

Sovereign Risk Management



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The global financial crisis and the role of official investors in the Gulf

Nasser Saidi

The economies of the Gulf enjoyed a stellar economic performance in the years preceding the global economic crisis that started in 2007 and reached its apogee in the final quarter of 2008 following the collapse of Lehman Brothers. Indeed, the Gulf economies and their financial systems performed comparatively well during the first phase of the crisis, as large-scale projects aimed at infrastructure investment and developments, the accumulation of human capital and the diversification of their production base continued at a healthy rate. However, the Lehman Brothers collapse resulted in a sharp reversal of fortunes for the region, which forced central banks, fiscal authorities and sovereign wealth funds into unprecedented actions to support their domestic financial systems and counteract the spill over and real effects of the financial crisis. This chapter reviews these actions, emphasising the extent to which the crisis has necessitated the building of the policy toolkit by the monetary authorities in the Gulf required to manage a modern economy. The chapter will also review the role of sovereign wealth funds in the crisis; assess whether the domestic support function they performed during the crisis is likely to be a permanent feature and how medium- to long-term institutional and structural changes in the Gulf economy will affect the environment in which these funds operate.

Responding to the crisis

With high oil prices and strong global investor interest in the region, the oil-exporting countries of the Middle East grew on average by a robust 5.75% a year in 2005-08. From 2002 to 2008, the countries of the Gulf Cooperation Council registered unprecedented growth, with Kuwait, Qatar and the United Arab Emirates registering annual real GDP growth of 8% or more, while Saudi Arabia, Oman and Bahrain recorded solid rates of between 4% and 6% a year. Governments in the region planned and launched huge investment

projects to promote economic diversification and the development of human capital, as well as investments in higher value-added industries such as petrochemical downstream, tourism, financial services and education. In addition, oil exporters, having learnt the lessons of the 1970s and 1980s, became fiscally conservative and saved considerable portions of their record-high export receipts. Fiscal and current-account surpluses enabled the region to reduce external government debt and accumulate around \$1.2 trillion in foreign assets.

Even as sign of strain in the Western financial system became evident in 2007 and early 2008, the Gulf – along with most emerging-market economies worldwide – retained healthy growth rates, helped to a large extent by rising oil prices during the first phase of the crisis, through June 2008. Financial systems too appeared sound: with rapidly growing economies and greater private sector participation in economic activity, banks continued to make healthy profits, had high capital adequacy ratios, and reported low non-performing loan ratios. The turning point for the region, however was the devastation caused by the Lehman Brothers failure in September 2008. As was the case for most emerging-market economies, financial and economic conditions in the Gulf countries took a dramatic turn for the worst in the final quarter of 2008. Financial markets in the region – from equity markets to those for sukuk bonds – fell across the board.

While many of the causes for the sharp deterioration in the post-Lehman Brothers fortunes of the Gulf economies were present across most emerging markets – a sudden halt in capital inflows as investors fled for the perceived comfort of traditional safe-haven assets, increased risk aversion and a re-pricing of emerging-market risk and the associated increase in sovereign-risk spreads, and other generalised contagion effects emanating from the core of the global financial system, the policy response in the Gulf to the fallout was characterised by a number of unique elements and developments. Most emerging-market economies in the past had to deal with periodic crises and moments of extreme uncertainty and speculation over the health and stability of their domestic financial markets, hence their policymakers, economic institutions and financial-market authorities, having learned from experience, are equipped with the tools required to combat contagion and reduce uncertainty and have developed a framework on how and when to use them.

In the Gulf, in contrast, policymakers confronted the aftermath of the Lehman Brothers collapse armed with a much smaller toolkit. True, they had built up a substantial level of international reserves allowing them to cushion the decline in oil export revenues and the sudden stop in capital flows. As a result they

were able to avoid and did not face a balance of payments or currency crisis. For most countries in the Gulf region, this period marked the first sustained and systemic banking crisis, coupled with the first downswing of the real-estate cycle. At the policy level, central banks and the fiscal authorities were ill prepared to implement counter-cyclical measures. First, Gulf central banks, having never experienced a crisis of this nature, did not have the requisite tools to confront the problems in financial markets. Though they had largely implemented bank supervision and prudential standards issued by the Basel Committee, those were useless in addressing contagion effects and the sudden stop of capital and trade credit flows. Indeed, as elsewhere, the implementation of Basel standards exacerbated the crisis by providing false signals as to the soundness of banks and capital adequacy.

