

Web Commentary

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Arab Countries Stumble in the Face of Growing Economic Crisis

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Introduction

Faced with the growing effects of the global financial and economic crisis manifested by declining oil prices, a slowdown in exports, stumbling stock prices, and diminishing worker remittances and foreign direct investment, Arab governments have come up with different approaches to mitigate the adverse effects of the crisis. Some, such as the Gulf Cooperation Council (GCC) countries, have designed comprehensive rescue packages and allocated significant resources to sustain economic performance. Others have been trapped and unable to respond due to their budget constraints and limited financial resources and weak institutions.

However, none of these responses have been adequate. In the case of the GCC countries, the plans have been partial, focused on only a few sectors, lacking in transparency, exclusively designed by governments with minimum engagement from the private sector, and lacking a long-term vision. In other countries, financial resources are inadequate and plans are not publically debated and have appeared arbitrary—compromising long-term stability for short term gains. The coordination between monetary and fiscal policy has been weak in all of the Arab countries, with most taking fiscal measures before utilizing monetary tools such as interest rates to stimulate the markets.

The GCC countries were among the first to feel the heat of the financial crisis and they responded earlier than other Arab non-oil-producing countries by adopting an open approach with their citizens about the implications of the crisis. Officials in the GCC, to varying degrees, have been keen to update their citizens with regard to the proposed measures. On the other hand, burdened by skyrocketing budget deficits, countries in the *Maghreb* (Algeria, Morocco, and Tunisia) and the *Mashreq* (Egypt, Jordan, Lebanon, Syria, and Yemen) are lost in a vicious circle of arbitrary policy decisions. They suffer from weak institutions and have limited resources to allocate to potential “rescue packages.”

Varying Patterns of Policy Response

The disparities in responding to the crisis can be attributed to five main factors. First, individual economies depend on different drivers for economic growth, worker remittances, foreign direct investment (FDI), and trade orientation and thus, different factors will affect these drivers differently. For example, North African countries depend mainly on European countries as primary markets for their products; hence, recession in their export destinations will have a more direct effect on their economies, while FDI and worker remittances play a more significant role in Egypt, Jordan, Lebanon, and Yemen. Second, the political context greatly influences the speed with which states respond to emerging difficulties and shapes the measures they take. The institutional and political vibrancy with which Kuwait has reacted to the crisis differs greatly from the belated response of Egypt. Third, the financial wealth of countries has decisive implications for their policy choice flexibility. GCC countries sitting on a comfortable financial cushion are in a better position to maneuver policies in the short run, while countries such as Egypt, Jordan, Lebanon, and Syria all suffer from current account deficits that are expected to deteriorate further, according to the IMF projections. Fourth, the quality of public institutions and the lobbying powers of the business elites and private sector in the respective countries affects the content of the rescue packages. Fifth, countries are facing different social challenges in varying degrees. While the poverty rate in Yemen is at 46 percent due to higher than 15 percent unemployment, the situation in several GCC countries corresponds to the priority given to maintaining national employment rates.

GCC Countries: Social Contract Challenged

The GCC countries recently faced falling oil prices, disastrous stock market performance, bankrupt financial institutions, and rising public criticism—and were some of the first to admit that there had been a significant destabilization of their economies. Initial financial bail-outs failed to elicit public confidence and public figures called for urgent steps to counter any adverse implications. Policy responses were carried through two main channels: the national and regional levels. At the national level, countries relaxed monetary policy on one hand, and opted for expansionary fiscal policies, on the other. At the regional level, GCC countries unanimously agreed to coordinate their fiscal, monetary, and financial policies as well as measures to help ease inter-bank lending rates and add new regulations to their stock markets. This consensus has been further emphasized in the Arab Economic and Social Summit recently held in Kuwait. It was done, however, without addressing the practical means for bringing it about.

Internal political dynamism was decisive in widening the policy agenda to include social policies in addition to the adopted financial and monetary policies. While the stimulus bill in Saudi Arabia passed smoothly, Kuwait finds itself in a political deadlock, with many parliamentarians objecting to the bill proposed by the cabinet. Kuwait is arguably the only country that has developed a comprehensive rescue package by resorting to an institutional mechanism that guarantees the adoption of a satisfactory agenda. More importantly, we observe mounting criticism questioning the role of “public money” in mitigating the repercussions of the crisis on the lives of citizens.

