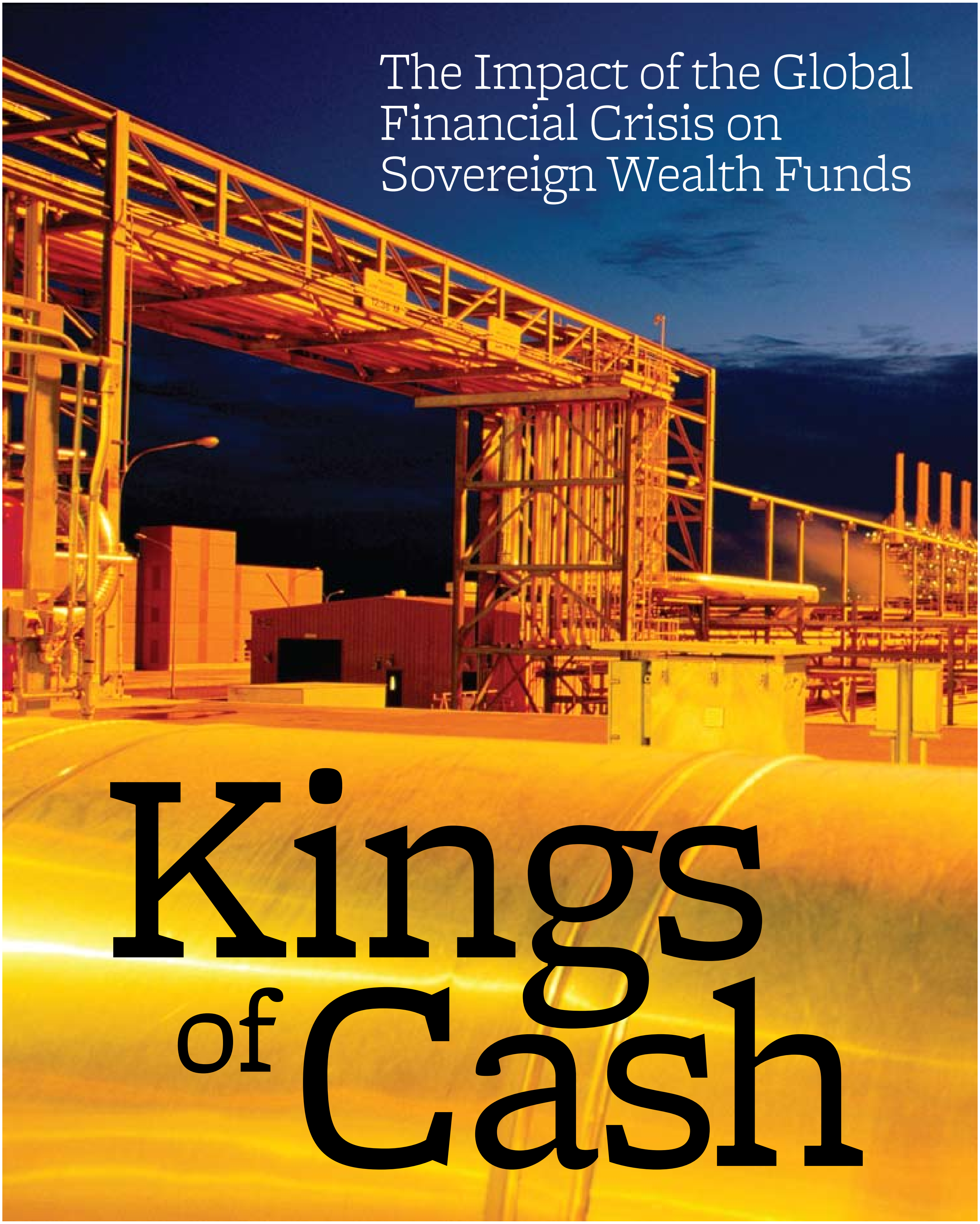
SPECIAL REPORT

Life After The Oil Bust

Time was when oil was being sold at $140 a barrel, and while consumers cringed at the high prices, the oil-rich nations of the Middle East prospered. The result was an economic boom that spanned industries ranging from financial services and real estate to tourism. Stock prices soared. Sovereign wealth funds snapped up choice assets around the globe. In late 2008, the oil bubble burst, the financial crisis began to roll across the world and boom turned to bust. How have the combined effects of the global slowdown and low oil prices affected the economies of the Middle East? In this special report, Knowledge@Wharton and Khaleej Times explore how businesses in the region are coping with today's brutal reality.



The Impact of the Global Financial Crisis on Sovereign Wealth Funds

Kings of Cash

The worldwide financial crisis has raised many questions about the efficacy and role of sovereign wealth funds (SWFs), the large, state-controlled investment funds typically carrying a mix of assets. Some of the largest funds reside in the Middle East, and in the wake of the financial meltdown, many of them have become risk-averse and are turning inward to stimulate their own slumping economies. Knowledge@Wharton asked Wharton faculty and other experts discuss this change in SWF strategy and what it means for long-term economic stability.

