The Macroeconomics of the Arab States of the Gulf

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Foreword

The Gulf Cooperation Council (GCC) countries have made immense progress in developing their economies over the past ten years. While the prosperity of the region is undeniably linked to developments in the oil and gas sectors, it was prudent policymaking emphasizing domestic investments that led to the region’s rapid growth and increased economic diversity. The importance of the GCC has now expanded beyond oil and gas markets into other sectors: it is a major market for migrant workers, a source of remittances, a financial center, and a hub for international trade and business services. That is why this book not only examines the region’s management of macroeconomic cycles, but also analyzes issues around labor markets, immigration, diversification, and market efficiency.

Some of the region’s challenges are clear. Commodity exporters such as the GCC often run the risk of overreliance on their natural resources, eventually resulting in a “resource curse”. This can originate in inefficiencies in government, or the mismanagement of volatile national income.

Despite these challenges, the region has so far managed to use its oil wealth to provide services for its citizens and to attract the foreign workers and capital needed for the infrastructure developments that will lead to quality-of-life improvements.

Indeed, the GCC countries entered the global crisis from a position of strength. GCC governments had the policy tools and options available to them when they were needed to support domestic demand, provide liquidity support, and recapitalize banks. While the economic impact of most of these measures was intuitively understood by GCC policymakers, by and large only a few such decisions were based on rigorous data analyses. Going forward, ensuring that these policies are implemented for maximum benefit will require the kind of deeper analytical inquiry this book provides.

Fiscal and monetary policies are important aspects of that inquiry in the GCC. With pegged exchange rate regimes, monetary policy is constrained by financial integration, and fiscal instruments become the policymakers’ main method of adjustment. But because these countries now rely heavily on foreign workers and imports, fiscal multipliers may be weak. An important empirical question thus becomes determining the impact of fiscal and
monetary policies on economic activity. It is questions such as these that this book attempts to answer. A fuller understanding of the interplay of these policy choices is vital to the work of the region’s policymakers who are shaping the economic futures of these countries’ citizens for years to come.

The global crisis revealed the region’s strengths and weaknesses, making this a particularly appropriate time to analyze the GCC region’s macroeconomic situation. Such analysis relies on the expertise of this book’s authors but also on the spirit of trust and cooperation that has been cultivated between the International Monetary Fund and its member countries’ authorities. To date, this is the only book available on the macroeconomics of the GCC countries, providing original insights into the functioning of the GCC markets and the policy challenges ahead.

This book, like other IMF work in the region, is part of an ongoing research agenda that recognizes the area’s important contributions to global economic and financial stability. Maintaining and building on that stability are important steps toward broadening equality and fostering prosperity.

Christine Lagarde
Managing Director
International Monetary Fund
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Introductory Chapter

1.1 Introduction

The countries of the Gulf Cooperation Council (GCC) have gone through considerable changes in the last decade, spurred by high oil prices and ambitious diversification plans. The changes have affected literally all sectors of the economy. Large-scale immigration has provided the labor force while capital inflows and financial development have leveraged oil wealth to finance diversification. Regional integration plans are advancing although it is not clear yet what the prospects are for monetary union.

As the GCC economies modernize, macroeconomic policies will gain importance. And with the increasing sophistication of their market economies, policymakers and analysts will need to further their understanding of the macroeconomic structure and of the linkages that are now at work in the region. The aim of this book is to provide original insights into the functioning of the GCC macroeconomy and the policy challenges ahead, and is based on quantitative assessments of the structure of the economy and of the key macroeconomic relationships. Econometric models can now be estimated in the GCC because the structural break that took place in the late 1970s is more than thirty years ago. A major drawback for statistical analysis remains, however, the absence of quarterly data for the national accounts. Analyses can benefit nevertheless from the cross-sectional dimension: panel models are often appropriate because the GCC is a fairly homogenous group. This is one reason why the focus of the book is on the GCC as opposed to a larger group

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1 The GCC comprises six member countries, namely, Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and the United Arab Emirates.
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of Middle-Eastern oil producers, though many of the issues covered in the different chapters would also be relevant for the broader region.

