Gulf Research Center

Knowledge for All

Impact of the US Financial Crisis on GCC Countries

GRC Report

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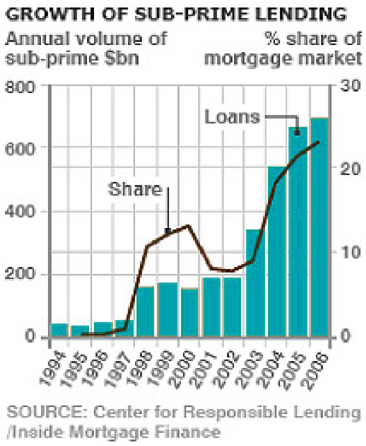
Introduction

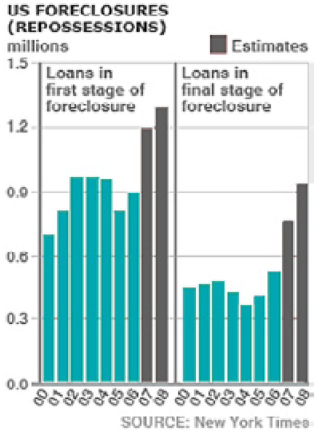
The subprime crisis, which started in the US in 2007, has developed into a full-blown international financial crisis with potentially severe consequences for the GCC countries and their growth models. Hopes that the GCC countries and emerging markets in Asia like China might be able to decouple have proven futile. All of them have considerable assets in the US but most importantly, they have been hit by the increased costs of funding and liquidity problems in the wake of the crisis. After showing resilience in 2007 and remaining relatively unaffected by the global subprime turmoil in 2007, the GCC equity markets have suffered much more than the ones in the US and other developed markets. In Saudi Arabia and the UAE (Dubai), indices have shed more than 40 percent since the beginning of 2008.

After giving a short overview of the current crisis, this report gauges its possible impacts on the GCC economies, namely the exposure of banks and sovereign wealth funds to asset write-downs, higher financing costs and widening bond spreads for corporations and banks, and the likely impact on demand for GCC export goods such as oil, petrochemicals and aluminum.

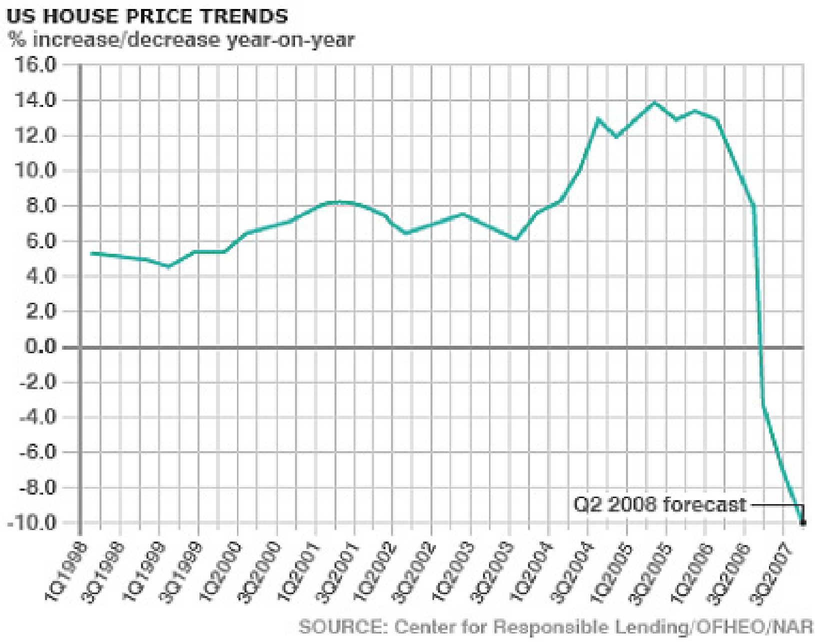
The Financial Crisis Formerly Known as “Subprime Crisis”

Fuelled by access to cheap credit, a housing bubble developed in the US from 2001. Outstanding credit volumes skyrocketed and there was a confluence of supporting factors. The Fed followed a low interest rate policy, while the banks marketed risky mortgage products aggressively (e.g. teaser rates, interest-only adjustable-rate mortgages or ARM) and increased the lending to subprime customers at reduced risk premiums. Home owners in turn got used to ever-increasing house prices and increased borrowing against their house values without regard for the implied risks. Finally, a burgeoning securitization industry and the practice of putting assets in off balance Special Investment Vehicles (SIV) led to the bubble, as rating agencies were complacent and gave unrealistic ratings based on model calculations. The first cracks appeared in 2006, with home prices falling in some segments and foreclosures increasing. The real outbreak of the crisis then came in March 2007 when more than 25 subprime lenders in the US declared bankruptcy, announced significant losses, or put themselves up for sale.





