The Global Crisis and the Credit Channel

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Outline

1- Setting the stage: Global and Emerging Market issues

2- The credit channel in the Arab economies

3- Policy responses and challenges

1- Global and EM developments: Setting the context

- Global growth slowed down sharply due to the US downturn – which spread globally- and to the global credit crunch, which is unlikely to dissipate for the next two to three quarters

- A series of unwinds, leading to a vicious redemption-price decline circle has been testing the resilience of the developing world

- EM Inflationary pressures dissipated rapidly, allowing central banks to shift towards liquidity provision and an easier monetary policy stance…

- …but banks balance sheets had been further stretched by write-downs, thereby reducing the broader economy's access to credit

- With no obvious sector to "leverage up" and banks in defensive/survival mode, monetary easing is taking longer than usual, as the credit system is likely to remain unresponsive for some time

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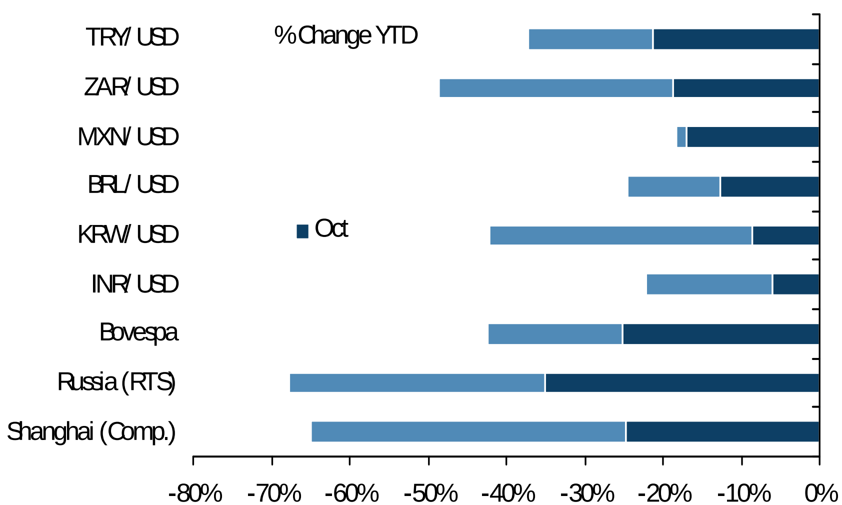
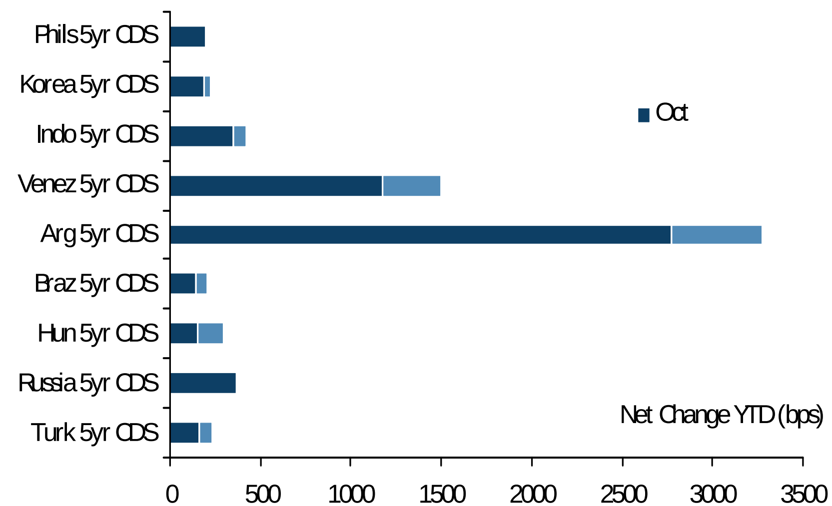
1-EM Assets: Black October…

- Emerging Market Assets have been selling-off during the last months but sell-off accelerated dramatically in October