The worldwide financial crisis has raised many questions about the efficacy and role of sovereign wealth funds (SWFs), the large, state-controlled investment funds typically carrying a mix of assets. Some of the largest funds, as a proportion of GDP, reside in the Middle East — a prime example is Abu Dhabi Investment Authority, with $875 billion in assets. In the wake of the financial meltdown, most of the SWFs in the Middle East have either stopped investing or have become very risk-averse. Instead, they are now turning inward to stimulate their own slumping economies — and thus reducing purchases of foreign assets. The need to expand government spending to moderate the hit on local economies, along with lower oil revenues, is absorbing most, if not all, of any surpluses at home.

Have SWFs in the Middle East been successful in bringing some economic stability and diversification to their domestic economies? Knowledge@Wharton asked Wharton faculty and other experts to weigh in.

A History of Competitive Returns

Generally passive investors with little significant interaction with the management of their investment targets, SWFs in the Middle East have largely followed a long-term, conservative investment strategy.

It is widely accepted that traditional reserve management by central banks, usually heavy on dollar-denominated Treasury bill holdings, generate low returns and sometimes actual losses in real terms over the longer run. Yet a typical pension fund portfolio of 60% stocks and 40% bonds — at least up until the current crisis — was expected to provide much higher returns in the long term. SWFs that followed the pension-portfolio investment approach generally saw higher returns, which are more consistent with returns generated by oil investments and much higher than funds that followed the central bank investment model. Now, however, the global crisis has made it clear that conservative SWFs that placed the bulk of their investments in less risky, liquid securities performed better than those that invested aggressively, an approach mostly tied to the recent oil boom. On balance, most Middle Eastern SWFs, like their peers elsewhere, are estimated to have lost up to 30% of their portfolios in the precipitous decline in global equity markets.

> “The last 30 years have been so good for equities that we have been lulled into thinking they must inevitably go up

Yet, “if they have only lost 30%, they are doing pretty well relative to most other institutional investors,” notes Wharton finance professor Franklin Allen. “I think the main lesson is that downside risks are definitely there. The last 30 years have been so good for equities that we have been lulled into thinking they must inevitably go up. This is a stark reminder of how much they can lose.”

What are the likely effects going forward? Howard Pack, a Wharton professor of business and public policy, says it is too early to have a firm sense of the impact of the recent oil price decline on capital flows, but “it is certain that many of the governments such as [that of] Dubai have significant problems. Given that there was a substantial commitment of resources to diversify the economies, and that this effort was far from complete before the precipitous decline in crude prices, it is pretty certain that all of the Gulf countries will suffer from a significant slowdown in growth and substantial drawing down of accumulated reserves.” He adds that the full effect of the drop in oil prices will not be known for about six months when more data be-

comes available, "but it would be very surprising if both the slowing of growth, perhaps a significant downturn, and large scale loss of reserves are not occurring."

Not all SFWs suffered equally, however. Libya's SWF investments of $50.6 billion have returned profits of about $2.4 billion since 2006, with 78% of the portfolio invested in short-term financial instruments and only $8 billion in equities, spread mostly across North Africa and Asia. Similarly, the Saudi Arabian Monetary Agency (SAMA), which acts as both the country's central bank and wealth manager, is understood not to have lost as much as others in the financial crisis thanks to its conservative dollar-and-bond-heavy portfolio, with only a 20% exposure to equities.

One important risk management lesson in all this is clear. "If your export revenue stream is correlated with global growth, not all of your wealth should be invested in assets that are also likely to be highly correlated with global growth. For funds with a stabilization mission, the value of an asset in bad times matters far more than its value in good times," noted the Council on Foreign Relations in a working paper titled, "GCC Sovereign Funds — Reversal of Fortune," published in January. (GCC stands for the Gulf Cooperation Council, a group of six Arab nations — Saudi Arabia, the United Arab Emirates, Oman, Bahrain, Qatar and Kuwait.)

Wharton finance professor Richard Herring notes that since SWFs are long-term investors, the fall in asset values should offer an opportunity to reallocate some assets in a way that will be highly profitable in the long run. At the same time, "I'm sure they will be looking for new and better ways to diversify and hedge their investments, since many of the anticipated diversification measures simply didn't work in a down market. They learned that the only thing that goes up in a falling market is correlations." Just how Middle East SWFs change their investment patterns in the future "is the key issue," notes Allen. "It depends a lot on the governance in the country whose wealth they are investing. I think they will come under considerable pressure to reduce risk taking and to invest mainly in bonds."

