

The Challenges of Balance

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In their quest to build sustainable economies, the Gulf states of the Middle East are learning to manage opposing forces.

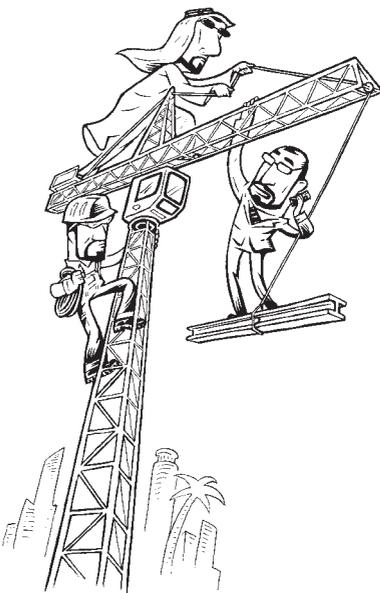
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Visitors to cities such as Abu Dhabi, Doha, and Dubai are likely to encounter a near-constant state of change. Building construction continues apace, even during the current economic downturn. It will eventually lead to better transportation systems, less traffic, and more energy-efficient buildings. But in the short term, it means that each city's landscape is different from one day to the next. The footpath that a frequent traveler might have taken last week from the airport terminal to the taxi stand is now blocked by scaffolding; the road to the hotel has been plowed over and the taxi is forced to take a detour. The taxi drivers are likely to be confused by the routes, as they are often recent immigrants who don't yet know the area and are also perplexed by its constant evolution. And yet, such inconveniences are directly linked to the region's economic dynamism, which has drawn so many people there in the first place. The paradox of travel in these countries, growing more difficult as it attracts more people, is a metaphor for the nature

of development in the Gulf states, and by extension in all rapidly emerging economies.

The more rapidly a country moves toward industrialization, the more powerful the constraints and counterbalances that seem to hold it back. System dynamics pioneer Jay Forrester coined the phrase "limits to growth" in the late 1960s to describe such phenomena. The harder a complex system is pushed, the more it resists — often in unpredictable, nonlinear ways. Frequently, the push-back is experienced as a seemingly unrelated symptom: a traffic jam, a labor shortage, or a mysterious inability to reach a critical goal. The challenge facing any emerging economy is to find a way to balance opposing forces in the midst of rapid development: to enjoy the benefits of growth with as few side effects and unintended consequences as possible.

Since 1998, the nations of the Gulf Cooperation Council (GCC) — Bahrain, Kuwait, Oman, Qatar, the Kingdom of Saudi Arabia, and the United Arab Emirates (UAE) — have become a kind of laboratory experiment in meeting the challenges of balance. Together, they



provide the world with one of its most prominent examples of rapidly accelerating economic growth. In the space of a few years, they built up manufacturing, finance, and service industries and started to establish a sustainable middle class. They consciously set out to develop the legal and technological infrastructure of fully industrialized nations, without losing their close-knit cultural identity and political stability. And though they have a common culture, they are also diverse states, with different industries and different approaches to growth.

In “Oasis Economies” (*s+b*, Spring 2008), we described the rapid economic growth of the GCC in recent years, and its impact on the Middle East and the world at large. Since then, economic crisis has affected these countries; they are wrestling visibly with constraints and resource gaps that might have seemed unimaginable a year ago. But the aspirations of the region have not faltered. The GCC states’ sovereign wealth funds (SWFs) remain major global investors, and the states continue to be models of rapid development that are closely watched and emulated. After the first dozen years of this experiment, one primary lesson is clear: The forces of growth and reaction are interdependent, and every growth spurt is likely to be accompanied by some unexpected setback. Leaders of governments and businesses in emerging markets everywhere would do well to understand these forces and their impact, so they can more effectively steer the growth of their economies.

In the Gulf states, leaders have begun to master five types of balance between opposing forces. They manage their finances for volatile

stability, using short-term uncertainty as a means of bringing about long-term development. They practice restrained *laissez-faire*, balancing heavy and light regulation. They promote public privatization, combining autonomous entrepreneurship and government ownership. They pursue fast and slow talent strategies simultaneously to strengthen their workforces. And they seek to achieve open nationalism, balancing greater exposure to the world with a traditionally focused political system and culture. Each of these capabilities involves political and economic skill, and also a fair degree of subtlety and insight. Observations of how the GCC countries are faring can reveal much about what it takes to succeed in the domain of rapid growth.

Volatile Stability

The capital base of the Gulf nations is founded on the region’s most famously volatile natural resource, oil. In the early 2000s, these countries began investing that capital more broadly in the global markets. This step made long-term stability possible, but, as the financial crisis demonstrated, it also created new kinds of short-term uncertainty.

