ECONOMIC DEVELOPMENT AND GLOBALIZATION DIVISION

Impact of European Debt Crisis on ESCWA Economies

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Introduction

The Debt crisis started in Europe, specifically in Greece, before moving to the US. From 2000 to 2007, the Greek economy grew at an annual average rate of 4%, the fastest in the Euro zone. The confidence in the Greek economy was high especially after it joined the Euro. Capital inflow flooded Greece allowing its government to run a budget deficit at low cost but at higher risk of accumulating public debt. The 2008 crisis and the following recession that hit most economies, severely affected two important industries in the country: tourism and shipping. As a result of that, government revenues dropped by 15% in 2009. Greece was not able to honor the monetary union guidelines not to exceed public deficit and public debt by 3% and 60% of GDP respectively. In 2010, the estimated deficit was 13.6% of GDP and the public debt was estimated at €216 billion or around 120% of GDP. On April 2010, Standard and Poor's downgraded the Greek debt to the upper level of junk status. The yield on the government two-years T-bills rose to around 15% and investors feared that Greece would default on its debt.

The crisis also spread to other European Nations- mainly Ireland, Spain and Portugal with their deficits to GDP equaling 32.4%, 9.2% and 9.1% respectively which reduced public confidence in these economies and increased their borrowing cost. The European Union, the ECB and the IMF rushed to prevent the Greek default that might have encouraged other European Nations to default as well. As a prerequisite step, the Greek government announced a set of austerity measures to save around €5 billion, while the European Union and the IMF agreed to immediately provide Greece with €45 billion.

Most economists agree that the suffering of the US and the Euro economies will continue in the absence of real solutions that address their structural issues. For the US, the real challenges are: restoring international competitiveness, introducing more regulations in the financial markets, and preserving the dollar as an international currency. For the Euro Zone the main challenges are: preserving the union and the common currency, achieving political unity with a unique fiscal policy, and supporting and strengthening the banking system to withstand the expected sovereign defaults.

The US and the Euro Zone are closely linked to the Arab region through several channels and the ongoing economic and financial problems in both regions would significantly impact the later mainly through: the financial markets and the real estate sector as well as the real sectors

The Impact on the Financial Markets & Real Estate Sectors

<u>The Impact on the Financial Markets</u>

As a result of the crisis, Arab stock markets lost 40% of their market capitalization in 2008, dropping from $1,330 billion at the end of 2007 to $806 billion at the end of 2008. In 2010, these stock markets were able to recover part of their losses, increasing market capitalization to $991

billion by the end of 2010. The financial crisis exposed the fragility of Arab stock markets and their inability to absorb global shocks. However, the uncertainties in the world economies, in particular the emergence of the current debt crisis, led to a 12% decrease in market capitalization in 2011, reaching $873 billion by mid August. The largest drop in market capitalization took place in Cairo and Alexandria Stock Exchange (27% decrease), followed by Kuwait Stock Market and Muscat Securities Market (a decrease of 22 and 15% respectively). The markets of the UAE, namely Abu Dhabi and Dubai, lost between 3% and 4% of their market capitalizations in 2011.

If the current crisis persists, the largest impact is expected to hit companies operating in the financial services and the petrochemical sectors. Loss in consumer confidence and the bad investments of some banks would force the banking sector to cautiously provide less credit that would in turn impact their profits. Furthermore, according to forecasts by some international banks, oil prices are expected to decrease by 10% due to slowdown in oil demand is expected to negatively affect the petrochemical sector on one hand and the liquidity in the banking sector on the other hand.

The Impact on the Banking System

Although, preliminary figures for 2010 indicate an increase in loans and deposits in most Arab countries, it is expected that the debt crisis will affect negatively consumer confidence and will pose restrictions on credits available to investors and individuals, even though central banks of several GCC countries have lowered their required reserves and injected liquidity in the banking sector in response to the 2008-2010 crisis. The expected restrictions on credit will negatively affect investments, which in turn will slow down growth and increases unemployment. Furthermore, the credit constraints will negatively impact the aggregate demand which will deepen the recession. Credit restrictions are expected despite the US Federal Reserve intentions to keep the Federal Fund Rate at low levels till 2013 which would help to keep interest rates at low levels in the region, mainly in the GCC countries. As a preliminary response, some of the local banks operating in the UAE are implementing a tightening policy on retail lending but in the same time they are extending loans to SMEs, which are getting a considerable support from the government.

The Impact on Sovereign Funds

The crisis is expected to have the most obvious and direct impact on sovereign wealth funds from the ESCWA member countries that are involved in investing in international financial markets. During the 2008-2010 crisis, the ESCWA SWFs lost around 45% of their market value due to investments in equities, while their losses totaled around 18% in holding bonds[1]. To limit their future losses given the uncertainty of the financial markets, SWFs shuffled their portfolio

[1] Balin, Bryan (2010).The impact of the global economic crisis on soverign wealth funds. The Asian-Pacific Economic Literature; volume 24, issue 1, 25 May 2010.

away from equities towards less risky fixed income holdings especially the US T-bills. The current crisis deprived the SWFs from the "safe haven" that the US T-bills used to provide. Today, the faith in the US government backing the US T-bills is not enough. The new challenge for the SWFs is to resist the temptation of investing in the US markets and to adopt new optimal investment strategies based on new risk management models, especially that the current models failed to prevent substantial losses to the supposedly diversified and uncorrelated assets.

