DUBAI FINANCIAL SERVICES CLUSTER: OASIS OR MIRAGE?*

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1. COUNTRY ANALYSIS

Dubai is one of the seven Emirates that make up the federation of the United Arab Emirates (UAE). Six of these seven Emirates, including Dubai, are city states. The UAE is ruled by a Supreme Council, comprised of the seven hereditary leaders of each of the Emirates. The head of state or president is traditionally the ruler of Abu Dhabi, the largest of the Emirates, while the prime minister is customarily the ruler of Dubai (EIU 2005).

As the map in Exhibit 1 illustrates, Dubai and the UAE are strategically located at the entrance to the Persian Gulf, adjacent to the important shipping lanes through the Strait of Hormuz. The UAE's closest neighbors include Qatar, Oman, Bahrain and Saudi Arabia. Approximately 90% of the UAE's land mass is desert and less than 1% is arable (CIA World Factbook 2006).

Like many countries in the region, the UAE's economy is heavily dependent on the oil and gas sector (see below). It should be noted however, that Dubai itself, is estimated to have only 5-10 years of petrochemical reserves (EIU 2005), with oil and gas contributing just 6% of its GDP (IMF 2005). In contrast to much of the region though, the UAE is known for it comparatively liberal social and economic policies, and largely pro-Western and pro-liberalization stance (EIU 2005).

1.1 Economic and Social Performance

The UAE's and Dubai's economic performance compares very favorably with that of neighboring countries but also with that of similar economies; in particular, with the East Asian city state "tigers", Hong

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* **Disclosure**: Julie Gavage lived in Qatar and worked in the region between 2003 and 2004 and Shahzad Bhatti has done business in the region. The team did not visit the region during the course of the project, and apart from the interviews listed in the reference section, we used only publicly-available information.

* **Sources**: A surprising number of sources expressed deep concern about being quoted for fear of various forms of retribution. One person interviewed (but not quoted in the body of the paper) said: "They could put a bullet in my head, toss me in the desert and no one would ever know." While some of these feelings may be somewhat overstated, quotes are nonetheless not attributed to sources without permission. Wherever possible, we have also attempted to distinguish between industry interviews and official government interviews. Some, but not all, of the names of people interviewed are included in the bibliography.

Kong and Singapore. Over a longer time frame, it's also clear that the UAE has been pulling away from its neighbors and converging on Hong Kong and Singapore. (See Exhibits 2 and 3.)

However, if we decompose the composition of GDP per head performance, the UAE's performance is much less impressive. In particular, Exhibit 4 shows that all its GDP per capita growth has come from growth in the size of its labor force – up to 90% of which is imported in the case of Dubai (The Economist 2004). Even more disconcerting, labor productivity growth has actually been negative. The paper returns to the important subject of Dubai's labor force in later sections.

The composition of the UAE's GDP is also interesting. Of all the countries in the GCC,[1] the UAE has reduced its dependence on oil by the greatest amount. Between 1980 and 2004, the percentage of its total exports from oil fell from over 90% to well below 60%. Similarly, the ratio of oil to government revenues has fallen from over 95% to around 65% (IMF 2005). In short, the UAE has successfully diversified its economy. Qatar is the only other GCC member to have made similar, though less impressive, strides.

It is apparent from Exhibit 5 that while the oil and gas sector is still growing, its share of GDP has fallen five percentage points since 2000. Government services have also grown more slowly than overall GDP. Construction, the wholesale & retail trade, and finance & insurance have taken their place. Real estate and transportation, storage & communications have also significantly increased their percentage of GDP.

It will be interesting to observe whether these successful attempts to reduce oil dependency can be sustained with the high crude oil prices of recent times. While there are concerns that regional economies and stock markets are overheated, there are also indications that governments have learnt some, though not all, of the lessons of past oil spikes. In particular, the region's governments have developed more careful spending strategies. According to Michael J. Baumgartner, the Saudi government, for example, has been very conservative in its budgeting, assuming until this year that oil prices would return to $25 per barrel. However, governments are also having to deal with a new challenge: the implications of greater oil revenues being invested and consumed at home rather than abroad, as in past periods of oil-driven prosperity.

[1] Gulf Cooperation Council: comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE.

Before turning to an analysis of the UAE's and Dubai's business environment and national diamond, it should be noted that broad economic success has translated into high performance on social measures as well, with the notable exception of literacy, an important theme to which the paper returns. (See Exhibit 6.)

1.2 Analysis of Business Environment and National Diamond

The UAE's economic performance has been impressive, although its business environment lags behind its income ranking: the UAE was ranked 24th in the world by per capita GDP (at PPP), but only 33rd in terms of business competitiveness (BCI 2005). While much of the UAE's performance has been facilitated and reinforced by its strengths in infrastructure, it has significant weaknesses in innovation and education. The UAE's greatest relative strengths and weaknesses are listed in Exhibit 7.

In terms of the ease of doing business, the UAE is also only a mediocre regional performer. (See Exhibit 8.) Of particular concern for Dubai are the UAE's low ratings for starting a business, getting credit, protecting investors, and enforcing contracts. The key driver for each of these rankings is, respectively: high minimum capital requirements (4 times GNI per capita); the almost complete absence of credit histories; the difficulty of initiating a shareholder suit; and the number of days (614) it takes to enforce a contract. The UAE also receives very low marks for closing a business because of the length of time and cost required (5.1 years and 30% of the estate respectively), and the low average recovery rate (just 5.5 cents on the dollar).

The most significant area for attention however, is the UAE's education system. The UAE has relatively low levels of adult literacy (78%), even relative to many of its neighbors. Of even greater concern though, is that the situation will take a long time to redress. This is because, even today, the UAE's primary and secondary education participation and completion rates remain low. (See Exhibit 9.) With the exception of Saudi Arabia, Yemen and Iraq – countries with far lower levels of GDP per capita – the UAE is the worst performer. The contrast with Bahrain, Iran, Jordan and Qatar is particularly sobering.

The strengths and weaknesses discussed are captured, along with some less important ones, in the national diamond in Exhibit 10. As noted, most of the economy's weaknesses are related to factor conditions

involving the local human resource base. One of the peculiar consequences – albeit a decade ago[2] – of the weak local education system was that 90% of UAE nationals were employed in the public sector (including state-owned enterprises), yet the public sector then accounted for just 28% of total employment (IMF 2005). Among the current generation of local university students, two-thirds graduate with degrees in education, religion or arts, qualifications that are arguably less attractive to the private sector. A final reason for alarm is that only 16% of nationals, a strikingly low figure, graduating from UAE universities were male (IMF 2005).

Dubai's national strategy is to be the *"Singapore of the desert"* with some even arguing that Dubai has already outstripped Singapore (source: government interviews). As shown in Exhibit 11, there are four key factors that were relevant in the development of this goal. First, Dubai is strategically located (with a deep water port) and has a history as an important trading center. This unique position grants Dubai a sustainable competitive advantage in becoming the regional logistics hub. Second, the country is located in an unstable region. This represents an ironic opportunity to create a haven of stability to attract business from its less stable neighbors. Dubai has made remarkable progress on both of these dimensions.

Third, Dubai has a small population and must import both low and high skilled labor. Along with the poor quality of the local educational infrastructure, this explains the high levels of expatriate labor in Dubai. The final factor is that Dubai – unlike Abu Dhabi – has limited natural resources, explaining why Dubai is now focused on developing new clusters. While some of the UAE's existing clusters have flourished, others need to be deepened and broadened to succeed internationally. (See Exhibit 12 for a breakdown of the UAE's current exports). For Dubai, the financial services cluster is one of its most important projects, and as the next section will reiterate, the dearth of local human capital will be one of its key challenges.

When comparing Dubai to Singapore there are similarities in geography but important differences in how Singapore has positioned its competitive advantage in financial services and service-oriented clusters. Singapore is a densely populated country with a high standard of living, a shortage of land and a high-cost, highly-skilled labor force. Accordingly, the country's comparative advantage lies in the development of high

[2] More recent data is not yet available.

value, export-orientated service industries and activities not present in the UAE. These include research and development, the production of computers and robots, and computer aided design and manufacturing.

2. Cluster Analysis

Dubai has already achieved notable economic progress and its vision for a financial services cluster is similarly ambitious. Dubai's financial services cluster can be divided into two categories: (1) Local and regional banks competing in the domestic and regional economy; and (2) International banks who are being attracted to the region through Dubai's efforts to create a regional financial services center.

