

# Is the GCC prepared to handle the downturn?

The global downturn is likely to hit the GCC hard. But **Stefan Hofer** thinks that a medium-term recovery of the oil price should help the region hold its own.

**W**ith economic conditions deteriorating around the world, international investors are asking themselves how well the GCC is prepared for such an environment. Although the impacts of deleveraging and recession have been slow to reach the GCC, this situation appears to be changing. Given the increased financial and trade integration in recent years, it can be argued that the effects of the slowdown could be more marked during this downturn and synchronised across countries and regions.

In terms of real GDP growth, the GCC is forecast to outperform the OECD average by a wide margin this year. Even if the region slows to below three per cent, marking a significant departure from the previous six years (during which growth averaged close to seven per cent), this figure is in stark contrast to the US, the Eurozone and Japan. These economies are likely to contract by two to three per cent this year and the recovery in 2010 and 2011 is expected to be modest.

Unlike the previous two US recessions, where household consumption did not suffer major setbacks, the current contraction is now being characterised by both consumers and businesses reducing their debt levels. The severity of the ensuing contraction is therefore most reminiscent, in our view, of the early 1980s recession, which also saw a pronounced credit crunch. The deleveraging taking hold today means that US consumption as a percentage of GDP may fall from 72 per cent to 68 per cent by 2010. This circumstance would have very significant repercussions for financial markets, global trade and demand for commodities, among other factors.

## Energy exports

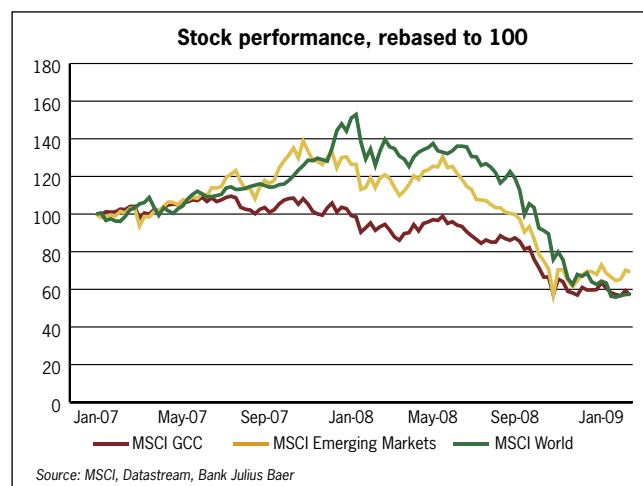
Given the importance of energy exports for the GCC, these should be the focus in terms of assessing the shorter-term impacts. Market forecasts point to a drop in global consumption of oil of 1.5 million barrels per day (year on year for 2009), with weakness being registered in the US, Europe and even China. The current moderation in demand has not been seen since the early 1980s. On the supply side, curbs in production by producing nations in the Gulf should help support prices, but market consensus points to higher non-OPEC output in 2009. We maintain the view, however, that

on a three to five year horizon, oil prices will recover to the US\$60-75 level. Current prices are not only linked to diminished demand, but also to tight credit market conditions, which should normalise over time.

In addition, the International Energy Agency remarked in its February report that oil companies have reduced their spending on maintenance, which could threaten future production capacity. To sum it up, the stage is set for oil prices to move higher over the medium term, which is fundamentally very supportive for the GCC's outlook.

Retrenching consumers have characterised the recession in the US. For the GCC, it can be said that cancelled or delayed investment projects have been the most visible symptom. On one hand, a decreased supply of new real estate and other projects will help bring the market back to equilibrium. On the other hand, the costs and spillovers associated with this rebalancing need to be considered as well. Beyond those factors, most analysts and economists would agree that the key is a longer-term strategy of diversifying economic activity away from the reliance on energy exports.

Against this backdrop, it is worthwhile to consider the efforts undertaken by GCC policymakers to offset the financial market turmoil and economic slowdown. While many countries have launched large fiscal stimulus programs (notably the US and China), the focus in the GCC has tended to be on supporting banks and liquidity conditions. For example, according to J.P. Morgan, deposit guarantees have been extended in a number of countries



such as Saudi Arabia, the UAE, Kuwait and Bahrain. Interest rates have been lowered across the region, while other special facilities have been put into place to assist banks' capital. The recent US\$20 billion bond programme announced by the Dubai government to support companies in their refinancing efforts should also be mentioned. Other steps, such as greater access to lending for lower-income citizens in the Kingdom, should provide further support.