The second reason why we focus on the GCC is that this group of countries has been advancing economic union. In May 1981, the rulers of the six GCC states reached an agreement, formulated in the GCC Charter, that the objectives of the GCC include strengthening ties between peoples, formulating similar regulations in various economic and administrative areas, and fostering scientific and technical progress. The creation of a monetary union has also been an important objective of the GCC that was stated soon after its foundation in 1981.

The GCC economic agreement of 1981 was revised in 2001, setting a timetable to establish a customs union and peg currencies to the US dollar by January 1, 2003. The Common External Tariff was established in 2003, and the common market, giving citizens the same rights and entitlements in each country, started on January 1, 2008. Convergence criteria for a monetary union, to be achieved by 2005, have also been discussed since 2001, and the initial plan was to introduce the single currency by 2010 (Al-Jasser and Al-Hamidy 2003).

The convergence criteria established ceilings and floors on: inflation rates (the weighted average of inflation rates in all members plus two percentage points); short-term interest rates (the average of the lowest three among members’ three-month interbank rates plus two percentage points); foreign exchange reserves (at least four months of imports); fiscal deficits (not to exceed 3 percent of GDP); and public debt to GDP ratios (not to exceed 60 percent). The GCC countries have made a lot of progress and have achieved the convergence criteria on nearly all fronts. Table 1.1 shows the relevant economic indicators for the GCC on average. In addition, GCC countries officially pegged their currencies to the US dollar in 2002–3.

There are both costs and benefits to regional integration, which are well documented and quantified in the literature (see, for example, McCallum 1995 and Frankel and Rose 2002). The most straightforward argument in favor of common markets and currency unions is that countries that lower tariffs and that share currencies trade larger volumes of goods within the union because transaction costs are substantially reduced. International trade

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2 The convergence criteria have been agreed and are under discussion, but are not yet formally adopted.

3 The ceiling would be higher if oil prices fall below $25 per barrel.

4 The GCC currencies have been formally pegged to the US dollar for a long time and have been very stable over the years. The Bahraini Dinar, Qatari Riyal, Saudi Riyal, and the UAE Dirham were officially pegged to the Special Drawing Rights exchange rate, but in practice have moved with the US dollar since the 1980s (Al-Jasser and Al-Hamidy 2003). The Omani Riyal has been formally pegged to the US dollar since the 1970s. The Kuwaiti dinar was linked to a special basket of currencies, but since the US dollar was assigned a very large weight in the basket, its exchange rate vis-à-vis the dollar has remained broadly stable over time.
theory also suggests that a reduction of transaction costs induces a more efficient allocation of resources by encouraging countries to engage in specialization in industries in which they have a comparative advantage. Closely related to this argument is that common markets and currency unions encourage financial integration. The idea is similar: reducing transaction costs encourages greater intra-regional holdings of assets in money markets as well as in equity and bond markets. This is advantageous because risk-sharing within the region allows residents of one country to insure against domestic shocks by holding assets in neighboring countries. Financial integration is also thought to facilitate greater investment in physical capital within a region by allowing borrowers to make use of savings in neighboring countries (see, for instance, Agénor 2003).

A currency union is particularly important for financial integration because foreign exchange rate risk is the biggest risk taken in international financial transactions. In addition, currency union arrangements are good for controlling inflation: pegging currencies to another country that is pursuing a credible anti-inflationary monetary regime is a strong way to anchor inflation expectations. However, as member countries’ central banks lose independence in setting monetary policies, currency unions are fragile when facing asymmetric growth and inflation shocks. A contractionary monetary policy may be appropriate for one country but highly inappropriate for another union member. Mundell (1961) famously highlighted four criteria to judge the benefits of monetary union: (1) the extent of regional trade; (2) the

