SOME THOUGHTS ON THE MIDDLE EAST REGION FROM A FINANCIAL STANDPOINT

Intervention de Jacques de Larosière
dans de la réunion du comité stratégique international
de l'American International Group (AIG),
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I would like to touch on three issues :

- the current account surpluses of the Middle East,
- the different ways in which petrodollars have been recycled over the last thirty years,
- the potential of the region as an actor in the international financial system.

I. Current account surpluses in the Middle East have exploded :

1. The size of the phenomenon :

The following table shows the evolution of the Middle East[1] current account over the last decade or so.

(in Billion$)	1998	1999	2000	2001	2002	2003	2004	2005	2006 (f)	2007(f)
	- 25,7	+12,9	+ 70	+ 39,8	+ 29,5	+ 59	+ 103,4	+ 196	240,9	235,6
Of which GCC[2]			+ 49	+ 31	+ 25	+52	+ 89	+ 167	+ 227	+ 221
In % of GDP	- 5 %	+ 2,3 %	+ 11,1 %	+ 6,2 %	+ 4,6 %	+ 8, %	+ 12,4 %	+ 19,1 %	- 20,4 %	- 18,1 %
Of which Saudi Arabia	- 9 %	+ 0,3 %	+ 7,6 %	+ 5,1 %	+ 6,3 %	+ 13,1 %	+ 20,5 %	+ 28,3 %	+ 28,3 %	+ 23,9 %

Source : IMF – World Economic Outlook, April 2006

The accumulation of surpluses from 1998 to 2006 amounts to some 726 Billion$.

This is a major counterpart to the large deficits registered by the US which have reached, over the same period, the following amounts :

US current account (in Billion$)	1998	1999	2000	2001	2002	2003	2004	2005	2006 (f)	2007 (f)
	- 214,1	- 300,1	- 416	- 389,5	- 475,2	- 519,7	- 668,1	- 805	- 864,1	- 899,4

Source : IMF – World Economic Outlook, April 2006

The cumulated US current deficits over the period amounts to 4.650 Billion $. 15 % of this deficit has been mirrored by the Middle East surplus.

[1] Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi-Arabia, Syria, United Arab Emirates, Yemen.
[2] GCC : Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

2. The importance of the Middle East in the world economy :

The above figures illustrate the importance of the Middle East in terms of it's role in shaping and financing the world imbalances.

The GCC countries alone account, indeed, for 40 % of proven world oil reserves, and contribute to some 22 % of the world's crude oil production.

But the magnitude, in real terms, of the present oil shock for the Middle East (and, more widely, for OPEC), is not very different from the shocks of the 1970's and the early 1980's[3] . From the perspective of the global economy, the current shock is, if anything, somewhat smaller than it was in the two previous episodes : "whether measured relative to the world GDP, private capital flows, or financial markets"[4].

What is new is the way oil exporters and, in particular, the Middle East countries are spending and investing their surpluses.

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II. The modalities of the recycling of "petrodollars" by the Middle East have considerably changed since the 1970's and the early 1980's :

1. The past oil shocks gave rise to a boost of public spending and a massive increase in deposits with international banks :

a) **In the wake of the two first shocks, oil exporters increased their spending significantly**. This translated in higher imports and public expenditures. Some of the public project finance that took place at the time proved questionable in terms of economic efficiency.

b) **The bulk of the current account surpluses was channelled in deposits with the international banks.**

Besides the "official" recycling (for example, the major lending transaction -9 Billion US dollars- by SAMA to the IMF in 1981) and the increase in official reserves[5], **more than half of the surpluses during the periods 1974-1976 and 1979-1981 took the form of bank deposits**. These deposits were then on-lent by the banks to emerging oil importing countries especially in Latin-America.

[3] See IMF, World Economic Outlook – April 2006.
[4] Ibidem.
[5] Official reserves of fuel exporters (as defined by the IMF World Economic Outlook and which is a wider concept than the Middle East Countries) increased by some 180 Billion dollars from 1975 to 1976 and by some 300 Billion from 1979 to 1981).

2. The present situation is substantially different : bank deposits have been replaced by market instruments :

a) Oil exporters are saving a considerable share of their income and seem to be more prudent on local public project spending.

Nonetheless, **the massive improvement of their fiscal situation has provided oil exporting countries with a margin for** :

- investing in social benefits (which is important for political stability, especially in countries like Saudi Arabia with a growing young labour force) ;
- and improving public infrastructure (health, housing, transportation…).

b) **By contrast with the previous shocks, the Middle East countries have practically not increased their official reserves nor their bank deposits but have invested in portfolio funds** :

- they have increased their official reserves by relatively limited amounts (an increase of 5 Billion dollars in 2005 in the GCC to only 57 Billion outstanding[6]) ;
- the major part of the surpluses has been invested in portfolio (400 Billion dollars for the Middle East over the period 1999-2005) mainly through a variety of state-investment funds run by fund managers[7].