Varying Investment Strategies

Across the world, there are an estimated 53 SWFs of varying sizes and mandates, with an estimated $3.8 trillion in assets as of early 2008. GCC funds are the wealthiest, and according to figures from management consulting firm Booz & Company, they make up about 40% of the total. In the Middle East, SWFs' critical stabilization role came into play in the 1990s when oil prices fell to around $10 a barrel. For example, SAMA, which has been accumulating surplus oil revenues since the 1970s, helped fund expansion in Saudi Arabia throughout a decade of low growth. In the aftermath of the first Gulf War, the Kuwait Investment Authority (KIA) emerged as the main driver for rebuilding the country's war-shattered economy.

Until the 1990s, Middle Eastern SWFs were primarily risk-averse investors of foreign exchange reserves that injected funds back into the local economy only in times of need. But then, several significant, regional political events highlighted the need for the region's economies to diversify revenue streams and reduce their dependence on oil. With fewer immediate possibilities at home, these SWFs started investing in relatively riskier assets abroad, such as equities and real

estate. The trend gained strength as oil prices started to rise at the beginning of the new century, and ran up further support through the expansion of globalization.

Given the condition of world financial markets, it is not surprising that SWFs might be more wary today of making investments abroad, Don DeMarino, co-chairman of the National U.S.-Arab Chamber of Commerce, notes. "The sovereign funds are financed from retained earnings. At $40-per-barrel oil, there are other, more pressing local calls on those retained earnings. But I think of equal if not greater importance in explaining the inactivity of the funds during the meltdown is the treacherous political environment for them in the West. All the Gulf funds vividly remember the Dubai Port World debacle. The prospect that the funds might again encounter another firestorm — this time of 'Arabs buying up assets too cheaply' — is a real concern."

With oil prices rising, the number of SWFs grew and new entrants sought not just to serve as ballast for economic stability and investment diversification, but also to maximize returns. That drove most of them to even riskier investments. Even some of the older, more conservative institutions were sucked into the general shift of national savings from bonds, which had been the traditional style of reserve management by central banks, to value- and return-driven equity investments, once thought to be the appropriate domain of private equity and hedge funds. Examples of aggressive investors among Middle Eastern SWFs would include the Abu Dhabi Investment Authority, Kuwait Investment Authority and Qatar Investment Authority (QIA).

QIA, however, also belongs to the club of SWFs that emerged during the oil boom with a mandate to complement ambitious domestic socioeconomic development plans. These proactive SWFs seek investments at home and abroad will underpin economic development, boost knowledge and technology transfers and leverage cost advantages. These more proactive SFWs also seek more involvement in managing the companies they invest in. Other examples of proactive investors include the U.A.E.'s Mubadala Development Company and Dubai Investment Corp.

Taking the lead from Asian SWFs like Singapore's Temasek Holdings and Malaysia's Khazanah Nasional Berhad, Mubadala is probably the most successful of the proactive SWFs in the Middle East. Its 5% stake in Ferrari brought with it the potential for increased tourism to Abu Dhabi in the form of the Ferrari theme park. More recently, Mubadala has invested $8 billion in an R&D partnership with General Electric, which in turn has committed to increasing its investments and technology transfers to the U.A.E.

Whatever investment strategy GCC SWFs ultimately adopt, economists agree that the region will have to look beyond its oil wealth for future growth. Herring notes that many of these economies have a finite pool of natural resources which they are converting to better diversified assets.

Over the long term, those assets can continue to produce income once the natural resources have been exhausted. "Some of the opportunities may be within their own economies, but generally they are so small relative to the world economy that it's unlikely a very large share should be devoted to domestic investments."

Empowering Others through Information

> The Gulf region is not a monolith, so women's rights vary from country to country. I say without hesitation that women in the UAE in terms of their rights have become a model for the region.
>
> **Najla Al Awadhi**

As deputy CEO of Dubai Media and the youngest member of the United Arab Emirates parliament, Najla Al-Awadhi has quickly risen to prime leadership positions in a society that is still largely male-dominated. A graduate of the University of New Hampshire in the United States, she has been outspoken about women's rights, and advocates a progressive yet culturally relevant media. In an e-mail interview with Knowledge@Wharton, Al-Awadhi talks about her own role models, why it's still hard for women in the Middle East to break out of traditional gender roles, and what advice she would give the next generation of women business leaders in the region.

Knowledge@Wharton: What are the principal barriers that women face in rising to senior executive positions in the Middle East? How did you overcome them in your case?

Najla Al-Awadhi: I believe the key challenges facing women in this area stem, at a macro level, from the negative or limited perceptions that exist in a male-dominated [society] about a woman's overall abilities, particularly in the public domain. At a micro level, I believe the challenges begin in our homes. They begin with how we raise our children, since gender roles are taught to children from a young age. The dominant trend is not to raise daughters to think like leaders and drivers of change or progress; girls are nurtured primarily to think of marriage, children, or [of working in] specific industries like education and medicine. They are not raised to be bold leaders. Boys are primarily raised to see women in the same light. These gender roles transcend the home and become part of the social practices that girls and boys carry with them once they become adults. I was blessed to have parents who are very progressive, so gender was never an issue in my upbringing. I was taught that I have the same rights and responsibilities as my brothers, and that the core values to human progress were strong morals, faith, education, vision, determination and a solid work ethic. I carried these principles with me throughout my career. In addition, our government in the UAE has created many opportunities for women, so I had access to opportunities and was given the chance to prove myself.

