

Distr.  
LIMITED  
E/ESCWA/EDGD/2009/WP.3  
14 March 2009  
ORIGINAL: ENGLISH

**ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA (ESCWA)**

**THE IMPACTS OF THE FINANCIAL CRISIS ON ESCWA  
MEMBER COUNTRIES:  
CHALLENGES AND OPPORTUNITIES\***

---

\* This paper was prepared within the framework of the ESCWA Initiative on Responding to the International Financial Crisis.

## CONTENTS

	<i>Page</i>
Executive summary.....	iv
<i>Chapter</i>	
<b>I. INTRODUCTION .....</b>	<b>1</b>
<b>II. THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON ESCWA MEMBER COUNTRIES .....</b>	<b>2</b>
A. The banking sector.....	2
B. Stock markets.....	3
C. Oil prices and revenues.....	4
D. Real estate.....	6
E. Sovereign wealth funds.....	9
F. Trade.....	15
G. Foreign direct investment .....	19
H. The tourism sector .....	22
<b>III. OUTLOOK FOR ESCWA MEMBER COUNTRIES IN 2009.....</b>	<b>24</b>
<b>IV. POLICY RECOMMENDATIONS.....</b>	<b>28</b>
<i>References .....</i>	<i>29</i>

### LIST OF TABLES

1. Housing prices in the GCC countries, 2007-2008.....	6
2. Real estate contribution to GDP, 2005, 2006, 2007.....	7
3. Medium-term outlook for the real estate market in the GCC countries .....	8
4. Estimated size of major Arab SWFs in 2007, or the most recent year available .....	11
5. Estimated currency composition and asset allocation of major Arab SWFs, 2007 .....	12
6. Scoreboard of major Arab sovereign wealth funds .....	14
7. Trade openness of Arab countries, 2004 .....	16
8. Geographical orientation of Arab exports, 2005-2007.....	16
9. Oil market estimations and projections, 2008-2009.....	17
10. FDI inflows, 2007-2008 .....	19
11. International tourism in selected ESCWA member countries, 2005-2007 .....	22

### LIST OF FIGURES

I. Arab stock markets – end of 2008 .....	4
II. OPEC basket price.....	5
III. Regional market share of sovereign wealth funds at the end of 2008.....	11
IV. Geographical distribution of FDI in the Arab region, 2006 .....	20
V. Nominal GDP of GCC countries .....	24
VI. Fiscal surplus of GCC countries as a percentage of GDP.....	24
VII. Current account balance of GCC countries as a percentage of GDP .....	25

## **Executive summary**

The financial crisis which hit the global economy in the autumn of 2008 represents the first and most difficult challenge to the globalization process. The crisis, which began as a liquidity crunch, went on to severely affect global financial markets moved quickly to the real economy, hence transferring the global economic expansion into the deepest global economic recession since the 1930s. Moreover, the crisis has shaken confidence in the international financial system, which has, in turn, exacerbated its impact on the global economy. The Asian Development Bank estimates that global financial losses from the financial crisis amount to about US\$ 50 trillion. Arab countries are expected to have lost at least about US\$ 2.5 trillion as a result of falling market capitalization, bank assets, oil revenues and losses incurred by the sovereign wealth funds (SWF).

Countries around the world have implemented rescue plans to save their financial markets and regain trust in their financial systems. Global rescue plans are estimated to exceed US\$ 3 trillion, about one trillion of which was spent by the United States. While these measures have rescued the financial markets from melting, their impact on economic growth remains to be seen. Global growth in 2009 is expected to be the lowest since the economic depression of the 1930s. Fears are now growing over the introduction of protectionist policies, which could disrupt the trade flows, lead to a prolonged recession and eliminate the progress made in the trade liberalization over the last two decades. According to the International Monetary Fund (IMF), several major countries have taken steps to limit the inflow of foreign goods. This is a worrying move as it could spill over in trade retaliation by other countries.

Latest projections indicate that global economic activity in 2009 will contract by 0.5 to 1.0 per cent. Economic growth in the United States, the largest economy in the world, is projected to be negative at about 2.6 per cent in 2009. In the Euro area, the recession is projected to be even deeper as negative economic growth is projected at 3.2 per cent, while in Japan it is estimated at 5.8 per cent.

In ESCWA member countries, the financial crisis started during a period of high economic growth, particularly in the GCC countries, which enjoyed huge oil revenues. Therefore, the overall picture of the impact of the crisis on ESCWA member countries is relatively mixed. In the GCC countries, growth is expected to remain positive, but expected to reach lower levels. The main factor behind expected lower economic growth is the sharp drop in oil revenues, as a result of the looming recession in the major advanced economies, a sharp drop in stock market indices, lower profits and disruption in the boom in the housing sector, particularly in the United Arab Emirates. The impact of the crisis on economic growth will be less severe on ESCWA member countries, particularly GCC countries, compared with other regions, such as Africa and Asia, as GCC countries managed to accumulate huge surpluses during the last few years thanks to the unprecedented jump in oil prices.

In other Arab countries, economic growth is estimated to be either low or negative, precipitated by factors such as lower export earnings, the poor performance of stock markets, underperforming banking sectors, expected drops in both ODA and FDI and the expected drop in tourism revenues.

Global oil demand is expected to drop by 1.6 per cent in 2009 due to the decrease in global economic activities. This is expected to have a negative impact on GCC economies which will, in turn, lead to a slowdown in economic activities. Several GCC countries have taken steps to boost domestic demand by applying expansionary fiscal policies; it is expected that this may lead to a decline in oil investments and may delay plans to boost oil production capacity. Some countries have shelved plans to increase energy spending. For example Kuwait has dropped plans to build an oil refinery worth US\$ 15 billion. Furthermore, the private sector, which is highly dependent on public sector spending, may also be negatively affected by the crisis and wait to see how Governments weather the financial storm.

The construction sector, particularly the real estate of the United Arab Emirates, has been hit badly by the financial crisis. This has resulted in the return of thousands of migrant workers and has reduced the

income of many families who lost part of their savings following the sharp correction in the real estate market.

The banking sector in the GCC countries has fared relatively well over the past few months. Most banks in these countries remain well capitalized, particularly those with less exposure to sophisticated financial products. Available figures indicate that non-performing loans to total loans remain below 5 per cent, with few exceptions. As for 2009, it is estimated that profits will fall below 2008 profit levels as economic activity drops, and given expected capital outflows from the region and the reluctance of the private sector to play a greater role.

Available data also shows that the foreign liability of the GCC banks increased substantially in 2008, reaching US\$ 172 billion, up from only US\$ 53 billion in 2005. In other ESCWA member countries, banks have less exposure to the global financial crisis and some countries, such as Lebanon, have received some of the repatriated funds from Europe and the United States. Their stock of foreign exchange reached record highs in 2008.

The performance of stock markets in the ESCWA member countries worsened in 2008 as a result of the financial crisis. Arab stock markets went through a major correction as indices declined by about 50 per cent in 2008. The Arab Monetary Fund index for these stock markets dropped in 2008 to 166.2 points from its 2007 level of 328.7 points, while the capitalization of these markets dropped by over 42 per cent in 2008 to reach US\$ 769 billion, down from US\$ 1,137 billion in 2007. The worst performance was recorded in stock markets with a high proportion of banks and real estate companies in their indices, such as those in Dubai and Abu Dhabi.

Sovereign wealth funds in the region have suffered great losses as a result of the crisis. The major loss was recorded by those funds that invested heavily in stock markets in the United States, particularly in financial institutions, such as banks and insurance companies. Although there are no official figures, some estimations show that losses of SWFs were greater than US\$ 200 billion in 2008. The financial crisis is expected to lead to a shift in the investment strategy of these funds by, among other things, directing more funds and investments into their own economies, reducing their investments in paper assets and investing more in the real economy.

Foreign direct investment (FDI) inflows to the region started to drop in 2008 and are expected to decline further in 2009. According to the United Nations Conference for Trade and Development (UNCTAD) estimate for 2008, global FDI inflows have dropped by 21 per cent. The expected drop in FDI inflows to the region is due to several factors, including falling oil prices, the sharp correction in the housing sector, the slowdown in economic activity and financial problems of multinational corporations which represent the major source of the FDI inflows. Egypt announced a fall in FDI inflows of about US\$ 4 billion in the second half of 2008, down from more than US\$ 7 billion over the same period in 2007.

The decline in external sources of development finance, together with the drop in both exports and tourism, is expected to place pressure on the exchange rates of the currencies of the non-GCC countries, which may complicate the economic conditions faced by these countries. On the other hand, intraregional FDI, which has been around 25 per cent of total FDI inflows to these countries, could increase as a result of the repatriation of investments abroad back to the region. This could be a major boost for intraregional FDI inflows and hence for the promotion of regional integration.

Countries in the region have taken measures to mitigate the impact of the crisis on their economies. Several countries, including Egypt, Saudi Arabia and the United Arab Emirates, have adopted expansionary fiscal policies to boost domestic demand. Several countries have also declared their readiness to guarantee bank deposits to restore confidence in the banking sector. Several GCC countries have also taken steps to ease credit conditions. Kuwait, for example, has cut its benchmark discount rate, while the Saudi Arabia Monetary Agency lowered the repo rate and reduced reserve requirements. In the United Arab Emirates, the

Central Bank has tried to alleviate liquidity bottlenecks by providing short-term facilities to banks and the Government has declared its readiness to protect national banks from credit risks.

The financial crisis is expected to have a negative impact on international trade. Latest estimates by the IMF indicate that world trade volumes will decline by at least 3 per cent in 2009. Trade in the ESCWA member countries is estimated to achieve a negative growth rate in 2009. Arab countries, in general, are characterized as highly open with the trade openness index for 13 Arab countries averaging 71 per cent in 2004. GCC countries registered the highest trade openness indices, owing to the high share of oil in their exports.

The geographical distribution of Arab exports indicates that 47.6 and 28.5 per cent are exported to Asian and European Union countries, respectively. The expected drop in demand from European Union and Asian countries, particularly Japan, will therefore have a significant impact on Arab countries.

Oil revenues in the GCC countries are expected to drop by 60 per cent in 2009. This will have a severe impact on their investment, including investments to add to their oil production capacity. In the non-GCC countries exports are also expected to drop, although no data is available on how big the drop will be. However, their exports to both the European Union and the United States are expected to decline in 2009. Arab oil-importing countries will benefit from the drop in oil prices which will alleviate the pressure on their current accounts. Moreover, intraregional trade could also benefit as some of the exports that used to be directed to Europe and the United States could be directed to other Arab countries. If this were to occur, it would have a positive impact on intraregional trade.

The tourism outlook in the region is mixed. Those countries which rely on international tourism receipts from outside the region, such as Egypt, Morocco and Tunisia, are expected to be hit by the crisis. Egypt, for example, announced a drop in reservations of about 15 per cent in December 2008. For those countries that depend mainly on intraregional tourism, the picture is expected to be better. Lebanon, for example, is expecting about two million tourists in 2009, a higher level than in 2008. As many Arab tourists may change their destinations from Europe, Asia and the United States to Arab countries, the impact of the crisis may be mitigated.

Workers' remittances are also expected to drop as a result of the financial crisis. The freezing of huge housing projects in the GCC countries will lead to the return of thousands of foreign workers and to falling remittance levels. This will have a huge impact on those countries which depend on remittances as a source of foreign exchange. Several ESCWA member countries will be affected by a decline in remittances, for example Egypt, Jordan, Lebanon and Yemen. If this situation lasts, it will lead to an increase in both unemployment and poverty, and hence jeopardize their efforts to meet the Millennium Development Goals (MDGs) by 2015.

ESCWA member countries need to take appropriate measures to mitigate the impact of the financial crisis on their economies. Recommended policy options include the need to:

1. Continue to apply expansionary fiscal policies to boost domestic demand, notably in infrastructural projects, in order to stop the recent slowdown and increase economic activity levels.
2. Inject liquidity to the banking sector through rescue packages, thus restoring confidence in the banking and financial sector.
3. Monitor mergers between financial institutions and ease Government regulations to encourage the private sector to play a more active role during the crisis.
4. Formulate and implement more vigilant regulatory measures to be adopted by the banking sector in the long term.

5. Develop initiatives to ease the problems and minimize speculative activities in the real estate sector, which represents an important source of economic growth in some countries.
6. Enhance governance standards of SWFs, in particular those related to good governance, transparency and accountability.
7. Diversify the investments of SWFs, both in terms of sectors and geographical distribution, by investing more in the real economy and targeting developing regions, notably in Africa, Asia and Latin America, in order to increase South-South ties.
8. Promote financial integration. ESCWA member countries with major financial surpluses may consider approving loans to other ESCWA member countries, to help them overcome the repercussions of the financial crisis and the expected fall in external inflows including ODA, remittances and FDI. This can be done either on a bilateral basis or through the development funds and banks available in the region.
9. Increase intraregional investments. Promote investments in sectors in which many ESCWA member countries have a comparative advantage, such as agriculture, clothing and footwear, textile fibres, chemical products, and services such as tourism and research and training centres. The latter would contribute to long-term growth prospects.
10. Ensure the full implementation of the Greater Arab Free Trade Area (GAFTA), in particular in terms of harmonization of production standards; facilitation of cross-border transit; computerization of customs services; streamlining of inspection/control methods, including service liberalization and investment flows.
11. Enhance the role of some regional institutions, such as the Arab Trade Financing Programme, in order to further facilitate trade credit;
12. Pursue more efforts to diversify Arab exports away from oil, and move towards greater specialization in products with higher added-value and a large number of trading partners.
13. Continue efforts to improve the “doing business” environment, in particular by enhancing good governance and combating inconsistency in the implementation of laws.
14. Promote South-South cooperation by, among other things, increasing investments and trading levels with other developing countries.