Second, the currency pegs to the dollar of the Gulf Cooperation Council countries implied the loss of monetary policy independence, compounded foreign contagion and transmission effects and implied a perverse monetary policy that eased at a time the economies of the Gulf Cooperation Council were booming and led to a contraction of money and credit at the height of the great panic and onset of the great recession. The lack of exchange rate flexibility hindered the policy response and required a larger decline of asset prices, including real estate prices. The countries of the Gulf Cooperation Council need to move to a currency basket with more flexible exchange rates that will smooth adjustment to future crises and as a tool to counteract financial contagion and real effects of crises.

Third, the exchange-rate pegs led to structural financial weakness, as it was a major contributor to the lack of development of local money and debt markets, including the critically important interbank market. Central banks had to develop and put in place lender of last resort, credit and liquidity facilities that had never been needed in the past, while being constrained by the absence of money and debt markets. Central banks in the region had to consider ways of injecting liquidity into the banking and financial system against a background where a government securities markets was non-existent or negligible, preventing open market type interventions and liquidity injections on the scale necessitated by an all-engulfing crisis. For most advanced countries, and indeed crisis-hardened emerging markets, this is relatively easy, since government securities or other eligible collateral, repos and reverse repos are the standard means by which to implement open-market operations or liquidity injections. Since central banks in the Gulf typically lacked such securities in their markets, much of the intervention tools and liquidity windows had to be invented and put in place in the midst of the crisis. Moreover, counter-cyclical, anti-crisis policy was also hampered

by the lack of fiscal tools: the countries in the Gulf have not had personal or corporate income taxation, so policymakers did not have the counter-cyclical policy lever of reducing taxes at their disposal, leaving them with only government-expenditure policies with which to conduct activist fiscal policies, with limited knowledge of the magnitude of fiscal multipliers.

Thus, Gulf central banks and other economic policymakers faced the most devastating stage of the financial crisis, the turbulent final quarter of 2008, with underlying structural financial weaknesses – the non-existence of money and debt markets and the financial instruments that accompany them – and the non-availability of tested policy tools. The fourth quarter of 2008 and the first quarter of 2009, consequently, saw a scramble on the part of central banks and governments to put in place various policy tools and undertake measures aiming at stabilising the banking and financial sector. Indeed if there is a silver lining to the crisis for the Gulf region, it is the fact that it forced the authorities to develop an economic, monetary and financial policy framework and instruments with which to manage a modern economy. In the United Arab Emirates, the central bank cut interest rates in line with the policy of the Federal Reserve, but also introduced a number of targeted measures and facilities aimed at promoting financial-market stability. This included a liquidity facility of up to 50 billion United Arab Emirates dirham (AED), the establishment of new swap operations between the dollar and the dirham, a blanket guarantee of all deposits (including all interbank deposits) and a government injection of some AED 70 billion in deposits, which banks were allowed to convert into Tier 1 capital or, subject to conditionality, into Tier 1 capital.

Table 4.1 Financial support measures in the Gulf Cooperation Council

	Deposit guarantees	Liquidity support	Capital injections	Equity purchases
Bahrain		✓		
Kuwait	✓	✓	✓	✓
Oman		✓		✓
Qatar		✓	✓	✓
Saudi Arabia	✓	✓		
UAE	✓	✓	✓	

Source: International Monetary Fund, *Regional Economic Outlook*, Spring 2009

While the creation of these new facilities have strengthened the toolkit of central banks and other economic authorities in the region, and in many ways achieved their primary objectives, it is clear that they could not be established overnight.

As a result the policy response took longer, perpetuating uncertainty generated by contagion effects. Second, the region suffered a sudden retrenchment of foreign capital flows on an unprecedented scale, as external investors pulled out of emerging markets and, in the specific case of the Gulf economies, cut back on speculative flows built on expectations of exchange-rate appreciation and a possible break with the dollar pegs. The sudden reversal of foreign capital flows on such a massive scale cannot be easily replaced, which meant that publicly owned pools of wealth, whether in the form of accumulated fiscal surpluses, or indeed the more externally orientated reserve holdings of central banks and the assets held in the region's sovereign or future-generation funds, were called on to provide some measure of domestic support.