Knowledge@Wharton: You graduated from the University of New Hampshire [in the United States]. How difficult was it for you to adjust to the business environment of the Middle East?

Al-Awadhi: It was not difficult at all, because I am from the Middle East, so I understand my society's culture. Of course, it is not always easy to bring back best practices from other countries -- in this case, from the U.S. -- and just apply them at work. This takes time, because you need to address the issue of mindsets, and sell the idea of change and progress. You need to prove to people that things can be done better and that the results will be in their interest.

Knowledge@Wharton: How did you become interested in media?

Al-Awadhi: I have always been interested in helping my society and my region. I have always been interested in advancing the rights of Arab/Muslim women, as part of my belief in human rights, so I knew that awareness -- or the lack thereof -- was at the heart of [many] is-

sues. I also understood that mass media represents a powerful platform to create that awareness, and that's why I decided on media.

Knowledge@Wharton: As you advanced in your career, who were your role models?

Al-Awadhi: In terms of my work ethic, my role model is [His Highness Vice-President and Prime Minister of the UAE and Ruler of Dubai] Shaikh Mohammad bin Rashid Al Maktoum. He has a will of steel; he has great vision; he empowers his people; he has the courage to take action and try new things that others deem impossible, which is why Dubai has become an international hub -- and he is very humble. My parents have also been role models for me; they are so progressive in their way of thinking. I wouldn't be who I am today if it were not for the way they raised me.

I also admire the wife of the prophet Muhammad, Khadija the great. While she lived more than 1,400 years ago, as an Arab and Muslim woman she was revolutionary for her time. In fact, in many ways, she is revolutionary even in our time. Her rebellious, wise and driven spirit has always inspired me.

Knowledge@Wharton: How is the oil-price decline affecting the media business in the region? Have there been any cutbacks, either in print or television, as we see happening in the West?

Al-Awadhi: We live in a global world, so I believe all industries are now making corrections and working on doing things better to meet the challenges of the market. We have not had to cut back or lay off employees in our company.

Knowledge@Wharton: What would you say is your biggest business challenge, day-to-day?

Al-Awadhi: Strategically developing human capital in an institutionalized way, and diversifying sources of income. We need to continuously work to make our operation more efficient, people centric and value driven.

Knowledge@Wharton: How would you compare the media environment in the UAE to what you have experienced elsewhere? What's on your to-do list as a top priority?

Al-Awadhi: I don't like to compare, because every society is at a different stage of development. [The media environment in the UAE] has unique needs, and the media reflect that. We always look at best practices and work to adopt suitable practices. Original productions and developing the Emirates' human capital are at the top of my list of priorities.

Knowledge@Wharton: In your columns, you have been quite outspoken in defense of women's rights, encouraging women to hold political office, have a successful career, etc. How would you frame the issue of women's rights in the UAE and in the Gulf region as a whole? In your view, are there significant differences between what women see as their "rights" there versus in the West?

Al-Awadhi: We don't look at the Western model as what we want to emulate. Yes, we want to learn from the experiences of every society and their best practices, but we are developing our rights according to what we believe is appropriate for our society. The Gulf region is not a monolith, so women's rights vary from country to country. I say without hesitation that women in the UAE in terms of their rights have become a model for the region. This does not mean that we as women in the Emirates have achieved our targets, but we are certainly moving forward without hesitation.

Knowledge@Wharton: What is on your agenda for the Federal National Council? If there is one thing you would like to accomplish during your term, what would it be?

Al-Awadhi: In our four-year term, I would like to ensure that we strongly represent the issues [that are] critical to our people. I am especially focused on the areas that fall under the committee I am [on], which covers education, media, youth and culture.

Knowledge@Wharton: You were on the Human Right Committee in college: Are you continuing to work on Human Rights issues, and if so, what in particular?

Al-Awadhi: I believe through my work in media and parliament, when I can create awareness about critical issues facing us as people -- [perhaps] through the production of programs that address [those issues], or through parliament debates -- I believe that this is a humble contribution toward empowering people through information. This contributes to creating a more educated and active populace, which is critical to the advancement and maintenance of human rights.

Knowledge@Wharton: How important is work-life balance to you? How do you define it and achieve it for yourself?

Al-Awadhi: It is critical to balance everything and unhealthy not to. I believe in defining in your heart and mind what is important in your life and what will still be important in your life 40 years from now, and then prioritizing based on that. After you have done that, the rest is all about solid time and task management.

