Covid-19 presents Arab economies and banks with unanswerable questions

Jordan is receiving IMF support to address the economic consequences of Covid-19

The half-year results posted by many Arab banks showed profits despite higher loan-loss provisions, but it is generally accepted that this is the calm before the storm. Middle East economies are being assailed from all sides – though they are hardly alone in that – and bank performance will suffer accordingly. However, Arab banks began this year with exceptionally high capital levels, and these should ensure that their survival, however painful the next few years might be.

Arab Banker's Editor, Andrew Cunningham, looks at some of the challenges that Middle East economies and their banks will face in the year ahead.

Governments in the Middle East reacted swiftly to the economic and business challenges arising from the Covid-19 pandemic. In common with governments everywhere, they announced fiscal stimulus packages and instructed or encouraged banks to grant repayment holidays to debtors. Monetary authorities reduced interest rates and cut banks' reserve requirements.

The headline numbers were dramatic. The Central Bank of the UAE announced a Dh100 bn ($27 bn) programme on 15 March and increased it to Dh256 bn three weeks later. The Saudi government announced a SR70 bn ($19 bn) package just days after the country's central bank, SAMA, had announced SR50 bn of measures to enable local banks to defer interest payments due from local businesses and individuals. Morocco created a MD33 bn ($3 bn) fund to upgrade the country's health sector and mitigate the social impact of the pandemic.

However, the headline numbers over-simplify what has been a complex series of measures that will affect Middle East governments' finances in many different ways. Many of the support measures announced by central governments entail forgoing fees and taxes which they had been hoping to collect, so the effect will be a reduction in anticipated revenues rather than a new expense. That said, the measures have also included cash payments: the Egyptian government has been disbursing between EgP600 ($37) and EgP1,765 per month to some of those working in the tourism sector.

Saudi Arabia has also implemented measures to subsidise the salaries of workers in heavily affected industries, but it has also trebled Value Added Tax (to 15%) and abolished some of its income support measures for government employees.

Reducing interest rates takes some of the pressure off heavily indebted companies, but it also supports the finances of those heavily indebted governments whose bills and bonds have been bought by local banks. For example, the Central Bank of Egypt's decision on 16 March to reduce its overnight deposit rate by 3% to 9.25% will significantly reduce the government's debt service burden (which accounted for about 45% of total revenues, when both foreign and domestic borrowing is taken into account) while simultaneously reducing the interest income earned by the country's banks (who lend more to their own government than they do to the Egyptian private sector).

Multinational lenders have also been quick to announce support packages for emerging market countries. In May, the IMF extended $396 mn to Jordan through its Rapid Financing Instrument (RFI), a programme that was created some time ago to provide emergency balance-of-payments assistance to governments (for example following a natural disaster) and which has now been increased in size and pointed towards those governments who are facing difficulties arising from the Covid-19 pandemic. The facility for Jordan is expected to cover about one quarter of the country's external financing needs.

In April the IMF approved a $745 mn RFI facility to Tunisia and in May it approved $2.8 bn for Egypt. In July, the European Investment Bank approved $1.1 bn in financing for Egypt's public transportation sector and $800 mn for small and medium-sized businesses that are affected by Covid-19. The European Bank for Reconstruction and Development has also been increasing its financial assistance to the countries where it works in North Africa and the Middle East.

However, such external support will only cover a small proportion of the expenditures and foregone revenues that Middle East governments will face as a result of Covid-19. In late July, credit rating agency S&P estimated that GCC governments' debt would rise by about $100 bn over the course of 2020 alone, even after taking into account an expected drawdown of $80 bn in state reserves.

Even Kuwait is expected to enter the international debt markets by the end of the year. Unlike its Gulf neighbours, Kuwait has eschewed borrowing in recent years, relying instead on its massive financial reserves to cover budget deficits. However, recent reports indicate that the liquidity of the remaining reserves (which are still huge) has been depleted, leaving the government with the choice of calling on local banks to fund the deficits, or issuing Eurobonds. A new debt law, that will empower the government to raise money overseas, has been delayed in the Kuwaiti parliament for months, but the economic challenges of Covid-19 are expected to focus law-makers' minds and enable the passage of the law. Kuwait is expected to raise about $15 bn after the law is approved. With very little international debt outstanding, and credit ratings in the AA range, investor appetite for Kuwaiti bonds should be high, despite reduced global liquidity.

Oil price declines add to oil exporters' problems

For oil exporters, the costs associated with the Covid-19 pandemic are only part of the problem. Oil prices collapsed in early in 2020 in response to a disagreement between Russia and Saudi Arabia over oil production targets and they remained subdued even after that immediate incident had passed, due to an expectation of reduced economic activity (and therefore reduced energy demand) in the years ahead.

Brent crude averaged $42/barrel in the year to 16 July, compared to $64/b in 2019 and $73/b in 2018.

As a result, oil producers are facing the need to increase expenditure (or forego revenues) in response to the economic effects of Covid-19, while at the same time seeing their principal source of income decline.

