

THE IMPACT ON THE FINANCIAL SYSTEM OF GOVERNMENT DEVELOPMENT IN ABU DHABI

We are all aware that since the end of 2004 The GOAD has embarked on a massive development programme for the Emirate of Abu Dhabi.

Everyday we read in the newspapers new projects being planned and in some cases actually started. There are various estimates as to the costs involved, depending on who you listen to. For the purpose of my talk today, I am using an estimate from the Finance Department of Abu Dhabi, who suggest that there is some AED85 billion needed by the GOAD for their cash contribution to the many planned projects over the next 5 years.

This does not mean that is the total value of the projects concerned, simply the amount needed from GOAD contributions. Also this does not take into consideration the financial needs of the private sector, or the ongoing needs of other Emirates, particularly Dubai, -- both these two groups could be as much as \$270 billion over the next 5 years – again depending on whom you listen to, and what we care to believe.

So we could use all the usual clichés of “no-one really knows” and that the UAE is in “unchartered waters” in regards to the total amounts, and the pressure on the financial system this unprecedented pace of development will have.

Since the end of 2004 there has been a deliberate GOAD policy to open up Abu Dhabi to private, local and foreign investment. Indeed the demands of foreign direct investors, whether as private equity, or investment monies in the form of borrowings such as bonds or bank loans, seems to be the driving factor as to why the GOAD does not open it's cheque book to completely pay for all the government sponsored investments planned. Therefore banks and financial institutions and private equity are finding many opportunities to put their money to work in Abu Dhabi.

But the impact of these investment needs are creating major pressures on the financial system, as well as the legal system and as well as the general environment in which we all live and work.

We have all experienced the rise in interest rates in recent times. The cost of borrowing has doubled in the last 2 years. Primarily this is due to the rise in global inflation and U.S. interest rates. This in turn is reflected in AED interest rates due to the exchange rate peg of the AED to the U.S.Dollar. But in addition the margin charged by local banks above the interbank cost of borrowing has increased substantially due to the pressures on the financial system locally.

Some of the local banks are overlent and are currently operating outside of the ratios set by the Central Bank. These ratios dictate that a bank's lending must be matched 1:1 against customer deposits. As a result of the development plans in place, very few of the major local banks are capable of operating inside of these ratios. Therefore the same

banks are obliged to pay deposit rates to customers considerably in excess of their published rates, in an effort to maintain, and correct, their legal ratio obligations. Regardless of the credit quality of the borrower, it follows that no local bank can lend money to those borrowers below their real cost of funds. HOWEVER, alternatively more and more foreign banks are entering the UAE market with their balance sheets. As these foreign banks cost of funding is substantially lower than the local banks, we are rapidly approaching a situation where much of the borrowing needs of both the GOAD and the private sector, will be met by foreign banks, rather than the traditional borrowing from local banks.

This may well be considered a good thing, if we remember that it is a deliberate policy of GOAD to encourage foreign investment in Abu Dhabi, but the outcome can mean some substantial changes to the “System” that we are all used to. I believe we will see a situation where local banks are reduced to retail and ‘savings’ institutions, and the major part of the development programmes for Abu Dhabi, indeed for the UAE, will be financed with foreign money.

As the local banks’ market share is inevitably reduced, in time, their profitability will also reduce, and thus have an impact on their share value in the stock market. The local banks therefore need to seek alternative business practices to keep up their profitability in future years. Merger of some of the local banks will be inevitable in an effort to maximize market share. But this alone will not stave off indefinitely a reduction in business and profits.

We have many examples around the world where local banks have been priced out of their own markets in the middle of major economic expansion in their domestic markets. – The Baltic states, The Balkans, Central and South America. As the local banks in these areas lost market share, and were subsequently reduced in value, then the bigger international global banks have stepped in to buy those local institutions at bargain prices. Thus it is possible, due to the development plans currently underway in Abu Dhabi and the UAE, to see our local banking institutions more and more owned by foreigners.