### Table 1.1. GCC selected economic indicators, 1981–90 average, 1991–2000 average, 2001–10 average

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<tr>
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<tr>
<td>Nominal GDP (USD billions)</td>
<td>184.3</td>
<td>274.2</td>
<td>721.1</td>
</tr>
<tr>
<td>Real GDP growth (PPP GDP weighted average)</td>
<td>0.6</td>
<td>4.2</td>
<td>5.0</td>
</tr>
<tr>
<td>Non-oil real GDP growth (PPP GDP weighted average)</td>
<td>4.6</td>
<td>6.6</td>
<td></td>
</tr>
<tr>
<td>GDP per capita (USD)</td>
<td>10206</td>
<td>18092</td>
<td>20756</td>
</tr>
<tr>
<td>Oil production (mbpd)</td>
<td>11.0</td>
<td>13.5</td>
<td>15.0</td>
</tr>
<tr>
<td>Oil exports (mbpd)</td>
<td>8.2</td>
<td>10.7</td>
<td>14.6</td>
</tr>
<tr>
<td>CPI (period average, percent change)</td>
<td>1.2</td>
<td>1.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Fiscal balance (USD billions)</td>
<td>–7.8</td>
<td>0.9</td>
<td>89.7</td>
</tr>
<tr>
<td>Fiscal balance (percent of GDP, PPP GDP weighted average)</td>
<td>–6.3</td>
<td>5.4</td>
<td>11.6</td>
</tr>
<tr>
<td>Gross public debt (percent of GDP, PPP GDP weighted average)</td>
<td>13.2</td>
<td>56.8</td>
<td>32.1</td>
</tr>
<tr>
<td>Current account balance (percent of GDP, PPP GDP weighted average)</td>
<td>5.1</td>
<td>–4.8</td>
<td>15.8</td>
</tr>
<tr>
<td>Current account balance (USD billions)</td>
<td>12.0</td>
<td>–2.4</td>
<td>121.6</td>
</tr>
<tr>
<td>Gross official reserves (USD billions)</td>
<td>102.2</td>
<td>66.1</td>
<td>280.1</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>18.9</td>
<td>25.9</td>
<td>35.6</td>
</tr>
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*Source: Authors’ calculations*
synchronization of economic cycles; (3) the degree of labor mobility; and (4) the extent of risk-sharing.

Rutledge (2009) covers these aspects in detail, discussing the history and key developments to date and considering the appropriateness of GCC monetary union. Our book therefore does not cover these issues directly. In addition, topics related to the level of the exchange rate and to intergenerational equity are not discussed here either, as exchange rate issues have been covered in Cobham and Dibeh’s edited volume (2009) and in IMF (2008), and there is a recent literature on the optimal spending/savings of resource windfalls under uncertainty (Cherif and Hasanov 2012), capital scarcity (van der Ploeg and Venables 2011), or absorptive capacity constraints (Araujo, Li, Poplawski-Ribeiro, and Zanna 2012; van der Ploeg 2012). This book is about long-term growth and structural issues and short-term macroeconomic stabilization policies.

The book can be divided into two groups of studies, and we follow this structure in this introductory chapter. The first part of the book discusses structural characteristics: the determinants of long-term growth (Chapter 2); the macroeconomic importance of the foreign labor force (Chapter 3); and the prevalence of government spending in the economy (Chapter 4). The second part discusses short-term macroeconomic policy: the effect of fiscal and monetary policies (Chapters 5 and 6); the determinants and consequences of financial instability (Chapter 7); and the performance of the financial sector during the crisis (Chapter 8). This first chapter provides some background on the region and introduces the other book chapters before concluding on the importance of the GCC for its neighbors.

1.2 Structural Characteristics

The GCC countries occupy 2 percent of world total land area and host about 36 million inhabitants (less than 1 percent of total world population; 2009 data). Non-nationals comprise on average about one-third of total GCC population, and they account for two-thirds or more of the labor force. The total GDP of the six GCC member countries in 2006 was $713 billion, with a weighted average per capita income of $20,000 (Table 1.1). Social indicators point to a high standard of living: life expectancy has increased to seventy-four years and the literacy rate exceeds 70 percent. Infant mortality is less than half the world average, and primary school enrollment is 90 percent of the school-age population.