Dubai's effort to further develop and strengthen the financial cluster is concentrated in the DIFC (Dubai International Financial Centre). The DIFC is a regional capital market and has been designated as a state-run, financial free-trade zone. Its mission is to be a globally-recognized financial centre and a catalyst for regional economic growth, development and diversification. The DIFC has positioned Dubai as an international investment hub in the global financial community between Tokyo, Hong Kong and Singapore in the Far East, and Frankfurt and London in Europe, to capitalize on its time zone advantage. Integrity, transparency and efficiency are, nominally at least, the guiding principles. Financial services in the DIFC are regulated to international standards by the Dubai Financial Services Authority (DFSA).

The six primary sectors of focus within the DIFC are: (1) Banking services (investment banking, corporate banking and private banking); (2) Capital markets (equity, debt, derivatives and commodity trading); (3) Asset management and fund registration (including fund administration and management); (4) Reinsurance; (5) Islamic finance; and (6) Back office operations. To attract international firms to the DIFC, a favorable investment environment has been created, including "best in class" regulatory frameworks (source: industry interviews) and infrastructure (see Exhibit 13). These are discussed in greater detail below.

2.1 Financial Services Overview

2.1.1 Local and regional banks

"[Local and regional] banks are benefiting from an economy that is experiencing strong growth on the back of government spending on infrastructure and oil and gas related projects, a private sector construction boom, growth in tourism, consumer spending and trade-related services coupled with a low level of interest rates." (Source: EFG Hermes 2005, p 4). As more and more international banks enter the region through the DIFC, these local banks will have to improve their business practices to maintain market share. Given the relationship-driven nature of financial services (particularly in the GCC countries), in the short run, local and regional banks will benefit from their competitive advantage of pre-existing relationships with key clients in the region. Over time, however, this advantage will dissipate and local and regional banks will have to seek out alternative means of strategic differentiation.

2.1.2 International banks and the DIFC

As noted, the focus of Dubai's financial cluster efforts is the DIFC, with particular attention on the Dubai International Financial Exchange (DIFX). Since it opened in September 2004, over 100 international financial firms (mostly international banks and insurance companies) have joined, and many have already established operations in the DIFC. A few prominent examples are displayed in Exhibit 14. The DIFX itself opened in September 2005. Mr Iyad Duwaji of Shuaa Capital believes that "the DIFX will highlight the emergence of the region as a destination for global investors. The new drive across the region to join the World Trade Organization and to integrate into the world's economy means that investors will start looking at the opportunities in regional markets. The DIFX will be the place to access the entire region." According to Mr Christian Mouchbahani, head of corporate finance and board member of Dubai Bank, the "DIFX will provide a platform for reprieve from the overheated local markets for shareholders and investors as well as companies planning to list".

On its website, the DIFC's ambition is to develop the same stature as New York, London and Hong Kong by serving the vast region between Western Europe and East Asia. This sentiment is further supported by government development officials who feel that "… Dubai is on a path to outstrip Singapore and rival New York, London and Hong Kong." (Source: government interviews.) According to Mr Lynton Jones of

the DIFX, "the DIFX intends to provide issuers with an international gateway to global institutional investors. It will be an intermediate financial centre bridging East and West. The DIFX will provide an alternative liquid capital market to the London Stock Exchange, for example, where such corporates are only small fish in a big pool."

2.2 Advantages of the DIFC

Regulatory. Dubai's financial regulatory framework is unique and has been developed to attract foreign firms using "best in world" standards (source: industry interviews). 100% foreign ownership is allowed, transactions are denominated in US dollars and English is the prime language. The regulations have been strongly influenced by British standards to encourage transparency, and there are no restrictions on foreign exchange, and no taxes on income and profits.

Infrastructure. Dubai authorities are investing heavily to provide state of the art infrastructure for the center. A fifteen-storey building has already been built and a whole complex with offices, leisure and housing is currently under development. Other requirements like telecommunications have also been addressed. Dubai is also home to the biggest airport in the Middle East with over 24 millions passengers visitors in 2005 and with a capacity expansion in 2006 to 70 million (Dubaiairport.com). In a relationship-driven industry such as financial services, the airport is a critical asset to allow financial professionals easy access to clients.

Regional demand. Recent geopolitical events have encouraged regional high net-worth individuals to invest in the region. This represents an opportunity for banks to raise funds and manage this money.

Government support. The DIFC enjoys the support of Sheikh Mohammed Bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, together with the Government of Dubai.

2.3 Potential of the financial sectors of activity chosen by the DIFC

Some sectors targeted by the DIFC seem well on their way while others may struggle to develop.

2.3.1 Banking Services (Investment, Corporate and Private Banking)

Major investment banks such as Goldman Sachs and Morgan Stanley have opened offices in Dubai. The main attraction of the region has been private banking (source: industry interviews). Over 320 billion dollars has been generated in oil and gas exports by the Gulf countries and it is estimated that one quarter has been repatriated back to the Middle East (Reed 2006). This represents a large pool of money which foreign banks are eager to access.

Based on our interviews, investment banking and corporate banking have also been identified as potential profit centers with teams being deployed in Dubai to serve the financing needs of local companies.

2.3.2 Capital Markets (Equity, Debt Instruments, Derivatives and Commodity Trading)

The DIFX has been opened to complement the local Dubai Financial Market (DFM). The local market serves local Dubai firms and a few companies from the region (such as Bahrain and Kuwait), but trading is largely restricted to locals. Denominated in US dollars, the DIFX hopes to attract companies interested in accessing foreign capital. Regulatory requirements (similar to London regulations) for listing on the DIFX are also much more stringent than those on the DFM, which might make local firms reluctant to switch. While the DIFX hopes to attract international firms, the uptake has been very slow.

2.3.3 Asset Management and Fund Registration and Business Processing Operations

Asset management is a particularly promising sector for Dubai given the concentration of wealth in the region. Investors in the region are becoming increasingly sophisticated. Beat Naegeli, the Dubai-based head of Credit Suisse Dubai private banking, said that big Arab investors, while still predominantly invested locally, are increasingly on the hunt for alternative investments (private equity, hedge funds, etc.). Many local investors are also willing to invest in local funds or Islamic law-compliant funds. Fund managers seeking a Middle Eastern base to be close to clients and investments are likely to choose Dubai for its high quality of life, infrastructure and the presence of other financial firms.

Fund registration and operations will be more challenging. On the one hand, Dubai benefits from a short-term cost advantage due to the low-cost labor from India that could be used to service shares. There is

nothing, however, to prevent companies from establishing operations where labor costs are even lower (e.g. in India itself). Regional political instability may also deter the fund registration business.

2.3.4 Insurance and Reinsurance

Insurance companies may eventually benefit from the tax-free status and the presence of other mutual funds but in the short term, political risks may prevent insurance companies from investing heavily in Dubai.

2.3.5 Islamic Finance

With the strengthening of Islamic identities throughout the region (source: Pew Global Attitudes Project 2005), Islamic Finance is a rapidly growing industry (source: internal confidential data from interview). While the industry started in Bahrain, companies are migrating to Dubai because of the higher quality of life and better infrastructure (source: industry interviews). Dubai is, consequently, rapidly becoming the dominant regional center for Islamic Finance.

Financial institutions may apply for licenses in the above sectors. As noted, firms in the DIFC are eligible for benefits including zero tax rate on profits, 100% foreign ownership, no restrictions on foreign exchange or repatriation of capital, and operational support and business continuity facilities.

2.4 Competition for the DIFC

Dubai's DIFC project has significant regional competition from Qatar, Saudi and Bahrain. However, Dubai's lifestyle – particularly for expatriate staff – and its regulatory environment should provide a sustainable advantage (see Exhibit 17 for a summary).

Fueled by the oil boom, local stock markets have risen anywhere from over 200% to more than 1,000% in the past four years, despite current sharp corrections in the UAE (Reed 2006). The UAE currently has two stock exchanges: the DFM and the Abu Dhabi Securities Market ("ADSM"), whose average traded value per year totals in excess of $200 million. The regional capital markets are growing with UAE and Saudi Arabia leading the GCC states. See Exhibit 15 for a summary of selected financial services clusters.

While each market has distinct rules and regulations, the capital markets and company legislation across GCC states are broadly similar, meaning that no one country has captured a regulatory advantage. Potential regional issuers face a number of obstacles under domestic legislation such as foreign ownership restrictions (e.g. foreign ownership of public joint stock companies in the UAE is restricted to 49%) and free float restrictions (e.g. public joint stock companies in the UAE must offer no less than 55% of the company's issued share capital to the public). In addition, prices of listed shares on subscription are generally limited to their nominal value: public joint stock companies are limited in their ability to issue shares at a premium. In addition, the UAE, Qatar, Bahrain and Kuwait permit unregulated over the counter trading.