There have been a handful of higher-profile corporate consolidations and bailouts, but these pale in comparison to the large-scale losses and turbulent restructurings seen among US and European financials.

### Softening the downturn

Interestingly, the growth of Islamic banking has been especially fortuitous for the region. Moody's raised this issue in a report published late last year. The agency noted that since Islamic Financial Institutions (IFI) are structurally excluded from holding certain assets in their books, they have been able to avoid some of the toxic products that have plagued other banks. Moody's also stated that some clients would perhaps find it more comforting to transact with an IFI, given the perception that these institutions focus more on the basics of financial intermediation and are therefore less prone to excessive financial innovation. Moody's did point out, however, that real estate lending exposure for some GCC members is significant; therefore, falling real estate values will have negative repercussions.

It clearly makes sense to consider how prepared GCC governments are in terms of being able to smooth out the cycle. In aggregate, the GCC has reportedly constructed conservative budget frameworks, so it should be well prepared to partially soften the downturn. To illustrate, analysts estimate that in 2006 alone, the GCC had budget surpluses of 20 per cent of GDP, with the last deficit year being 2001. While cyclical factors have seen budget balances deteriorate for most economies in the current environment, there are marked differences in the GCC.

For example, the recently enacted US stimulus package

will likely see some of the largest fiscal deficits (excluding World War II) since the 1930s. But it can be argued that without this package, the global slowdown would be far worse. Other economies with fairly high debt levels to begin with (for example, Japan) will find it more difficult to enact large stimulus packages. The GCC, however, appears to be well positioned. Its total external debt as a percentage of GDP is less than 30 per cent, according to J.P. Morgan estimates.

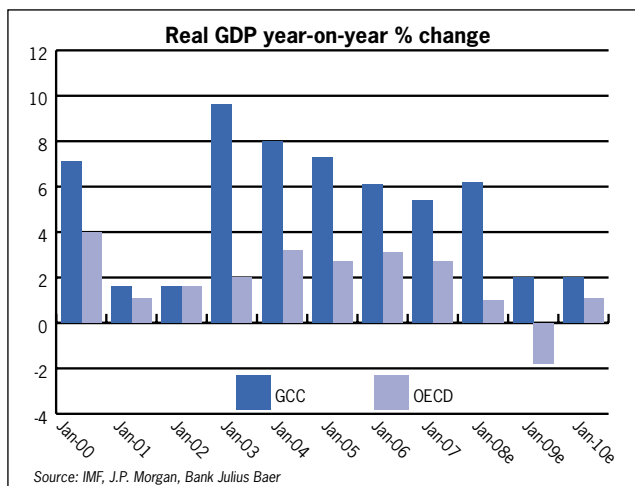
Financial market performance last year demonstrates that the GCC, while possessing relatively strong fundamentals, could not avoid the impact of global deleveraging. As such, the larger GCC bourses saw declines in 2008 comparable to global equity returns. For example, while the MSCI GCC dropped about 50 per cent, some stock markets in Europe and other emerging markets fared worse. Other than the safest category of government bonds, even large segments of traditionally lower risk credit did poorly. As such, the overriding factor last year was that risky assets were highly correlated as investors, gripped by the financial system's turmoil, sought to reduce risk to a minimum.

One positive development so far in 2009 is that national stock markets are beginning to show a greater divergence in performance. This suggests that investors are starting to draw greater distinction between differing economic and corporate outlooks, which is an important step towards the normalisation of financial markets.

GCC credit markets have not been immune. Credit default swap (CDS) spreads have risen substantially across the region, even for the strongest borrowers. According to Moody's, some traded entities even saw spreads hit 1000 basis points last quarter, a level that is generally considered distressed. But here the GCC is not alone. Russia's sovereign CDS spread exceeded 1000 basis points last year, although most observers would probably agree that the likelihood of a sovereign default, even in the face of worsening economic fundamentals, appears limited. In that sense, the rise in CDS spreads is partly a reflection of overall tensions in the credit markets and international investors' general attitude towards risk, which remains at conservative extremes.

Although the GCC is certainly feeling the effects of slower economic growth, the capacity for governments to smooth out the cycle is strong. Crucially, the medium-term outlook for energy prices, in our view, is also supportive of the fiscal frameworks for the GCC as a whole.

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