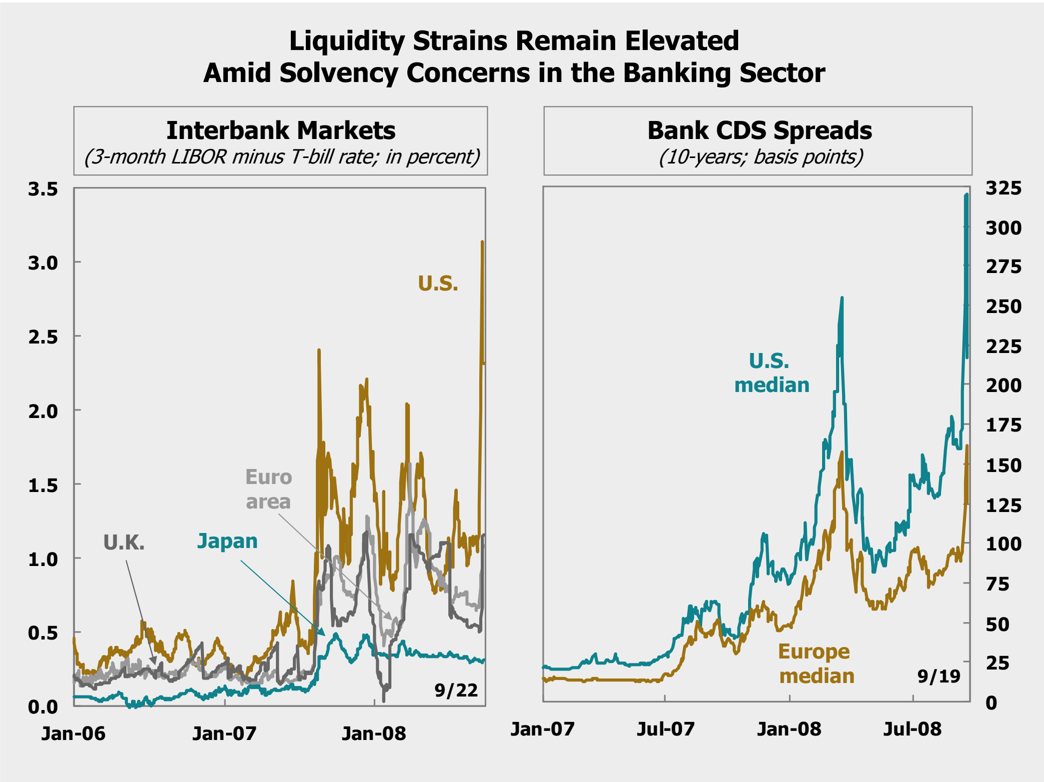
While in the beginning the crisis only affected real estate related companies like home builders and mortgage lenders, it has since spread and developed into a general liquidity and credit crunch that affects various asset classes such as money market funds, credit default swaps and other OTC derivatives. As a result, major banks have declared bankruptcy, sought government bailouts or looked for potential buyers to save them.



Lehman Brothers went bankrupt, while Bear Stearns and Washington Mutual had to be bought by JP Morgan Chase, which has fared comparatively well through the financial crisis thus far. An initial capital injection into Merrill Lynch by the Kuwait Investment Authority (KIA), the Korean Investment Corporation, Mizuho Financial Group of Japan and Singapore's Temasek was not enough and Merrill Lynch was finally acquired by Bank of America for $50 billion in stocks. Equally the Abu Dhabi Investment Authority (ADIA) purchased a 4.9 percent stake in Citigroup for $7.5 billion in a structured deal that grants it an 11 percent interest payment before acquiring Citi shares at a price range of $31.83 to $37.24 between March 15, 2010 and September 15, 2011. At current prices of Citigroup shares,[1] and disregarding the interest income from the bond component of the deal, ADIA's Citigroup investment has lost almost half of the value, about $3.4 billion thus far.

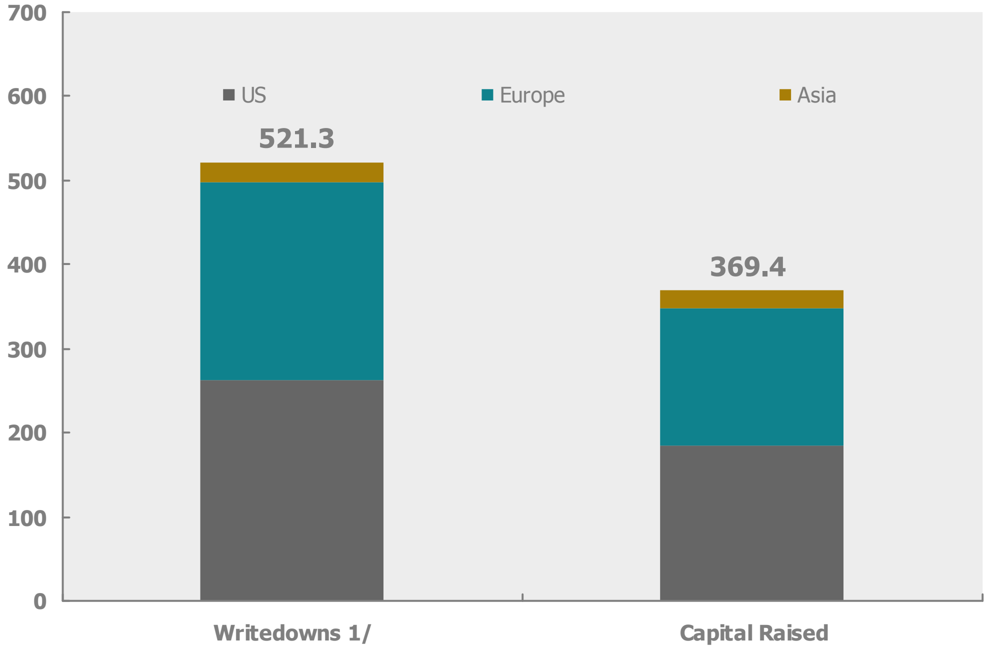
Morgan Stanley was rumored to be in merger negotiations with Wachovia Corporation, which in turn has been the target of bankruptcy speculation recently and is now eyeing a merger with Wells Fargo after initial negotiations with Citigroup failed to produce results. With the announcement of the last two remaining independent US investment banks, Morgan Stanley and Goldman Sachs, in September 2008, about a change in their status from broker to "bank holding," the business model of independent investment bank, which had acquired a glamorous reputation over the last decade, has ceased to exist. From now on, they will be fully regulated banks with corresponding capital adequacy requirements but also with the ability to seek liquidity from the Federal Reserve Board.

As a result of the crisis, interbank liquidity has dried up and refinancing costs have increased dramatically. Over half a trillion US dollars in write-downs had already occurred by the end of September, mainly in the US and Europe. Officially acknowledged write-downs in Asia have been considerably lower.



Source: IMF

Global Bank Writedowns and Capital Infusion
(in billions of U.S. dollars)



1/ Includes writedowns due to asset valuation, yet to be passed through income statement.