The governments of the GCC countries first focused on recapitalizing the banking sector by purchasing toxic assets to strengthen the banks' balance sheets and on issuing state guarantees on fresh loans to investment firms. Hence, monetary policy focused on injecting liquidity in the market, a step that would hopefully boost investor confidence. Of all GCC countries, the Emirate of Dubai has been the worst hit. While the sovereign debts of Dubai are (U.S.)\$10 billion, the debt of the companies affiliated with Dubai total around \$70 billion. The UAE central bank and Finance Ministry have together made available Dh120 billion (\$32.67 billion) in emergency funding to help banks cope with tight credit conditions and ease the funding shortage. The government of Abu Dhabi is in a better financial position and recently revealed plans to inject 16 billion dirham (\$4.36 billion) to five of its main banks, especially those contending with increasing default rates. Furthermore, the UAE¹ central bank designed swap facilities with maturities ranging from one week to twelve months to help banks meet liquidity needs if funds were not available on the inter-bank market.

Unlike the UAE and Kuwait, Saudi Arabia (SA) was cautious of curtailing inflows of speculative money to throw its banking system off balance, and it has somehow managed to deflate the emerging property bubble. Additionally, SA has maintained a conservative monetary policy by imposing restrictions on international capital flows from foreign investors. Highly criticized at times, the Saudi Arabian Monetary Authority (SAMA) has insisted on pegging its exchange rate, even though it resulted in inflation in the short term. Also, SAMA has cut interest rates five times so far, lowering them by more than half to bolster the credit market. Since the beginning of the crisis, SA has been vigilant about putting its accumulated wealth to use. The Kingdom increased public spending to maintain all current and planned projects worth \$600 billion in construction (51 percent), petrochemicals (21 percent), oil and gas (19 percent), and water (3 percent). Basing its budget on a conservative assumption that oil prices would average at \$36 a barrel, the 2009 budget projected expenditures of \$126 billion (Dh463 billion), up by 15 percent from the originally planned figure for fiscal year 2008. Though the government anticipates a deficit for the first time since 2004, SAMA is expected to come to the rescue. The Fund has been successful in accumulating foreign assets by sustaining a policy of "very liquid, very safe, minimal risk" international assets.² A large portion of expenditures will be put toward subsidizing the price of basic goods, increasing public wages, enhancing education and health services, and investing further in agricultural projects and other projects that will generate job opportunities for the citizens.

Oman and Bahrain, constrained by their limited financial resources, have followed a different track of intervention by focusing on policies to strengthen the manufacturing and construction sectors. Even though the Omani central bank has pronounced its readiness to provide liquidity to banks in hardship, no case has been recorded in that direction. Instead, the Omani minister of trade and industry called upon Omani industrialists to respond effectively to the financial crisis by doubling the efforts to develop new marketing and management strategies and become more competitive by enhancing quality and more competitive prices. The minister invited Omanis to buy local commodities to support their industrial sector. Compared to other countries, the Omani construction sector was not marginally influenced since real demand is generated locally and is not subject to global speculation.

Bahrain is also in a political deadlock. Compared with other oil producers, the country has limited liquid financial assets, resulting in crippled deficit finance, since 75 percent of its state revenues come from oil and the country's budget breaks even at an oil price of around \$70 per barrel. The government's policy response is focused on expansionary fiscal policy. However, the parliament rejected the draft budget proposed by the government and demanded that it increase its proposed spending by 8.9 percent to finance additional social services and education. Members of parliament suggested that additional spending be contributed by state-owned Bahrain Petroleum Company (Bapco) and the country's state-owned *Mumtalakat* wealth fund. Bahrain's ministry of works has decided to halt all future road projects until budget approval is granted, forcing Bahrain to seek external development aid. On February 10, the country announced the establishment of the Creativity Bank or the "Bank of the Poor," with \$5 million in capital to provide small loans to small enterprises in order to involve them in the development process. Bahrain will be home to the fourth AGFUND Bank, becoming the first Gulf country to introduce such schemes.

Qatar is in a relatively more comfortable position and has focused its efforts on preventative measures. Qatar's minister of finance and acting minister of economy and commerce recently revealed intentions to consolidate and restructure the regulatory bodies within the financial sector in Qatar by establishing the Financial Regulatory Authority of Qatar.

