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GCC, UAE/Dubai: from Financial Contagion to Growth

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Agenda

- Financial Crisis & Contagion, 2007-2008 …
- Linkages, Transmission Effects & Contagion: GCC, UAE, Dubai
- Policy reactions in the GCC, UAE, Dubai
- Economic Outlook

Analysis Global Situation

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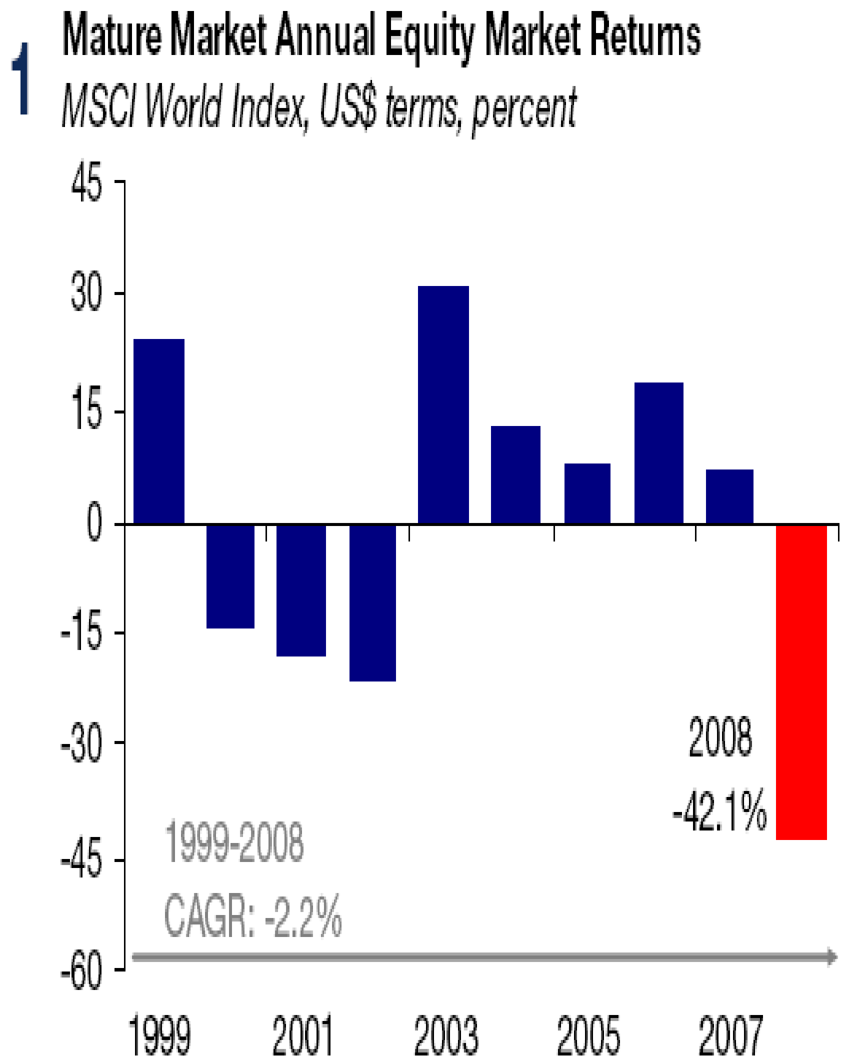
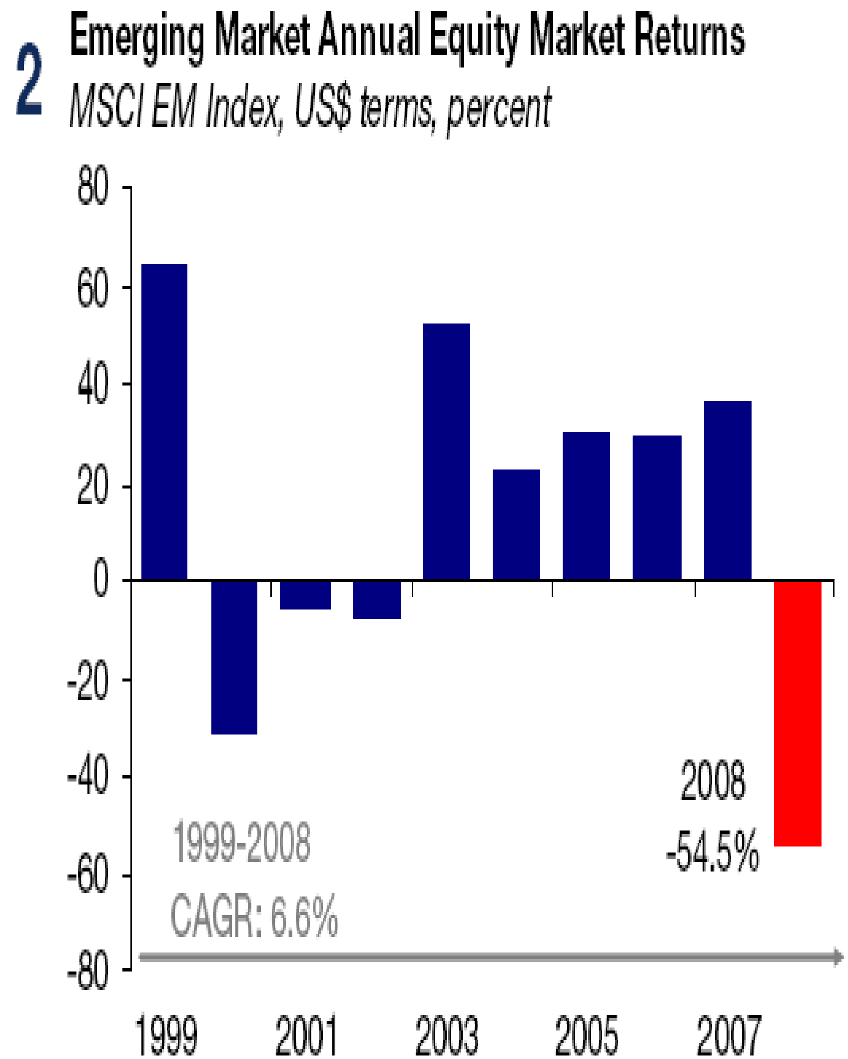
- Origins of crises: US loose fiscal and monetary policy, leading to lower than required interest rates, to increase housing starts and housing boom and to excessive risk taking
- Despite a historic coordinated intervention of all major central banks and a series of unprecedented, wide ranging and extensive government intervention the financial sector remains fragile and a return to normality is slow. Damage assessment is still underway
- Authorities, financial intermediaries and corporations are bracing for at least three quarters of deep recession and widespread weakness until end 2009 as the credit crunch spreads to the real economy. Forecasts have been corrected sharply downwards from even a few weeks ago.
- Lower consumption, cuts in investment projects and corporate downsizing in the wake of sharply reduced credit availability will in all likelihood prevail until the deleveraging comes to an end and trust in financial markets is restored.
- At present nobody can be sure for how long markets will remain dysfunctional and what results the stimulus packages will produce

