



Research Bulletin

February 2012

The Eurozone Economic Turbulence and Policy Paralysis: Implications for the GCC Economies

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OVERVIEW

The global economic recovery, which began in earnest in late 2010, slowed down considerably in early 2011 so much that growing fears of a slide to recession became the talking points of economic conversations throughout the whole year. Such concerns were largely created by the lingering eurozone's fiscal and debt crisis as much as by policy dithering on the part of the eurozone leaders, which apparently allowed the situation to spread to peripheral countries in the euro currency area.

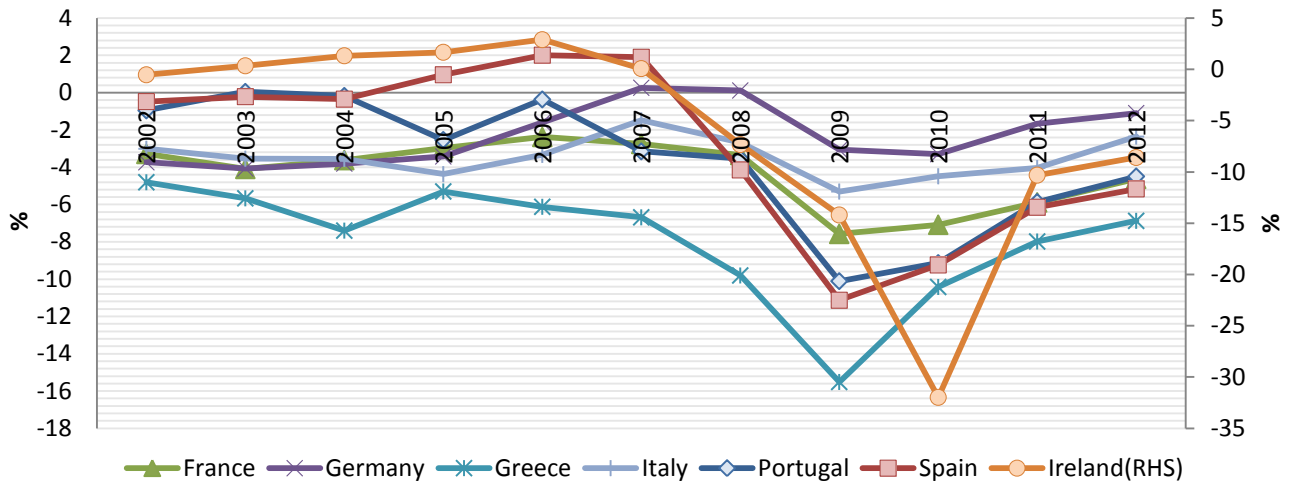
The crisis, which has already swept away the leaders of the debt-stressed countries, has introduced uncertainty, eroded consumer and investor confidence, and rattled markets across the globe. The escalation in the crisis and the lack of decisive action to comprehensively address the problem has recently led Standard and Poor's (S&P) to downgrade many countries in the eurozone, including triple-A rated France, the second richest country in the region. As the crisis continues to escalate, questions are frequently being asked about the existential nature of the eurozone project and the single currency. Whether or not the crisis eventually leads to the demise of the eurozone, the intensification of the problem will have severe consequences for the rest of the world.

Much of Europe, including the eurozone, is expected to slip into a recession in 2012 and, as a result, international institutions such as the IMF, the World Bank and the Organisation for Economic Cooperation Development (OECD) have revised down their global forecasts of the world economy. The eurozone crisis could impact the global economy through a number of transmission channels, including the financial markets, international trade, and commodity prices. The main purpose of this bulletin is to scrutinize these channels in order to assess the nature and extent of the eurozone crisis on the economies of the Gulf Cooperation Council (GCC).

GENESIS OF THE EUROZONE CRISIS

The 2008 global financial crisis has undoubtedly played a catalytic role in unravelling the economic turbulence in the eurozone, but the root causes of the crisis go back to the beginning of the single euro currency journey in the late 1990s when borrowing limits were flouted with impunity without penalties. The EU's Stability Pact limit on budget deficits (maximum 3% of GDP) was supposed to enforce prudent fiscal behaviour, and yet it been frequently ignored by large and small countries in the eurozone. In fact, up until 2008, with the exception of Ireland and Spain, all the countries at the heart of the eurozone crisis, including the region's two wealthiest nations, Germany and France, have regularly exceeded the maximum spending limit of 3% of GDP (Figure 1).