## I. INTRODUCTION

The recent global financial crisis has spread rapidly since the fall of 2008 and both developed and developing countries have been affected. Almost all major developed countries are now in recession, and economic activities in emerging and developing countries are slowing down. According to the latest IMF projections, global GDP growth will contract by 0.5-1.0 per cent in 2009. Global industrial production declined by 20 per cent in the fourth quarter of 2008. In 2009, world trade is expected to experience its largest decline in 80 years. Trade growth turned negative in the last quarter of 2008 (World Bank, 2009).

The financial turmoil will have a long-term impact on developing countries. Weak global demand is compounded by the growing scarcity of financing resources. The World Bank estimates that developing countries have currently a financing gap of US\$ 270-700 billion, and the available international financial resources appear inadequate to meet the financial needs of the developing world. The shortage of financing will have major repercussions for infrastructure spending. Further, foreign direct investment (FDI) is expected to decline in all regions.

As most ESCWA member countries are now more integrated into the global financial system than a decade ago, they are more vulnerable to the global financial crisis. The crisis has had a serious direct impact on ESCWA member countries, as reflected in the sharp correction of stock markets, expected decline in FDI flows, falling oil prices, and losses incurred by sovereign wealth funds. In addition, Arab economies are likely to be affected by the indirect impact of global financial turmoil through changes in monetary liquidity and in the valuation of financial and tangible assets, and in a slowing regional and world economy. These different areas are interlinked and will have a significant impact on the real growth of these countries.

Since November 2008, the Arab region has entered the first-round effect of liquidity constraints. This effect is being felt in the countries whose banking sectors have sizeable direct linkages to international money and capital markets, namely Bahrain, Kuwait, Saudi Arabia and the United Arab Emirates. The liquidity crunch will have a severe impact on the private sector, even though GCC policymakers have eased interest rates.

The combined size of GCC economies will decrease from about US\$ 1.04 trillion in 2008 to about US\$ 923.6 billion in 2009. Real growth is estimated to reach about 5.2 per cent in 2008, while in 2009 the growth rate is likely to decline to about 2.4 per cent. The Saudi economy, the largest economy in the region, is likely to report a real growth rate of 4.2 per cent in 2008. However, in 2009 economic growth is likely to decelerate to about 1.0 per cent.

Coordination at the level of ESCWA member countries and the GCC countries, particularly with regard to monitoring and studying the impact of the crisis, is needed in order to avoid greater problems for ESCWA member countries. Therefore, urgent and coordinated measures, and increased regional cooperation, are needed to diminish the consequences.

The rest of the paper is organized as follows. Section 2 discusses the impact of the financial crisis on the economies of ESCWA member countries and the measures taken by policymakers to mitigate the negative consequences. Section 3 presents the outlook for ESCWA member countries in 2009, while section 4 provides policy recommendations.



## II. THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON ESCWA MEMBER COUNTRIES

### A. THE BANKING SECTOR

The majority of banks in the GCC countries remain well capitalized and profitable with limited exposure to sophisticated financial products. The ratio of non-performing loans to total loans is less than 5 per cent. Profits remain strong with average return on equity of 21 per cent and capital-adequacy ratio ranges from 13 to 20 per cent, far exceeding the minimum requirements (IIF, 2008).

Losses associated with subprime assets are limited and only affected a small number of banks and investment firms in the GCC countries (IIF, 2008).<sup>1</sup> However, the prospects for 2009 look much more difficult as banks face a credit crunch due to the large capital outflows and repatriation of foreign funds from the region. Thus, financing costs have risen sharply, and reductions in bank lending will lead to less investment, lower growth and increased unemployment. This means a reduction in demand which, in turn, will reduce economic growth further. The International Institute of Finance (IIF) reports that foreign liabilities in GCC banks increased from US\$ 53 billion in 2005 to US\$ 172 billion in June 2008 to meet the rise in domestic demand for credit to finance infrastructure and real estate projects. The foreign liabilities of banks in the United Arab Emirates, especially Dubai, experienced a sharp increase from 17 per cent of GDP in 2005 to 40 per cent in 2007, and jumped from US\$ 23 billion in 2005 to US\$ 93 billion in June 2008. The foreign liabilities of banks in Oman are considerably smaller, and stood at US\$ 4 billion in 2008. Banks in Bahrain, Kuwait and Qatar had moderate levels of foreign liabilities in June 2008, at US\$ 25 billion, US\$ 24 billion and US\$ 20 billion, respectively. As a result, the external debt of GCC countries rose sharply from US\$ 10 billion in 2005 to US\$ 358 billion in June 2008, equivalent to 33 per cent of GDP in 2008. However, all GCC countries continue to be net external creditors. On the other hand, local banks in Kuwait and Saudi Arabia are insulated from the current financial crisis as they rely on domestic deposits and local borrowings to finance large increases in domestic credit, limiting their vulnerability to the deterioration of the global financial conditions.

According to the IIF, large capital outflows from GCC countries began in March 2008 when investors, who bet on an appreciation of the currencies of GCC countries, revised their stance. Central banks in the region reacted swiftly by injecting funds and providing credit facilities to maintain the liquidity of the banking sector. Central Banks also cut interest rates and reduced reserve requirements in an attempt to ease funding pressure. The United Arab Emirates was the first GCC country to provide guarantees for bank deposits and offer a credit facility of DH50 billion in October 2008, which was supplemented by a government deposit of DH70 billion in banks. The Saudi Arabian Monetary Authority reduced reserve requirements on current account from 13 to 7 per cent, lowered the repurchase rate by 150 basis points, and made US\$ 36 billion available to local banks. In addition to this, the Saudi Government announced plans to spend US\$ 400 billion on development projects over the next five years. The Central Bank of Bahrain reduced the one-week deposit rate by 25 basis points in October 2008 and dropped the overnight repurchase rate by 125 basis points. The Central Bank of Bahrain also plans to raise the bank deposit guarantee requirement from 15,000 dinars to 20,000 dinars (equivalent to US\$ 53,200). The Qatar Investment Authority bought a 20 per cent share of local banks, valued at US\$ 5.3 billion. The Central Bank of Kuwait (CBK) reduced the repurchase rate by 100 basis points and the discount rate by 125 basis points in October 2008. Then, a further cut of 50 basis points to the repurchase rate was introduced in December of the same year. It also allowed banks to raise the loan-to-deposit ratio from 80 to 85 per cent and injected about US\$ 1.87 billion into local banks. The Central Bank of Oman reduced its repurchase rate by 220 basis points in November 2008 to ease liquidity in the financial sector.

---

<sup>1</sup> The Abu Dhabi Commercial Bank announced an exposure of US\$ 272 million and the Gulf International Bank of Bahrain made provisions of US\$ 966 million against its holdings of US mortgage-backed securities. The Arab Banking Corporation wrote down US\$ 1.2 billion and the Gulf Investment Corporation, based in Kuwait, announced a write-down of US\$ 246 million.

Banks in other ESCWA member countries were less exposed to the global financial turmoil compared to their GCC counterparts. In Lebanon, banks have the highest capital adequacy ratio in the region, with 24 per cent in 2007. Lebanese banks have increased their capital to match the increase in their assets, and a large share of domestic credit is financed through domestic funds. The ratio of private sector deposits to assets exceeded 70 per cent in 2007, while the ratio of non-resident deposits to assets was about 16.6 per cent. The Lebanese financial system has no direct exposure to distressed financial products or markets and remains very liquid. Prudent macroeconomic and financial policies have strengthened the capacity of the economy to weather external shocks (IMF, 2009). Global Research (2008) argues that the Lebanese banking sector remains vulnerable because of the high level of dollarization since deposits denominated in US dollars stood at 72 per cent in September 2008. But the IMF (2009) points out that the deposit dollarization ratio has been declining steadily on the back of a growing interest differential in favour of the local currency and because of continued confidence in the Lebanese financial system. The IMF fears that the political uncertainty surrounding the 2009 elections may translate into a substantial drop in deposit inflows, which could complicate government financing.

The fundamental credit outlook for the Jordanian banking sector is stable, reflecting the solid financial fundamentals of the country's banks and the healthy operating environment (Capital Investments, 2009). Banks in Jordan enjoy a substantial amount of excess liquidity. Capital Investments forecasts that banks in Jordan will confront challenges in upcoming years, as tighter lending regulations adopted by most banks in the face of increased uncertainty will probably affect their profitability. High domestic inflation and decreased demand for goods and services will also affect asset quality and thus the effectiveness of the credit policies of banks.

In Egypt, a slowdown in economic activity is inevitable given the increased global integration of the Egyptian economy. The financial sector has managed to avoid the worst effects of the international crisis because of the strength of bank balance sheets, improved banking supervision and conservative practices with respect to funding, investments and lending (IMF, 2008). The Egyptian banking sector is unlikely to face a credit crunch since banks in Egypt sit on excess funds. Egyptian banks have a very low loans/deposits ratio of less than 60 per cent. The deposit base is stable and there is no interruption to the flow of credit to the private sector. There is little bank dependence on foreign credit lines and banks have little exposure to fluctuations in the prices of equities and other investments.

The Central Bank of Egypt has announced that it will guarantee the deposits of all banks. Domestic liquidity conditions might tighten in response to portfolio outflows; some repatriation of overseas assets seems likely, which would give some relief to the balance of payments (IMF, 2008).

## B. STOCK MARKETS

According to the Arab Monetary Fund (2009), Arab stock markets fell sharply by nearly 50 per cent in 2008 and posted some of the worst performances in the world. The Arab Monetary Fund index for the Arab stock markets fell to 166.2 points at the end of December 2008, as compared with 328.7 points at the end of 2007. The index tumbled by 34.2 per cent in the third quarter of 2008. The combined capitalization of Arab stock markets dipped by 42.5 per cent to about US\$ 769 billion at the end of 2008, from a high of US\$ 1,137 billion at the end of 2007. The loss in 2008 pushed the Arab markets to their lowest level since December 2004. The loss of Arab stock markets is equivalent to 40 per cent of their nominal GDP for 2007. Compared to other markets in both developed and developing nations, the decline in Arab bourses was larger than those in other markets, as the decline in the major global bourses was in the range of 38 to 43 per cent.

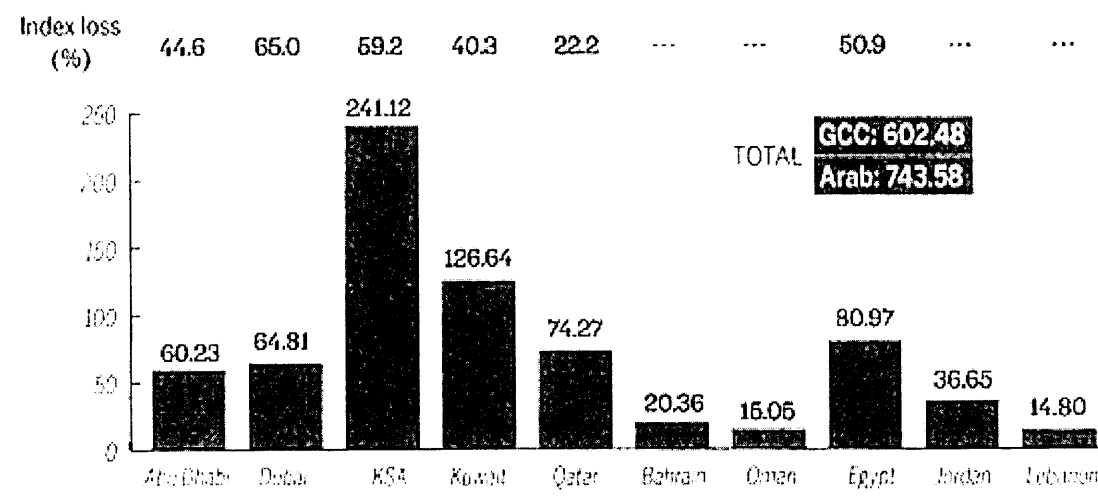
The decline in Arab bourses, with the exception of Tunisia, was a result of several factors, including the global financial crisis, foreign sell-offs and panic among small investors. Uncertainties in the global economic outlook led to a lack of investor confidence, greater risk aversion and a shift to high quality assets, such as government bonds. The decline in Arab stock markets had nothing to do with market fundamentals, since the region's economy was strong, oil prices were high in the first nine months of 2008, most of the

companies performed well and the bourses were not highly correlated with the global markets. Financial experts describe 2008 as the worst and most controversial year for Arab stock markets in general as they suffered their largest annual losses since share dealing began.

The stock exchanges of the GCC countries were hit hardest, in spite of the measures taken by authorities to support the local financial sector. In terms of capitalization, the markets lost nearly US\$ 368 billion in 2008 and dipped to their lowest levels in four years. The drop in Arab stock markets varied as it was as high as 65 per cent in Dubai and below four per cent in Algeria. Saudi Arabia's stock exchange, the largest and most speculative bourse in the region, dipped by 59.2 per cent, while the Egyptian stock market plunged by 50.9 per cent and those of Abu Dhabi and Kuwait fell by about 44.6 and 40.3 per cent, respectively.

