Middle East and Central Asia Department

Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead: An Update

Prepared by May Khamis and Abdelhak Senhadji
with contributions from Joshua Charap and Serhan Cevik

INTERNATIONAL MONETARY FUND

Middle East and Central Asia Department

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I N T E R N A T I O N A L   M O N E T A R Y   F U N D

Production: IMF Multimedia Services Division

Cataloging-in-Publication Data

Khamis, May Y. (May Yusuf)
Impact of the global financial crisis on the Gulf Cooperation Council countries and challenges ahead : an update / prepared by May Khamis and Abdelhak Senhadji, with contributions from Joshua Charap and Serhan Cevik – Washington, D.C. : International Monetary Fund, 2010.
p. ; cm.

Includes bibliographical references.
ISBN 978-1-58906-510-9

1. Financial crises – Persian Gulf States. 2. Global Financial Crisis, 2008-2009. 3. Finance – Persian Gulf States. 4. Finance – Persian Gulf States – Statistics. 5. Banks and banking – Persian Gulf States. 6. Nonbank financial institutions – Persian Gulf States. 7. Economic forecasting – Persian Gulf States. I. Senhadji Semlali, A. II. Charap, Joshua, 1963- III. Cevik, Serhan. IV. International Monetary Fund. V. Title.

HB3808.55.K43 2010

Please send orders to:

International Monetary Fund, Publication Services
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Internet: www.imfbookstore.org

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Acknowledgements

The authors would like to thank Masood Ahmed, Director of the Middle East and Central Asia Department (MCD); Alfred Kammer, Senior Advisor in MCD; and Ratna Sahay, Deputy Director in MCD, for their guidance, comments, and suggestions.

The opinions expressed in this publication are solely those of the authors and do not necessarily reflect the views of the International Monetary Fund, its Executive Directors, or the authorities of the countries of the Gulf Cooperation Council.

Foreword

This paper updates the IMF publication *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead*.[1]

The major risk to the outlook continues to be a protracted period of low oil prices, which may arise in connection with a slow global recovery. As of June 2010, the debt crisis in Dubai had had minimal spillovers to the rest of the Gulf Cooperation Council (GCC) countries, and the fallout from the sovereign debt crisis in Greece has had a limited financial impact on the region so far. In response to events in the Euro area, GCC policymakers have noted the need to evaluate lessons from the crisis, stating also that these developments do not necessarily imply a delay in the establishment of the GCC monetary union.

[1]Available at: http://www.imf.org/external/pubs/ft/dp/2010/dp1001.pdf

Chapter

I Impact of the Global Crisis and Policy Response

The GCC countries performed well during the 2003–08 oil boom, but the boom also presented challenges. Buoyant economic activity, rising consumer and investor confidence, and abundant liquidity spurred excessive credit growth, inflation, and asset price increases. In addition, in some countries, banks' growing dependence on foreign financing and exposure to real estate, construction lending, and—to a lesser extent—the equity market, contributed to balance sheet vulnerability in the event of a slowdown in economic growth and a decline in asset prices. In the corporate sector, the boom was associated with higher leverage, which increased the sector's vulnerability to the availablitity and cost of financing.

As the global economic crisis took hold, the GCC countries were affected through trade and financial channels. By the second half of 2008, GCC government finances and external positions were directly affected by the decline in oil prices and demand. At the same time, GCC countries underwent reversals of speculative capital inflows experienced in 2007 and early 2008. These developments tightened liquidity conditions and affected investor confidence, and were further exacerbated by Lehman's collapse in September 2008 and the ensuing global liquidity shortages and deleveraging. GCC financial sector imbalances came to the fore, especially in the United Arab Emirates (U.A.E.), Kuwait, and Bahrain, given these countries' close linkages with global equity and credit markets.

A forceful response by the authorities contained the impact of the crisis. To offset the fallout from the crisis, GCC governments maintained or even increased spending levels despite a sharp decline in oil revenues. In particular, Saudi Arabia adopted the largest fiscal stimulus (as a share of GDP) among the G-20. They also introduced exceptional financial measures, including capital and liquidity injections (Table 1 and Figure 1). In line with monetary easing in the United States in late 2008, and to ease domestic credit conditions, GCC countries (except Qatar) lowered interest rates, and eased liquidity through direct injections in the money market and through statutory changes, including reductions in reserve requirements and relaxation of prudential loan-to-deposit ratios.

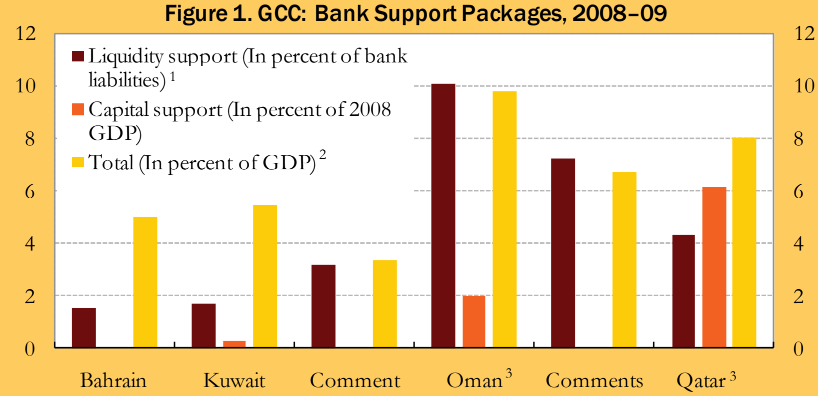
The global crisis triggered a steep fall in asset prices, and credit default swap (CDS) spreads on sovereign debt widened. Tighter global liquidity conditions and the subsequent slowdown in credit growth and economic activity deflated real estate prices in most countries in the GCC. As regards equities,

Table 1. GCC: Policy Response to the Global Crisis

Country	Deposit Guarantees[1]	Central Bank Liquidity Support	Long-Term Government Deposits	Capital Injections	Bank Asset Purchases	Stock Market Purchases	Monetary Easing
Bahrain		✓	✓				✓
Kuwait	✓	✓	✓	✓		✓	✓
Oman		✓	✓			✓	✓
Qatar		✓	✓	✓	✓		
Saudi Arabia	✓	✓	✓				✓
U.A.E.	✓	✓	✓	✓			✓

Source: Country authorities.
[1] Includes expansion of retail deposit insurance and guarantee of wholesale liabilities.