Public offers can only be marketed through financial institutions licensed by the relevant regulator in the GCC state (e.g. the Central Bank in the UAE and the Capital Markets Authority in Saudi Arabia). Potential issuers sometimes encounter a bureaucratic, slow and uncertain listing process. Historically, financial services regulation throughout the GCC states has suffered from investor perceptions of poor corporate governance, transparency and reporting. There are currently however, important initiatives in a number of territories to adopt internationally acceptable regulatory practices (e.g., the Capital Markets Authority in the Kingdom of Saudi Arabia, the Qatar Financial Centre and the Bahrain Financial Harbor).

2.5 Cluster Evolution and Development

While there are significant potential risks to a thriving financial services cluster in Dubai, some of these risks are outside of Dubai's control (such as regional political risk). In other matters, Dubai has done most of what it can do quickly in order to strengthen the cluster. See Exhibit 17 for a map of Dubai's financial services cluster.

2.5.1 Industries/Clients Driving the Financial Services Cluster

Dubai's financial services industry enjoys a regional and global competitive advantage in region-specific industries and clusters, including energy, logistics (driven by Dubai's deep-water port), real estate

and trading. Additional industries which require high levels of energy (such as aluminum smelting) are now also gravitating towards the region, in part to defray fuel transport costs (source: industry interviews).

2.5.2 Professional Supporting Industries Offer a Mixed Record

Financial industry executives seem pleased with the strengthening of the legal and accounting services sectors (primarily through expatriates) (source: industry interviews), but still reflect concern about the lack of financial research and training capacity within Dubai, most of which is still based in London (source: *Euromoney* interview, industry interviews). Risk management by many local banks, and particularly Islamic banks, is done largely by proxy: if an international bank has deemed the risk acceptable, then a local bank will accept the risk without any further due diligence of its own (source: industry interviews).

2.5.3 Infrastructure

In internet and wireless communications, the UAE government has granted a domestic monopoly to Etisalaat. While most industry players find Etisalaat acceptable, there are already signs that Etisalaat is losing ground in the highly innovative battleground in ICT. For instance, the use of Skype (the popular internet-based telephony technology) is banned in the UAE because it is a threat to Etisalaat's monopoly (source: government interviews). As innovation continues at a rapid pace, Dubai's ICT infrastructure and service levels will need to find ways to keep pace.

2.5.4 Regulatory Bodies

More than most industries, financial services is heavily reliant upon regulatory structures to ensure confidence in the industry as a whole. There are some relatively serious concerns here as our own requests for data from various government ministries were either rebuffed entirely or promised but then undelivered. The region's reputation for opacity and corruption absolutely requires that the regulatory bodies hold the industry to high standards and support them with transparent enforcement. The DIFC is the government's major effort in this regard but it leaves local and regional banks in a different class, as they compete with international banks but do not enjoy the regulatory benefits (or constraints) of the DIFC.

Support clusters are discussed in the cluster diamond analysis below.

2.6 Financial Services Cluster Diamond Analysis (see Exhibit 18)

2.6.1 Related and Supporting Industries

Large numbers of trade shows. The government and tourism industry's sponsorship of trade shows fosters business dealings which generate significant financial services business (source: industry interviews).

Influx of foreign firms has raised local standards. The introduction of international banks to the market has forced local and regional banks to try and ramp up operations, efficiency and innovation to compete with the international banks.

DIFC effort to create transparent regulatory regime with respected foreign regulators and judges. This regulatory effort is critical given the region's reputation for opacity and will boost Dubai's competitiveness vis-à-vis its neighbors.

Airline/airport infrastructure and service, and "open skies" policy. Financial services requires substantial client contact. Emirates Air is regularly ranked as one of the top two or three airlines in the world (source: Business Traveler Magazine and http://www.ddia.ae/English/?action=article&ID=52&p=3). One of our interviewees marveled that he could exit his plane, pick up his bags and be at his home within 45 minutes. Similarly the service and routes offered by Emirates Air make Dubai a relatively easy place from which to do business, further strengthening Dubai's competitive advantage vis-à-vis its neighbors.

Local legal, accounting and finance infrastructure, while improving, remains weak. As the cluster continues to grow, more expatriate dominated firms will continue to enter Dubai and strengthen its otherwise weak legal and accounting industries.

2.6.2 Factor/Input Conditions

2.6.2.1 Positive conditions

Strong political support from Sheikh Mohammed. Dubai is, for all intents and purposes, run by a single individual. While he is alive, he is viewed as being supportive of Dubai's development and seems intent on delivering good governance. His political support of the industry is a crucial asset and differentiating factor in the GCC region where poor governance is the dominant norm. However, if

something were to happen to Sheikh Mohammed, one might worry about future leadership, as it has limited democratic accountability.

Vibrant place to visit/live (strong leisure cluster). One of Dubai's critical advantages over its neighbors is its vibrant lifestyle. Whereas other countries in the region have been described as "sleepy", "dull" and "boring" (source: multiple interviews), Dubai has been described as "fun", "vibrant", "exciting" and "like a global university campus where you have people from all over the world – except now they have money to spend" (source: multiple interviews). Activities available in Dubai which are attractive to expatriates include a thriving nightlife, well-developed beaches (including water sports), loads of shopping (including the largest mall in the world), an indoor ski slope and entertainment and sporting "events" attended by international celebrities and athletes. One European expatriate described Dubai as a "bit of the West in the middle of the Arab world." The vibrant lifestyle is attractive to those within the region as well. Two interviews described a dynamic where businesspeople needing to meet from different parts of Saudi Arabia choose to meet in Dubai rather than in Saudi (source: industry interviews).

Other positive competitiveness attributes. (1) Physical and cultural proximity to cash-rich oil and gas cluster; (2) Strong history as trading center; and (3) High levels of regional growth.

2.6.2.2 Negative conditions

International / extra-regional politics. As long as the international community continues to associate anything Arab with "terrorist" or "corrupt", the Dubai financial services cluster will be unlikely to garner significant business from outside the GCC region.

Other negative competitiveness attributes. (1) Low levels of skilled local labor; (2) Residual reputation of opacity; and (3) Poor management and finance education.

2.6.3 Context for Firm Strategy and Rivalry

2.6.3.1 Positive conditions

Intense local competition. The introduction of the DIFC (and the more than 100 international banks which have already signed up) has placed intense competitive pressures on local and regional banks.

International banks and competition have forced local and regional banks to rapidly adopt best practices and seek differentiation in the market-place. There is, however, also substantial sentiment that the region is "substantially over-banked" (source: industry interviews).

Domestic / regional politics. One of the ironic benefits of competing in the GCC region is that governance amongst the UAE's neighbors is considered so poor that financial services clients have been streaming into Dubai as a haven of security for regional investment. Moreover, the anti-Arab or anti-Muslim sentiment which runs through much of the rest of the international community does not exist within the GCC given that the clients in the GCC themselves share the same identity set.

Rocketing stock market. A great deal of wealth has been created in recent months on the back of the UAE's rocketing stock market. Confidence in the market is so high, in fact, that many consumers in the UAE have been taking out short-term "margin" loans to buy IPO stock, selling the stock when its share price rises and then repaying the loans (source: EFG Hermes 2005, p 2; industry interview). This may be sustainable as long as the market continues to rise but creates obvious risks if share prices do not always rise. Dubai's "…Securities and Commodities Authority (SCA) ordered brokerage firms not to provide margin lending to customers is a sign that the regulatory authorities perceive that excessive risk is being undertaken by financial intermediaries." (Source: EFG Hermes 2005, p 2.) Unfortunately, this directive does not prevent banks from providing unsecured loans which serve essentially the same purpose as margin lending.

Heavy reliance on expatriate talent. The GCC benefits from having large amounts of concentrated wealth but suffers from a lack of indigenous skilled human resources to handle the financial services needs of the region (source: multiple interviews). As a consequence, the financial services industry throughout the region is heavily dependent upon expatriates. Combined with the fact that most of the clientele for financial services in the region will likely come from regional players (see International /Extra-regional politics section above), the competitive focus of Dubai should be on making itself a more attractive choice for expatriates to live and work than its neighbors in the GCC.

Other positive competitiveness attributes. (1) Streamlined immigration processes; (2) Regional financial services competitors are poorly developed (see above and Exhibit 16); and (3) Low or zero tax rates.

