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Chazen International Study Tour Report

Beyond Oil: Sustainability in the Persian Gulf

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It is no secret that the Persian Gulf countries derive their wealth and strength from oil and gas. One can visit the region without seeing so much as a drop of the stuff, as our Chazen study tour did in March 2008, but its impact nevertheless drenches the region. In 2006, the Gulf countries—Bahrain, Iran, Iraq, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates (UAE)—produced about 28 percent of the world's oil, held 55 percent of the world's crude reserves and accounted for 41 percent of total proven world gas reserves.[1] With energy commodities trading at dizzying new heights—oil famously cracked the $100 barrier on January 2, 2008, more than tripling in price since 2002—and no sign of relief on the horizon, the coffers of the Gulf nations have exploded. These "oasis economies" are driven by windfall revenues of an estimated $387 billion a year through 2012, at a base case of $50 per barrel net capital outflow;[2] take an optimistic stance at $70 per barrel, and petrodollar inflows climb to $628 billion.

Even in these times of plenty, however, hangs the ominous question, What happens when the oil money dries up? The oil bust of the 1990s is not forgotten, when oil dipped below $20 a barrel, and indeed fuels the search for economic sustainability. The strategy, succinctly stated by the Executive Affairs Authority of Abu Dhabi, relies on diversification. A number of challenges make that much easier said than done, namely, inflation, human-capital development, labor-supply difficulties and infrastructure shortfalls. However, the future of this sizzling region depends on the successful translation of today's petrodollars into tomorrow's sustainable prosperity.

At the forefront of the charge to diversify are state-owned investment funds, or sovereign wealth funds (SWFs). Each consisting of large pools of capital controlled by a government and invested in private markets abroad, these funds have rapidly become powerful vehicles for recycling oil wealth. While SWFs have quietly existed since 1953, only recently have they truly burst onto the world scene, suddenly proliferating into more than 40 entities, with at least a dozen formed since just 2005.[3] Indeed, the *Wall Street Journal* had not published an article on the topic before June 2007; today, the growth of SWFs is attracting close attention as this asset pool grows in size and importance. Globally, SWFs are thought to control as much as $3 trillion in assets, compared to $1.5 trillion managed by hedge funds, and $53 trillion by institutional

[1] Energy Information Administration, "Persian Gulf Region Energy Data, Statistics and Analysis," June 2007, http://www.eia.doe.gov/cabs/Persian_Gulf/Full.html.
[2] Diana Farrell and others, *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets* (McKinsey Global Institute, October 2007), 56.
[3] Stuart Eizenstat (speech, Council on Foreign Relations, New York, February 12, 2008).

investors, such as endowments and pension funds. The *Economist* associates two-thirds of all SWF wealth with oil-producing countries.[4]

Unlike central-bank reserves, SWFs manage diversified portfolios that span a variety of asset classes: equity, fixed income, real estate, bank deposits and alternative investments, such as hedge funds and private equity. Further insight into the funds is unfortunately quite limited. Their exact contribution towards regional economic sustainability is unclear due to a lack of transparency: these "secret societies," so dubbed by the *Economist,* disclose only crumbs of data concerning portfolio size and composition, even strategy. Our visit to Qatar Investment Authority, while a valuable lesson on Gulf economics, yielded no additional clarity regarding investments or returns. The Abu Dhabi Investment Authority (ADIA), believed to be the largest worldwide SWF, with approximately $875 billion, is no more descriptive, providing scant few clues as to its true asset allocation and investment goals. Leading experts can only vaguely guess as to yearly ADIA returns, suggesting a wide range of 10 to 20 percent.[5]

Further complicating the issue, the mystery about the intentions of SWFs has as of late swung from parlor guessing game to panicked public deliberation, as funds extend their financial reach to acquiring sizable stakes in Western companies. Most recently, SWFs have snapped up substantial numbers of shares in several leading American financial-services companies. ADIA invested $7.5 billion in Citigroup in November 2007, for example, becoming its single-largest shareholder, and the SWF maintains significant positions in private equity firms Apollo Management and Carlyle Group. Meanwhile, Dubai International Capital has taken a 9.9 percent stake in hedge fund Och-Ziff.

Some parties have reacted with xenophobic fear over certain deals involving SWFs, recalling the proposed sale in 2006 of some American ports to Dubai Ports World, an incident raising U.S. border-security concerns. In the wake of the credit crunch, however, critical cash injections into Wall Street have been received with more welcoming words. Warren Buffett, MS '51, has criticized the protectionist stance of some, accepting Arab investments as "not some nefarious plot by foreign governments."[6] His view is supported by the passive nature of SWFs thus far. In the case of ADIA, the fund has agreed to hold not more than a 4.9 percent stake in Citi, with no role in its management or governance, and no right to any seats on its board. Moreover, the

[4] Lee HudsonTeslik, *Sovereign Wealth Funds* (Council on Foreign Relations, January 18, 2008), http://www.cfr.org/publication/15251/.
[5] Landon Thomas, Jr., "Cash-Rich, Publicity-Shy, Abu Dhabi Fund Draws Scrutiny," *New York Times,* February 28, 2008.
[6] Mairi Mackay, "The Sovereign Wealth Funds Dilemma," CNN.com, March 7, 2008, http://www.cnn.com/2008/BUSINESS/03/07/sovereign.mme/.

drive for human-capital development through expatriate recruitment has elevated SWFs to new levels of professionalism and sophistication, enabling their smooth and savvy participation in opportunities like Citi. While greater international regulation may be warranted to ensure goodwill going forward, the positive contribution of SWFs toward Gulf economic sustainability is perhaps best summarized by Giyas Gokkent, head of research at the National Bank of Abu Dhabi: "It [ADIA] is a fund for future generations. It does not want to run companies. It wants to invest in companies that will generate a good return. The strategy is to buy exposure to blue chip economies and blue chip companies."[7]