Figure 1: Fiscal Balances of Selected Eurozone Countries (% of GDP)

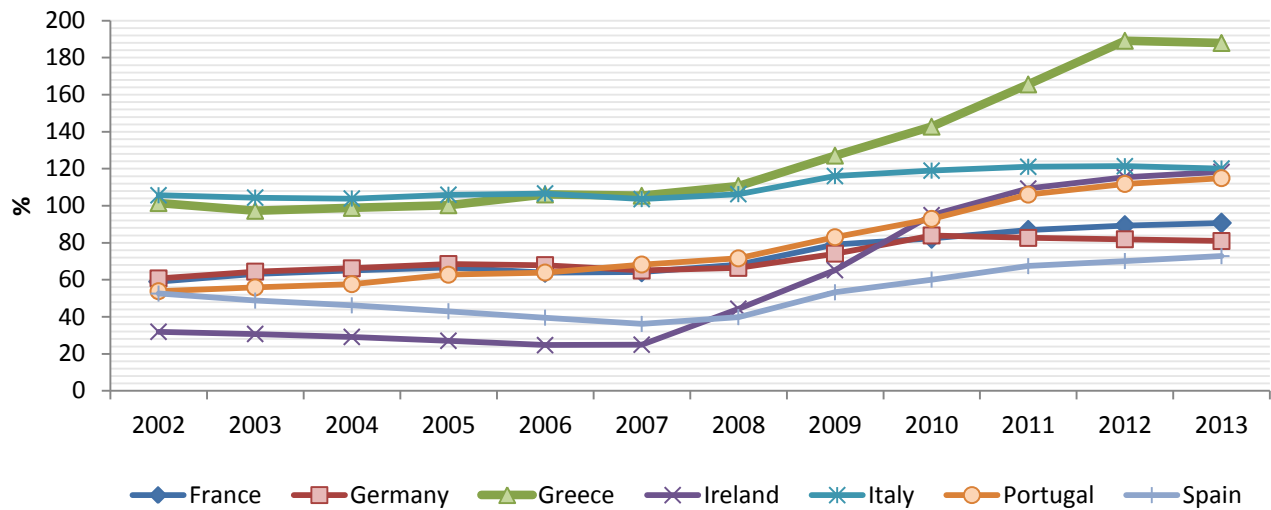


Source: IMF; Gulf One

Greece, the first country to have sparked off the eurozone economic crisis, deserves special mention here. Not only is Greece the biggest and consistent violator of the spending target, but it is also widely accused of manipulating its borrowing statistics to look good to allow it to get into the eurozone in 2002. But the extent of the manipulation was only uncovered in 2009, a year after the 2008 global financial crisis. Since then, Greece has struggled to sustain its economy for a number of reasons.

In the first few years of joining the eurozone, interest rates were too low for Greece and other peripheral countries in the region thereby leading to a big build-up of debts (Figure 2). In these and other countries such as Spain and Italy, the debt was largely on account of the private sector (companies and mortgage borrowers) taking out cheap loans and lashing it out on unproductive activities, creating a debt-fuelled boom.

Figure 2: Government Debt of Selected Eurozone Countries (% of GDP)

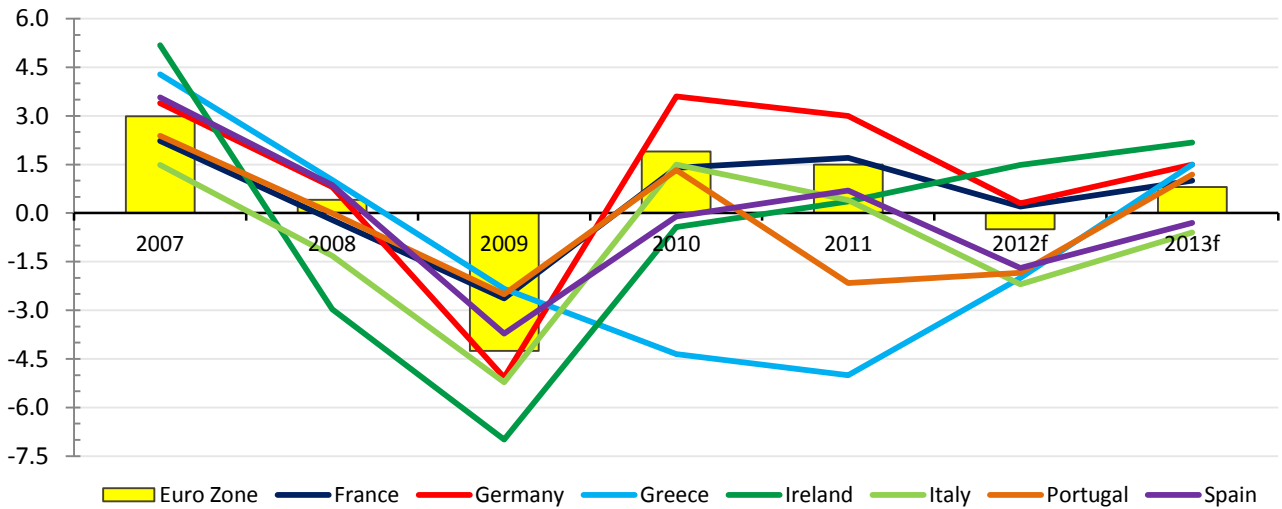


Source: IMF; Gulf One

The borrowing spree, however, increased inflation and led to a marked decline in competitiveness. When euro interest rates rose a few years later, the debt-fuelled boom turned to slump, exacerbated by the global economic downturn of 2008 and 2009, forcing Greece and other countries to seek external help to avoid disorderly default.