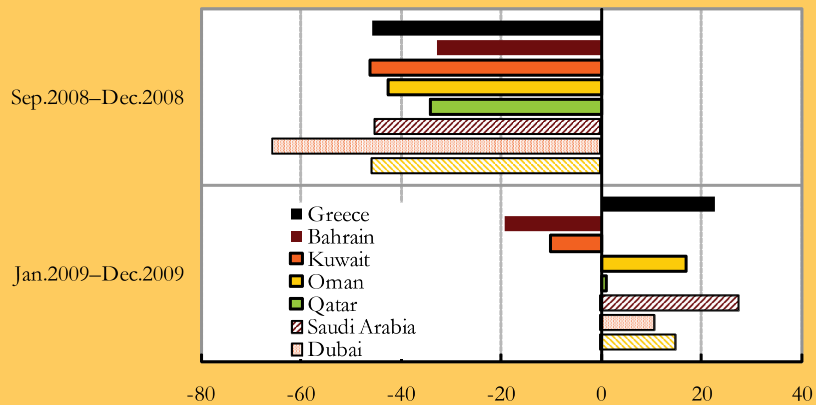
Figure 1. GCC: Bank Support Packages, 2008–09



Source: Country authorities.
[1]Pre/post-crisis change in government deposits and use of central bank facilities.
[2]Includes purchases of bank assets, stock market interventions, etc.
[3]Includes some double counting of capital liquidity support.

despite some recovery in 2009, equity prices remained at much lower levels compared to the pre-Lehman collapse (Figure 2). After their initial rise in late 2008 and early 2009, CDS spreads declined markedly, indicating an improvement in global investor sentiment. Nevertheless, CDS spreads on Dubai government debt remained elevated, reflecting developments associated with highly leveraged Dubai government-related entities, notably Dubai World (DW): the announcement in November 2009 of a debt standstill by DW resulted in a sharp increase in market perceptions of the default risk for Dubai-related entities and negative—but rapidly dissipating—spillovers throughout the region (Box 1).

Figure 2. GCC: Equity Prices
(Percentage change)



Sources: Bloomberg; and IMF staff estimates.

The global crisis had an adverse impact on financial institutions, but there were no systemic consequences. The crisis had a moderate impact on financial institutions' profitability and led to defaults by a few, isolated GCC nonbank financial institutions.[2] Despite a significant decline in bank profitability, banks remained profitable overall (Table 2 and Figure 3). Nonperforming loans (NPLs) increased in most countries, with a notable increase in Kuwait due to loan concentration in real estate, equities, and the battered investment companies' (ICs) sector, in addition to significant losses by Gulf Bank in 2008.[3] Profitability declined in 2009 across the board, reflecting higher provisioning needs.[4] Nonfinancial corporate sector profitability also declined in many GCC countries (Figure 4).

[2]In Kuwait, as of June 2010, five Investment Companies (ICs) had defaulted on their debt—including Gulfinvest International, which was in default on a U.A.E. dirham 200 million loan from the Abu Dhabi Commercial Bank, and International Investment Group, which was in default on payment for its $200 million Islamic bond.

[3]Gulf Bank losses were on account of client-related derivatives transactions. In the U.A.E., the bulk of the increase in NPLs in 2009 resulted from instructions issued by the Central Bank to classify loans to the Saudi Arabian conglomerates Algosaibi and Al-Saad. For 2010, exposures related to DW are likely to raise NPLs by less than 1 percentage point, and some deterioration in the rest of the loan book cannot be excluded.

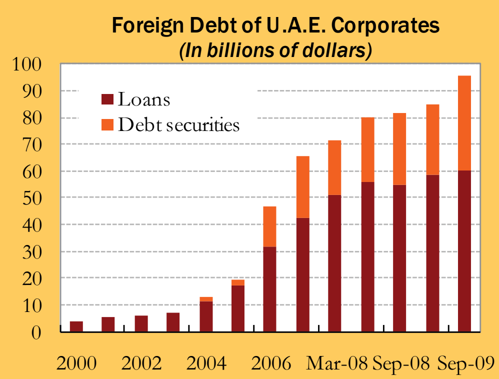
[4]With the exception of Kuwait, which had already experienced a significant decline in bank profitability in 2008.

Box 1. Update on Dubai World Debt Restructuring

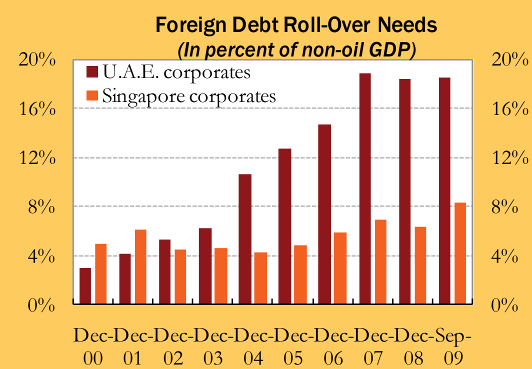
Tightened global liquidity conditions and a slowdown in economic activity led to the deflation of real estate prices in most GCC countries. The correction was most pronounced in Dubai, where some government related entities (GREs) had engaged in highly leveraged property development projects. In light of the scale of funding needs compared to domestic banking system assets, GREs relied on foreign borrowing, which, in the wake of the global financial crisis and a slowdown in international credit flows, turned out to be the Achilles' heel of the development model.

On November 25, 2009, the Government of Dubai announced that Dubai World (DW) and its two real estate subsidiaries, Nakheel Properties and Limitless World, would seek a standstill until May 2010 on property-related debt to allow time for an orderly restructuring. The announcement effectively abolished the perceived implicit sovereign guarantee for GREs and brought to light the effect of the perceived guarantee on borrowing costs. The initial negative market reaction was strong and spread beyond Dubai. Prior to the collapse of Lehman Brothers, five-year CDS spreads for Dubai had averaged about 70 basis points, well below those of countries with similar or lower indebtedness ratios. Following the post Lehman spike, CDS spreads fell significantly, but soared from about 300 basis points to 654 basis points in response to the standstill announcement. The initial impact of the DW debt standstill spread to other emirates and to countries throughout the region, although these spillovers had largely dissipated by end-2009.

