United Arab Emirates

Towards a new crisis in Dubai?

As the most diversified economy of the Gulf countries and a major oil producer, the United Arab Emirates faces a double shock: the economic fallout of the COVID-19 pandemic and plummeting oil prices. The current situation risks accelerating the real estate market crisis in Dubai, which has been developing for several years, eroding the financial health of companies in the construction and services sectors. As credit risk rises, it will place a negative strain on banks. Although public finances seem healthy enough to handle the decline in oil revenues, public debt is bound to rise. The UAE's solid external position guarantees the dirham's peg to the US dollar.

An economy hit on two fronts

Like all of the economies of the Gulf countries, the United Arab Emirates (UAE) is currently being hit by a double shock: the fallout of the COVID-19 pandemic and the drop in oil prices. The structure of the UAE economy makes it particularly sensitive: Abu Dhabi is a major OPEC oil producer, and Dubai is especially dependent on tourism and the real estate sector. To slow the pandemic's spread, a number of restrictions were imposed on non-essential travel and economic activity.

For the moment, fiscal stimulus measures have been rather moderate at about 2% of GDP. They are comprised essentially of tax cuts, higher subsidies for water and electricity, and the strengthening of Ghadan 21, Abu Dhabi's small business development programme[1]. The central bank of the UAE (CBUAE) has cut its key rate by 125 basis points (bp) since the beginning of the year[2] and announced a USD 70 bn support package (17% of GDP) comprised of zero-interest rate collateralized loans to banks; postponed loan repayments for certain companies; the reduction in reserve requirements for demand deposits, the easing of prudential standards for SME loans; and lifting the ceiling on bank exposure to the real estate sector. Certain companies in the hardest hit sectors, such as the airlines, will also benefit from capital injections from the government.

Non-oil activity plummets

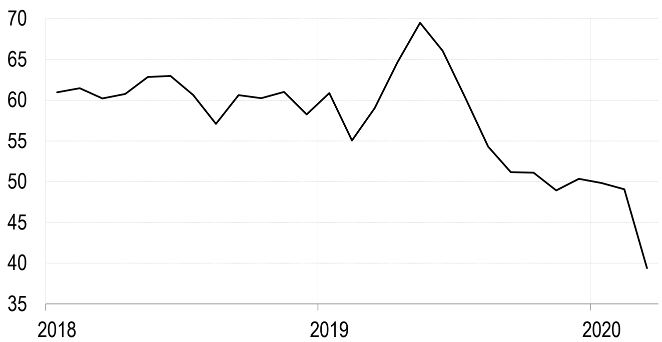
Growth has slumped in the UAE's non-oil sector since 2017, to less than 2%, due to the slowdown in activity in Dubai. Over the past three years, the Federation's most diversified economy (about 30% of total GDP), Dubai, has experienced a sharp slowdown in the real estate sector (15% of GDP) and a decline in the number of tourists (tourism accounts for at least 10% of GDP). What has been a structural slowdown so far is likely to become a contraction this year with the slowdown in construction projects, the temporary halting of tourist visits and the decline in global trade. An aggravating factor is the possible postponement by a year of World Expo 2020, initially planned for October, which would dash any hopes of a recovery in the second half of the year.

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.7	1.9	-6.7	3.8
Inflation (CPI, year average, %)	3.1	-1.9	0.2	1.8
Gen. Gov. balance / GDP (%)	1.8	0.4	-8.3	-6.9
Current account balance / GDP (%)	1.0	7.3	-0.4	1.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMI index non-oil private sector, new orders



Source: Markit

In Abu Dhabi, difficulties in the real estate sector also weigh on non-oil GDP growth (less than 1% since 2018). For the UAE as a whole, we estimate that non-oil GDP could contract by 5% in 2020 (from an estimated +1.1% in 2019).

Oil-sector GDP, which accounts for about 30% of the UAE's total GDP, is expected to report significant decline in 2020. The OPEC+ group (binding OPEC and Russia together in terms of production quotas) agreed to reduce oil production by 9.7 m b/d from May 2020. The UAE is the 3rd largest OPEC producer (11% of the total; 3.09 m b/d on average in 2019), and should cut oil production by 0.74 m b/d. Total oil production should decrease by about 10% on average in 2020.

Credit risk is expected to rise

All in all, we expect activity to contract by 6.7% in the UAE in 2020. Considering the drop in non-oil activity, which primarily affects Dubai, the UAE economy will mainly be hit by a significant rise in credit risk. For several years, government-related entities participating in the development of Dubai have been hit by the slowdown in the real

[1] This AED 50 bn programme (3.4% of GDP) was launched in 2019 to support the development of small and mid-sized enterprises (SME), notably in new technologies.
[2] The key rate cut (on 1-week CDs) was not really an economic support measure but reflects efforts by the CBUAE to keep pace with Fed decisions given the dirham's peg.

estate sector. These heavily-indebted companies [3], which are mainly active in construction and real estate, will rapidly encounter liquidity problems.