Knowledge@Wharton: What do you do outside of work?

Al-Awadhi: I spend lots of quality time with family, and I also do a lot of reading. I [go to the] gym, [and do] pilates, yoga and outdoor sporting activities. I also spend time writing, and designing abayas (women's robes).

Knowledge@Wharton: What advice would you give to young women who want to succeed in business in the Middle East?

Al-Awadhi: When you start your career, don't think about job titles or pay. Focus on being in an industry that you are passionate about; on learning as much as possible; and on working harder than anyone else. It is only when you challenge yourself and get out of your comfort zone that you truly grow. Always respect yourself, and respect others -- from the CEO to the garbage collector. Humility and self-respect are critical; these attributes contribute to the creation of healthy corporate cultures.

Be diplomatic. Never give up. Always think positively. Be solution driven. Empower good people, and be a team player. Do not allow yourself to be defined by your gender; you can do whatever you set your mind to. Forget the word "impossible." Have a vision for where you want to be in your life, and set a practical plan to get there. Always review this plan to make sure you are moving closer to your targets. Be flexible, because you will face challenges. This is where positive thinking always becomes the force that drives you forward and makes you see the challenges as opportunities.

Time for Transparency

What will It Take to Improve Corporate Governance in the Middle East?

As the financial crisis roils the world economy, scandals are surfacing in various parts of the world. In the Middle East, the latest scam to hit the headlines involves Nabil al-Boushi, an Egyptian broker who is accused of swindling investors in Dubai and has been termed the "Egyptian Madoff." As is usual in such circumstances, demands are being heard for improving corporate governance and financial regulation in the Middle East. This, however, is an enormous task. A 2008 survey found that barely 3% of publicly listed companies and banks in the region have good corporate governance practices. Can this situation be turned around? Experts from Wharton and elsewhere offer their suggestions.

Last month, news broke that Nabil al-Boushi, an Egyptian brokerage owner based in Dubai, swindled his clients – including several celebrities — to the tune of millions of dollars. Among other things, he is thought to have used money from Egyptian investors to pay off investors in the United Arab Emirates, while falsely claiming to have had relationships with top government officials in the region. His doings brought to mind another person in the news: Bernard Madoff, the former chairman of the NASDAQ stock exchange, who has been charged with running a $50 billion Ponzi scheme and duping numerous well-heeled investors, both in the United States and elsewhere.

As al-Boushi's dealings were brought to light, he was quickly termed the "Egyptian Madoff" in the press – and in both cases, the finger pointing began. As if that weren't enough, investors in the region had already been spooked by the ongoing long-term probe into allegations of bribery and corruption at Dubai Islamic Bank and its subsidiaries, which sent more than 20 executives to jail.

To what extent might strong and enforceable financial regulations and good corporate governance standards have kept these frauds from happening – or at least limited their impact? How important are such regulations to help buoy investor confidence in the Middle East, especially since oil prices have taken a nose dive? Knowledge@Wharton asked several experts for their take on this timely issue.

Can't Stop Believing

Just having rules in place – in the Middle East or elsewhere — doesn't mean these things won't happen, says Wharton legal studies and business ethics professor Ann Mayer. "The United States supposedly is well regulated, but we see that numerous huge Ponzi schemes have been conducted without detection in this country." The Madoff scandal, for instance, happened despite numerous investigations into the funds in question, as reported in the press. "The Madoff [scheme] probably occurred because regulators didn't do what they were supposed to," notes Wharton finance professor N. Bulent Gultekin. "As long as people continue to 'believe' [the sales pitches], such scandals will continue to happen."

In the Middle East, each country is at a different stage of development, explains Gultekin. "You often see such problems in financially-repressed markets, where there isn't much room to maneuver. They

are also common during the process of liberalization in the case of emerging markets or deregulation in more developed countries. It can be very easy to swindle people."

Howard Pack, professor of business and public policy, economics and management at Wharton, says, "Given the huge amounts of capital account surpluses that have been accumulated in the Middle East, perhaps a trillion dollars, it would be difficult to enact regulation that would prevent Ponzi schemes or other malfeasance. It is unlikely that local expertise exists, any more than in the U.S., to enforce these regulations. Standard codes of conduct according to the OECD or other international sources would be difficult to enforce."

Several countries in the region are trying to promote best practices, adds Gultekin. "Dubai is trying to bring more of an Anglo-Saxon structure to its financial markets. And in areas of the region [that are compliant with Islamic] Sharia laws, there may be fewer problems because some arbitrary structure has been conceived out of traditions. But people can always find ways to beat the system."

Survey Findings

A 2008 survey covering corporate governance practices in the Middle East and North Africa (MENA) bears out the concerns of Wharton faculty and other experts. Conducted by the Washington, D.C.-based International Finance Corporation (IFC) and Hawkamah, a corporate governance institute in Dubai, the survey found that while the vast majority of publicly listed banks and companies in the MENA region believe corporate governance to be vitally important, more than half – 53% — of the participants did not know what the expression means; they confused corporate governance with corporate social responsibility or with corporate management.