2.6.3.2 Negative conditions

Low levels of indigenous talent. The financial services cluster in Dubai runs the risk of falling apart if there is any sort of exodus of the expatriates who dominate the industry. Expatriates are given very few rights and tend to treat Dubai as a place to go for a few years before returning home, meaning they tend not to have very strong roots in Dubai. Given the volatile geopolitical region that Dubai resides within, a political crisis is an ever-present possibility, as pointed out by one analysis: "The UAE is also aware that any escalation of conflict in the region has economic implications for the Emirates, undermining the bullish projections for … the country's medium-term economic strategy…" (EIU 2005, p. 8). If expatriates leave, the financial services industry in Dubai would essentially fall apart.

Unfortunately, efforts to improve the indigenous talent levels have not been promising, in part because of cultural barriers. One prominent example is that the government was trying to organize a satellite campus of Wharton's business school in Dubai but abandoned the project because they did not believe it would be successful, citing the lack of motivation perceived amongst Emiratis to seek out management education (source: government interviews). Pseudo-affirmative action policies are also in place which require a certain percentage of Emiratis in management positions of publicly-related companies – often getting them placed in positions much higher than their qualifications would otherwise merit, getting them "in over their heads" - particularly when competing against international banks (source: government and industry interviews). The relatively few Emiratis with international level skill sets are in extremely high demand (source: industry interviews).

2.6.4 Demand Conditions

Openness to imported skills. Dubai has exhibited a strong willingness to import skills, evidenced by Dubai's large expatriate population (80-90%). Given the lack of indigenous Emiratis with the skills to work in financial services, this openness is absolutely critical to the success (or maintenance) of the cluster.

Demanding client base. The large number of local and regional banks combined with the more than 100 international banks who are joining the DIFC has created an environment of intense competition amongst banks. This competition has precipitated two dynamics – one positive and one negative: (1) The large number of competitors has increased the access to capital which, eventually, could facilitate increased commercial and entrepreneurial activity; but (2) The downside to so many banks is that levels of credit risk have been skyrocketing (described in Section 2.7.3 below).

Local and regional investors are beginning to prefer to keep assets in the region post September 11. After 9/11 (and again with the recent Dubai Ports controversy), financial services clients in the Gulf region are starting to exhibit a reluctance about keeping too much money in the "West" for fear of political reprisals in the future (source: industry interviews). As a consequence, banks in the region have started to see increasing amounts of funds staying in the region. One consulting firm estimates that over US$300 billion of regional oil revenue alone is being created in the region, roughly one-fourth of which is estimated will remain in the GCC. (Reed 2006). Whereas it is unlikely that Dubai will successfully attract significant business from outside the GCC, as long as Dubai maintains a competitive advantage vis-à-vis its neighbors (see Exhibit 16) in the GCC, the cluster should continue to thrive.

High oil and gas profits. High energy sector profits are both a blessing and a curse: On the one hand, the high levels of profits and political pressures keeping money in the region mean that local and regional banks in the financial services cluster are flush with capital. On the other hand, the high levels of capital mean that banks feel a great deal of pressure to deploy their capital, raising the levels of unsecured credit risk (source: multiple interviews). Given the low levels of credit risk evaluation capacity, the higher levels of unsecured credit increase the risk of a banking crisis. (See Section 2.7.3 below.)

Booming (bubble?) real estate sector. The real estate sector in Dubai is booming, generating massive profits in the last several years, and will soon turn into a bubble. Much of this boom has been driven by Dubai's decision to open up ownership of certain areas to foreigners. Whereas developers have made substantial amounts of money to date, there will soon be excess supply in the market – particularly in condominiums and "un-landed" properties. For instance, in one 1.8 kilometer stretch beginning with the Dubai Marina, 200 apartment buildings are being built (ranging between 10 and 40 stories each) (source: multiple interviews). According to one interview, whereas only 20 to 30% of bank obligations are nominally tied to real estate loans, in reality, a substantially larger percentage of bank exposure is tied to real estate through corporate loans which are then used for real estate ventures. The concern is that real estate will suffer from over-supply in two or three years time and debtors will simply return the buildings to banks rather than perform under their loan obligations. Given the particularly illiquid nature of real estate and the likelihood that defaults on real estate will happen in waves, banks could suffer enormous losses if a bubble develops and real estate suffers a downturn.

Improving legal environment. While the legal environment in Dubai used to suffer from opacity, the government has made positive steps towards creating transparency by granting the DIFC the autonomy to craft its own governance free from government interference.

Retail investment products lacking. Most of the financial services sector is either dedicated to corporations or high net-worth individuals or the giving of loans to consumers (source: industry interviews). There are few retail investment products available to local consumers from the cluster.

Under-developed equity and debt markets. Despite high hopes for the equity and debt markets (source: government interviews) they remain largely underdeveloped and, in the case of equity markets, still largely dominated by oil and gas entities.

2.7 Challenges and Risks for the Financial Cluster

2.7.1 Reliance on Expatriates

Dubai has experienced rapid growth recently in a particularly challenging geopolitical neighborhood. However, much of this growth has been driven by expatriates. Dubai must either protect against over-dependence upon expatriates or foster long-term commitment on the part of expatriates to Dubai (perhaps through civil society initiatives and the granting of incremental rights). Expatriates have little long-term commitment to Dubai, partially because they are not given significant property, legal and civil rights. A political crisis may precipitate large-scale departure of expatriates which, in its current state, would decimate the financial services industry.

Dubai needs to develop a local human resource base, particularly focusing on education in management, finance and English language skills. To manage the transition to a skilled local workforce, Dubai should increase expatriate commitment to Dubai by granting incremental rights and maintain the lifestyle that expatriates find so appealing.

2.7.2 Transparency, Lack of Track Record and Illiquidity of the DIFX

The DIFX faces a number of challenges in the initial phase of its launch as it has had difficultly gaining momentum. According to Mr Christian Mouchbahani of Dubai Bank, "there is a psychological obstacle of listing on an exchange which is untried and unknown, especially for GCC incorporated companies. A greater level of sophistication is expected of issuers and market participants." There is a huge unknown with the effort to develop the DIFC. It has been slow to get started and may take a long time to get established. Our interviews revealed that there has been some tension in the already established financial market. Even today most listings are on the DFM, not the DIFX. Local companies not used to international regulations view the regulatory provisions as more burden than benefit. The lack of accountability is reflective of the lack of transparency in companies in the Middle East where most local and regional companies will seek to list on the DFM until they see substantial benefit of listing on the DIFC.

According to Mr Adam Key of Citigroup, one of the DIFX's challenges is to attract sufficient issuers and instruments to ensure a meaningful liquidity pool, which will be attractive to investors. Adoption and enforcement of international regulatory standards will be key. Mr Mohamed Metwally of Standard Chartered

Bank remarked that "the DIFX is a new exchange and is yet to be tested in relation to its legal framework, enforceability of the legal framework, and its ability to attract the trading volume and liquidity issuers and investors would seek in such a market."

2.7.3 Credit Risk

A banking crisis could do permanent damage to the cluster. Dubai currently bears potentially high levels of credit risk from over-exposure to real estate, construction and energy, and because due diligence is weak. A Customer has the ability to compel a bank to offer it credit on attractive terms because there are so many alternatives to any one bank. Combined with the large influx of cash due to high oil prices, you see high levels of willingness to offer credit (source: industry interviews). If oil prices begin to drop or too many of these loans become non-performing at once, Dubai runs the risk of a severe banking crisis. In response, as the EIU UAE report describes, "…the UAE is considering raising reserve requirements on demand deposits in order to restrain bank lending, which increased by 35% in the 12 months to the end of the first quarter of 2005." Overheating is also a concern, with investors borrowing money to chase local stocks and consumer debt growing to worrying levels.

2.7.4. Competitive Risk from Regional Competitors

As Dubai's neighbors, particularly Qatar and Saudi Arabia (by far the largest market for financial services), begin to notice Dubai's success, they may begin to seek their "share" of the market more aggressively. Qatar, for instance, has required banks working on its energy projects to have a local presence.

2.7.5 Political Risk

The GCC region, including Dubai, also suffers from political risk and perception problems which may impair the cluster. As Dubai strengthens its position as a regional financial services center, it will become increasingly vulnerable to political volatility, both internally and from its neighbors.

3 RECOMMENDATIONS

3.1 Recommendations for the DIFC and Financial Firms

Focus on those services where Dubai has a regional competitive advantage: While the risks defined above are serious, there is still a great deal of promise in Dubai's financial services sector. There are several things that Dubai-based firms should do to maintain that promise: In creating sustainable competitive advantages, Dubai should consider focusing its financial services on services where it has a regional competitive advantage including: Funds based on regional assets (such as oil and gas), Islamic law-compliant funds and investment banking for regional firms. Other parts of the cluster (e.g. reinsurance), can wait.

