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The Arab world amidst the global financial crisis of 2008–2009

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Abstract
When the problems in the United States housing sector mushroomed into a global financial crisis by September 2008, it was assumed that Arab countries would remain immune: the oil-rich Gulf Cooperation Council (GCC) countries because of their massive financial reserves, and the resource-poor countries because of their limited linkages to the global economic system – in particular, the global financial markets. However, this assumption has proven to be false. The US subprime mortgage collapse not only pushed the advanced economies into recession, but also it shattered global economic confidence, resulting in a massive financial contagion around the world. What explains the Arab World's vulnerability to the crisis? How has the crisis impacted both the resource rich and the resource poor? How have Arab countries responded to the crisis, and what must they do to insulate their economies better from the vagaries of global financial markets? This paper addresses these questions.

Keywords
Arab World, financial crisis, Gulf Cooperation Council (GCC), sovereign wealth funds, the United Arab Emirates (UAE)

When the subprime-induced financial crisis broke out in the United States (the country with the world's most sophisticated financial system) in mid-2007, it was widely believed that the economic fallout would be mainly limited to the United States and that American authorities would eventually contain the crisis. After all, the US economic slowdown was related to factors specific to the US economy, especially problems associated with expansionary monetary policy that had kept US interest rates low for some years and led to a real estate (property) bubble, rather than to more systemic factors such as an oil shock or adverse trade relations (Cohan 2008, Schwartz 2009, Taylor 2009). Even as some analysts predicted a contagion spreading to other economies and regions, there was broad consensus that the Arab World – an economically diverse region that includes both the oil-rich economies in the Gulf and the resource-poor (in relation to the population), such as Egypt, Morocco, Syria and Yemen – would either escape or successfully weather the worst of the crisis. 1

The reasons for the Arab countries' supposed immunity to the crisis varied. The prosperous oil-rich Gulf Cooperation Council (GCC) states who together control 45% of the world's oil reserves and 18% of the natural gas reserves and are awash with cash from skyrocketing oil prices invested in their well-endowed 'sovereign wealth funds' (SWFs) seemed well-sheltered, if not invulnerable, to

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the fast-spreading subprime-induced crisis. 2 In fact, SWFs such as the Kuwait Investment Authority (KIA) and the Qatar Investment Authority (QIA) were widely believed to have the capacity continually to boost liquidity and confidence in both the domestic and the regional economy. 3 Indeed, the GCC countries were seen as possible shock absorbers and 'stabilizers' – their exceptionally strong economic positions serving as both a potential cushion against the global downturn and the engine pulling cash-starved economies from recession by providing the desperately needed liquidity and supporting global demand. On the other hand, for hydrocarbon-poor countries, their economic backwardness and relative isolation from the global financial and capital markets (minus the oil industry, the Arab World accounts for only 2.5% of world economic growth) was seen as their saving grace – a shield against the vagaries of global financial turmoil. However, as shown in Table 1, both these predictions have proven to be false. Real gross domestic product (GDP) growth has declined across the region.

Table 1. Real gross domestic products (%) of selected Middle Eastern economies (2010 estimate).

	2007	2008	2009	2010 (estimate)
Middle East	*6.3*	*5.9*	*2.5*	*3.5*
Oil exporters[a]	*6.2*	*5.6*	*2.2*	*3.7*
Iran	7.8	4.5	3.2	3.0
Saudi Arabia	3.5	4.6	−0.9	2.9
United Arab Emirates (UAE)	6.3	7.4	−0.6	1.6
Kuwait	2.5	6.3	−1.1	2.4
Mashreq	*6.7*	*6.9*	*3.4*	*3.1*
Egypt	7.1	7.2	3.6	3.0
Syria	4.2	5.2	3.0	2.8
Jordan	6.6	6.0	3.0	4.0
Lebanon	7.5	8.5	3.0	4.0

Note: [a]Includes Bahrain, Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, the UAE, and Yemen.
Source: International Monetary Fund (IMF) (2009g), p. 92.

The current crisis has unambiguously and painfully underscored that in today's globalized and interconnected world no nation is an island. The ferocious contagion or the 'exogenous shocks' from the advanced economies has put the world economy in its most serious crisis since the 1930s (Krugman 2009, Posner 2009). In the Arab countries, after an initial period of calm and seeming resilience, the economic turbulence reached both the oil-rich and oil-poor economies – albeit the forces behind the contagion and the impact have been varied and uneven across the region. Despite the adoption of highly expansionary policies (with the central banks in the region providing stimulus packages and liquidity, besides lowering reserve requirements and interest rates) in Egypt, Jordan, Kuwait, Saudi Arabia, the UAE and other Arab countries to mitigate the adverse economic shocks, the region, nevertheless, saw economic growth contract from 6% in 2008 to 2.5% in 2009. In fact, the slowdown is broadly similar in oil-producing and non-oil-producing countries – albeit their socio-economic impact is varied.