EM FX and Equities collapsed



…and credit spreads widened



Source: Barclays Capital, Bloomberg, Markit

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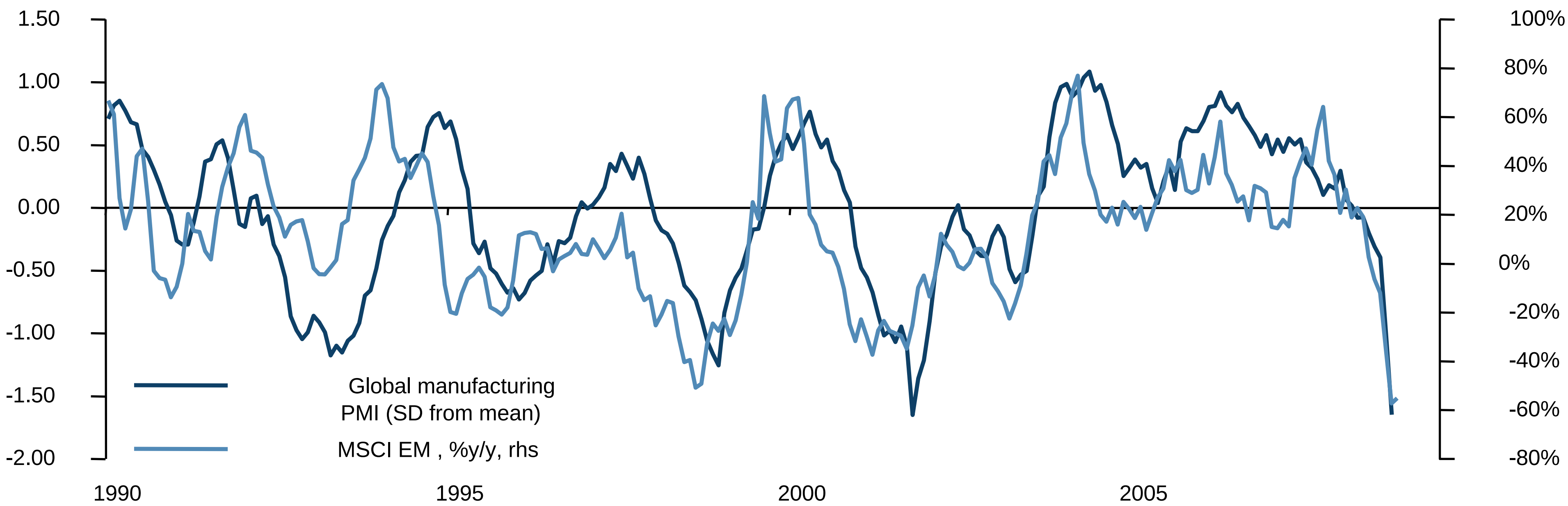
1- EM Equity Markets consistent with Global PMI..

- The collapse in EM equity markets coincides with very weak global PMIs.

MSCI EM and Global Manufacturing PMI



Source: Barclays Capital, as of close on October 29, 2008

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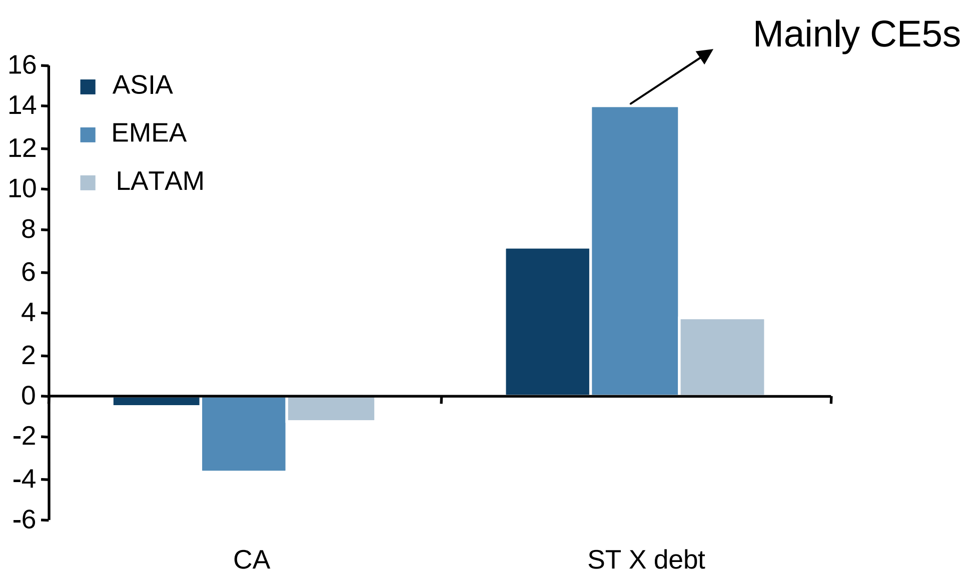
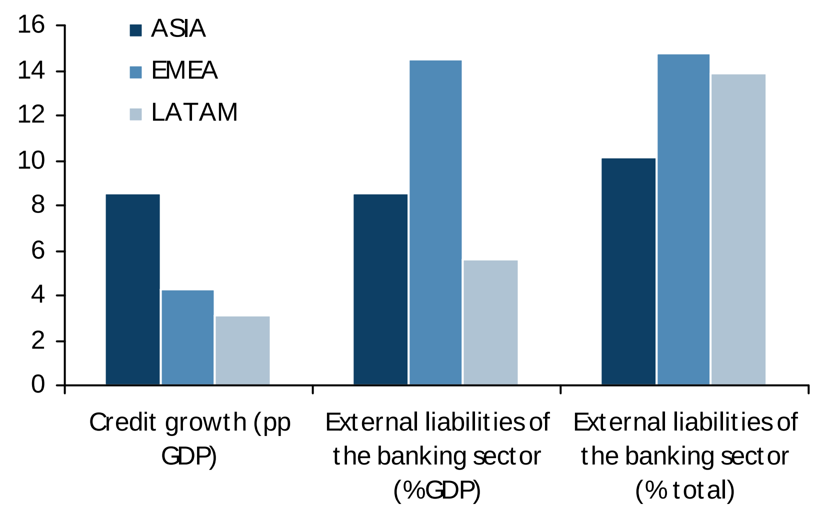
1-…Short-term concerns about external vulnerabilities have been raised

- Traditional calculations of vulnerabilities suggest that weaknesses are largest in EMEA (Emerging Market Europe, Middle East and Africa)

External sector vulnerabilities (%GDP)