Indeed, the financial risks of playing on the world stage have never been greater. The investment climate fluctuated as dramatically in the Gulf states in 2008 as it did in the rest of the world, closing the year with 57 percent losses in overall stock prices. Although turbulent highs and lows are unsettling, it is a sign of a healthier economy that they are triggered by the world’s financial markets, instead of by surging or crashing oil prices. The leaders of the Gulf region have begun to take that volatility in stride;

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they are learning that, by broadening their exposure to global markets, they increase the resilience and effectiveness of their financial assets.

Consider the region's sovereign wealth funds. From the 1980s through the early 2000s, they were

poured billions of dollars into big U.S. investment banks reeling from the credit crisis. Abu Dhabi and Kuwaiti funds own major stakes in Citibank; the Qatar Investment Authority, a sovereign wealth fund, is a major shareholder in Barclays

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seen purely as ways to use investments: to buffer against the highs and lows of oil prices and to provide for intergenerational savings. But between May 2003, when oil prices began to rise, and June 2008, when they approached a peak, the accumulated foreign exchange reserves of the Gulf states increased nearly fourfold. The region became rich — far richer than most observers, including its own leaders, ever dreamed it would be. At the end of 2008, the assets of major SWFs in the region were estimated at more than US\$600 billion — and with the assets of central banks included, the figure was more than \$1 trillion. Given a rebound of the world economy and (as is widely expected) another increase in oil prices, the Gulf countries' assets could grow to between \$2 trillion and \$3 trillion by 2015.

Already, the size and liquidity of the Gulf's SWFs have forced them to move massive amounts of capital outside the region, and to take on new types of risk. This makes the Gulf states' destinies interdependent with the outside world's financial markets. Since mid-2008, the GCC nations have

PLC. The Gulf states are also investing in emerging economies, both in Asia and across the Middle East and North Africa. Jordan Dubai Capital, an investment bank affiliated with Dubai Holding Group LLC, invests in privatization, infrastructure projects, private equity funds, and publicly listed companies in Jordan. SWFs are also beginning to behave like venture-capital and private equity funds, investing in startup companies and incubators and influencing the policies of management. In August 2008, for the first time, a number of Gulf SWFs raised debt for transactions.

Some of these measures may seem to court volatility — investments in financial institutions, for instance, could be perceived as dangerous in the market environment of 2009. But in fact, these steps are calculated risks that will generate stability in the long term. The GCC governments are using the returns from their investments to develop a more diversified regional economy. They are also funding the sort of socioeconomic development, including education reform, that will prepare the region and its labor force for a strong economic future.

Restrained Laissez-Faire

Since the late 1990s, the GCC countries have been steadily deregulating the telecommunications, media, financial-services, airline, and real estate industries. As a result, companies that are based in these countries (and often partly owned by their governments) have reaped the benefits of competing in more open markets. For example, the Emirates Telecommunications Corporation, known as Etisalat (the primary telecommunications provider for the UAE), the Zain Group (a Kuwait-based mobile services company), and Saudi Telecom Company (STC, the primary telecom provider for Saudi Arabia) all have the potential to join the ranks of the world's 10 largest telecom service operators. The Saudi Basic Industries Corporation, which once held a monopoly position as Saudi Arabia's primary manufacturing company, is now the world's second-largest petrochemical company and the world's largest producer of polymers; in 2007 it acquired General Electric Company's plastics unit.

Yet as governments relax their regulatory approach, they must pay greater attention to the effectiveness of their regulation. And the appropriate balance between restraint and laissez-faire — between the government roles of deregulator and regulator — is not always obvious. Successful deregulation needs to be intricately paced, with a constant mindfulness of its impact.

In the financial-services sector, the global crisis — and particularly the failure of oversight that led to it — dramatically illustrated the importance of good governance to leaders in the region. Even before then, GCC governments had recognized that a measured approach to

regulation was important. For example, Saudi Arabia has slowly but steadily opened its financial markets to foreign competitors, at the same time that it has introduced formal exchanges that are independently, and more rigorously, regulated. Saudi Arabia's careful deregulation of telecommunications has also benefited both the country and the players in the market. When STC sold 30 percent of its shares in a public offering in 2002, new licenses were granted to other players for the first time, and STC's monopoly as a service provider ended. STC continues to employ more than 20,000 people — more than its international competitors, on average — because eliminating these jobs would result in sizable unemployment, especially among low-skilled workers. The government made a point of going slowly, introducing limited competition, and offering skills training to nationals to help ensure a smoother transition.