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For example, in the ever-resilient Kuwait, in keeping with global trends, the country's stock exchange index fell by 50% in October 2008. However, news that a Kuwaiti bank had suffered significant losses in late 2008 from trading in currency derivatives further spooked the markets and saw the third largest bank lose US$1.4 billion – forcing the authorities to guarantee customer deposits at local banks. In December 2008, Kuwait's largest investment company defaulted on most of its US$3 billion debt obligations and has been forced to negotiate a debt restructuring. However, the impact on the real economy has been modest as Kuwait (like other oil-rich countries) has a comfortable financial cushion to mitigate the impact. On the other hand, the impact on resource-poor countries has been more severe. Since the GCC is a key source of investment financing (through foreign direct investment [FDI] and other flows) as well as remittances for these economies, the abrupt decline in income and investment flows has contributed to the overall decline in growth. No doubt, it has made the lives of about 23% of the 300 million people in the Middle East and North Africa who draw subsistence on less than US$2 a day much more difficult (The World Bank 2008).

What explains why the current crisis which originated in the US market for subprime mortgages has spread so quickly and virulently to other credit markets and economies with limited or no exposure to these toxic assets? What are the 'transmission channels' or how specifically has the crisis spread to the Arab countries? How have the Arab countries been impacted by the crisis and what are the short- and potential long-term economic implications? How have governments and regional bodies responded to the challenges posed by the unprecedented crisis in their midst? How can the Arab countries, especially the poorest, better insulate their economies from the vagaries of the global financial markets? This paper addresses these issues with reference to selected Arab countries: Egypt, Yemen and the UAE. 4

Broad transmission channels

The adage that in this era of globalization no country is an island is apt. The volume of international capital flows has surged from just under US$2 trillion in 2000 to US$6.4 trillion in 2006. These funds now cross national borders, often at will, despite attempts by governments to control and regulate their movement. Deep financial integration also means more rapid and powerful spillover across economies through both traditional trade and more new types of financial channels. 5 As Table 2 shows, Arab countries are quite open in terms of trade – the trade openness index of thirteen Arab countries averaged around 71.3%. Of course, oil-exporting countries register the highest indices reflecting the weight of oil and gas in their exports, as well as the importance of imports in their economies. 6 Although spillovers through the trade channel remains a central transmission mechanism (even though global trade patterns have become more diversified), financial spillovers have become more pronounced as the rising correlation of global equity prices and the potential for

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sudden capital flow reversals mean that shocks at the core can be transmitted rapidly throughout the entire global financial system (Allen and Douglas 2009).

Table 2. Trade openness of Arab Countries in 2004 (%).

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
Syria	22.3	29.2	51.6
Tunisia	33.6	44.1	77.7
United Arab Emirates (UAE)	46.2	40.3	86.6
Yemen	30.8	28.5	59.3

Note: GDP, gross domestic product.
Source: Economic and Social Commission for Western Asia (ESCWA) (2009, p. 16).

Significant withdrawals from emerging economies, including the GCC equity and debt funds, confirm that investors in the advanced economies began to retract from emerging economies around October 2008. Leading the charge were cash-strapped US financial institutions that began en-mass to 'deleverage' or sell their assets to raise cash to strengthen their balance sheets back home. In turn, this led to sharp drops in stock prices around the world (in the GCC this was most evident in a widening of sovereign risk spreads and a sharp downturn in stock markets – especially for real estate companies), the relative increases in the value of the US dollar against all currencies, a reversal in capital flows, a shortage of liquid foreign reserves, and tighter restrictions on credit availability. In the GCC this was made worse by expectations of an appreciation of the dirham vis-à-vis the dollar. Further, as investors began to flee global markets for the safe haven of US Treasuries (not only because of risk aversion, but also due their need to sell assets to raise cash to cover debts), stock markets around the world plunged and many currencies depreciated – some overnight.

Exacerbating the problem was the proliferation of new hybrid products such as derivatives, sovereign credit default swaps, collateralized debt obligations and new forms of mortgage-backed securities. Coupled with creative accounting practices that often overlooked risk and prudent corporate governance it has meant that economies that earlier had been relatively sheltered could be suddenly hit – especially if there were concerns regarding equity and currency mismatches. This partly explains the rapidity by which equity and bond prices plummeted, sovereign and corporate

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spreads increased, and inter-bank spreads rose. Beyond these conduits, global shifts in market sentiment or 'risk aversion' which often manifest themselves through low public confidence and herd behaviour in markets have been particularly pronounced in this crisis. The sharp deterioration in household wealth in the advanced economies and concern about the overall soundness of the US economy and the exposure of hitherto unknown domestic structural vulnerabilities have resulted in a heightened sense of vulnerability and a rise in risk aversion. This has only led to further reduction in household consumption and precautionary saving.