Next, Dubai should capitalize on its regional private banking market as most international banks are attracted by these opportunities. The DIFX has the potential to act as a catalyst to attract regional heavy weight issuers, enhance liquidity and enlarge ownership of securities to institutional and high net worth investors.

The DIFC must maintain investor confidence and focus on ***secondary*** *listings:* The DIFC must maintain investor confidence. Mr Christian Mouchbahani of Dubai Bank believes the DIFX must continue its efforts to attract and maintain the confidence of investors, in particular international institutions in the initial development phase. Given the constraints defined above, the DIFX is unlikely to be the site for primary public listings but could well position itself for companies seeking a dual or secondary listing. Mr. Ghassan Medawar of DIFX indicated that "the DIFX has developed a strong pipeline of prospective IPO candidates and companies wishing to do a secondary listing in terms of equities and/or bonds. In fact, over ten potential issuer candidates are considering IPOs on the DIFX in the first six months following the launch date. The issue sizes range from US$200 million to US$1 billion." On February 23, 2006, for example, Saudi Arabia's Prince Alwaleed raised $397 million for his Kingdom hotel investments, which will be dual listed on the DIFX and London.

3.2 Recommendations for the Government

Coordinate the creation of a financial services IFC: Dubai's government should coordinate the creation of a regional financial services IFC, funded and administered jointly with regional competitors to:

(1) Serve as a center for innovation (particularly in new financial products); (2) Spread costs in the marketing of the region's financial services; (3) Facilitate the spread of best practices; and (4) Provide much-needed training to the sector and encourage local talent development. Many people outside the Middle East still view the region with undue suspicion, so Dubai should coordinate an IFC to "re-brand" the region. This regional IFC should also develop a long-term strategy to "re-brand" the region, coordinate policy initiatives to support and strengthen the marketing strategy, and facilitate exchanges with business and policy leaders in target markets.

Take steps to foster stronger expatriate ties to Dubai: Finally, the government needs to treat the expatriate community as long-term residents and give it a voice in the community by allowing for the building of a civil society. This would include gradually granting additional civil rights and liberties. It should also seek to improve conditions for low-income labor.

Open up the local financial sector to foreign competition: The government should also open the local financial sector to foreign competition. It seems difficult to establish a world-leading financial center when local banks are protected from competition for domestic business. Foreigners should therefore also be allowed to operate and trade shares on the local stock market.

Facilitate liquidity in the DIFX through privatization: The government should also accelerate privatization by selling off its financial holdings quicker and transfer ownership of public entities as a way to stimulate deal flow in the capital markets.

Long-term educational advancement by promoting a culture of education and reading: Dubai's exposure to expatriate talent demands the development of an indigenous talent pool. The political leadership should seek to change the social narrative within Dubai towards one of valuing and seeking education.

Take steps to protect against political risk: Dubai's government should consider the following steps to mitigate its complex political risks:

- Avoid conflicts with other states; and

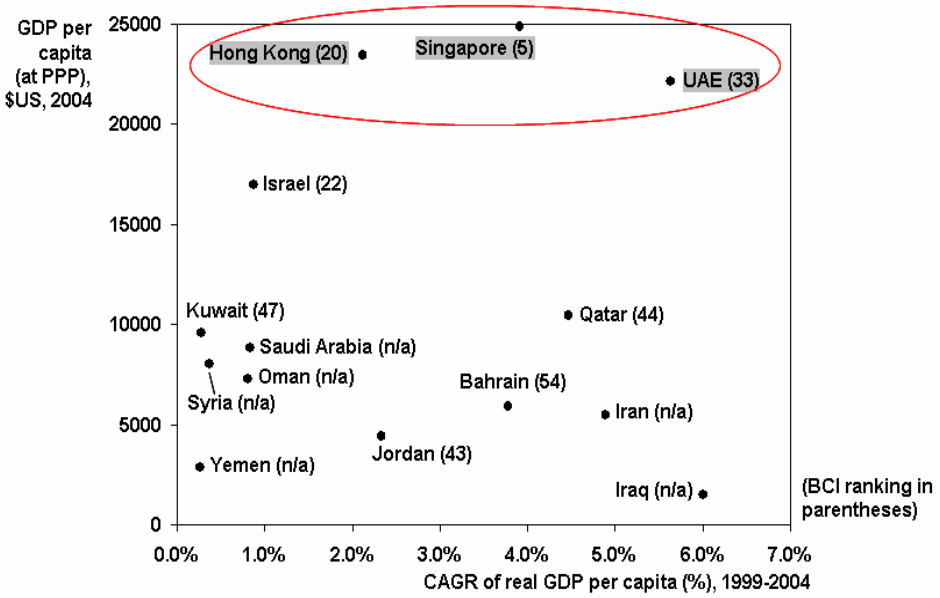
- Encourage (or require) banks (particularly exclusively local or regional players) to retain more earnings and/or acquire political risk insurance.

EXHIBITS

Exhibit 1: Map of Persian Gulf area, UAE and Dubai

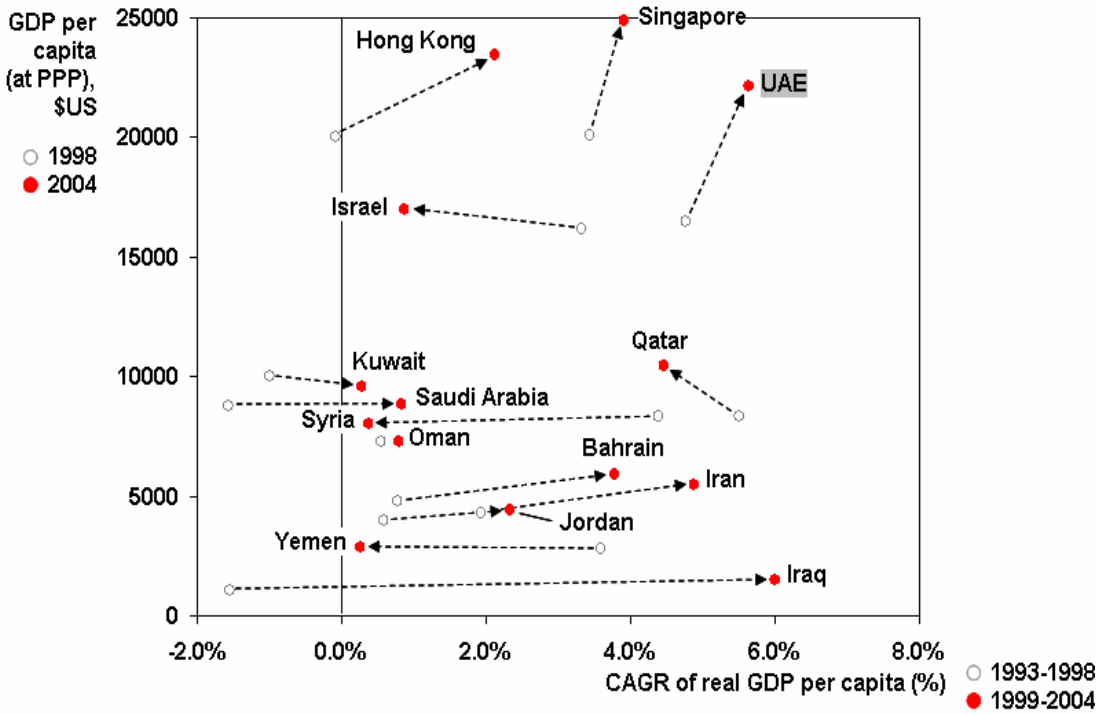
Source: http://www.uark.edu/depts/globmark/middeastmap.jpg