In essence, the twin problem of fiscal deficits and massive debt overhang, coupled with the banking crisis and credit crunch issues, made it difficult for many countries in the eurozone to fight the recent recession effectively as they did not have the sound economic fundamentals that could have helped them to weather the impact of the recession. In fact, Greece has never recovered fully from the impact of the 2008 global financial crisis, while others such as Ireland and Portugal slipped back into recession after a brief exit and will do so again this year. As a result, the euro area's economy is expected to slip into a mild recession, with real GDP to shrink by 0.5% in 2012 before returning to a positive growth path in 2013 (Figure 3).

Figure 3: Growth Rates of Real GDP for Selected Eurozone Countries (%)



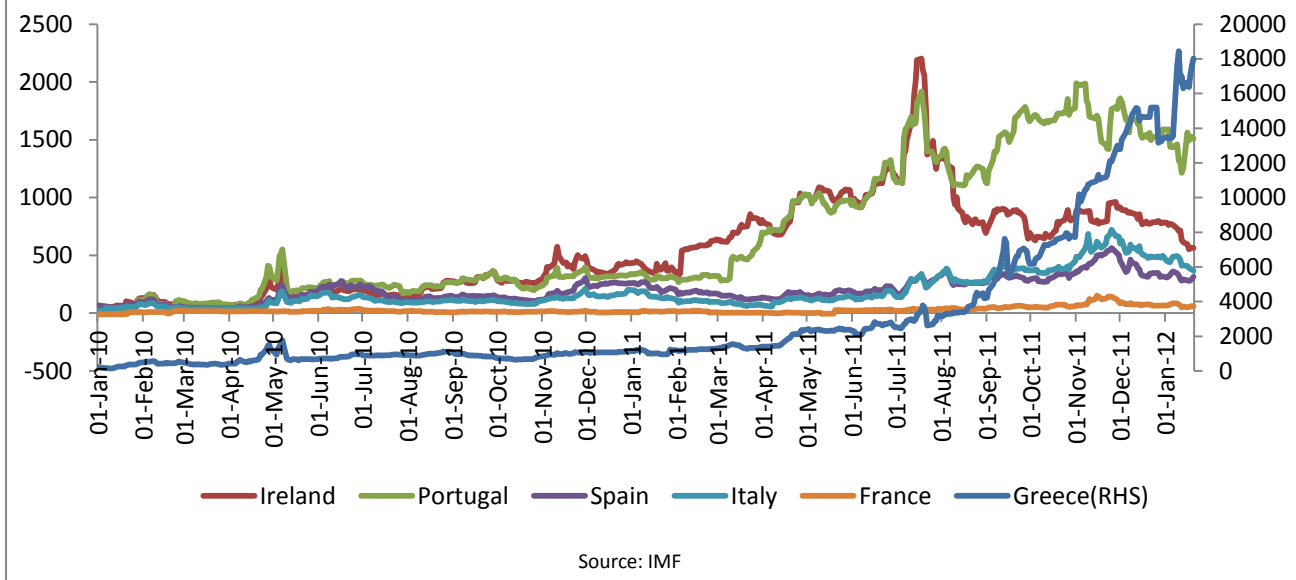
Source: IMF, WEO January 2012

This is not surprising because the economy of the euro bloc had already contracted by 0.3% in the last quarter of 2011 with two of region's biggest economies, Italy and the Netherlands, already slipping into recession as they shrank in the last two successive quarters of 2011. This is in addition to Greece, which had been in recession for the past five years anyway, and the economies of Portugal and Spain are expected to shrink in 2012.

Rising costs of borrowing

The lingering eurozone debt crisis has undoubtedly created so much consternation around the world as it eroded investor confidence, increased speculations, rattled international markets and, as a consequence, raised costs of borrowing in all the debt-stressed countries. For example, the spreads in government bond yields in three peripheral countries (Greece, Ireland and Portugal) over the German bond had escalated rapidly to astronomical levels (Figure 4). This means that these countries might not be able to borrow in the markets at rates they can afford in the foreseeable future due to the high risks associated with default.

**Figure 4: Government bond spreads
(2-year yield spread over German bunds, basis points)**



What does the future hold for the euro?

It is apparent that policy dithering on the part of the Eurozone leaders has dragged the eurozone crisis almost beyond redemption. All policy measures, including the €440 billion European Financial Stability Facility (EFSF), funded by the “Troika” (IMF, ECB, and EU), were ad hoc in nature and based on knee-jerk reactions as opposed to a comprehensive plan for fixing the root causes of the region’s economic problems. In essence, efforts to boost the EFSF to €1 trillion and to get private holders of Greek bond to take a 50% haircut all proved problematic as much as the Greek government’s intransigence towards implementation of the agreed reforms as conditions for accessing additional bail-out funds. Thus, the lack of decisive actions and foresight in dealing with the Greek crisis in the past had facilitated contagion, eroded investor confidence and fueled uncertainty and speculations about the future of the single currency project.