On the labor front and across all GCC countries, the challenge of unemployment has resurfaced. After years of decline in unemployment among Gulf nationals due to the strategy of labor market "nationalization" through citizen quotas in private sector employment, the lay-off threat reversed the trend. Private sector employees, considered at a disadvantage relative to their peers in secured public sector positions, held their governments responsible for securing their jobs. This situation forced governments to diversify their policy response and introduce labor market policies. However, diverse trends converged to contain rising labor governance issues. Saudi officials issued protectionist "anti-foreign" statements, denouncing the employment of foreigners at the expense of "unemployed national[s]" but with no practical strings attached. Kuwait has drafted a progressive new labor law that practically equates—in terms of benefits—citizens and foreigners but maintains the "sponsorship scheme." The economic hardship that Dubai faces has resulted in deplorable working conditions for foreign laborers. Official figures show that more than half of the residents in the UAE have family or friends who have lost their jobs. This is not surprising, considering the fact that employees have been deprived of basic rights, such as the right to file suit against their employers. The adopted labor policies in the GCC countries will have a severe impact on *Al-Maghreb* and *Al-Mashriq* countries that depend greatly on their expatriates' remittances.

The Maghreb Countries: Limited Opportunities Against Mounting Challenges

The global financial crisis will have had its heaviest impact on the real sectors of Tunisia, Algeria, and Morocco, where export revenues, capital inflows, and tourism are expected to slow significantly. In 2007, export revenues as a share of GDP was 44.7 percent in Algeria, 42.7 percent in Tunisia, and 19.5 percent in Morocco. The three countries are expected to witness deteriorating labor market conditions. Also, as unemployment in Europe rises, remittances from expatriates will decrease, affecting

investment and household consumption. In 2007, remittance inflows made up around 9 percent of GDP in Morocco, 5 percent in Tunisia, and 2.2 percent in Algeria.

In addition to remittances, capital inflows from the GCC countries are expected to reverse the growing trend, worsening the current account balance in these countries, which had a 1 and 2.6 percent deficit in 2008 and is expected to further worsen by 2012, according to IMF estimates. Algeria, which is running a surplus of about 28 percent in its 2008 current account, is expected to have its surplus decline to only 10 percent by 2012. Deteriorating current account deficits mean that these countries must find new sources to fund their deficits. The crisis is making this more difficult.

In Tunisia, Sama Dubai, *Bou Khater* Group, *Al Maabar* International Investment (UE), and the Bahraini Gulf Financing House all have big projects. Though governments emphasized that the projects by Gulf investors will not come to a halt, the situation on the ground indicates otherwise. The countries depend primarily on European outlets for their goods. Electric and machinery factories in Tunisia have been closing. Figures regarding the extent of the European recession's effect on the real commodity economy are lacking, but the fact that 50 percent of Tunisia's industrial exports are from the textile factories, electric, and mechanic supplements point to a difficult situation. The Tunisian government lacks an effective policy to mitigate the impact of the crisis on its economy. Though the country's Social Security Fund is considered an international success story, the country is expected to face difficult times securing benefits for the newly unemployed. The government has advised factory owners to employ workers on half-day shifts to avoid laying-off workers. This, however, remains optional and subject to employer discretion.

Morocco is threatened with a decline in its revenue from international tourism, expatriate remittances, and its external investment (the banks' external deposits have lost around 7 percent), which has already decreased by 17 percent. These sources make up around \$20 billion (the country's main international reserves sources) and have been traditionally used to finance Morocco's external trade deficit. For example, the garment and textile sector has lost around 6 to 10 percent of its European market. Though the government has publicly stated that the Moroccan economy will face difficulties in 2009 due to the wider spillover of the financial crisis and its potential impact on its revenues of hard currencies, Morocco has been slow to develop recovery packages. In an interview with *Al Hayat* newspaper on January 9, 2009, minister of Economy and Finance, Salahiddin Mizwar, stated that the government of Morocco decided to address the crisis by designing different policy scenarios. These scenarios will include policy measures specifically designed to address each sector of the economy. Policy measures are also expected to include a fiscal stimulus package to maintain growth rates by increasing public investment by \$16.7 billion (135 dirham), subsidizing citizen purchasing power with a 40 billion Dirham, introducing tax cuts on small and medium enterprises, and spending around 103 billion dirham on the education and health sectors. However, the implementation of this plan has been arbitrary and eligibility criteria have never been clear. The stimulus plan was not discussed in parliament.

Algeria is less dependent on the Western European market but is more vulnerable to the decrease in oil and gas prices since it depends on revenues from hydrocarbon exports to sustain its five-year \$62 billion expenditures on infrastructure. Contrary to

the GCC countries, Al-Maghreb countries limited their policy schemes to the national level and there is no indication that they will discuss the coordination of financial, monetary, and sectoral policies at the sub-regional level.