Another example comes from the much-touted real estate markets of the United Arab Emirates. In March 2009, after its local governments had begun to introduce new real estate laws, the UAE established a federal authority to coordinate existing regulatory bodies. Additionally, it arranged a merger of leading mortgage finance companies into a new Emirates Development Bank, which will receive government funding and equity capital and will be tasked with energizing the mortgage sector. Measures like this send a clear signal that the government of the UAE recognizes that some regulatory constraints and a deliberate evolutionary path, even in a sector known for hyper-rapid construction and freewheeling creativity, are crucial to sustained growth.

Public Privatization

New companies continue to rapidly emerge from old government agencies in the Gulf. The Saudi Arabian government has divested about 30 percent of its ownership of SABIC; GCC governments have also partially privatized STC, Etisalat, and Oman's state-run power plant, Al Rusail. By so doing they have set up these institutions to behave like private companies; to focus on operational efficiencies, cost optimization, and increasing returns rather than merely providing services to citizens. This type of energetic, commercially focused privatization is a cornerstone of the Gulf's evolving economic policy.

But it also places GCC governments in the unfamiliar role of major shareholder. And the skills required to run a private company are not the same as the skills required to

special privileges than government-owned entities of the past. And as the private sector grows stronger, the need for government support is expected to decrease.

Thus, in 2004, when Abu Dhabi decided it wanted to open the doors to a real estate development industry, it created Aldar Properties PJSC, to be run and operated like a private company. This company was launched not through a government press release, but through a public share offering. Aldar has since become a major real estate development corporation, with \$72 billion worth of developments in progress. The Qatari Diar Real Estate Investment Company, wholly owned by the government's sovereign wealth fund, plays a similar role in Qatar.

These governments are also learning to avoid jumping too

Governments in GCC countries are taking measures to ensure that development is matched to explicit societal benefits.

oversee a government agency or a tightly regulated monopoly. Government overseers must thus make unprecedented choices that will enable the public and private sectors to reinforce one another. For example, the Gulf governments are investing hundreds of millions of dollars in strategic industries such as real estate and infrastructure (including power, water, and transportation). The new government-owned companies are designed and managed as free enterprise operations, with commercial-style profit-and-loss accountability; they receive far fewer

quickly into privatization. Without proper controls and oversight in place, an overemphasis on the profit motive can lead to unfortunate excesses — as evidenced in the rapid rise and fall of some of the region's real estate prices. Now governments in the GCC countries are taking measures to ensure that development is matched to explicit societal benefits — for instance, through regulations and public-private partnerships in which government provides funding and the private sector provides expertise. These partnerships, new to the region, involve

shared risk and asset ownership; they help create jobs in the private sector, they provide quality services and facilities for citizens and stakeholders, and they shoulder much of the burden of development. For instance, in numerous infrastructure developments involving water and wastewater, private corporations are now frequently brought in to provide new technologies, increase efficiency, and help governments ensure continuous, universal access to quality water.

Fast and Slow Talent Strategies

In the first months of 2009, the financial-services sector in Saudi Arabia continued to recruit of people with the specialized knowledge to manage sophisticated financial instruments — even as banks elsewhere shuttered their doors or cut their staff. This was just one sign of the shortages of skilled workers that rapid economic growth creates, particularly in such industries as financial services, telecommunications, engineering, and IT. At the same time, there is a human surplus among Gulf nationals, many of whom have liberal arts degrees or other education credentials that leave them unprepared for the particular talent needs of the region.

Gulf state leaders are dealing with this challenge by focusing on new capabilities and ways of thinking. For instance, they are providing greater opportunities for women, and thereby confronting an ongoing set of contradictions in their culture. A growing number of women in the Gulf region have entered the workforce in recent years, and some have the opportunity to achieve substantial success. (Prominent women in the region include Lubna Al Qassimi, the minister of economy and

planning in the UAE; Hessa Al-Jaber, the head of ictQATAR; Nora Al-Fayez, the first female deputy education minister for girls' education in Saudi Arabia; and Maassouma Al-Mubarak, the former health minister of Kuwait.) It is increasingly understood that the promotion of female employment and education is a factor in sustainable economic growth.

But in many parts of the GCC, opportunities for women remain limited. Preferred jobs are often reserved for men, and in some countries, conservative social norms tend to discourage women from working outside the home. Furthermore,

schools to give math, English, and science as much emphasis as Arabic and religion. And several Western university branch campuses, including those of Weill Cornell Medical College and Texas A&M University, are up and running in Qatar's newly formed "Education City."

Even as they pursue education reform within their borders, the GCC states continue to draw on the global talent pool — and thus feel continuing pressure to make it easier and more attractive for expatriates to work. And as they reshape their immigration, labor, and education systems, they must integrate a widely varied set of deadlines into

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women's ability to enter the labor market remains limited by the weakness of social services (such as transportation and child-care services) and support programs. Thus, for one or more generations, most women's jobs will probably be concentrated in such service-sector professions as teaching and banking, with the policymakers aware that, over time, these roles will broaden.

