

# Europe's Financial Crisis and its Impact on the Arab World



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## Europe’s Financial Crisis and its Impact on the Arab World

Economies in the Middle East-North Africa region were already in trouble because of investor nervousness after the Arab Spring. Now large parts of Europe are in turmoil, and the road to recovery is likely to be long and hard. What does this spell for companies and investors in the Arab world?

A specter is haunting Europe and the Middle East -- the specter of social discontent. After the Arab Spring that spurred the fall of three governments, today Syria stands at the brink of civil war. Many Europeans, too, in Greece and elsewhere, have taken to the streets to protest austerity measures, as their governments are forced to make drastic cuts to government spending, wages and pensions. Still others vehemently debate if and how long the European Union itself will last. In fact, though Greece may have won a brief reprieve, the road to recovery is likely to be long and hard.

The International Monetary Fund (IMF) predicts that the euro zone economy, comprising 17 of the EU’s 27 members, will contract again by 0.5% this year. Even with painful austerity measures, Europe’s debt problems remain enormous: The EU reports that government debt for all its members increased to 82.2% of their gross domestic product at the end of last September.

Regional indexes in the Middle East experienced precipitous drops in economic activity with the start of the Arab Spring. Most have now recovered, and in fact have been trending upwards. After losing almost 45% of its value after protests, Egypt’s EGX 30 Index has rallied nearly 50% as of March; Saudi Arabia’s Tadawul All-Share Index is on its best run since 2005, while the Dubai Financial Market General Index has risen over 20% this year. The reasons for the uptick include investors playing catch-up with the undervalued market, positive prospects of a growing economy, and confidence that Arab Spring tumult has not

impacted Saudi Arabia, says Fadi Arbid, CEO of Amwal Alkhaleej, a Riyadh-based private equity firm that operates exclusively in the Middle East and North Africa (MENA) region.

Arbid adds such performance can still be impacted by euro zone weakness. The direct risk for oil demand should be obvious to exporters. But the euro zone’s problems will weigh on other economies too, with indirect effects on Middle East economies. Representing 19% of the world’s GDP, the euro zone’s malaise has inevitably seeped outside its borders. Trade between China and the EU fell by more than 7% in January, for instance, while the Bank of Canada estimated US\$10 billion in lost growth for Canada this year because of the European recession.

With GDP growth expectations of 4.5% this year, Dubai has managed to regain some lost ground in the wake of the global financial crisis. It has benefited as a perceived safe haven in the Arab Spring, and the Dubai Financial Market has booked two-year highs in trading volumes. But its real estate largely remains soft, with another expected 23,000 residential units entering the market this year. Its sovereign entities, meanwhile, continue to negotiate debt -- Dubai’s DP World is in talks

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with banks about a US\$1 billion syndicated loan to replace its existing \$US3 billion deal that matures in October, according to wire reports.

For guidance, analysts and investors look at demand for oil, trade volumes, and investment flows between the MENA region and Europe to gauge what will come. While determining the impact of the euro zone crisis's impact on world markets is difficult, experts from Wharton point out that if businesses in the Arab world hedge their bets by pursuing growth opportunities in other regions, they should be able to ride out the current storm.

### A Point Of View

It's a matter of perspective, says **Stephen M. Sammut**, Wharton senior fellow and lecturer. Trade between regions in manufactured goods and hydrocarbons will be obviously impacted, he says, but that will vary from country to country. "Trade will inevitably be affected by the value of the currencies, and it's quite possible European goods might become more attractive to some of the Arab countries. By the same token, [MENA oil or manufactured goods] may suddenly be more expensive from the European point of view."

British banks moved to cut their exposure to French, Italian and Spanish assets by US\$50 billion in the third quarter of 2011, according to the Bank of England. Corporations are also reducing their financial exposure in Europe; drug giant GlaxoSmithKline recently said it had withdrawn tens of millions from the euro zone.

Wharton management professor **Mauro Guillen** says Arab countries will probably have to follow a similar strategy for trade policies if Europe's troubles continue. "The only way to be protected is to look for alternative markets," he says. "[Arab countries] would need to reorient their exports to other types of markets that wouldn't be subject to the same kind of a downturn as Europe."

