Emirates Business 24/7 · Wednesday, November 25, 2009

THE REPORT

Economic recovery is confirmed

■ Growth seen rebounding in the Gulf ■ Hydrocarbon prices driving the UAE's upturn ■ Positive economic

DUBAI Karen Remo-Listana

Recovery, as various economists propose, may come in the shape of U, V, W, L and some even said it may not be an alphabet character but a mathematical one such as the square root.

In a press briefing with the media, Standard Chartered top economists did not say, which shape growth will look like.

But two things are certain, they say, that there is growth next year and that the possibility of a double dip, which looks like a flash of lightning shape, is unlikely.

"Will there be a double dip? Our view is that there won't be," said Gerard Lyons, chief economist and group head of global research. "To have a slipping down again would require an external shock or a policy-driven shock. There won't be a policy shock. An external shock such as escalation in problems with Iran – something that would trigger high oil price when the world economy is too fragile – is impossible to predict.

"To use this room as an analogy – two years ago, the world economy was on the ceiling now we're at the table, we're somehow off the floor but lower than peak."

Marios Maratheftis, the regional head of research at Standard Chartered, said: "There will be economic recovery in 2010. Our main case is that growth is rebounding in the Gulf. There is also good rate of growth in the UAE and it is driven by the price of hydrocarbon, which is stabilising now.

"We think oil price would average above $80 next year. And this is excellent for the region, and even in Dubai whose revenues from oil-related products are only two per cent. This will impact Dubai indirectly because high oil price would increase market sentiments and investor confidence."

The crisis can be taken as a "blessing in disguise" or an eye opener that massive resources, especially in Dubai, were going to real estate investments and not into real drivers of economy. "In 2008, 70 per cent of contracts awarded were related to real estate. These drivers will not be there anymore. This means less was given to real productive sectors. So now we will have lower but better quality growth," said Maratheftis.

The amount of money in the system during the boom years was overwhelming – liquidity grew 50 per cent year-on-year as of June 2008. The growth in money supply had become uncontrollable with salaries skyrocketing and attrition levels on record high to address the dramatic increases in cost of living, especially in terms of housing prices.

The UAE, however, had very limited tools to limit the rate of growth of money supply because it is pegged to the dollar. Resultantly, as the US, which was in recessionary mode since 2007, had been cutting its interest rates for the past two years, the UAE had also been following it, resulting in more liquidity-driven growth. Money continued flowing primarily in loans and these loans went into the highest inflationary assets – real estate. While it was happening, deposits were going down.

> To use this room as an analogy - two years ago, the world economy was on the ceiling now we' re at the table, we're somehow off the floor but lower than peak
>
> **Gerard Lyons,** Standard Chartered

But this problem was completely disguised by the fact that there is a lot of "hot money" in banks sitting on deposits speculating on the dirham revaluation. The more it became evident that it will not happen, all that hot money went out of the banking system.

The banks suddenly realised that their deposits-to-loan ratio is not what they thought. And this is one of the major reasons of the liquidity crunch in the UAE, which affected companies across all sectors.

Official figures show that foreign banks withdrew more than Dh47 billion out of the UAE banking system in the first half of this year after liquidity shortages at home and an end to speculation about a revaluation of the dirham.

Hot money

Deposits by foreign banks with the UAE's 24 national banks and 28 foreign units declined to Dh128.4bn at the end of June from nearly Dh175.67bn at the end of 2008, showed figures by the UAE Central Bank.

Foreign banks began repatriating this hot money in the second half of 2008 when the UAE made clear it has no intention to quit the dollar for the time being. Such a policy was further backed by the UAE's decision early this year to quit the GCC monetary union and repeated announcements by the Central Bank that there are no plans to end the dollar peg.