Specific transmission channels: the cases of Egypt and Yemen

Between 2007 and mid-2008, the Egyptian economy had been growing at an unprecedented rate of about 7%. The unemployment rate was down from 11% to 8%, and the seemingly entrenched poverty levels were finally on the decline. The country's financial sector, especially banks and investment companies, were not large holders of subprime mortgage-backed securities – the so-called 'toxic assets' – and banking sector reforms, especially in the area of bank supervision and consolidation of non-performing loans (NPLs), had made the banking sector more resilient. Just as important, Egypt's net international reserves stood at a robust US$35 billion in October 2008 (International Monetary Fund (IMF) 2009a). Yet, these robust fundamentals have hardly made the Egyptian economy immune to the contagion emanating from the advanced economies. In large part this is because the resource poor or the non-oil exporting Arab countries such as Egypt already facing significant economic pressures and heavily depended on external assistance (in the form of aid, FDI, and through worker remittances) were from the outset extremely susceptible to exogenous economic shocks. In fact, countries such as Egypt and Yemen, but also Morocco, Tunisia, Jordan and Lebanon, depend much on exports, tourism, remittance receipts from workers abroad (largely from Europe and the GCC countries), and more recently through FDI flows. In most of these countries the revenue generated accounts for a substantial proportion of their GDP. A decline of these revenues both in absolute terms and as a share of GDP has had negative consequences for growth and development.

The Egyptian economy has been impacted via a number of broad transmission channels discussed above such as global deleveraging and a drop in export revenues, as well as country-specific ones such as contraction in the tourism industry and sharp reductions in Suez Canal tolls and remittances from expatriate workers. The sharp decline in export volumes to the Euro Area, East Asia and the United States has hit Egypt hard. Similarly, tourism, which is the country's major foreign exchange earner (bringing in some US$11 billion dollars in 2007), and contributing 8.5% of Egypt's GDP, has experienced a significant decline since mid-2008. According to the Egyptian Ministry of Economic Development, 'each tourist dollar spent ultimately generates US$4 or US$5 in income' – showing a strong correlation between incomes and tourism (Mohieldin 2008). Similarly, in the fiscal year 2007–

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2008 (end of June 2008), remittances from Egyptian expatriate workers (the vast majority work in the oil-rich Gulf countries) sent about US$8.56 billion to the home country. 7 However, the economic crisis has forced a major retrenchment with massive layoffs of emigrant workers. In fact, thousands of workers from Egypt, Yemen, and the West Bank and Gaza Strip (among other countries) have already returned 'home' from the Gulf – adding to the ranks of the unemployed. Exacerbating Egypt's woes has been the loss of revenue from the Suez Canal. Despite concerns about pirates off the Somali coast, the waterway earned a record US$5.2 billion in 2007. However, the shrinkage in global trade and the resultant drop in the numbers of ships using the canal have led to a sharp drop in toll revenue – which stood at US$301.8 million in February 2009 – a 25% decline compared with the US$408 million in January 2008. Moreover, plunging exports of manufactured goods to the United States and the European Union, and food exports to the European Union and the Arab World have exacerbated the problem of falling revenues and growing unemployment. Overall, the country's real GDP growth fell by 2 percentage points in 2008/2009 and the International Monetary Fund (IMF) projects a further decline to about 4.5–5.0% in 2009–2010 (IMF 2009a). In mid-2008, Egypt experienced an abrupt reversal of portfolio flows as foreign investors pulled out of the equity and government bond markets. The central bank responded by running down its foreign currency deposits with commercial banks. The sharp decline in external liquidity has raised the cost of debt servicing and put pressure on the current account balance (IMF 2009c).

Countries lacking in oil wealth now face weaker prospects for exports, FDI, tourism, and remittances as the worldwide recession has deepened. The case of Yemen is illustrative. Yemen is one of the poorest countries in the Arab World. Its economy has been stagnating with an estimated 35% of its population living below the poverty line. As the Middle East and North Africa is the world's largest net food-importing region, Yemen, like a large number of countries in the region, suffered heavily from the food and fuel crisis which preceded the onset of the global financial crisis. With food (and oil) prices skyrocketing to record levels over 2006 to mid-2008, the terms of trade for food and oil-importing countries, including Yemen, Morocco, Tunisia, Lebanon, Jordan and Egypt, among others, plummeted – with rising inflation (around 17% in Yemen) having an adverse effect on the poor (IMF 2008b). Yet, when the financial crisis broke and food and oil prices sharply declined, it provided some relief to countries reeling under its inflationary impact. Furthermore, Yemen's isolation from the global economy was seen as a blessing. Like most resource-poor Arab countries, Yemen is insulated from global financial markets. Yemeni banks have low exposure to private foreign lending and portfolio investment is almost non-existent given the absence of a domestic stock market or commercial credit market (IMF 2009e). Yet, Yemen is highly vulnerable to commodity shocks as it is an importer of food and inputs, and depends heavily on remittances from workers in the Gulf, and FDI in the form of official aid. In fact, the case of Yemen confirms the empirical evidence that aid is procyclical with donor incomes. Moreover, domestic financial institutions have limited deposits and liquidity. Therefore, unlike its resource-rich neighbours, Yemen does not have the wherewithal to

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meet revenue shortfalls. This means that Yemen has been unable to put in place a vigorous fiscal stimulus to respond to the economic downturn. As a result, the crisis has hit Yemen particularly hard. Already the loss of revenue from returning workers has placed great pressures on government expenditures, as have declines in donor assistance and tighter external financing conditions. This has translated into ballooning fiscal deficits, pressures on the balance of payments and overall worsening of the country's budgetary position. If unemployment and poverty levels continue to increase, it could have adverse implications for social and political stability.