Oil and gas dominate the GCC economies (Figure 1.1). Oil contributes to about one-third to total GDP and three-fourths to annual government
revenues and exports. The global importance of GCC countries stems from their jointly accounting for over 40 percent of global oil reserves and close to one-quarter of global natural gas reserves. Saudi Arabia, Kuwait, and the UAE are major oil producers and exporters, while Qatar has the third largest gas reserves in the world and is currently the largest liquefied natural gas exporter. These four countries have around 50 to 100 years of reserves at current production levels. Notwithstanding that, oil and gas endowments differ greatly between countries: in particular oil reserves are small in Bahrain

Even in Bahrain and Oman, where oil resources are not small, oil represents a dominant share of exports and fiscal revenues.
Given this variance, the Gulf countries will face the challenge of diversifying their economies over different time horizons.

When discussing the performance of oil producers, it is common to start with a diagnosis of relatively low growth and of the so-called natural resource curse. Figure 1.2, taken from Sachs and Warner (2001), exemplifies the cross-country relationship between growth and resource abundance, and in this plot, the GCC countries would seem to feature extreme forms of the natural resource curse (Bahrain, Saudi Arabia, Kuwait, and the UAE are in the bottom right corner).

However, there have been progressive improvements in macroeconomic performance of GCC countries over the last decades and the updated data does not confirm the dismal performance that could be expected from a reading of Figure 1.2. We discuss in detail the long-term growth performance of the GCC in Chapter 2 and show that although productivity growth has been disappointing in the region, GDP growth has not been weak and we do not think the resource curse diagnosis is applicable to the GCC.

Oil producers typically have difficulties diversifying exports and the “Dutch disease” has been pointed at as a possible explanation for low growth in resource-rich countries. Revenues from exports appreciate the real exchange rate (because demand for domestic goods increases as the government and the private sector become wealthier), and this can affect the competitiveness of those very export industries that matter for long-term growth (manufacturing, hi-tech industries, etc.—see Sachs and Warner 1999). Chapter 3

Figure 1.2. Sachs and Warner’s (2001) natural resource curse
Source: Sachs and Warner (2001)
discusses why the real exchange rates of the GCC have not appreciated dramatically, looking at the importance of foreign workers and their remittances in relieving the pressure on domestic markets and the real exchange rate.

A second reason why growth may be disappointing for commodity exporters is that economic incentives are distorted by rent-seeking and by wealthy governments that can afford to heavily intervene in markets. Since the crash in oil prices in 1998–9, GCC countries have undertaken a number of structural reforms and improved their business climate and international competitiveness. The restructuring and privatization of utilities and related services have also received some attention. Chapter 4 shows nonetheless that there remain many distortions in these economies, in particular subsidies that affect incentives and market efficiency. Subsidies may be justified from a distributive point of view, but the chapter argues that subsidy policies in the GCC countries need to be more carefully calibrated.

1.3 Macroeconomic Policy During the Crisis

The global financial crisis affected the GCC countries mainly through (i) the sharp fall in oil prices and a cutback in oil production, (ii) a sharp fall in asset prices, and (iii) the drying up of external funding. Global deleveraging, heightened risk aversion, and reversal of speculative inflows attracted by expectations of revaluation of local currencies dried up international credit markets and increased substantially refinancing costs. The co-movement in these stress factors was accentuated by country-specific factors (such as cross linkages in the financial and corporate sectors in Kuwait and significant external leverage in Dubai).

The direct exposure of GCC countries’ financial systems to the US sub-prime market was however relatively low.6 As a result, the direct financial transmission of the global crisis appears to have been limited. However, high oil prices and easy liquidity conditions had fueled high bank credit growth, of over 30 percent in the two years preceding the crisis, and encouraged banks and other financial institutions (particularly investment and real estate companies) to increase their leverage and investments in stock markets. This led to an unprecedented increase in asset prices and overheating of the economy. The onset of the global financial crisis and the fall in oil prices triggered a vicious cycle of a steep fall in asset prices, reduced liquidity, and credit constraints.