Syria, Egypt, Lebanon, Jordan, and Yemen: Arbitrary Policies

Egypt, Jordan, Lebanon, Syria, and Yemen are in a difficult position due to limited financial resources, traditional budget deficits, dependence on foreign aid, and exposure to the economies of the GCC countries. These countries are running current account deficit in 2008, 1 percent in Egypt, 18 percent in Jordan, 2.7 percent in Syria, and 13.5 percent in Lebanon. Add to this a high level of unemployment and poverty, with the highest rate in Yemen (46 percent), followed by Egypt (18 percent) Jordan (14 percent), and Syria (12 percent).

These factors have constrained policy responses, and most countries have sought solutions from outside with limited success. By examining the cases of these countries, we conclude that the policy responses lack a clear vision and are highly arbitrary in setting benchmarks to define priority sectors for aid. Part of this predicament has roots in years of IMF advice to these countries that centered around cutting budget deficits by “minimizing the direct intervention of the state.” Thus, the wave of current nationalization and direct intervention has hit advanced countries off balance, resulting in both contradictory statements and policies. Another explanation is that naturally, in some countries like Egypt, political rather than social calculations have dominated policies, making government decisions seem arbitrary.

For example, the Egyptian government has been criticized for being five months late in responding to the crisis. Prime Minister Ahmed Nadif indicated that his government had wrapped up a package of economic policies that include spurring economic growth in the form of spending EGP 15 billion (\$2.63 billion) on labor-intensive projects and forging a social solidarity program aimed at fighting unemployment. The government has approved a fiscal stimulus of around 3 billion dollars—of which around 85 percent will be channeled to public investment. To counteract exacerbating unemployment, the government has charged the Social Development Fund to focus more on labor-intensive and small-scale income-generating projects for young people.

Another policy action is related to the proposed exemption of certain industries from customs duties on the import of machinery and capital equipment. This step has been highly criticized, with many accusing the government of working for the interest of a few and proposing that the exemption be strictly applied to industries that use local raw materials. Moreover, under a plan to enhance loans granted to SMEs, the central bank of Egypt has recently canceled the 14 percent reserve requirement on loans to small businesses and worked towards facilitating procedures.

In the case of Jordan, the government issued a statement in which it guarantees all deposits in the commercial banks. The minister of finance also declared the government’s intention to allocate JD 183 million (\$256 million) as a rescue package. This, however, has not been implemented yet. The government also formed a committee to monitor economic indicators, proclaiming that this unit will function as an alert button and would be in a position to provide some policy recommendations.

The government also tried to launch initiatives in the direction of helping troubled real estate firms, but escalating criticism on the grounds that both the real estate and construction sectors are not a priority sectors resulted in their annulment. In effect, no substantial efforts have been adopted on the fiscal front except official statements praising the soundness of the financial situation. On the monetary side, the central bank reduced the level of reserve requirements from the commercial banks and stopped issuing letter of credit traditionally used to absorb excess liquidity in the market when the main concern was inflation, not a slowdown. Interest rates remain high and the private sector has been complaining about the credit crunch.

The Jordanian economy is highly dependent on remittances, which represent nearly 20 percent of the GDP, the bulk of these coming from its 500 thousand expatriates working in the GCC countries. A limited ability to respond puts Jordan in a difficult position.

Lebanon, on the other hand, is in a different financial position. The country's private bank assets stand at more than \$100 billion, almost four times the country's gross domestic product (GDP), with the central bank itself holding almost \$20 billion more in foreign currency and other assets. According to Lebanon's minister of finance, Lebanon is in no financial position to increase public spending, as public debt was estimated at around \$47 billion by the end of 2008. According to the central bank's figures, remittances from the region to Lebanon add up to more than \$5.5 billion a year, with about two-thirds of remittances coming from Lebanese working in the Gulf. Official figures point that over 400,000 Lebanese work in the GCC countries.

