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What perspectives for the United Arab Emirates after COVID-19?

Executive summary

The UAE's economy was hit by a double shock in 2020. The first was related to the collapse in oil prices following the disagreement between Russia and Saudi Arabia in March 2020, the second being the COVID-19 pandemic. According to preliminary estimates, the UAE's economy shrank by 6.1% in 2020. However, growth the outlook is brighter for 2021, as Coface expects growth to stand at 3.1% this year thanks to a fast vaccination campaign in the UAE, a sharp recovery of the global economy and the rebound in energy prices.

Nevertheless, the extent of the recovery will vary across sectors. We expect performance in tourism, construction and retail to be closely in step with new variants of the virus. Expo 2020, scheduled to start in October 2021 after a year of postponement, will attract tourism inflows into the country. However, pre COVID-19 tourism performance is not expected to return immediately and will depend on the health situation locally and in originating countries. The return of tourists and expatriates to the UAE, due to their hub status, will largely determine the recovery in construction and real estate, however, remote working and shopping could be a drag. Through tourism, COVID-19 will also be determinant for the retail sector, one of the most diversified and developed in the region. However, sales are supported by pent-up demand as consumers postponed their big-ticket purchases during the pandemic.

Oil and transport will benefit from the sharp global and regional economic recovery, as well as that of trade. In July 2021, the UAE agreed with the OPEC+ group to increase their baseline oil production reference. Despite challenges, the outlook remains positive for the UAE oil sector, in line with some investment projects aiming at expanding the country's production capacity. The position of the UAE as the regional trade hub will support their transport sector.

Under these circumstances, the normalization of relations between the UAE and Israel will be profitable for both sides in terms of trade and investments across a variety of sectors. On the other hand, some unexpected tensions may arise with Saudi Arabia, a long-time ally of the UAE, over competition for the regional hub status. However, these are expected to remain limited to the economic sphere.

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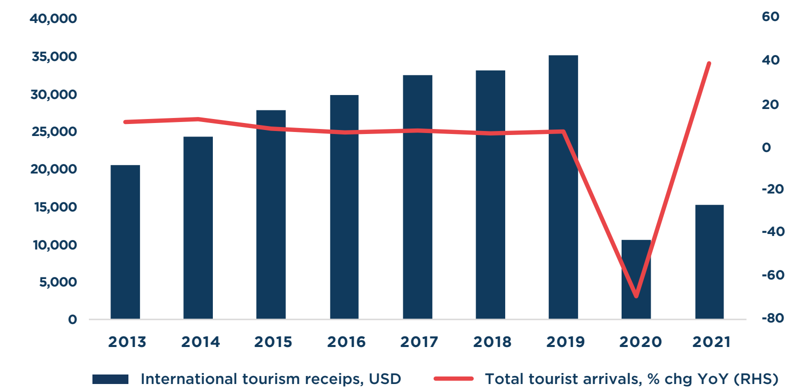
I - A sustainable recovery after COVID-19?

Tourism, construction and retail dependent on the pandemic's evolution...