To address these problems, all 27 EU countries (except the UK and the Czech Republic) agreed to introduce a fiscal compact aimed at deepening fiscal integration and instilling fiscal discipline among signatory countries. The key elements of the deal, announced on 8 December 2011, include scrutinizing member countries’ annual budgets by the European Commission; adopting a golden rule to ensure balanced budget (with structural deficit of no more than 0.5% of GDP); penalizing countries whose fiscal deficit exceeds 3% of GDP; and setting up a permanent bail-out facility (European Stability Mechanism – ESM); introducing tough financial services regulatory measures to prevent financial crisis similar to the one that occurred in 2008.

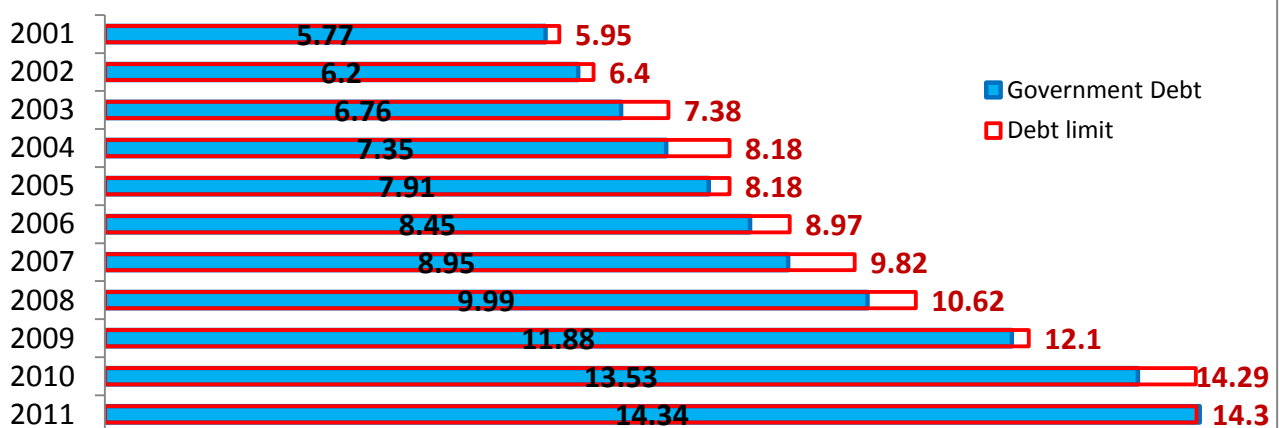
Thus the new fiscal compact deal is a right step in the right direction, as it would introduce stricter discipline in economic policy in the euro area countries, but it will not address the current debt crisis

facing Greece and other peripheral countries. Although the Troika have now agreed to release the second tranche (\$170 billion) of the Greece bail-out facility, thereby saving it (Greece) from defaulting in March 2012, there is a high probability that it will default in the second half of this year or early 2013 due to the mammoth nature of the problem, and Greece will be forced out of the eurozone. It is therefore not a matter of “if” but “when” Greece will default, and the crucial issue for eurozone leaders is managing the process that could lead to orderly, as opposed to disorderly, default and exit.

Ideally, a Greek exit would be good for the euro as it will be a good riddance to a problematic element, but even if Greece remains in the euro bloc, the euro project will endure because it is essentially a political venture and the core founding members, especially Germany and France, are committed to propping it up. Thus, a eurozone without Greece and/or a couple of other problematic countries could, over the long haul, strengthen the euro and could even bolster its stature as an international reserve currency, along with China’s renminbi, due to the apparent weakness in the US dollar as the shift in global economic power accelerates.