6 However, investment companies (non-deposit-taking financial institutions) in Bahrain and Kuwait had significant exposures in international real estate assets, including subprime assets.
With global demand falling and lower oil prices, lower exports and government revenues drove down the fiscal and current account surpluses of the GCC in 2009. In addition, GCC countries are estimated to have lost about $350 billion in valuation of their sovereign wealth fund assets (Setser and Ziemba 2009). Despite these losses, GCC authorities reacted to the crisis by maintaining or even increasing government spending in 2009–10, in line with the G20 push for countercyclical fiscal policies. The resulting stimulus proved useful in shielding the region from a deep recession. Indeed, Chapter 5 estimates the size of fiscal multipliers in the region and finds that one dollar of spending increases GDP by 0.2–0.4 dollars in the short term.

The immediate impact of the global crisis on the financial system was felt in interbank liquidity and manifested in increased interest rates. Reversal of speculative short-term wholesale funds linked to the exchange rate speculation resulted in significant liquidity pressures, increasing the need for central bank medium-term liquidity injections and placement of government deposits with commercial banks. There were temporary sharp spikes in short-term interest rates, necessitating central bank measures to reduce policy rates. In the post-September 2008 period, sporadic events such as the announcement of losses by a commercial bank due to customer-related derivative transactions (in Kuwait) and the difficulties in refinancing by banks in Abu Dhabi created some risk aversion among private depositors.7 The authorities responded forcefully to stabilize the interbank market and restore liquidity. All central banks except Qatar (where inflation was high until 2009) cut policy interest rates, and reserve requirements were also reduced. Chapter 6 discusses in more detail the role of monetary policy in the GCC countries and shows that despite the peg to the US dollar, the GCC monetary authorities’ decisions do have an impact on local interest rates and inflation.

The interaction of tight credit markets and asset price deflation weakened the financial system’s balance sheets to some extent, and prompted government intervention of varying degrees in the financial sector. However, the global crisis had little adverse impact on overall bank profitability. The banking sector continued to record profitability—albeit lower, in 20088—despite several banks showing a fourth-quarter 2008 loss reflecting slower loan growth, higher funding costs, higher provisioning, and negative marked-to-market valuation in investment portfolios.9 Banks also continued to record high profits in the

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7 Possibly reflecting some uncertainties in the banking sector, the GCC currencies were trading at a depreciation in the forward market in September 2008.
8 Only three banks, the Gulf Bank, Gulf International Bank, and Arab Banking Corporation, ended up with losses in 2008.
first quarter of 2009. Weaker economic conditions, lower oil prices, weaker corporate sector performance, and lower asset prices eventually had an adverse impact on overall bank profitability in 2009. The property market correction had a further negative impact on banks asset quality. NPLs—which were low at that time, possibly because of the credit expansion—rose. Fortunately, capital adequacy ratios in most countries were high going into the crisis. In addition, to shore up investor confidence, some governments provided guarantees for deposits at commercial banks (Kuwait, Saudi Arabia, and the UAE), and sovereign wealth funds were asked to support domestic asset prices (Kuwait) and provide capital injections to banks (Qatar and Kuwait). In Qatar, the government cleaned up the balance sheets of banks by purchasing equity investments in the trading book and real estate investments. All these measures helped preserve stability in the financial system. Chapter 7 discusses the sensitivity of banks' balance sheet to macroeconomic factors and individual bank's characteristics and finds that past credit expansion and low growth trigger higher rates of nonperforming loans. The chapter shows also that a systemic weakness in the GCC banking system would have affected credit and GDP growth, providing a justification for the exceptional measures taken in support of the GCC banks.

The crisis had a common effect in the banking sector, stock markets, and real estate markets of GCC countries. The global crisis and stress in international credit markets curtailed private capital inflows in the GCC countries, creating funding pressures in the banking system. The region’s stock market capitalization fell by about $400 billion between end-September and end-December 2008 in a volatile market. Volatility in the stock markets increased after August 2008. The average correlation of the GCC markets with the global markets turned positive in the period after September 2008, as compared to a negative correlation during the period between January 2007 and September 2008, as the contagion from the global crisis dominated. The correction in local real estate prices, which had begun in the summer of 2008, intensified after the global crisis. Heightened risk aversion was particularly apparent in Dubai where the CDS spreads widened significantly, by over 1000 basis points during the crisis.

