,022	15,806	19,602	21,273	1,694	3,603	3,820	2,325

Sources: Individual bank reports, NBK MENA Capital

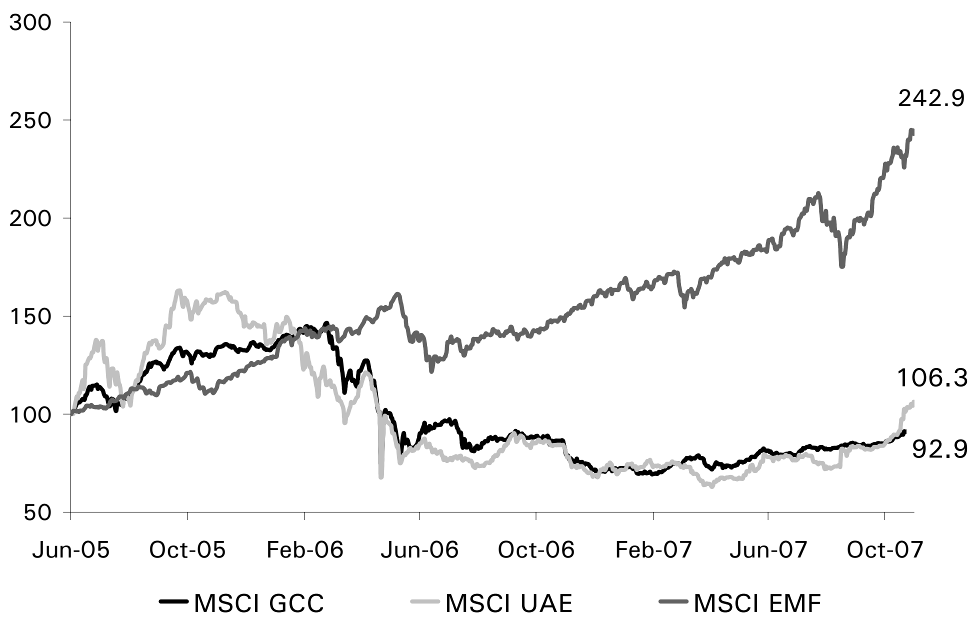
Notes: National Bank of AbuDhabi, Emirates Bank International, Abu Dhabi Commercial Bank, National Bank of Dubai, Dubai Islamic Bank, Mashreq Bank, First Gulf Bank, Union National Bank, AbuDhabi Islamic Bank, Commercial Bank of Dubai

8. UAE Equity Markets

Like most GCC equity markets, prices in the UAE equity markets, the Abu Dhabi Stock Exchange and the Dubai Financial Market, have been on a downward trend since the equity bubble burst in the second half of 2005. By the end of October 2007, the MSCI UAE index had dropped 35% from its peak on September 21, 2005. This situation is not so different from the performance of the MSCI GCC index, which fell 37% from its peak on February 23, 2006. The UAE market has had a series of ups and downs in 2007, with the MSCI UAE index dipping 12% by early April, but ending up 48% by the close of October, mostly from strong gains this last month. This late rally, following a period where neither market bulls nor bears could establish dominance, and the fact that the PE ratio for the UAE is currently at 14.2, could be a signal that the market has passed its lowest point and is in the recovery phase. Notwithstanding, interim corrections cannot be ruled out, especially after such sharp gains within a short period of time.

Two things can be inferred by tracking the rebased performance of the MSCI UAE index since mid-2005 along with the MSCI GCC index and the MSCI Emerging Markets Free index (MSCI EMF): firstly, that there is a correlation between the MSCI UAE index and the MSCI GCC index; secondly, both indices significantly underperformed the MSCI EMF index over the last two and a half years.