Although residential property prices have fallen by about 30% since 2018, lower prices have not slowed the growth in supply in a market that was already suffering from surplus capacity. According to S&P, 2019 was a record year for Dubai for the delivery of residential property, and this record could be broken again in 2020. The possible cancellation of World Expo 2020 in Dubai will only accelerate the decline in demand and the drop in prices. Certain conglomerates have already approached their main creditors to try to renegotiate their debt, while others have seen their ratings downgraded by the rating agencies. Dubai's capacity to support ailing entities is constrained by limited fiscal resources. Issuance of costly external debt or support from Abu Dhabi could be needed to support those entities.

The banking sector is first in line

In the midst of an economic slowdown and a possible acceleration of the real estate sector's troubles, the quality of bank assets is likely to deteriorate. The doubtful loan ratio as a share of total loans has deteriorated regularly since 2017. According to the IMF, it rose to 6.5% at year-end 2019. The exposure of UAE banks as a whole to the construction and real estate sectors is equivalent to about a quarter of private-sector lending.

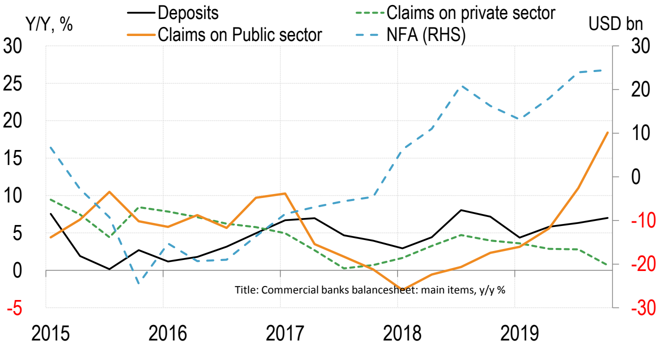
Since the bursting of the 2008 housing bubble, banks have strengthened their balance sheets, conglomerates have rescheduled their debt and real estate market speculation has slowed. For the financial sector, and thus for the economy as a whole, the real estate sector is no longer seen as a systemic risk. Yet the CBUAE recently took measures to relax prudential standards for banks, notably for SMEs. Another source of risk is the shutdown of businesses in many economic sectors and its impact on employment. Bank lending to the retail sector is equivalent to 11% of private-sector lending while consumer loans account for 25%.

On the resource front, the erosion of public finances could strain government deposits with banks. They accounted for 18% of total deposits at year-end 2019. Yet in the short term, Emirate banks are unlikely to face liquidity problems. Deposits, which are banks' main funding source, increased at an annual rate of 7% in December 2019, while private-sector lending (67% of total lending) stagnated (+0.7%). Signalling an absence of liquidity pressures, banks reported a net external surplus of USD 24 bn (5.9% of GDP) in December 2019, the highest level in 15 years.

Solid public finances

With the drop in oil revenues (about 50% of total revenues) and the implementation of fiscal stimulus measures, the UAE is expected to report a significant fiscal deficit in 2020. The expected decrease in

3- Commercial banks balance sheet: main tems



Source: IMF

oil production and the average 40% decline in oil prices during the year will significantly impact oil revenues. To offset partially the decline in fiscal revenues, the government could draw on the revenues of its sovereign funds. All in all, we expect a fiscal deficit equivalent to 8.3% of GDP in 2020 (USD 35 bn) and 6.9% of GDP in 2021.

The government has several options for financing the deficit. An international bond issue in 2019 (USD 10 bn) provided liquidity, and a USD 7 bn Eurobond was issued in April 2020. Lastly, the government has more than USD 800 bn (200% of GDP in 2019) in various sovereign funds, which could be a source of additional financing. Government debt is low, and could reach 28% of GDP in 2020.

A solid peg

External accounts are solid and the economy generates recurrent current account surpluses. Given the decline in oil prices and the contraction in world trade, the current account should show a deficit of 0.4% of GDP in 2020 (USD 1.8 bn). According to the IIF (Institute of International Finance), external debt amortisation (loans and bonds) will amount to USD 60 bn in 2020. The central bank had foreign reserves of USD 107 bn in 2019 (7.5 months of imports of goods and services). In this environment, and after taking into account the government's external assets, the dirham's peg to the US dollar is not at risk.

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[3] Total debt of the Dubai government and government-related entities which depend on it exceeds 100% of Dubai's GDP.