This has been particularly important in Dubai given that banks' direct exposure to the construction sector and real estate mortgages as of the third quarter of 2008 was over 30 percent of total private-sector credit. In Qatar, the government purchased the real estate and equity exposures in the trading books of banks, thereby improving banks' capitalization and asset quality.

Empirical work has shown that wealth effect from financial wealth is significant. There has been relatively little research on emerging economies. Peltonen et al. (2009) estimated financial wealth effects in sixteen emerging economies using dynamic panels and found that an increase of 10 percent in stock prices is associated with a 0.3 percent increase in consumption.

The standard deviation of daily average returns doubled between August 2008 and February 2009 as compared to the period January 2007 to August 2008.
Spillovers within the GCC may have worsened the impact of the crisis through intra-GCC country linkages in addition to the direct effects coming from world shocks. Tight liquidity and credit conditions and some overleverage\(^{13}\) led to some defaults by financial institutions within the GCC. Two Bahrain-based offshore banks—The International Banking Corporation (TIBC) and Awal Bank—owned by Saudi conglomerates defaulted on their debts. TIBC, which belongs to the Saudi Algosabi Group, defaulted on its $2.2 billion debt, pending a group-wide debt-restructuring exercise. Awal Bank, owned by another prominent Saudi conglomerate (Al-Saad Group) sought a renegotiation of its debt. In Kuwait, Global Investment House, an investment company, was deemed to have defaulted on most of its $3 billion debt, as a result of actual default on a $200 million loan in December 2008. Investment Dar, another of Kuwait’s largest investment companies, had defaulted on a $100 million loan even as it was trying to reach an agreement with creditors over a debt restructuring. The UAE Federal Government merged two Dubai-based mortgage companies (Amlak Finance and Tamweel, which together accounted for an estimated two-thirds of Dubai’s housing lending market) that faced financing difficulties, with an amalgamation of the Abu Dhabi’s Real Estate Bank and Emirates Industrial Bank.

Although these defaults were isolated and did not have any systemic consequences, partly due to swift actions taken by countries to reinforce stability,\(^{14}\) the correlation of stock market returns within the GCC increased after the crisis. Chapter 8 discusses in more detail the impact of the global crisis and intra-GCC contagion on banks’ performance post-Lehman.

Despite the global crisis, growth was overall resilient in the GCC, and the region was a stabilizing factor for the broader Middle East and North Africa region (MENA). The GCC has long been a significant source of financial flows to the neighboring Arab countries as well as to South Asian countries through

\(^{13}\) Leverage was not a major issue in GCC countries except in Dubai and some investment companies in Kuwait. Hence in the banking system, the worries were related to liquidity rather than to solvency.

\(^{14}\) These defaults however had an adverse impact in the stock markets. An event analysis in Kuwait shows that as compared to an average daily stock index return of –0.24 percent between September 2008 and June 2009, the average return plummeted to –2.2 percent in the seven-day period before and after the announcement of losses by Gulf Bank. The effect was felt across the GCC. In the seven-day period before and after the Global Investment House default, the average return was –1.3 percent and there was again negative returns across the GCC. In Saudi Arabia, following the default by the Algosabi family, SAMBA’s (a Saudi bank managed by this group) share prices declined by 15 percent between May 18 and June 2, 2009, compared to a decline of 5 percent for all banks. The Saudi index fell by 2.8 percent on May 16, the day after the announcement of default, but recovered immediately thereafter. The other GCC markets recorded declines by around 1 percent.
remittances, foreign aid, FDI, and trade. Throughout the last three decades, GCC countries have provided large amounts of foreign aid, with Saudi Arabia being the top Arab aid donor, followed by Kuwait, the UAE, and more recently Qatar. Remittances from the GCC are also an important source of income for many Arab and South Asian countries, and constituted a large share of total remittances receipts in these countries. The concluding chapter (Chapter 9) discusses the channels of outward spillovers from the GCC countries and estimates the magnitude of growth spillovers. The results point to the importance of understanding the GCC economy not only for itself but also for its significance for the wider region.

References