Financial sector vulnerabilities



Source: Barclays Capital

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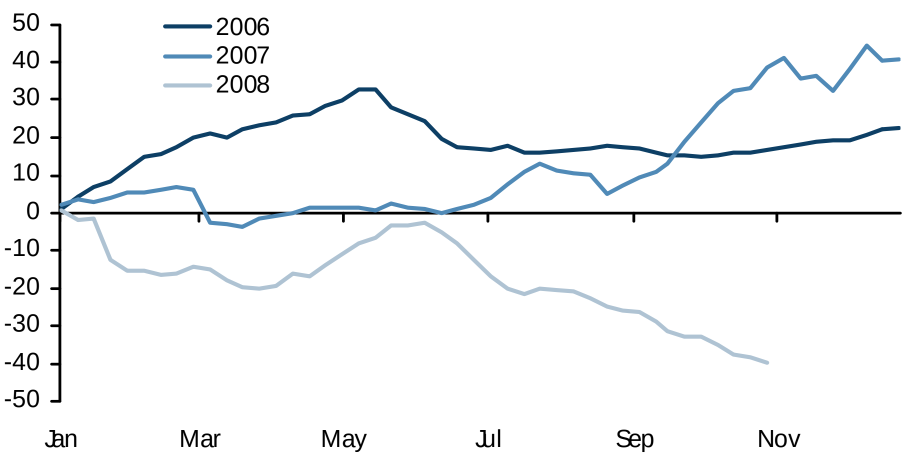
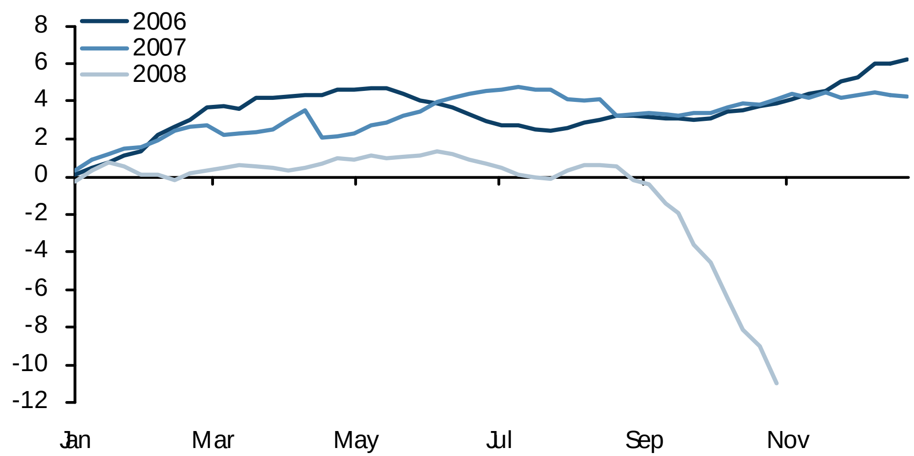
1- In addition to fundamentals, flows crucial for performance

- International investors exited from both EM equity and bond markets, with the outflows from latter accelerating recently as the credit crunch has significantly weakened EM sovereign bond prices. EMEA and LatAm asset prices have been additionally impacted by the broad-based fall in commodity prices
- Macroeconomic uncertainty has likely converged with redemptions from EM funds to trigger large portfolio outflows
- Adjusted by valuation changes, the equity and bond stocks held by foreign investors are already at the beg-2006 levels: most of the inflow in the boom years is already gone.

Cumulative flows to dedicated EM equity funds (USD bn)



Cumulative flows to dedicated EM bond funds (USD bn)



Note: adjusted by regional MSCI total returns. Source: EPFR Global, Barclays Capital.

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2- The credit channel in the Arab economies

- The crisis will affect the Arab economies through the various channels discussed today

- The credit channel is most critical, although with varying degrees across the countries (Gulf, vs. MENA)

- The effects are likely to be contained given the absence of structural defects in most banks in the Arab region (Gulf, Egypt, Lebanon)
    1. Strong capital base
    2. Relatively high on liquidity
    3. Profitable
    4. Relatively strong supervision
    5. Continued reforms in the financial sector
    6. Wealthy sovereigns with strong external balance sheet

- Presentation largely based on experience in GCC countries

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2- The credit channel: external and domestic factors

- Definition: Central bank actions affect output, in part, by causing shifts in the supply of loans.

- External factors affecting the credit volume:

    1. Oil revenues recycled through the banking system domestically
    2. credit volume received from international banks and capital markets

    ➔ Both are significantly reduced

- Domestic factor affecting the credit channel: Monetary easing and the credit response