Exhibit 2: GDP per Capita for Selected Countries



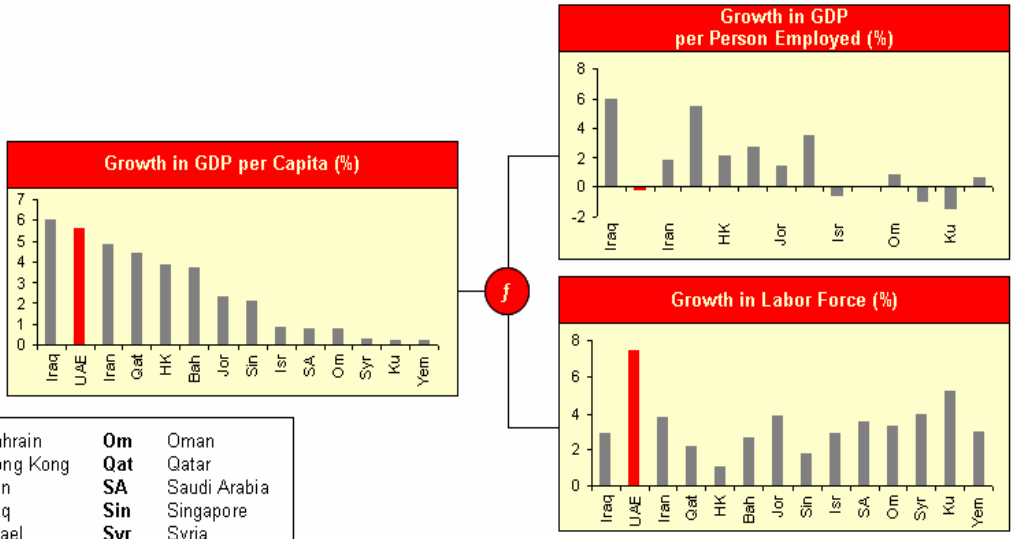
Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2006, http://www.ggdc.net; BCI

Exhibit 3: Longer-Term GDP per Capita for Selected Countries



Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2006, http://www.ggdc.net

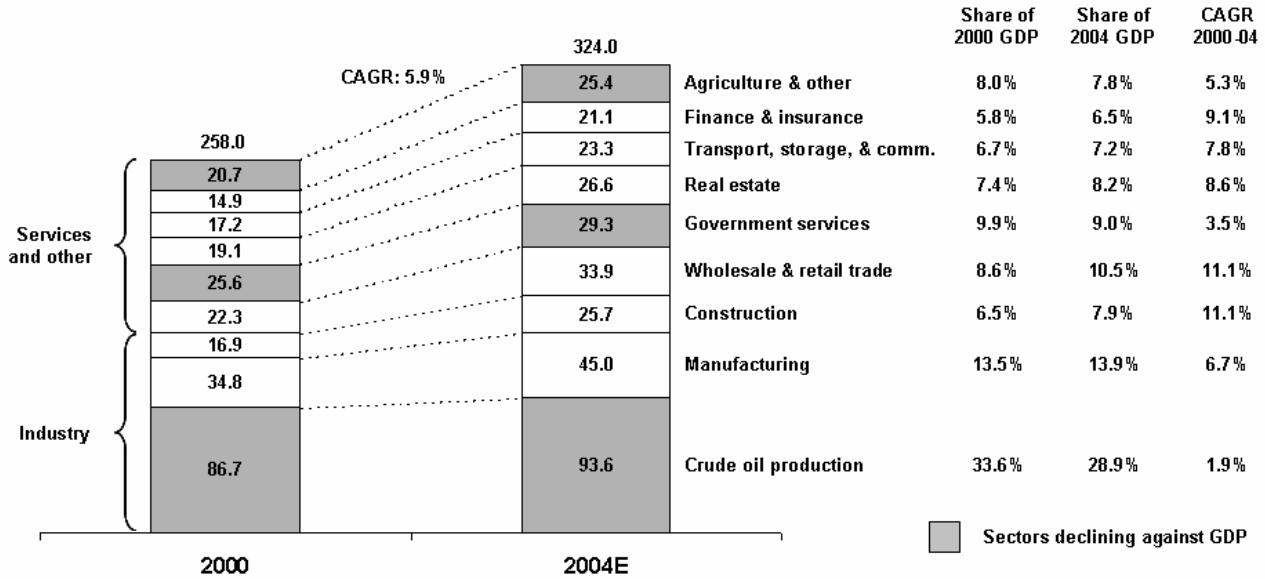
Exhibit 4: Decomposition of Growth in GDP per Capita, 1999-2004



Bah	Bahrain	**Om**	Oman
HK	Hong Kong	**Qat**	Qatar
Iran	Iran	**SA**	Saudi Arabia
Iraq	Iraq	**Sin**	Singapore
Isr	Israel	**Syr**	Syria
Jor	Jordan	**UAE**	UAE
Ku	Kuwait	**Yem**	Yemen

Note: no hourly labor data available
Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2006, http://www.ggdc.net

Exhibit 5: Composition of UAE GDP, constant 2000 prices, millions of dirhams



Source: IMF 2005

Exhibit 6: Selected Social Development Indicators, 2004

	Bah.	Iran	Iraq	Israel	Jordan	Kuw.	Oman	Qatar	Saudi	UAE	Yem.
Life expectancy at birth (yrs)	75	71	n/a	79	72	77	75	74	72	79	61
Infant mortality (per 1000 live births)	9	32	n/a	5	23	10	10	18	21	7	82
Under-5 mortality (per 1000)	11	38	n/a	6	27	12	13	21	27	8	111
Adult literacy rate - female	84	70	64	96	85	91	74	89	69	82*	n/a
Adult literacy rate - male	89	84	84	98	95	94	87	89	87	76*	n/a

Source: World Bank, World Development Indicators; IMF (2005); *CIA World Factbook

Exhibit 7: Business Competitiveness Index Ranking for UAE, 2005

Strengths Relative to GDP Per Capita	
Prevalence of trade barriers	3
Air transport infrastructure quality	4
Port infrastructure quality	7
Reliability of police services	11
Overall infrastructure quality	13
Prevalence of foreign technology licensing	15
Intensity of local competition	17
Favoritism in decisions of government officials	23

Weaknesses Relative to GDP Per Capita[1]	
Extent of staff training	58
Extent of bureaucratic red tape	59
Effectiveness of antitrust policy	66
Capacity for innovation	73
University/industry research collaboration	73
Quality of scientific research institutions	77
Railroad infrastructure development	83
Quality of management schools	84

Source: Institute for Strategy & Competitiveness, BCI

Exhibit 8: Relative Ease of Doing Business in UAE and Neighboring Countries, 2005

Metrics	Israel	Saudi Arabia	Kuwait	Oman	UAE	Jordan	Yemen	Iran	Iraq	Syria
Starting a business	12	147	87	61	**134**	119	151	54	117	135
Dealing with licenses	83	34	95	114	67	59	32	145	70	78
Hiring and firing	58	28	26	33	73	68	53	112	102	94
Registering property	134	3	79	19	10	104	41	98	44	76
Getting credit	12	56	52	147	**104**	65	137	64	133	124
Protecting investors	6	74	71	50	**96**	124	108	138	85	105
Paying taxes	97	5	8	4	6	15	112	23	3	42
Trading across borders	11	87	69	79	19	61	68	132	155	146
Enforcing contracts	103	95	98	87	**133**	58	57	55	74	149
Closing a business	38	67	45	76	**130**	70	68	94	148	65
Doing business	**29**	**38**	**47**	**51**	**69**	**74**	**90**	**108**	**114**	**121**

Better ← → **Worse**

Source: World Bank Group www.Doingbusiness.org

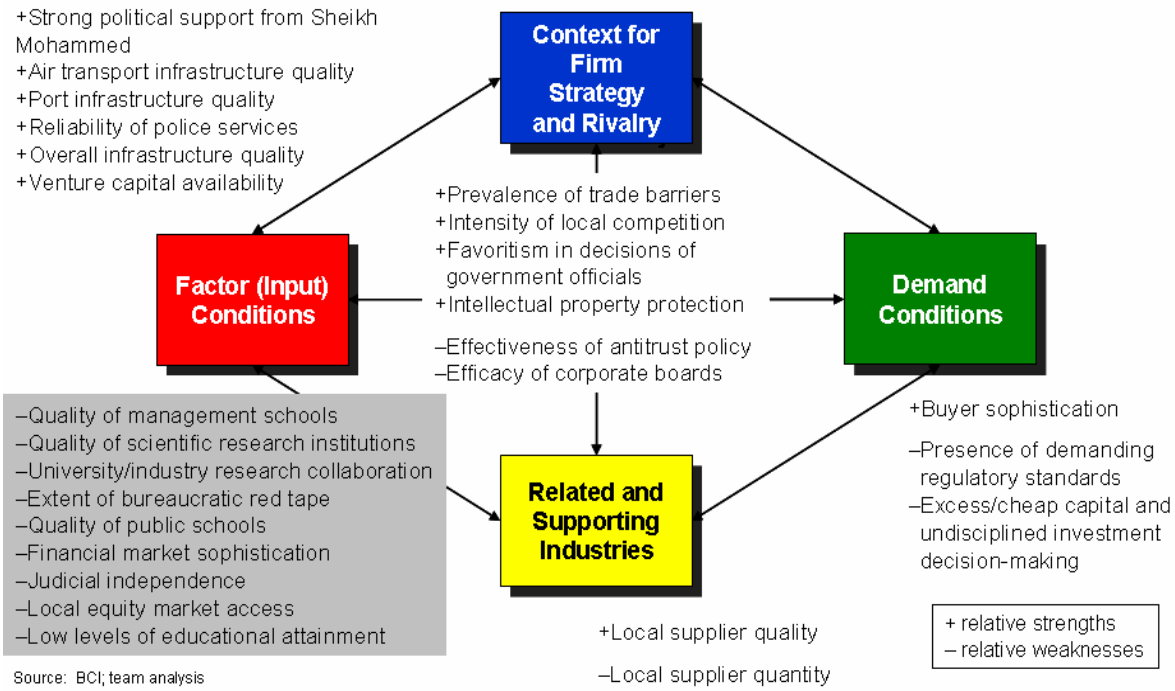
Figure 9: Selected Educational Performance Indicators, 2004