Global Equity Market Meltdown (Source IIF 2009)

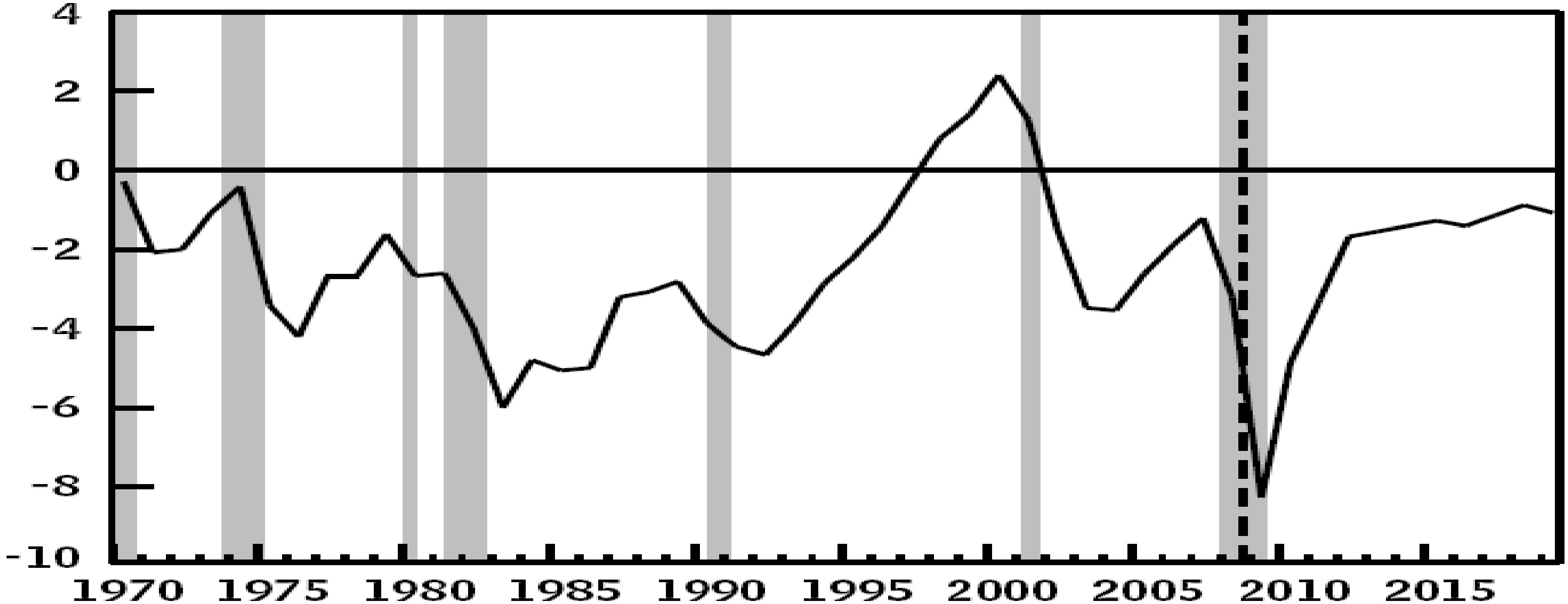




US going for record post-WWII deficit

The Total Deficit or Surplus as a Share of GDP, 1970 to 2019

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: GDP = gross domestic product.

Data are for fiscal years, plotted through 2019.