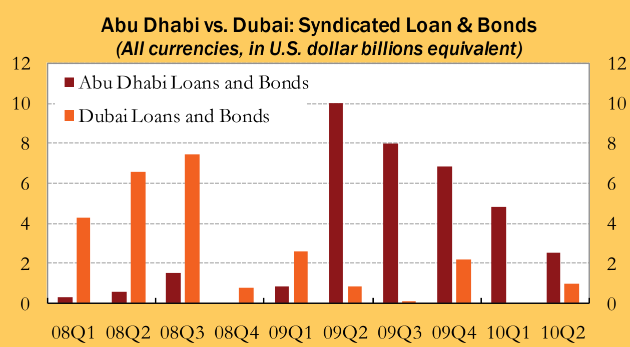
Foreign borrowing of corporates surged ...



... roll-over risk became much higher than in Singapore.



Dubai is shut out of global markets post-Lehman.



Sources: JEDH; Dealogic; and IMF staff estimates.

Box 1. Continued

On May 20, 2010, DW reached an agreement in principle with its core bank creditors on restructuring $23.5 billion in liabilities for itself and Nakheel (Limitless did not need restructuring). This agreement, which built upon a proposal dated March 25, 2010 by the government, clarifies the nature and extent of government support and limits DW-related uncertainty. The agreement has been put to the full group of bank creditors and has three components:

(1) $8.9 billion of debt owed to the government will be converted into equity, as announced on March 25;

(2) full repayment of principal through the issuance to two tranches of new debt: (i) $4.4 billion with an interest rate of 1 percent and a five-year maturity; and (ii) $10 billion with an eight-year maturity and a menu of interest rate options that combine interest of 1 percent, deferred interest payments between 2½ to 3½ percent, and a limited guarantee from the Government of Dubai in the event that DW is unable to meet these obligations; and

(3) upon creditor agreement, the Government of Dubai will provide up to $9.5 billion in new funds, mainly to continue work on Nakheel's projects. Separate proposals have been made for Nakheel's liabilities to customers, contractors, and suppliers.

With negotiations on the DW debt restructuring proceeding well and the economy beginning to recover, the immediate focus should be on successfully completing the debt restructuring, determining the full breadth of potential debt problems in other GREs, and maintaining the stability of the banking system. Although Dubai's sovereign and GRE CDS spreads have narrowed from their early 2010 peaks, they remain elevated compared to other countries and to their historical levels.

Sovereign and GRE CDS Spreads

	11/2/09	11/26/09	12/31/09	5/31/10
Nakheel[1]	86.7	88.1	59.5	105.5
Dubai World	319.7	629.5	462.4	394.6
Dubai Holding CO	608.1	1292.4	2089.9	1011.8
DIFC	378.1	464.1	2024.6	1772.0
Government of Dubai	302.1	537.6	438.1	471.0
Government of Abu Dhabi	97.2	161.6	149.5	108.4

[1]Bond Price.
Sources: Bloomberg; Markit; and IMF staff estimates.

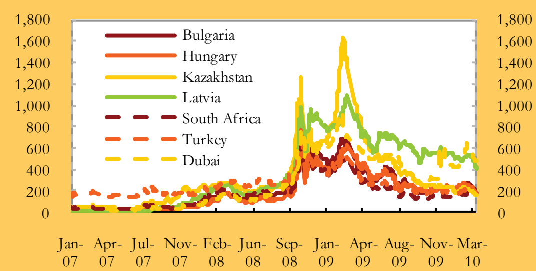


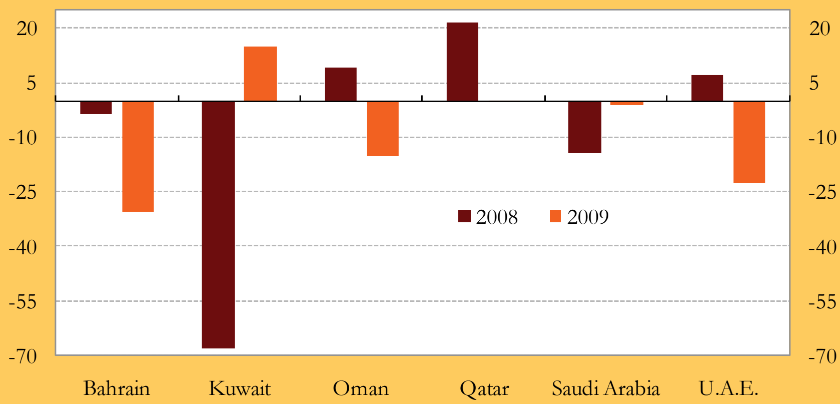
Table 2. GCC: Banking Sector Performance and Soundness[1]
(In percent)

	Nonperforming Loans		Capital Adequacy		Provisioning Rate		Return on Assets		Return on Equity	
	2007	Latest	2007	Latest	2007	Latest	2007	Latest	2007	Latest
Bahrain	2.3	3.9	21.0	19.6	74.0	60.3	1.2	1.2	18.4	10.6
Kuwait	3.2	9.7	19.4	17.2	48.2	38.5	3.6	0.8	29.4	6.9
Oman	3.2	2.8	15.8	15.5	111.8	113.8	2.1	2.2	14.3	14.2
Qatar	1.5	1.7	13.5	16.1	90.7	84.5	3.6	2.6	30.4	19.3
Saudi Arabia	2.1	3.3	20.6	16.5	142.9	89.8	2.8	2.0	28.5	25.8
U.A.E.	2.9	4.6	14.0	20.3	100.0	79.0	2.0	1.5	22.0	12.1

Source: Country authorities.