Among the most significant findings of the IFC-Hawkamah report was that "not a single responding bank or listed company could claim to have applied corporate governance reforms holistically, i.e. to have followed a set of 32 indicators which could reasonably qualify a bank or listed company as following 'best practice.'" The survey found that while not a single company followed best practices, only 3% had "good practices," and more than 90% had emerging practices. (The latter are defined as firms that have implemented between eight and 15 of the 32 best practice indicators.) For example, among the companies surveyed, only 36.5% had a company level code for corporate governance or ethics policy.

> Given our superior economic fundamentals, we should have outperformed other emerging markets, but the lack of transparency — both on a macro and micro level — erodes the confidence of investors

The IFC-Hawkamah researchers recommended that in order to improve the state of corporate governance in the MENA region, several changes are needed. For starters, chairmen of the board and corporate CEOs "should set the tone at the top and champion corporate governance reforms, with the support of a professional company secretary," they wrote. "The two largest barriers in implementing corporate governance reforms are a lack of internal corporate governance knowÐhow, as well as the unavailability of external qualified specialists in the region."

A Financial Times article about this survey noted that companies in the Middle East have often paid the price for poor corporate governance practices, which result in a lack of transparency. The newspaper quoted Ali Al Shihabi, head of Rasmala Investments, a Dubai-based asset manager, who identified opacity as "one of the main reasons why Gulf-wide stock markets have underperformed emerging markets indices over the past 12 months. Given our superior economic fundamentals, we should have outperformed other emerging markets, but the lack of transparency — both on a macro and micro level — erodes the confidence of investors," he told the newspaper.

A Checklist for Investor Confidence

Wharton's Gultekin believes that several standards are important for maintaining international investor confidence. "On the corporate side, full disclosure, international accounting standards and protection of minority shareholders are crucial. On the financial side, you need a good watchdog, such as the U.S. Securities and Exchange

Commission." He adds that the SEC failed to detect the Madoff scheme despite some advance warnings – which points to the weakness of the U.S. regulatory model. Still, for each Madoff scheme that might slip through the cracks, experts acknowledge that U.S. regulators do uncover several fraudulent activities each year and penalize their perpetrators.

Gultekin further notes the need for regulators to function with autonomy. "You also need the watchdog to be free of the political structures, and you need a framework for independent entities," he explains. "If [culturally] people are not used to being independent of the political systems, this may be difficult to accomplish." Moreover, autonomous organizations must exist to enforce the legal structures. "And you need to educate people. In many countries, the financial markets connote gambling, so you need strict rules. You need to keep private information private yet provide transparency – both are needed for a proper financial market."

A small group of people may treat the market like a casino, notes Gultekin, but if everyone acts like a speculator, the markets will not function the way they should. "If people use the stock market for speculation decoupled from reality, how do you regulate it? Probably the same way you would regulate gambling." The countries in the Middle East, Gultekin says, will need to have high standards to preserve investor confidence and keep the markets running effectively.

Standards vs. Behavior

Corporate governance is tricky, says Gultekin. "Just by applying laws themselves, you don't achieve what you want. In the U.S., we have the Sarbanes-Oxley Act [which established standards for public companies and accounting firms], but if things worked correctly, we wouldn't be in the financial mess we're in. In the Middle East, my conjecture is that you need to involve the customs and cultures of the countries as well."

Gultekin cites Japan as an example: "The country had a different corporate culture which reflected its value system and structure. Japan was successful for a long time, but it had trouble integrating its financial markets with the rest of the world." A major issue is behavioral change. "Simply adopting rules without changing people's behavior won't get you anywhere. The laws are necessary but not sufficient." In the Middle East, many companies are family held, and as a result, their governance structures are different than those of companies in the U.S. and elsewhere in the West. "Even within the region, there is little homogeneity," notes Gultekin. "Bahrain is different from the U.A.E.; Saudi Arabia is different from Egypt. Ownership structures are different; the way people conduct business is different. For instance, in an environment where reputation is culturally crucial, it may be possible to encourage ethical behavior even beyond what is legally required."

These factors may make it difficult to implement uniform corporate governance norms throughout the region. Still, some initiatives to drive change have already begun. In November, for example, IFC and Hawkamah, authors of the 2008 report, announced a partnership to offer advisory services in corporate governance to family-owned businesses in the MENA region. In addition, the Dubai-based Mudara Institute of Directors has launched an initiative to educate board members of companies about best practices in corporate governance.

If some of these initiatives pay off, companies and shareholders alike should benefit – as will the Middle East. They might not prevent future Madoffs and al-Boushis from ripping off investors, but they could at least ensure that such scandals are fewer in number.

