

Crystallising new ideas

Although doom and gloom surrounds us at the moment, there are some healthy processes taking place under the surface that could bring long-lasting prosperity to the Arab world. **Utpal Bhattacharya** highlights some of the change agents.

Economic cycles, booms and busts are real. When the bull runs hard, it's all exhilaration and free for all. We saw it last year and the year before, at home and across the world. Unfortunately, the result of unbridled greed and irresponsibility is now hitting the very core of our systems and financial engines. We are starting to accept the fact that regulators and regulations were just not good enough.

Even when there were regulations, the sheer intensity of belief in the bull-run was so great that regulators failed to come down hard enough on the implementation side to stem some of the excesses of the financial services industry. In many cases, there was a complete lack of understanding – even among institutional buyers of securities – of the risks involved in these transactions, especially of derivatives. Bernard Madoff's

ponzi scheme is a classic example of how gullible investors, including institutional buyers, were led up the garden path to their doom.

Some blame the flood of petrodollars not only for fuelling asset inflation, but also for forcing banks into excesses and causing them to try to build up assets too quickly by lending out the liquidity that came to them easily during the run up of

rates to anybody who will save money with them. Banks have also stopped lending to correct their distorted asset-to-liabilities ratios – an approach that has caused tremendous difficulties for businesses and it is not helping the economy at all. In fact, it could lead to demand destruction across industries in the medium term, including retail.

The moot question here is why the UAE central bank did not foresee this problem coming. Or did officials at the bank just deliberately look the other way when banks were crossing the red line? It will be very difficult to find out why banks were allowed to lend more than their deposits in the first place. But will we have at least some accountability check, even if it is too late?

The undercurrents

Before getting into a discussion about where to go from the mess we are in today, it might be interesting to look at the US housing market, which triggered the current crisis across the world. In fact, a look at the Case-Shiller chart will easily explain what happened to the US housing market. Any analyst worth his salt should have seen disaster coming as the US housing market hit an all-time high. Although the index has been moving relentlessly south since hitting the top, it shows what sort of euphoria was built up in the housing market globally just a year ago. The same is also true for the UAE, the region's leading real estate market, as significant capacity-building was not ultimately supported by other factors. The downside now looks extremely vulnerable. Banks are now refusing to fund capacity growth, leaving developers, the industry and investors on the road.

There are many examples of small, medium and large companies that have been working in the realty industry suddenly becoming pariahs for banks that were falling over each other to woo these accounts just a couple of months ago.

Take one small construction and electromechanical group that has projects in prime locations in Dubai worth AED750,000. The group has been servicing its loans diligently. But the managing director of the group, whom this writer happened to bump into last month,

says that he is facing tremendous pressure from banks to pay back loans at a time when his receivables are getting delayed. In fact, the pressure on him is so great that he is willing to sell out over a period of time.

The anecdotal reference above does indicate what's happening in the UAE market – especially Dubai – where perfectly healthy companies are suddenly facing financial problems because their credit lines are being squeezed by lenders. This situation is dangerous, as it could have negative consequences for the economy – unless much more is done on the policy front.

It is also time for consultants to come into the picture and advise policymakers, governments, big corporations and whoever pays to listen to them about what needs to be done. A presentation from the Boston Consulting Group last month seemed to suggest that the whole economic model of real estate, tourism and leisure and financial services that the GCC was building – which was somewhat based on Dubai's successes – is not going to be the hot thing for the region in the future.

Dr. Kamel Maamria, partner and head of the telecommunications, media and technology practice in the Middle East for the Boston Consulting Group, urges GCC constituents to carve out a position in the global economy using the downturn as an opportunity. He suggests that the GCC countries reprioritise their investments and focus on creation of competitive advantage platforms, while the regional sovereign wealth funds support local economies strategically and help create global players from the region.

Dr. Maamria notes that banks, construction and materials and travel and leisure have been the worst performers in terms of total shareholder return since June 2007, compared to sectors like food and beverages, health care, utilities and telecommunications. He argues that GCC economies should focus on some of these sectors that are able to hold their own during a recession.

Dr. Maamria also urges the Arab countries to start building knowledge-based economies, although he stops short of talking about the actual brass-

the price of oil to US\$147 per barrel. Of course, central banks across the world (barring probably a few) did not manage money properly. Even at home, one of the examples that keep popping up from analysts is the over-lending of banks vis-à-vis deposits under the central bank's very nose.

A recent research note from Standard Chartered reported that the UAE alone needs to inject in excess of AED100 billion in the form of deposit funds in order to bring advances-to-deposit ratios of the country's banks to below the required 100 per cent level. This factor is one of the reasons banks in the UAE are busy shoring up the liabilities sides of their balance sheets, offering very high interest

tacks regarding how to build these economies.