Emergency support measures across the world

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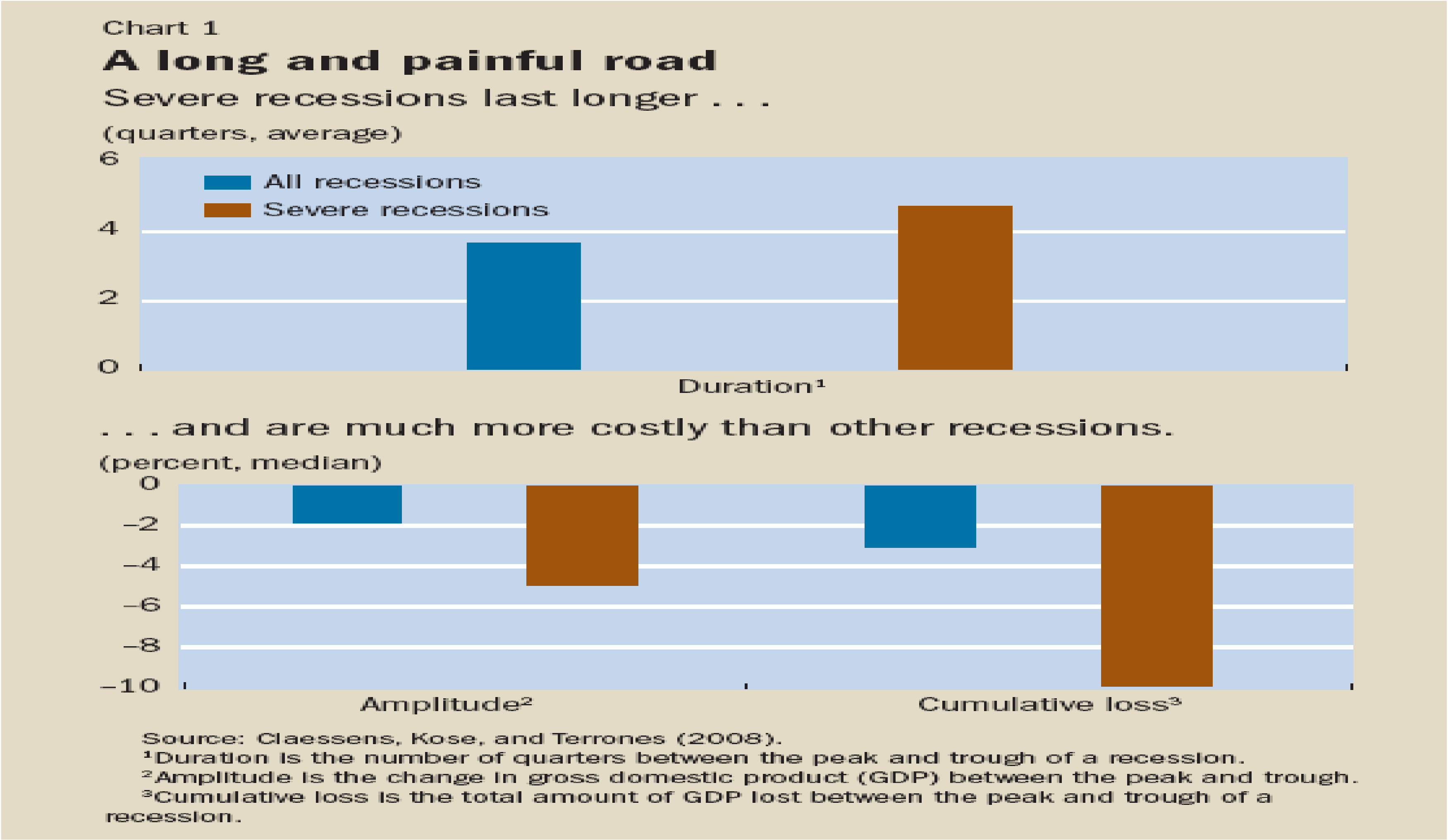
Summary of Key Support Measures for Bank Balance Sheets