It remains to be seen whether this trend marks a medium- to long-term policy shift and indeed whether the rationale of long-term, foreign-investment-orientated official investment funds will remain in tact under the new global and regional financial architecture that emerges in the aftermath of the crisis. The crisis is likely to act as a catalyst for speeding up long-running efforts at developing deeper and more sophisticated domestic financial markets, and promote further regional economic and financial integration. These processes could contribute towards a fundamental reorientation of the official wealth held in Gulf towards domestic or perhaps regional markets. The remainder of this chapter will outline the most important structural and macroeconomic trends in the Gulf economy and how they are likely to impact on the future of official investment funds in the region.

Long-term investment after the crisis

Before considering how various medium- to long-term trends will affect the future strategies of the sovereign funds of the Gulf, it is important to briefly revisit the rationale that accompanied their establishment and guided their decision-making and operations. First and foremost, the Gulf sovereign wealth funds were set up with the intention to be inter-generational savings vehicles that transfer part of the revenues and profits received from the extraction of the region's vast natural resources to future generations. These funds can, therefore, most usefully be described as future-wealth funds. However, through the process of investing saving and investing current windfalls in international markets, these future-wealth funds performed important ancillary functions.

First, by investing in countries that were oil importers and industries that benefit from periods of low oil prices, the sovereign wealth funds of

oil-producing countries in the Gulf help to diversify the inherent macroeconomic risks and smooth the business cycle. Moreover, given the size of the funds in question, they typically had to invest in the advanced economies and financial markets of the West, which had the required depth, breadth and capitalisation to absorb the large investments by the sovereign- and future-wealth funds of the Gulf. A second ancillary function, which became particularly important in the years leading up to the crisis when oil and other commodity prices were above their historic averages resulting in significant capital flows and fiscal surpluses, was that these funds acted as domestic sterilisation tools that prevent a sharp rise in domestic monetary and credit aggregates. Sovereign- and future-wealth funds therefore acted in part as an automatic sterilisation device, in the absence of which the central banks would have had to engage in extensive market operations to mop up the excess liquidity associated with capital inflows and fiscal surpluses to prevent an inflationary cycle of money and credit expansion.

Finally, the severity of the financial crisis and the magnitude of the short-term financing needs meant that sovereign wealth funds were called upon to provide liquidity and financing support to their domestic financial and banking systems. While the measures taken by funds in the region varied (and the majority of funds retained their largely externally orientated investment strategy), a number of interventions in particular caught the attention of market analysts. For example, the Kuwait Investment Authority repatriated part of its foreign assets and deposited them in domestic banks to provide liquidity. The resources of sovereign wealth funds in Kuwait and Oman were also used to set up funds investing in local equity markets. In addition, the Qatar Investment Authority (amounting to 10-20% of the capital of the banking sector) and the Kuwait Investment Authority (up to \$1 billion) bought shares in their domestic banking systems to help boost bank capitalisation and confidence.

In assessing how the role of sovereign- and future-wealth funds of the Gulf might be affected by the emerging post-crisis financial and economic environment, it is useful to identify three effects that are currently in operation – and will continue to do so for years to come: the ability of the monetary authorities to sterilise capital flows and control the expansion and withdrawal of credit and liquidity in the domestic financial system; the depth and sophistication of domestic and regional financial markets, and their impact on the ability of corporations, banks and sovereigns to raise resources to finance investments; and finally, the wider and more long-term process of structural and macroeconomic adjustment taking place in the Gulf economy.¹

(i) The expanding monetary toolkit

As discussed earlier in this chapter, in addition to their long-term objective of saving part of the current windfalls associated with the extraction of natural resources for future generations, future wealth funds also performed an important function with regard to sterilising the expansionary effects of capital inflows on credit, liquidity and the money supply. Once the credit cycle took a sharp turn for the worst following the collapse of Lehman Brothers, the funds were called upon to perform the opposite function of restoring liquidity to the financial and banking system, rather than withdrawing it. However, as this role of controlling credit, liquidity and the money supply typically resides with a central bank in a modern economy, the expansion of the Gulf central banks' instruments during the crisis, as described earlier with the establishment of expansion of lender-of-last-resort function, currency-swap arrangements, repo and reverse repo systems, is likely to reduce the need for sovereign wealth funds to provide an emergency liquidity backstop. This will allow them to remain engaged with their long-term inter-generational savings objective, although a higher premium may be placed on keeping some part of their holdings as liquidity buffer or tranche.