Abdullah M. Al-Subyani, president of the Gulf Venture Capital Association, is of the same view. While emphasising the need for investing in knowledge-based industries, he says that Saudi Arabia is putting a lot of effort and resources into creating educational infrastructure that will help boost such industries in the Kingdom. King Abdulaziz University, which is under construction, is one such initiative.

But what differentiation will knowledge-based investing create? It will create more jobs, answers Al-Subyani. He notes that investing in specialty chemicals, specialty plastics, healthcare solutions or the processing of primary resources and boosting the tertiary sector creates more employment than just investing in raw materials. Going up the ladder into secondary and tertiary sectors needs

knowledge, and that's where Arab countries will need to invest their money in the future, he adds.

The future of Arab liquidity

Al-Subyani probably embodies the sentiments of the majority of Arab investors when he says that western companies looking to raise money for their funds to invest in the European and US markets may have to go back from the Arab world empty-handed in the future. There are two reasons for this discernible change in the Arab investor's mindset in the last few years: the big losses suffered in the western markets and an increasing willingness to invest in the home turf, the market that these investors know.

The present recession has only added fuel to the fire as far as new thinking is concerned and has, in fact, started a renaissance of sorts. Consultants and

various governments are increasingly encouraging industrialisation and are boosting the service sector in the region.

"If you are an investor who wants to collaborate with us and invest in Saudi Arabia, we will listen to you, rather than if you are looking to take our money into a fund to be invested in the US or Europe," Al-Subyani says.

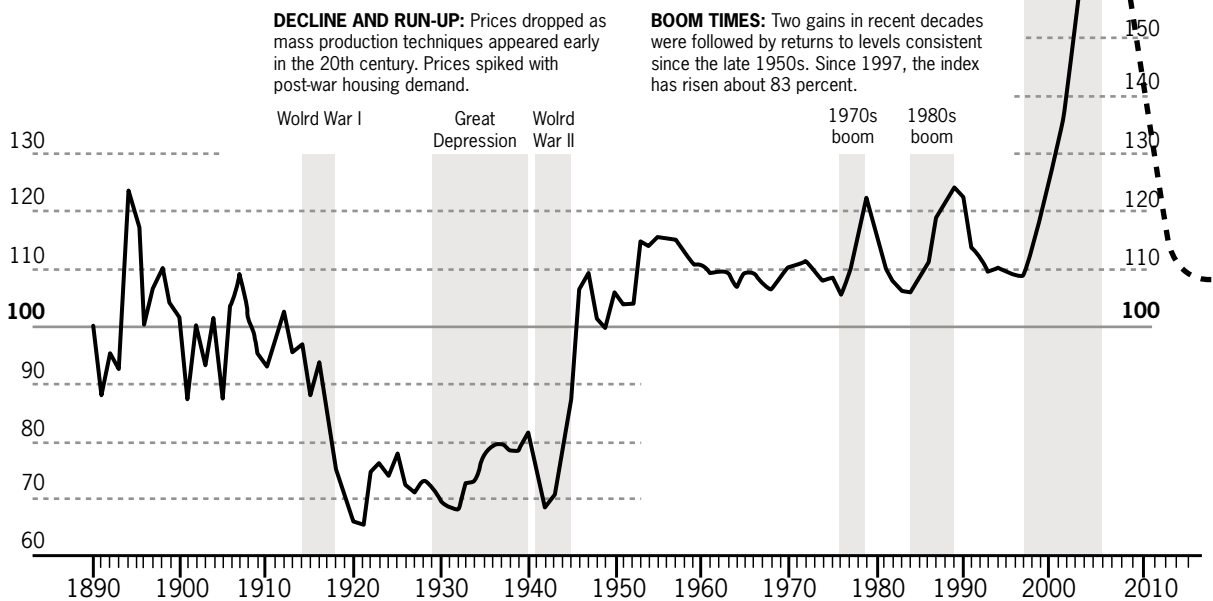
But can't investors lose at home, too? "Of course," says Al-Subyani, "but that's better than losing money investing outside your home."

While the new thinking crystallises, the immediate worry for many is when the situation will turn for the better. David Rhodes, global leader of the Boston Consulting Group, underlines a few trends for 2009. He says that the real economy will continue to deteriorate globally and that there will be negative earnings surprises. He is also of the opinion that there will

A HISTORY OF HOME VALUES

Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for US\$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for US\$66,000 in 1920 (66 on the index scale) and US\$199,000 in 2006 (199 on the index scale, or 99 per cent higher than 1890).