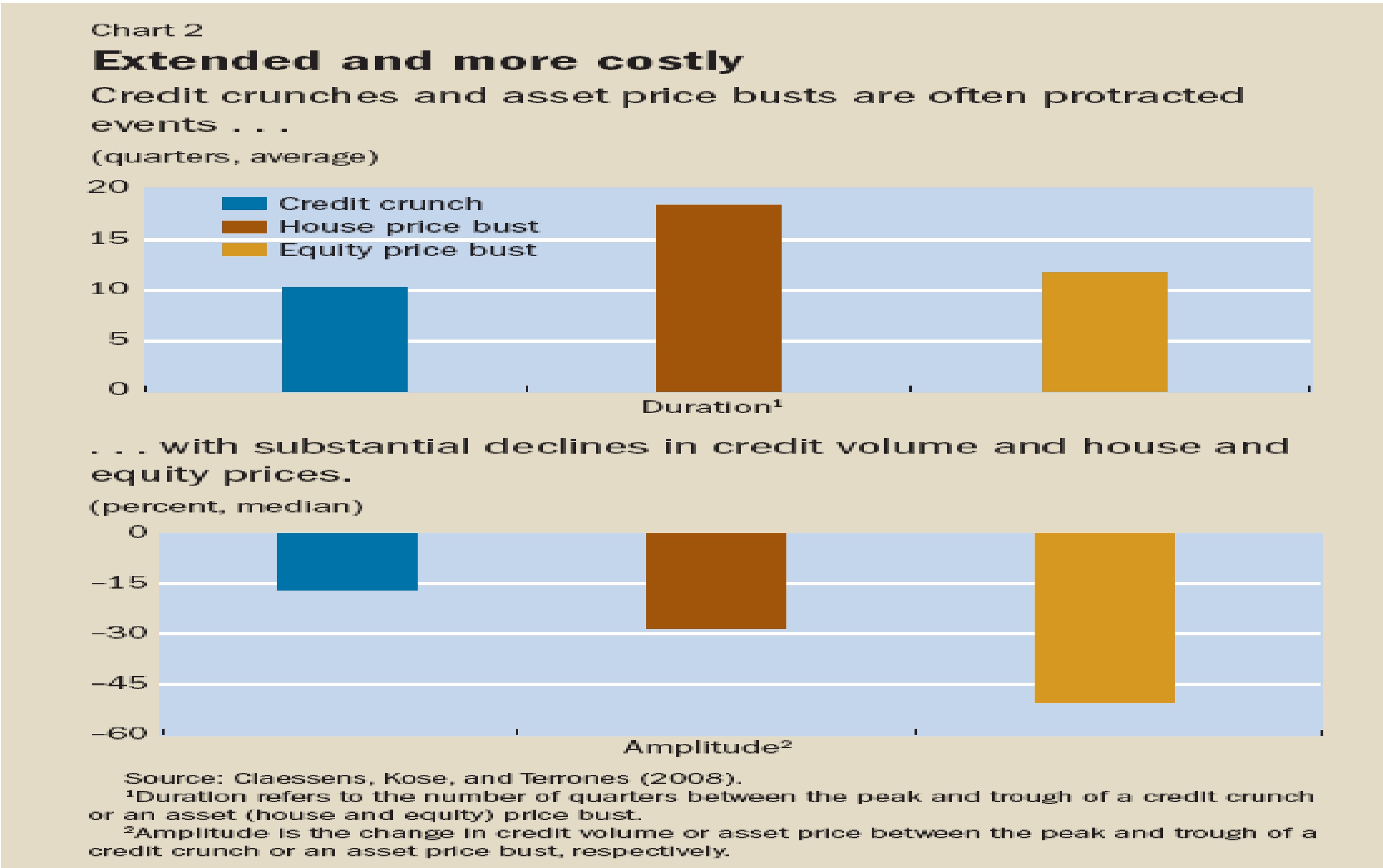
Country	Actions to Help Assets	Actions to Help Liabilities	Actions to Boost Capital	Total ($ billions)	% of 2008 GDP
US	x	x	x	4,750.0	33.14
UK	x	x	x	860.0	30.85
Germany	x	x	x	643.0	16.84
France		x	x	475.0	15.95
Spain	x	x		200.0	11.88
Ireland		x		565.0	198.23
Netherlands		x	x	318.0	34.97
Sweden		x	x	202.0	39.38
Switzerland	x		x	59.2	12.02
Australia	x	x		455.5	42.60
Korea		x		100.0	10.49
Saudi Arabia		x		5.0	1.00
UAE		x		19.0	8.00
Qatar					0.00
Oman					0.00
Kuwait		x	x		0.00
Bahrain					0.00

Source: IIF; IMF; Samba

Empirical analysis: 21 OECD countries, 1960-2007, 122 recessions, 28 credit crunches, 28 house price busts, and 58 equity price busts *(Claessens, Stijn, M. Ayhan Kose, and Marco Terrones, 2008, "What Happens During Recessions, Crunches, and Busts?", IMF Working Paper.)*



Credit Crunches + Asset Price Busts = Lengthier events (IMF, 2008)