The value of shares traded on the Arab stock markets also dropped by about 9.9 per cent to US\$ 997.8 billion. The number of listed companies also declined to 1,542 from 1,550. Turnover in the United Arab Emirates, Saudi Arabia and Kuwait accounted for nearly 80 per cent of the total value of shares traded on the Arab bourses in 2008.

**Figure I. Arab stock markets – end 2008**



The Government of Oman set up a US\$ 390-million fund, in partnership with the private sector, to act as market maker for the Muscat Securities Market. Other bourses in the region need to introduce market makers in order to reduce the high volatility of their markets which causes a lack of investor confidence.

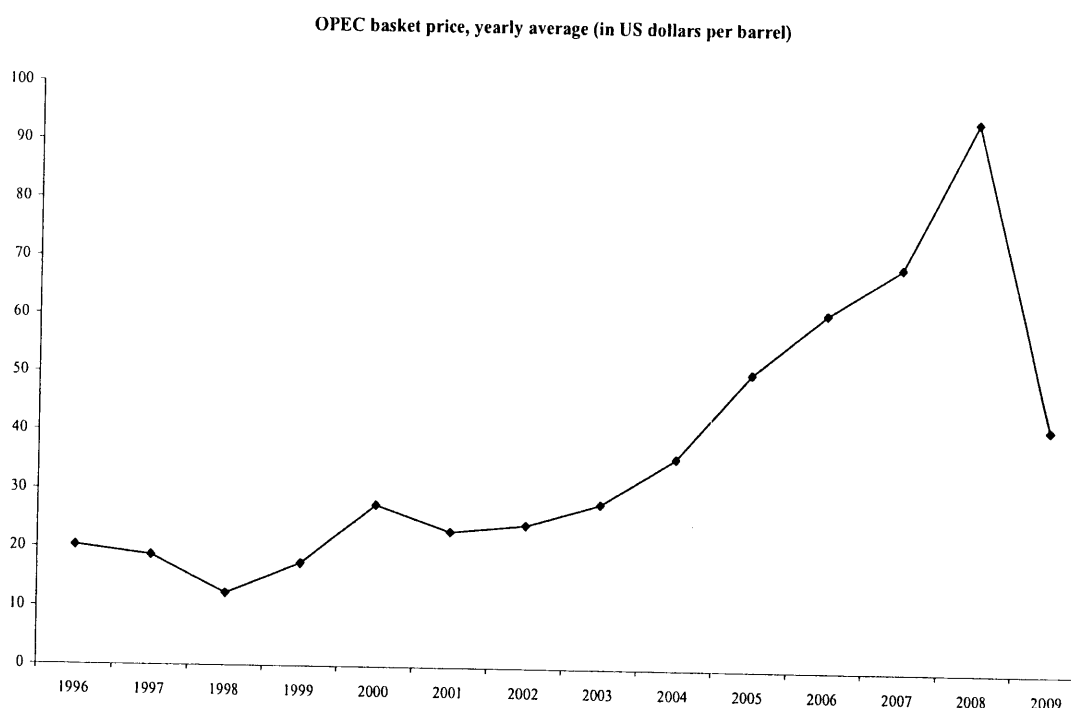
### C. OIL PRICES AND REVENUES

The oil sector continues to be the key sector in many Arab economies, particularly among GCC countries where oil revenues exceed 30 per cent of GDP. Strong oil prices over the past five years have played a significant role in boosting the economic growth of the GCC economies. Oil prices increased from US\$ 29 a barrel in 2003 to reach a peak of US\$ 147 a barrel in July 2008. Due to the growing expectation of global recession in 2009, oil prices fell sharply towards the end of 2008 to trade at about US\$ 35 a barrel. Although oil prices averaged about US\$ 94 in 2008, Global Investment House (2009) predicts the average oil price will not exceed US\$ 60 in 2009, due to the sharp fall in world oil demand. In 2008, OPEC announced production cuts of 4.2 million barrels per day. Saudi Arabia has already cut production by 5 per cent and is likely to cut further (Khan, 2009). Declining oil prices and the slower-than-expected demand for oil will have a significant impact on economic growth in 2009. Global Finance House argues that lower oil prices coupled with reduced oil production and demand for goods and services will cause a significant loss in the region's export income, trade surplus, current account and fiscal surplus. Thus, capital investments in the GCC countries are likely to be affected and plans for new projects may not materialize, while projects in the

pipeline could also be postponed. It is predicted that if oil prices average US\$ 60 per barrel in 2009, this will lead to a significant reduction in external and fiscal surpluses, and that GCC current account surpluses will fall from 27.6 per cent of GDP in 2008 to 18.1 per cent in 2009. The GCC fiscal surplus as a percentage of GDP would also fall from 29.4 per cent in 2008 to about 10.3 per cent in 2009.

To gauge the likely impact of the fall in oil prices on the GCC economies, Mushtaq Khan (2009) sets out two scenarios for the direction of oil prices in 2009: one scenario assumes an average price of US\$ 75 per barrel, while the other scenario assumes an average price of US\$ 50 per barrel. Khan argues that both scenarios show bleak prospects for the GCC economies in 2009. At US\$ 75 per barrel, United Arab Emirates, Qatar, Kuwait and Saudi Arabia could achieve positive growth and surpluses in their external account and fiscal budget, but at much lower levels than in 2008. In the second scenario at US\$ 50 per barrel, the Saudi economy would shrink and run substantial deficits in its external and fiscal budgets of greater than 20 per cent of GDP. The United Arab Emirates would be able to record positive real growth due to the diversified nature of its economy, but would have a current account deficit of 34 per cent of GDP and a fiscal deficit of 10 per cent. At US\$ 50 per barrel, real growth would remain positive in Qatar where the Government is likely to continue expanding domestic investment. Such an option means that Qatar would run a fiscal deficit of 12 per cent and a significant current account deficit of over 20 per cent of GDP. On the other hand, Kuwait would be less affected among GCC countries. Kuwait would be able to record an external surplus of about 25 per cent of GDP assuming oil prices average US\$ 50 per barrel but the fiscal budget would slip into a deficit of 12 per cent.

**Figure II. OPEC basket price**



Source: The Organization of the Petroleum Exporting Countries, available at: <http://www.opec.org/home/basket.aspx>.

Khan (2009) also estimates the oil price that would balance the current account and the fiscal budget for the GCC countries. The results show that the current account break-even price of oil is about US\$ 70 per barrel in Saudi Arabia, Qatar, United Arab Emirates, and US\$ 20 in the case of Kuwait, as the latter was able to accumulate most of its current account surplus over the period 2001-2008. On the other hand, the fiscal break-even price of oil is US\$ 70 per barrel in Saudi Arabia and United Arab Emirates, and about US\$ 60 in Kuwait and Qatar.

The Institute of International Finance (2008) computes the break-even price of oil per barrel that balances 2009 budgets at US\$ 36 for the United Arab Emirates, US\$ 38 for Qatar, US\$ 48 for Kuwait, US\$ 51 for Saudi Arabia, US\$ 71 for Oman and US\$ 73 for Bahrain.

#### D. REAL ESTATE

Recent buoyant economic growth, largely fueled by soaring oil prices, has provided an impetus for a vibrant real estate sector throughout the GCC countries, as reflected in record levels of construction prices and rents, the increasing contribution of the property sector to economic activity and growing credit allocation to the sector.

However, the recent global credit meltdown has affected the real estate market in most of the GCC countries, and a widespread price correction is currently in progress, notably in Dubai. Furthermore, declining economic conditions and falling oil prices will significantly reduce economic growth in the region and, subsequently, that of the real estate sector.

##### 1. *The real estate sector in GCC countries: facts and figures*

Several factors have driven the recent boom in the real estate sector in the GCC countries:

- High sustained growth rates reflecting the surge in oil price;
- High influx of expatriate population;
- Large public investments in real estate projects aiming at diversifying the economy, notably in Bahrain, Oman and Qatar;
- Recently-enacted laws extending property ownership to foreigners (in Bahrain, Oman and Qatar);<sup>2</sup>
- Attractive financing conditions induced by abundant liquidity and negative real interest rates in a number of countries (IIF, 2008).

These factors have recently driven housing prices to unprecedented heights, as shown in table 1:

TABLE 1. HOUSING PRICES IN THE GCC COUNTRIES, 2007-2008  
(Average 2005 = 100)

Month	Bahrain	Kuwait	Oman	Qatar	United Arab Emirates
October 2007	172	132	336	251	143
March 2008	215	156	381	293	164
June 2008	224	148	438	313	185

Source: The Institute of International Finance (2008).

As shown in the previous table, housing prices have recently grown at double-digit rates, with a growth rate between October 2007 and June 2008 of 30 per cent in Bahrain and Oman, 29.4 per cent in the United Arab Emirates and 24.7 per cent in Qatar, where rents have lately become the single most important component of inflation (GIH, 2009).

<sup>2</sup> In 2003, a royal decree fully endorsed a declaration asserting the right of foreigners to buy certain types of property in certain parts of Bahrain. In 2006, a royal decree extended foreign ownership rights to non-GCC nationals in Oman. In 2004, the Government of Qatar issued a decree that allowed non-Qataris to own properties in specific housing projects (GIH, 2009).

Echoing the recent upbeat sentiment in the real estate sector, the weight of this sector in the GCC economies has become a major contributor to the GDP of the countries concerned, as shown in table 2.

TABLE 2. REAL ESTATE CONTRIBUTION TO GDP, 2005, 2006, 2007\*  
(Percentage)

Country	2005	2006	2007
Bahrain	9.2	9.9	9.8
Kuwait	7	6.3	6.1
Oman	5.4	5.1	5.5
Qatar	9.4	10	10.4
United Arab Emirates	15	15	16

Source: Global Investment House (2009).

Note: \* in nominal terms; except for Bahrain.

The real estate sector is particularly important for the Bahraini economy where it accounted for almost 10 per cent of GDP in 2007, the Qatari economy (10.4 per cent) and the Emirati economy (16 per cent). However, these figures arguably understate the magnitude of the real estate sector in these economies as they do not distinguish between oil GDP and non-oil GDP. For instance, the real estate sector represented 13.4 per cent of Kuwaiti non-oil GDP in 2007. In addition to its weight in the GCC economies, the real estate sector has been growing rapidly: in Qatar, the sector's growth rate was 30.3 per cent in 2007, while the previous year it grew at 41.6 per cent (GIH, 2009).

As noted above, part of the resurgence of the property sector was the abundant liquidity that was made available by banks. Indeed, an important part of the total credit allocated by banks went to the construction and real estate sector. In 2007, about 25 per cent of total credit extended by banks in Kuwait was allocated to the real estate sector, whereas in the United Arab Emirates it represented about 20 per cent of total banking credit. Moreover, the share of the real estate sector in total credit facilities has been growing rapidly in recent years. Between 2003 and 2007, credit facilities available to the real estate sector grew at a constant annual growth rate of almost 80 per cent in Qatar and 15.5 per cent in Oman (GIH, 2009).

## 2. Recent developments in the wake of the crisis

### (a) Falling prices and rents

The credit allocated to the real estate sector in the GCC countries has shrunk due to the worldwide credit crunch. This has led to lower demand and exerted downward pressure on prices in the real estate market. These pressures are likely to be compounded by a widespread economic slowdown that is expected to affect both residential and commercial segments of the property sector, as many firms are beginning to downsize their investments and lay off some of their employees.

Indeed, in many GCC countries property prices have been falling since the last quarter of 2008. The Bahraini real estate index fell between October 2008 and December 2008. In Kuwait, recessionary pressures and the scarcity of financing has resulted in property prices falling between 20 and 40 per cent. The ongoing global economic turmoil has also put a sudden halt to the property boom in Qatar, with land prices dropping by nearly 30 per cent in Doha during November 2008 (GIH, 2009). In addition to plunging prices, housing rents have also begun to drop as a result of the current crisis. In November 2008, rents were reported to have fallen by as much as 20 per cent (GIH, 2009).

The country that witnessed the most severe turmoil in the real estate market is undoubtedly the United Arab Emirates, specifically Dubai. For the first time in years, the United Arab Emirates property market is slowing down as credit has tightened, projects are scaled down and jobs are cut. In October 2008, this was reflected by a decline of the volume of sales by 35.5 per cent on a monthly basis and a decline of the general price index for real estate transactions (by 13.3 per cent), relative to the previous month.

In Dubai, and within the freehold market, the prices of off-plan properties were among the hardest hit. This is partly due to speculators' buying off-plan properties for small down payments and then selling them off at a profit. The prices of these same properties have been falling sharply as the same speculators have been rushing to get out of the market (GIH, 2009).

(b) *Measures recently implemented by Governments*

Monetary authorities in many GCC countries have recently taken measures to ease credit conditions in their markets, helped by the current expansionary stance of United States monetary policy.<sup>3</sup> The Kuwaiti Central Bank cut its benchmark discount rate and pursued active liquidity injection, which has led to declining interbank lending rates since October 2008 (Woertz, 2008). In the same month, the Saudi Arabian Monetary Authority cut its repo rate for the first time since 2007 and reduced reserve requirements (Woertz, 2008). The Government of the United Arab Emirates has been particularly proactive and has introduced a number of policies aimed at regulating and stabilizing the market, and ultimately restoring confidence. Broadly, the measures implemented by the United Arab Emirates fall into two categories: (a) measures aimed at offsetting the liquidity trap; and (b) measures aimed at deleveraging the speculation activity in the real estate market.