A ‘Downward Spiral’

Gulf Region Real Estate in the Era of Cheap Oil

In 2002, oil prices in the nations of the Gulf Cooperation Council (GCC) stood at $25 a barrel. By July 2008, that number had jumped to $147. The increase enabled the GCC’s six member countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) to almost triple their gross domestic product — from $350 billion to more than $1 trillion. Now oil prices have fallen again — this time to below $40 a barrel — and the oil boom and bust have come at a steep price, especially for Dubai.

In 2002, oil prices in the nations of the Gulf Cooperation Council (GCC) stood at $25 a barrel. By July 2008, that number had jumped to $147. The increase enabled the GCC’s six member countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) to almost triple their gross domestic product – from $350 billion to more than $1 trillion, according to the International Monetary Fund.

The increase in oil prices widened the fiscal surplus of GCC economies to a record high. From 2002 to 2008, an estimated $1.5 trillion in surplus was accumulated, leading GCC members to embark on a mission to diversify their economies. The focus was on developing and improving infrastructure overall, which had suffered from decades of under-investment. Government efforts concentrated on developing oil and gas, the power sector and transport infrastructure. The private sector, for its part, concentrated on residential, commercial and tourism real estate projects.

As Don De Marino, co-chairman of the National U.S.-Arab Chamber of Commerce, notes, "Real estate in the Gulf is fundamentally a private sector game. Actual recourse lending is pretty limited, so real estate investors who borrow from the banks do so personally. The rest of the investment funds come mostly from the earnings from other businesses."

Dubai-based developers Emaar and Nakheel led the region by launching the world's tallest tower, largest shopping mall and largest manmade island, along with a string of luxury hotels and residential developments. Other developers, such as Saudi Arabia's Kingdom Holding, jumped on the bandwagon by launching massive mixed development projects in Jeddah and Riyadh.

However, the oil boom — and subsequent bust, with a decline to below $40 a barrel — came at a price. The strong project pipeline caused a surge in the expatriate population, as people came to fill open jobs. This led to increased domestic demand and an acute housing shortage. Such factors, coupled with the weak U.S. dollar and high commodity prices, raised average inflation in the GCC to about 13% year-on-year in June 2008. The oil windfall expanded domestic credit growth but was intensified by the inflow of hot money. (All the GCC currencies, with the exception of Kuwait, are pegged to the U.S. dollar.) The large current account surpluses and high inflation resulted in speculative inflows looking for currency revaluation.

According to widespread press reports, the impact has been especially hard on Dubai. As Ashwin Verma, a partner at Black House Development Company, a New York-based real estate investment and development firm, notes: "Dubai went from a trading economy to a real estate economy. Unlike [oil-rich] Abu Dhabi, most of Dubai's GDP comes from real estate. Real estate is a game of credit and lever-

age. You can't make money in real estate without that."

Dubai is one of seven emirates and the most heavily-populated city of the United Arab Emirates. Abu Dhabi, a sister emirate and the largest by area, is the capital of the U.A.E.

Another 'World's Largest Mall'

The possibility of super profits in real estate attracted companies and individuals alike. The easy availability of liquidity enticed property developers to launch such highly-ambitious projects as an underwater hotel, a mile-high tower, a kilometer-high tower, a revolving high-rise apartment, yet another "world's largest mall," massive theme parks, a floating city and a twisted residential tower.

While the governments channeled most of the surpluses into their sovereign wealth funds, the government-linked companies and the private sector tapped international markets to finance domestic projects. Lulled by a false sense of security brought by bulging state coffers, these companies integrated leverage into their business model. They regularly went to the international debt markets to fund their construction plans. The generous mortgage finance and attractive rental yields due to the housing shortage sparked investors' interest in real estate, while the relaxation of strict foreign-ownership-of-property laws in countries such as the U.A.E., Bahrain and Oman added another impetus.

As the list of elaborate projects grew, so did the line of investors queuing overnight to book properties. Residential properties were sold even before they were built solely on the basis of blueprints, and strong demand led to massive speculation in the secondary markets for these off-plan properties. In some cases, properties were sold even before the developer had approval from the respective government departments. The hype brought international attention, and that, in turn, drove overseas investment.

Flipping of properties became the most profitable venture, sending property prices to dizzying heights. What was supposed to be an auxiliary support for economic diversification efforts become the main pillar of it. The construction contagion spread from one country to another as real estate and tourism development became the common denominator of the GCC diversification strategy.

In January 2008, the projects planned or underway totaled $1.6 trillion. This had increased to $2.54 trillion by January of 2009, with Saudi Arabia and the U.A.E making up 70% of the projects, mostly in the real estate, leisure and infrastructure sectors.

However, as the global credit crunch froze the international financial markets, the hot money evaporated. The drastic $100 slide in crude oil prices eroded investor confidence in the region. The tourist arrivals slowed to a trickle during the peak winter season as a recession engulfed major economies. In a spectacular swing, abundance of liquidity in the beginning of 2008 had vanished before the year end.