(ii) The development of domestic and regional financial markets

The parallel, if more medium- to long-term, objective of building domestic and regional financial and capital markets – particularly those of sovereign and corporate debt – is likely to receive a strong impulse from the crisis. Policymakers in the Gulf have identified an urgent need to develop the region's nascent debt markets, both conventional and sukuk. Currently, Middle East debt markets are tiny by global standards at less than 10% of GDP compared to a global average of 150%. Globally, debt securities form the largest financial market; in the Middle East, they represent the smallest. Yet there have been signs of change. The first decade of the 21st century saw the announcement of landmark sovereign bond issues in Dubai, Abu Dhabi, Bahrain, Qatar and Saudi Arabia and this trend is certain to continue and indeed accelerate as a consequence of the crisis.

Over time this will mean that companies and sovereigns seeking to raise debt financing will be better placed to do so in the domestic and regional financial markets. At a very minimum, this will reduce the dependence of Gulf investors on the intermediation services offered in the traditional "hubs" of the global financial system – London, New York and Tokyo – and by the domestic banking institutions. In the Gulf Cooperation Council countries in particular, the growing propensity to invest in infrastructure and long-gestation projects make a compelling case for developing a sophisticated debt market. At the time of writing

(September 2009), commercial-bank channels are the primary source of funds, which heightens financial vulnerability due to maturity mismatching. Deeper bond markets in local currencies would allow the Gulf Cooperation Council countries to absorb volatile capital flows, gain monetary-policy independence and be the main source of financing for infrastructure and development projects. For future-wealth funds, this will create opportunities to tap domestic and regional markets. This also raises the prospects for funds to act as partners with other Gulf investors in meeting the financing needs of the region.

(iii) Long-term structural adjustment

In addition to the development of a more extensive toolkit for monetary policy and the establishment of deeper and more sophisticated capital markets, the environment in which the region's funds operate will be affected by the long-term structural changes taking place in the economies of the Gulf. While these trends extend well beyond the domain of sovereign investment and are generally driven by the needs and strategic decision of the private sector, future-wealth funds are likely to play an important role in their strengthening. Three salient structural shifts are of particular significance in this context: the need for massive infrastructural investment at the regional level (not only in the Gulf, but also in the wider Middle East and North Africa region); the diversification of the domestic production base of the Gulf economies; and finally, the increasing importance of Asia in the trade and financial links of the Gulf.

Efforts have begun to develop key aspects of the regional infrastructure, starting with an integrated power grid for the countries of the Gulf Cooperation Council, followed by similar projects for transport and telecommunication. While governments have typically encouraged the private sector to take the lead in developing and financing these large-scale, cross-border infrastructure projects, a number of the region's state-owned investment funds, particularly those that already have a strong domestic orientation, could play an important role in financing these projects given the magnitude of the investment needs that attend them and the wider societal benefits their completion will entail. Second, efforts to diversify the regional economy and reduce its reliance on oil will gain pace in the wake of the crisis. Even within the extractive industries, there will be a push towards higher value-added functions in the energy-production process. Finally, the crisis is likely to lead policymakers and the private sector to look increasingly towards Asia – and indeed emerging markets more generally – as a source of income and economic and financial cooperation. Asia has already surpassed Europe and the United States as the leading trading partner of the Gulf², and these links will be reinforced by the crisis. The financial crisis has painfully demonstrated how vulnerable countries are if they are linked only to the advanced economies.

Notes

1. See Saidi, N. Scacciavillani, F. and Prasad, A. (2009). *Wealth Effects in the GCC from Energy Commodity Prices*, Economic Note 6, Dubai International Financial Centre, September 2009.
2. See Prasad, A. (2009). *Trade & The New Economic Geography Of The Middle East*, Economic Note No. 4, Dubai International Financial Centre, April 2009.