Specific transmission channels: the UAE

The experience of the UAE, at least of some of the federation's member states, underscores the fact that wealth is not necessarily a protection against financial crises. Rather, misallocation of resources can make even wealthy states extremely vulnerable to a fast-moving financial crisis. However, when the crisis began, the UAE was assumed to be well insulated from the global financial turbulence despite the fact that its economy is among the most globally integrated in the world. 8 In fact, the UAE is an important participant in global capital markets through several 'blue-chip' investment institutions, including the Abu Dhabi Investment Council, the Dubai Ports and Free Zone World, Dubai Holding and the Abu Dhabi International Petroleum Investment Company (IPIC). In addition, the Dubai Financial Market, Abu Dhabi Securities Exchange, Nasdaq Dubai and the Saudi Stock Exchange are an integral part of global financial markets. Moreover, the UAE's banking sector awash with 'windfall' liquidity from record oil prices was seen as being healthy. In fact, the UAE's banking system were not only well capitalized, but also highly profitable as the 'banks' assets and profits increased sharply in 2007 and the capital adequacy ratio stood at 13.3 percent by mid-2008, above the regulatory minimum of 10 percent' (IMF 2009b). 9 In fact, one of the unintended outcomes of the punitive investment restrictions imposed by the United States (especially on Middle East nations) after September 2001 forced the GCC to diversify its massive foreign exchange surpluses regionally. That is, instead of investing the bulk of its revenues in US Treasury bills or in eurodollar accounts at multinational banks, the GCC government's began aggressively to build up their SWFs, including investments in a variety of domestic state-controlled institutions (Table 3). The UAE, which began devoting a significant portion of its oil revenues in the SWFs was able to build up a colossal 'war chest' worth more than US$875 billion by May 2007. This massive accumulated wealth (at least relative to its GDP) was seen as a bulwark that could be used to mitigate the effect of oil price cyclicality and support continued investments to sustain growth. Finally, since the federation's write-downs from subprime assets were minimal, it was seen as being immune to the crisis.

Yet, in the oil-producing countries where the export of hydrocarbons is the single most important determinant of economic success, the rather abrupt drop in oil prices (from US$147 per barrel in July 2008 to US$38.60 per barrel in December 2008) was an ominous sign. Indeed, according to The World

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Bank (2009a), 'for the GCC in aggregate, oil and gas revenues dropped from US$670 billion in 2008 to an estimated US$280 billion during 2009 – a massive decline equivalent to 38 percent of the group's GDP' (p. 126). In the UAE, the sharp decline in the price of oil heightened concerns, namely that since the oil sector accounts for about 37% of the Emirate's GDP, it could now face deflation as the era of cheap credit was over and that the federation would not be able to generate the considerable fiscal surpluses to meet its ambitious, if not, profligate spending targets. 10 In addition, several SWFs in the Gulf region have suffered heavy losses on equity investments following the sharp slide in stock markets in 2008. It is believed that the Abu Dhabi Investment Authority (ADIA) has lost an estimated US$125 billion in 2008 after the credit crisis sharply cut asset prices. According to Setser and Ziemba (2009), the SWFs and foreign-currency funds of the GCC have lost about 27% of their assets – or US$350 billion in 2008 alone.

Table 3. Major investors. Sovereign wealth funds (SWFs) maintained by Gulf Cooperation Council states account for more than 40% of the assets of all such funds.

Country	Fund	Assets (billion dollars)	Inception	Rank
United Arab Emirates (UAE)	Abu Dhabi Investment Authority	875	1976	1
Saudi Arabia	SAMA Foreign Holdings	365.2	1990	3
Kuwait	Kuwait Investment Authority	264.4	1953	6
Qatar	Qatar Investment Authority	60	2003	12
UAE - Abu Dhabi	Mubadala Development Company	10	2002	29
Bahrain	Mumtalakat Holding Company	10	2006	30
Saudi Arabia	Public Investment Fund	5.3	2008	32
Oman	State General Reserve Fund	2.0	1980	39
UAE - Ras Al Khaimah	Rak Investment Authority	1.2	2005	40
Gulf Cooperation Council SWF assets		1,593.1		
Percentage of total global SWF assets				41.6

Note. The United Arab Emirates, Kuwait, Qatar, and Bahrain are member countries in the International Working Group of Sovereign Wealth Funds; Saudi Arabia and Oman are permanent observers.
Sources: International Monetary Fund (IMF) (2008a); Mohieldin (2008, p. 41).

Compounding this, and to some the real threat, was the Emirates (especially Dubai's) real estate sector's potential exposure to global markets – in April 2008, 'the six members of the GCC … announced or begun projects worth US$1.9 trillion' (The Economist 2008). Specifically, when the Dubai International Financial Centre (DIFC) free-zone opened in 2004, it soon became the world's fastest-growing financial centre boasting the presence of hundreds of banks and insurance companies from around the world. 11 Since foreign financial institutions did not have to pay any tax on profits and faced no restrictions on foreign exchange or repatriation of capital, they expanded

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rapidly via franchising their operations throughout the region and lending to the Emirates booming real estate and construction sectors. However, foreign banks were not the only willing lenders. The UAE's banks and financial institutions in partnership with foreign subsidiaries also engaged in rampant speculative lending in real estate. Indeed, over the past decade, the UAE via its quasi-government companies (including Nakheel, Emaar and Dubai Properties) invested billions in its property sector in an effort to diversify its economy and reduce dependence on the oil industry.

