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Effect of Oil Price Volatility on Construction Projects in United Arab Emirates

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Abstract: **Oil price volatility has sparked a lot of speculation in the market, forcing investors to criticize their investment decisions with hindsight. Simply put, volatility is a numbers game; one that applies statistics in the analysis of how returns disperse for a particular market index or security. Either variance in income generated from the same market index/security or standard deviation can be used to measure volatility. This paper targets to expound on the effect of oil price volatility on U.A.E construction projects. By analyzing the extent to which investment decisions in U.A.E's construction industry have been affected by the almost unpredictable nature of oil prices, the paper seeks to shed some light on viable solutions that, when properly implemented, can help salvage the booming industry from complete annihilation.**

Keywords: **Oil price volatility, U.A.E, construction industry.**

1. INTRODUCTION

The prevailing volatility in oil prices has set a plethora of project companies on paths of uncertainty and possible future bankruptcy; the U.A.E is no exception. In the event of a continuous period of unpredictable oil prices, project companies may end up making massive losses and may be forced to postpone their activities or shut down altogether (Rowland, Christopher and James, Mjelde 212). These changes in oil prices, from USD 115 in 2014 to USD 33 in 2016, that is, about 70% decrease in prices (Figure 1.0) , have seen to it that the values of assets, especially within the Gulf Cooperation Council, due to the heavy dependence on the oil industry, have staggered towards an all-time low (Rowland, Christopher and James, Mjelde 212). The property market has been hit hard as it experienced up to 2.3% reduction in average rent during the second quarter of 2015's financial year (Emirates247.com).

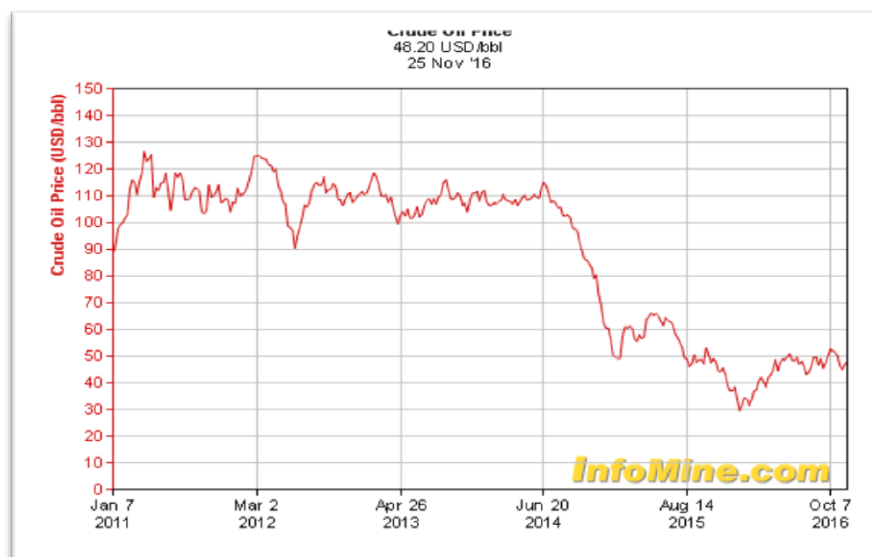

Figure 1.0: 5 Year Crude Oil Prices and Price Charts; source: Investment Mine.

The Kingdom of Saudi Arabia took an oblivious stand by refusing to lower total oil production like they previously used to do (Rowland, Christopher and James, Mjelde 212). Owing to this, and the fact that China's economy has plummeted and has helped create a market with excess supply and weak demand. Various factors have come into play as the U.A.E is struggling to cushion participants of the construction industry from the lurking dangers of oil price volatility (Rowland, Christopher and James, Mjelde 212). From reducing the number of construction contracts that the Gulf Cooperation Council (GCC) governments are awarding to market diversification away from oil dependency, no stone has been left unturned in the quest for economic revival within the U.A.E (Salah 257).

