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Credit crunch increases Gulf's influence in corridors of power

The region has suffered from the financial crisis but it might reap some benefits too, writes Ben Wright

It is no longer a question of whether the credit crunch will hit the financial markets of the Middle East, but how bad and lasting the impact will be now that it has.

The crisis has all but paralysed interbank lending across the region, caused stock markets to crash – by as much as 50% in the case of the Dubai Financial Market – prompted sovereign wealth funds and central banks to intervene, and, since July, halved the value of crude oil, upon which much of the region's wealth is based.

At the end of last month, the Kuwaiti central bank was forced to save the country's Gulf Bank following steep losses from derivatives trading. The Kuwaiti Government also decided to guarantee all bank deposits, a precaution that has been taken by most other countries in the region, and there are rumours that other Middle Eastern banks have received cash injections via the back door.

There is an air of uncertainty in the region's aspiring financial hubs. The most common answer to any question is resigned but honest: "I don't know." As one Dubai-based banker said: "Everything that I am telling you now was true, as far as I could tell, in September. I don't know whether it is true now."

In the past few years, the banks, fund managers and financial centres of the region have striven to increase their influence across global markets. They are now experiencing the downside of that ambition. Georges Makhoul, managing director and president for Middle East and North Africa at Morgan Stanley, said: "You cannot operate in isolation. If you want to become the crossroads of world trade then you cannot remain immune to global issues."

However, there are also indications – some of them faint and hope-

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ful, others more concrete – that the credit crisis may prove to be a double-edged sword for the region. It can no longer be considered a haven immune from the rest of the world's difficulties, but that does not necessarily mean that the Middle East will not benefit from the crisis, at least in the medium term.

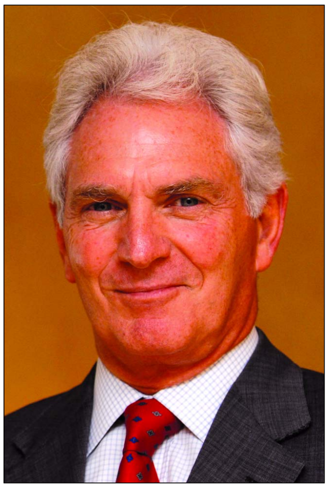
A trip by Gordon Brown, the UK Prime Minister, to the region at the beginning of this month demonstrated that the credit crisis is increasing the Middle East's political clout. The large stakes in Barclays taken by sovereign wealth funds based in Abu Dhabi and Qatar the week before Brown's visit illustrate why he made the trip – the budgetary surpluses and oil riches amassed by sovereign wealth funds as a result of the prolonged bull run in global commodity prices mean that these countries hold the last remaining pools of liquidity in a global financial system that is running dry.

Most of the countries in the Middle East have saved money in the fat years and are now being asked to share the benefits of their good luck and forward planning in the lean years. Ali al Shihabi, founder and chief executive of Rasmala, a regional investment bank, said: "Globally there is a shortage of credit, but this region has supply and will act as net lenders to the global system."

Brown has urged the oil-rich Gulf states – and China – to come up with hundreds of billions of dollars to aid struggling countries. If they do so, there will be strings attached. China and the Gulf states are demanding seats at the International Monetary Fund and the World Bank tables. Both organisations are currently dominated by the US and Europe.

As well as developing their political clout, Middle Eastern governments are also looking to accelerate the development of their financial muscle. Nasser al Shaali, chief executive of the Dubai International Financial Centre, believes local markets need to build capital to fund their growth rather than rely heavily on international funding. He said: "These markets need to take the opportunity to step up to the plate – they need to develop their own capital markets so that they can take control of their destiny."

Al Shihabi: more level playing field



Saïdi: praise for the banking sector

Nasser Saïdi, chief economist of the DIFC and a former Lebanese Minister of Economy, thinks the credit crunch will also enable Middle Eastern financial institutions to steal market share from western rivals. He said: "We are witnessing a period of Schumpeterian "creative destruction" in the world financial markets. The destruction is occurring in New York, London and many other European capitals among the banks and other financial institutions. The creation will come to and from the growing markets in the Middle East and Asia. Ultimately, I don't think the credit crunch will have a huge impact on the region."

Saïdi said the banking system was strong and sound, benefiting from high economic growth rates achieved in the region. Banks have high profitability and low vulnerability to the various risk and stress factors that have led to the demise of institutions in the US, the UK and Europe.

He, like many other market participants, believes this resilience is at least partly down to the growth of Islamic finance, which accounts for some 20% of bank assets in the UAE, 25% in Bahrain and 50% in Saudi Arabia. Saïdi said: "The mode of operation in Islamic finance is different from conventional banking – account holders share in profits and risks, there is equity risk-sharing. Disclosure and transparency therefore have to be higher because banks are more accountable."

What is more, this culture of prudence is reflected by the region's central banks, which have been extremely diligent in applying Basel I, especially capital adequacy rules. The average ratio of a bank's capital as a percentage of its risk-weighted assets across the UAE is in excess of 12% compared to the 8% required by Basel. Few banks have invested in sub-investment grade assets.

The image of those western banks that did invest in assets that turned out to be toxic has taken a battering. Rasmala's Al Shihabi said: "There was a mystique to some of the largest international financial brands that regional firms were up against. But that has now been punctured, there is a more level playing field." He argues that local operators were less sophisticated and less complex than some of the large international firms. A year ago this would have been a criticism, now it is a unique selling point along with the liquidity they can tap.