As a result, the UAE experienced a boom in property development – boasting more glittering skyscrapers than Manhattan – and with prices to match. The lid came off the real estate sector following Dubai's decision to allow foreign investors to buy property in designated areas on a freehold basis in 2002. The red-hot property market literally 'exploded' with skyrocketing property values, rampant speculation, and 24-hour construction to meet insatiable demand – not only in Dubai, but also in every area of the Emirates. The most ambitious, the mega-projects, included the three Palm Islands and Burj Dubai – at 818 meters the world's tallest building. Yet, what was not fully known was the extent of the banks' (both foreign and domestic) exposure to the real estate market via loans to developers, namely if these loans were backed by strong collateral. Given this, there was palpable fear that a sharp reversal in the UAE's real estate and property market could (like the United States) implode with devastating effect.

In October 2008, Nakheel, one of the Emirate's big three land developers (as well as companies directly controlled by Dubai's bullish ruler, Sheikh Muhammad bin Rashid al-Maktoum such as Dubai World, Investment Corporation of Dubai, and Dubai Holding), announced that it was scaling back dredging work on its massive Palm Deira Project – the largest of three Palm Island archipelagos audaciously named 'the World' as the island is designed as a replica of the world. Together, 'the World', an archipelago of some 300 artificial islands created just off the coast of Dubai, boasted that upon completion it would house more than 1 million 'highly selective' residents who would have access to state-of-the-art conveniences – not only luxury complexes personally designed by no other than the irrepressible Donald Trump himself, but also the world's largest indoor ski slopes featuring fresh powder year round.

The 'unthinkable' shocking news about Nakheel served as a wake-up call and finally to underscore that Dubai's real estate bubble built on the back of borrowed cash and speculative investment was finally unravelling. As global deleveraging intensified, it led to a large contraction in liquidity and severe tightening of credit conditions, particularly in countries that were highly leveraged and dependent on foreign lines of credit such as Dubai. Soon this resulted in distressed sales of Dubai property, including the high-end Palm Jumeirah – which saw prices plummet as investors rushed to offload homes and other property. Among the casualties was the exquisite tower Donald Trump promised would be 'the ultimate in luxury' and a US$100 billion beachfront resort complex. By early

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November 2008, property prices fell by 4% in Dubai and 5% in Abu Dhabi for the first ever since 2002. 12 But this was just the beginning. By the end of November prices had dropped by 25%. Sensing further losses, the large foreign banks that had been financing the UAE's and much of Dubai's real estate boom quickly began to pull out. The burden now fell squarely upon local banks and financial institutions, most of which were simply ill-equipped to deal with the burden. Abu Dhabi's largest mortgage lender Amlak Finance shocked investors when it announced (in early November) that it was temporarily halting new home loans. A few days later the UAE's biggest bank, Emirates NBD, announced its decision to stop lending to foreigners who work for Dubai's property firms. Other banks followed suit. Worried about the health of their loan-to-value ratios, banks either refused to lend or simply lent less. By the end of 2008 the UAE's once-booming property sector lay moribund – not only facing a major slowdown in loan growth and real estate activity, but also potential collapse. Only the UAE could now provide the desperately needed liquidity. 13

Yet, with an estimated US$1.8–2.0 trillion in foreign assets (by the end of 2008), of which roughly 60% was in dollars, it was only a matter of time before the GCC would experience asset depreciation (Woertz 2008, pp. 1–21). These were soon felt on the Emirates stock markets as stock and asset values plunged and the SWFs took their share of losses, especially funds with a high allocation in equities. It has been estimated:

that GCC sovereign wealth funds lost 27 percent of their value in the 12 months ending December 2008, with losses as high as 40 percent among those funds heavily allocated to emerging markets and private equity placements. GCC equity prices in dollar terms dropped by some 58 percent between September 15, 2008 and March 12, 2009 (a period during which virtually all bourses registered sharp declines). Over the same period, equity prices in UAE plummeted by 70 percent, contrasted with a decline of 55 percent for all emerging markets. (The World Bank 2009a, pp. 126–127)

On 16 November the Dubai Financial Market (DFM) index closed at 1981.44 points, falling by 68.51% from the year's peak of 6291.87 points on 15 January with a loss of 4.67 billion dirhams (US$1.27 billion) in market value. On the same day, the Abu Dhabi Securities Exchange (ADX) also fell to its lowest point in 2008, with its general index hitting 2755.62, down 46.48% from 5148.49 points on 11 June with a loss of 1.52 billion dirhams.