Source: "Irrational Exuberance" 2nd Edition, 2006, by Robert J. Shiller

Bill Marsh/The New York Times

Global inflation to touch zero in 2009

*It could take between two and three years for global recovery to begin, according to a top official at Merrill Lynch. **Ehab Heyassat** finds out more.*

The GCC region is comparatively in a much better position to withstand the ongoing economic and financial crisis, according to Gary Dugan, chief investment officer of Merrill Lynch. Dugan expects the region to show positive growth in 2009, although he says the pace of growth will slow down considerably. One of the reasons for the slowdown is the falling price of oil.

Dugan predicts that Saudi Arabia, which is the largest GCC economy, will grow at a rate of 2.9 per cent in 2009, compared to 4.9 per cent in 2008. The Kingdom's pace of growth will further slow down to 2.3 per cent in 2010, he adds.

Dugan's predictions are in line with his views on how global growth is going to pan

out in the next few years. According to him, global recovery is not expected to happen in the next two to three years. He thinks the world has started to witness a destruction of inflation, which will lead to a deflationary environment.

"We expect global inflation to reach zero this year with the fall in demand. You can see the dramatic decline of inflation in the US already," Dugan told **MONEYworks** on the sidelines of a press conference in Dubai last month.

Dugan also said that the UAE economy is expected to grow at 3.5 per cent in 2009.

Speaking about the price of oil, Dugan said it will be range-bound between US\$40 and US\$45, due to the fall in demand and the recession. He added that the price could go

back to US\$60-70 in the long term, depending on global recovery.

Dugan also cautioned that if OPEC fails to stick to its stated production cuts, then the oil price could slip below US\$30. At these price levels, the production of oil becomes unfeasible and would lead to a further cut in supply, he noted. However, such a scenario is remote at this point in time, said Dugan.

On real estate, Dugan expects Dubai's property prices to fall further, following peers in London and Hong Kong.

Dugan said that gold could become the favourite investment for investors, while cash and bonds will also have a major share during the period of recession. He has not ruled out the possibility of gold hitting US\$1500 an ounce in the near term.

be new troubles in the financial sector as companies and consumers default and deleveraging continues. There could also be a risk of deflation, he adds.

Rhodes also points to Yale economist Irving Fisher's debt-deflation theory, pointing out that over-indebtedness and deflation make a devastating combination. The first leads to the second and vice-versa, as deflation caused by debt reacts to debt.

At present, there is a global debate raging on about how the US's stimulus package is going to impact the global markets in the medium term. While some say that this package could boost inflation, others say that with the US becoming more indebted, it could spur deflation as consumption and demand fall, driven by falling employment.

Since the US contributes to the global GDP in the high teens, how its economy fares will have far-reaching consequences for the entire world, including Arab investors who still own significant US and other western assets. The growing Arab opinion that more petrodollars need to be invested at home could further impact foreign capital inflows into the US economy and thus have its own negative ramifications on the existing Arab assets in that market.

The current thinking, however, is more influenced by what needs to be done at

home, rather than by what went wrong in the past and what needs to be corrected.

Opportunities

In an environment of uncertainty and a constant flow of negative news, it is easy to be part of the wait and watch brigade and wait for the nightmare to go away. But such an approach may not be the right one, cautions Jean-Marie Péan, Middle East chairman of consulting firm Bain & Company. Péan says that recessions hit some industries harder than others, so staying alert matters.

"Before the crisis, we had companies in the Middle East asking us to help them grow, but post-crisis, our mandate has been one of helping our clients weather the crisis and strengthening their operating platform," he explains.

Péan also feels that while the crisis requires companies to reduce costs and investments, increase revenue and margins, shift resources to core business activities and prepare for bold moves, it also opens up the market for mergers and acquisitions.

Bain & Company has published a booklet entitled "Winning in Turbulence" in which it recommends that companies act depending on where they stand on three critical dimensions. The booklet notes: "If your company has a strong financial position, for example, you may be able to out-invest competitors in marketing to increase

customer loyalty. You may be able to attack or even acquire weaker competitors. If financial resources are scarce, you face a different set of possibilities. Depending on your strategic position and your industry's volatility, your best options may be to divest non-core assets and restructure the balance sheet, or to accelerate decisions around reducing cost and debt. You may need to seek alliances or merger partners and dispose of anything that is not essential to survival [during a sharp downturn]."

The performance of companies is very important to the health of economies, so we will have to see how some of our regional and local ones fare through the crisis. Consultants say that some will not survive. But surely those companies that do survive and do well through the crisis will be among the leaders when the next boom comes.

For both large and small individual investors, it will be important to keep a close watch and choose good companies that have strong revenue prospects and are not leveraged. While it is generally not possible to catch the bottom, it would be wrong to remain all in cash for a long time. Long-term bargain hunters should be getting ready to acquire some of the leaders of tomorrow in their portfolios. A large theme for regional investors should be local and regional equities, given the new thinking of boosting industrialisation and knowledge-based initiatives in the Arab world. 