The United Arab Emirates Central Bank attempted to alleviate liquidity bottlenecks by providing short-term facilities to banks in October 2008.<sup>4</sup> Moreover, the Government has promised to guarantee bank deposits and protect national banks from credit risks. The Government will also provide funds to the newly established real estate finance company, Emirates Development Bank (EDB). The latter resulted from the merger of Dubai's two largest mortgage providers (Amlak and Tamweel) and two Abu Dhabi-based banks (Real Estate Bank and Emirates Industrial Bank). In a similar effort to ease the liquidity trap, Abu Dhabi launched Abu Dhabi Finance, which has announced that it will offer mortgages with a loan-to-value ratio as high as 85 per cent. Both the Dubai Land Department and the Real Estate Regulatory Agency have introduced measures aimed at stabilizing the market and reducing speculation.

In addition to these measures, a number of Governments in the GCC region have announced initiatives to spend large sums of money on infrastructure developments and real estate projects (IIF, 2008).

### 3. *Prospects: Medium-term outlook*

According to Global Investment House, the expected slowdown in economic growth and capital investments will directly impact real estate sector growth in the GCC region. Nonetheless, with much lower international commodity and material prices – particularly cement and steel – certain countries will continue to offer opportunities. Table 3 summarizes the outlook of the real estate sector in the GCC region.

TABLE 3. MEDIUM-TERM OUTLOOK FOR THE REAL ESTATE MARKET IN THE GCC COUNTRIES\*

Segment	Bahrain	Kuwait	Oman	Qatar	United Arab Emirates	
					Abu Dhabi	Dubai
Residential	↔	↔	↔	↑	↔	↓
Commercial/Retail	-	↓	↔	↔	↑	↓
Commercial/Office	↔	↓	-	↔	↑	↓

Source: Global Investment House (2009).

Note: \* Saudi Arabia is not included as it was relatively unaffected by the crisis and its real estate sector is expected to continue its growth.

<sup>3</sup> With the exception of Kuwait, all GCC countries have pegged their currencies to the United States dollar.

<sup>4</sup> The amount injected was AED 120 billion (GIH, 2009).

Residential prices in Bahrain are expected to stabilize and while the price of premium housing is likely to drop further due to tightening liquidity, prices in the middle-income bracket are expected to stay firm, driven notably by demographic demand. As for commercial and office properties, supply-side shortages will be offset by the decrease in demand, translating into moderate prices.

Expected recessionary pressures coupled with scarce liquidity could cast their shadow over Kuwaiti commercial properties, resulting in an eventual increase in vacancy rates. On the residential front, prices are expected to remain moderate as downward pressures exerted by tight mortgage and financing regulations are offset by upward pressures induced by high population growth.

Flat growth in real estate prices is most likely in Oman due to an anticipated oversupply in the medium term, resulting from a combination of: (a) weakened demand and (b) the completion of many major projects.

In Qatar, residential rates are likely to increase as a two-year rent freeze comes to an end,<sup>5</sup> and the demand for commercial properties should remain stagnant in the medium term due to the current crisis.

In the United Arab Emirates, the property market is expected to experience further corrections in 2009, with significant differences from one Emirate to another. Abu Dhabi should be more resilient to the downturn, while Dubai will witness a severe correction process in both the residential and commercial segments of the property market.

In the midst of weakened demand and dwindling liquidity, it would be highly desirable for GCC countries to implement measures aimed at boosting internal demand. The following measures are recommended:

(a) Government spending, notably on infrastructural projects, would stem the recent slowdown in economic activity. This option is the most desirable as inflation is no longer a principal concern for most GCC Governments;

(b) Monitoring mergers between financial institutions would also be a means to ease current liquidity constraints. The recent mergers which took place in the United Arab Emirates could set a precedent for other GCC countries;

(c) Finally, amending existing real estate sector regulations would be highly advisable. For instance, countries would benefit from introducing measures aimed at minimizing speculation possibilities and favouring a demand-driven property market. Other countries, such as Kuwait, are invited to loosen some tight financing regulations that had negatively impacted the real estate sector well before the current crisis.<sup>6</sup>

#### E. SOVEREIGN WEALTH FUNDS

Even though it is difficult to present a clear definition of an SWF, the one given by the Sovereign Wealth Fund Institute is as telling as it is concise. It states that an SWF is a “state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets”.<sup>7</sup> From a broader perspective, SWFs can be seen as one end of a spectrum of public institutions managing foreign assets held by Governments: at first are foreign reserves managed by central

---

<sup>5</sup> In order to contain soaring rents, the Government imposed a two-year freeze on property rents in 2008 (GIH, 2009).

<sup>6</sup> In 2008, the Kuwaiti authorities issued two laws that affected the real estate market. The objective of these laws was to forbid shareholding companies from dealing in private residences. However, the bans induced by the laws undercut the secondary market for residential lots (GIH, 2009).

<sup>7</sup> More information can be obtained by visiting the Sovereign Wealth Fund Institute’s website at: <http://www.swfinstitute.org/swf.php>.



banks and monetary authorities, where short-term considerations of liquidity and safety are paramount. Further along the spectrum are stabilization funds, designed primarily for medium-term macroeconomic stabilization objectives. SWFs are found at the other end of the spectrum, with longer-term investment objectives and, consequently, a broader array of managed assets (Truman, 2007). One can distinguish between two origins of the funds invested by the SWFs: (a) commodity export revenues and (b) assets transferred from official foreign exchange reserves. Arab SWFs largely fall into the first category, as their funds stem mainly from oil export resources. As savings funds for future generations, they are entrusted with the mission of achieving long-term returns on oil revenues (Behrendt, 2008).

The unfolding crisis has highlighted two major issues regarding these funds. First, given the size of their investments in developed countries, there are concerns that they have experienced substantial losses that could jeopardize their long-term objectives. These concerns are compounded by the relative secrecy surrounding the SWFs' managed portfolios. Second, as a broader consensus is being formed on reshaping international financial market regulation, Arab SWFs will be under increasing pressure from host countries that might brandish some protectionist measures. These issues suggest that there is a good case for enhancing the accountability and transparency of these funds, and for reconsidering some of their investment strategies.

### 1. *Brief review of Arab SWFs*

#### (a) *Role of Arab SWFs*

The global objective of SWFs in Arab countries is to generate long-term resources from export revenues. SWFs in the GCC countries fall into two broad categories: large and well-established SWFs and smaller, more active ones (Setser and Ziemba, 2007). In line with their status as savings funds, large SWFs such as the Abu Dhabi Investment Authority (ADIA) and the Kuwait Investment Authority (KIA) have historically been portfolio investors, with little involvement in management stakes. Smaller funds, such as the Qatar Investment Authority (QIA) and Mubadala in Abu Dhabi, have focused on alternative investments. Mubadala has developed a network of partnerships in sectors such as energy, real estate, infrastructure and services. The Qatar Investment Authority has forged alliances throughout the Arab world, mainly through its Diar Real Estate Investment Company (Behrendt, 2008). The case of the Saudi Arabian Monetary Authority (SAMA) is unique and instructive as the Saudi authorities have decided not to establish a full-fledged SWF. However, as SAMA manages its international holdings and foreign reserve assets, it is considered to be a *de facto* SWF as well as a central bank.

#### (b) *Estimated size of Arab SWFs*

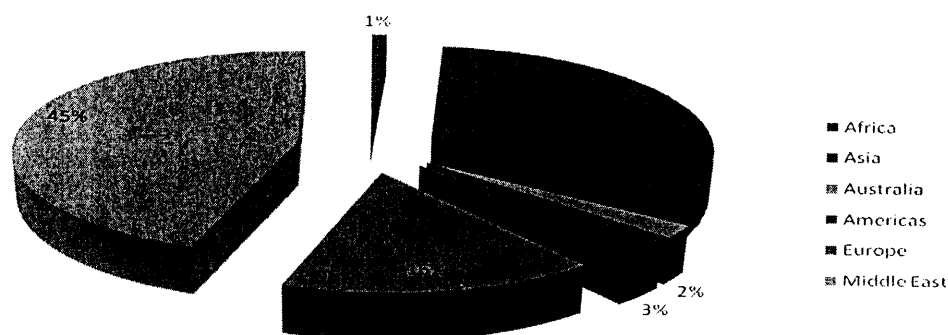
Several factors explain recent efforts to analyse the holdings of Arab SWFs, not the least of which is their impressive size. Indeed, as shown in figure 3, around 45 per cent of total assets managed by SWFs were held by Arab SWFs by the end of 2008.<sup>8</sup>

As shown in table 4, the estimated assets of major Arab SWFs ranged somewhere between US\$ 1.3 trillion and almost US\$ 1.6 trillion at the end of 2007. In addition, many Arab countries are home to some of the world's largest SWFs. ADIA, for example, is considered to be the biggest SWF in the world, with an estimated foreign portfolio ranging somewhere between US\$ 500 billion and US\$ 875 billion (see table 4). The United Arab Emirates is thought to manage funds accounting for almost 25 per cent of assets held by SWFs, while the share of Kuwait and Saudi Arabia is valued at 7 and 11 per cent, respectively (IFSL, 2009).

---

<sup>8</sup> Arab SWFs are located mainly in the GCC countries and in other commodity-exporting countries, such as Algeria and the Libyan Arab Jamahiriya. Given their size, the rest of the analysis focuses on the SWFs of the GCC countries.

**Figure III. Regional market share of sovereign wealth funds at the end of 2008**



Source: International Financial Services, London (2009).

**TABLE 4. ESTIMATED SIZE OF MAJOR ARAB SWFs IN 2007,  
OR THE MOST RECENT YEAR AVAILABLE  
(Billions of United States dollars)**

Country	Fund name	Date of establishment	Estimated size
Algeria	Revenue Regulation Fund (RRF)	2000	47
Kuwait	Kuwait Investment Authority (KIA)	1953	213
Oman	State General Reserve Fund (SGRF)	1980	13
Qatar	Qatar Investment Authority (QIA)	2005	60
Libyan Arab Jamahiriya	Libyan Investment Authority (LIA)	2006	50
Saudi Arabia	Saudi Arabian Monetary Agency (SAMA)	1952	270
United Arab Emirates (Abu Dhabi)	Abu Dhabi Investment Authority (ADIA)	1976	500-875
	International Petroleum Investment Company (IPIC)	1984	12
	Mubadala	2002	10
United Arab Emirates (Dubai)	Dubai International Capital (DIC)	2004	13
	Investment Corporation of Dubai (ICD)	2006	82
	Istithmar	2003	12
Total			1 282-1 657

Source: Truman (2008).

**(c) Portfolio composition of Arab SWFs**

Given the opaqueness surrounding the funds, it is difficult to determine the composition of their portfolios. Nevertheless, some observers have recently proposed estimates that, in the absence of official information, could be enlightening.

Based on available data reported by Euromoney and the Wall Street Journal, as well as information published by the Norwegian Government Pension Fund, Setser and Ziemba (2007) estimated the currency composition and asset allocation of several Arab SWFs. Table 5 summarizes their findings.

As revealed in table 5, the currency composition of the SWFs' portfolios is dominated by the United States dollar, reflecting the surpluses invested in the United States in recent years. Indeed, on average, United States dollar-denominated assets accounted for around 47 per cent of total investments. However, investments in emerging markets, especially in Asia, are steadily increasing and many SWFs have stated plans to further increase their holdings in Asia (Setser and Ziemba, 2007).

SWFs have a high equity allocation, ranging between 25 and 60 per cent. As already pointed out, smaller funds, such as the QIA and Mubadala, hold significant stakes in public companies and large real estate companies.

TABLE 5. ESTIMATED CURRENCY COMPOSITION AND ASSET ALLOCATION OF MAJOR ARAB SWFs, 2007

Fund	Currency composition	Asset allocation
Abu Dhabi (ADIA)	USD (50%); EUR, GBP, JPY (36%); other currencies (14%)	Equity (50-60%); fixed income (20-25%); private equity (5-10%); alternatives (5-10%)
Abu Dhabi (Mubadala)	USD (40%); EUR (50%); other currencies (10%)	Equities (60%); alternatives (20%); bonds (20%)
Dubai (DIC, Istithmar)	USD (35%); EUR, GBP (50%); Asian currencies (15%)	Equities (50%); alternatives (40%); deposits, bonds (10%)
Kuwait (KIA)	USD (40%); EUR, GBP, JPY (40%); other currencies (20%)	Equity (60%); bonds (25%); alternatives (15%)
Qatar (QIA)	USD (40%); EUR (40%); GBP, Asian currencies (20%)	Equities (60%); alternatives (20%); bonds (20%)
Oman (SGRF)	USD (50%); other currencies (50%)	Alternatives (50%); equities (20%); bonds (30%)
Saudi Arabia (SAMA)	USD (75%); other currencies (25%)	Deposits (10%); fixed income (65%); equities (25%)

Source: Setser and Ziemba (2007).

Relying on different counterparty information sources, Sturm *et al* (2008) tracked down recent petrodollar investments and established three main conclusions that corroborate the analysis undertaken by Setser and Ziemba. First, the United States remains the primary destination of funds from the GCC countries. Second, GCC countries have recently diversified their portfolios and have been involved in mergers and acquisitions and initial public offerings, while the importance of international bank deposits has declined. SWFs have enlarged the range of their investments to include private equity, real estate and other high-yield products. Finally, data suggests that there is a growing importance of investments in emerging markets, notably in Asia. This trend is supported by improved fundamentals in emerging economies and flourishing earnings prospects.