The UAE Central Bank responded vigorously (and pre-emptively) to mitigate the adverse economic developments, in particular the drying-up of liquidity following the outflow of foreign deposits. On 22 September 2008, the bank announced the establishment of an emergency lending facility of 50 billion dirhams to provide much-needed liquidity for the banking sector, and on 8 October it announced a 2-percentage-point cut in its lending rate to 3% – again to generate liquidity of local

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banks. On 8 October the bank lowered the rate on its repurchase of certificate of deposit (REPO) from 2.0% to 1.5%. The Kuwait Investment Authority (KIA) and the ADIA also repatriated part of their foreign assets and deposited them in domestic banks to provide liquidity. In addition, SWFs' resources have been used to invest in local equity markets, and the Qatar Investment Authority (QIA) and the KIA have purchased domestic bank shares to help enhance bank capitalization. Equally significant, to prevent spillovers from global turmoil and boost confidence in the economy, the central banks in a number of countries (the UAE, Kuwait, and Saudi Arabia) announced they would provide a three-year blanket guarantee to deposits and savings in all national banks and foreign banks with 'significant operations' in the federation, including a guarantee to all interbank lending operations between banks. It also made a commitment to inject liquidity in the financial system if and when necessary. The government's decision to inject an additional 70 billion dirhams into the banking system in late October 2008 under an 'emergency liquidity support fund' (in the form of interest-yielding government deposits) to provide banks with long-term funding relief underscored the UAE's willingness to restore liquidity to the markets and rebuild confidence in the Emirates financial sector (IMF 2009f).

However, the policy response, including the purchase in February 2009 by the UAE's Central Bank of US$10 billion of Dubai's bonds, provided some respite, but failed to stop the panic or the financial bleeding. This is because although the global financial turmoil in the Emirates' (and the GCC countries') banking sector has been uneven, all have seen a reduction in their profitability due to reduced growth in business volumes, tighter interest rate margins, increased credit costs, and direct and indirect exposure to the increasingly volatile local stock and property markets. For states like Dubai, which unlike oil-rich Abu Dhabi relies on debt and equity finance raised on international markets to support its overly ambitious plans, access to credit has become a huge problem. The fact that the UAE Central Bank quietly purchased half of a US$20 billion five-year bond issued by Dubai was seen as proof that Dubai was having trouble meeting its US$80 billion debt obligation. Not surprisingly, property prices which had fallen by about 25% in the last quarter of 2008 fell by the same amount in the first quarter of 2009. According to The Economist, in March 2009 the 'UAE developers had postponed US$335 billion-worth of construction projects. One two-year project was proceeding so slowly that it would take 20 years to complete'. Similarly:

> the debt of Dubai's government and government-controlled companies is about $80 billion. Almost $11 billion comes due this year (including interest) and $12.4 billion next. Nakheel alone must refinance a $3.52 billion bond in December and another worth 3.6 billion dirhams ($980 million) five months later. (The Economist 2009)

According to the IMF, the decline in oil prices coupled with OPEC production cuts are projected to reduce oil export revenues by almost 50% in 2009 – or a loss of some US$300 billion compared with

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2008. 'As a result, oil exporters' current account surplus of around US$400 billion in 2008 is expected to turn into a deficit of US$30 billion in 2009' (IMF 2009d). This will further compound the problems faced by some 1.5 million foreigners working in GCC countries. South Asians, in particular Indian nationals who make the largest expatriate community, mostly work as contract labourers – often on perilous construction sites earning as little as US$150 a month. The literal grounding to a halt of the once booming construction industry has hit these traumatized workers particularly hard because, among other restrictions, employees who lose work in the UAE and other states automatically have their visa rescinded, generally giving them about 30 days to leave the Emirate. This is unfortunate as the large expatriate community, even unemployed, can help support domestic demand to stimulate growth in the non-oil GDP.

Responding to the challenges

Of course, given a crisis of this magnitude, a sustained economic recovery is only possible with the restoration of the global financial markets, in particular the unclogging of credit markets and growth in demand in the United States, the European Union and other advanced economies. The Arab World's challenge in the near term is to preserve the region's financial stability and cushion the impact of the global slowdown. This will not be easy if the global recession is prolonged, and for the region's stabilizers, the oil-rich countries, the price of oil remains below US$50. This could result in further deterioration in the balance sheet of financial institutions, besides adversely impacting investor and consumer confidence. For the Arab countries, especially in the UAE, if the global economy does not pick-up, there is the possibility of further asset price corrections. As noted above, the sharp downturn in asset prices since early 2008 has already translated into losses for the SWFs. If this trend continues, it would place even greater stress on the financial institutions of the Emirates. Given this, there is no better time than now to review the SWFs long-term strategy for individual countries and the region. In particular, SWFs not only can play a greater role in supporting domestic macroeconomic and financial stability, but also can pursue profitable investment opportunities in the region.