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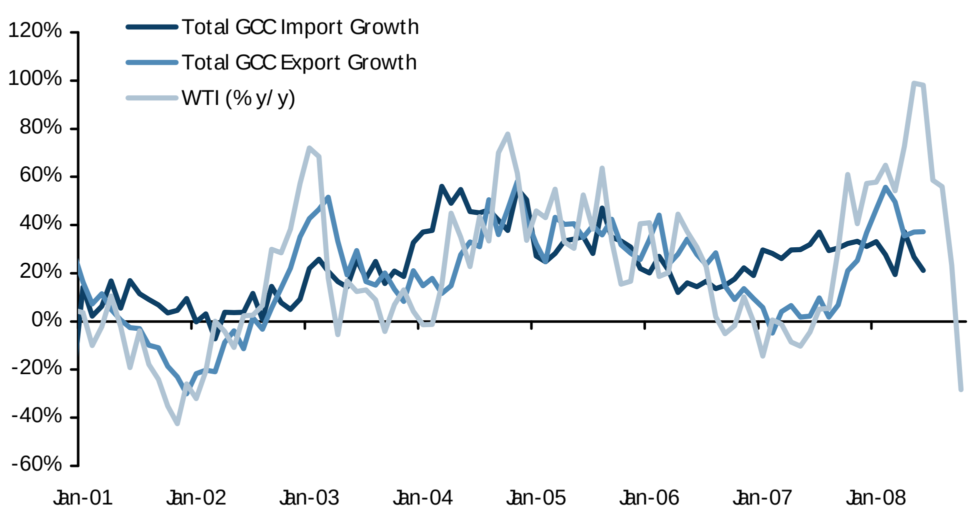
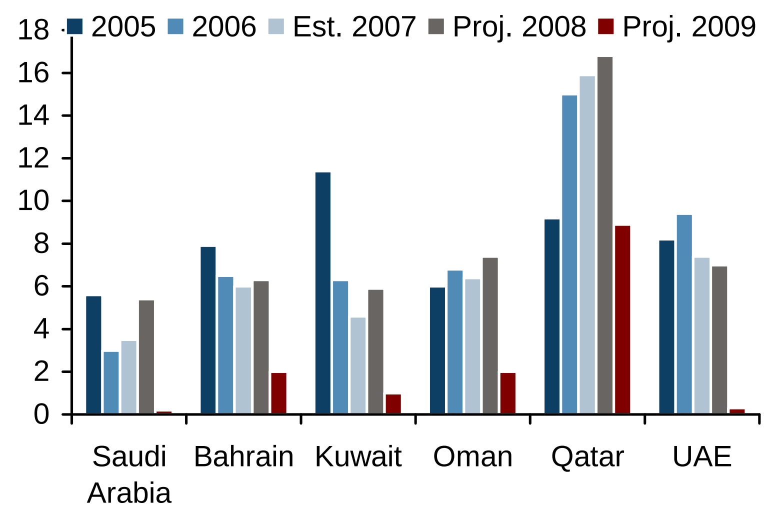
2- External factor: The dissipation of oil windfalls

- In 2007, credit growth was growing rapidly largely fuelled by oil windfalls and capital inflows into the financial sector
- Global demand for oil decelerated sharply as both OECD and EM countries growth fell
- Oil receipts plummeted leaving banks with less inflows than originally planned

Imports, Exports and Change in Oil Prices



Real GDP growth (yoy %)



Note: adjusted by regional MSCI total returns. Source: EPFR Global, Barclays Capital.

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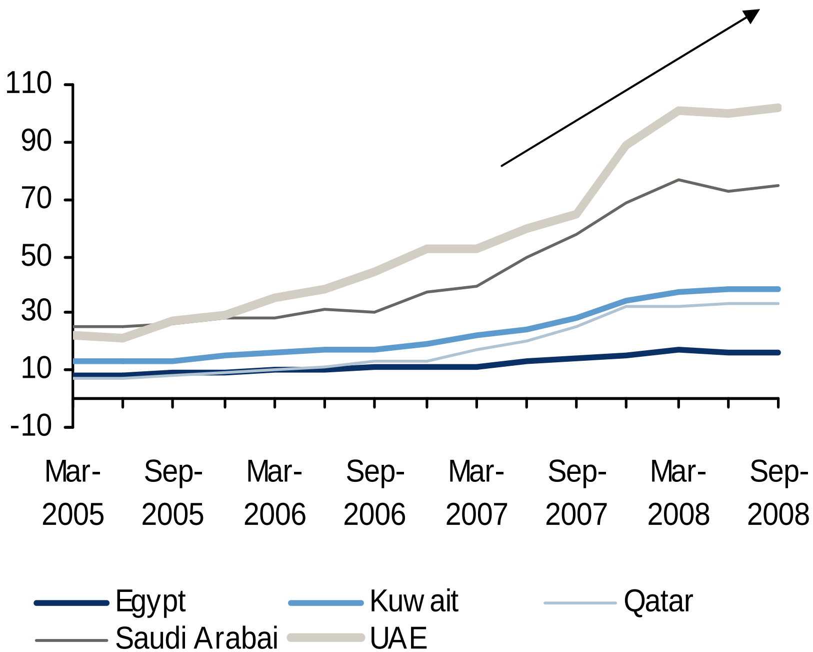
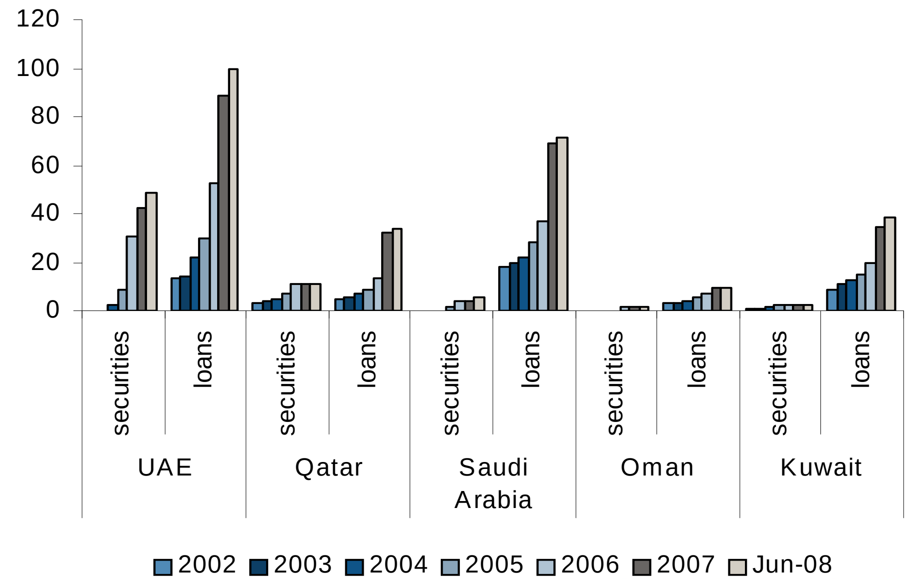
2- External factor: Increased reliance on external finance