## 2. Implications of the crisis for Arab SWFs

### (a) Short-term implications

#### (i) Estimated losses

At the time of writing, it is still too early to accurately assess the losses incurred by SWFs in the financial crisis. Some sources, for example International Financial Services, London, estimate that US\$ 60

billion have been lost in the subprime crisis following investments in American, Swiss and British banks. The importance of the United States as a recipient of Arab SWFs' investments, as well as the predominance of the equity component in their assets, suggests that the exposure of SWFs to the market turmoil must have been significant. However, little has been disclosed regarding Arab SWFs' losses, due to a prevailing culture of opaqueness. Nevertheless, leaked information has highlighted a number of recent risky investments made by some SWFs: KIA invested US\$ 3 billion in Citigroup and US\$ 2 billion in Merrill Lynch at the end of 2007 and early 2008. During the same period, it was reported that ADIA acquired close to a 5 per cent stake in Citigroup (Behrendt, 2008). However, given the large export resources enjoyed in recent years and the diversified portfolios of SWFs, the losses should be manageable.

## (ii) *Reactions*

As an immediate reaction to the crisis, many SWFs started to place more emphasis on injecting liquidity and propping up their local economies. For instance, KIA invested around US\$ 1 billion in the local stock market to stem further declines in the equity market. In the same vein, QIA announced its decision to buy 10-20 per cent shareholdings in local banks to boost their share prices (IIF, 2008). Finally, as suggested by Woertz (2008), SWFs could place some of their funds in local commercial banks to shore up their deposits.

However, and despite the current crisis, it looks highly unlikely that Arab SWFs will retreat massively from the United States market, for at least three reasons: (a) in times of crisis, major markets are perceived as "safe havens"; (b) the depth of the United States market makes it possible for investors to move up the risk curve without having to turn away from the dollar; and (c) since the majority of GCC countries have currencies that are pegged to the United States dollar, a massive sell-off of the United States currency would significantly affect their own currencies<sup>9</sup> (Sturm et al, 2008).

## (b) *Long-term implications*

The growing importance of SWFs as key players in international financial markets reflects two significant distributional changes in international finance: (a) the redistribution of wealth from developed countries to emerging and oil-exporting countries; and (b) the redistribution of wealth from private to public hands (Truman, 2008). These changes have given rise to certain concerns. Some believed there was a risk that could be mismanaged, leading to a destabilization of the financial system, and many questioned the decision-making framework of SWFs and hinted that political considerations might outweigh purely economic reasons. These concerns were behind measures that have recently been implemented in the United States and some countries in the European Union.<sup>10</sup>

In the light of the above mentioned elements, it seems appropriate to ask about the implications of these changes and concerns for Arab SWFs. In this regard, two medium-to-long-term implications can be stressed:

### (i) *The need to enhance the governance standards of SWFs*

As previously presented, Arab SWFs have recently stepped up their efforts to become major purveyors of funds invested in developed countries. These investments take the form of strategies to generate long-term resources for future generations. Consequently, Arab SWFs have a profound stake in open global financial markets. Therefore, it would be wise for the Arab funds to cushion the recent measures taken by some developed countries and heed calls to enhance governance standards. Indeed, Arab SWFs rank poorly in terms of governance, transparency and accountability, as shown in table 6.

<sup>9</sup> With the notable exception of Kuwait, the remaining GCC member countries have pegged their currencies to the US dollar.

<sup>10</sup> The revised United States legislation governing the Committee on Foreign Investment in the United States and similar developments in Germany illustrate the suspicion of developed countries regarding the role of SWFs' investments (Truman, 2007). In addition, the Organisation for Economic Co-operation and Development (OECD) has been mandated to propose measures to be taken by member countries with respect to SWFs. In this respect, a Declaration on Sovereign Wealth Funds was adopted at the OECD Ministerial Council Meeting in June 2008 (Truman, 2008).

TABLE 6. SCOREBOARD OF MAJOR ARAB SOVEREIGN WEALTH FUNDS  
(Percentage of maximum possible points)

Fund	Structure	Governance	Accountability and transparency	Behaviour	Overall
Algeria (RRF)	56	40	11	17	27
Abu Dhabi (ADIA)	25	0	4	8	9
Abu Dhabi (Mubadala)	44	10	7	0	15
Dubai (Istithmar)	38	10	7	0	14
Kuwait (KIA)	75	80	41	0	48
Oman (SGRF)	50	0	18	0	20
Qatar (QIA)	34	0	2	0	9

Source: Truman (2008).

Note: The scoreboard rates funds on their practices and includes 33 elements grouped into four categories: (a) structure; (b) governance; (c) accountability and transparency; and (d) behaviour. The overall score summarizes the four categories. The scores are out of a possible 100 points.

Among Arab funds, only KIA appears to manage a relatively respectable overall score of 48, roughly equal to the average score of non-pension funds on Truman's scoreboard (46). However, it falls short of the overall average score (for both pension and non-pension funds) of 56. Even when benchmarked against developing countries' funds, Arab SWFs compare poorly. For instance, Timor-Leste's Petroleum Fund scored 80, and Azerbaijan's State Oil Fund scored 77 (Truman, 2008).

Not surprisingly, the overall score is highly correlated with the accountability and transparency score, and with the structure score.<sup>11</sup> In fact, in addition to the opaqueness problem mentioned earlier, many have raised some concerns about the structure of some of the Arab SWFs. An example is the case of Dubai International Capital (DIC). DIC is owned by Dubai Holding, which in turn is owned by the ruler of Dubai. This type of ownership structure has raised international concerns about eventual political incentives underlying some of the investments made by such funds (Behrendt, 2008).

All in all, it is in the interest of Arab Governments and their SWFs to implement measures that would enhance the funds' governance standards. On the one hand, embarking on a governance-enhancing programme would permit the Arab funds to ease the fears of some developed countries and to fully participate in shaping the new financial architecture. On the other, such reforms would make it possible to increase the accountability of these funds before their Governments and citizens, which is completely desirable given their role as savings funds.

Recently, Arab Governments started to respond to international calls for a regulatory framework for SWFs' investments. In March 2008, an agreement was reached between the United States and the sovereign wealth fund of Abu Dhabi on: (a) better governance; (b) investments made solely on commercial grounds; and (c) non-discriminatory regulatory measures taken by host countries. Moreover, and recognizing the importance of the matter at hand, ADIA co-chaired the international working group of SWFs, established in April 2008 by the International Monetary Fund.

<sup>11</sup> The correlation coefficients are respectively 0.95 and 0.96.

(ii) *The need for diversifying the investments of sovereign wealth funds*

About 80 per cent of SWFs of oil-exporting countries are invested in overseas assets (IFSL, 2009). As 50 per cent of these investments were made in the United States, oil-exporting countries, along with some Asian countries, are considered to be partially responsible for the increase of consumption and mortgage loans in the United States that subsequently led to the subprime crisis. The crisis should therefore be an opportunity for Arab SWFs to expand their investments in:

- a. The real economy as it would reduce their risk exposure and dilute some of the fears expressed about their investments in developed countries;
- b. Developing regions, notably in Africa, Asia and Latin America, in order to increase South-South investments and cooperation. This could strengthen South-South economic ties and help to shape a unified position vis-à-vis the issues at stake in international finance;
- c. The ESCWA region. Indeed, SWFs can invest in sectors in which many ESCWA member countries have a comparative advantage, such as agriculture, clothing and footwear, textile fibers and chemical products. They can also invest in research and training centres, thus contributing to long-term growth prospects. Increasing regional investments at a time when an economic slowdown is looming in several ESCWA member countries, and when inflationary pressure is no longer a threat, would be most welcome.

All in all, this crisis has a silver lining as it presents an opportunity for Arab SWFs to improve their governance standards and to review the structure and geographical distribution of their investments.

#### F. TRADE

Trade is one of several transmission mechanisms through which the crisis is hitting developed countries and will impact the Arab economies. The severe economic slowdown in developed countries will undoubtedly affect their demand for foreign products, thus reducing mainly energy and commodity prices and negatively affecting exports from developing countries. Indeed, in the updated World Economic Outlook, the International Monetary Fund (IMF) projects a decrease in world trade by just under 3 per cent in 2009.<sup>12</sup> In particular, imports from advanced economies' are expected to fall by 3.1 per cent. In addition, oil prices are forecast to drop by almost 50 per cent in 2009, and non-fuel commodities prices are expected to decline by 29 per cent (IMF, 2009). Moreover, trade finance is starting to dry up as a result of the credit crunch, thus compounding the impact of the decrease in demand for exports from developing countries.

##### 1. *The weight of trade in the Arab economies*

As shown in table 7, Arab countries are highly open: in 2004, the trade openness index of 13 Arab countries averaged around 71.3 per cent.<sup>13</sup> Oil-exporting countries registered the highest indices, reflecting the weight of oil and gas in their exports, as well as the importance of imports in their economies. Among the more diversified economies, high trade openness indices were registered by Jordan (110.9 per cent), Lebanon (54.5 per cent), Morocco (56.2 per cent), the Syrian Arab Republic (51.6 per cent) and Tunisia (77.7 per cent).

In addition, exports accounted for a significant part of the GDP of Arab countries, notably in oil-exporting countries: exports represented 72.1 per cent of total Bahraini exports, 70.6 per cent of total Qatari exports, and 57.7 per cent of Omani exports. Thus, the contraction of world trade will deeply affect Arab countries as they are highly open and because they are to a large extent dependent on exports.

---

<sup>12</sup> Available at: <http://www.imf.org>.

<sup>13</sup> The trade openness index is defined as the ratio of the sum of exports and imports to GDP.

TABLE 7. TRADE OPENNESS OF ARAB COUNTRIES, 2004  
(Percentage)

Country	(Exports/GDP)	(Imports/GDP)	(Trade/GDP)
Algeria	40.6	23.1	63.7
Bahrain	72.1	63.2	135.2
Egypt	10.6	17.9	28.6
Jordan	35.8	75.1	110.9
Kuwait	47.4	22.8	70.3
Lebanon	8.0	46.5	54.5
Morocco	20.1	36.1	56.2
Oman	57.7	35.3	93.0
Qatar	70.6	22.6	93.3
Saudi Arabia	49.9	17.5	67.5
Sudan	16.5	19.6	36.1
Syrian Arab Republic	22.3	29.2	51.6
Tunisia	33.6	44.1	77.7
United Arab Emirates	46.2	40.3	86.6
Yemen	30.8	28.5	59.3

Source: Harb (2007).

## 2. Geographical orientation of Arab world trade

Despite the fact that the Arab world will be affected by the drop in world trade, it should not be severely impacted by the slowdown in the United States economy. Indeed, as shown in table 8, Arab exports to North America accounted for only 10.5 and 14 per cent of total Arab exports in 2005 and 2006, respectively. They represented a meager 2.3 per cent in 2007. Specifically, Arab exports to the United States averaged a mere 7.8 per cent of total Arab exports between 1997 and 2005.<sup>14</sup> However, the United States market is relatively important for a number of countries. In 2004, about 19 per cent of total Egyptian and Saudi exports went to the United States. In the same year, the United States market accounted for 14 and 15.6 per cent of total Algerian and Jordanian exports, respectively.<sup>15</sup> Thus, with the expected recession in the United States holding back demand for foreign products, these countries should be the most affected among the Arab countries.

TABLE 8. GEOGRAPHICAL ORIENTATION OF ARAB EXPORTS, 2005-2007  
(Percentage)

Arab world	2005				2006				2007			
	Asia	European Union*	North America	Others	Asia	European Union*	North America	Others	Asia	European Union*	North America	Others
Oil-exporting countries	54.6	14.3	11	20.1	57.6	17.2	15.6	9.6	71.3	3.9	1.2	23.6
Non-oil exporting countries	29.2	48.6	6.2	16	29.3	45.8	6.2	18.7	26.8	50	3.2	20
Arab countries	51.7	18.2	10.5	19.6	53.4	21.5	14.2	10.9	47.6	28.5	2.3	21.6

Source: Calculation based on the UN-Comtrade database.

Note: \* EU-15.

Oil-exporting countries include: Algeria, Bahrain, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, Sudan and the United Arab Emirates.

Non-oil exporting countries include: Comoros, Egypt, Jordan, Lebanon, Mauritania, Morocco, Syrian Arab Republic, Tunisia and Yemen.

<sup>14</sup> Calculation based on the UN Comtrade database.

<sup>15</sup> Op. cit.

If Arab exports are not to be significantly affected by the drop in demand from the United States, many Arab countries will nevertheless suffer, as European economies are also running out of steam. Indeed, the European market is an important outlet for Arab exporters. As shown in table 8, about 29 per cent of total Arab exports went to EU-15 countries in 2007.

In particular, non-oil exporting countries are highly dependent on the European market.<sup>16</sup> Sluggish economic activity in European countries will therefore have an impact on the exports of these countries and, consequently, affect their growth potential.