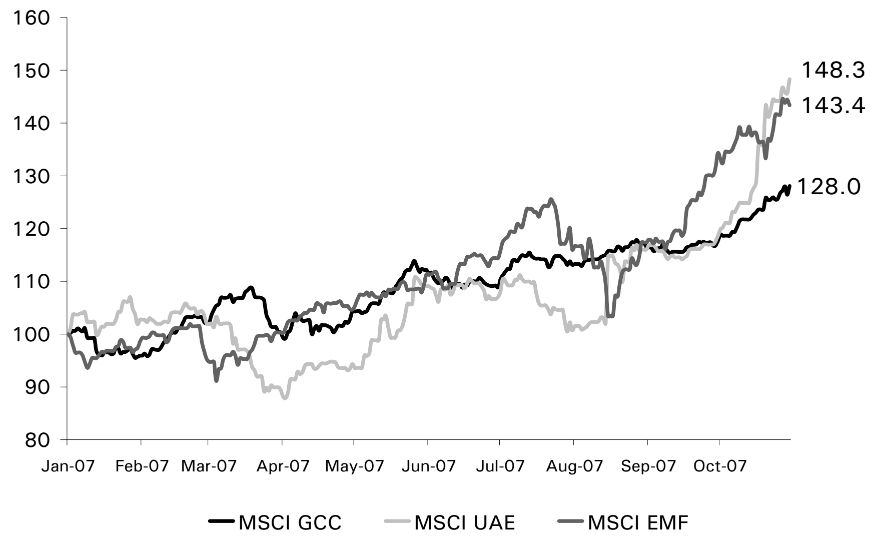
Graph 14: Rebased Performance of UAE Market Index



Sources: MSCI and NBK MENA Capital.

Relative to the MSCI GCC and MSCI EMF indices, the MSCI UAE index has shown more volatility in 2007; the index had a major fall through March and April only to see a rebound in May and June, accentuated by a sharp rally in October that allowed it to outperform the MSCI GCC year-to-date.

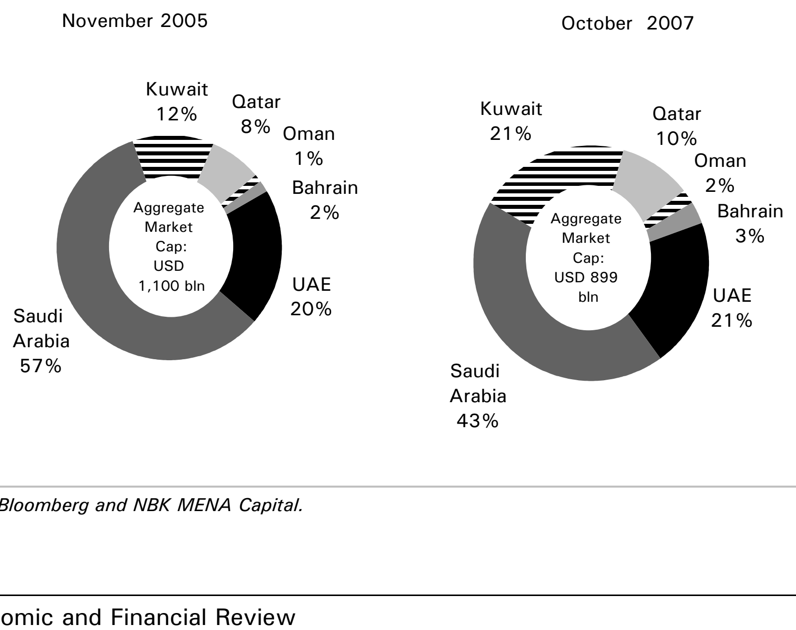
Graph 15: YTD Rebased Performance



Sources: MSCI and NBK MENA Capital.

Back in November 2005, before the equity bubble in the GCC burst, the market capitalization of the UAE market stood at $216 billion. Today, despite having 40 additional companies list during that period, the market cap of the UAE market is $186 billion. This represents a decline of 14% since November 2005 which makes the UAE, along with Saudi Arabia, the hardest hit of the GCC markets. Even though the UAE's share of total GCC market capitalization did not change significantly, it has lost its position as the second largest equity market in the GCC to Kuwait.