Furthermore, the Arab countries can both individually and collectively put in place policies to mitigate the adverse impact of the crisis as well as lay the foundations of future growth. There is no doubt that the Arab countries, especially the economically vulnerable economies, will require massive fiscal stimulus packages to stave off the immediate negative impacts of the crisis. Yet, these packages must be geared toward job creation and investment in infrastructure, including properly targeted safety net programmes to alleviate the suffering of those most adversely affected by the crisis. 14 Moreover, the stimulus packages must be well coordinated across countries so the outcomes can be reinforcing across the region. Both the oil-rich Arab countries (which despite their own difficulties have greater fiscal space and are in a stronger position to help) as well as multilateral

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financial institutions such as The World Bank and the IMF must help fund the stimulus packages for the region's poorer nations. In fact, for low-income Arab countries, an increase in donor financing will be necessary to maintain aggregate demand and enhance social safety nets.

Finally, one of the lessons of the Great Depression was that lack of cooperation and retreat into protectionism exacerbated the depression. Clearly, UAE President Sheikh Khalifa bin Zayed Al-Nahayan understands this and has embraced multilateralism and a cooperative approach to solve economic and financial challenges. The UAE along with the six Gulf Arab countries that make-up the GCC have been working together to stem the economic challenges. Yet, besides adopting expansionist policies discussed above, the other item on top of their agenda seems to be putting in place a long-planned pact to issue a single currency before a self-imposed 2010 deadline for monetary union. Of course, this raises the thorny question regarding the dollar peg. Specifically, even as the dollar has been depreciating against major currencies (and central banks around the world have been gradually moving away from the dollar in an effort to stem losses from the declining dollar exchange rate), the UAE and the GCC have for long stated that they would not de-peg their currency from the dollar as the dollar peg had served them well for decades. 15 The five GCC members (Saudi Arabia, the UAE, Qatar, Oman and Bahrain) peg their currencies to the dollar – thereby setting an official reference rate at which central banks buy and sell. The only exception is Kuwait, which in 2007 abandoned its peg and now links its currency to a currency basket that includes the dollar, the euro, the yen, and the pound sterling. The five GCC members have long maintained that the peg strengthens economic cooperation in the region, reduces the speculative pressure on regional currencies, prevents capital flight in UAE banks toward foreign-denominated accounts, and that continuing the peg is an important requirement for issuing a common currency by 2010. 16 However, as the dollar has further plummeted, member states, most notably Dubai (including business interests in the region), have urged member states to rethink the peg and the region's broader monetary policy – namely, for the GCC to peg against a basket of currencies. They claim that such a policy would not only take into account the region's growing trade with the euro zone and Asia, but also curb the region's growing inflation problem. 17 Dubai and other states of the UAE (the UAE is one of the world's main holders of dollar-denominated assets) are also concerned that the dollar's decline is hurting expatriates (both professionals and ordinary workers) from taking jobs in Dubai and other UAE states.

In early 2008, the UAE Central Bank set up a task force to study a possible de-pegging or revaluation of the dirham from the dollar. The study concluded that the dollar was a reliable peg for the Gulf currencies and that the GCC's planned common currency would remain linked to the dollar. Evidently, this strong endorsement helped reserve the large private capital inflows that were driven by expectations of an appreciation of the dirham vis-à-vis the dollar. Indeed, currency futures indicate that markets no longer doubt the peg. Moreover, in recent weeks (April–May 2009), the fact

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that countries with pegged exchange rates (Bahrain, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria and the UAE) have benefited from the continued monetary easing in the United States seems to have vindicated the central bank's decision. Nevertheless, what is certain is that in the near future the GCC will need a new monetary regime with a single currency set against a basket of currencies and interest rates that are appropriate to the domestic economy. In that sense, revaluation should be seen as the first step towards a GCC single currency. No doubt, even as the debate on the merits and demerits of the peg will continue (currently the only alternative given serious consideration is re-pegging the dirham to a stronger basket of currencies), deeper intraregional trade among the Arab countries should be accelerated as it can act as a buffer against global downturns. Currently, the region is more integrated through labour mobility than through trade and investment. Although, regional integration from FDI and portfolio investments have risen in many Arab countries, the extent of intraregional trade still remains lower than in all other regions of the world, except for South Asia. Intraregional integration via freer movement of goods, services, labour and capital, including harmonization of regulatory and supervision standards, can help improve the competitiveness and resilience of the region.

Postscript

On 25 November 2009, the Dubai government was forced to ask its creditors for a six-month payment standstill on an estimated $60 billion of liabilities owed by one of its own flagship conglomerates, Dubai World. 18 Coming at a time when many felt the worst of the crisis was over, this sent shock waves throughout the global financial and stock markets. The situation was further compounded when a senior government official (the Director General of Dubai's Department of Finance) stated that the Emirate did not believe it was under any obligation to stand behind the debts of Dubai World forever, and that creditors should take their share of the responsibility. Investors who had long been under the assumption of a blanket guarantee provided by the federation were clearly shocked and unnerved. Panicked investors fearing a possible bank-run, and at worst, a sovereign default (as the Dubai government felt no responsibility to guarantee the debts of a state-owned company), began to flee by retreating to the traditional safe haven: the US dollar. The panic only subsided after the Central Bank of the United Arab Emirates promised to ‘stand behind’ the region's banks by providing more emergency liquidity. Although fears have receded for now, the inability and unwillingness of the Dubai government to refinance the debt of its own company (Dubai World), has been a rude awakening for investors around the world. Investors can no longer take for granted the explicit backing governments have traditionally given to state-owned companies against insolvency. The reality is that governments around the world have responded to the financial crisis by taking on unsustainable levels of debt and many are simply no longer in a position to provide more finance – Dubai is a case in point. Finally, the manner in which the government of Dubai handled (or mishandled) this issue has done damage to its credibility and put a significant stain on its once stellar reputation as the premier place to do business in the Arab world.