2. REDUCTION IN CONSTRUCTION CONTRACTS AWARDED

If at all history is anything to go by, then the relationship between expenditure on projects and oil prices is directly proportional. Over the duration of 2002 to 2008, the price of oil rose from USD20 to USD100 whereas government spending on construction contracts increased from USD 9.7bn to USD 126bn (Linesight.com). It is, therefore, safe to say that when the oil prices are low, the government is less assertive in the decision-making process and is less willing to award construction contracts. The year 2015 was a period of a tightened cash flow and fewer awarded contracts because most organizations needed to recheck their plans on capital expenditure. The GCC governments have estimated to award contracts valued at around USD 140bn in 2016 (Salah 257). The figure translates to about 15% decrease when compared to last year's numbers.

Risk has a real bearing on government expenditure. The government spends more when the risk is low and reduces the spending when the risk is high. Everybody seeks to cushion themselves against losses before investing in high-risk ventures. Lowering expenditure would mean that if the market does not pick up, the setback that results from the loss would not be as immense. The people rely on the government to make such important decisions while they are the most affected by such economic crises.

Furthermore, the government has resorted to speculation since accurately predicting the oil prices has proven to be quite cumbersome. Speculation cannot guarantee accuracy. The government cannot go all in with its investment if the oil industry depends on speculation. It, therefore, makes a lot of sense that the U.A.E has reduced the amount of expenditure in the construction sector. By withholding some of the money spent on investments in the construction industry, the government has provided itself a safe landing in case the volatile oil prices results in severe losses.

The graph below (Figure 2.0) illustrates GCC's contract awards forecast in 2016. Even though emphasis should be laid on U.A.E, the point of fact that U.A.E is a key player in the GCC should not be ignored

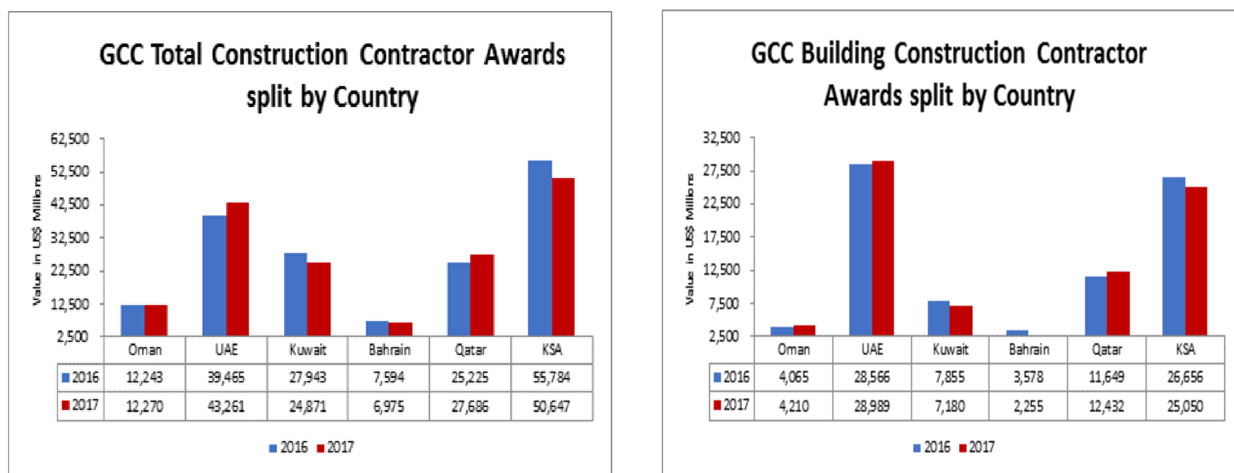

Figure 2.0; Source: Ventures Onsite MENA Projects Database: www.venturesonsite.com

3. DIVERSIFICATION

Dubai has however managed to maintain a cautious but optimistic outlook when awarding contracts. The government spent a total of USD 12bn on construction projects last year. From this year's planning, this number is set to go up by around 12% (Ghassan, Hassan Belkacem, and AlHajhoj 389). Furthermore, the government has set out to facilitate its

current investment expenditure on Dubai's infrastructure. Projects like the Metro Link that is intended to link Dubai to Expo 2020 has not experienced any shortage in funding due to the oil price volatility (Ghassan, Hassan Belkacem, and AlHajhoj 389).