- Banks and corporates have been highly reliant on external sources of funding from international banks and international capital markets, especially in UAE
- Much of the funding to banks has been used to finance loan extension

Cross-border loans from foreign located banks to selected GCC and Egypt ($bn)



Stock of loans and securities outstanding reported by BIS banks (bns $)



Source: IMF, Haver, Barclays Capital

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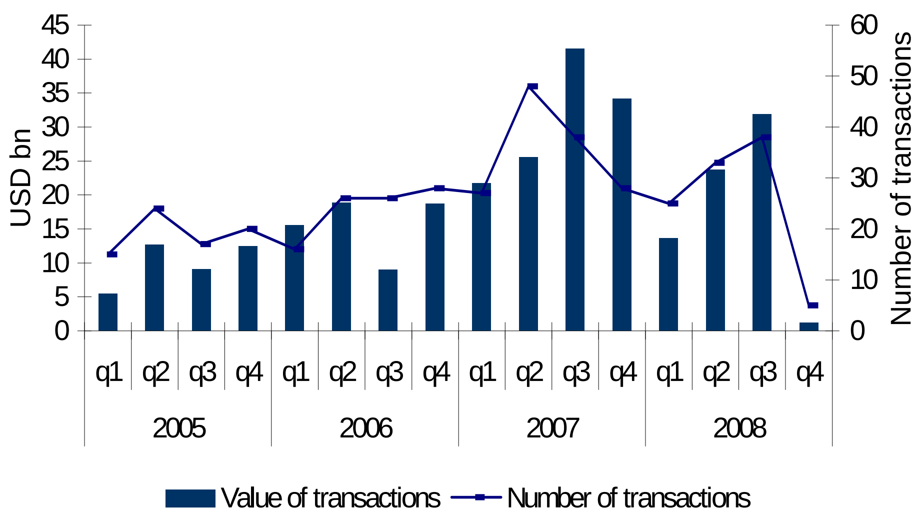
2- External factor: Credit volume to narrow as credit markets remain closed

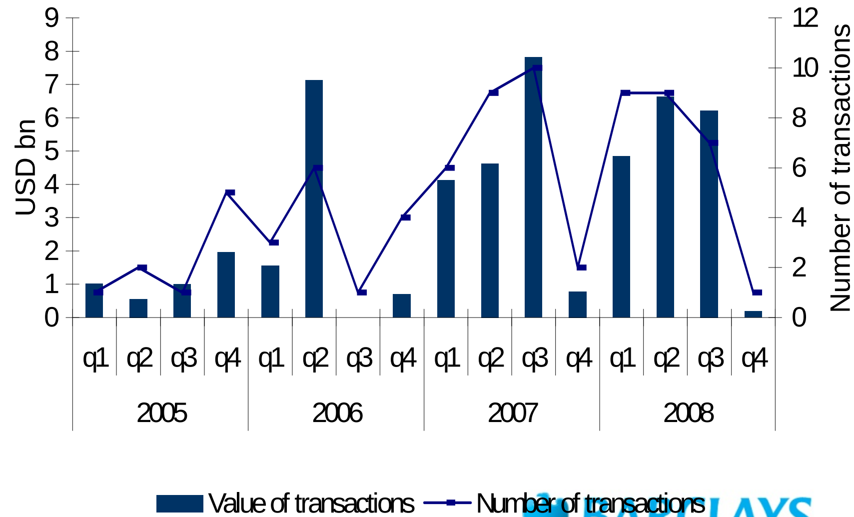
- The value of transactions in syndicated loans and sukuk in the region fell sharply
- The restricted access may be prolonged as global risk aversion is still prevalent
- Difficulties in credit syndication and borrowing in foreign currency (Dubai)

➔ Sudden stop of bank credit to firms that relied extensively on foreign credit recycled through domestic banks. Companies and banks pushed to scale down their balance sheets.