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Notes

1. The Arab World, broadly termed the Middle East and North Africa (MENA) by The World Bank includes: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates (UAE), the West Bank and Gaza Strip, and Yemen.
2. GCC countries include the UAE, Oman, Bahrain, Kuwait, Qatar, and Saudi Arabia.
3. While there is no agreed upon definition of an SWF, the US Department of Treasury defines SWFs as government investment vehicles funded by foreign exchange assets that are managed separately from official reserves. More broadly, SWFs are investment funds controlled by governments. They are state-owned investment funds composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. SWFs can be structured as a fund or as a reserve investment corporation. The types of acceptable investments included in each SWF vary from country to country. For example, countries with liquidity concerns limit investments to only very liquid public debt instruments. A number of countries have created SWFs to diversify their revenue streams. For example, funding for the Norwegian Government Pension Fund comes from oil revenues; the government of Singapore Investment Corporation is funded through foreign exchange reserves; while the UAE relies on its oil exports for its wealth. As a result, the UAE devotes a portion of its reserves in an SWF that invests in assets that can act as a shield against oil-related risk. The amount of money in SWFs is substantial. The estimated value of all SWFs is estimated to be US$3.6 trillion – and if current trends hold, they are projected to reach US$10 trillion by 2012 (International Monetary Fund (IMF) 2008a).
4. The UAE is a federation of seven states situated in the south-east of the Arabian Peninsula. They include: Abu Dhabi, Ajman, Dubai, Fujairah, Ras al-Khaimah, Sharjah, and Umm al-Quwain.
5. Of course, the trade and financial channels of crisis transmission often interact because the availability of trade credit is linked to trade volume.
6. The ‘trade openness index’ is the ratio of the sum of exports and imports to GDP.
7. Remittances totalled US$6.3 billion in 2007 – up 25% over 2006 levels (The World Bank 2009b, p. 15).
8. Over the past decade, the UAE has pursued ambitious free-market policies to diversify its economy away from a dependence on fossil fuel. In 2004, the United States and the UAE entered into a Trade and Investment Framework Agreement (TIFA) which established a formal dialogue to promote increased trade and investment between the two countries.
9. By the end of 2008, only a few Gulf banks had exposure to subprime loans. Abu Dhabi Commercial Bank with US$272 million, Bahrain's Arab Banking Corporation with US$1.2 billion, and Kuwait-based Gulf Investment Corporation with US$446 million, and Bahrain's Gulf International Bank was downgraded by Moody's because of the bank's holdings of US mortgage-backed securities. It had to make provisions for US$966 million and raise additional capital (Woertz 2008, p. 8).
10. Abu Dhabi accounts for 94% of the UAE's crude oil output. Not surprisingly, is the wealthiest of

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the seven members of the Emirates with more than half of its GDP.

11. In fact, Dubai came to rival Bahrain, the major financial centre in the region for more than four decades.

12. According to the Cummins (2008), the average asking price for homes in Dubai fell by 4% in October 2008 from September 2008, while prices for the upscale Dubai 'villas' fell by 19%. In the next-door emirate Abu Dhabi, average home prices fell by 5%.

13. On 11 May 2009, Nakheel confirmed it was receiving funds from the Dubai government to meet its outstanding obligations. In 2009, Dubai sold US$10 billion of bonds to the UAE Central Bank to raise funds to support cash-strapped state-linked companies and plans to issue another US$10 billion in bonds later this year.

14. In fact, job creation is very critical as unemployment in the region is high with 14% of the labour force on average being unemployed, compared with a world average of 6.7%. Unemployment is particularly acute among youths and women.

15. The dirham was adopted as the official currency of the UAE in 1973 when it was pegged to the US dollar at a rate of 3.9474. In 1978, the dirham was de-pegged. The dirham's exchange rate against the US dollar was raised to 3.671, and in 1998 the exchange rate was adjusted to 3.672.

16. Only Oman has ruled out revaluing its currency, arguing that a weaker rial helps attract foreign investment and make exports more competitive – and in the process it offsets inflation. It has also ruled out joining the plan to create a single currency. Oman also dropped out of proposed monetary union in 2006.

17. An undervalued dirham imports inflation into the UAE because exports are priced in US dollars and the bulk of imports in other currencies.

18. It is estimated that the total debt Dubai owes is about $80 billion – with Dubai World shouldering the bulk. Dubai World, an investment company, is owned by the government of Dubai. It is one of the three main state-owned enterprises in Dubai, besides the Investment Corporation of Dubai and Dubai Holdings (which 'owns' the Jumeirah Hotel Group, including the seven star Burj Al Arab).

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