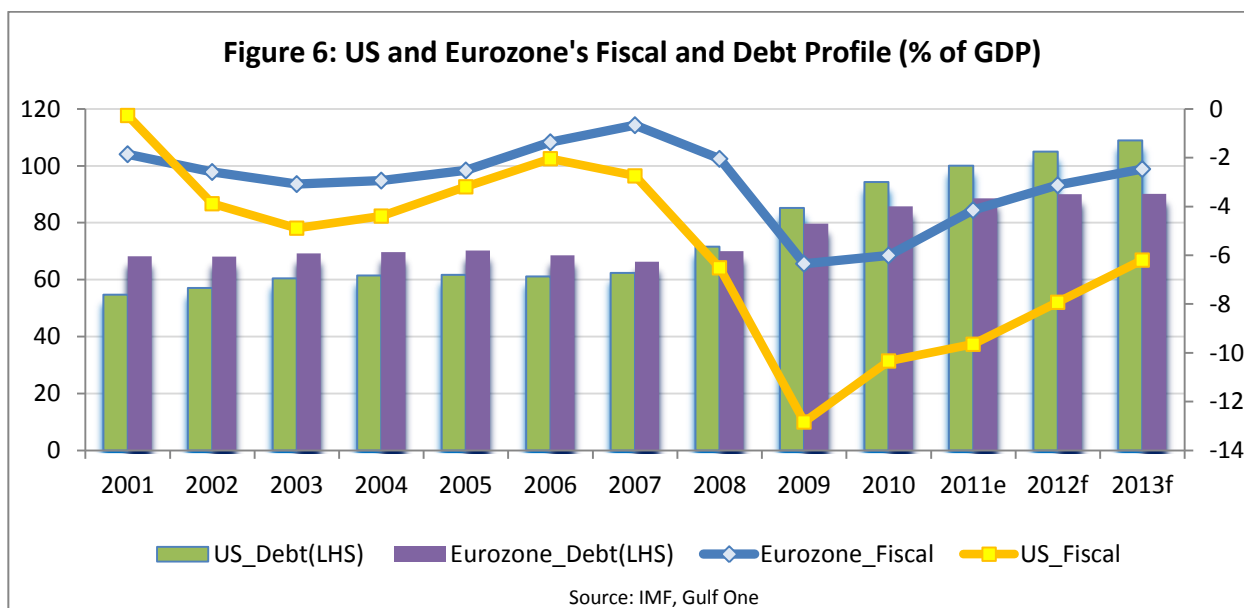
It is also worth pointing out that the eurozone is in a much better financial health than the US, which nearly defaulted on its debt repayments in August 2011, prompting Standard and Poor’s rating agency to downgrade America’s triple-A rating by one notch to double-A, the first time in history. Over the past decade, the US has rapidly amassed huge debts that in 2011 it overshot its \$14.3 trillion debt limit (Figure 5), sparking political wrangling between the White House and Congress. Such a huge US debt overhang dwarfs the \$8.3 trillion debt outstanding for the euro area as a whole!

Figure 5: US Gross Government Debt (US\$ trillion)

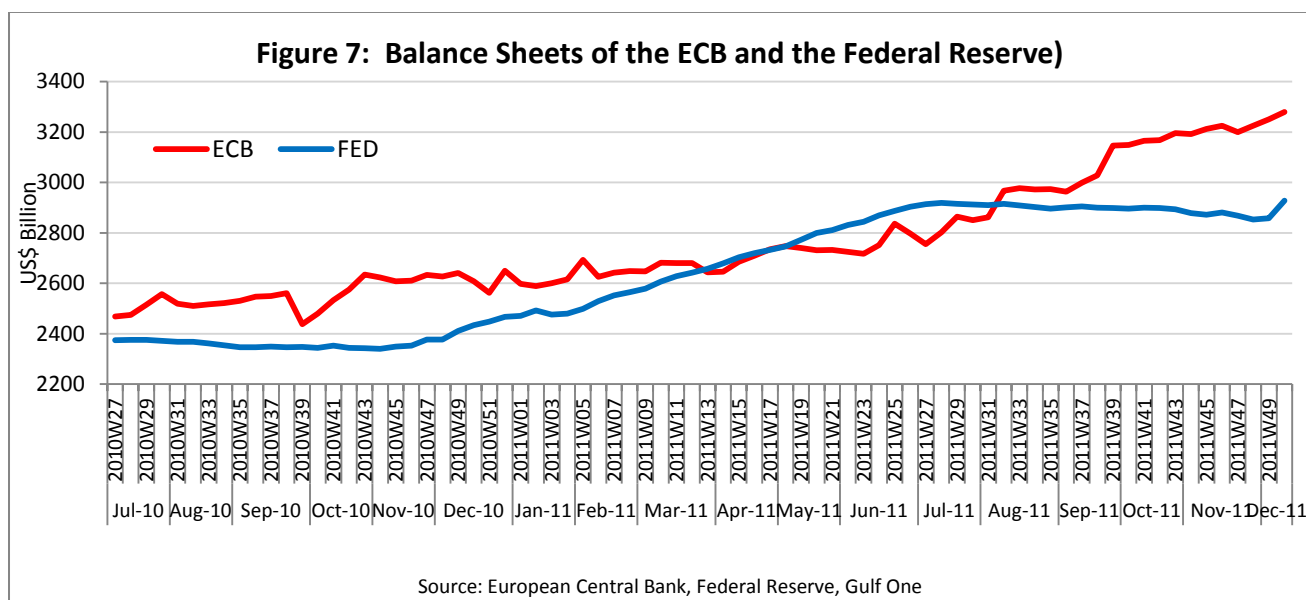


Source: Thomson Reuters

Indeed, since 2008, the US has overtaken the eurozone in terms of overall debt burden, with an estimated debt-to-GDP ratio of 100% in 2011 compared with 88% for the euro bloc as a whole. Similarly, the fiscal deficit for the US since 2008 has outstripped that of the eurozone by two-fold (Figure 6).