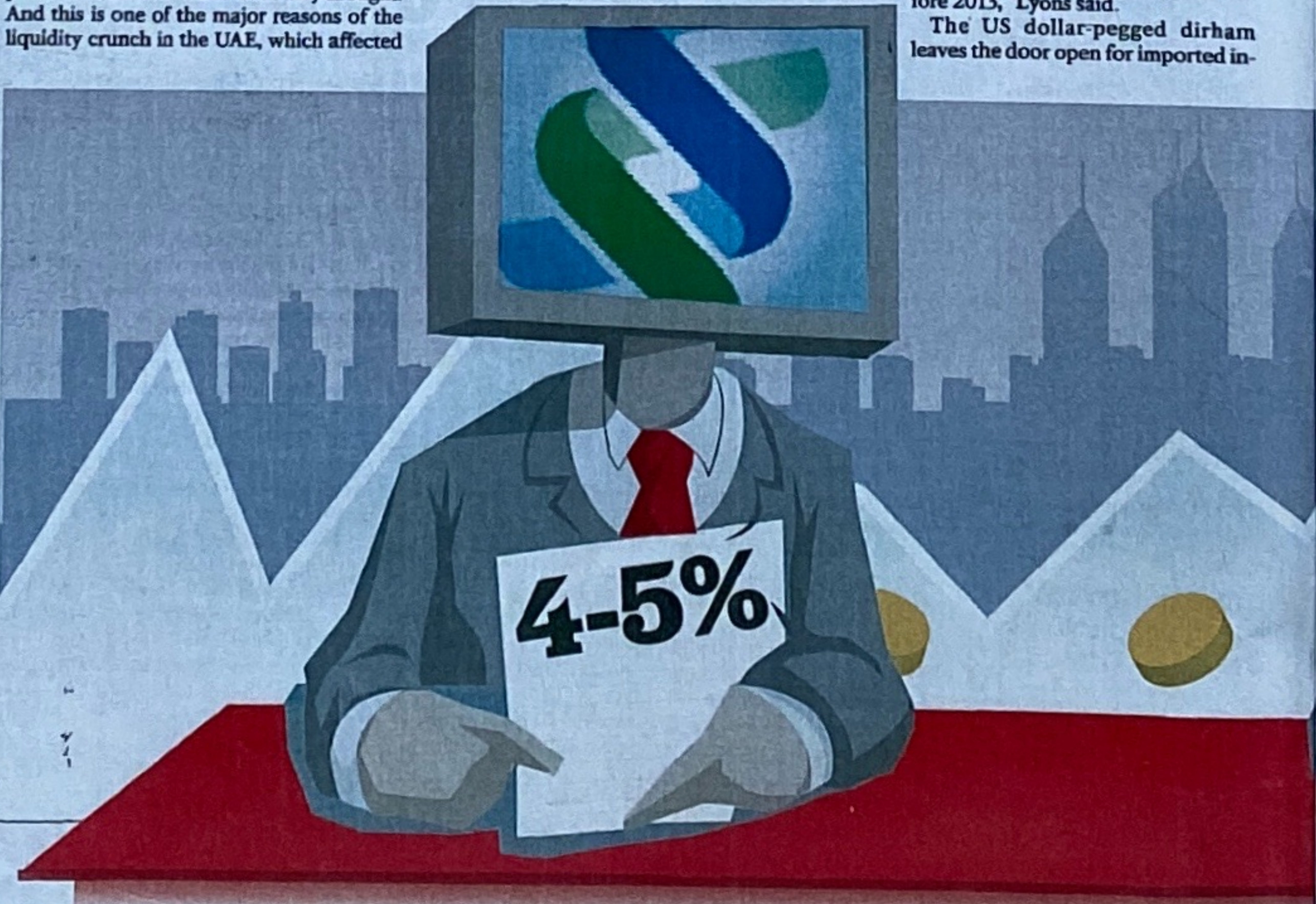
The crisis has pushed inflation down but it is feared that the UAE may once again see inflationary pressures by the turn of next year, as economic indicators begin to pick up.

The UAE should begin assessing alternative currency regimes before inflation gets out of control, said Maratheftis.

"It is much more important to be pro-active and tighten policy before the situation gets out of hand," he said. "They don't have to wait for the Fed to hike because they will have inflation long before the US. It's much more important to be proactive. If we wait until inflation becomes double digit then policy won't be as effective."

Standard Chartered forecasts inflation will reach six per cent next year. The US Federal Reserve is slated to keep interest rates very low until its economy recovers and prices start rising again. "We're into a prolonged period of low interest in the West and I don't really see the UK hiking rates before 2013," Lyons said.