Guillen also suggests that Arab governments hold off on awarding contracts to European firms, particularly in construction projects. Since business has dried up in Europe, many will seek the lucrative infrastructure projects in the MENA region. But the risk, he says, is that many will need financing in order to undertake their projects, which will come from European banks. "They're going to have to look for alternatives to that in case the European banks are no longer in the position to offer them financing for a project that they undertake outside of Europe."

For North African countries, turning elsewhere is difficult. Arab Spring protests and civil fighting hit them hardest. Europe remains their biggest trading partner, and they need financial support and trade with it to rebuild their economies. On the ground in Egypt, the recovery has been slow -- one third of its trade volume is with Europe, notes Karim Saada, executive vice president for Amwal and also its Egypt head. "Everything was frozen for a year; there is a lot of worry about sustainability," he says. "It has impacted volumes, price negotiations, and most importantly the way orders are done." According to Egypt-based CI Capital research, foreign direct investment into Egypt stood at US\$400 million in the third quarter of 2011, versus US\$1.6 billion a year earlier.

Guillen says that if Egypt can sort its politics out, investment opportunity would be readily available in the tourism, infrastructure, and financial services sectors. Amwal experts suggest if Egypt calms, opportunities exist in consumer goods, and those specific industries, such as the glass industry, which takes advantage of Egypt's cheap, skilled labor, and its abundance of sand and other

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**Stephen M. Sammut,**  
Lecturer and Senior Fellow  
at the Wharton School

such raw materials. So political stabilization will be crucial in bringing trade back, Sammut adds. “There will be a tendency to do as much cross-trading as possible. Now [there will be a lag] on the variety of goods available, but it could well be that things get imported into Dubai and then redistributed elsewhere into the Middle East.”

## Wild Cards

Despite recent measures, institutional patience with Europe has grown thin, and a loss of confidence in the euro looms. Such an outcome would raise larger issues about the dollar to which most Gulf countries peg their currencies.

“This is a true wild card in all of this,” Sammut says. “If there is devaluation of the euro, certainly that puts European manufacturers in an advantageous position. But at the same time, it’s a question of what is the euro going to devalue against? Many of the Middle Eastern countries, particularly some of the Gulf countries, are pegged to the dollar. Whether they will sever that or realign with a basket of currencies is an open question.”

Depreciating currencies could offset sluggish demand from Europe, Guillen notes. “But keep in mind the issue here is that the Europeans wouldn’t buy as much oil if the economy is slowing down. If the dollar gains relative to the euro, many economies in the Middle East and Africa that peg to the dollar would see their exports become more expensive. That would be bad for them.”

Saada says there is ongoing concern in Cairo about devaluation of the Egyptian Pound, because while it would be good for exports to Europe, it would obviously hurt imports from Europe: In 2010, EU exported 14.8 billion euros’ worth of goods to Egypt, while Egypt exported 7.2 billion euros’ worth of goods to Europe. Guillen says that a devaluation of the Egyptian Pound would at least make tourism to Egypt less expensive, a needed boost as the industry accounted for 11% of its GDP and 10% of the country’s employment before the

Arab Spring.

Guillen also suggests it is possible that a massive devaluation of the U.S. dollar could occur in five years. Despite recent positive economic indicators, he notes weakness in the U.S. economy persists due to a large current account deficit (US\$110 billion in the third quarter of 2011), quantitative easing by the Federal Reserve, and much of the country still living beyond its means. “Countries in the MENA region are going to see their own currencies depreciate, if they continue the peg or soft peg to the dollar,” he says.

Despite Kuwait’s decision in 2007 to de-peg its dinar from the dollar to a basket of currencies, the Gulf’s other oil exporters have no plans to scrap their dollar peg, says

Ammar AlKhudairy, managing partner for Amwal Al Khaleej. “It’s not on the table at all,” he says, taking Saudi Arabia as an example. “Revenue in the country is dollar denominated. The last thing you want on top of the risk of oil price fluctuation is currency fluctuation.” Arbid adds political and economic considerations weigh in on such policy: “If you’re expecting a drop in oil demand, and that happens, if you’ve de-pegged and you have expensive oil, will that help or worsen the situation?”

Regional investors can be prepared for a massive devaluation of the U.S. dollar by taking approaches of hedging and diversifying currency, Sammut says. But it’s trickier for countries with dollar pegs because of the euro, he says. “There aren’t very many currencies of refuge that they can face and there’s no other single currency to which they can realign their currencies... If you believe that despite the problems with the euro that the dollar will devalue, then keep non-dollar currencies. Hedging

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Khaleej

contracts themselves are probably not practical and too expensive given the uncertainties.”