Source: IMF

As a reaction to the crisis, the Fed and the US Treasury have taken the following measures:

- Lowering of fed fund rates to the current 1.5 percent. The last 0.5 percent cut was done in unison with other central banks worldwide thus signaling the international dimension of the crisis
- Lowering the discount rate more than the fed fund rate and opening the discount window for refinancing via lower rated securities that had not been accepted previously (e.g. commercial paper)
- Arranging the sales of Bear Stearns to JP Morgan Chase with a total credit facility of $55 billion, of which $29 billion were a non-recourse facility to JP Morgan thus effectively putting most of the risk of the transaction on taxpayers' shoulders
- Nationalizing Fannie Mae and Freddie Mac by buying $200 billion of preferred stock, thereby effectively guaranteeing more than $5 trillion liabilities of the two companies
- Nationalizing AIG by taking over 80 percent of the company's share capital in exchange for an $85 billion loan. An additional injection of a $37.8 billion facility by the Fed became necessary shortly after on October 8
- "Troubled Assets Relief Program" (TARP), a $700 billion emergency stabilization package for illiquid structural products and bad loans, for which essentially no market exists at this stage and whose "real value" is impossible to define; thus, additional funds might be eventually necessary. Instead of just buying distressed assets, on October 13 the

US government has decided to use $250 billion of TARP in order to buy stakes in banks directly and shore up their capital, like European states had done shortly before

- The US financial crisis has become an international one, markets and banks elsewhere are now seriously troubled as well. The UK has partly nationalized its banking system. The three-part package encompasses a capital injection of $85 billion, $340 billion of fresh funds for interbank lending, and a $425 billion guarantee of bank debt. Germany too has approved a $635 billion rescue plan for cash-strapped banks that would include guarantees to jump-start the frozen interbank lending market, liquidity support and offer up to $95 billion for recapitalization of distressed banks by the state, if necessary. Equally, the EU has declared a common umbrella of guarantees for its banking system alongside measures on the national level by its various governments

It remains to be seen whether the US bailout package and similar programs by other governments will be sufficient. Estimates by Goldman Sachs in November 2007 of subprime losses reaching a total of $400 billion have proven to be way too low and current estimates may continue to stay behind the curve. Government estimates about anticipated costs are often too low as the Iraq war has shown. Nobel laureate Joseph Stiglitz estimates the cost of the Iraq war at $3 trillion if all hidden and opportunity costs are included, considerably higher than the $700 billion expenditure for the war thus far and much higher than the $50 billion, which then Secretary of Defense Donald Rumsfeld had announced at the beginning of the war. In the end the total costs of the current financial crisis might be substantially higher than the bailout programs that have already been announced, with economist Nouriel Roubini gauging them at $2 trillion.

If successful, the bail out package(s) might prevent a deflationary scenario and move the problem from the micro level, i.e. the threat of bank failures, to the macro level, i.e. increased inflation due to liquidity injections and increased skepticism regarding the dollar and the hegemonic standing of the US financial system. Combined with existing borrowing needs, the US Treasury may easily need to sell up to half a trillion dollars worth of debt before the end of the year. With the US savings rate essentially zero, the buyers will need to be foreigners – they already own, half of all outstanding US Treasury debt. Thus, it will be the Asians and Gulf Arabs with their surplus savings who will need to foot the bill of the bailout package, not the American taxpayer alone.

The Direct Financial Effect: Subprime Exposure of GCC Banks

With an estimated $1.8-2 trillion in foreign assets by the end of 2008, of which about 60 percent are held in US dollar, the GCC countries must naturally be concerned about asset depreciation. However, the most visible effects of the US financial crisis thus far have not been caused by direct exposure to troubled assets but in indirect form, as the GCC countries and their burgeoning project finance markets have been affected by the rising costs of borrowing and declining availability of large credit facilities.

Thus far only a limited number of Gulf banks have publicly admitted and quantified their exposure to the subprime crisis. Abu Dhabi Commercial Bank has announced an exposure of $272 million and has sued Morgan Stanley and other banks for wrong advice in the case of an ill-fated SIV deal.[2] Bahrain's Arab Banking Corporation has to cope with write-downs of $1.2 billion;[3] Kuwait-based Gulf Investment Corporation has announced write-downs of $246 million at the end of 2007 and is expected to add another $200 million by the end of this year,[4] while 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 $966 million and raise additional capital.[5] Although S&P deems overall Gulf subprime exposure as limited, it reckons that banks may be concealing related losses and more might surface going ahead. Among others, Qatar Insurance Company has also been associated with possible subprime losses.[6]

The UAE Central Bank has asked UAE banks to declare their exposure to Lehman in the wake of the bankruptcy of the US bank, but no public announcement by banks about further exposure has resulted from this measure. Exposure could be in the form of bank bonds, derivative trades where Lehman has acted as counter party (e.g. credit default swaps) or structured investment products that were guaranteed by the failed US investment bank. In mid September 2008, UAE's Central Bank Governor Nasser Al-Suwaidi ruled out a systematic risk exposure of the UAE in the context of the financial crisis in the US. Three of the UAE's largest banks state no or limited exposure to the Lehman bankruptcy, according to Reuters.[7] The Saudi Arabian Monetary Authority (SAMA) was quick to announce that no serious Lehman exposure of Saudi banks exist, amidst serious doubts that with time passing, such exposure may well surface or in fact might be already there but is not being acknowledged. On the other hand, the Central Bank of Bahrain conceded on September 17, 2008 in an interview with MEED that banks in Bahrain could be carrying exposure to Lehman Brothers but did not give any details.[8] Tawuniyya, the leading Saudi insurance company, has lost about two thirds of its value since January 2008, severely underperforming in an already battered Saudi stock market.[9] The loss in market capitalization cannot be explained by problems in the operating business alone, and may well be attributable to exposure to dealings with AIG, the US insurance giant.