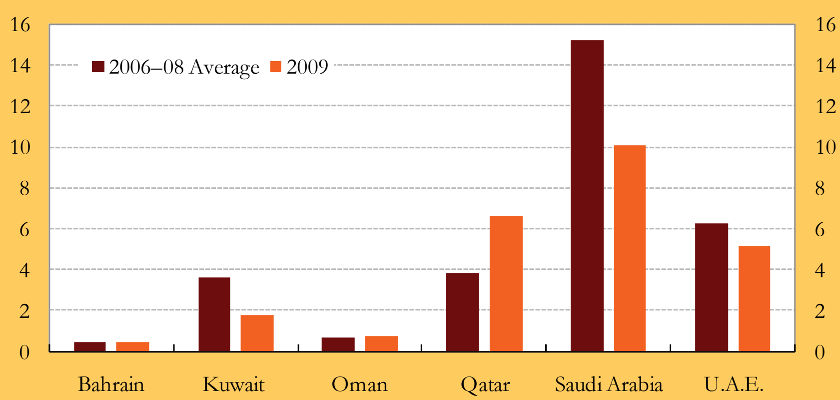
[1]Latest data is as of end-2009 for Bahrain, Kuwait, Qatar, and Saudi Arabia; Nov. 2009 for the U.A.E., except for CAR, which is Mar. 2010; and June 2009 for Oman.

Figure 3. GCC: Listed Banks' Profits
(Annual percent change)



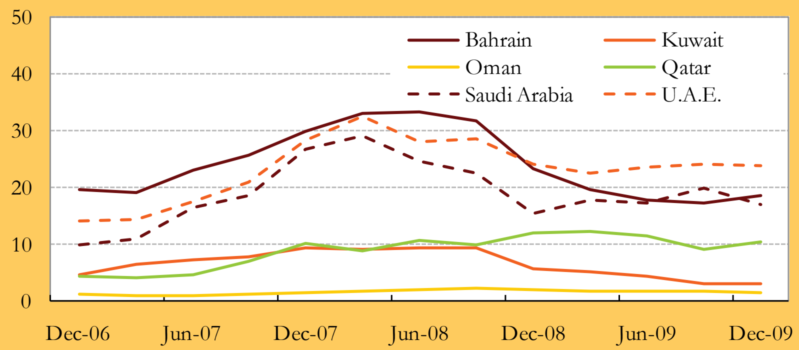
Sources: Zawya; and IMF staff estimates.

Figure 4. GCC: Nonfinancial Sector Profitability, 2006–09
(In billions of U.S. dollars)



Sources: Country authorities; and IMF staff estimates.

Figure 5. GCC: Banks' External Financing [1]
December 2006–December 2009
(In billions of U.S. dollars)

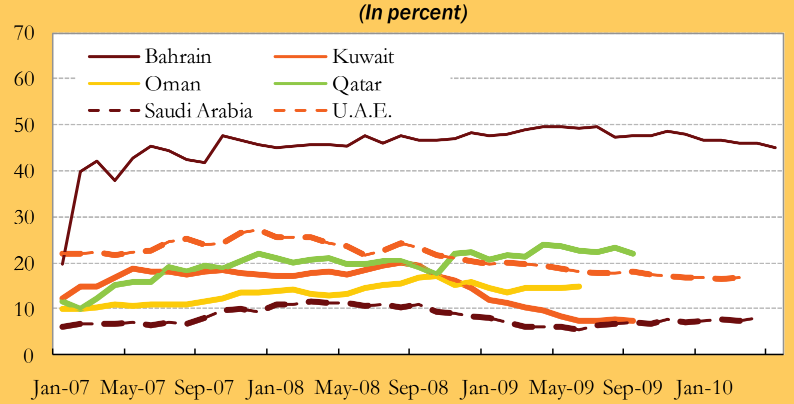


Source: BIS Consolidated Banking Statistics.
[1]Includes foreign currency interbank lending extended by foreign bank branches in GCC countries.

While external financing for GCC banks declined substantially, the impact on nonbank financing was less severe (Figures 5–8). Banks' external financing declined significantly post-Lehman, both in levels and as a share of total liabilities, and is yet to recover. External financing of nonbanks was less affected. Furthermore, despite heightened risk aversion among global investors, Qatar and the U.A.E. were able to raise significant funding on international bond markets in 2009, largely through sovereign debt issuance. Nevertheless, by end-2009, over 20 percent of an estimated $2½ trillion in projects at different stages of planning and implementation at end-2008 had been placed on hold due to financing constraints.

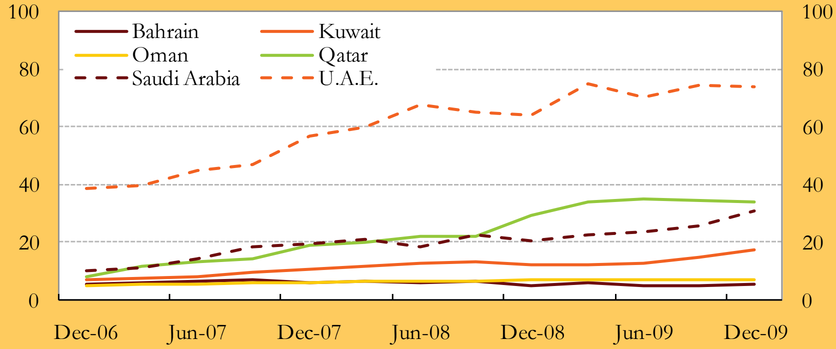
Private sector credit growth stagnated in 2009. Higher risk aversion by banks and weaker investor and consumer confidence stifled credit growth (Figure 9). In Qatar, however, although credit growth declined sharply

Figure 6. GCC: Commercial Bank Foreign Liabilities to Total Liabilities, January 2007–May 2010
(In percent)



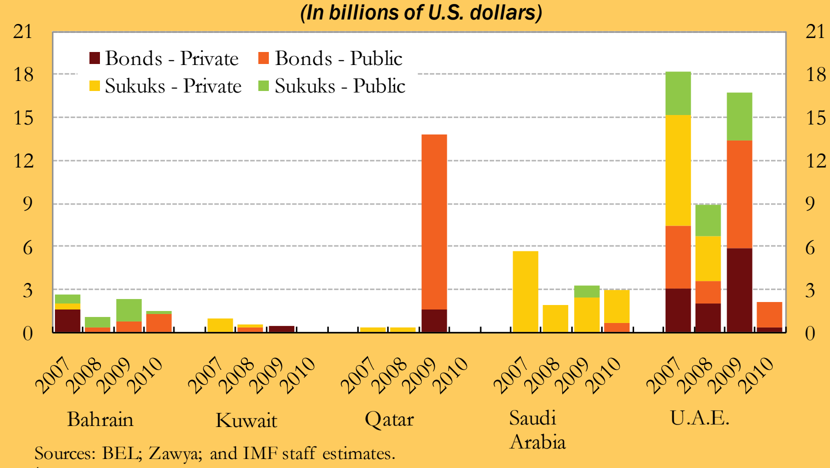
Sources: Country authorities; and IMF staff estimates.