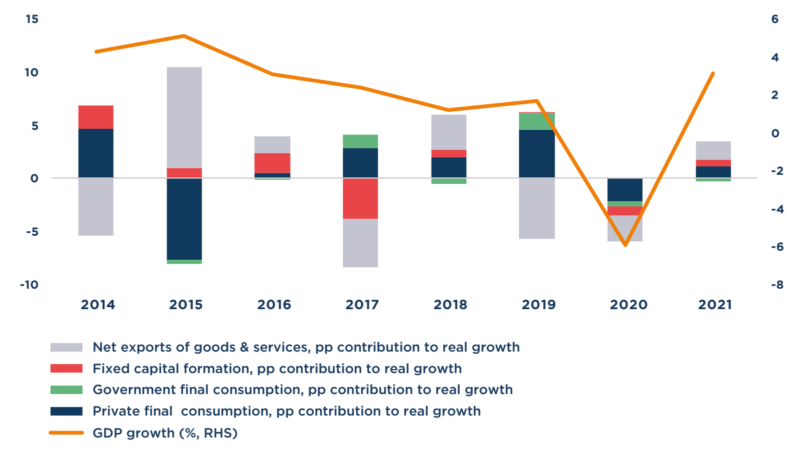
The UAE's economy was hit by a double shock in 2020 like the rest of the region's oil exporters: the oil shock and the COVID-19 pandemic. Following the oil price war between Saudi Arabia and Russia in March 2020, oil prices fell as low as USD 20 per barrel, from around USD 70 at the beginning of the year. According to preliminary estimates, the UAE's economy shrank by 6.1% in 2020, in line with the contraction of the global economy due to the COVID-19 pandemic. The non-oil economy contracted by 6.2%, with accommodation and food services declining by 23.6%, wholesale and retail trade by 13%, and construction by 10.4%. However, growth perspectives are brighter for 2021 due to several reasons: the base effect, higher oil prices, the high rate in local vaccination and the faster-than-expected recovery of the global economy. Coface expects UAE growth to stand at 3.1% in 2021. Indeed, the country has one of the world's highest COVID-19 vaccination rate. By the end of June 2021, the country had administrated over 15.7 million vaccine doses, reaching the rate of 159 doses per 100 people. All seems on track to reach 100% of all eligible age groups vaccinated by the end of 2021. Consequently, authorities have been able to gradually ease COVID-19 restrictions, fuelling business activity, while many other developed, emerging and developing countries have been struggling to vaccinate their population **(Chart 1)**.

CHART 1
Net exports are the biggest contributor to GDP in 2021



Source: Fitch Solutions, Coface

CHART 2
Tourism revenues in the UAE



Source: Fitch Solutions, Coface

Tourism, first in line with the recovery, but also facing COVID-19

The first impact of this quick vaccine rollout and lifting of pandemic-related restrictions will be felt in the tourism sector, which accounted for 7-8% of GDP in 2019. Due to COVID-19, international arrivals in the UAE are estimated to have collapsed by around 70%, from 28 million in 2019 to 8.5 million in 2020. In 2020, Dubai hosted 5.5 million visitors, a fall by a third from 2019. Thanks to the vaccine rollout, authorities have allowed hotels to operate at full capacity since 17 May. This should allow the emirate to maximize the Dubai Expo, a much anticipated six-month long event scheduled to start in October 2021, after a year of postponement. Around 35% of total tourist arrivals in the UAE are from Asia Pacific, 27% from Europe and 26% from the Middle East. Once these key source markets reopen and visitors are vaccinated, the tourism sector will rebound. However, pre COVID-19 performance is not expected to return immediately. The vaccine rollout and quick reopening of hotels and restaurants will help the UAE be an outperformer in the MENA region in terms of tourism arrivals. However, the 12 million tourists expected in 2021 will be below pre-crisis levels, generating tourism revenues of USD 15 billion compared with USD 35 billion in 2019. In the first two months of 2021, Dubai hosted only 810,000 international visitors compared with 3.27 million a year earlier. Hotel occupancy levels were at 60% compared with 81% in 2020 according to a JLL report (the UAE real estate market research, Q1 2021). The recovery in the sector will follow the pace of vaccination in originating countries, travel restrictions (such as the temporary suspension of passenger flights from India) and persistent health risks across the world. Moreover, the federal authorities' decision to implement fiscal discipline by cutting expenditure by 5.3% in 2021 (Dubai's budget foresees a 14% cut in headline expenditure, including a decline of 35% in capex and 12.4% in administrative costs) will weigh on the completion of new projects in the tourism and hospitality sector. More than 150 hotel projects are in the pipeline with over 50,000 rooms under development in the country, according to Fitch Solutions **(Chart 2)**.