Loans to GCC companies



Islamic finance transactions in GCC



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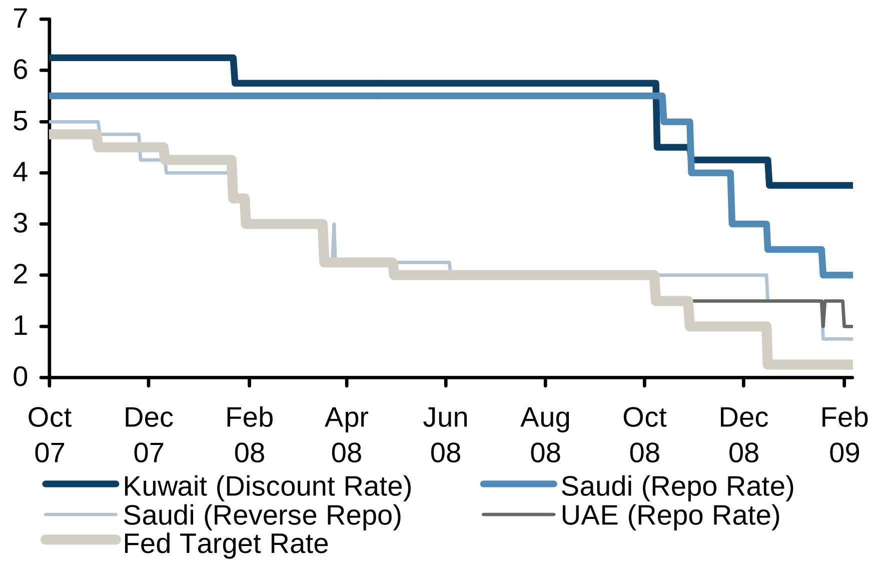
Source: Deal Logic

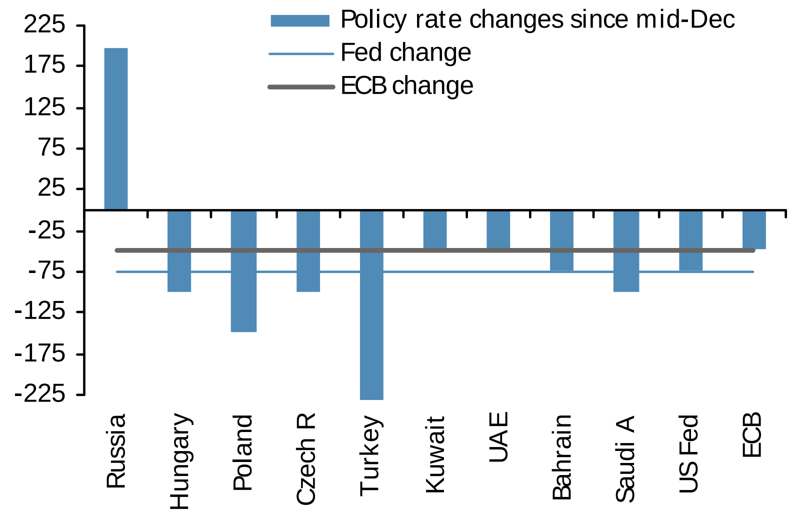
2- Domestic factor: Central Banks eased monetary policy stance

- Attempts to make the credit channel work
- In the GCC, monetary authorities proceeded with significant rate cuts
- In Egypt, as inflation receded, the CBE cut overnight deposit and lending rates.
- But market reaction has been slow to come, notably in the Gulf.

Rate policy changes in GCC countries



Rate policy changes in emerging Europe



Note: adjusted by regional MSCI total returns. Source: EPFR Global, Barclays Capital.

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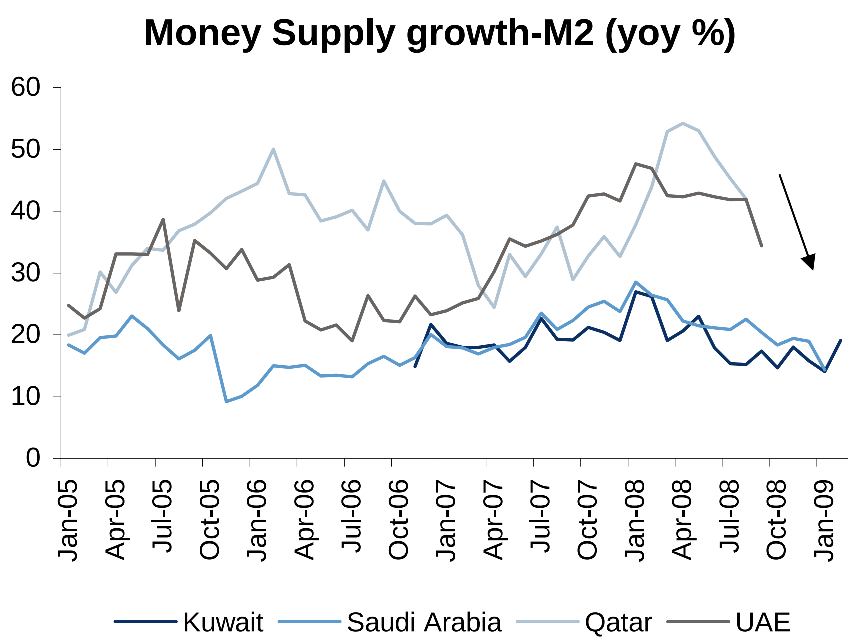
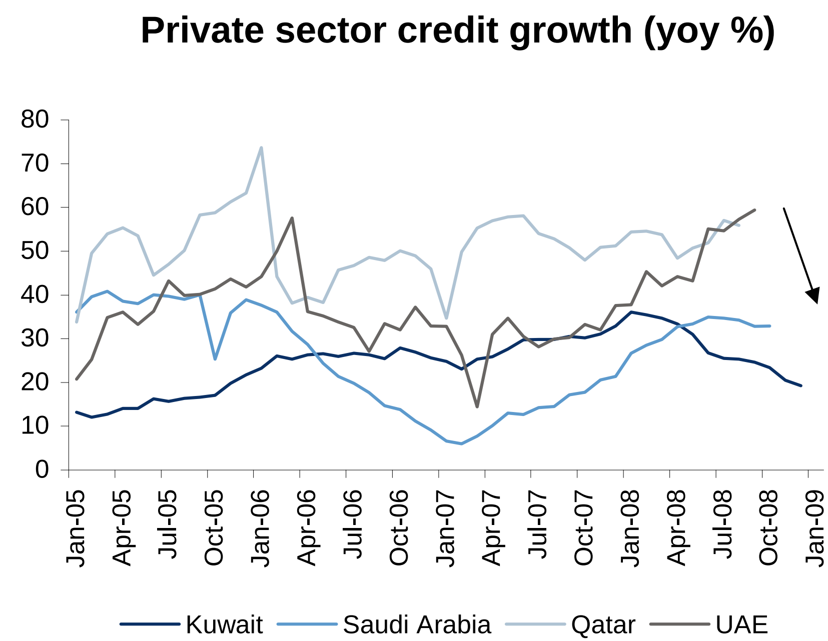
2- Domestic factors: Effect of monetary easing is subdued

