



Emerging Market Focus

FIM RESEARCH

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GCC: How vulnerable to European shockwaves?

Summary

- In the short term Gulf Arab states are more insulated from the impact of the European sovereign crisis than other MENA countries, such as those in North Africa.
- For Gulf oil exporters, uncertainty about the direction of oil prices is the most potent risk related to the European debt crisis. Gulf equities are coupled on the downside with global markets.
- Given European banks' rather large claims on the GCC (UAE in particular), some deleveraging in Europe could affect the GCC markets. However, abundant FX reserves and government proactivity would likely lead to some mitigation of the impact.

While European policymakers and the IMF have hammered out a loan package of almost USD1trn designed to dodge a potentially scathing and wide-reaching sovereign debt crisis, the ripple effect of debt troubles in Europe is unlikely to disappear in the coming months. **In the short term Gulf Arab states are more insulated from any European deleveraging than other Middle East countries, such as those in North Africa. Gulf banks' exposure to Europe is contained and provides little systemic risk.** Still, any precipitous and sustained price drop in commodities such as oil or global equities would not bypass the Gulf.

Oil price: the key factor to watch

For Gulf oil exporters, uncertainty about the direction of oil prices is the most potent risk related to the European debt crisis, which otherwise would have moderate direct implications for the region's fiscal and monetary wellbeing. Oil prices averaging above USD55/bl for the year would be high enough to enable the UAE, Kuwait, Qatar, Oman and Bahrain to balance their fiscal budgets while keeping state spending at elevated levels to support an economic recovery. In 2009, as WTI averaged USD62/bl, Saudi Arabia witnessed a very manageable USD18.7bn budget deficit.

Oil price fluctuations will, however, hurt business confidence and, if sustained, will affect private sector psychology. Oil at USD55/bl, while providing sufficient state revenues, would shake confidence greatly. **For each dollar drop in the price of oil, the weekly opportunity cost amounts to USD56m for Saudi Arabia, USD19m for the UAE, USD11.5m for Kuwait and USD9.6m for Qatar.**

Currency pegs: not under pressure

Gulf currency pegs to the USD are also a moot point for the short term. The strong USD makes importing cheaper, easing some inflationary pressures. Consumer prices have varied substantially in the Gulf over the past year, with Qatar and the UAE experiencing periodic deflation due to acute falls in housing prices and others, such as Saudi Arabia, continuing to witness relatively higher inflation. **Saudi Arabia, Kuwait, as well as Oman (due to higher price pressures) are set to benefit most from the currency effect resulting from a structurally weaker EUR, which will make imports of machines, luxury goods and vehicles, and other items more competitive.**

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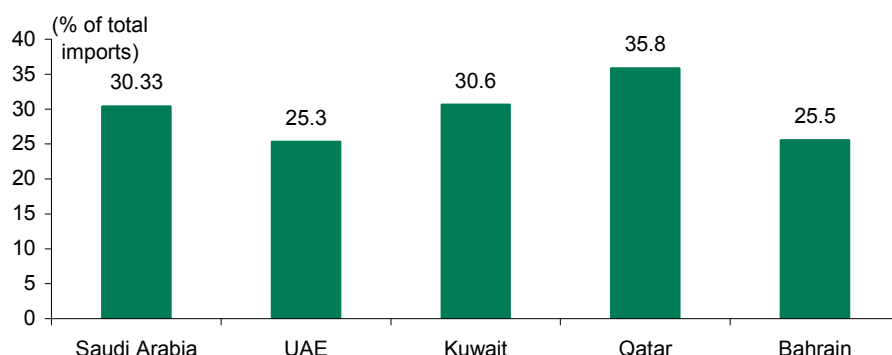
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Inflationary pressures will not be a cause of worry for the Gulf this year. Saudi inflation rose to 4.7% in March, although we anticipate that, in the event of a slowdown in global commodity prices and lower pressure on rents at home, the overall rate for the year would be 4.3%, down from 5.1% in 2009. **Only Qatar is expected to experience a second year of deflation in 2010 albeit a mild drop, considering that as recently as 2008 inflation averaged a high 15% for the year. In the UAE, the recent liberalisation of fuel prices is going to exert some upward momentum on inflation, forecast at 2.5% for 2010.**