Construction and real estate are hoping for the return of tourists (Dubai Expo) and expatriates

This fiscal discipline will thus contribute to the slow recovery in real estate and construction, which contracted in 2020. In the first quarter of 2021, average sales prices and rental rates in Dubai were still down by 5% and 10% from a year earlier, respectively, as per the JLL real estate market research in Q1 2021. In Abu Dhabi, average sales prices seem to have stabilized in the first quarter of 2021, while average rental rates were still 3.5% below their level in 2020. Nevertheless, the UAE remain an attractive hub thanks to their political stability and business-friendly environment. The authorities have recently allowed 100% foreign ownership of local companies to encourage foreign direct investments (USD 11 billion in 2020) and implemented new initiatives regarding visas for expatriates. However, the COVID-19 pandemic has caused a flight of expatriated professionals from the UAE, which could reach 900,000 jobs in a population of under 10 million, according to Oxford Economics. Consequently, the office and retail sub-segments' prices will remain under pressure in the upcoming period. Additionally, the office segment will continue to suffer from remote working policies. While the rise in online shopping will exacerbate this pressure, other real estate types that focus on entertainment and leisure will continue to benefit from household demand. Moreover, thanks to the Expo 2020, some delayed projects in the country could resume, which in turn would support construction sector growth in 2021.

Retail sales mostly dependent on tourism and the easing of restrictive measures

Rapid vaccination and recovery in tourism flows will positively affect retail sales, albeit gradually. After plunging by 14.3% in 2020 from a year earlier, private consumption is expected to grow by 1.1% in 2021. Government stimulus programs have so far supported this outlook. As of July 2021, the authorities have allocated around USD 9 billion (or 2.5% of GDP), most of which is addressed to companies rather than households. These measures include federal support by reducing fees, taxes and other charges on companies, credit guarantees, tax reimbursements, etc. For households, the government introduced payment deferrals on outstanding instalments and interests on loans and credit cards, water and electricity subsidies, as well as various banking facilities. Consequently, the rebound in private consumption will mostly depend on the vaccination progress and the reopening of the economy. Food and non-alcoholic spending, which has priority for consumers, should increase by 3.3% in 2021 compared with 2020, according to Fitch Solutions. Household goods is another segment that will benefit from the post-pandemic recovery: sales are expected to increase by 4.9% in 2021, after declining by 9.2% in 2020, supported by pent-up demand as consumers postponed their big ticket purchases during the pandemic. Having said that, due to changing consumption habits and the economic contraction of last year, consumers are expected to remain price sensitive and opt for more discount-priced goods. This may lead to an increase in turnover for companies having business lines in low and medium-end market segments.

II - Oil and transport are surfing on the recovery of the global economy and trade

Oil revenues remain cardinal in the UAE

Rising oil prices will also help the UAE's economic recovery as oil accounts for around 30% of GDP and 50% of fiscal revenues. So far, in 2021, oil prices have increased by nearly 50% from end-2020 to hover around USD 73 per barrel on the back of rising global demand and some supply disruptions. The UAE exports around 90% of their oil to Asia, which indicates that the economic recovery for major buyers, such as Japan, South Korea and China, will be crucial for the UAE's export revenues. The terms of the OPEC+ (the Organization of the Petroleum Exporting Countries and its allies) deal agreed on in April 2020 - to cut oil output by 10 million barrels per day (b/d) in May and June 2020 to support ailing oil prices - were penalizing the UAE. Their reference production and quota were at 3.168 million b/d and 2.7 million b/d, respectively. This was below the UAE's latest capacity of 4 million b/d, meaning the country was allowed to produce around 68% of its capacity compared with nearly 85% for Russia and Saudi Arabia. As a result, the UAE opposed the OPEC+ proposal for higher quotas in July 2021 asking for a review of their baseline.