The situation of major oil-exporting countries is more subtle, due to the geographical orientation of their exports.<sup>17</sup> On the one hand, their export resources will fall severely as the recession affects the demand for oil of developed countries and negatively impacts oil prices.<sup>18</sup> On the other hand, the more dynamic Asian countries are likely to continue to be an important outlet for exports from the GCC countries. Indeed, even if the current crisis is expected to blunt growth in Asia, many countries in the region are nevertheless expected to continue to register high growth rates.<sup>19</sup> Therefore, their demand for oil and energy is not expected to decrease dramatically, at least not in the short term. This is noteworthy as Asia constitutes the main destination of GCC exports of oil, chemical products and aluminum.<sup>20</sup>

### 3. Composition of Arab world trade

Energy (mainly oil and gas) constitutes the bulk of exports from the Arab world, notably to advanced countries. Between 1997 and 2005, mineral fuels on average accounted for 64 and 81.7 per cent of total Arab exports to the EU-15 countries and the United States, respectively.<sup>21</sup> As shown in table 9, oil prices and production are expected to fall sharply in 2009. Thus, it is expected that the exports from the region will be hit considerably.

TABLE 9. OIL MARKET ESTIMATIONS AND PROJECTIONS, 2008-2009

Expected oil market conditions	2008	2009	Percentage change
OPEC production (million of barrel/day)	37.2	34.9	-6.6
World oil consumption (million of barrel/day)	85.9	85.6	-0.3
Dated Brent price (US dollar/barrel)	97.0	35.0	-63.9
West Texas Intermediate price (US dollar/barrel)	98.5	35.7	-63.7

Source: The Economist Intelligence Unit (2008).

However, the severe contraction of oil prices will have a different impact on Arab economies, depending on their status as oil-exporting or net oil-importing countries.

<sup>16</sup> On average during the period 1997-2005, Tunisian and Moroccan exports to the EU-15 represented 80 and 72.2 per cent of total Tunisian and Moroccan exports, respectively. During the same period, Algerian and Syrian exports to the EU-15 averaged around 60 per cent of their respective total exports. The European market is also important for Egyptian and Lebanese exporters: on average 35 and 18.8 per cent, respectively, of Egyptian and Lebanese exports went to the EU-15. These figures were computed based on the UN-Comtrade database.

<sup>17</sup> Notably the orientation of the exports of GCC member States.

<sup>18</sup> The price of oil fell by more than 70 per cent in the second half of 2008.

<sup>19</sup> In particular, China and India are expected to grow at high rates in 2009.

<sup>20</sup> Asia absorbed the bulk of oil and chemicals exported by the GCC countries: in 2006, 70 per cent of the GCC oil exports went to Asia, as well as 46 per cent of their exports of chemical products. Conversely, only 13 and 10 per cent of oil and petrochemicals exports from the GCC countries went to the United States (Woertz, 2008).

<sup>21</sup> Authors' calculation based on the UN-Comtrade database.



Plunging oil prices will, in fact, exert additional pressure on the resources of major Arab oil-exporting countries. These countries include the GCC member countries, Algeria, the Libyan Arab Jamahiriya and the Sudan. Among these countries, the ones that have been actively pursuing policies aimed at diversifying their economies will be the least affected by the recent oil price collapse.<sup>22</sup>

If the collapse of oil prices will badly hurt major oil-exporting countries, it will significantly reduce the import bill of oil-importing countries. This is likely to lessen, and in some cases offset, the negative impact on their trade balances due to the expected decline in their exports (EIU, 2008). However, the more diversified economies, which are also highly dependent on their main trading partner, the European Union, are expected to experience falling exports. The bulk of these exports is primarily composed of machinery and transport equipment, and manufactured articles.<sup>23</sup> It should be noted that some of the more diversified economies exporting mainly to the European Union will also be affected by the fall in oil prices. This will be the case for Egypt, the Syrian Arab Republic and, to a lesser extent, Tunisia. During the period between 1997 and 2005, mineral fuels on average represented about 39.3, 90.7 and 10.7 per cent of Egyptian, Syrian and Tunisian exports to the EU-15, respectively.

Arab trade with the rest of the world could in the medium term be impacted by the scarcity of trade finance. Particularly, Arab imports could drop substantially if the credit crunch reduces available trade credit. A valuable option for Arab countries would be to prop up and broaden the role of some regional institutions, such as the Arab Trade Financing Programme (ATFP), in order to further facilitate trade credit.

In the medium-to-long term, the crisis has highlighted the urgent need for Arab countries to actively diversify their exports and their trading partners. ESCWA member countries should continue their efforts to diversify their economies away from oil and specialize in niche segments and products with higher added-value. The achievement of such targets goes beyond trade policies and involves a broader range of business and investment-friendly measures.

The crisis has also outlined the risks of an excessive geographic concentration of trade relations, notably with developed countries. ESCWA member countries could reduce such risks by strengthening trade relations with dynamic developing regions, notably with Asian countries. With the current pause in the multilateral trade negotiations, ESCWA member countries could benefit from triggering a series of bilateral/plurilateral trade agreements with these countries.

The economic crisis and its implications on world trade will most likely divert some Arab exports from world markets to regional markets, thus increasing intraregional trade prospects, notably for manufactured products. In order to facilitate the eventual increase in intraregional trade, Arab countries should tackle key issues, which are still hampering the full implementation of the Greater Arab Free Trade Area (GAFTA), including the harmonization of production standards, the facilitation of cross-border transit, the computerization of customs services and the streamlining of inspection/control methods.

Arab countries will also benefit by promoting trade finance for intraregional trade. This could be achieved through regional institutions such as the ATFP, the projected Maghreb Bank for Investment and Foreign Trade and the trade financing operations of the Islamic Development Bank.

---

<sup>22</sup> This would be the case for Bahrain, Oman and the United Arab Emirates, where machinery and transport equipment exports have grown significantly.

<sup>23</sup> During the period 1997-2005 machinery and transport equipment on average accounted for 14.4 and 15.8 per cent of Moroccan and Tunisian exports to the EU-15, respectively. During the same period, manufactured articles and products accounted for 39.3, 45.4, 43.7 and 52.8 per cent of Egyptian, Lebanese, Moroccan and Tunisian exports to the EU-15, respectively. These figures were computed based on the UN-Comtrade database.

## G. FOREIGN DIRECT INVESTMENT

According to UNCTAD, the global economic turmoil has put an end to a four-year growth cycle of international investment flows.<sup>24</sup> As shown in the following table, FDI flows are estimated to have decreased by around 21 per cent in 2008, largely due to the sharp setback registered in the last quarter of 2008.

TABLE 10. FDI INFLOWS, 2007-2008

Region	FDI inflows		
	2007 (Billions of United States dollars)	2008 (Billions of United States dollars)	Growth rate (Percentage)
World	1 833.3	1 449.1	-21
Developed economies	1 247.6	840.1	-32.7
Developing economies	499.7	517.7	3.6
Africa	53	61.9	16.8
Latin America and the Caribbean	126.3	142.3	12.7
Asia and Oceania	320.5	313.5	-2.2
West Asia <sup>b</sup>	71.5	56.3	-21.3
South, East and South-East Asia	247.8	256.1	3.4

Source: UNCTAD (2009).

Note: (a) preliminary estimates; (b) including Arab countries.

Preliminary estimates show that developed countries have been the hardest hit, as FDI flows fell by almost 33 per cent in 2008; however, developing countries experienced an increase in investment flows of nearly 4 per cent in the same year. As the crisis unfolds, UNCTAD projects a further decline in investment flows in developed countries and a slower pace of FDI flows in developing countries in 2009.

The contraction of FDI is due to reduced access to finance and tighter credit conditions, and that lower corporate profits have narrowed the internal and external capacities of firms, notably transnational corporations, to invest overseas. Gloomy prospects and the perception of heightened risk have also narrowed the propensity of firms to invest. The first signs of falling FDI are already apparent as evidence suggests that cross-border mergers and acquisitions declined by 17 per cent in the first ten months of 2008, as compared with the same period during 2007 (UNCTAD, 2009). Furthermore, evidence points to the cancellation or postponement of several projects worldwide, suggesting that greenfield investments are likely to suffer in 2009.

Developed countries could be the hardest hit in terms of market-seeking FDI. Indeed, as the recession casts its shadow over OECD countries, enterprises are likely to start to rein in the launching of new projects aimed at increasing their production. Conversely, developing countries, notably resource-rich countries, are likely to suffer from a decline in terms of resource-seeking investments, notably in the short term.

### 1. Expected impact on FDI inflows in ESCWA member countries

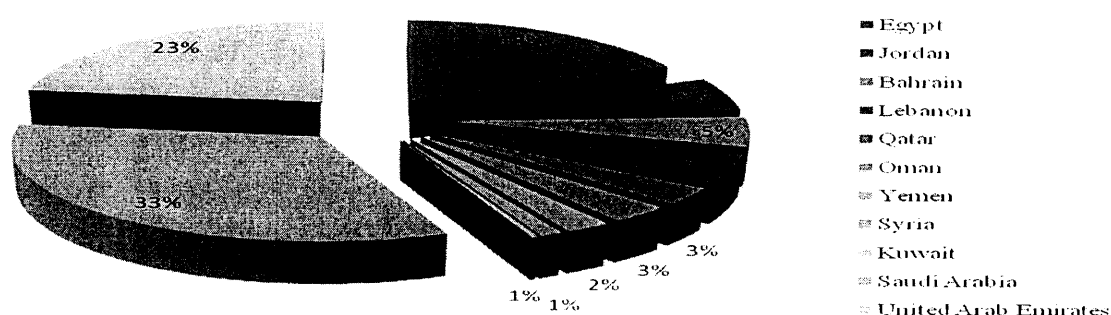
The Arab world has experienced strong and increasing levels of FDI inflows since 2002. Between 2003 and 2006, the share of the Arab world in total FDI flows to developing countries has more than doubled, increasing from 6.2 to 14.6 per cent (ESCWA, 2008). Several regional factors have contributed to this upward trend of incoming flows, including (a) considerable improvements in the business and investment environments; (b) the privatization of many public enterprises; and (c) buoyant economic conditions, underpinned by soaring oil prices, in the GCC countries.

<sup>24</sup> UNCTAD (2009).

However, as shown in table 10, ESCWA member countries are expected to experience a fall of no less than 21 per cent in incoming FDI in 2008. This decrease chiefly reflects the steep decline in resource-oriented FDI, induced by meager export expenses as oil prices declined.

Arguably, the countries that will be the most affected are those which have accounted for the dominant share of FDI inflows to the region. As shown in figure 4, three countries secured the lion's share of incoming investments to the region in 2006, namely Saudi Arabia (33.1 per cent of total FDI), the United Arab Emirates (23.1 per cent) and Egypt (18.1 per cent). According to ESCWA, the United States and Japan captured the largest shares in investments in Saudi Arabia in 2006; the bulk of these FDI inflows were directed towards the oil and gas sector.

**Figure IV. Geographical distribution of FDI in the Arab region, 2006**



Source: ESCWA (2008).

In Saudi Arabia, FDI inflows concerned the establishment of joint ventures between Saudi Aramco and international energy firms. It is likely that such investments will dry up as American and Japanese companies are likely to decrease their investments abroad as a result of the current recession and reduced access to finance. Plummeting oil prices will undoubtedly reduce the profitability of such investments, at least in the short term.

Regarding the United Arab Emirates, four sectors have recently captured the bulk of FDI inflows, namely the oil and gas sector, the financial services sector, the construction sector, and the wholesale and retail trade sector (ESCWA, 2008). The recent turmoil in Dubai's real estate sector is thus expected to sharply reduce investments in both the commercial and residential segments of the sector. However, over the long run investment prospects in the United Arab Emirates should remain quite interesting as the country has a sound infrastructure and one of the most business-friendly environments in the region.

Saudi Arabia and the United Arab Emirates are likely to witness a contraction, mainly in greenfield investments, with postponements of several projects in the oil and gas sector and the construction sector.

In Egypt, in 2006, about 60 per cent of inward investment flows originated from the European Union (33 per cent) and the United States (29 per cent).<sup>25</sup> These investments have gone into the energy and construction sectors, but also into telecommunications and in the banking industry, where large privatizations have recently taken place. Often, such transactions have taken the form of mergers and acquisitions and

<sup>25</sup> ESCWA (2008).

have involved large transnational companies. Arguably, the current crisis hitting the United States and major European economies, as well as the expected decrease in cross-border mergers and acquisitions, will delay some of the projected privatizations.

Smaller ESCWA member countries that have nonetheless been important FDI recipients are also expected to be affected in terms of lesser FDI inflows. Oman is an example of a small resource-endowed country in which recent FDI – partly originating from the United States and the United Kingdom – primarily flowed into the oil and gas sector (ESCWA, 2008). Among the more diversified economies, Lebanon could experience a severe decrease in investment flows as it is largely dependent on a small number of GCC countries that have been affected by the crisis, notably Qatar, Saudi Arabia and the United Arab Emirates.