Impact on trade: manageable

The region relies heavily on imports, particularly of foodstuffs, a large part of which comes from Europe. A quarter of imports to the UAE and Bahrain arrive from Europe, while more than 30% of imports to Saudi Arabia, Kuwait and Qatar are sourced from the Eurozone, according to official data. **Declines in the value of European exports to the Gulf could enable exporters to gain greater market share countering Asia's ever-growing role.**

Gulf reliance on imports from Europe



Source: Official data of respective countries

Gulf states are also a major source of oil and non-oil exports to Europe and, as exports become more expensive and European economies slow down, these could doubly hit Gulf exports. **Still, with trade links in Asia gaining greater prominence, only 10.5% of Saudi exports are destined for Europe while only 5.8% of Qatar's are, palling in comparison to Asia's 55% and 80% share of each country's exports, respectively.**

With forecasts of higher energy demand from Asia this year, we expect it will be relatively easy for Gulf states to post current account surpluses, particularly as import costs fall. Saudi Arabia made a current account surplus of USD26.5bn last year despite subdued world trade conditions, and we expect the surplus to rise to USD46bn this year.

While Europeans visiting the Gulf will face lower purchasing power, meanwhile, **we do not expect tourism to Dubai and Oman to be hit in a major way as both destinations will opt for price resilience so as not to dissuade tourists.**

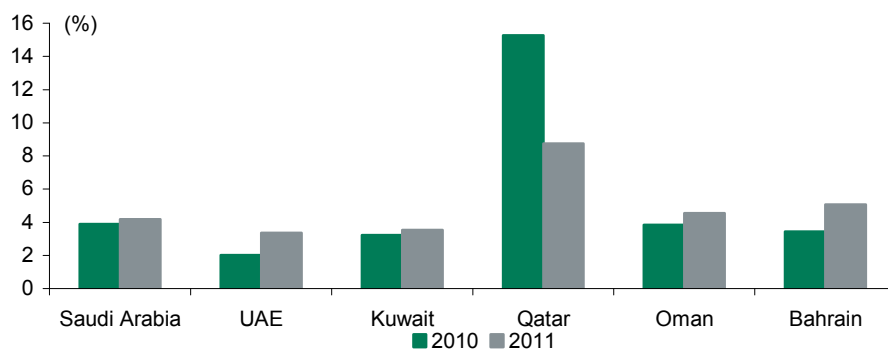
Economic vulnerabilities: looking beyond Dubai

The Gulf is for the most part insulated from the Greek crisis, but the UAE does exhibit some vulnerability due to the debt troubles facing the emirate of Dubai, contending with debt exceeding USD100bn, including USD25bn under negotiation for restructuring. An escalation of troubles in Europe will only raise the burden on Dubai, which – like Greece – relies heavily on the support of its wealthier neighbour, Abu Dhabi, to bail it out of tight spots in exchange for adopting greater austerity measures.

Kuwait, heavily reliant on crude oil exports, is affected most by oil price swings since almost 94% of state revenues come from oil – the highest ratio in the Gulf. Kuwait's often paralysed parliament in recent years has meant infrastructure projects have been shelved, keeping more money in state coffers that it can now draw on to weather the crisis. The parliament passed a

USD104bn four-year development plan in February to reduce dependence on oil and stimulate the private sector.

Gulf GDP growth rates seen accelerating this year



Source: Crédit Agricole CIB

One key drawback of volatile oil is the risk that, if oil prices worsen, OPEC would be forced to scale back output to curtail oil supplies. A decline in oil output would also dim the prospects for economic growth across the region this year. **Our 2010 forecasts for real economic growth now stand at 2.0% in the UAE, 3.9% in Saudi Arabia, 3.2% for Kuwait and 15.3% for Qatar – the world's top exporter of liquefied natural gas, where the government is bringing new natural gas capacity and production on-stream. Growth in Oman and Bahrain should also exceed 3%.**

Gulf equities are coupled on the downside with global markets. Petrochemical stocks, seen as a proxy to world trade and oil prices, were the main drag on the Saudi index recently. Even if oil offers very auspicious returns for petrochemical companies, a drop in prices has cultivated caution among investors.

In terms of bank risk, we are not particularly concerned about absolute banking exposures of Gulf lenders to Europe and most of the acquisitions of regional sovereign wealth funds have largely taken place based on mostly equity. On the other side, BIS data as at Q409 shows European lenders have around USD174bn of Gulf exposure, US banks a small USD34bn and UK banks USD83bn. **Out of the total exposure of European, UK and US cross-border banking exposure in the Gulf, half is with the UAE, 16% with Saudi Arabia and 17% Qatar.** If a further liquidity squeeze materialises, important counter-cyclical measures can be taken by Gulf banks, based on high FX reserves and non-hesitation by central banks to provide emergency liquidity facilities to its banks. Certain banks in the Gulf are differentiated due to better asset quality and capitalisation but overall there are no systemic bank-wide risks.

