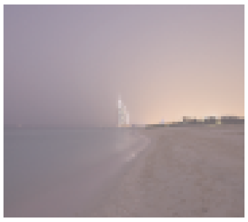


Dubai's field of dreams

THE GLOBAL FINANCIAL CRISIS HAS LEFT DUBAI WITH LITTLE ALTERNATIVE OTHER THAN TO TAKE THE PAIN OF THE DOWNTURN AND WAIT FOR OTHER ECONOMIES TO REIGNITE THE BOOM, AS **MUSHTAQ KHAN** REPORTS.

In the baseball movie Field of Dreams, starring Kevin Costner, the plot revolves around a cryptic message: "If you build it, he will come." At the risk of being flippant, the miraculous growth of Dubai was based on something similar: "If you build it, they will come." The leadership had an ambitious vision of what could be done and acted; the world, for its part, came to marvel and participate. However, events since the third quarter of 2008 seem to suggest that this strategy only works during a global boom.

Executive summary

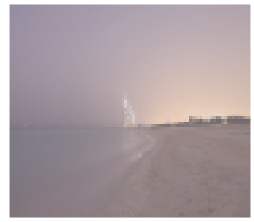
Infrastructure investment alone will not bring Dubai's growth rate back to above 20%. With a local population and indigenous economy too small to generate inward-looking growth, the emirate remains heavily dependent on regional and global growth for its economic fortunes.

DUBAI LEADS THE WAY For fast-growing countries like Qatar and the UAE, a virtuous cycle took hold during the boom years. The inflow of expats generated domestic demand, which in turn encouraged more investment. To implement this, more expats were required and so the cycle gained further momentum (see Figure 1).

Armed with ambitious diversification plans, ample surpluses, a focus on high-earning professionals and an environment designed to attract expats, Dubai quickly became a destination of choice. The ease of doing business, an efficient state machinery, world-class infrastructure, free capital flows, a pegged exchange rate and political stability all helped attract foreign investors, who sought to participate in the boom and also service the larger MENA (Middle East North Africa) region.

But foreign funding was a secondary goal. The prize was the expat expertise that would allow these countries to diversify away from hydrocarbons. Creating an environment for high-earner expats (and their families) had other synergies: the area became a magnate for tourists and business travellers, and more importantly, was wildly successful in luring foreigners (both resident and non-resident) to buy real estate. Dubai's lead was soon followed by other members of the GCC willing to offer this lifestyle.

Investors (both local and foreign) made full use of the available infrastructure to push Dubai's non-oil growth to 15-20% in real terms between 2004 and 2006. Despite aggressive infrastructure development, private investment soon overwhelmed what was available, and signs of overheating were increasingly visible: rising inflation, input bottlenecks and traffic congestion had all become policy challenges by early 2008. The Dubai authorities brushed the problems off as a sign of success.



However, the money pouring into the Dubai property market generated such high capital gains that speculative investments began to dominate. Since real estate and infrastructure development boost a host of allied subsectors, GCC countries had little incentive – and few policy instruments – to slow things down. Before the global credit crunch hit in mid-September 2008 with the demise of Lehman Brothers, little was done to contain speculative demand, which was pushing pipeline supply well above sustainable levels.

LIQUIDITY IS NECESSARY, BUT NOT SUFFICIENT By most accounts the region is currently grappling with the lack of liquidity, although the issue is not equally problematic across the entire GCC. This concern is highlighted by – and masks – a more fundamental set of problems: where does Dubai's real-estate sector find its floor and when does it rebound?

In recent years liquidity growth in the region has been very rapid, with the UAE and Qatar leading the pack. Driving this was private sector credit growth, which directly fed domestic demand and stoked the real-estate sector. In the UAE, lending peaked in September 2008 with year-on-year growth above 59%; Qatar peaked in July 2008, posting year-on-year growth of 57%. The sharp increase in property prices between the fourth quarter of 2007 and the third quarter of 2008 reflects the frenzied investment before the slump. The trajectory of credit growth in the UAE is shown in Figure 2.

It is interesting to note that Dubai's property boom was robust enough to brush off the reversal of speculative foreign exchange positions in April 2008. In other words, while the resulting build-up in central bank reserves increased domestic liquidity (Figure 3), the subsequent drawdown (which absorbed liquidity and pushed interbank rates up) did little to ease the pace of credit expansion.