This is a significant change for the international financial system. **It means that the Middle East is now much better integrated in the global system and is recycling its surpluses in market-based instruments** which has no doubt contributed to a reduction of long term interest rates and of emerging market spreads.

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III. The economic and financial environment in which the Middle East operates is significantly more promising that it was in the 1970's and 1980's :

1.The Middle-Eastern balance of payment surplus is only a part of the world's global imbalances :

Under the two first oil shocks, the world imbalances were "bipolarized" : oil exporters surpluses (mainly the Middle-East) matched oil importers deficits.

In that respect, the massive borrowing of petrodollars from international banks by oil importing emerging countries -in a climate of high inflation- paved the way to the major debt crises of the 1980's especially in Latin America.

[6] See IIF : GCC, August 2006
[7] Some of these funds invest, of course, in US Treasury instruments. Purchases of US securities are booked largely through banks based in London and in off-shore financial centres. This may be a way of seeking to protect official reserves against possible political action by the US.

In the present case, the current account surpluses are much more spread out. The Middle-Eastern surplus (241 Billion dollars in 2006) is only one of the counterparts of the world's deficits. Indeed, emerging Asia is registering in 2006 a surplus of 160 Billion, Japan of 140 Billion and Russia of 106 Billion. These surpluses offset essentially the very large current account deficit of the US (864 Billion), and, this time in a modest way, the deficits of countries like Central and Eastern Europe (- 72 Billion).

On the whole, the Middle East represents a quarter of the financing of the global world deficit. The picture is therefore much less "bipolarized" than it was and the emerging oil importing countries are, this time, globally in balance.

<u>2. The Middle East countries have improved their economic and financial outlook although many problems remain :</u>

a) **In the wake of the first two oil shocks**, two phenomena were clear :

- overspending had led to high inflation,
- and to large fiscal imbalances.

Indeed spending rose to considerable levels "reflecting in large part badly planned and wasteful projects"[8], which became all the more problematic when oil prices declined. Public spending was eventually cut back in the 1990's. But large debt in some of the Middle East countries was outstanding as a legacy of past excesses.

b) Since oil prices have firmed over the recent years, one can observe that **public spending is less directed to major costly state initiatives and more to social investment and economically sound projects. One can also note that it is private investment that is the main factor at play.**

This tendency, coupled with high domestic liquidity and the lack of many local corporate investment opportunities, has led to a boom in real estate and equity prices (with a sharp and inevitable correction in 2006).

But inflation has remained in single digits (at 7 to 8 % on a yearly average from 1999 to 2006 against 14 % between 1988 and 1997).

One can add that fiscal positions have considerably improved and that government debt is being significantly reduced.

c) Much will depend on the development and the deepening of local financial markets :

The Middle-Eastern countries have a good and efficient domestic banking sector but have yet to upgrade and adapt it to the new financing needs of the region.

Compared to the amount of investment planned for very large projects[9] (in oil and gas, -sector which had been lagging over the last decade-, and in other industrial and service sectors), the local financial market potential is limited. **As a result, investment continues to be financed**

[8] IMF World Economic Outlook, April 2006.
[9] « Projects worth over 1 trillion dollars at various stages of implementation or planning, focus on expanding infrastructure and generating greater value added from hydrocarbons », IIF. GCC. August 11, 2006.

largely through external financing including bond issues.[10] International banks are thus evolving quickly to adapt their financing supply to the needs of GCC countries. Sophisticated financing structures supplied by international banks are getting more popular including Islamic finance provided by international banks.

But, it remains that a larger part of petrodollars could and should be invested internally. This movement of domestic and regional reallocation is on the way but its magnitude is difficult to assess. **The more the Middle Eastern financial system will be open to competition, the more the local financial markets will grow in size, credibility, liquidity and depth, and the more domestic projects will be financed by local savings.** This is one of the major challenges for the region if it wants to become an important economic actor, to contribute to the reduction of the world imbalances and not overly rely on external financing.

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Leaving aside the geopolitical dangers and uncertainties which this paper has deliberately not touched upon, one can assume that, if the reform process continues and intensifies on all fronts[11], the region can become a source of growth and a relying partner in international direct investment (in this respect, the Dubai Port take over of P&O of the UK and the difficulties this transaction raised in the US only give a flavour of what could be M&A developments in the future if the political environment were either to improve or to deteriorate[12]). And if economic targets are met, the GCC could well embark on a regional common currency in the years ahead.

[10] Ibidem. « Over 30 billion dollars was raised by he GCC companies through syndicated loans in 2005, greater than the total of the previous five years".

[11] The small State of Qatar is one example of successful reform in particular in political and educational fields (several US colleges have now their campuses there).

[12] The Kuwaiti logistics company PWC is bidding for that business of Holland's TNT ; the Abu Dhabi based Mubadama is acquiring a significant share of VW and the Dubai Investment Entity Istithmar has recently acquired the Swiss Avionics firm SR Technics as well as the Victoria & Albert properties on the Cape Town waterfront. These are all major investments.