	Bah.	Iran	Iraq	Israel	Jordan	Kuw.	Oman	Qatar	Saudi	UAE	Yem.
Primary completion rate – female	100	97	63	100	96	92	90	91*	61	74	46
Primary completion rate – total	100	95	74	100	97	91	91	92*	62	75	62
Enrollment – primary (%)	97	89	88	99*	93*	86	78	90	53	71	75
Enrollment – secondary (%)	90	78	38	89*	82*	78**	75	87	52	62	n/a

* 2003 ** 2002

Source: World Bank, World Development Indicators

Exhibit 10: UAE National Diamond



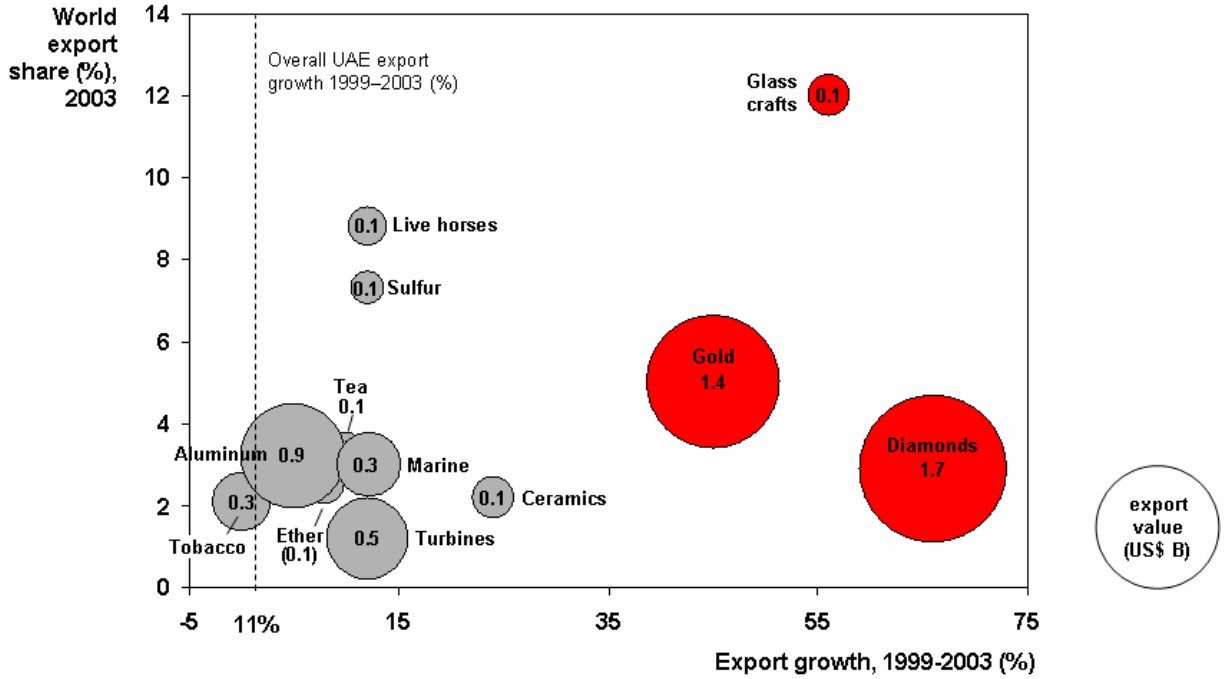
Source: BCI; team analysis

Exhibit 11: Dubai's National Economy Strategy

National Context: Strengths and Weaknesses	National Response / Goal	Evaluation of Response / Goal
Strategic location for shipping and air transportation	Become regional logistical hub with efficient infrastructure	Excellent: e.g. Emirates (1st or 2nd in the world),100 airlines to 145 cities, Jebel Ali port, 2600 companies in tax-free zone
Located in unstable region	Become regional haven of efficiency, transparency and tolerance to attract multinational regional head offices	Good: e.g. home to 800 US firms' regional headquarters, but concerns with bureaucracy and transparency remain
Small population and lack of advanced educational infrastructure and innovative capacity	Import low-skill manual labor Lure high-skill expatriates and create appealing environment to retain their services	Reports of widespread abuse May not be sustainable in long-term as talent is lured away, repatriated or fails to upgrade skills
Limited reserves of oil and gas and few natural attractions	Invest in new service clusters: • Logistics / transportation • Tourism / leisure • Financial services • Media	Excellent Very good: e.g. 5m tourists p.a. Emerging Emerging, but concerns over independence and transparency

Source: Press reports; team analysis

Exhibit 12: UAE Goods Exports by Cluster(1)



(1) Services data unavailable
Note: Petroleum oil and gas products (exports worth $24 billion) excluded to avoid distortion of chart; otherwise includes only goods in which UAE has >2% of world exports
Source: UNCTAD; WTO; ITC

Exhibit 13: DIFC Environment

Regulatory	Infrastructure	Regional Demand
100% foreign ownership allowed Strong regulatory framework and transparency Transactions denominated in US$ English used as working language No tax on income and profits No foreign exchange restrictions	Modern, first-class infrastructure • Telecommunications • Office buildings • Local transportation network • Airport and airlines Operational support Good quality lifestyle for highly-skilled employees	Ready access to wealthy individual and corporate clients

Source: Team interviews; press reports; team analysis

Exhibit 14: Selected International Cluster Participants

Cluster Participant	Country of Origin	Selected Cluster Activities of Participant
ICICI	India	Set up branch in DIFC in December 2005
Lloyds TBS	UK	Private bank established in December 2005
Permal (hedge fund)		Gained license in July 2005
Standard Bank Plc	UK	Established first full overseas branch in DIFC
Deutsche Bank	Germany	Opened Dubai branch in DIFC in March 2006
Morgan Stanley	US	Licensed to establish first Middle East office at DIFC in March 2006
Standard Chartered	UK	Purchased Landmark Building in DIFC in March 2006
HSBC Holdings	UK	Expanding regional operations in Dubai
Credit Suisse	Switzerland	Considers Middle East to be one of its most important markets and will offer investment banking, private banking and asset management. The first international bank to be granted a license
Rasmala investment		Shifted office from Bermuda to Dubai
Merrill Lynch Swiss Banking Arm	US	Licensed to operate from DIFC in April 2005 and planning to offer services to high net worth individuals
Lehman Brothers	US	
Goldman Sachs	US	Recently announced intention to invest in DIFC after initial skepticism

Source: Team interviews, press reports

Exhibit 15: Size of Selected Financial Services Clusters: 2005

	Domestic Listings	International Listings	Total Market Capitalization (USD MM)	Daily Trading Value (USD MM)
Global				
New York	1892	472	10,311,156	56,052
London	1890	382	4,001,340	10,148
Tokyo	2119	34	1,564,244	12,894(1)
Hong Kong	968	10	194,004	2,342
Singapore	434	67	63,048	481
Regional				
Saudi Arabia	77	0	649,047	2,150
UAE / Dubai	79	4	188,018	207
Qatar	32	0	78,649	56
Bahrain	49	0	17,062	2