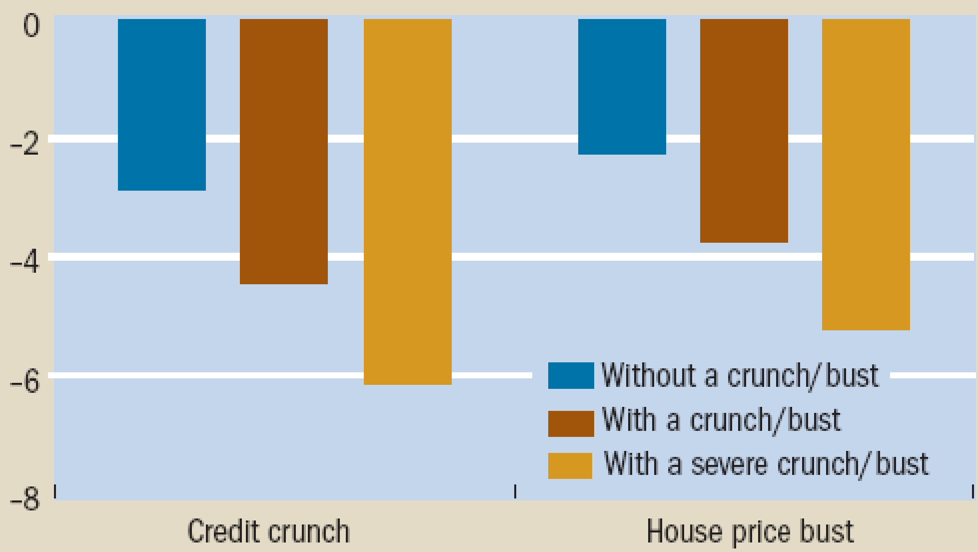
Recessions + Credit Crunch + Housing Bust = large GDP losses (IMF 2008)

Chart 3

Battered by severe crunches and busts

Recessions that coincide with severe credit crunches or house price busts exhibit larger cumulative GDP losses.

(cumulative loss, percent, median)



Source: Claessens, Kose, and Terrones (2008).

Notes: Cumulative loss is the total amount of GDP lost between the peak and trough of a recession. Severe credit crunches and house price busts are those that are in the top half of all crunch and bust episodes.

27 Things you may not have known about banking crises

Systemic Banking Crises: A New Database, IMF Working Paper, Nov 2008

1. In 55 per cent of cases, the banking crisis coincides with a currency crisis.
2. Bank runs feature in 62 per cent of the crises.
3. Banking crises are often preceded by credit booms, in 30 per cent of the cases.
4. Non-performing loans average about 25 per cent of loans at the onset of the crisis.
5. Macroeconomic conditions are often weak prior to a banking crisis.
6. Extensive liquidity support is used in 71 per cent of crises.
7. Peak liquidity support tends to be sizeable and averages about 28 per cent of total deposits.
8. Blanket guarantees are used in 29 per cent of crises, often introduced to restore confidence even when previous explicit deposit insurance arrangements are already in place, lasting for an average of 53 months.
9. Prolonged regulatory forbearance - where banks, for example, are allowed to overstate their equity capital in order to avoid the costs of contractions in loan supply - occurs in 67 per cent of crises.
10. In 35 per cent of cases, forbearance takes the form of banks not being intervened despite being technically insolvent, and in 73 per cent of cases prudential regulations are suspended or not fully applied. Existing literature on forbearance shows it is counterproductive, with banks taking on additional risks at the future expense of the gove11. In 86 per cent of cases, government intervention takes place in the form of bank closures, nationalizations, or assisted mergers.
12. 51 per cent of crisis episodes have experienced sales of banks to foreigners.
13. The more bank closures there are, the higher the fiscal costs.
14. A blanket guarantee, however, reduces the instances of bank closures.
15. Bank restructuring agencies are set up in 48 per cent of crises.
16. Asset management companies are set up in 60 per cent of cases to manage distressed assets.
17. In 76 per cent of episodes, banks were recapitalised by the government, mostly with cash, government bonds or subordinated debt.
18. Recapitalisation programs are usually accompanied with some conditionality.
19. To the extent that debt relief schemes are discretionary, they run the risk of moral hazard as debtors stop trying to repay in the hope of being added to the list of scheme beneficiaries.
20. Average net recapitalisation costs to the government amounts to 6 per cent of GDP.
21. On the bright side, recapitalisations tend to be associated with lower output losses.
22. Monetary policy tends to be neutral during crisis episodes, while fiscal policy tends to be expansive.
23. Average fiscal costs, net of recoveries, associated with crisis management average 13.3 per cent of GDP.
24. The average recovery rate is just 18 per cent of gross fiscal costs.
25. Real GDP losses average 20 per cent relative to trend during the first four years of the crisis.
26. There is a negative correlation between output losses and fiscal costs: the higher the fiscal costs, the smaller the loss of output
27. Inflation and currency devaluation help reduce the budgetary burden and thus have been a feature of the resolution of many crises in the past.