The lack of liquidity forced developers to put many projects on hold, and speculators were left with inflated assets that could not be sold, as banks tightened mortgage lending criteria. Most of the projects have either been cancelled or put on hold for lack of funding. In Dubai, construction cranes — once jokingly called the national bird – have mostly been idle. According to Proleads, a firm that tracks construction projects, about 150 projects in the GCC were on hold in January this year, about 88 of them in the U.A.E. alone.

Given what he calls "some consistent overbuilding in the Gulf," the "current very steep decline in oil prices is playing havoc with virtually all real estate projects," says De Marino. "If there is a bright spot, it's that the banks are not sitting with the properties. But clearly the downside is the private cash tied up. The fact is that no one locally saw just how rapidly oil prices would collapse."

Of course, the overbuilding and speculation are not confined to the Gulf. "Every country and city in the world is in the same spot — Miami, China, even New York," notes Verma. "However, Dubai is not supply-constrained like New York or London, so prices can fall much further."

Heading for the Exits

In explaining why the problem is magnified in the region, Verma points to three factors. "As the real estate sector unwinds, there are fewer jobs, and people are forced to leave because they cannot stay without a job. Fewer people means less demand for real estate and fewer shoppers at the mall. It becomes an obvious downward spiral."

In addition, he says, "bankruptcy and debt laws in Dubai are very harsh. It makes sense in markets [not characterized] by the wide adoption of credit for growth. However, so many buyers have [been using] credit without knowing the legal implications of default. Now that they know, people are leaving, which once again translates to fewer buyers, less shoppers – again, a downward spiral."

Finally, he notes, "monetary policy is important. In the U.S., the government can print trillions of dollars and amortize over the largest economy in the world. They can slash interest rates to practically zero to reduce debt and the cost of servicing debt. In Dubai, they can't. That's why they need Abu Dhabi [to help]. They can't lower interest rates. In fact, interest rates are going up, further squeezing borrowers and stifling any remaining growth. This further increases [the number of] defaulters, again driving people out."

Many leading contractors and developers have laid off employees and adopted a wait-and-see approach to future projects. The retrenchments may have significant repercussions on domestic demand.

In 2007, Dubai's construction and real estate sectors employed about 50% of the total workforce. Moreover, OPEC's December cut of 4.2 million barrels a day will also affect the GCC countries. The cuts translate to about a 10% contraction in the oil sector of Saudi Arabia, Kuwait and the U.A.E. Meanwhile, the Algerian oil minister has said that OPEC may announce further production cuts to support the prices on March 15. Lower oil prices, reduced oil production, outflow of expatriates and falling demand for goods and services are expected to slow GDP growth to a bare minimum.

Meanwhile, the huge amount of wealth destroyed by the crash in the GCC stock market has hurt investor sentiments. The GCC stock markets collectively lost more than $600 billion in market capitalization last year. According to the IMF's most recent forecast, the GCC economy is expected to expand by 3.5% in 2009 compared to 6.8% last year. After years of heady growth, reality is returning to the GCC real estate market. Recent surveys indicate average home prices in the GCC falling by 10% to 40% from their peak prices — with Dubai being the most affected.

Moreover, the GCC companies, mostly in real estate and financial services, face severe headwinds when it comes to repayment or rollover of an estimated $40 billion of debt due this year, given the absence of liquidity and investor appetite.

Going forward, governments are expected to replace the private sector as the leading entity to announce new mega projects. Unlike during the 1970s oil boom, GCC governments have spent only one third of their oil wealth and can pursue countercyclical fiscal measures to rescue their economies. The region's countries are better equipped to weather a low-revenue scenario due to their huge foreign asset positions and low public debt. The extent of spending in each country will be dependent on oil prices, as countries have different breakeven points.

Nevertheless, the emphasis has shifted from real estate to investment in human capital and infrastructure to improve non-oil-sector growth over the long term, including technological universities, mass rapid transport systems and value-added industries. Abu Dhabi has unveiled a 131-km metro line while Saudi Arabia, Oman, and Qatar are going ahead with power, petrochemical and transport projects.

A recent Gulf Construction Survey indicated this shift. According to the survey, two thirds of senior executives from construction companies predict that the operations will move away from Dubai to Abu Dhabi, Qatar and Saudi Arabia.

Still, some investors are cautiously optimistic. "Dubai is a model for the region; as Dubai goes, so goes the perception of commerce and trust in commerce in the region," says Verma. "Dubai is built on entrepreneurship and innovation. These may sound like buzzwords, but it's actually true. They just had the world — and investors — build them a first-class city and infrastructure. So they will use this as a base to recreate themselves."

"Dubai is built on entrepreneurship and innovation. These may sound like buzzwords, but it's actually true