The idea that a U.A.E city like Dubai has succeeded to overcome the adverse effects of unpredictable oil prices might seem strange at first glance, but because Dubai has diversified its economy to the extent that it only relies on oil for 6% of its income, this should not be a mystery (Ghassan, Hassan Belkacem, and AlHajhoj 389). Diversification has helped reduce the implications of the incessantly volatile oil prices. Of the total volume of the world's proven oil reserves, U.A.E can only account for 5.8% (Ghassan, Hassan Belkacem, and AlHajhoj 389).

Economic growth in UAE slowed to 3.0% in 2015 from 4.6% in 2014, the lowest growth since 2010 (ING Business Report June 2016; www.ingwb.com). Nonetheless, this is a respectable growth rate for a mature economy compared to major economies worldwide. The oil price crash induced drop in economic growth was cushioned by increased fiscal spending and surprisingly resilient investment. Although the UAE is more diversified than most other oil exporting partners, oil dependency is still high. Because oil prices are not expected to reach their pre-crisis levels in the coming few years, general expectations is of a modest economic growth, hovering around 3% until 2018 (ING Business Report June 2016; www.ingwb.com).

The UAE central government promotes innovation, sustainability and diversification. Indeed, the UAE has long known that dependence on one sector is poor risk management, and the UAE's economy has been diversifying since the 1990s. However, the low production cost and high global demand for oil has long prevented policymakers from pushing diversification even further. The oil price crash of 2015 - in which the average monthly oil price fell from US$108.3/bbl in January to US$39.0/bbl in December (ING Business Report June 2016; www.ingwb.com) - has been a wakeup call. This has led the UAE to plan to limit the contribution of oil to GDP to 20% by 2020. In this process, Dubai has been a prominent frontrunner. As Dubai's oil reserves were limited, the Emirate grew its tourism and services export sectors. Less than 5% of Dubai's revenue now comes from oil.

U.A.E has remained resilient in the wake of plummeting oil prices due to the diversity regarding investments (Demirer, Rıza, Shrikant Jategaonkar, and Ahmed Khalifa 135). In fact, U.A.E happened to be the most diversified economies among the countries that are part of the GCC. The revenues generated from hydrocarbon in the U.A.E in 2015 created 25% of its GDP. Hydrocarbon products revenue also accounted for only 19.8% of the total income generated from the exports (Demirer, Rıza, Shrikant Jategaonkar, and Ahmed Khalifa 135). Dubai is a force worth reckoning with when it comes to the diversification of the economy. Dubai shunned the irrationality of overemphasis of the oil industry as a prime revenue source.

The tourism sector is booming in Dubai. Dubai International Airport has now been ranked as the world's busiest airport, a title that was previously owned by Heathrow Airport. The government has projected a steady increase in the number of visitors to about 126 million by 2020. The aviation sector intends to cater for 22% of employment opportunities in the U.A.E. The continued deflection to non-oil revenue sources should be received as good news in the Emirates since the rest of the world is also turning to sources of energy that are not necessarily oil related. Abu Dhabi intends to focus more on diversification to the extent that by the year 2030, 64% of the emirate GDP will have little or nothing to do with oil products (Yanxiang 1357).

13% of U.A.E's GDP stems from the manufacturing industry that mostly deals in plastic, chemicals, and other related products. A skeptic may dispute U.A.E's intention to focus its manufacturing industry on pharmaceuticals, health, metals, and the aerospace industry but the truth is that with the global trends in the oil industry, this appears to be their safest bet so far. As Kingdom of Saudia Arabia (KSA) still has oil products providing for 85% of budget income and 80% of exports, U.A.E has continued the efforts to diversify the economy through their manufacturing industry.

4. CONCLUSION

In summary, the UAE, due to the brutally volatile oil prices, has experienced adverse effects in the construction industry because there was an urgent need to either reduce the number of construction contracts awarded or diversify the economy. Except in emirates like Dubai that diversified the economy long before their hands were tied, the rest of the Emirates had to deal with the volatility of the oil prices. The rest of the GCC members should not wait till their economies crash before they embark on measures that will help protect them from the unpredictable prices of oil. As the demand of oil in the global market reduces, the supply should take the form that will contribute to saving the oil industry from total annihilation.

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