Figure 7. GCC: External Financing of Nonbanks[1]
December 2006–December 2009
(In billions of U.S. dollars)



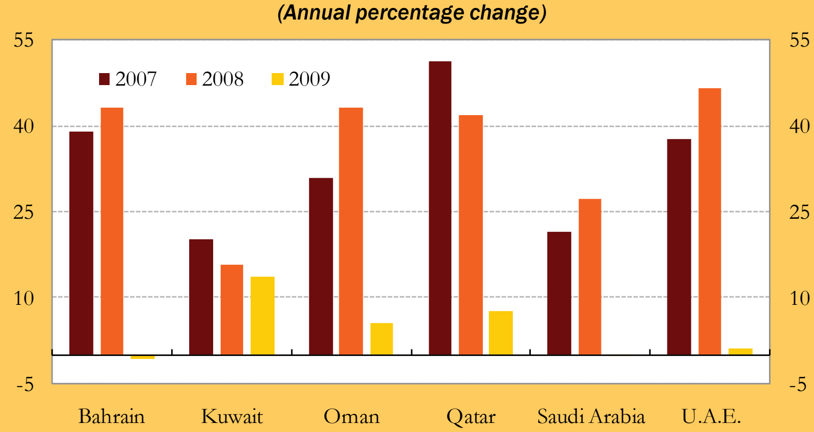
Source: BIS Consolidated Banking Statistics.
[1]Includes foreign currency credit extended by foreign bank branches in the GCC to local nonbank financial institutions and corporates.

Figure 8. GCC: Bond and Sukuk Issuances[1]
(In billions of U.S. dollars)



Sources: BEL; Zawya; and IMF staff estimates.
[1]Through May 2010.

Figure 9. GCC: Growth of Credit to the Private Sector, 2007–09[1]
(Annual percentage change)

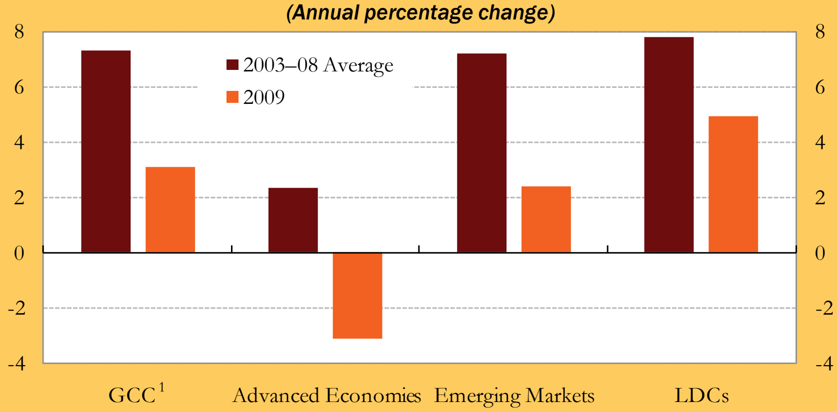


Sources: Country authorities; and IMF staff estimates.
[1]Includes credit to public enterprises in Qatar and Saudi Arabia.

compared to during the boom years, credit growth registered higher levels than in the rest of the GCC in light of continued strong growth. In Saudi Arabia, credit extended by the state-owned specialized credit institutions mitigated the impact of the decline in bank credit growth on non-oil activity.

Fiscal and financial measures helped support non-oil activity in 2009. Real growth in the GCC's non-oil sector declined by about half in 2009, to 3.2 percent, but surpassed growth in advanced economies by a large margin and outperformed other emerging markets (Figure 10). The decline in global oil demand had a significant impact on oil GDP output and, combined with lower oil prices, led to weaker fiscal and external balances. The fall in imported food prices and slowing aggregate demand—with its particular impact on rents—caused annual inflation to decline from double digits in 2008 to 3.3 percent in 2009.[5]

Figure 10. Real GDP Regional Comparisons
(Annual percentage change)



Sources: Country authorities; and IMF staff estimates.
[1]Non-oil GDP.

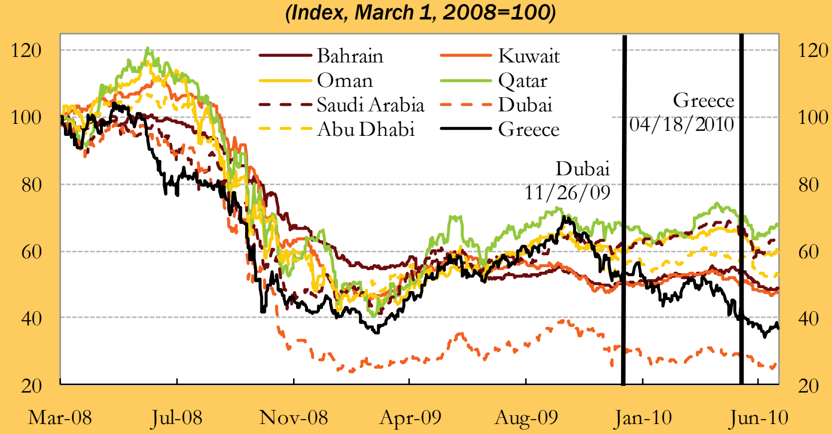
[5]In 2009 in Qatar, prices measured by the consumer price index declined by almost 5 percent.

Chapter

II Recent Developments and Outlook

After a strong recovery in equity markets in 2009, GCC markets were broadly flat during the first half of 2010, mirroring global developments. The trend in GCC equity prices tracks global equity market developments without an apparent link to the Greek debt crisis (Figure 11). Market perceptions of sovereign default, as reflected in CDS spreads, show persistent uncertainty about Dubai, but other GCC sovereigns remain stable and there has been negligible fallout from the Greek debt crisis on CDS spreads (Figure 12). The Greek debt crisis, however, heightened uncertainty regarding global growth prospects and resulted in a reduction in oil prices and higher equity price volatility. With the exception of the U.A.E.,[6] the GCC countries did not implement any new measures in the aftermath of events in Dubai and Greece.