The current crisis is expected to cause a double dip recession in major economies. The ESCWA region will suffer from the expected drop in oil prices driven by low demand for oil, and therefore is expected to witness also a decline in growth. The region is expected to experience three major implications resulting from the involvement of SWFs. First, the SWFs governments would be urged to use their wealth to stabilize the local economies by financing the unsustainable non-oil fiscal deficits and bailing out troubled sectors. Such interventions would impact the returns, the time horizon, and the makeup of the SWFs portfolios. Second, in order to interfere on time, the SWFs should hold more liquid assets such as- cash, bonds, and interest bearing deposits that on the other hand would jeopardize the Funds long-term returns. Third, most SWFs are currently investing in pro-cyclical assets such as real estate, commodities, and direct investments. SWFs need to hold larger share of countercyclical assets (such as food and health care sector) to avoid large losses when they are requested to interfere during crises.

The Impact on the Purchasing Powers of Currencies

In the absence of real solutions for the growing US deficit and debt, and the recent downgrade of the US debt rating, there will be growing pressures on the dollar to depreciate. That would impact the purchasing power and the foreign reserves in the Arab region. The current crisis might create inflationary pressures in the region, similar to what region experienced in 2007-2008. This could happen for several reasons. First, the depreciation of the dollar will increase the Arab importing bills, especially food (Arab region has the largest food deficit in the world) which constitutes 40-50% of Arab CPI. Second, the decrease in oil revenues and the decline in growth would urge the governments to increase public spending that would in turn push up the prices. Therefore, balanced monetary policy is needed to ease money supply and encourage investments in order to neutralize the expected crowding out effect due to governments' increased spending. Third, portfolio managers and economic agents in the region will decide to hold less of the depreciating dollar to preserve the real wealth of their holding. In ESCWA member countries with fixed exchange rate systems, central banks would have to intervene in the exchange rate markets in order to increase money supply that would further exert an upward pressure on general prices and erode the purchasing power of region's currencies.

Most Arab countries accumulated foreign reserves, mostly in US dollar, to keep their currencies fixed to the US dollar by intervening in exchange rate market. The Arab accumulation of reserves in US dollar exceeds $1 trillion, with half of that amount accumulated by Saudi Arabia alone. There are two issues worth mentioning. First, this tremendous wealth exceeds the needed

amount to defend the region's currencies. The Arabs should take advantage of this idle wealth to mitigate the expected consequences of the current crisis in the short run by immediately creating public jobs, subsidizing the basic needs of peoples living under poverty line, and extending credits to SMEs. Second, with the dollar expected depreciation, the real value of this reserve is at risk. China, Russia, and Brazil announced their concerns several times regarding the way the US is managing its currency and they called for the establishment of a new international reserve currency. This should be a concern also for the Arab countries and they should consider the best alternatives to diversify their reserves away from the US dollar.

The impact on the Real Estate

The expected decrease in the purchasing power of the region's currencies would urge economic agents to substitute money for less liquid assets. In the absence of well developed regional financial markets, the real estate sector might witness growing demand. The implications are expected to vary across countries. The real estate sector in the region developed a bubble before the 2008-2010 crisis. The crisis brought it to bursting point and significant corrections in prices took place mainly in the GCC countries. The huge incurred losses and the lessons learned should prevent similar bubble from developing in the Gulf region. In the more diversified economies, the real estate sector did not witness any correction; on the contrary, the prices and rents reached very high levels in countries such as Lebanon, Syria, and Jordan. Such rents are not affordable to vast majority of people, which adds to the cost of production especially of small business and fuels the general prices level.

The Impact on the Real Sectors

The Arab Exports

The current global circumstances would affect the ESCWA oil exports as well as the non-oil exports. The impact in the short run will be limited to oil exports; in the medium to the long-term, the non-oil exports might be impacted as well.

Exports from the ESCWA countries are heavily concentrated in the oil sector and fuels represent around than 70 % of total export from the ESCWA countries. Developments in this sector are often very sensitive to global conditions. If economic growth declines in the United States, the world largest oil consumer, global energy demand will be greatly reduced and oil prices will most likely fall. As a matter of example, as an immediate response to the US downgrade, the oil prices fell more than $10 in the week following the downgrade which highlights how quickly commodity markets responds to circumstances in the US. This sharp fall together with predictions about sustained lower oil prices in the long run will reduce export revenues for oil exporting ESCWA countries.