Graph 16: Share of UAE in GCC Market Cap



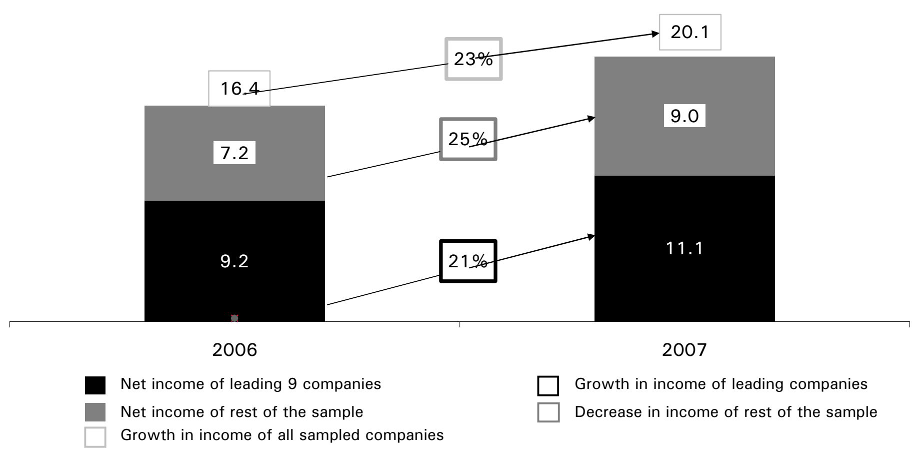
Sources: Bloomberg and NBK MENA Capital.

First-Half Results

The combined earnings of a sample of 61 companies listed on the Dubai Financial Market and Abu Dhabi Stock Exchange increased 23% in the first-half of 2007 compared to the same period in 2006. The earnings of the 9 leading companies grew 21% in the first half of 2007, while the non leading companies enjoyed growth of 25%. This shows that growth in earnings in the first half of 2007 was not concentrated among the leading companies only, as was the case in the first half of 2006 when the earnings of the leading companies increased 20% and the earnings of other companies declined 1%.

The three features that the 9 leading companies have in common are:
- sizeable market capitalization;
- they are considered liquid
- most of their income is generated from core operations.

Graph 17: First Half Earnings



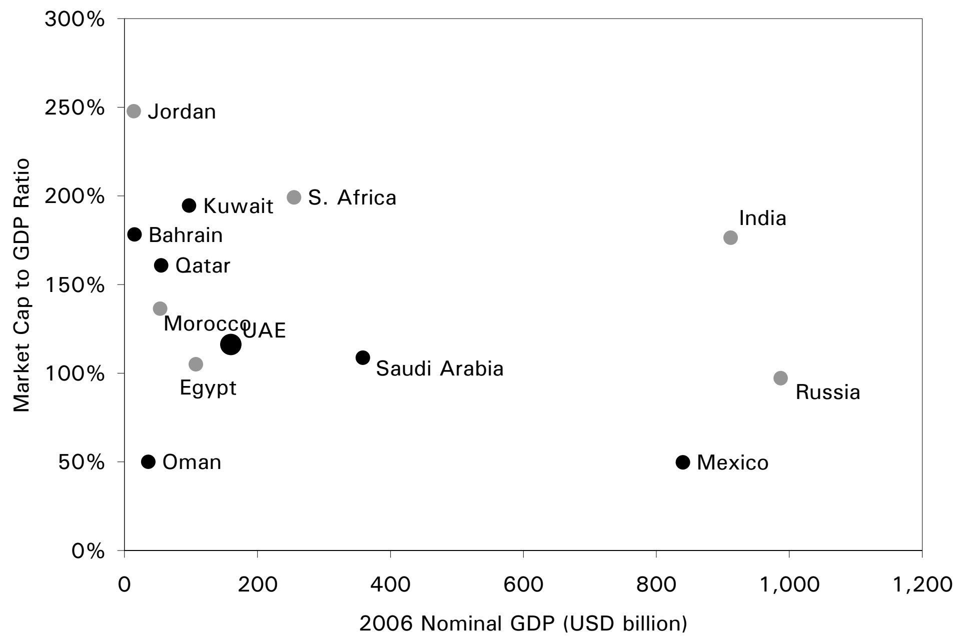
Sources: Company reports and NBK MENA Capital.

Valuation

The correction wave experienced in the UAE has brought down valuation levels significantly. In terms of the market capitalization to GDP ratio, the UAE is trading at attractive levels compared to other GCC and emerging markets. The UAE's market capitalization to GDP ratio stands at 116%, compared to 124% for the GCC.