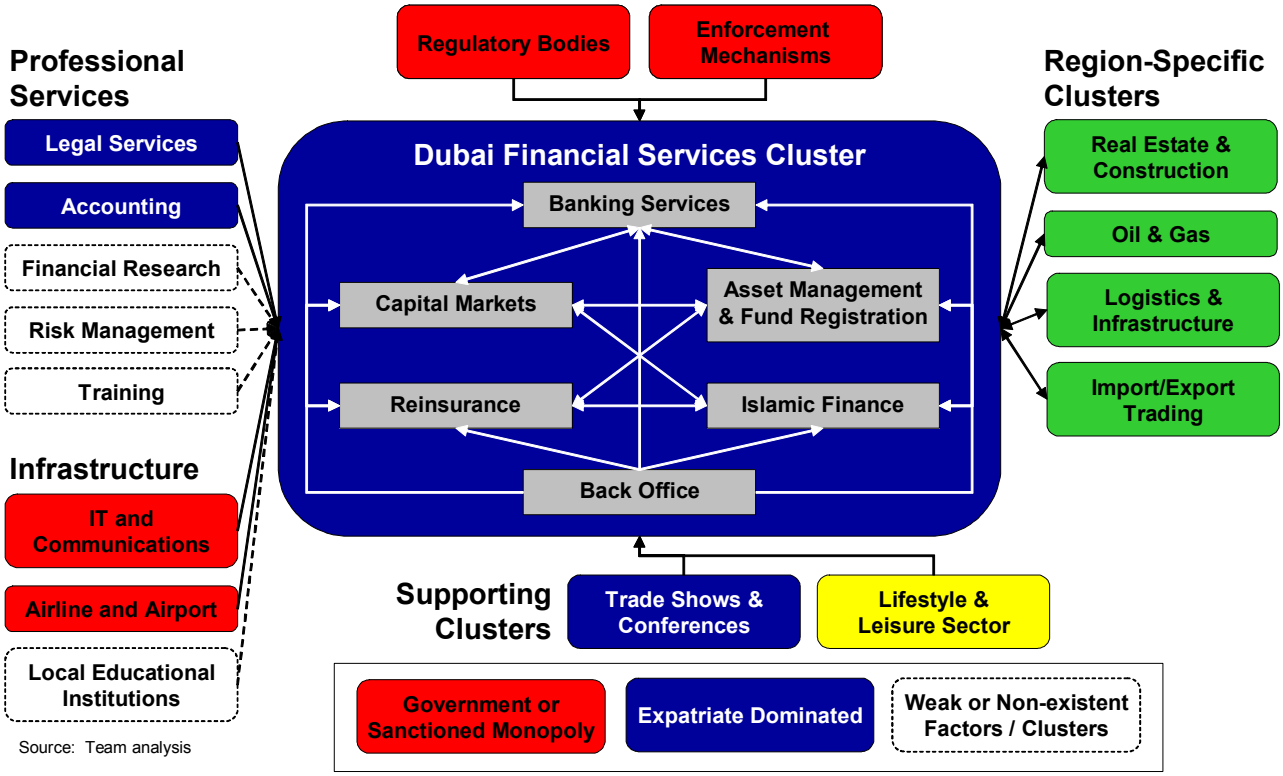
(1) 2004
Source: NYSE; LSE; TSE; HKSE; SSE; SHUAA Capital

Exhibit 16: Regional Financial Services Competitors for Dubai

Regional Competitor	Competitor's Actual (or Potential) Advantage Over Dubai	Dubai's Sustainable Advantage Vis-à-vis Competitors
Qatar	- Foreign players permitted to conduct local business - Large energy sector projects serve as a carrot/stick	- First mover advantage (Dubai's "brand" is already far ahead) - Dubai lifestyle is more attractive to expatriates - Existing financial and regulatory regime superiority - High costs of switching or duplicating offices already in Dubai
Saudi Arabia	- Strengthened regulatory infrastructure - Slowly opening financial markets - Geography and existing relationships are large advantages in a relationship-driven industry - Easily the largest market in the GCC	- Expatriate concerns about living in Saudi Arabia - Political stability - Financial and regulatory superiority - The Saudi market itself is already comfortable with Dubai
Bahrain	-First mover in Islamic finance	- Bahrain is characterized by expatriates as "sleepy", "dull" and "boring", whereas Dubai is considered "vibrant" and "exciting". - Dubai has already outstripped Bahrain
Other Emirates	- None	- None of the other Emirates has exhibited any strong interest in competing with Dubai - Most banks are already in Dubai. It would make little financial sense to have duplicate offices in the UAE - Emirates Air has high quality service, planes and routes, allowing for easy access to clients / customers
Rest of GCC	- None	- First mover advantage (Dubai's "brand" is already far ahead) - Attractive lifestyle for expatriates - Will have financial and regulatory superiority - High costs of switching offices to a regional neighbor

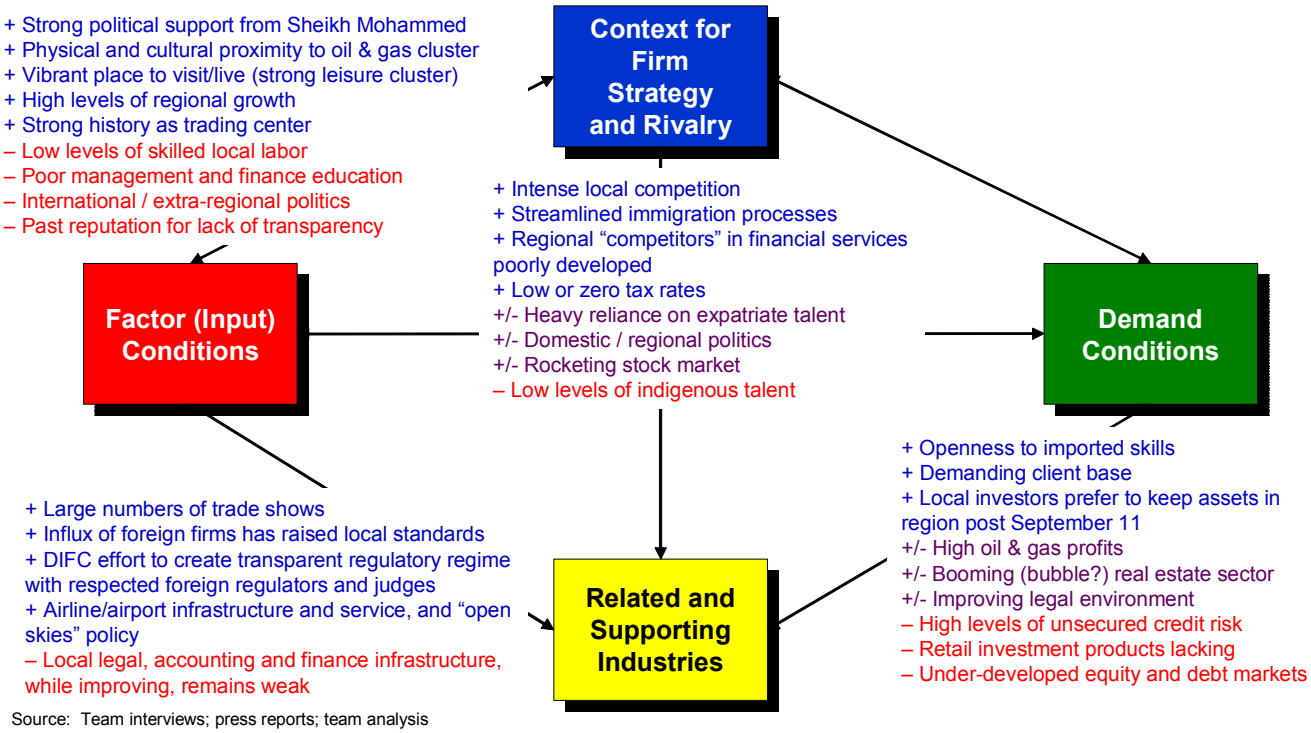
Source: Team interviews; press reports; team analysis

Exhibit 17: Dubai Financial Services Cluster Map



Source: Team analysis

Exhibit 18: Dubai Financial Services Cluster Diamond



Source: Team interviews; press reports; team analysis

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Interviews Conducted:

Georges Makhoul, Managing Director Morgan Stanley, Regional head for Middle East and North Africa.

Bernhard Engelien, Associate Principal, McKinsey Dubai office, financial sector expert.

Karen Kenneally, Morgan Stanley Dubai office.

Phillip Haerle, Director McKinsey Germany, stock exchange expert.

Michael J. Baumgartner, MOC class alumni.

Elizabeth Stephens, Marketing Manager at *EuroMoney*

Banking executives (who preferred to remain anonymous) from the Middle Eastern or Dubai offices of ABN/Amro, HSBC, Citibank, Dubai Islamic Bank and Standard Chartered Bank

Members of the Dubai Development Investment Authority

Officials from a number of stock exchanges in the region