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The Rise and Fall of Dubai

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In 1954, the Ruler of Dubai and father of the current ruling Amir Sheikh Mohammed bin Rashid Al Maktoum, borrowed 400,000 pounds sterling from Kuwait to clear the Dubai creek and create the port that would become the basis of its remarkable economy. It is significant that the earliest stage in Dubai's development was made possible by borrowing and that the first steps were taken by the Ruler: leverage and government-initiated development have largely been the story ever since. Construction of the port at Jebel Ali, 35 kilometers southwest of the city of Dubai, commenced in the late 1970s: today it is the largest man-made harbor in the world and the biggest port in the Middle East. In 1985, the Jebel Ali Free Zone (JAFZ), an industrial area surrounding the port, was established. International companies were lured there by exemptions from corporate and personal income taxes, import and export duties, the absence of restrictions on the movement of funds and easy recruitment of labor. As a result, hundreds of firms opened facilities there. The combination of a huge port and a tax-free industrial zone enabled Dubai to

become a major entrepot center: a tax-free transshipment zone serving the Gulf at a time when its appetite for imports was growing exponentially as a result of the rise of oil wealth. Everything Dubai did was tied to oil, usually someone else's.

Subsequently, the government created holding companies that spanned the public and private sectors: Dubai Holdings (founded in 2004) a company directly controlled by the ruler; Dubai World (2006); and the Investment Corporation of Dubai (2006). The latter two are both fully owned by the government, which the Ruler effectively runs. These three groups control Dubai's quasi-government-owned companies, all of which pursue business activities designed to achieve economic growth and generate profits for private sector investors.

An integral part of Dubai's strategy of encouraging foreign companies from East and West to establish their presence in Dubai was the adoption of much more liberal policies towards dress, drink and other matters of personal decorum and norms than other states in the Gulf, including its partners in the seven-member United Arab Emirates (UAE). This approach proved to be a dramatic success, turning an already thriving city-state into an international financial center. But on November 25, 2009, Dubai World announced that it would ask its creditors to extend the maturity of its obligations to them: it could not pay what it owed them on time. The announcement sent shock waves through the international financial system. The crisis centered on its subsidiary, Nakheel, that had borrowed vast sums to finance rapid growth, especially in real estate.

UAE members publish little economic data but the recent IMF report on the

UAE economy reveals what went wrong in Dubai. The boom had been partly funded from an increase in borrowing from abroad. Dubai-based corporations were the main borrowers on international capital markets. Although the UAE banking system had adequate capital and was highly profitable until mid-2008, the acceleration of the growth of credit to the private sector, from a year-on-year growth of 40% in 2007 to 50% in 2008, increased the risks from the growth of non-performing loans. This was particularly true because of the rising exposure of the financial system to consumer and real estate loans and the uncertain outlook for asset prices following strong speculative increases in the value of real estate and stocks. The banking system's loans-to-deposits ratio continued to rise even after it had exceeded the regulatory limit of 100% by the end of 2007.

Dubai's success stemmed from its role as a transshipment center. It imports billions of dollars of goods that are subsequently sold mainly in Iran and Russia. Consequently, Dubai has attracted Iranian investments and tens of thousands of Iranian residents, some permanent, some semi-permanent. The economy doubled in size between 2002-07, thanks to labor inflows that increased the population by about 50 percent and huge inflows of capital. Little of this growth was directly due to oil income: Dubai produces scant amounts of oil and its development effort was designed to compensate for this lack. It did, however, rely on investments by oil producers, notably Iran and Abu Dhabi.

The strong growth of the economy and high inflation would normally have called for a tightening of monetary policy. Between 2005-07, Dubai's GDP grew by an annual average rate of 7.8% in real terms, while imports and exports increased from \$206 billion to \$481 billion! Inflation doubled, from 6.2% in 2005 to 12.3% in 2008. The UAE, however, maintains an exchange

rate pegged to the US dollar and an open capital account. From mid-2007, it was therefore forced to follow the United States' easing of monetary policy. As a result, the UAE's monetary policy acted as a further stimulus to the economy with negative real interest rates providing additional momentum to an already powerful boom in private sector credit. As oil export prices continued to rise in 2007 and the boom in the UAE showed no signs of easing, speculation on a revaluation of the Emirati dirham developed. This triggered large capital inflows into the UAE, further exacerbating credit growth and inflationary pressures. As a result, the outstanding stock of credit to the private sector, already the highest in the GCC, rose further. A vast speculative bubble in real estate, stocks and bonds was thus created. But as the world economy went into its worst recession since the 1920s, the bubble eventually burst.

Unlike Dubai, Abu Dhabi, its main rival in the UAE, possesses huge oil reserves. One of the motives for Dubai's development effort was to reach Abu Dhabi's income levels, which it did, at least until recently. Internal political dynamics of the UAE, like that of its component emirates, are secretive. This lack of transparency may have advantages in the political sphere, but in the economic one it has proven disastrous. The relationship between the holding companies set up in Dubai and the government of Dubai only became clear (or clearer) in recent months when the latter refused to underwrite them. The relationship between Abu Dhabi and Dubai only became clear (or clearer) when the former refused to bail out the holding companies owned by the Dubai government. Abu Dhabi has oil revenues currently estimated at over \$65 billion annually; the Abu Dhabi Investment Authority, its sovereign wealth fund, is one of the largest in the world, with assets of \$750 billion. Dubai's foreign debt of \$80 billion and Dubai World's share, worth \$24 billion, of which the \$3.5 billion due to be repaid in December 2009 has been defaulted on, are small in

comparison. However, Abu Dhabi offered only limited financial assistance to its suddenly struggling fellow UAE member. Several explanations for Abu Dhabi's coolness have been put forward. The first is the traditional rivalry between the two emirates and Abu Dhabi's desire to bring Dubai to heel. The second is the aim of the United States and Abu Dhabi to pull Dubai away from Iran. Dubai is not only the home of many Iranians and their funds; it is also the bunkering station for Iranian gasoline imports.

The crisis in Dubai not only threatens speculators with large losses but also represents a setback, if not a defeat, for Amir Al Maktoum's development philosophy, which had consciously sought to move Dubai away from religious conservatism and the state's exclusive control over the economy towards a more liberal economic model. The state continued to play an important role but the private sector was encouraged to do as much as it could. One sector after another was opened to it and the level of foreign investment was unprecedented. However, liberal economics needs transparency and that, among other things, is still lacking in Dubai.

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