Overseas investment has been crucial to diversification, yet ample initiatives within the Gulf nations' borders must be noted as well. Dubai, anticipating that its oil reserves will be exhausted within 20 years, is undergoing a dramatic repositioning as a trade and business hub. A key step is the development of the stock exchange, Borse Dubai, a product of the 2015 Dubai Strategic Plan that identifies financial services and capital markets as a top focus area. At Columbia Business School's inaugural Middle East and North Africa Conference in March 2008, Felix Herlihy, MBA '86, chief investment officer of Dubai-based Istithmar World Capital, described the emirate's rationale in building its own powerhouse stock exchange: "The oil and gas will not last forever. To have sustainability, you need to be able to invest some of that liquidity locally." A second high-profile effort is the Dubai International Financial Center (DIFC), an ultramodern complex to host the world's leading financial institutions. In addition to architecturally stunning accommodations, members are offered 100 percent foreign ownership of their businesses, a 0 percent tax rate on income and profits, no restrictions on foreign exchange and a dollar-denominated environment. The center bills itself as an ideal cross between an offshore tax haven and an onshore capital market, such as New York, London or Hong Kong.

The center exemplifies the "field of dreams" philosophy—If you build it, they will come—that captures the hyperactive spirit of the Gulf real estate market, yet another source of diversification for the region. The flood of oil riches has buoyed a swath of eye-popping projects, from Dubai's Palm Islands, three man-made landmasses in the shape of trees visible from the International Space Station, to the soaring Burj Dubai, set to be the world's tallest tower upon completion in 2009. Thick clusters of skyscrapers sprout from the desert landscape like beautiful weeds. Real estate prices have rocketed off the charts as demand from a burgeoning population and international investors continues to outstrip supply. So much frenzied activity has in fact prompted use of the

[7] David Wighton, "Citi Gets $7.5Bn Capital Top-up from Abu Dhabi," *Financial Times,* November 27, 2007.

B word—*bubble.* Dubai and Abu Dhabi's supercharged real estate environment has been cited as a main driver of inflation in the UAE, estimated to have hit a 20-year high of 12 percent in 2007.[8] In an effort to keep the market from overheating, both emirates have recently lowered rent caps to 5 percent.

The shortage of labor necessary for construction and subpar working conditions are further concerns. With a very limited indigenous labor pool, developers look abroad for help, typically relying on India. However, the UAE's dollar-pegged currency is losing ground to the Indian rupee, and India's flourishing economy boasts improved labor standards and wages, incentivizing many would-be workers to stay in their home market. For Gulf companies to remain competitive, they must offer more attractive employment packages or look to other labor sources, such as Sri Lanka, Bangladesh and Nepal. Ultimately, considering some experts' belief that the area's real estate prices are still cheap compared to those in other parts of the world, combined with endeavors to address inflation and labor difficulties, Gulf real estate may yet overcome fears of being a speculative market and provide solid opportunities for long-term economic growth.

Many new and upcoming real estate ventures center on tourism, which is already the source of 30 percent of Dubai's GDP. As the most liberal Middle East destination, with a tolerance for relaxed dress and alcohol consumption, Dubai advertises sun and fun to Western vacationers, targeting 15 million visitors by 2010.[9] Its roster of more than 300 hotels features the Burj Al Arab, a luxury sail-shaped resort that calls itself the world's only "seven-star" property, hyperbole that nonetheless conveys its extraordinary opulence. Another popular tourist draw is an indoor ski resort at the Mall of the Emirates, one of the largest malls in the world. What remains to be developed in order to support Dubai as a top vacation destination is the necessary infrastructure. Alongside premier hotels, restaurants and other attractions must exist a sufficient framework of roads and public transportation to accommodate the rising number of visitors and residents. Our tour often found itself trapped in Dubai's notorious traffic, a phenomenon not confined to a single rush hour but choking the city at most times of the day and night. Dubai Metro, a $4 billion subway project, is now under construction, expected to be partially operational by 2009 and fully functioning by 2012. If visitors and locals can change their habits to adopt mass transit, the city will have a long-term infrastructure solution for its hospitality sector, an essential component of Dubai's diversification strategy.

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[8] Joel Bowman, "Fears of Dubai Property Correction," ArabianBusiness.com, February 5, 2008, http://www.arabianbusiness.com/510305-dubai-property-bubble-waiting-to-burst?ln=en.
[9] Gopal Bhattacharya, "Growth Stories," *Gulf Business,* March 2008, 62.

Following other sustained successful societies, the Gulf states need all components of their systems to operate in a steady, balanced way. Energy resources are a blessing to the region but will not last ad infinitum and must be applied toward the rigorous development of other vital sectors: financial services, real estate, tourism and many more not discussed but no less important, such as consumer, retail, media, industrials and education, to name a few. Dubai's leader, Sheikh Mohammed bin Rashid Al Maktoum, concurs, vowing to make his emirate "free of the direct influence of oil price fluctuations" in his quest to create a "global pioneering city."[10] His mission, though generously funded with a torrent of petrodollars, is fraught with economic and social challenges unique to the area. Runaway inflation, a hunger for talent and experienced human capital, labor-supply issues and infrastructure gaps all threaten to undermine the delicate seeds of diversification he and other regional heads have sown. With patience and diligence, however, a variety of industries may blossom over the long term, springing forth from the oil-fed desert fields of the Persian Gulf to provide sustainable growth for generations to come.

[10] James Calderwood, "Dubai Serves as Diversification Model," *Washington Post,* February 4, 2007.