Finally, given that valuations have become relatively more attractive and given that the UAE market is exhibiting signs that it has reached the bottom, some institutional investors consider this an opportune time to enter the UAE market. As companies listed on the UAE market are of differing quality, investors may look to cherry pick companies with solid fundamentals, i.e. companies that focus on their core operations and are not dependent on investment income.

Graph 18: Market Cap to GDP Ratio vs. 2006 Nominal GDP



Sources: IIF, Bloomberg and NBK MENA Capital.

Table 20: Valuations of Listed Companies

Company	RIC	Market Cap. (AED million)	Price 31Oct 07 (AED)	Price at 52 Weeks		Average Daily Turnover ('000 shares)	PE Multiple (x)
				High	Low		
Aabar Energy	AABAR.AD	3,762	4.2	4.6	1.5	7,798	NM
Abu Dhabi Commercial Bank	ADCB.AD	27,800	7.0	8.0	5.2	1,895	14.8
Abu Dhabi Islamic Bank	ADIB.AD	10,050	67.0	73.0	44.5	521	16.1
Abu Dhabi National Energy Co.	TAQA.AD	14,525	3.5	3.8	1.8	10,000	33.1
Abu Dhabi National Hotels	ADNH.AD	6,084	8.5	9.1	4.0	290	14.4
Abu Dhabi National Insurance Co.	ADNI.AD	2,772	9.2	10.0	7.1	43	9.6
Air Arabia Co.	AIRA.DU	7,980	1.7	1.8	1.1	142,636	42.0
AL DAR Properties Co.	ALDR.AD	16,922	9.8	9.9	3.5	13,142	10.4
Amlak Finance	AMLK.DU	7,080	4.7	6.9	2.7	18,110	45.7
Arab International Logistics Co.	ARMX.DU	3,377	3.1	3.4	1.3	8,862	29.9
Arkan Building Materials Co.	ARKN.AD	3,938	2.3	2.3	1.1	31,719	20.4
Bank Of Sharjah	BOS.AD	4,225	3.4	3.4	2.1	500	12.1
Commercial Bank International	CBI.AD	3,025	2.8	3.9	1.9	838	14.6
Commercial Bank of Dubai	CBD.DU	11,295	10.0	10.0	6.3	112	15.1
Dana Gas PJSC	DANA.AD	11,340	1.9	2.0	1.3	19,108	14.8
Deyaar Development	DEYR.DU	12,943	2.2	2.3	1.8	232,283	29.8
Dubai Financial Market	DFM.DU	41,440	5.2	5.4	1.9	67,414	27.7
Dubai Investment	DINV.DU	11,874	5.5	5.6	3.9	18,592	9.5
Dubai Islamic Bank	DISB.DU	33,855	11.3	11.6	6.0	8,535	14.4
EMAAR Properties	EMAR.DU	78,577	12.9	13.9	9.8	23,053	11.9
Emirates Integrated Telecom. Co.	DU.DU	20,160	5.0	7.3	4.6	3,947	NM
Emirates NBD	ENBD.DU	69,193	15.8	17.8	9.6	1,576	NA
Emirates Telecom. Co.	ETEL.AD	112,303	22.5	23.8	14.6	1,196	16.6
First Gulf Bank	FGB.AD	25,000	20.0	21.3	11.0	1,178	15.0
Gulf Cement Co.	GCEM.AD	4,605	6.5	7.2	3.6	1,459	13.4
Invest Bank	INVB.AD	3,800	3.8	4.1	2.0	198	20.3
Islamic Arabic Insurance Co.	IAIC.DU	4,257	3.9	3.9	2.3	14,035	29.6
Mashreq Bank	MASB.DU	28,377	252.0	270.0	180.5	2	15.2
National Bank Of Abu Dhabi	NBAD.AD	36,600	23.0	26.0	15.5	207	17.0
National Bank of Fujairah	NBF.AD	3,795	3.5	5.5	3.2	11	13.3
National Bank of Umm Al-Qaiwain	NBQ.AD	5,082	7.7	7.7	3.6	87	20.9
National Cement Co.	NCC.DU	2,870	10.4	18.2	8.5	5	14.6
National General Cooling Co. (Tabreed)	TABR.DU	3,765	3.3	3.6	1.8	9,191	29.7
Oasis Capital Company	OILC.AD	4,320	2.9	3.0	0.9	36,949	32.7
Ras Al Khaimah Ceramic Co.	RKCE.AD	2,652	5.7	6.7	3.4	34	18.1
Ras Al Khaimah Properties	RPRO.AD	3,860	1.9	2.0	1.3	13,973	9.8
Sharjah Cement & Industrial Dev. Co.	SCID.AD	2,194	4.7	4.8	3.2	232	8.0
Sharjah Islamic Bank	SIB.AD	3,784	3.4	3.5	2.0	1,300	16.4
SHUAA Capital*	SHUA.DU	3,691	6.7	6.9	3.9	1,029	16.2
Sorouh Real Estate Co.	SOR.AD	15,625	6.3	6.3	2.1	13,257	10.3
TAMWEEL	TAML.DU	5,710	5.7	6.0	3.2	11,142	27.0
The National Bank of Ras Al-Khaimah	RAKB.AD	4,810	7.8	8.0	5.5	38	15.0
Union Cement Co.	UCC.AD	2,584	4.7	5.5	3.6	101	10.5
Union National Bank	UNB.AD	14,297	9.2	9.7	5.8	649	15.6
Union Properties	UPRO.DU	12,243	4.4	4.6	2.4	9,070	18.1