- Despite monetary easing, money supply is decelerating
- Private sector credit growth is also cooling down
- Massive injection of capital and liquidity has not yet trickled down into an increased supply of loanable funds.



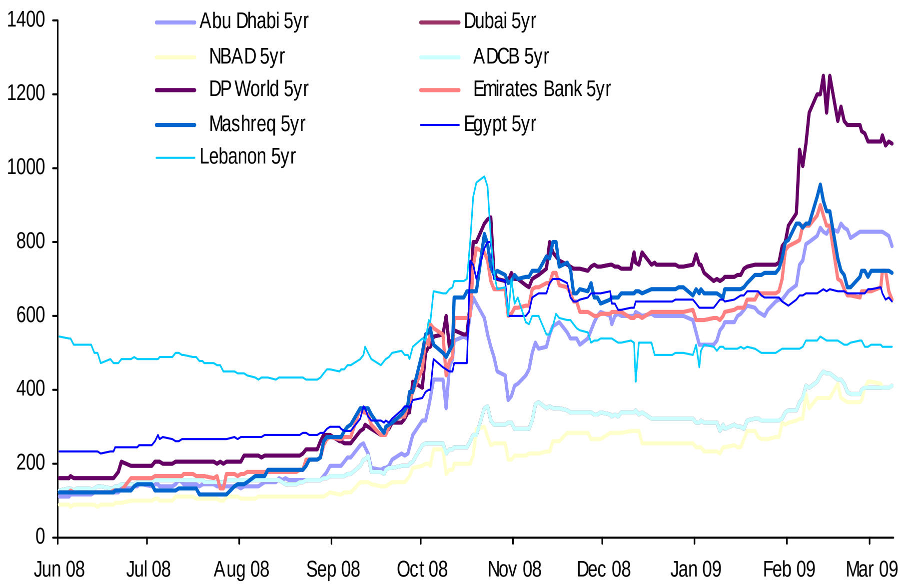


Note: adjusted by regional MSCI total returns. Source: EPFR Global, Barclays Capital.

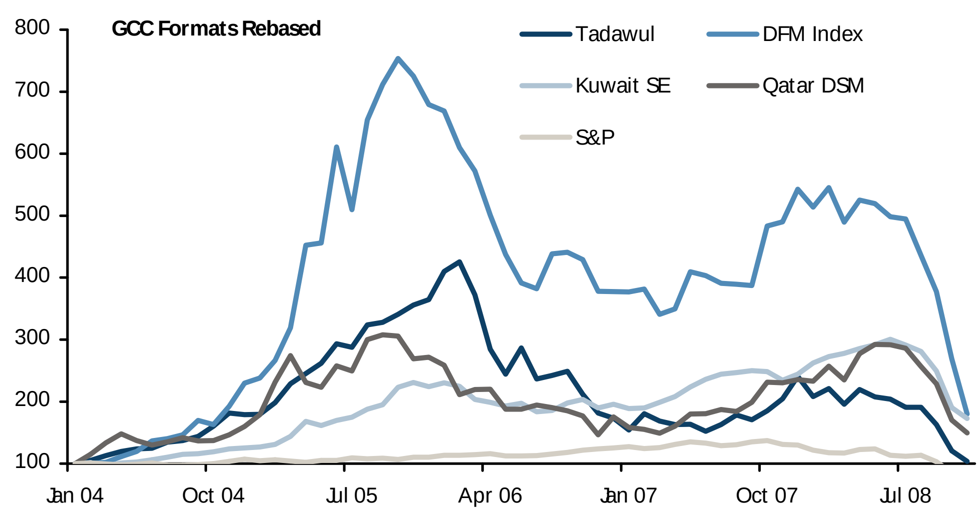
2- Domestic factors: impairment of bank's asset quality

- Exposure to falling equity markets in the region
- Increased exposure to the ailing real estate sector (on average 30%)
- Correction of property is significant (30-40%)
- Rising NPLs, provisions, and significant reduction of profits, all affected the credit score of the country