Non-oil-sector growth is also likely to be muted across the region this year as banks continue to adopt risk-aversion policies that have reined in credit growth and forced the states to take the upper hand in financing projects, sometimes crowding out the private sector. Saudi Arabia and Abu Dhabi are moving ahead with key energy projects even after ConocoPhillips pulled out of plans for a USD12bn refinery in Saudi Arabia and a USD10bn Shah gas field project in Abu Dhabi this quarter. **Downward pressure on regional FDI flows from Europe are inevitable should conditions worsen.**

There are significant lessons to be learned for the Gulf's own monetary union efforts. Although the Gulf monetary union could lie a few years ahead, there are important liquidity and early warning fiscal and other macroeconomic mechanisms that have to be put in place. Moreover, timing is of the essence and governments and the institutions of the union have to demonstrate resilience and political will.

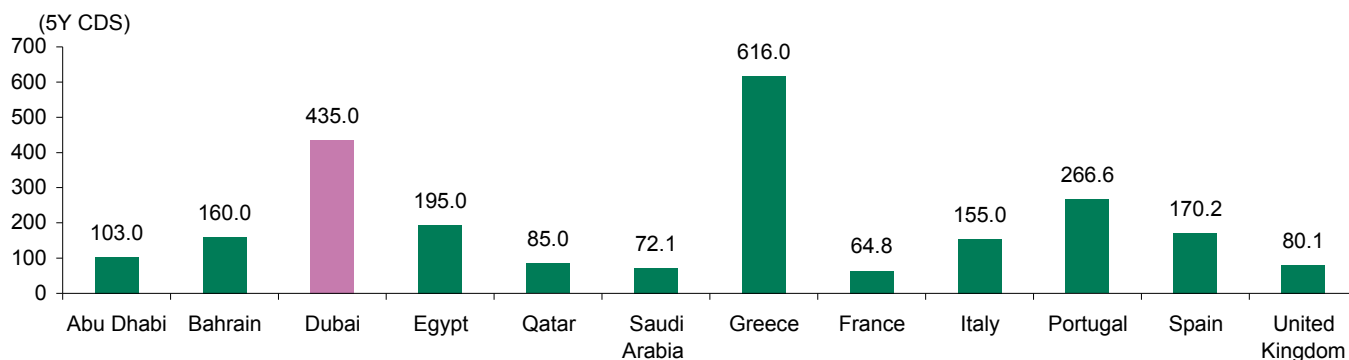
Differentiating credit risk

Should European bank deleveraging pick up pace, the Gulf will be compelled to continue relying on domestic funding sources. **European banks could perpetuate their risk aversion towards the region, except where the borrower affords explicit sovereign or quasi-sovereign status.** The Dubai debacle has compounded risk aversion in the UAE. European bank deleveraging would also hit the book value investments of Gulf sovereign wealth funds. A deepening crisis in Europe could weigh on wider Gulf SWF investments, particularly in property.

Saudi Arabia stands out as a particularly compelling investment case compared with some of its neighbours, owing to its large indigenous population fuelling domestic demand, foreign assets of USD415bn supporting twin surpluses, and noticeable lack of asset price bubbles. The cost of insuring Saudi debt against default remains low relative to regional peers. This week, 5Y credit default swaps (CDS) for Saudi sovereign debt stood at 72.1, about 12bp lower than Qatar and 31bp less than Abu Dhabi. Dubai and Bahrain are perceived as most-likely to default – Dubai CDS stands at 435 while Bahrain's is at 160.

Should European contagion spread, Gulf credit spreads would widen. **Inter-regional differentiation is clearly happening, however, with Saudi Arabia, followed by Qatar and Abu Dhabi, perceived as least risky.** While Gulf issuers had faced challenges in tapping the debt market after Dubai World delayed debt repayment in November, the pessimism has shifted to some extent since then. Bahrain raised USD1.25bn from sovereign issues, against a USD1.0bn target, while bonds issued by National Bank of Abu Dhabi and Banque Saudi Fransi were well oversubscribed.

Dubai debt regarded as most risky in Gulf



Source: Thomson Reuters

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