Altogether the hitherto announced subprime exposure of GCC banks of about $2.7 billion seems to be small compared to more than $500 billion in Europe and the US. Part of this may be attributable to a lack of transparency with more exposure likely to surface over time, for sure; on the other hand, anecdotal evidence suggests that GCC banks have been relatively conservative compared to their American and European peers. In many cases, the investment criteria of banks did not allow the purchase of non-investment grade bonds or complicated structured products and an occasional lack of sophistication may have proven to be beneficial for some banks, now that such products are literally discredited.

Officially Announced Subprime Losses of GCC Banks

Bank	Write-downs in $ million
Abu Dhabi Commercial Bank	272
Gulf Investment Corp.	246 (another 200 expected)
Gulf International Bank	966
Arab Banking Corporation	1200

However, the majority of assets in the region are not managed by banks but by Sovereign Wealth Funds (SWFs) like Abu Dhabi Investment Authority (ADIA) or Kuwait Investment Authority (KIA). The SWFs invest in a broader range of securities, but public data about the size and composition of their assets is not available, and one has to rely on estimates. As they are sophisticated investors with a considerable equity component of 40 percent and more, according to estimates, their exposure to the current market turmoil must have been considerable. They probably have also invested more in riskier debt structures like CDOs than the region's banks. Unlike banks they do not have to act when the values of these assets decrease on a mark to market basis; in case these assets do not default, they have the luxury of holding them until maturity or until the storm has hopefully passed. Still, unlike 2007, the losses of 2008 must have hurt the region's SWFs to a considerable extent, although they have diversified portfolios and have enjoyed continuous inflows because of relatively high oil prices. Larger overseas investments of GCC companies, like Emaar's $1.05 billion investment in John Laing Homes, the second largest privately held home builder in the US or SABIC's $11.6 billion purchase of GE Plastics, have not been faring too well either and will affect the foreign asset position of the GCC countries negatively for the time being.

The Indirect Financial Effect: Rising Costs of Finance and Tight Liquidity

While the direct subprime exposure of GCC banks has been limited thus far, the real problem for the GCC banks lies in the indirect exposure to increased costs of funding amidst maturity mismatches and credit exposure to local consumer, project and real estate financing.

With inflation in double digit territory and interest rates in the lower single digits, massively negative real interest rates in the GCC countries do not constitute a compelling incentive to save. At the same time, a lot of funds that were speculating on revaluations of local GCC currencies have been withdrawn in the wake of the recent strengthening of the dollar. Thus, GCC banks need to turn increasingly to the capital markets to refinance themselves. But here the cost of credit has risen tremendously as the following chart shows; spreads for corporate bonds in the GCC have risen from around 145 a year ago to over 500 basis points above LIBOR and the EIBOR, the Emirates interbanking rate, has approximately doubled since June 2008.

GCC Corporates (GCCI): Spread above LIBOR, HSBC/ DIFX GBCI Index

Source: HSBC, DIFX

A major reason for this distressed scenario is the deterioration of Dubai-related credit that constitutes a large part of the GCC bond market universe, as the emirate borrowed extensively to finance its development projects and Dubai Inc. companies were among the most prominent issuers in the GCC. While on October 10, credit default swaps for Saudi Arabia traded at 125, for the UAE at 174, for Samba at 265 and for Abu Dhabi National Bank at 216, Emirates Bank and Dubai Ports World traded at 580 and Nakheel signaled severe caution on the part of investors as it traded close to a staggering 2000 and doubts existed about its sukuk which will expire in December 2009.[10] Dubai will need to refinance $6 billion of debt in 2008 and another $16 billion in 2009, according to JP Morgan.[11] The CDS market clearly shows increased concern about debt funding of local projects and the real estate market. As a vast amount of long-term projects have been financed with short-term funds, this maturity mismatch puts additional pressures in current tight capital markets.[12]

The GCC bond markets had shown some sign of weakness in 2007 with major issues like Bahrain's Ithmaar Bank's $300 million sukuk or Abu Dhabi's First Gulf Bank's $3.5 billion eurobond program being postponed because of unfavorable market conditions. Equally, the $1 billion sukuk of Sharjah-based Dana Gas had to be postponed initially and could only be placed after a convertible component was added. SABIC initially aimed at raising $2.7 billion via bond issuance in 2007 to finance its purchase of GE Plastics but had to finally settle for $1.5 billion.[13]

The problems of 2007, however, seem mere hiccups compared to the constrained financing conditions in 2008. The syndicated loan market in the GCC is now severely disrupted, according to senior banking sources. International banks, which are a dominant force in the local project finance market as they have larger capitalizations than their GCC peers, are reluctant to extend their commitments as they face liquidity constraints in their established markets at home. Postponements, modifications and drawdowns of loans have become a widespread occurrence.[14] According to Reuters, the Middle East has borrowed 16.5 percent less in the third quarter of 2008 (down to $91 billion from $109 billion a year ago), a trend that is likely to continue in the fourth quarter.[15] Overall $15 billion of foreign currency debt (loans and bonds) have to be repaid in the GCC in 2008 and $35 billion in 2009, plus $6.9 billon in local currency. Half of the outstanding debt will come from the UAE alone.[16] Among those debts will be $6.5 billion bond issues, which will need to be refinanced, such as the ones of Emirates Bank and Mashreqbank. The conditions that these issuers are facing have worsened considerably with spreads on GCC corporate bonds now much higher than the 80 basis points and over Libor and less that prevailed during 2006 and early 2007.[17]

Recent Developments in GCC Credit Markets

Country	Loan Taker	Loan Amount	Action/Forecast
Qatar	Qatar Investment Authority (QIA)	$ 3 bn	Repaid instead of securing refinancing loan
Kuwait	Global Investment House	$410 mn	Increase of margin by 35 bps to 210bps over LIBOR
UAE	Dubai Bourse	$3.78 bn	Refinancing problems of loan facility
UAE	Port & Free Zone World (Dubai World)	$1.003 bn	Reduction from $1.25bn
UAE	DIFC Investments	$1.5 bn	$1.5bn., five year loan under discussion since June 2008, is now in doubt as Barclays bank and others show withdrawal of support
UAE	Dubai Aerospace Enterprise	$1 bn	Negotiations since July, uncertain future