After a breakdown in talks, the UAE and Saudi Arabia agreed on a new production baseline of 3.5 million b/d effective from May 2022 onwards. The UAE need their oil revenues to finance their economic diversification strategy and expand their capacities into other segments of the oil sector. Despite these short-term challenges, the outlook remains positive for the UAE oil sector, in line with some investment projects aiming at expanding the country's production capacity. Abu Dhabi National Oil Company (ADNOC) plans to increase its capacity by an additional 600,000 b/d at the al-Ruwais refinery. It also aims at additional gas and oil production through new investments, like in the Northwest offshore region, to meet the country's increasing demand for gas. In late 2020, ADNOC received the Abu Dhabi Supreme Council's (SPC) approval to invest USD 122 billion over the next five years to expand the UAE's hydrocarbon reserves. After falling by nearly 10% on an annual basis to 2.8 million b/d in 2020, the UAE's oil production stood at 2.68 million b/d as of June 2021. However, constraints on production and delays in starting the projects could weigh on the expansion of the country's current production capacity, and thus limit the revenues needed to finance the economic diversification in an environment where tourism revenues remain under pressure due to COVID-19 cases.

As a regional hub, the UAE benefit from the recovery in international trade

The resilience of the economic recovery from the COVID-19 crisis will also depend on the continuity of the regional hub role of the UAE. The country is the key centre of sea, land and air transport connections. Port of Jebel Ali is the world's ninth largest port and serves the Gulf, Africa and the Indian subcontinent. The rise in international trade volumes (Coface estimate at 11% for 2021) thanks to the reopening of economies and the acceleration in global vaccination efforts will support the UAE's trade, which is expected to reach USD 540 billion in 2021 compared with USD 478 billion in 2020. Hydrocarbon accounts for around ~~20~~% of total merchandise export revenues. As the country's key re-exported goods consist of mineral products, plastics, chemicals, metals and transport vehicles, they are very sensitive to global commodity prices. The recovery in all these categories will increase road freight during 2021 and 2022 by 3% and 2.9%, respectively, from a year earlier, as per Fitch Solutions. Stronger domestic demand and the organization of the Expo 2020 between October 2021 and March 2022 will drive demand for road freight, but also for airfreight.

The transportation by air of emergency healthcare products needed for the fight against COVID-19 will also boost airfreight demand in the short-term. Air freight tonnes-km is expected to increase by 7.5% in 2021 from a year earlier and by 6.9% in 2022. These positive dynamics will also support traffic in the UAE's key ports in 2021 and 2022. Container throughput in 2021 is expected to increase by 5.2% at the port of Khalifa and by 2.9% at the port of Jebel Ali. However, a rise in COVID-19 cases and a renewed wave of lockdowns in the global economy might weigh on this positive outlook. The small population of the UAE (10 million) leaves the country vulnerable to fluctuations in international trade volumes. The efforts from other countries in the region to become transport hubs increase the competition for the UAE. Saudi Arabia said it would invest USD 133 billion in the transport sector, which is a key pillar of the Kingdom's 2030 Vision plan. Qatar, which will host the 2022 FIFA World Cup, has also made significant investments within its Qatar Expressway Programme that should deliver over 800 kilometres of new roads across 78 projects. Conversely, the fiscal discipline that the UAE government implements in order to narrow the budget deficit may represent a drag on further investment opportunities in the sector.

Under these new global economic conditions induced by COVID-19, building new alliances has become more important to seize new opportunities. The efforts for normalization of the relations between the UAE and Israel can be analysed for this purpose. On the other hand, recent disagreements with Saudi Arabia during the OPEC+ talks could create new challenges.