The question of what price oil exporters need in order to balance their budgets is complex and variable, and of

Crude oil prices, and Middle East oil production

Avg. price ($/b)	y-t-d 2020	2019	2018	2017	2016	2015	2014	2013	2012
Brent crude oil	42.17	64.16	72.69	54.64	43.32	52.32	98.97	108.56	111.63
Oil production: '000 b/d	May-20	2019	2018	2017	2016	2015	2014	2013	2012
Algeria	819	1,022	1,042	1,043	1,090	1,106	1,151	1,159	1,210
Iraq	4,165	4,678	4,550	4,446	4,392	3,934	3,265	3,027	2,979
Kuwait	2,198	2,687	2,745	2,708	2,853	2,728	2,774	2,822	2,793
Libya	82	1,097	951	817	390	405	473	928	1,393
Saudi Arabia	8,482	9,771	10,311	9,954	10,406	10,139	9,683	9,586	9,737
UAE	2,477	3,094	2,986	2,915	2,979	2,891	2,761	1,741	2,624
Total 'Arab OPEC'	18,223	22,349	22,585	21,883	22,110	21,203	20,107	19,263	20,736
Total OPEC	24,195	29,337	31,344	32,017	32,643	31,470	30,771	30,198	31,132
Total non-OPEC	61,080	65,030	63,010	59,450	57,020	57,850	55,640	54,240	52,860

Notes on data consistency and on sources.

1. Figures for oil prices are taken from the IEA until 2016, after which they are taken from Middle East Economic Survey. 2020 year-to-date refers to the period up until 16 July.

2. Figures on oil production are taken from OPEC's Monthly Oil Market Report (MOMR). The figures should not be taken too literally, since the MOMR constantly revises its numbers. The important thing is to see the long-term trend. The figures in this table have been taken from the January editions of the MOMR, except for 2020 which are from the July 2020 edition. Note that the figures for May 2020 are not 'year-to-date' but for the month of May only.

3. Note that OPEC members were not consistent over the period shown in the table. Most importantly, Qatar announced in December 2018 its intention to leave OPEC. In previous years, Qatar had been producing 600,000–750,000 b/d.

course differs widely between countries. (Most obviously, if a country exports more oil from one year to the next, then it can generate the same revenues with a lower price.) Algeria is generally assumed to need a price of at least $100/b to stand a chance of balancing its budgets, while Kuwait and Qatar can get by with prices around $50/b.

However, the long-term trend is for production to remain broadly constant while the financing needs increase as economies expand. Simply put, the threshold price the oil exporters need to balance their budgets is steadily rising. The increase in crude oil production by Arab exporters over the past 10 years is almost wholly attributable to Iraq, which has been rebuilding its oil industry after the destruction caused by the US invasion of 2003 and its aftermath. (See table on page 13).

Leaving aside the immediate and medium-term challenges of Covid-19, oil exporters are in a long-term race with the clean energy and environmental movement: can the exporters restructure their economies and reduce their dependence on oil and gas revenues faster than global demand for oil and gas decreases?

In February, the IMF published a research paper entitled, "The future of oil and fiscal sustainability in the Gulf region". This predicted that the region's net wealth would be depleted over the next 20–30 years in the absence of big increases in tax rates and changes to the employment practices that have led both to expensive public sector wage burdens and inefficient bureaucracies. The paper also called into question many of the prestigious development projects that have been undertaken in the region, noting that the economic return on such projects has been declining.

Banks face short- and medium-term challenges

Many Middle Eastern banks are facing the challenges of Covid-19 and low oil prices from a position of strength although, as with the Middle East's economies and governments, it is hard to generalise across the region as a whole.

GCC banks are well capitalised and generally profitable. Mergers and acquisitions have been removing weaker banks from the scene and this process seems set to continue over the next year. Banks in Egypt, Jordan and Morocco entered 2020 with generally healthy balance sheets and profitability. Tunisian banks continue to pursue restructuring and reform, though the state-owned banks remain burdened by huge amounts of non-performing loans from previous years.

Lebanese banks are of course a special case and their problems are well known. (See pages 24–27). Algerian banks have been hampered by political unrest and economic uncertainty for over a year. The financial statements of the state-owned Algerian banks offer no reliable pointers to their true profitability and solvency.

Financial statements for the first half of 2020 were starting to trickle out as Arab Banker was going to press. Qatar National Bank and Emirates NBD both reported big increases in loan-loss provisions; but both were still able to report strong earnings and capital levels far in excess of international norms. The first Saudi banks to report showed the same profile of net profits reduced by higher loan-loss provisions, but strong underlying capital ratios.

Over the next year, Middle East banks will face many of the same problems that are facing banks worldwide as they make judgements on the extent of loan loss provisions that need to be taken against delinquent loans. IFRS 9 requires banks to recognise a deterioration in a client's ability to repay at the next reporting period, even if no interest payment has been missed. Yet, if provisions are taken against all clients whose ability to repay has been impaired by Covid-19, the additional charges will overwhelm the income statements of even the most profitable of the Middle East's banks. In the year ahead, it will be auditing firms, who express opinions on the adequacy of provisioning and sign off banks' public accounts, who will have one of the most important roles to play in determining whether banks can continue to declare profits.

Slower economic growth – or negative economic growth – will affect all economies in the Middle East. Some, such as those of Dubai and Bahrain, that are heavily dependent on providing cross-border services, or those dependent on tourism, such as Egypt, Morocco and, again, Dubai, will be particularly hard hit. All banks will face the twin challenges of fewer business opportunities and higher provisions on existing credit facilities.

This is hardly the first time that the Middle East banks have faced such difficulties. What is different this time is the impact of the public health crisis. It is too early to tell whether Covid-19 has already been suppressed in the Middle East or whether a second wave will emerge, either from within or imported from outside. What is even more difficult to predict is how social patterns – work practices, consumption trends, leisure pursuits – will change. In such circumstances, we should expect business strategies based on caution and conservatism rather than innovation in the year ahead. ■

Egypt is receiving support from the IMF and other multilateral agencies to address the economic consequences of Covid-19