GCC - Limited Repercussions

- Gulf region (MENA more widely) has been minimally affected by the recent crisis thanks to
  - Strong macroeconomic fundamentals
  - Fiscal discipline and sizeable stock of foreign assets
  - Profitable domestic markets
  - Small stock of outstanding securitised/structured products
  - Limited expertise in managing structured investment products
  - Regulatory/prudential requirements limited exposure to sub-investment grade investments & instruments
  - Growing importance of and compliance with Shari'a
  - Ample liquidity from the increasing net capital flows (due to high returns) and from oil exports

Policy measures in the GCC

- Bahrain cut the repo rate by 25bp and the overnight rate by 50bp
- Kuwait cuts the repo rate by 100bp and the discount rate by 125bp. A series of other measures included 1bn USD investment by KIA in local stock market, liquidity injections, increase in the loan/deposit ratio, extensive deposits guarantee.
- Qatar has instructed QIA to buy 10-20% of local banks' capital
- KSA reduced its repo rate by 50bp (but left unchanged the reverse repo rate), and set up a 36bn USD liquidity facility (only 2-3 bn have been used) and reduced reserve requirements from 13% to 10%.
- UAE guaranteed all deposits (including interbank) and set up a 50bn USD emergency liquidity facility (little used so far), while the government deposited 70bn USD in local banks. The repo rate was reduced to 1.5%

Banking sector in GCC

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- GCC Banks remain well capitalized and profitable, with NPL below 5% of the total.
- Liquidity problems were caused mostly by an outflow of speculative capital betting on a currency revaluation and by the seizure of international money markets
- While cost of wholesale funding has increased, the region has no shortage of capital and its creditworthiness is solid
- However, IIF estimates that international banks have provided between 20% and 50% of project financing with the highest share in the UAE. In June 2008 foreign liabilities of the UAE stood at USD 88 from 23 billion at end 2005.

Break Even Oil Prices

(In U.S. dollars/barrel)

Algeria	56	Kuwait	33
Azerbaijan	40	Bahrain	75
Iran[1]	90	Oman	77
Iraq	111	Qatar	24
Kazakhstan	59	Saudi Arabia	49
Libya	47	United Arab Emirates	23
Average MCD	57	Average GCC	47

Source: IMF staff estimates and projections.

[1] Fiscal year 2008/2009.

UAE/Dubai Outlook

- Policy mix is sound: monetary easing, increased liquidity and fiscal stimulus
- Expected lower growth and lower inflation
- Benefit from greater economic & financial integration of the region, including Gulf Monetary Union
- Global economic/financial geography shifting East
- Infrastructure and demographics will remain key
- Institutional & Structural policy reforms required to sustain growth

Structural Reform & Policy Issues

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1. Real Estate & the Housing Market: sustain demand through ‘Mortgage Guarantee Co.’
2. Financing Growth: deposit & credit guarantee
3. Building Capital Markets: bond market, money market, alternative investment market
4. Public Debt & Finances: build capacity for fiscal sustainability

Outlook

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- The risk of a global financial meltdown has been avoided for now thanks to massive government rescue plans
- Volatility however will persist for the months to come with bad and good news
- Conjunction of financial crisis, housing bust and credit crunch portends deep recession in the US, UK & some EU countries
- Emerging markets and the GCC have been so far more resilient, but the shock has been too forceful to be offset by domestic factors
- However the Gulf and Dubai could be among the long term gainers in this process, if business interaction and transparency are improved and a more coherent policy response is framed during 2009