UAE	Investment Corp. of Dubai (IDC)	$6 bn	Complete drawdown of existing loan facility that had been arranged prior to the crisis
UAE	Nakheel	$3.52 bn	Worries about Nakheel's sukuk maturing in December 2009 push CDS of the company to 2000
UAE	Shuweyhat 2 Water and Power Plant, Abu Dhabi plus sewage project	$1.28 bn	Calyon contemplates withdrawing its underwritten share of the $3.7 billion projects using exit clauses

Sources: Reuters, MEED, Zawya

While GCC central banks had been preoccupied with runaway credit growth and inflation during the first half of 2008, they have now started to react to the liquidity crunch by monetary easing and other stabilizing efforts. The UAE was the first GCC country whose government announced guarantees for bank deposits thus echoing similar measures in the US and Europe, and the UAE central bank has tried to alleviate liquidity bottlenecks by providing an additional Dh50 billion short-term facility to banks. Initially this has done little to ease tight liquidity in UAE markets and the EIBOR has continued to rise. The terms offered were deemed too expensive, and against the backdrop of deteriorating international markets, skepticism persisted. This has led to an additional injection of Dh 70 billion on October 15, which was well received by local equity markets.

The Kuwaiti central bank chose a more active approach than its UAE peer by cutting its benchmark discount rate from 5.75 percent to 4.5 percent on September 29, followed by active liquidity injection which has led to declining interbank lending rates since October 5. In Saudi Arabia, SAMA equally cut its repo rate to 5.5 percent for the first time since 2007 and reduced reserve requirements from 13 percent to 10 percent on October 12. As SAMA has resisted rate cuts since September 2007 when the Fed started easing, there is room to maneuver for further rate cuts.

Generally, it seems that GCC central banks are increasingly following an accommodative stance at the expense of anti-inflationary considerations. However, they have acted unilaterally thus far and have not found a common policy like the European Union. If interbanking rates start to differ considerably due to different policies and their differing reception in each country, the more successful one country is in bringing down rates the more likely it will attract borrowers from neighboring countries. Authorities will need to address this, otherwise they may be tempted to impose some kind of capital controls to make sure that the accommodative measures they are undertaking will benefit their own economies and do not evaporate via open capital markets.

Sovereign Wealth Funds Stepping in?

It has been speculated that Sovereign Wealth Funds and state-linked funds of the region might help out and invest increasingly in the domestic market although this runs counter to their traditional practice of investing overseas in non-oil assets in order to diversify the overall economic capacity.[18] In Russia, there have been discussions on using the funds of the “Stabilization Fund of the Russian Federation” to shore up its badly-shaken stock market which lost 65 percent in the wake of the financial crisis and the fallout of the Georgian crisis.[19] In China, the China Investment Corporation (CIC) was allotted $200 billion from Central Bank funds in 2007 in order to pursue more strategic investments in foreign equity that could be potentially higher yielding than the traditional investments of the central bank government and agency bonds.[20] But after an initial ill-fated $3.5 billion investment in Blackstone which has lost 40 percent of its value since then and a similarly hapless $5.5 billion purchase of 9.9 percent of Morgan Stanley, it has turned to investments in the domestic Chinese market.

The SWFs of the Gulf have a much longer experience with equity investments than their Asian counterparts, although they do not have the experience and capacities to evaluate investment decisions in domestic markets. It remains to be seen whether they are going to build up such capacity, and possible trends of increased GCC SWF activity at home need to be monitored. In Kuwait, the Kuwait Investment Authority (KIA) announced in September that it was considering investing within the country to prop up local capital markets, but no detailed figures about possible investment targets or troubled asset exposure of Kuwait banks were given. The announcement suggested some sense of urgency and estimates about the possible investment volume were as high as $15 billion.[21] In an unprecedented move the Qatar Investment Authority (QIA) has set aside funds of $5.3 billion on October 13 in order to buy up 10-20 percent stakes of the local Qatari banks. Beside the liquidity easing measures of central banks and purchases of bank and company shares by SWFs, direct placement of SWF funds with local commercial banks to shore up their deposits could be a distinct possibility. It remains to be seen whether other GCC SWFs may follow the example of the KIA and QIA and whether they will play the white knight for a badly-shaken GCC banking scene should things aggravate further. Moody’s assumes that Abu Dhabi would help out Dubai companies with equity if a systemic bail-out was needed.[22] Bank mergers could also be a distinct possibility: National Bank of Dubai and Emirates Bank merged in 2007, and a merger is now also being contemplated for Abu Dhabi Commercial Bank and Abu Dhabi National Bank.