So my message to the local banks is stop making commitments to funding local development programmes if you cannot afford to fund those commitments. The consequences for this unrestrained lending will eventually lead to disappointment for your shareholders.

The other major impact on the financial system brought about by the unprecedented development plans is inflation. I would like to talk a little about inflation. We all have to live with it, but do we know how to manage it. Global inflation is one thing. It affects everybody at the same time. BUT much of the inflation in the UAE is imported unnecessarily because of the persistence of maintaining the current currency peg of the AED to the US Dollar. The current peg rate has been in existence for 26 years. Times have changed The perception of a strong Dollar has changed. U.S. government policy has

changed (despite the denials of the U.S. Government.) A strong Dollar is no longer desirable from an American point of view.

When H.E. The Governor spoke in this very room at a previous BBG lunch, his charts showed that approximately 88% of the UAE's imports were from non-Dollar based countries. Therefore as the Dollar and Dirham continue to weaken against other major currencies, the cost of everything is rising here. Particularly the cost of labour.

As we have seen there are massive development programmes underway in Abu Dhabi and the UAE. This has called for a huge increase in the population of skilled, professional and unskilled labour coming to work and live here. Initially the demands of development programmes brings in the engineers and artisans with their families. But this in turn causes a demand on teachers nurses, doctors, and a whole host of other qualified people to service the community accordingly. To attract the right people the cost of wages has increased substantially. It is no longer taken for granted that people will come to work here because the salaries and tax friendly environment is beneficial. In my own industry it is difficult to attract good people, as the buying power of a Dirham or Dollar package has decreased approximately 30% in the last three years.

For a country like the UAE, which has one of the strongest economies in the world in GDP terms, a simple realignment of the value of the Dirham against the Dollar would alleviate the inflation problems – almost overnight. The only Emirate that I can see who could object to this would be Dubai. They naturally would have concerns that a revalued Dirham would hurt their blossoming tourist and industrial development markets. BUT to allow the import of unnecessary inflation on a continued scale of what we have seen in the last few years will have the same effect. How long is it going to take for the ever increasing cost of rents, food, and services to wipe out the advantages to business's and individuals' for being in the Emirates. Indeed it is impossible to reverse the long term damage done by having not already curbed this unnecessary import of inflation.

However if there was a substantial revaluation of the Dirham, perhaps by increasing the bands at which the currency is allowed to float against the Dollar, we can at least counter act the rising cost of importation. Then in a more stable economic environment, one can reverse decisions at a later date. We would then have a useful tool for managing the economy better in these times of unprecedented government sponsored development.

We hear much about regional financial integration. Indeed in Dubai this last week the Middle East Managing director of the International Monetary Fund is quoted as saying, that it is essential for GCC countries to maintain a Dollar parity through till the planned GCC integration in 2010. The actual comment I believe was “ Gulf States should not alter their currency pegs which will do little to curb inflation and might threaten perceptions of Gulf currencies as stable.”

This is rubbish. The unstable benchmark is the U.S. Dollar. Why should Gulf currencies be held ransom to a fluctuating Dollar, when their domestic economies, collectively and individually, call for an upward revaluation of the domestic currencies.

As we all know, not all of the GCC countries buy into the integration programme designed to take effect in 2010. Why do we have to wait till then to face a reality that the Dirahm, and other Golf currencies need to be revalued now to help fight the importation of unnecessary inflation.

So to sum up. I believe that the main effects of the impact on the financial system of unprecedented GOAD development in Abu Dhabi, will be:-

- 1) Major changes in the current banking system.
- 2) increasing inflationary pressures on all of us.
- 3) Higher borrowing costs.
- 4) Moderation in corporate profits, brought about by the rising costs, and the relevant adjustment to the long term stock market prices this will make.

I believe it is incumbent upon the authorities here to develop more robust policies and practices to reduce these pressures, and allow a more orderly move into the next generation, which I hope we will all be here to enjoy for many more years.

Thank you

Terence Allen
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