On the monetary policy front, the European Central Bank (ECB) is well placed to sustain a stronger euro and the eurozone project, as its balance sheet has recently surged ahead of the US Federal Reserve's balance sheet (Figure 7). The ECB has recently played an active role in boosting the balance sheets of banks in the eurozone by providing unlimited liquidity to the banking sector at lower interest rate through its long term refinancing operations. Such an ECB intervention underscores the apex bank's determination to prop up the euro and eurozone countries in line with the ECB president's assertion that "the euro is irreversible".



So, if the eurozone's debt burden is much smaller than that of the US, and the ECB's balance sheet surpasses that of the Federal Reserve, then why have the eurozone economic problems become more intractable than that of the US? Why is the eurozone grabbing the bad press rather than the US? The answer lies in a number of explanations. First, the eurozone lacks appropriate fiscal policy rules across individual member countries due to absence of political integration. In contrast, the federal government in the US has the power to impose discipline on overspending regions and there is scope for fiscal transfers between regions. For example, if one State is booming while another is in slump, there is automatically a compensating transfer of resources through the tax system. This works in the US because it has a federal budget of some 20% of GDP, unlike the EU where the common budget is only 1% of GDP (*The Gulf Currency: Lessons from the Euro*, GOLCER Report, March, 2010).

Secondly, the policy responses of the eurozone leaders to the global financial crisis and the subsequent debt challenges of member countries were piecemeal in nature, muted, inadequate, and half-hearted. This contrasts sharply with the sustained rounds of fiscal and monetary policies in the US (stimulus packages, special jobs bill, two rounds of quantitative easing, near zero interest rate policy) aimed at creating jobs, increasing liquidity, and stimulating growth.

Third, the economic fundamentals for some of the eurozone countries were questionable prior to joining the single currency bloc, rendering them ineffective to withstand unanticipated external shocks such as the global financial crisis and the subsequent recession which combined to exacerbate the appalling government debt levels.

Fourthly, when some of the peripheral countries joined the eurozone (reporting falsely optimistic figures for their budget deficits), they were rewarded with much lower interest costs on their national debt. And euro membership enabled these governments and people to continue spending as before and even made this cheaper. Fifthly, the lower interest rate, however, increased inflation and led to a marked decline in competitiveness in the peripheral countries. And when euro interest rates rose in the mid-2000s, it confounded debt repayments and the 2008 global financial crisis turned boom to slump, exacerbated by the global economic downturn. In 2009, all these malign influences – the world recession and financial crisis, previous inappropriate interest rates and continuing fiscal incontinence – combined to bankrupt the Greek government and, in differing degrees, those of Portugal, Spain and Ireland (GOLCER Report, *ibid*).

GLOBAL CONSEQUENCES

With a combined GDP of over US\$ 13 trillion, the 17 member countries of the euro currency area account for nearly 20% of the world's US\$70 trillion income, second only to the US which accounts for 22% of world output. As a result, the eurozone crisis will undoubtedly present downside risks to the global economy but the nature and magnitude of the impact will vary considerably across individual regions, territories and countries depending on the extent of their direct and indirect linkages with the eurozone economies.

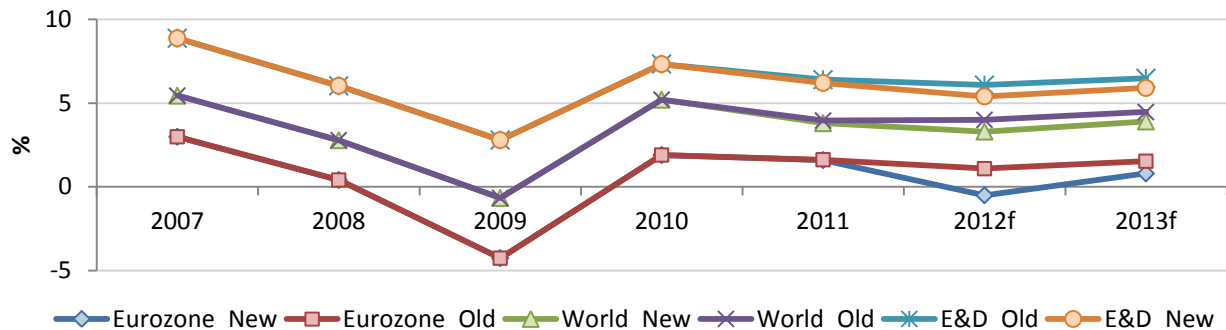
On the global front, a recession in the eurozone will have a dampening effect on the growth of the world economy due to a strong positive correlation between the two growth rates. For example, during the period 1980-2011 the correlation coefficient between the growth rate of real GDP in the EU and that of the whole economy as a whole is the highest relative to all other regions of the world (Table 1).