Though the minister of finance has proclaimed that it is unlikely that many of Lebanese will lose their jobs as a result of the recession, as many as 4,000 Lebanese have been moving back from the Gulf each month since June 2008. When questioned about its policy response to the crisis, the Lebanese government highlights the increase in its expenditures by around LL1200 billion (\$800 million) allocated to increasing minimum wage and public sector wages. Parliamentarians, however, have been pushing for the approved salary increments since 1998 to accommodate the rise in world commodity prices that has pushed inflation up to an estimated average of 12 percent in 2008. The Lebanese government is also brainstorming another plan to accelerate investment by introducing subsidies on interest rates to loans extended to the industrial and agricultural sectors. In parallel, the government stated its intention to improve medical and social benefits. These statements remain at the level of good intentions, however, since the government up to now has not adopted any practical measures. Considering that the cost of debt servicing and salaries represent 82 percent of the total 2009 draft budget, it is very unlikely that this wishful thinking will be implemented at the policy level. Amid these difficulties, the country faces a political deadlock with the cabinet's failure to approve the 2009 budget proposal for the fifth year in a row.

Putting monetary and financial policies aside, these countries have clearly failed to adopt a comprehensive social policy. So far, Syria has shown no intention of responding to the crisis. The prime minister has been subject recently to criticism by parliamentarians due to the government's failure in revamping social security, approving a raise in wages and salaries, and monitoring fuel prices. This deficiency is

not the result of a “hasty response to an uncontrollable crisis” but has roots in the ability of these countries to design a comprehensive economic and social policy.

In Yemen the financial crisis had led the government to postpone the submission of the annual budget because the government could not predict the oil prices and the level of expected external financial assistance. In responding to the crisis, the government has decided to cut down its capital and current expenditures but no rescue plans was put in place. The Yemeni central bank (CBY) governors assured the *Shora* council that Yemeni banks are insulated from the crisis and they are enjoying comfortable liquidity. Despite that, the CBY decided to reduce its interest rate from 13 to 12 percent, which is very high compared with the rest of the world, and also to reduce required reserves from the commercial banks to avoid credit crunch.

The Yemeni government has not utilized its 7 billion of foreign reserves to expand public spending and still claims that Yemen’s economy is not exposed to the international crisis. Though this might be the case so far given the low degree of integration of the Yemeni economy with the rest of the world, the Yemeni economy is vulnerable to any decline in workers remittances, FDI from the GCC countries, and the development assistance it receives. These factors will take time to have an effect on the economy that suffers a 42 percent poverty rate and over 15 percent unemployment.

Policy Recommendations

The policy responses of Arab countries thus far are simply deficient. Characterized by an initial state of denial, the adopted policy measures that followed are highly arbitrary and lack a clear vision. So far many governments are not dealing with the crisis with the needed degree of urgency. Governments should act before the crisis worsens in order to avoid losing confidence. Banks in the Arab countries that avoided the worst part of the crisis are becoming more conservative, contributing to deepening the crisis. Monetary authorities needs to be proactive and should not stay on the receiving end.

With the exception of the GCC countries, there are no coordinated efforts among Arab countries in terms of formulating policies. Since the crisis is global in nature, no single country can face its ramifications alone; hence a more collective effort in the *Mashreq* and *Maghreb* countries should be pursued at both governmental and private sector levels.

All of the Arab countries have disregarded the informal economy in their policy responses, despite the fact that it employs large segment of the labor force. With widening lay-off threats, the newly unemployed joining the informal economy would exacerbate further the situation in the informal economy by pushing wages down. There is a need to focus attention on the social implications of the crisis. Social unrest could result if the situation deteriorates further and if the rescue plans remain exclusive and lack transparency.

At the country level, there is no agreement on which sectors should be regarded as priority sectors in a given country. The criteria to select priority sectors have been neither clear nor transparent. Given the limited financial resources, especially in the

non-oil producing countries, it is important get these priorities right. In this group of countries, governments seem inclined to cut capital expenditures, which will have negative implications on the quality of utilities and infrastructure in the long run. Countries are advised not to compromise long-term objectives with short-term responses.

In addition to traditional rescue packages, governments need to pioneer schemes to ease their monetary policies. Central banks can help by releasing liquidity to small and medium scale industries under special schemes to ensure the availability of liquidity to these sectors. They can also encourage commercial bank lending by stopping the absorption of any excess liquidity. Along these lines, governments should limit their borrowing from the domestic market to avoid crowding out the private sector.

Notes

¹ “New Rates Set for Currency Swap Facilities,” *Gulf Daily News*, December, 26, 2008, <http://www.gulf-daily-news.com/NewsDetails.aspx?storyid=238552>, (accessed December 26, 2008).

² Travis Pantin, “The Most Powerful Banker in the Gulf,” *National*, February 16, 2009, <http://www.thenational.ae/article/20090216/BUSINESS/281611662&SearchID=73346957799199>.

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