The US dollar-pegged dirham leaves the door open for imported in-



THE NUMBERS

OIL (Brent crude)	DIRHAM/POUND	DIRHAM/EURO	GOLD	SILVER	DUBAI Index	ABU DHABI Index
$78.32 (+$1.12)	6.174 (-0.095)	5.565 (-0.005)	Dh1,395 (+2.50)	Dh23.20 (+0.10)	-1.93%	-0.47%

next year – but not its shape

indicators may add to inflationary pressures ■ Better social safety nets and stronger bond markets sought

flation in the coming months. Hence, once the global economy starts to recover, the UAE could face the new prospect of rising inflation as a recovery in domestic demand and higher import bills pushes the country back into price growth.

Then comes the question if we will see hot money returning to dirham revaluation speculation again. Maratheftis said it could.

"If the region rebounds and imports low interest rates from the US and faces inflationary problems long before the US and if at the same time, we hear policymakers in the Gulf that maybe we should be looking at alternative regime then I wouldn't be surprised at all if we see more inflows in the Gulf again related to currency," he said.

Speculation on dirham revaluation is not a remote possibility, especially with a handful of capital inflows looking for investments. Lyons said the bulk of capital flows to emerging market including the Middle East, whose local capital markets are relatively not developed.

Developing the domestic market is important because despite the rise of emerging markets and the so-called structural shift of power to these markets, the global economy's overall growth is still dependent on the West's recovery. The West still has the lion's share of trade with the US ($14.5 trillion or Dh53.26trn), Germany ($3.7trn) and the UK ($2.7trn) alone comprising a third of the global pie.

To see the same "ceiling" growth, countries that have the capacity to save such as the Middle East and East Asia, would need to see domestic-driven growth, he said.

To do this, three things are prerequisites – better social safety nets, help to SMEs who are most likely to invest at home and deepening bond markets.

THE NUMBERS

Dh128.4bn
The amount of deposits by foreign banks with the UAE's 24 national banks and 28 foreign units at the end of June from nearly Dh175.67bn in 2008

50%
The year-on-year growth in liquidity until June 2008 as the money in the UAE banking system during the boom period was overwhelming

Investment

"A bit of the challenge for the bond market, as some governments don't need to borrow. An active bond market is particularly relevant because companies can then raise funds from the market and it conditions companies to make hopefully sensible investment. It also gives most investors another source where they can put their money," said Lyons.

"The main reason why it hasn't happened here is because the region never needed it in financing in the past – they were running massive surpluses," Maratheftis said. "But our argument is you don't raise bonds just to fund yourself – you need to have the bond instruments to manage your economy, which is exactly that Singapore did. Singapore enjoys deep capital markets, that it always needed."

The UAE, however, still has a nascent bond market with low volume of issuance and virtually no secondary market.

"It will take time, but authorities in the government would have to lead the way and not the private sector," Maratheftis said.

"Bahrain has some local issuance but secondary market is lacking, but the problem here is that we are not seeing local currency bond – we're seeing issuances in dollars – which is not a development of debt markets in the country."

Lyons said: "This is an issue because it is linked to the dollar itself. When people say that dollar is a one-way bet – the reality is the US has the financial market and that is positive for the US dollar itself."

Dubai International Financial Centre chief economist Nasser Saidi said emphasis should not only be on creating a debt market but also developing it in its local currency. Instead of using the surplus liquidity to invest in other countries, he said the capital can be redeployed to the home country.

Mustafa Aziz Ata, Director of Capital Markets at HSBC Bank Middle East, said Mena central banks should develop the local currency bond market by establishing a risk-free yield curve that reflect the opportunity costs of funds at each maturity. This can be achieved through the issuance of treasury bills (T-bills) which are issued by the government for short-term financing requirements; or government bonds which are issued by the government for two-year, three-year, five-year and six-year periods.

"We believe that the development of the efficient local currency debt capital market is required to ensure a sustainable growth environment for GCC economies," Ata said.

According to a Markaz survey, a new trend seen in the first half of 2009 issuances compared to 2008 was the change in the currency/denomination of issuances back to US dollar.