Sovereign Wealth Funds and State-Funded/State-Controlled Entities in the GCC

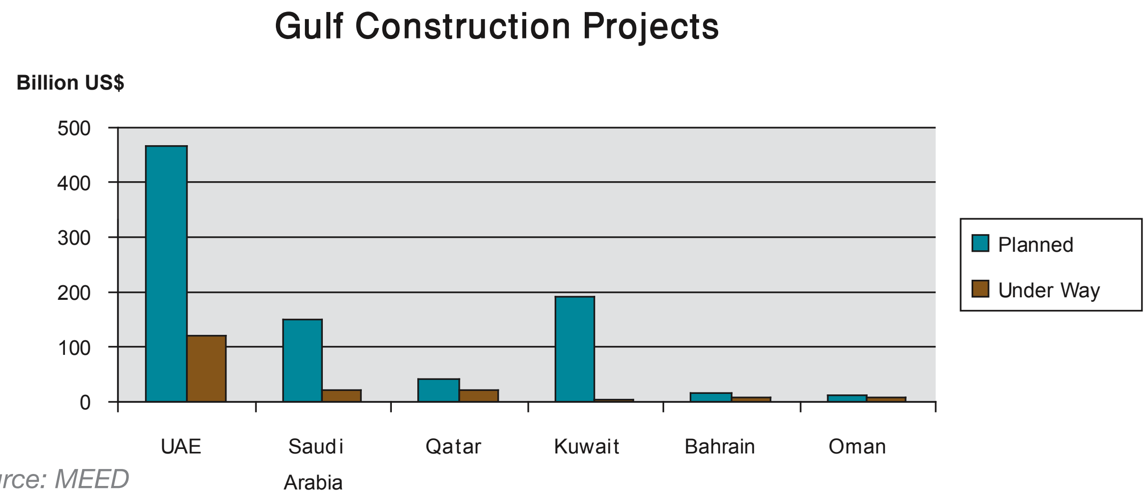
	Country	Fund	Year of Inception	Assets - (USD Billion)	Date of estimate/ reported data (2008 unless noted)	Source (RGE Monitor estimate unless noted)
Commodity Funds						
	UAE	Abu Dhabi Investment Authority (ADIA)	1976	600	Q2	est
	UAE	Mubadala	2002	25	2008	est
	UAE	Abu Dhabi Investment Council		20	2008	est
	UAE	Dubai International Capital (DIC)	2003-4	15	Q1	est
	UAE	Istithmar Global	Restructured in 2007	6	Q1	est
	UAE	Istithmar Real Estate	2007	10	Q1	est
				31		
	Saudi Arabia	Saudi Arabia Monetary Agency (SAMA) Non-reserve Foreign assets	1952	380	May	SAMA
	Saudi Arabia	other government institutions		60	May	SAMA
	Kuwait	Kuwait Investment Authority (KIA), Reserve and Future Generations Funds	1953	266	March	Kuwaiti Press
	Qatar	Qatar Investment Authority (QIA)	2004	65	Q2	est
	Oman	State General Reserve Fund (SGRF)	1980	10	2008	est

Note: Some estimates for ADIA are considerably higher and close to $900 billion

Source: RGE Monitor Estimates, Rachel Ziemba, Foreign Assets of Selected Wealth Funds/Government Investment Vehicles, August 2008

Effects on the Real Economy

It is now widely recognized that the financial crisis will spill over into the real economy and cause a recession, if not an outright depression as some analysts fear. The notion that was held by some until recently that China or the GCC countries could decouple from this trend must be deemed futile. The effects on the GCC countries will be far from negligible and will not be confined to the financial sector but will affect the real economy as well. Most notably, the demand for crude oil and products of the GCC's heavy industries like petrochemicals and aluminum will suffer. Besides, large project finance will not be as readily available as in the past and might affect the cost structure or even the feasibility of some mega industrial projects. The real estate sector will be equally hit especially in more heated markets like Dubai, where it has relied heavily on debt financing and speculation. Luxury demand from high net worth individuals from abroad and affordability for domestic demand are likely to decrease while projects that are still in the planning stage could face a financial squeeze. Whether this will lead only to a slowdown and not an outright collapse as Citigroup has argued recently in a research note remains to be seen.[23]



Source: MEED

Oil Demand

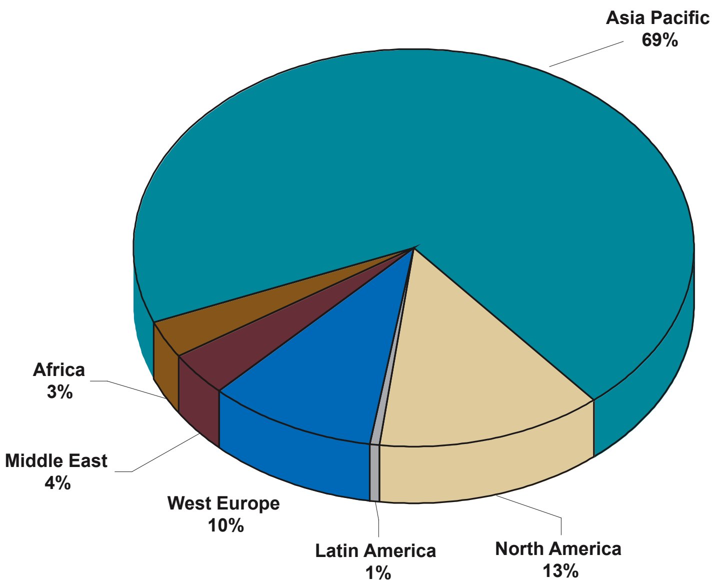
Oil prices have corrected considerably from their highs close to $150, and rampant optimism and speculation have given way to a bearish bias that emphasizes nascent signs of demand destruction. Supportive fundamental factors that have brought about the paradigm shift in oil prices in recent years like tight supply scenarios, inflation of money supply and dollar weakness are not in focus at this stage. By using various indicators, Deutsche Bank assumes possible corrections towards the lower $60 dollar area, where oil could be regarded as "cheap." This would still be considerably higher than the average long-term price in real terms ($35) and leave GCC countries with comfortable budget surpluses. In Saudi Arabia, for example, the budget is balanced as long oil stays northwards of $55, while the positions of Russia ($70), Iran and Venezuela ($95) are less comfortable, and it is not surprising that the latter two called for OPEC production cuts once oil corrected to the $100 level. It is conceivable that OPEC would engineer such cuts to support the market in the near future as oil has corrected below $80 and other producers such as the GCC countries are starting to feel uncomfortable as well. OPEC is considering an emergency meeting for November 18, 2008 in Vienna even before the next official meeting which is scheduled for December 18, 2008 in Algeria.[24]