Figure 11. GCC: Equity Market Indices, March 2008–June 23, 2010
(Index, March 1, 2008=100)

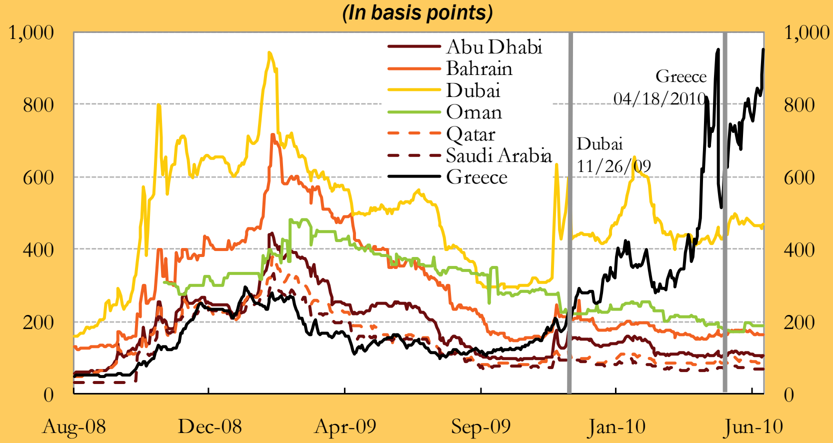


Sources: Bloomberg; and IMF staff estimates.

Bank deposit and credit growth remained anemic during the first half of 2010. Banks have had limited success in attracting private sector deposits and continued to receive significant public sector liquidity support (Figures 13–15). Despite high liquidity levels in banks and low interest rates, credit growth remained sluggish largely due to banks' risk aversion. Uncertainties surrounding the economic recovery, the default of two Saudi large conglomerates, problems in the Kuwaiti financial sector, and the DW

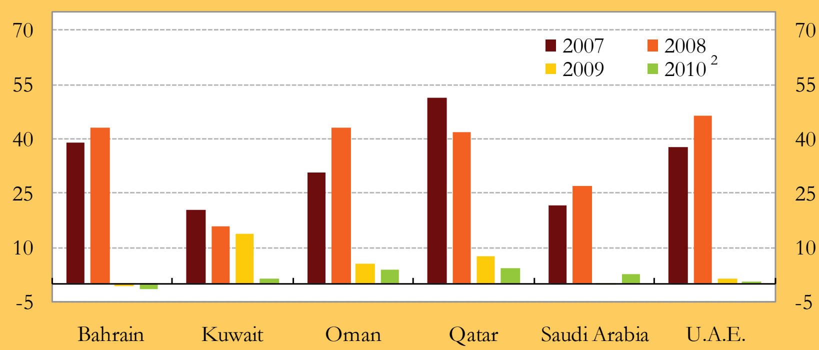
[6] The Central Bank of the U.A.E. introduced an additional liquidity facility in the aftermath of the DW events.

Figure 12. GCC: Credit Default Swap Spreads on Five-Year Sovereign Debt, Aug. 2008–June 23, 2010
(In basis points)



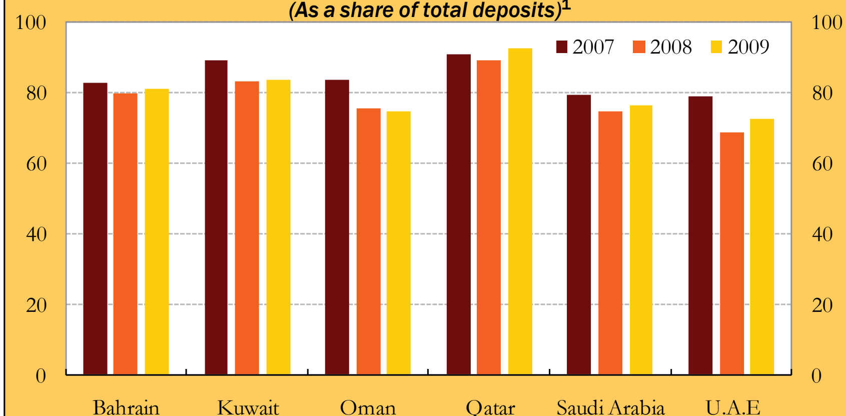
Source: Markit.

Figure 13. GCC: Private Sector Deposits, 2007–10[1]
(Annual percent change)



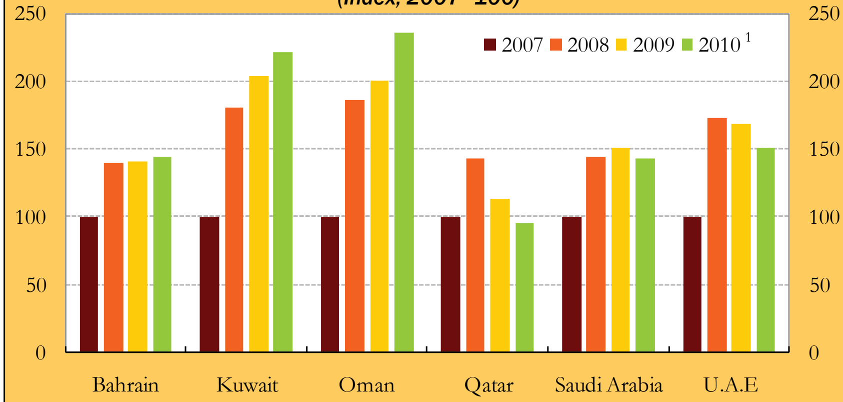
Source: Country authorities.
[1]Excludes non-resident deposits.
[2]Through March 2010.

Figure 14. GCC: Private Sector Deposits
(As a share of total deposits)[1]



Source: Country authorities.
[1]Excludes nonresident deposits.