Region/Country	World	EU	E&D	MENA	SSA	US
World	1.000					
EU	0.792*** (0.000)	1.000				
Emerging & Developing	0.736*** (0.000)	0.318* (0.076)	1.000			
MENA	0.312* (0.083)	0.094 (0.610)	0.487** (0.005)	1.000		
SSA	0.425** (0.015)	0.101 (0.583)	0.714*** (0.000)	0.2714 (0.133)	1.000	
US	0.682*** (0.000)	0.679*** (0.000)	0.102 (0.578)	0.0202 (0.912)	-0.0496 (0.787)	1.0000

*, **, *** denote significance at the 10%, 5% and 1% levels respectively.
Note: Figures in parentheses are probability values

It is therefore not surprising that with the intensification of the strains in the eurozone, many reputable international agencies have revised down their global economic outlook. For example, the IMF has marked down the global growth outlook for 2012 to 3.3%, from 4%, due to eurozone's expected slippage to recession (Figure 8). Similarly, the economic outlook for emerging and developing economies is expected to slow down to 5.4% in 2012, much lower than the 6.2% recorded in 2011.

Figure 8: Growth Rates of GDP for Eurozone, World and Emerging & Developing Economies



Source: IMF; Gulf One

The downside risks to the global outlook can be attributed to a number of sources, including the banking channel, capital markets, international trade linkages and commodity prices, discussed in greater details below.

The nexus between sovereign debts and banking crisis

The banking channel is perceived to be one of the most important sources through which the eurozone debt crisis could impact the global economy due to the adverse feedback loops between sovereign and bank funding pressures in the euro area. This could in turn result in much larger and more protracted bank deleveraging and sizeable contractions in credit and output, according to a recent IMF report. This arises from the fact that “increased concerns about fiscal sustainability force a more front-loaded fiscal consolidation, which depresses near-term demand and growth. Bank asset quality deteriorates by more than in the baseline, owing to higher losses on sovereign debt holdings and on loans to the private sector” (IMF, *World Economic Outlook Update: Global Recovery Stalls, Downside Risks Intensify*, 24 January 2012).

Even so, the extent of the financial contagion to the rest of the world is, however, debatable as the proportion of sovereign debt owed to banks outside the euro area appears to be relatively small. For instance, the proportion of Greek sovereign debt owed to UK, US and Japanese banks is only 19% while the proportion Portugal’s debt owed to banks in the three countries is 17%, Italy (21%) and Spain (34%), as Table 2 shows. Only Ireland has a relatively high proportion of government debt owed to non-euro area banks, the bulk of which is on account of UK banks. Thus, a default by Greece or any other periphery country in the euro area will have minimum direct impact on the banking sector outside the region, but the indirect linkages from banks in France and Germany could be quite considerable.

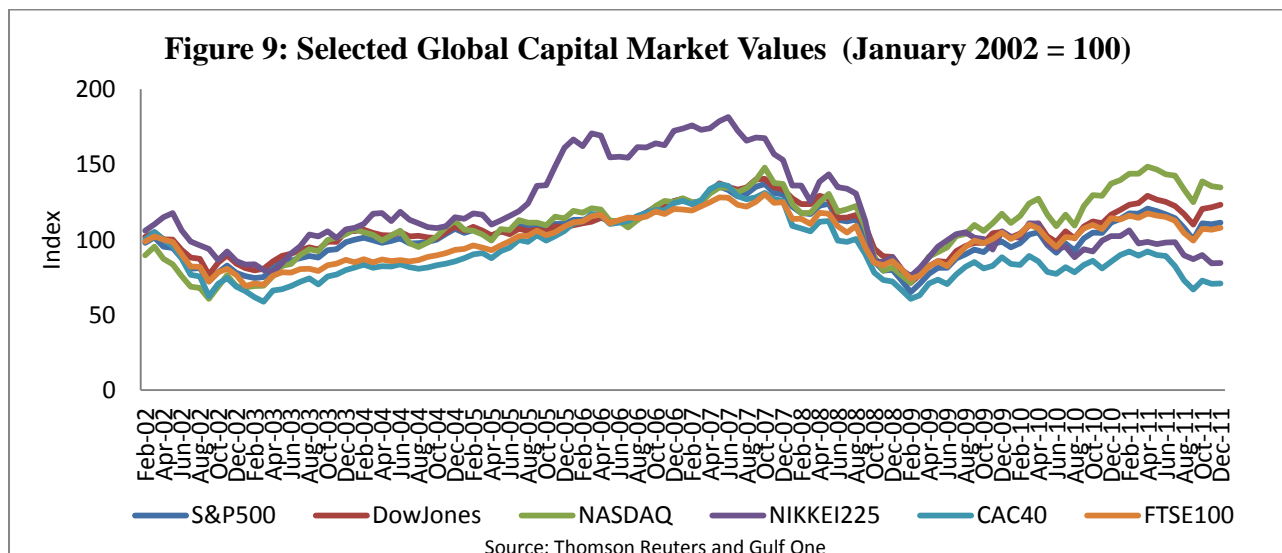
Table 2: Eurozone Debt Web: Money owed by each country to banks in other countries (€ billion)