No one in the regional market is preparing at present for a devaluation of the dollar, says Samer Sarraf, United Arab Emirates head for Amwal. Hedging against U.S. currency would be expensive with Gulf currencies, he says, since they are pegged to the dollar, and aren’t as liquid as other international currencies. It has been very expensive even to hedge against the Egyptian Pound, Sarraf notes, as no investors are willing to take long positions against the currency.

De-pegging from the U.S. dollar wouldn’t hurt Gulf currencies, Sarraf says -- such a move would likely see the currencies of oil exporters rapidly appreciate in value. In a scenario where the dollar is devalued while Gulf currencies remain pegged to it, he adds, “then the best way to hedge it is to do so against another international currency, such as the euro or the Yen, using a cross currency swap, or buying options or forwards. But each derivative instrument has a different risk profile to it that needs to be considered. If we believe the dollar is going to get devalued and we expect a de-pegging, then the best way to hedge is to borrow in dollars and then convert the loan to dirhams, for example, as this will make it cheaper once that occurs. However such a strategy is not a hedge in the case of devaluation only.”

### What About Oil?

Sammut adds there is another unknown. How will Europe’s problems affect those countries that export into Europe? “Does demand for Chinese goods actually drop? The effect on the oil producers will range from neutral to negligible if demand for oil continues to increase elsewhere. And I suspect that there may be a global slowdown as a result of what’s going to happen in Europe.”

Arab oil exporters still have a global buffer when it comes to oil prices, Guillen notes. Instead, he says, natural gas exporters would be more affected by

Europe’s issues. “Gas is produced in one location. You don’t ship it half way around the world. You normally ship it to a country that is relatively close. Algeria, for example, exports to France and to Spain.”

Additional embargoes on Iran and militants targeting foreign oil companies in Nigeria are two factors impacting the price of oil today, says **Howard Pack**, Wharton professor of business and public policy, economics and management. But nobody can say with certainty where oil prices will move, he notes. “Most commodity traders as well as institutions that forecast oil prices have very elaborate econometric models. There are none that can provide a definitive answer. There are too many things going on -- slowdowns in China, Brazil, and the EU, Iranian sanctions and increased supply from Gulf, and increasing energy output in U.S.”

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**Mauro Guillen,**  
Professor of Management and  
Director of the Lauder Institute  
at the Wharton School

But oil prices have yet to fall as they did with the start of the 2008 financial crisis, AlKhudairy notes. “There were local fears that this economic malaise would result in a longtime reduction of oil prices,” he says. “This has been dispelled. Even with Europe facing its problems and issues, oil prices are holding up, and in fact are going up. ... As far as foreign investors are concerned, the more worrying Europe becomes from an investment point of view, the more attractive our region looks.” Instead, AlKhudairy says a possible risk would be if China took a soft or hard landing, “because that would affect oil prices.”

### Missing European Banks

Middle East economies still have a good portion of European assets. Roubini Global Economics estimates that of US\$2 trillion in Gulf Cooperation

Council (GCC) foreign assets, nearly 30% is invested in Europe. Sammut sees a shift of Middle Eastern investment back into the region as a safe play, and more adventurous ones going into Asia.

“We may actually see some increase of an investment in South Asia, particularly India -- perhaps Southeast Asia, as well, particularly Indonesia or Malaysia. Whether or not Latin America will be the beneficiary of that, I couldn’t say. But I think the money will stay relatively close to home and in countries that generally are perceived as friendly and as relatively secure.”

European banks will unlikely be able to provide project finance in the region, as they face a US\$153 billion capital shortfall, according to the European Banking Authority. Instead of relying on European banks to finance projects, Sammut says Gulf oil producers would likely become sources of investment capital in the region, or even China. “I think it is a relatively safe assumption that the European banks will take a pass on these opportunities,” he says.

Guillen agrees that European banks are on strict diets, but they still can profit from investment in Middle East projects because of low interest rates. “There is an opportunity there for these European banks to continue making some money, which they badly need,” he says. “What is the net effect between the credit crunch on the one hand and these attractive interest rates in the MENA region on the other? We’ll have to wait and see.”

Arbid also sees profit chances for European banks. “Provided that their balance sheets can sustain it, I would look at markets like Saudi Arabia, where there are quite substantial development projects,” he says. “They would have less risk of default with their clients. It could be an opportunity for them. They’re not making the most of it as they could, and I still think they have a role to play.”