Figure 15. GCC: Public Sector Deposits
(Index, 2007=100)

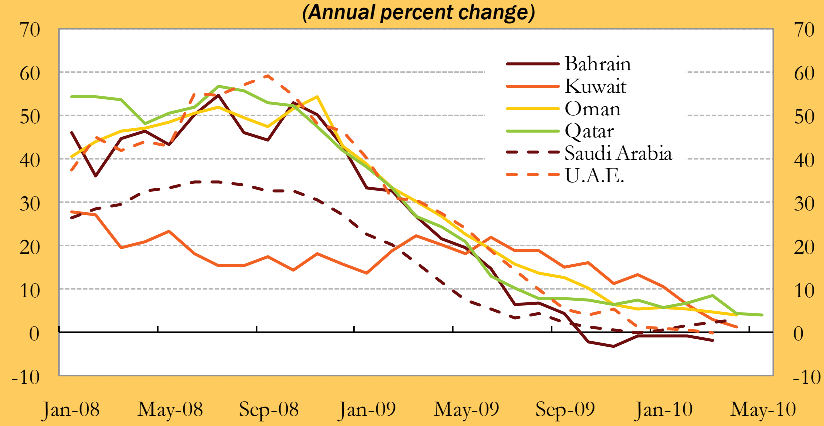


Sources: Country authorities; and IMF staff estimates.
[1]Through March 2010.

debt problem have all contributed to an increase in risk aversion on the part of banks and borrowers. The decline in credit may also reflect banks' reconsideration of lending practices, which relied on the reputation of a borrower (so called "name lending"), rather than credit analysis. There are signs of a modest recovery in bank credit in Qatar and Saudi Arabia (Figure 16).

Significant progress was made in financial and corporate restructuring during the first half of 2010. In Kuwait, Global Investment House, the largest IC, had defaulted on the majority of its $3 billion debt; in late 2009, it reached agreement with its 54 lending banks, demonstrating a speedy and orderly debt restructuring process with constructive facilitation by the Central Bank. In June 2010, Kuwait Finance and Investment Company signed an agreement to restructure 145 million dinars ($494 million) in debts to local

Figure 16. GCC: Bank Credit Growth, 2008–May 2010
(Annual percent change)



Sources: Country authorities; and IMF staff estimates.

and international lenders. Investment Dar has sought legal protection from creditors under the provisions of the financial stability law following the default on its $100 million sukuk. Similarly, in Dubai, DW made important strides towards the completion of its debt restructuring (Box 1).

Listed nonfinancial corporates in the GCC appear to have adequate buffers to service their debt. Staff analysis of listed non-financial corporates shows that, at end-2009, GCC corporates had adequate capacity to service their debt obligations. In addition to operating profits, corporate financial positions are strengthened by large cash buffers. Nevertheless, stress tests involving a 300 basis point increase in interest rates or a 25 percent income shock indicate potential weaknesses in certain sectors (petrochemicals and multi-investment in Saudi Arabia, services and industry in Oman, real estate and industry in Kuwait, and services in Qatar).

Banks' capital adequacy ratios remain strong and there are positive indications on profitability. The GCC financial systems entered the global crisis from a position of strength, with high capital adequacy and modest NPLs. Despite the general increase in NPLs in 2009, banks' capital adequacy remains high, supported by injections of public funds in Qatar and the U.A.E., and private capital in Kuwait and Saudi Arabia. Data for Q1 2010 indicate only a small year-on-year decline in profitability (4 percent) and a more than doubling of profits over Q4 2009.[7] Provisioning requirements were lowest compared to the last three quarters in 2009 but remain high compared to pre-crisis levels. Kuwaiti banks continued to fare the worst in the region, with profits year-on-year declining by 9 percent. NPLs in GCC banks are expected to increase further in 2010, although potentially at lower rates than those experienced in 2009.

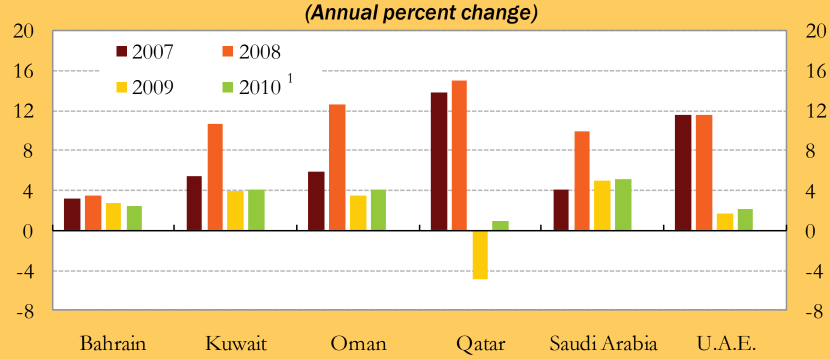
Growth is projected to strengthen in 2010, supported by strong fiscal spending and the global recovery (Figure 18). Non-oil growth is expected to strengthen to about 4.3 percent, supported by fiscal stimulus in Saudi Arabia and the U.A.E and, more recently, Kuwait.[8] Oil output is projected to rebound by approximately 4.8 percent in 2010 in line with global recovery. This, along with projected higher oil prices, should improve fiscal and external balances. A rebound in imported food prices is likely to boost inflation to 4 percent in 2010 (Figure 17).[9] The main risk to the outlook is a sharp decline in oil prices. Challenges in the financial sector may restrain

[7]Global Investment House, *GCC Banking Sector Quarterly*, June 2010. The analysis covers thirty listed GCC commercial banks.

[8]The expansionary 2010/11 budget in Kuwait was adopted in the context of the recently approved Development Plan. The plan seeks to boost investment expenditures across the board, with government cost estimated at $55 billion (56 percent of 2009 GDP) over the next four years, to be matched by the private sector through public-private participation and joint stock companies.

[9]Higher rents are also expected to contribute to inflation in Saudi Arabia.