The Gulf states are also addressing their labor shortages by investing in education that will match citizens' capabilities with the needs of local industry. For example, Sheikha Mozah bint Nasser al-Missned, wife of the emir of Qatar, is leading a transformation of the country's education system. In consultation with global experts, she changed the curricula at primary and secondary

their plans, because these systems operate under different time frames. It takes a very short time to change a visa policy, a few years to build a labor market, and a generation to educate a citizenry.

Open Nationalism

In office buildings in Dubai, construction sites in Kuwait City, and manufacturing plants in Jeddah, GCC nationals have been outnumbered by an influx of workers from India, Pakistan, Eritrea, Ethiopia, Bangladesh, Sri Lanka, the Philippines, the United Kingdom, Australia, and the United States. Expatriates outnumber nationals in most parts of the region by a ratio of three-to-one; they have made Gulf cities as ethnically diverse and cosmopolitan as any other cities in the

world, and the region depends on them to sustain economic growth. They are needed to help manage companies and to work, but also to supplement nationals as the region's consumers of goods and services.

Yet the GCC nations' need to preserve their identity makes it difficult for them to fully integrate expatriates — even those who live for many years in the region and want to make it their home. It's not surprising, then, that when the Gulf economies contract and work dries up, these transient workers simply pack their bags and leave. Even during these workers' stay in the region, a substantial portion of their wages leaks out of the GCC's economy as remittances to their countries of origin. If foreign workers lose their jobs, in some Gulf countries they also lose their work visas. Thus, the contraction that initially eliminated jobs is exacerbated as expatriates depart — reducing spending, creating housing vacancies, and lowering real estate prices.

To prevent or slow this type of downward spiral, several Gulf states are learning to integrate their expatriates and make them feel valued. Financial reforms are crucial: Expatriates cannot truly be tied to their new countries of residence unless they can invest there. Gulf states have instituted a number of new laws in response to this need. Real estate is one important segment. In 2002, Dubai removed restrictions that limited foreign ownership of property in some areas; for several years, foreigners have been allowed to own land anywhere in Bahrain. Abu Dhabi, Oman, and Qatar have introduced similar reforms.

Business ownership is another arena where Gulf states have made steady progress. Bahrain allows 100

percent foreign ownership in some business categories; Qatar, too, allows 100 percent foreign ownership (with special government approval) in sectors including agriculture, health, education, tourism, energy, and mining, although foreign ownership in other sectors is limited to 49 percent. Foreigners have similar independence in the UAE's free zones, where they can own 100 percent of commercial ventures, although they must partner with a local business outside these zones.

Pension reform will also be critical. Expatriates are generally excluded from government-run pension plans; some private companies, however, have made provisions for employees who are not nationals. Allowing more expatriate participation in pension plans would not only make the region a more attractive work environment, but would increase contributions overall, which will be necessary as the population of the Gulf states ages.

But financial reform alone cannot create cultural and emotional ties. To create these bonds, GCC countries have, for instance, begun to provide Arabic language classes for expatriates, which will boost their career prospects and enable them to communicate more easily with neighbors and co-workers. Abu Dhabi has taken steps to make expatriates feel welcome with measures like the newly built Construction Village on Saadiyat Island off the emirate's coast. Construction Village will house the workers building attractions, such as the Louvre and Guggenheim museums, on Saadiyat Island. The Tourism Development and Investment Company (TDIC) has invested \$258 million in the village, which includes residence halls, parks, dining

areas with multiethnic offerings, tennis courts, basketball courts, a cricket pitch, shops, Internet access points, and laundry facilities. TDIC CEO Lee Tabler said, "One of the core rationales behind the decision [to create] the village is to foster a sense of home and community for the workers on the island."

Growth and Balance

For decades, countries around the world associated the GCC countries strictly with oil. Now, when they look at the Gulf, they can see a rapidly emerging center for trade, finance, tourism and recreation, and even technological research — with expatriate businesspeople flocking to newly vibrant cities, reforms in education and training, more free market decision making, and tremendous amounts of sovereign capital invested in diverse industries throughout the world.

But they can also see a region coping with wild fluctuations in stock markets and real estate values, national labor forces that are not yet up to the task of growing key industries, and such daunting challenges as regulating privatized businesses or managing expatriates.

The indicators of exuberant growth and the complexities inhibiting it must both be seen as part of the Gulf's natural evolution. Ultimately, the ability to manage the challenges of balance will be the single most critical limiting factor — more important than capital or markets — affecting the pace and quality of the region's development. These capabilities don't come easily; they take time to develop. But they do come reliably, so long as the leaders of an emerging region recognize their importance. +

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