Not having financing available from European banks will hurt the MENA region in several

ways, Guillen notes. “This is going to reduce the alternatives available to governments in the region. It’s likely to increase their cost of borrowing.” Roughly US\$60 billion worth of bonds will mature in the GCC just in the next two years. Credit default swap spreads on MENA debt would be expected to rise, Guillen adds, and any downgrade of European debt would indirectly affect the Middle East, as exports to Europe would be hampered, and any downgrade of European debt would indirectly affect the Middle East, as European exports would be hampered, leading to less tax revenues and bigger deficits for MENA governments. “It would be another symptom of how the European crisis is affecting the MENA region in a negative way through the financial channel.”

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CEO, Amwal Al Khaleej

## Investment Opportunities

The Middle East market has been hurt by capital flight and investor perception following the Arab Spring. According to the World Bank, foreign direct investment flows [to the region] fell by 7% in 2010 and by another 16% in 2011. The recent rally in regional indexes point to a return in investor confidence. Sammut and Guillen say opportunities exist in the region for foreign investment and private equity.

“All indications are that the firms that are active there are poised to jump back in,” Sammut says, noting though that prevailing conservative attitudes will result in a reduction of European investment in private equity activity, be it directly or through funds.

“The other impact is whether or not deals will start to be leveraged in the Middle East more so than they are now, in which case, the sources of leverage outside of the Middle East -- with Europe,

in particular -- that almost certainly will be affected negatively. But I don't see that there's going to be a direct, immediate impact of the euro crisis on PE activity across MENA."

There are a number of sectors that probably represent good investment opportunities, Sammut says. "Certainly, consumer products and retail will expand as the middle class stabilizes, and as the region recovers generally and increases the population through expatriates. Health care and education still suffer shortages and represent important sectors. It also makes sense to pay attention to the energy sector. It's not going away and it is not shrinking, and it isn't just a matter of petrochemical-related services. The Middle Eastern countries are as concerned about the costs of energy for their own societies and seek alternatives."

Europe provides opportunities for Middle East investors, Arbid says, but there is divergence in approach. "From an investment perspective, there is interest in acquiring more assets, whether these assets are very synergetic to their economies, which is the SABIC (Saudi Basic Industries Corporation) model, or the Qatari model which is more heavy on European assets, for example, a sovereign wealth fund buying significant real estate assets in Germany," he says. "But I don't think the banks here, though they are well-capitalized, will be stepping up and providing lending there. They're very inward looking. Even some sovereign wealth funds have become inward looking."

Guillen says even those with funds to invest, whether companies or governments, are facing common doubts. It's not obvious where to put money. There is a lot of doubt as to the value of the euro and the dollar. And interest rates vary across the world. It will drive investors to diversify their holdings, he suggests, and the MENA region can take advantage of that willingness to pursue varied assets.

"We've seen that some countries, like for example Egypt, are being penalized by investors because of the political uncertainty there," he says. "But the region's other countries, especially the Gulf, are benefiting from the fact that they right now seem to be relatively safe."

Pack says the reasons for investor skepticism have to do with the opaque nature of the region's politics, and the still-developing nature of its consumer markets. "(Almost all of) the GCC countries are really small and the larger population nations (with the exception of Saudi Arabia) are all experiencing turmoil, and thinking through any investment depends on having a good forecast of political stability and likely economic policies, such as fiscal and monetary policy, once things calm down," he says. "There are a lot of young people but most don't have jobs so they don't offer a particularly large consumer market."

Arab countries enjoying positive investor perceptions can position themselves to capture liquidity from the West by reinforcing those perceptions, Guillen says, while those countries deemed unsafe need to address those concerns, particularly if they seek portfolio investors to be involved on a long-term basis.

"It is very important for countries in the MENA region to provide a stable financial, economic and political framework. Let me give you an example. Egypt has become a relatively volatile place. This is [one of] the largest economies in the MENA region, and it is a country that has been always very dependent on foreign direct investment. And over the last year, this funding has essentially come down to a trickle."

That is the challenge that Egypt -- and other countries in the MENA region -- will have to address, regardless of how things go in Europe.

The reasons for investor skepticism have to do with the opaque nature of the region's politics.

**Howard Pack,**  
Professor of Management  
at the Wharton School

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