Credit market Performance



Regional Equity Indices



Source: IMF, Haver, Barclays Capital

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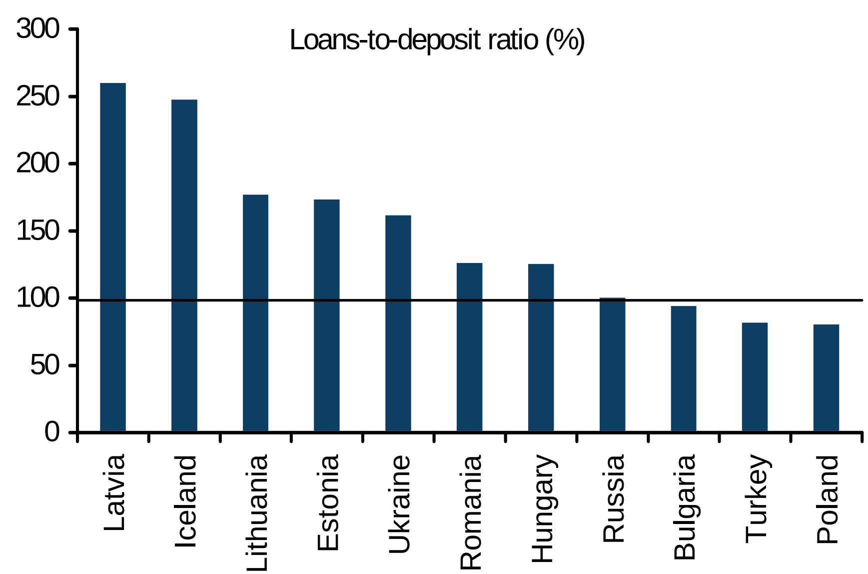
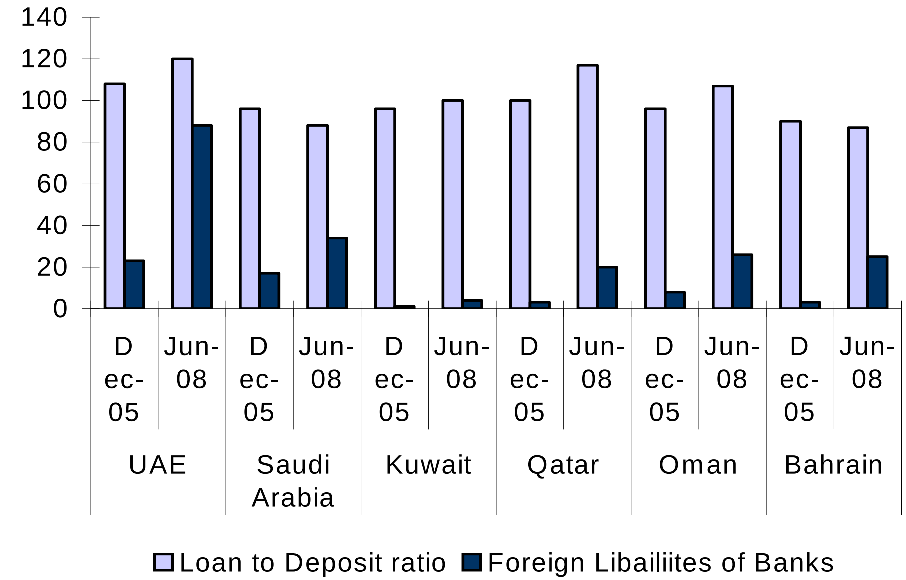
2- Domestic factors: Liquidity is dire

- In crease in loans to deposit ratios beyond 100%
- Over-extension of credit line using short-term capital inflows and deposits.
- Deposit base is not growing as rapidly

Loan to deposit ratios in Central Europe



Loan to deposit ratios (%) and banks' foreign liabilities ($ bn)- GCC



Source: IMF, Haver, IIF.

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3- Policy responses and future challenges

- GCC authorities responded to the financial crisis by adopting a number of measures:
  1. Ensure adequate access of banks to central bank liquidity
  2. Guarantee of retail deposits
  3. Massive injection of long term deposits
  4. Allow conversion to Tier 2 capital.
  5. Reduction in reserve requirements

  Others being considered:

  1. Improve bank's access to offshore debt markets: Guarantee new wholesale debt of major banks (UAE)

- As financing conditions from international markets deteriorate, we expect banks to seek government and central bank financial support, adding more strain on the fiscal side.
- We could witness a rethinking of the investment and asset allocation strategies of SWFs to traverse the liquidity squeeze.

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3- Policy responses and future challenges

Moving ahead:

1. Need to strengthen supervision and regulatory capacity of national institutions.

2. Greater transparency and timeliness of data release on the banking and financial sector.

3. Construct and enhance the understanding of the country's external balance sheets

4. Regular examination of the scale and composition of gross international assets and liabilities

5. Assessment of extent to which the local banking system is able to absorb a sudden deterioration in global financial market conditions and the likely pass-through to domestic credit conditions and the real economy.

To sum up

- The credit channel is clearly significant, more in the gulf than in other countries
- The authorities measures to provide liquidity and ease local market conditions are a step in the right direction and may need to be stepped up should a correction in real estate markets unfold.
- Focus on safeguarding financial stability is critical in the short to medium-term.

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