Source: NBK MENA Capital.

Key Economic and Financial Indicators for the UAE

(million $ except where otherwise stated)

	2002	2003	2004	2005	2006*
Population (million)	**3.75**	**4.04**	**4.32**	**4.10**	**4.23**
Oil price (Murban) ($/barrel)	**24.87**	**28.34**	**36.58**	**54.04**	**66.01**
Crude oil production (mb/d)	1.95	2.22	2.36	2.45	2.54
Gross domestic product	**74,297**	**87,611**	**105,253**	**132,202**	**163,167**
annual growth rate	*7.3*	*17.9*	*20.1*	*25.6*	*23.4*
Oil & gas share (%)	32	34	38	41	42
Per capita GDP ($)	19,791	21,681	24,364	32,208	na
Cost of living index (1999=100)	**105.80**	**109.10**	**114.50**	**121.70**	**133.00**
year-on-year inflation	*2.9*	*3.1*	*4.9*	*6.3*	*9.3*
Exchange rate (SR per $)	**3.67**	**3.67**	**3.67**	**3.67**	**3.67**
Broad money (M3)	**60,113**	**66,983**	**82,819**	**113,106**	**137,955**
Quasi-money	34,472	37,655	43,955	59,800	76,045
Net foreign assets	22,460	20,876	21,052	24,456	14,772
Central Bank foreign assets (net)	13,733	15,022	18,515	20,969	27,606
Commercial bank assets	**85,917**	**99,907**	**122,463**	**173,727**	**234,057**
Claims on private sector	39,662	44,988	55,764	79,048	105,048
Private deposits	44,034	49,766	61,665	83,470	102,779
Current account	**3,406**	**7,551**	**10,589**	**24,369**	**35,156**
Trade balance	9,122	14,682	17,526	30,908	35,174
Exports	51,775	66,756	90,996	117,287	142,505
Hydro-carbon exports	22,806	29,183	38,801	55,079	70,100
Other exports	2,355	2,883	3,997	5,014	5,909
Imports	-42,652	-52,074	-71,984	-84,654	-97,864
Overall Balance	-414	1,288	3,493	2,587	6,504

	FY02a	FY03a	FY04a	FY05a	FY06a
Consolidated Revenues	15,580	20,970	25,800	39,184	54,651
Oil revenues	11,144	15,449	19,965	30,327	43,980
Consolidated Expenditures	23,585	24,897	26,215	28,436	34,918
Capital expenditures	3,396	4,364	4,141	3,824	4,560
Surplus (deficit)	-8,005	-3,927	-415	10,749	19,732

Sources: Central Bank of the UAE, Ministry of Economy, OPEC.
*Note: * Preliminary estimates.*

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