The share of non-oil exports destined for the United States and the European Union is around 11 % of total exports (3 % to the US, 8 % to European Union). Reduced demand from these countries will negatively impact the ESCWA region. Some ESCWA countries are more vulnerable than others, in particular Jordan and Egypt. Jordan is highly dependent on demand from the United States given that more than 15 % of its non-oil exports are destined to the US. Egypt is more dependent on the European markets since around 23 % of its non-oil exports go to the countries of the European Union.

The Manufacturing Sector

The current global debts crisis is expected to have serious negative impact on the manufacturing sector in the Arab region due to falling exports and financial constraints. In comparison with the 2008 global financial crisis, global manufacturing industry decelerated clearly in 2008. The world manufacturing production growth rate fell from around 3.5% in the last quarter of 2007 to –15% in the last quarter of 2008. In the group of developing countries where most Arab countries belong, the deterioration went across all industrial sectors and activities, although some industries have been more affected than others due to lower foreign and domestic demand as well as a continuing lack of access to credit and trade finance. On the other hand, the decrease in production had significantly caused deterioration in employment which negatively affected poverty, especially among women and unskilled workers.

In fact, the manufacturing sector's share in GDP represented 16.2% in Bahrain, 23.4% in Jordan, 11.5% in Oman, 11.4% in Saudi Arabia and 8.4% in Syria in 2009. Moreover, the manufacturing exports of the diversified economies of Jordan, Lebanon, Morocco, and Tunisia represented more than 60% of their commodity exports in 2007. Additionally, jobs in manufacturing and construction sector represent 46.6% in Qatar, 28.4% in Syria and 22.8% in Egypt of the total employment.

In the first quarter of 2011, the figures show promising growth rates in manufacturing output compared to the last quarter of 2010. The manufacturing output of most developing countries increased by 11.5% in the first quarter of 2011. The growth rate of other developing countries including least developed countries was below 5%. Negative growth was observed in Egypt and Tunisia, where manufacturing output fell by 8.9% and 7.4%, respectively, during this period.

However, the chaos in the financial global market and debts crisis is expected to negatively affect the manufacturing sector all over the world as well as the Arab countries which will also affects the outcome of this sector whether in GDP, employment, exports, intraregional and international trade, etc. A similar scenario of 2008 is forecasted for the end of 2011 and beyond. Therefore, an Arab policy coherence and coordination is crucial to react to the coming debt crisis.

Tourism

Tourism is an important pillar for many Arab economies and it is a key socio-economic driver to create jobs, to boost exports, and to develop infrastructure especially in rural areas. For many Arab countries (especially non-oil producing countries such as Lebanon, Syria, Egypt, Jordan, Morocco, and Tunisia), tourism is one of the main sources of foreign currencies and it is estimated to contribute 8.1% to the total Arab GDP. However, as a result of the current global debt crisis, expected recession in major industrialized economies and the negative security perceptions due to the Arab Spring, tourism sector in the Arab world has witnessed a sharp drop in tourist arrivals. For example, the number of tourists fell by almost a half in the first quarter of this year in Egypt, costing Egypt around one billion dollar a month and directly affecting the two million Egyptians who are employed in the tourism sector. The number of tourists in Jordan fell by 18% during the first seven months of 2011 to 3.931 million, from 4.809 million in the same period last year. Tunisia, is suffering a sharp decline (around 45%) in the number of international tourist arrivals and tourism earnings decreased by nearly a half.

Recommendations for Short Term Mitigating Actions

It is important for policymakers to early recognize and to react swiftly to mitigate the possible impacts of the current crisis on the Arab region. The expected crisis would affect the major industrialized economies that would severely affect the international demand for oil and non-oil exports of the ESCWA region. As an alternative, domestic demand has to be boosted to make-up for the expected decrease in international demand. To do so, we recommend the following actions to be taken:

- Governments should increase public spending in general, especially in rural areas with the aim to create jobs for poor and low income people, to develop infrastructure, and to stabilize farmers' income.
- Fiscal policies should stand ready to help SMEs with access to loans and financing (through loan guarantees), and to bail out the troubling firms.
- Monetary policies should make sure that the nominal exchange rates are aligned with the real effective rates to keep the Arab goods competitive in the international markets.
- To assure the soundness of the banking systems, Basel III standards should be observed and applied.
- Governments of SWFs should allow more transparency and more domestic discussions on the best ways to manage and to invest such funds.
- Given the current low real returns in the international financial markets, the SWF governments should consider investing in those regions where the long-term returns are promising and where such funds are mostly needed to address the region's socio-economic challenges.
- The governments of the ESCWA member countries should take advantage of the excess accumulated foreign reserves and should consider diversifying their holdings of foreign reserves away from the troubled and depreciating US dollar.

Data Sources:

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- "Statistical Update on Arab States and Territories and North African Countries" (ILO, May 2011)
- Report on World Manufacturing Production, Quarter I, 2011 (www.unido.org/statistics)
- [1] The sources of the data in this section are:
- World Travel and Tourism Council
- World Tourism Organization