Indicators Oil Price Level	
Budget balance	$55-95
Marginal cost of production	$80
Based on futures forecasting error	$80
As a share of S&P500	$60-90
As a percent of US disposable income	$60-85
As a percent of global GDP	$40-75
Relative to G7 per capita income	$45
Versus US dollar	$30-60
In real terms (PPI)	$35
Average	**$61**

Source: Deutsche Bank, Crude Oil: Price Discovery to the Downside, Research Note, October 10, 2008

GCC exports of crude oil and refined oil products in 2007 amounted to 15m b/d, and its consumption of refined oil products stood at 2m b/d. Nearly 70 percent of GCC's exports of oil in 2006 went to Asia, 10 percent to Western Europe and a slightly higher share of 13 percent reached North America.[25]

GCC's Export Destinations of Oil and Refined Products*

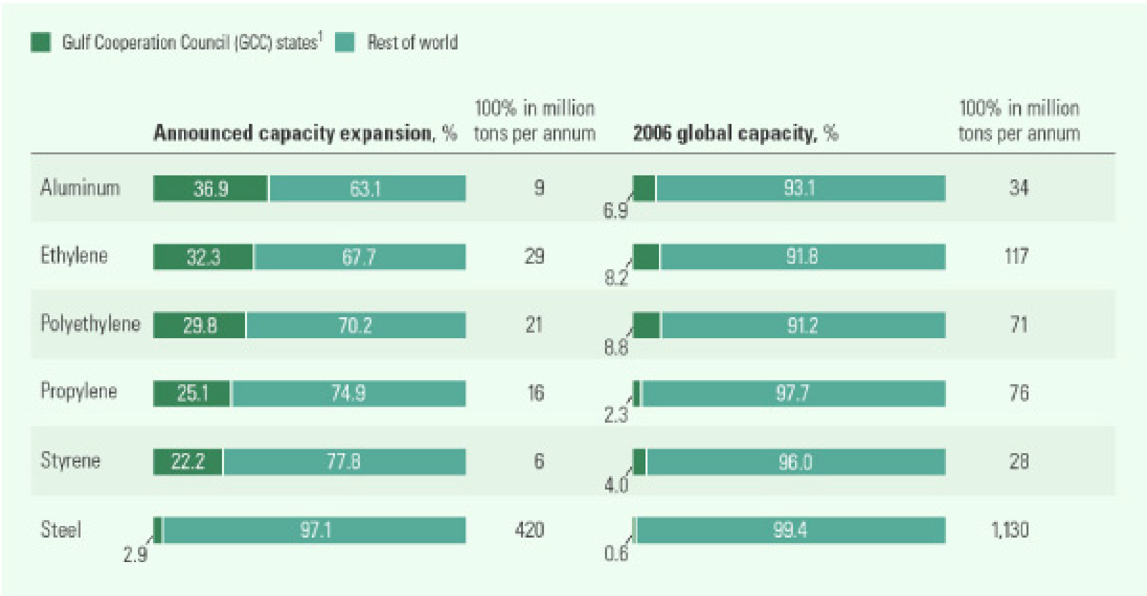


**2006. Note: Excluding Non-OPEC GCC states Oman and Bahrain*
Source: OPEC, Annual Statistical Bulletin 2007

Petrochemical Products

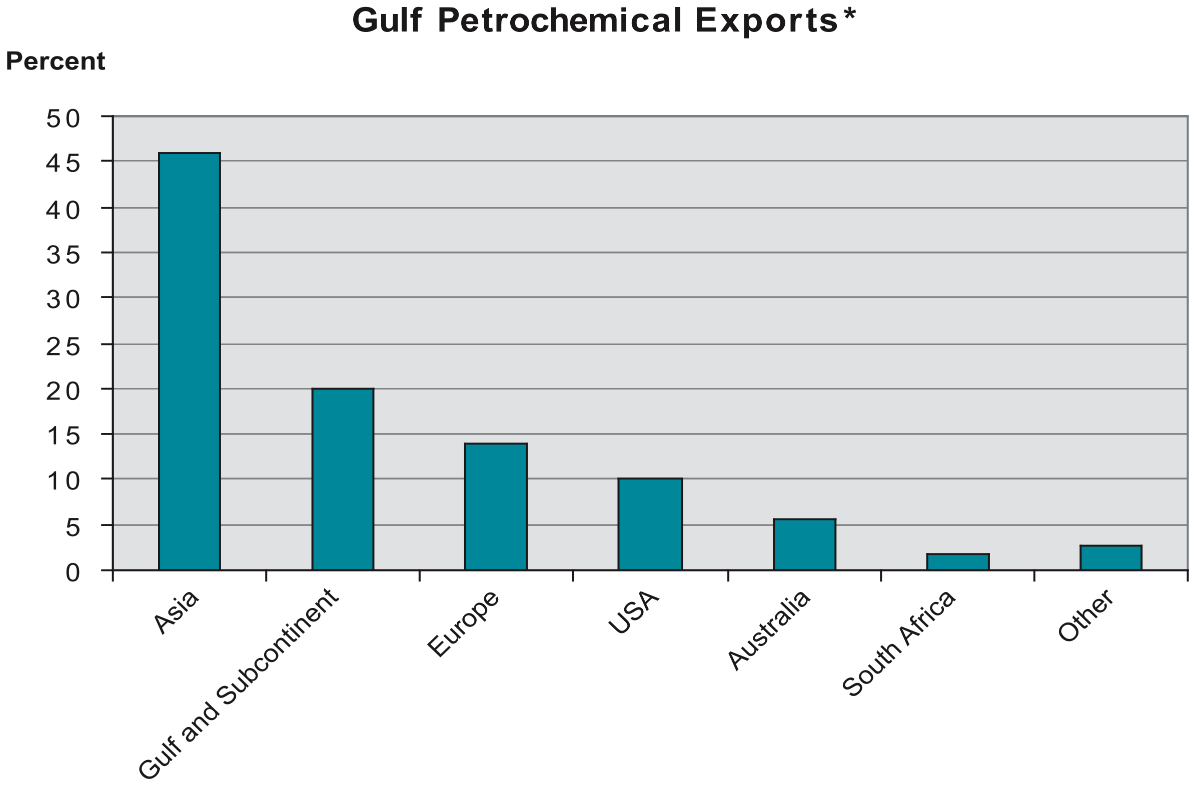
The GCC's global share of petrochemical production is close to 10 percent and is set to increase with ongoing multibillion expansion projects. About 30 percent of worldwide announced capacity additions in ethylene and polyethylene production are of Gulf companies, well above the region's share of 8.2 and 8.8 percent of global capacity (2006) in these two items.[26]