## 2. Prospects

The unfolding crisis points to a number of medium to long-term policy options that ESCWA member countries could adopt, for example:

- ESCWA member countries need to continue their efforts to enhance good governance, as private investors are highly sensitive to this issue. Many ESCWA member countries have recently carried out legal and regulatory reforms to enhance their attractiveness to foreign investors. However, even if the *de jure* situation in many countries has evolved and a healthier business environment is now in place, the *de facto* reality on the ground still leaves room for improvement. In particular, inconsistent implementation of laws continues to be a powerful deterrent to foreign investment in many ESCWA member countries. Moreover, the latter suffer from cumbersome bureaucratic and institutional frameworks. Such bureaucratic burdens impose high entry costs on newly established firms, particularly small and medium-sized enterprises.<sup>26</sup> Furthermore, these burdens impede commercial transactions and could well deter FDI in export-oriented enterprises. Endeavours should thus target a more transparent and efficient institutional environment. This can be achieved by adopting best practices by streamlining administrative procedures and the computerization of strategic services.
- In order to attract market-seeking FDI, ESCWA member countries need to reinvigorate regional integration. Regional endeavours should aim to expedite the full implementation of GAFTA. In addition, the integration process should be deepened to include service liberalization and investment flows.
- As emerging countries are becoming the main driving force behind FDI flows, ESCWA member countries would benefit from creating and expanding economic partnerships with countries such as Brazil, China, India and the Russian Federation. In addition, these countries also offer a number of interesting investment opportunities for Arab entrepreneurs.
- Now that the possibilities of investing in developed countries are becoming slim, Arab SWFs could redirect some of their investments abroad to promising opportunities in the Arab region. According to UNCTAD, many industries are still characterized by good FDI prospects despite the current crisis.<sup>27</sup> These industries include agro-food businesses, business services, personal services and textiles. Many ESCWA member countries enjoy an effective (or potential) comparative advantage in such sectors and could therefore benefit from incoming intraregional FDI. More precisely, Lebanon, Morocco, the Sudan, the Syrian Arab Republic and Yemen offer potential investment opportunities in terms of intermediate food products and processed seafood.

---

<sup>26</sup> The World Bank's "Ease of Doing Business" index reveals that the Middle East and North Africa (MENA) region is the second most costly region in the world to establish a business.

<sup>27</sup> UNCTAD (2009).

In addition, countries endowed with high-skilled labour could become large recipients of FDI in business services, for example R&D centres and providers of outsourced logistics. Finally, countries enjoying a comparative advantage in textile fibres and clothing, such as Egypt, Jordan, Morocco and Tunisia, could attract FDI in technical textiles. By investing in such sectors, SWFs would be contributing not only to intra-Arab FDI flows, but also to long-term growth prospects in the region.

## H. THE TOURISM SECTOR

Tourism is one of the fastest growing sectors across the world with international arrivals increasing at an average annual rate of 4 per cent during 1995-2007. International tourist arrivals grew by 6.6 per cent in 2007, registering a new record of over 900 million arrivals. According to the United Nations World Tourism Organization (UNWTO), global tourism increased by three per cent in the first half of 2008. However, world tourism fell by one per cent in the second half of 2008 from the same period a year earlier.

UNWTO forecasts for 2009 show that international tourism will stagnate, or even decline slightly, depending on evolving economic conditions. International tourism is expected to grow in the range of -2-to-zero per cent in 2009. In 2007, the Middle East had the best performance among all regions, with a growth rate at 16 per cent and about 48 million tourist arrivals. In the first eight months of 2008, the Middle East continued to grow at 17 per cent. Egypt, Lebanon, Jordan, and Morocco were among the most attractive destinations in 2008.

TABLE 11. INTERNATIONAL TOURISM IN SELECTED ESCWA MEMBER COUNTRIES, 2005-2007

Destination	International tourist arrivals					International tourism receipts		
	Millions			Change (Percentage)		Millions of United States dollars		
	2005	2006	2007	05/06	06/07	2005	2006	2007
Bahrain	3.914	4.519	-	15.5	-	920	1.048	1.105
Egypt	8.244	8.646	10.610	4.9	22.7	6.851	7.591	9.303
Jordan	2.987	3.547	3.431	18.8	-3.3	1.441	2.060	2.312
Lebanon	1.140	1.063	1.017	-6.7	-4.3	5.532	5.015	-
Qatar	913	946	964	3.6	1.9	760	874	-
Saudi Arabia	8.037	8.620	11.531	7.3	33.8	5.418	4.961	5.228
Syrian Arab Republic	3.368	4.422	4.566	31.3	3.3	1.944	2.025	-
United Arab Emirates	7.126	-	-	-	-	3.218	4.972	-
Yemen	336	382	379	13.8	-0.8	181	181	-

Source: United Nations World Tourism Organization, World Tourism Barometer, available at: <http://www.unwto.org/facts/eng/barometer.htm>.

Note: (-) means data is not available.

In Egypt, tourism is the major source of foreign currency. The tourism sector generated about US\$ 10.6 billion in 2008 (Al-Ahram Weekly, 2009). Egypt has already felt the impact of the crisis, with a drop of 10-15 per cent in reservations during Christmas 2008 and a decline of more than 30 per cent in January 2009. Eighty per cent of the tourists visiting Egypt are Europeans; however, their numbers are expected to fall because of the current economic crisis. EFG-Hermes predicts that tourism in Egypt will drop by 18 per cent in 2009, and hotel occupancy will decline from 77 to 58 per cent. In an attempt to boost the tourism sector during the current crisis, the Egyptian Government cut taxes on fees paid by charter flights.

In Jordan, tourism revenues are the second largest source of foreign exchange and the tourism sector is the fastest-growing economic sector, with a compound annual growth rate (CAGR) of 15.4 per cent during the period 2003-2007 (ABC Investments, 2009). ABC Investments estimates that Jordan will benefit from

the recent drop in oil prices as it will reduce hotel costs, but the appreciation of the United States dollar may turn the country into a relatively more expensive destination.

Saudi Arabia was the primary recipient of tourism in 2007, with 11.5 million visitors. With the global Muslim population growing at 2 per cent a year, Global Investment House predicts that the number of visitors to the holy sites in Saudi Arabia will continue to increase over the coming years. It estimates that Saudi Arabia will maintain its plans to develop various tourist sites and make investments of about US\$ 40 billion in order to ensure that the tourism sector continues to grow. The Saudi Arabian Government also expects domestic tourism to expand and generate US\$ 19.5 billion in revenues by 2010.

Tourism, along with the banking sector, continues to form the core of the Lebanese economy. In the first eight months of 2008, the number of tourists increased by 33.6 per cent from the same period in 2007. Global Research (2008) expects the Lebanese tourism sector to grow in 2009 because Lebanon relies mostly on Arab tourist flows. In 2007, tourists from ESCWA member countries made up 39 per cent of total tourism in Lebanon. However, the prospects of the tourism sector in Lebanon in 2009 will mainly depend on the outcome of the parliamentary elections which will take place in June 2009.

Dubai, which has emerged in recent years as one of the most popular tourist destinations in the Arab region, has started to feel the impact of the recent global financial crisis. In the third quarter of 2008, despite a 3 per cent increase in visitors to Dubai, hotel occupancy rates declined from 85 to 73 per cent. Global Investment House expects further drops in occupancy rates due to the global economic slowdown.

The number of tourists visiting Oman increased at a CAGR of 7.1 per cent during 2005-2007 and the average occupancy rate increased from about 60 per cent to 80 per cent during the same period. Global Investment House (2009) forecasts a decline in tourists visiting Oman between 2009 and 2011, since 44 per cent of the tourists are residents of developed countries.

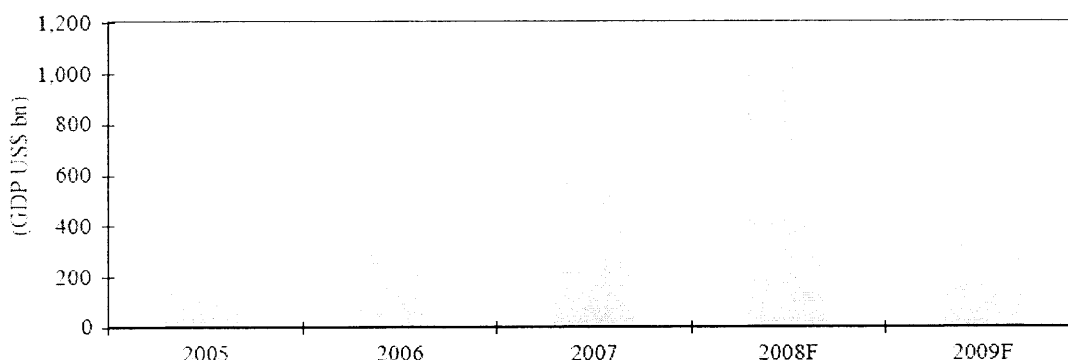
Qatar's tourism sector has picked up in recent years, coinciding with the economic boom, with a predominance of business tourism. The average occupancy rate in Qatar was in the range of 70 to 75 per cent during 2006-2008. Global Investment House expects a contraction in Qatar's tourism revenue in 2009; however, it is expected that tourism inflows will grow once again in 2010.

In general, countries such as Egypt and Oman which rely mainly on tourists from European countries should design and launch campaigns to attract Asian tourists from countries such as China, Malaysia, the Republic of Korea and Singapore, to compensate for the drop in European tourists. Countries such as Lebanon, the Syrian Arab Republic and Jordan, need to coordinate their tourism policies and introduce package tours to allow tourists to visit more than one country in the region. Furthermore, Governments should adopt immediate measures to avoid unreasonable charges and taxes on the tourism sector.

### III. OUTLOOK FOR ESCWA MEMBER COUNTRIES IN 2009

The 2009 economic outlook for GCC countries is challenging, even if these economies are underpinned by solid economic fundamentals and strengthened financial buffers. Many GCC countries have had to revise their GDP forecasts and cut back on infrastructure investments. According to the IIF (2008b), the real GDP growth rate is expected to decline in the GCC countries to 3.6 per cent in 2009 from 5.7 per cent in 2008, mainly due to the sharp drop in oil prices, reduced oil production and tight credit conditions. In 2009, growth in the GCC countries will be driven by private construction, retail trade, fiscal stimulus and transportation (IIF, 2008a). Global Investment House forecasts (2009) show that GCC countries will achieve lower growth in 2009 at about 2.4 per cent, down from 5.2 per cent in 2008. The combined size of the GCC economies is likely to fall from US\$ 1.04 trillion in 2008 to about US\$ 923.6 billion in 2009, leading to an expected contraction of nominal GDP by about 11.1 per cent in 2009.

**Figure V. Nominal GDP of GCC countries**

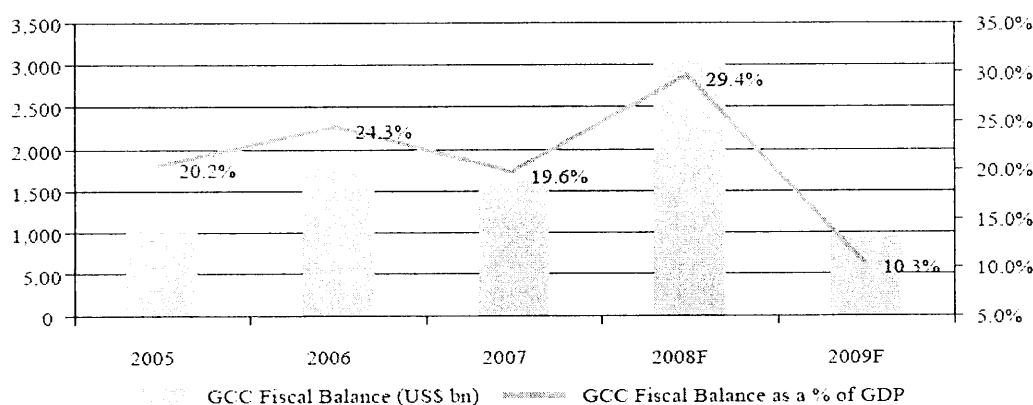


Source: Global Research

The Saudi economy will be the most affected in real terms in 2009 among the GCC economies. The Saudi economy is likely to contract by about 12.2 per cent in nominal terms and to experience real growth of 1.4 per cent in 2009. This will be the lowest growth rate for Saudi Arabia in many years. The United Arab Emirates real growth rate in 2008 is likely to stand at 5.5 per cent and will decline to 2 per cent in 2009. Furthermore, the real GDP growth of Kuwait, Oman and Bahrain is likely to reach 5, 6.4 and 6 per cent in 2008 respectively, while in 2009 the real growth of these countries is expected to decline to 2.5, 3.5 and 3, respectively (Global Investment House, 2009).

Among the GCC countries, Qatar is likely to remain insulated despite the slowdown in real growth rates from 10.4 per cent in 2008 to 9.4 per cent in 2009, as the country mainly depends on gas revenues.

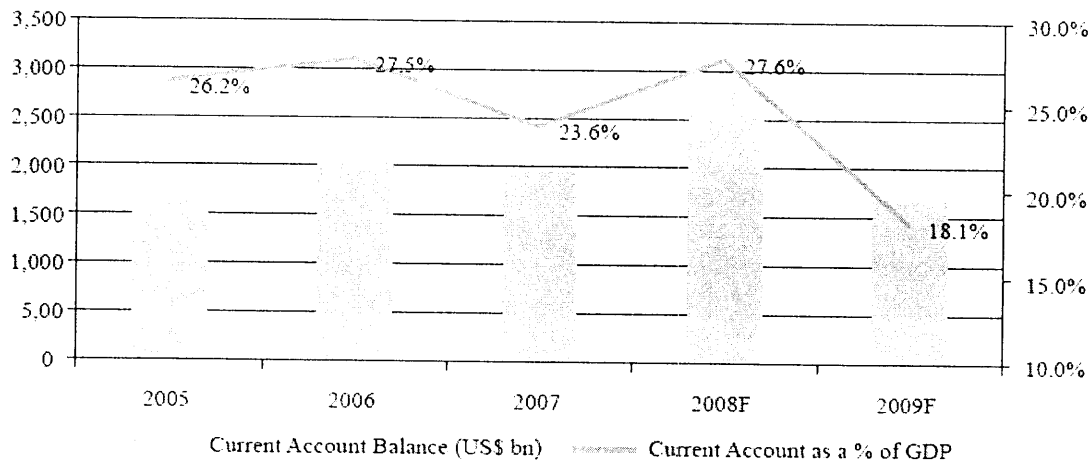
**Figure VI. Fiscal surplus of GCC countries as a percentage of GDP**



Source: Global Research

Global Finance House (2009) estimates that the combined fiscal surplus of the GCC countries reached US\$ 305 billion, or 29.4 per cent, in 2008, the highest ever fiscal surplus. However, in 2009 and due to the drop in oil prices, the revenue of GCC Governments is likely to experience a sharp decline while Government expenditure should remain expansionary to stimulate the aggregate demand for goods and services, and thus compensate for the drop in private consumption. The fiscal balance in GCC countries will therefore decline and reach 10.3 per cent of GDP in 2009. IIF has lower forecasts for the GCC fiscal balance in 2009. It expects the fiscal surplus to decline from 22 per cent of GDP in 2008 to 5 per cent in 2009.