Despite the $40bn fall in UAE's reserves in the second and third quarters of 2008, private credit growth actually accelerated, posting an increase of 22% in the same period. This rise was driven by real-estate lending, as speculators flocked to get a piece of the action. Banks, feeling comfortable with rising property values and the handsome profits that were being made, did little to ease the pace of lending or its exposure.

Even though interbank rates have fallen since November 2008, lending rates have not followed suit. This is not surprising as banks have built up such a large exposure to real estate that they are now erring on the side of caution. The need to build liquidity means competition to attract deposits, which has kept lending rates high to protect margins.

Although deposit insurance was provided in October 2008 to protect depositors, lending decisions (especially to individuals, but also to corporates) are now being hampered by an understandable risk aversion.

First, the economic downturn could increase non-performing loans, and provisioning against these would eat into profits. Second, increasing job insecurity among expats (who represent a large client base) could result in their departure. And third, high loan-to-deposit ratios translate to a real refinancing risk in current market conditions. In effect, the growing gap between the interbank and credit markets suggests there is not just a shortage of liquidity, but also uncertain demand conditions and risk-averse banks.

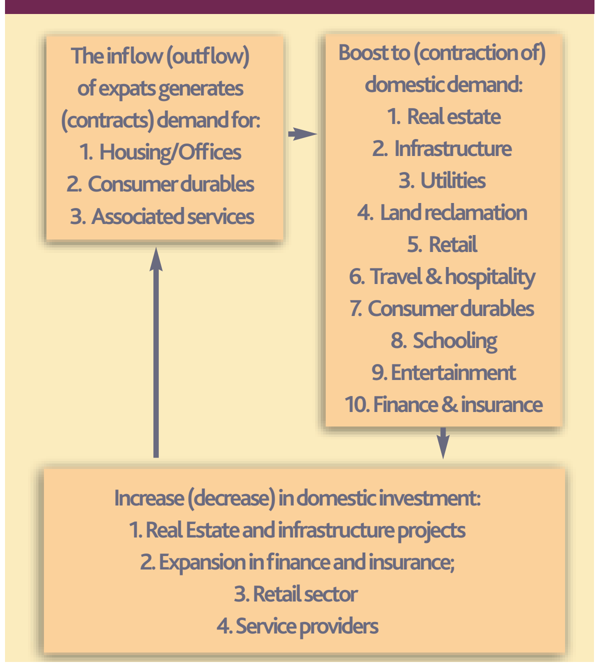
DUBAI IS CURRENTLY EXPERIENCING A BAPTISM OF FIRE. IF IT MANAGES ITSELF WITH STOIC RESOLVE, ITS STATUS AS A REGIONAL HUB WILL BE SECURED.

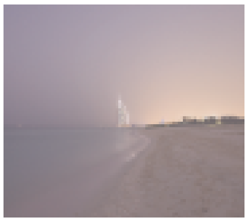
SPENDING THE WAY OUT OF THE PROBLEM Compared to the built-in stabiliser that moderates the fall in demand from people losing their jobs (because there is an even bigger fall in the income tax take and an even higher rise in welfare payments), for GCC countries with large expat populations, the downturn is being exacerbated by built-in destabilisers. However, GCC countries have ample resources for aggressive fiscal spending, especially for infrastructure. The issue is, will infrastructure spending save the day?

Policymakers in the GCC have customised their growth strategies to resource endowments, domestic compulsions and local attitudes. Historically, Dubai's growth was based on regional and global trade volumes, air travel between Asia and Europe, and a thriving duty-free port that relied on commerce rather than taxation. This made sense as Dubai has a small but very enterprising local population and has been the regional trading hub for decades. The initial steps in Dubai's recent makeover were taken by the late Sheikh Rashid al-Makhtoum, when he created the Jebel Ali Free Zone and launched Emirates Airlines in the 1980s, both of which were outward-looking investments in infrastructure.

The current leadership of Dubai has followed this successful formula, but has gone global. Nevertheless, Dubai's economy remains heavily dependent on regional and global growth; its local population and indigenous economy are too small to generate inward-looking economic growth.

Figure 1: Reversible growth cycle in the GCC





A comparison with Saudi and Qatar is useful to flesh out this point. Saudi's 28 million population (of which about 60-65% is below the age of 24) not only provides a strong base for the domestic economy, but also creates the urgency for fiscal spending to create sufficient jobs and housing for its expanding population; it also has ample overseas savings to finance this investment.