Heavy Industries: GCC's Share in Worldwide Production



Source: Mc Kinsey

The petrochemical industry is a major pillar of GCC diversification efforts and a logical choice as they strive to extend the value chain of their crude oil production.[27] GCC petrochemical companies like Borouge or SABIC are expanding internationally and seeking to develop into global leaders in their field as SABIC's purchase of GE Plastics has shown, for example. In terms of geographical distribution, there is once again a strong though less pronounced role of Asian countries. The bulk of petrochemical exports from the Gulf went to Asian countries (46 percent), while 14 percent went to Europe and 10 percent to the US. About 20 percent remained in the region or was exported to the subcontinent.



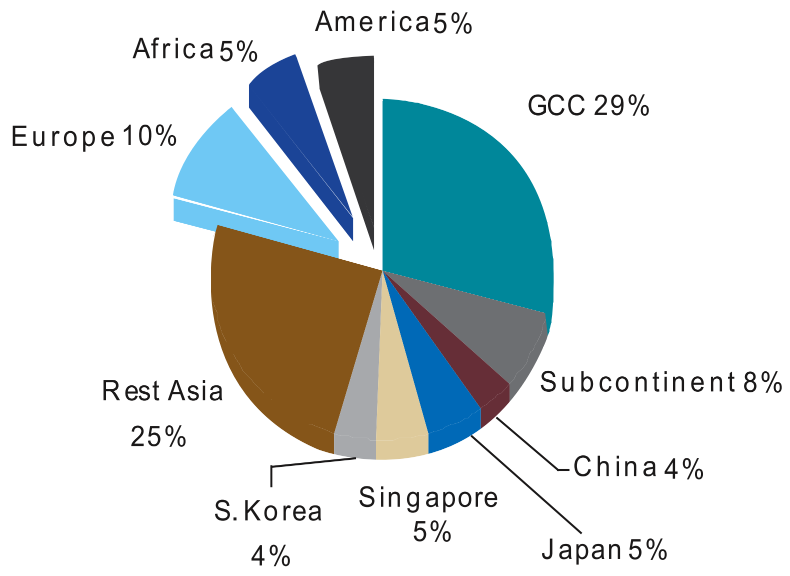
**2005, Including Iraq and Iran*
Source: SABIC

Aluminum

The GCC countries' share in worldwide aluminum production will increase from the current 7 percent to 13 percent in 2012.[28] National and international aluminum producers strive to profit from the relatively cheap energy costs in the GCC, and multi-billion expansion projects are on their way. However, some of these projects may not materialize, as project finance is not readily available anymore and a looming natural gas shortage in the region puts the necessary energy supplies for such projects into question. The planned aluminum smelter of Rio Tinto in Al Ruwais had to be put on hold for this reason. In any case, aluminum has developed into an important industry in the GCC. ALBA alone consumes more than 40 percent of Bahrain's electricity production and in 2006, DUBAL was contributing more than 7 percent to Dubai's GDP. Both companies have advanced to the world's seventh and eight largest aluminum producers respectively.[29]

The bulk of GCC's aluminum exports went to Asian countries – mainly due to the relative geographic proximity – while intra-GCC trade of aluminum amounted to 29 percent of overall aluminum export. Europe imported 10 percent, and the US and Africa 5 percent, respectively, according to latest available data from UN Comtrade.

GCC's Aluminum Exports*



*2006. Source: UN Comtrade Database

Note: For UAE and Kuwait 2007 data are not yet available. Subcontinent includes India, Pakistan, Sri Lanka, Maldives, Nepal and Bangladesh

As Asian nations such as China account for the bulk of demand for GCC crude oil, aluminum and petrochemical products, and as their export-led growth models are getting hurt by the ongoing recession, negative impacts on demand for GCC export goods can be expected. To take aluminum as an example: In 2006, China accounted for 25 percent of worldwide aluminum consumption and 55 percent of its global demand growth.

Conclusion

With less than $3 billion officially acknowledged, the direct subprime exposure of GCC banks has been limited thus far, although further exposure is likely to surface. Presumably, the exposure of the region's Sovereign Wealth Funds (SWFs) has been higher as they have been more sophisticated in their asset allocation, although data are not available due to the relative opacity of such funds. As they have enjoyed large inflows due to high oil prices and have diversified portfolios, the impact is probably manageable.

Much more important than the direct impact of the international financial crisis is its indirect effect on the GCC countries, as financing becomes scarce and its costs soar. Corporate spreads in the GCC have widened dramatically, and a couple of companies have already witnessed problems in refinancing existing bonds and loan facilities. The region's markets for large-scale project finance and real estate will be particularly affected by this credit crunch. Possible mitigation measures on the part of the GCC countries could include liquidity easing measures by the central banks without encouraging further credit growth. If push comes to shove, cash injections and strategic domestic investments by the region's SWFs could also be contemplated, most notably in GCC companies like SABIC or Emaar that position themselves internationally and are key for the future diversification of the region's economies.

As the financial crisis will cause a recession on an international scale, demand for important GCC export products like crude oil, petrochemicals and aluminum will be affected. As their budgets are balanced only as long as oil prices stay northwards of $55, the GCC countries should engineer OPEC production cuts in case oil prices correct further below $80 to stabilize their revenue situation.

Endnotes

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