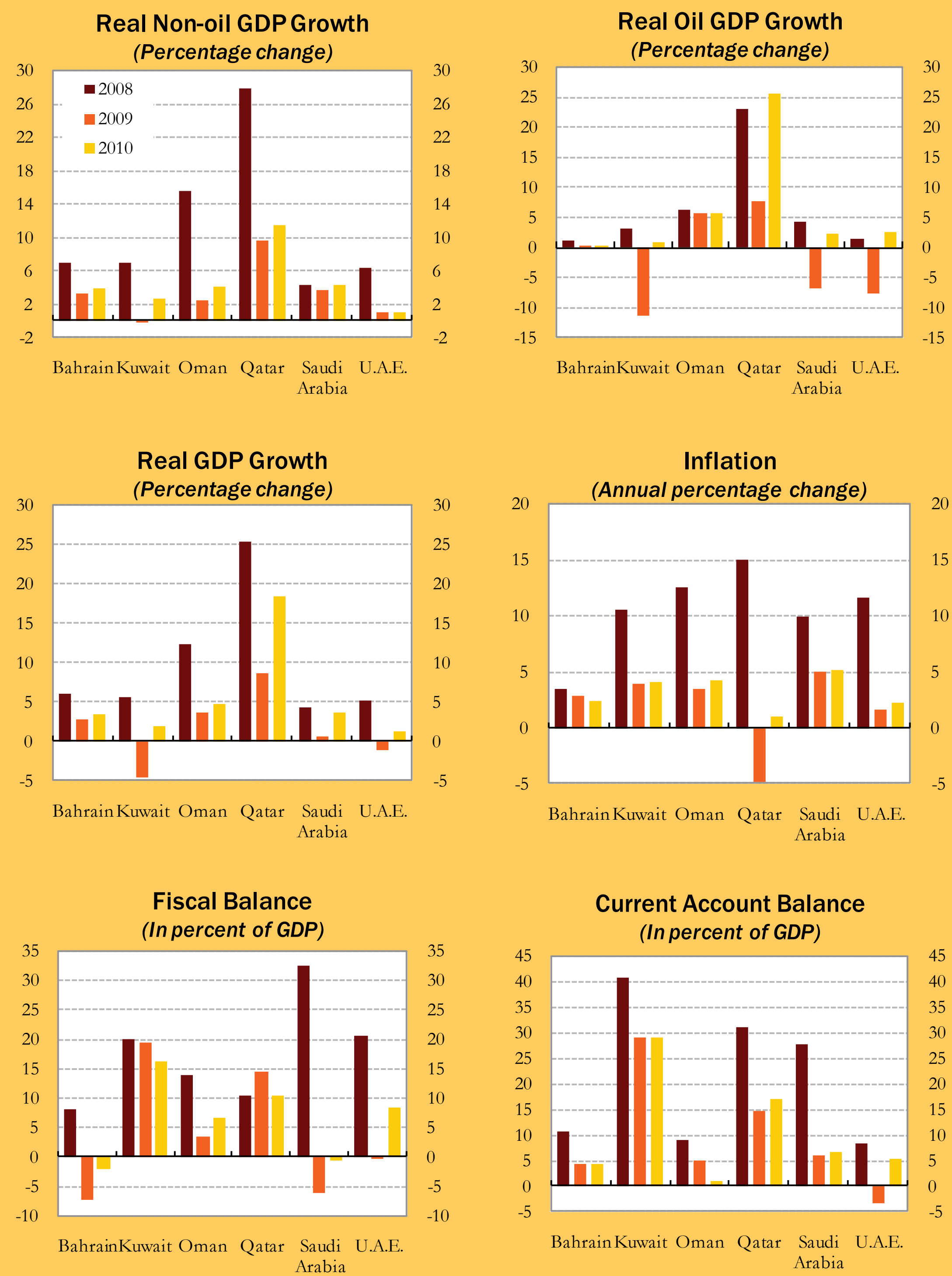
Figure 17. GCC: Inflation Dynamics, 2007–10
(Annual percent change)



Sources: Country authorities; and IMF staff estimates.
[1]Year-on-year using latest available data.

growth in the short term, but they remain manageable and should not undermine long term prospects. The impact of spillovers from financial developments in Dubai and Greece (if the fallout remains contained) should continue to have a limited effect on the GCC countries—and substantial foreign assets are available to mitigate the impact of new shocks.

Figure 18. GCC: Selected Macroeconomic Indicators, 2008–10



Sources: Country authorities; and IMF staff estimates.

Chapter

III Key Policy Challenges

The GCC countries have taken important steps to address the fallout from the crisis. Significant progress has been achieved in restructuring DW's debt, and similar progress has been made in the restructuring of some of the largest investment companies' debt in Kuwait. Central banks across the GCC have strengthened their oversight of the banking sector and many are conducting stress tests to identify vulnerabilities. The Central Bank of Kuwait has also started the process of improving the oversight framework for ICs. The capital adequacy of banks has been enhanced in most countries through the injection of public funds or private capital. Non-oil economic activity was supported by an expansionary fiscal stance.

The short-term priority remains the buttressing of the financial sector without unduly constraining the availability of credit. In the banking sector, this requires a continued forward-looking approach to monitoring bank capital adequacy through periodic reviews of bank asset quality and regular stress testing, including against tail risk. To encourage banks to address emerging problems expeditiously, the authorities should ensure that a prompt corrective-action framework with well-specified criteria for intervention is in place. In the nonbank financial sector, particularly in Kuwait and the U.A.E., the authorities should continue to facilitate restructuring of viable entities while ensuring a smooth exit of nonviable institutions. In light of the constraints of the dollar peg on monetary policy and the sensitivity of liquidity conditions to the oil cycle, macroprudential policies should be used effectively to protect financial stability and manage liquidity conditions. Fiscal stimulus has been successful in dampening the impact of the global crisis on non-oil growth, but countries should prepare an exit strategy from current high spending levels, to ensure long-term fiscal sustainability, which would be implemented once conditions allow.

Corporate governance and transparency need to be enhanced. To maintain and enhance access of private sector companies to domestic and external financing, the incentive structure to improve disclosure and governance should be strengthened. At the same time, countries should improve the governance of state-related enterprises, with greater attention given to transparency and management of leverage and balance sheet risks.

GCC countries should improve the timeliness and coverage of data, both on the financial and macroeconomic fronts. While data are broadly adequate for policy action and surveillance, there are important gaps in quality and coverage. The authorities have given top priority to improving their statistical data as they advance toward monetary union.

The ratification of the Monetary Council charter is a significant step toward monetary union. GCC policymakers have noted the need to evaluate lessons, at the same time stating that this does not necessarily imply a delay in the establishment of the GCC monetary union.

Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead: An Update