Qatar, on the other hand, has a minute population, but its economy is anchored to the world's largest gas field. With long-term sales of LPG that extend well into 2025, it has a guaranteed export market that is not hampered by OPEC production quotas or current global conditions. With a schedule of required infrastructure to meet these sales commitments, the investment momentum will remain strong irrespective of global conditions. Given the strong spillovers from flexible delivery of natural gas products (for example, construction, ports, shipping, finance, related services), Qatar's economic future is easily underwritten and quite independent of the current global slump.

Dubai, however, is different. Its status as a regional hub requires regional growth to sustain its service sector; it also needs an adequate number of foreigners willing to consume their savings and invest their wealth in Dubai. More simply Dubai's baseline demand depends more on regional growth than its neighbours do. Groping towards sustainable growth during a global recession will not be easy, especially after the expectations created in the past few years.

THE BIG QUESTIONS The view that supply will generate its own demand ("If you build it, they will come") will now have to be supplemented by the following questions: Build what? How large? When? And who precisely will come? These are relevant questions in a global recession. More to the point, Dubai's recent growth did not have to be carefully orchestrated or managed; the environment was such that the market made it happen.

But with the global market now in a tailspin, investors need more comfort. They need to know when banks will start lending; when the expat population will stabilise; how the government-owned master developers deal with the legal challenges from individual investors; when the cash supply-chain (receivables) begins to operate again. They will also want credible growth estimates to justify their investments; projections for the inflow of tourists and business travellers; whether regional markets will continue to accept being serviced out of Dubai; and most importantly, when the global economy will recover and individual investors return to Dubai. This is a tall order for any country.

THE VIEW THAT SUPPLY WILL GENERATE ITS OWN DEMAND ("IF YOU BUILD IT, THEY WILL COME") WILL NOW HAVE TO BE SUPPLEMENTED BY THE FOLLOWING QUESTIONS: BUILD WHAT? HOW LARGE? WHEN? AND WHO PRECISELY WILL COME?

Figure 2: Private credit growth in region

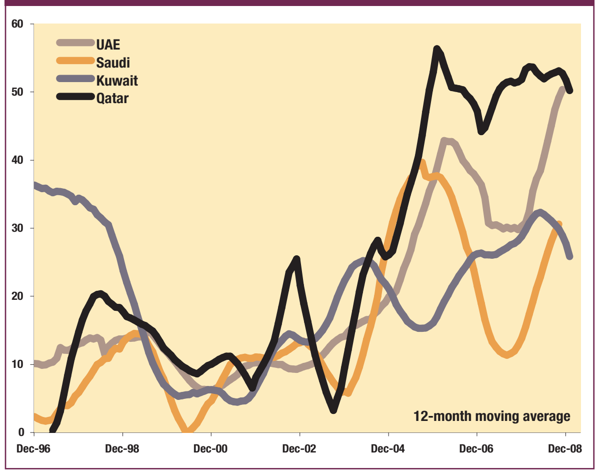
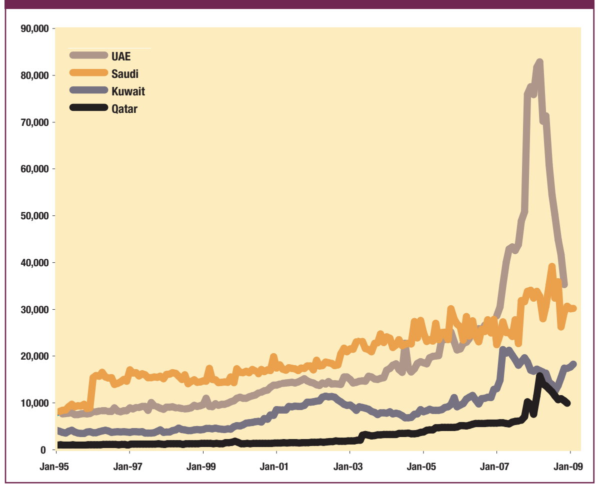


Figure 3: Central bank FX reserves ($m)



Dubai is currently experiencing a baptism of fire. If it manages itself with stoic resolve, its status as a regional hub will be secured. However, just like other hubs (Singapore, Hong Kong, Shanghai, London), Dubai will have to take the pain of the global downturn and wait for its neighbours to initiate the recovery.

More simply, its flair for branding and marketing should transition to a more realistic approach to economic management. Realising that what was possible in a boom is not possible in a recession and that (unlike some of its neighbours) it cannot spend its way out of the recession are important first steps. How it manages its debt overhang, the consolidation of Dubai Inc, the outflow of expats, the uncertainty in the real-estate sector and its relationship with other members of the GCC, will determine regional and global confidence in the city-state.

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