Al Shihabi added: "Local players, for example, never got into proprietary trading and not many were that leveraged. There have been some large losses among regional players but that is the exception rather than the rule. On the whole, profitability has been impacted but we are still profitable."

Ashley Painter, a partner at law firm Clyde & Co, said: "We are entering an era of financial regulation and of how people raise money. Islamic finance is based on real assets so its role in global finance could be significantly strengthened. The key is how it is applied in practice."

If the regional financial institutions can get it right and the balance of power begins to tilt slightly from western to eastern financial markets, there is likely to be, if not a reverse brain drain, at least a reverse brain trickle. Bankers from the area who have trained and worked abroad may sense that now is a good opportunity to head home. Western bankers who are reluctant to twiddle their thumbs indefinitely will want to be where there is at least some action.

This migration has started to happen, according to market participants. One investment banker at a local brokerage firm said: "The speed with which people have gone from demanding $5m to work in Dubai for an Arab firm to being prepared to work for food would be funny if it weren't so sad."

Many of the negative impacts of the crisis have a silver lining when viewed from the Middle East's unique perspective, though this should not detract from the short-term difficulties that the region is likely to face. It is also likely to put the lid on some of the more flamboyant aspects of the region's development before it has had a chance to develop into the irrational exuberance that so affected western financial markets.

Al Shihabi said: "This is a chance to take stock and tame some of the excesses in the market. Of course people are anxious but this may well act as a healthy timeout."

The most obvious issue facing the region is the sharp fall in crude oil prices. But market participants point out that government budgets are based on oil prices being far lower than they are now – estimates vary from between $25 to $45 a barrel. As long as prices stay above this level, regional economies will remain in surplus. The reduction in prices has also tamed inflation and reduced the amount of speculative money betting on currency revaluation.

Hashem Montasser, head of asset management at EFG Hermes, said: "The fall in the price of oil is a good thing – it will keep governments disciplined and it keeps inflation under wraps. The vital infrastructure projects will continue (certainly as long as crude oil stays about $50), but some of the non-vital projects may be shelved. Oil at $120 creates large surpluses but it is a bit of a mixed blessing."

While currency revaluation may have slipped down the agenda, the authorities in the region have worked in concert to stave off the worst effects of the credit crisis. This is particularly crucial in the UAE. There had been speculation over whether Abu Dhabi, the country's capital and largest emirate, would, in a pinch, come to the aid of Dubai, its brasher and more leveraged neighbour. As it has turned out, the credit crisis, so far at least, appears to have cemented the relationship.

Morgan Stanley's Makhoul said: "The reaction to the crisis has definitely solidified the federal system of the UAE. There was a degree of doubt about how the relationship between Dubai and Abu Dhabi would be tested but that has now been taken out of the equation."

In theory, there would have been less danger in allowing a UAE bank to go to the wall than elsewhere in the world. The banks are not interconnected like in London and New York so there wouldn't have been the domino effect. Letting one fail might have taught the others some valuable lessons without unravelling the system, according to market participants.

However, the psychological effect would have been hard to predict. One investment banker said: "They are trying to create something very fast here and I think they calculated that anything that badly shook confidence might have damaged their plans beyond repair."

But if the relationships within the UAE have been strengthened, those of the wider region could still benefit from closer ties.

Nasser al Shaali, chief executive of the DIFC, said: "The region needs greater co-operation. It has been unfortunate that central banks of the Gulf Co-operation Countries have not met to ensure that they are aligning their work on managing the crisis." Al Shaali said that if discrepancies emerge between how the different central banks handle things, it can only lead to greater problems. He added: "We want foreign direct investment but we also want stability in our capital markets – the UAE is beginning to learn how to balance those two things."

These are global problems and they require global solutions. The Saudis and other countries in the Gulf states are very important. They are the countries with great revenues and oil wealth

Gordon Brown, UK Prime Minister


REUTERS

Friends in need: UK Prime Minister Gordon Brown on his recent Gulf visit

The balance of the relationship between Abu Dhabi and Dubai is shaped by the larger emirate's greater oil wealth and the smaller emirate's attempts to diversify its economy through huge property and infrastructure developments. The commodity bubble may have burst but the property bubble continues to look dangerously inflated.

Again, if it were to burst, the effects would be painful for companies and individuals but could have medium-term benefits. For one thing the bubble is quite localised, concentrated heavily on Dubai's real estate market. It has also been the only investments show in town for several years.

There has therefore been little incentive for investors to put their money in equity or bond funds that might earn single-digit, or at best double-digit, returns when they could be earning triple-digit returns from property investments.

John McGaw, chief executive of Killik & Co in the Middle East and Asia, said: "Fund managers of all stripes have been competing against the property market in Dubai and now that music appears to be grinding to a halt."

Ziad Makkawi, chairman and chief executive of Algebra Capital, a local fund management firm, said: "The financial crisis might be good for the fund management industry in the region. People have been managing their own money up until now: this may cause them to reconsider the wisdom of that approach."

The fact that the correction to the regional markets was the product of a global crisis means that it occurred earlier than it might otherwise have done had it been operating in isolation. Some of the excesses and leverage in the market have thus been corrected before they grew out of control.

The Middle East will feel a great deal of pain from its closer ties to a globalised economy and the inherent financial interdependencies, but financial market participants will hope that pain can ultimately aid the region's financial education and development.