**Figure VII. Current account balance of GCC countries as a percentage of GDP**



Source: Global Research

Global Finance House (2009) also forecasts that the sharp drop in oil prices will have a strong impact on the balance of payments in GCC countries in 2009. The current account surplus as a percentage of GDP is expected to decline from 27.6 per cent in 2008 to reach 18.1 per cent in 2009, assuming an average oil price of US\$ 60 per barrel in 2009. If oil prices go below US\$ 60 a barrel, it will adversely affect the trade balance of the region. On the other hand, IIF (2008b) reports that the external surplus of the GCC countries will fall to US\$ 48 billion in 2009 from US\$ 321 billion in 2008, which means that the current account balance as a percentage of GDP will fall to 4.6 per cent in 2009 from 29.3 per cent in 2008.

In the Gulf region, IIF (2008b) forecasts a decline in the average inflation rate from a peak of 12 per cent in 2008 to 7.6 per cent in 2009, due to a slowdown in credit growth, a strengthened dollar and a decline in commodity prices.

The GCC countries have an opportunity to play a stabilizing role with regard to the global economy. However, despite the fact that oil export receipts are projected to decline by 50 per cent in GCC countries for 2009, policymakers should continue investment spending and maintain their investment plans, using part of the foreign reserves they have accumulated over the last seven years. By continuing to spend, GCC countries will contribute substantially to supporting global demand and therefore act as a stabilizing force during the global slowdown. If GCC countries decide to cut their spending, their economic growth will become even weaker and the global economic crisis is likely to last longer.

We urge GCC policymakers to use part of the wealth stored in regional SWFs, even though the global recession offers attractive asset prices in developed countries. Such investments will help SWFs to reduce their risk exposure and assist other ESCWA member countries to boost domestic demand and therefore enhance economic growth.



IIF (2008b) argues that the foreign assets of GCC countries provide an alternative source and could mitigate the effect of a sharp decline in oil revenues where almost half of the non-oil revenues in these countries are in the form of investment income and profit transfers from oil and gas public entities. However, there is a great deal of uncertainty about investment income for 2008 since a significant amount of foreign assets are in the form of global stocks.

According to the IMF, the short-term economic growth outlook for the Syrian Arab Republic is expected to be affected somewhat by the adverse global and regional developments currently underway. The Syrian Arab Republic is likely to be affected by a regional slowdown resulting from global financial transactions with other countries in the region, notably the GCC countries. The decline in oil output is likely to continue and will have a negative impact on Government revenues. On the other hand, inflation accelerated in 2008, driven mostly by higher food and fuel prices. However, it started to decelerate in the last quarter of 2008 due to the fall in international food prices, and the inflation rate is expected to be about 15 per cent in 2008. The medium-term outlook for the Syrian Arab Republic is expected to improve as the global and regional slowdown comes to an end and the world economy begins to recover.

With respect to the Egyptian economy, the IMF (2008) considers that the recent drop in inflation is likely to continue, with inflation in the range of 12-14 per cent by mid-2009, and to fall further to 8-10 per cent by the middle of 2010. The balance of payments has weakened and will remain vulnerable until the global economy improves. Moreover, there is the risk of further capital outflows in the short term in the light of ongoing turbulence in the global financial markets. Real GDP growth is likely to take output below its potential, which would leave some scope for a modest policy stimulus to assist the economy in 2009. The Egyptian Government expects real growth to fall to 4-4.5 per cent in 2009, as compared with 6.5 per cent in 2008. The EIU (2008) forecasts that Egypt's GDP growth will average 5.1 per cent in 2008-09 and will deteriorate to 4.9 per cent in 2009-10. It also expects the trade deficit to narrow in 2009-10 compared with 2008, due to the decrease in prices of imported goods. Thus, the current account surplus is expected to increase over the next two years. EFG-Hermes expects real GDP growth to be 3.3 and 1.4 per cent in 2008-09 and 2009-10, respectively.

In Egypt, the Government should continue to press ahead with its programme of economic reform aimed at creating new job opportunities and improving standards of living. Although the fiscal deficit will widen, the Egyptian Government should swiftly implement its fiscal stimulus package of spending LE 30 billion to support industries, exports, tourism and retail business, all of which are feeling the effects of the global financial crisis. The Government also intends to direct a great part of the fiscal package towards the acceleration of existing infrastructure plans in order to boost domestic demand and increase potential output.

The IMF (2008) argues that monetary stimulus may entail risk for Egypt. A cut in interest rates could lead to pressures on central bank reserves and the exchange rate. With the initial impact of interest rate cuts much more likely to be on the exchange rate rather than on the demand for credit, there would appear to be room to keep policy rates unchanged until there are clear signs that pressure on the balance of payments has stabilized.

The impact of the global financial crisis on Lebanon has so far been muted. After the Lehman Brothers failure, deposit inflows to Lebanon ceased for a short while, but have resumed at a rapid pace since then. However, the global economic downturn, especially in the GCC countries, is likely to affect the Lebanese economy. Tighter global credit and a pronounced global recession are likely to affect remittances, tourism, foreign direct and portfolio investments, and deposit inflows. As a result, economic growth is likely to decline to 3-4 per cent in 2009, from more than 8 per cent in 2008. Due to the sharp decline in oil prices, the Lebanese external current account balance is likely to improve, but capital inflows may weaken. As a result, commercial bank deposit growth may slow somewhat following the strong increase in 2008. Inflation has come down quickly from last year's food-and-fuel-price-induced spike and will likely remain subdued in the period ahead (IMF, 2009).

Prudent fiscal and monetary policies are recommended in the case of Lebanon, taking into account the three key risks the Lebanese economy is faced with (IMF, 2009). First, the global recession and slowdown in the GCC region will likely affect capital inflows and economic activity in Lebanon. While a soft landing remains the most likely outcome, there is significant downside risk. Secondly, Government financing may be more difficult than anticipated. Slower deposit inflows could complicate Government financing and require the preparation of contingency plans. Thirdly, Lebanon remains exposed to political and security shocks that could adversely affect economic and financial conditions.

Given the different risks confronting the Lebanese economy, there is not much room to lower domestic interest rates in the short term, as interest rates are essential to maintain strong deposit inflows, even during the international financial crisis. Interest rates should be gradually reduced only when deposit growth can hold up at comfortable rates.

In the medium term, the Lebanese Government should continue its programme of structural reforms in order to strengthen infrastructure and boost productivity in sectors where the Lebanese economy has comparative advantages, such as tourism and financial services. The Lebanese Government has formulated a plan to mitigate the impact of the financial crisis. The plan includes an acceleration and reprioritization of infrastructure spending within existing expenditure ceilings by the Council for Development and Reconstruction, an expansion of interest subsidies for Lebanese lira-denominated bank lending to the corporate sector, measures to improve the business climate, and incentive programmes to support job creation.

In all ESCWA member countries, well-targeted social policies are needed to shield the impact of the expected economic slowdown on the most vulnerable groups in society. Continued donor support is also an essential ingredient in any successful policy strategy. Saudi Arabia has announced plans to protect vulnerable groups by extending concessional loans to low-income citizens.

#### IV. POLICY RECOMMENDATIONS

ESCWA member countries need to take appropriate measures to mitigate the impact of the financial crisis on their economies. Recommended policy options include the need to:

1. Continue to apply expansionary fiscal policies to boost domestic demand, notably in infrastructural projects, in order to halt the recent slowdown and increase the level of economic activity.
2. Inject liquidity into the banking sector through rescue packages, thus restoring confidence in the banking and financial sector. Monitor mergers between financial institutions and ease Government regulations to encourage the private sector to take an active role during the crisis.
3. Formulate and implement more vigilant regulatory measures to be adopted by the banking sector in the long term.
4. Develop initiatives to ease problems and minimize speculative activities in the real estate sector, which in some countries represents an important source of economic growth.
5. Enhance the governance standards of SWFs, in particular those related to transparency and accountability.
6. Diversify the sectoral and geographical distribution of investments by SWFs by investing more in the real economy and targeting developing regions, notably in Africa, Asia and Latin America, as an opportunity to increase South-South ties.
7. Promote financial integration. ESCWA member countries with major financial surpluses may consider providing loans to other ESCWA member countries, in order to help them overcome the repercussions of the financial crisis and the expected fall in external inflows, including ODA, remittances and FDI. Such loans can be provided either on a bilateral basis, or through regional development funds and banks.
8. Increase intraregional investments. Promote investments in sectors in which many ESCWA member countries have a comparative advantage, such as agriculture, clothing and footwear, textile fibres, chemical products, and services such as tourism and research and training centres. The latter would contribute to long-term growth prospects.
9. Ensure the full implementation of GAFTA, in particular by harmonizing production standards, facilitating cross-border transit, computerizing customs services and streamlining inspection/control methods. Implementation should also include service liberalization and investment flows. Enhance the role of some regional institutions, such as the Arab Trade Financing Programme, in order to further facilitate trade credit.
10. Devote greater effort to diversifying Arab exports away from oil, specialize in products with higher added-value and diversify trading partners.
11. Continue efforts to improve the “doing business” environment, in particular by enhancing good governance and combating inconsistency in the implementation of laws.
12. Promote South-South cooperation by, among other things, increasing investment in and trade within other developing countries.

## REFERENCES

- ABC Investments. 2009. *Tourism Sector Report*. January. Amman: Jordan.
- Arab Monetary Fund. 2009. *First Quarterly AMDB Bulletin*. Abu Dhabi: United Arab Emirates.
- Behrendt, Sven. 2008. *When Money Talks: Arab Sovereign Wealth Funds in the Global Public Policy Disclosure*. Carnegie Papers no. 12, Carnegie Endowment for International Peace.
- Economic and Social Commission for Western Asia. 2008. *Foreign Direct Investment Report*. ESCWA: Beirut.
- Economist Intelligence Unit (EIU). 2008. *Country Report Egypt*. December. London: United Kingdom.
- \_\_\_\_\_. 2008. *Middle East and North Africa Regional Overview*. London: United Kingdom.
- Global Finance House. 2009. *GCC Real Estate Sector – Changing Time!* Kuwait.
- Global Research. 2008. *Lebanon Economic & Strategic Outlook: Climbing up the Cedar*. November 2008.
- Harb, G. 2007. *Arab Economic Integration: Appraisal and Prospects*. PhD thesis (unpublished), Institut d'Etudes Politiques de Paris. Paris: France.
- International Institute of Finance. 2008a. *Regional Report: Gulf Cooperation Council Countries*. 6 November.
- \_\_\_\_\_. 2008b. *Update: Gulf Cooperation Council Countries*. 4 December.
- The International Financial Services London (IFSL). 2009. *Sovereign Wealth Funds 2009*. IFSL research.
- International Monetary Fund. 2008. Arab Republic of Egypt—2008 Article IV Consultation. Preliminary Conclusions of the IMF Mission, 6 November 2008.
- \_\_\_\_\_. 2009a. Lebanon—2009 Article IV Consultation Mission, Concluding Statement. 5 March 2009.
- \_\_\_\_\_. 2009b. *World Economic Outlook* (update).
- Khan, M. 2008. *Managing Domestic and Global Expectations: The Policy Challenges Facing the GCC*. Citi Global Markets Ltd.
- Sester, B. and Ziemba, R. 2007. *Understanding the New Financial Superpower: The Management of GCC Official Foreign Reserves*. Roubini Global Economic Service, RGE Monitor.
- Sturm, M., Strasky J., Adolf P. and Peschel, D. 2008. *The Gulf Cooperation Council Countries: Economic Structures, Recent Developments and Role in the Global Economy*. European Central Bank, Occasional Paper Series No. 92.
- Truman, E. 2007. *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability*. Peterson Institute for International Economics, Policy Brief 07-6.
- \_\_\_\_\_. 2008. *Sovereign Wealth Funds: New Challenges from a Changing Landscape*. Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Services Committee, United States House of Representatives.

- United Nations Conference for Trade and Development. 2009. *Assessing the Impact of the Current Financial and Economic Crisis on Global FDI flows*. UNCTAD: Geneva.
- Woertz, E. 2008. *Impact of the US Financial Crisis on GCC Countries*. GRC report, the Gulf Research Centre.
- World Bank. 2009. *Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis*. Background paper for the G20 Finance Ministers and Central Bank Governors Meeting, Horsham, United Kingdom, 13-14 March 2009.
- World Tourism Organization. *World Tourism Barometer*. Several issues available at: <http://www.unwto.org/facts/eng/barometer.htm>.