III - Regional opportunities and challenges

Normalization of relations with Israel will bring opportunities

In September 2020, the UAE became the third Arab country agreeing to normalize its relations with Israel. The deal is thought to represent important opportunities for both countries in terms of trade and investments. For the UAE, this could be a key step to boost its diversification efforts. Tourism, defence, agriculture and energy would be the principal beneficiaries of the deal. Israel's crude oil and other liquids imports could reach 268,700 b/d in 2021, up 5.9% from a year earlier. The deal would allow the UAE to take a share of this extra demand and increase their oil revenues. The normalization of the ties would also allow the UAE to benefit from the Israeli technological and innovation capacity by investing in the high-tech sector of Israel. In late 2020, Abu Dhabi state investor Mubadala said that it was seeking potential technology companies, which represent opportunities with joint funds or joint ventures in Israel. In April 2021, Mubadala announced a memorandum of understanding to buy Israeli Delek Drilling LP's 22% stake in the Tamer offshore field. Both countries have also agreed to work together on artificial intelligence, anti-drone systems and big data analysis. In April 2021, the UAE announced the structuring of a USD 10 billion investment fund to invest in strategic sectors in Israel including energy, water, manufacturing, space, agro-tech and healthcare.

The two countries signed a bilateral agreement on economic and trade co-operation in June 2021, which will come into effect after its ratification by both governments. Authorities said that bilateral trade reached USD 675 million within 10 months of the signing of the deal normalizing the relations. The trade in agriculture remains particularly important for the UAE as arable land represents only 5% of the country's total land area. In 2020, the UAE imported USD 12.5 billion of live animals, vegetable products and other foodstuff.

The UAE are competing with Saudi Arabia over diversification and hub status

At the July 2021 meeting of the OPEC+, the strong opposition from the UAE to their reference base resulted in a confrontation with their long-time ally, Saudi Arabia. Although the disagreement was solved within the following days, bilateral relations remain relatively fractious. The spat coincided with Saudi Arabia's decision to restrict travel to the UAE, alongside Ethiopia, Vietnam and Afghanistan, over COVID-19 fears. However, the main reason behind the conflict between the two major countries of the region is actually related to their willingness to diversify their economies away from oil. Currently, the UAE holds the status of regional trade hub.

On the other hand, Saudi Arabia, whose economy depends more heavily on oil than the UAE (with 40% of GDP, 80% of export revenues and 65% of fiscal revenues coming from oil), has implemented the Vision 2030 strategy that aims at a national economic transformation to become a business and trade hub. Although the size of the UAE economy is around half of Saudi Arabia's, the former is able to attract an almost equal sum of capital flows from abroad. In 2020, total non-resident capital flows including foreign direct investments and portfolio flows to the UAE stood at USD 37.5 billion, compared to a total inflow of USD 31 billion to Saudi Arabia. In recent years, this situation has led Saudi Arabia to challenge the regional hub status of the UAE. In February 2021, the Kingdom announced its intention to cease its contracts with companies that have their regional headquarters not located in Saudi Arabia. In early July 2021, it announced that it had amended its rules on imports from other Gulf Cooperation Council (GCC) countries. The Kingdom decided to exclude goods produced by companies with less than 25% of their workforce in GCC from the custom exemption agreement. The decision also stated that goods made in free zones in the region would not be considered locally produced. Indeed, free zones represent a major driver of the UAE economy and allow foreign investors to take 100% ownership in companies. On their side, the UAE announced they would allow foreigners to own 100% of onshore companies, a move to boost investors' confidence and strengthen the country's position as the regional business centre.

Despite this growing competition, the conflict should remain limited to the economy. On the political front, they are expected to continue being allies, particularly in an era marked with uncertainties over regional stability. The ties between the GCC countries and the U.S. administration seem to be cooling down according to some political analysts (the U.S. no longer need Saudi Arabian oil and both countries can compete on the global energy markets, the U.S. government announced the end of U.S. military aid and intelligence sharing for the Saudi intervention in Yemen, etc.). Furthermore, the U.S. consider returning to the nuclear agreement with Iran, from which it unilaterally withdrew in 2018. These uncertainties should prevent a breakup of political ties between the two heavyweights of the region.

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