Greece	Ire.	Port.	Italy	Spain	France	Germ.	UK	US	Japan	Total	Non-Euro (%)
Greece		7.5	2.8		41.4	15.9	9.4	6.2		83.2	19
Ireland					23.8	82	104.5	39.8	15.4	265.5	60
Portugal			2.9	65.7	19.1	26.6	18.9	3.9		137.1	17
Italy				29.5	309	120	54.7	34.8	32.8	580.8	21
Spain		19.7	22.3		112	131.7	74.9	49.6	20	430.2	34
France			37.6			123.5	227	202.1	79.8	670	76
Germany			202.7		205.8		141.1	174.4	108.3	832.3	51
UK	113.5			316.6	209.9	379.3		578.6	122.7	1720.6	41
US				170.5	440.2	414.5	834.5		835.2	2694.9	62
Japan					107.7	42.5	101.8	244.8		496.8	70
Total	113.5	27.2	268.3	582.3	1468.9	1336	1566.8	1334.2	1214.2	7911.4	52

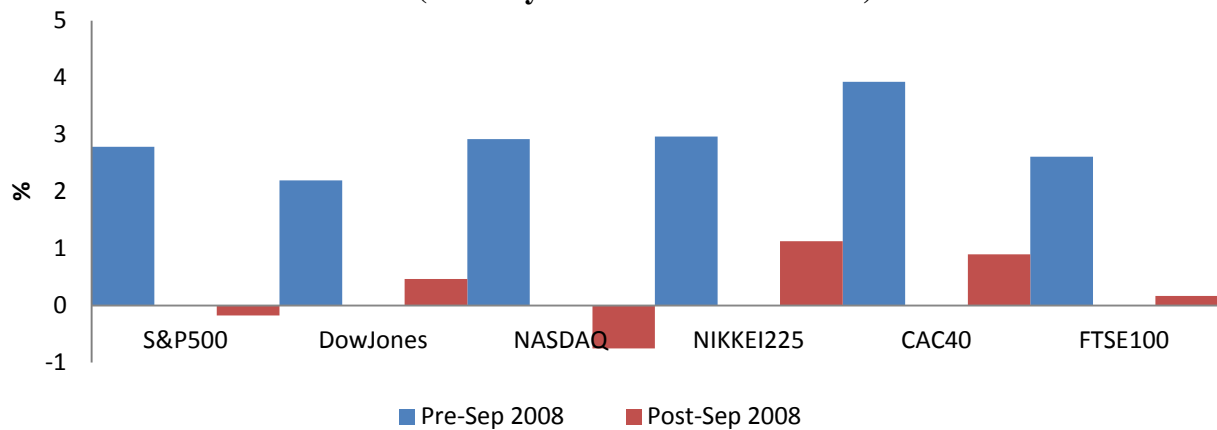
Note: Data in each row represents sovereign debt of the country in that row owed to banks in the countries in the columns corresponding to that row.
Source: BBC Business Online.

Capital Markets Channel

International capital markets provide another channel through which the euro area crisis could weigh on global economic outlook, by eroding investor confidence and raising costs of borrowing. As Figure 9 illustrates, there was a marked plunge in the market values of international capital markets during the 2009 global economic recession. Since then, stock markets have begun the process of recovery but are yet to return to their pre-2008 crisis levels (Figure 10). Although the volatility in capital market values had initially come from a variety of sources, including the fiscal and debt debacle in the US, the major risks to international markets are on account of the eurozone debt crisis and associated policy paralysis.



**Figure 10: Average Percentage Change in the Volume of Global Stocks
(January 2002 to December 2011)**



Source: Thomson Reuters and Gulf One

Is all to do with global trade!

Yet another risk to global growth could come from international trade, especially trade between the euro area and emerging economies. For example, China, which has been the main driver of global growth for the past decade or so, is the world's largest exporter to the EU with bilateral trade in goods worth \$570 billion in 2010 (Eurostat). And since China's economic growth is largely driven by exports, a recession in the eurozone will slow down exports growth in China and thereby immiserize economic growth, which could in turn reduce China's import demand from the rest of world, especially from the developing countries. Even so, China is still expected to achieve an enviable growth rate of GDP of around 8.2% in 2012 and would return to higher growth path in the following year (Table 3).

Needless to say, the eurozone will face serious trade financing challenges in 2012 as it did in 2011, which caused deceleration in manufacturing activity. This along with difficulties faced by banks in accessing term funding at reasonable rates and the likelihood of increased funding costs have impacted investment projects in euro area and its capacity to overcome recession. As a result, intra-eurozone trade plummeted pushing Germany's export-led economy to shrink in the final quarter of 2011. And given that over 65% of the eurozone's exports go to EU countries, the expected slump in exports will close a major source of foreign exchange earnings, and thereby dim the prospects of economic recovery in the short run.

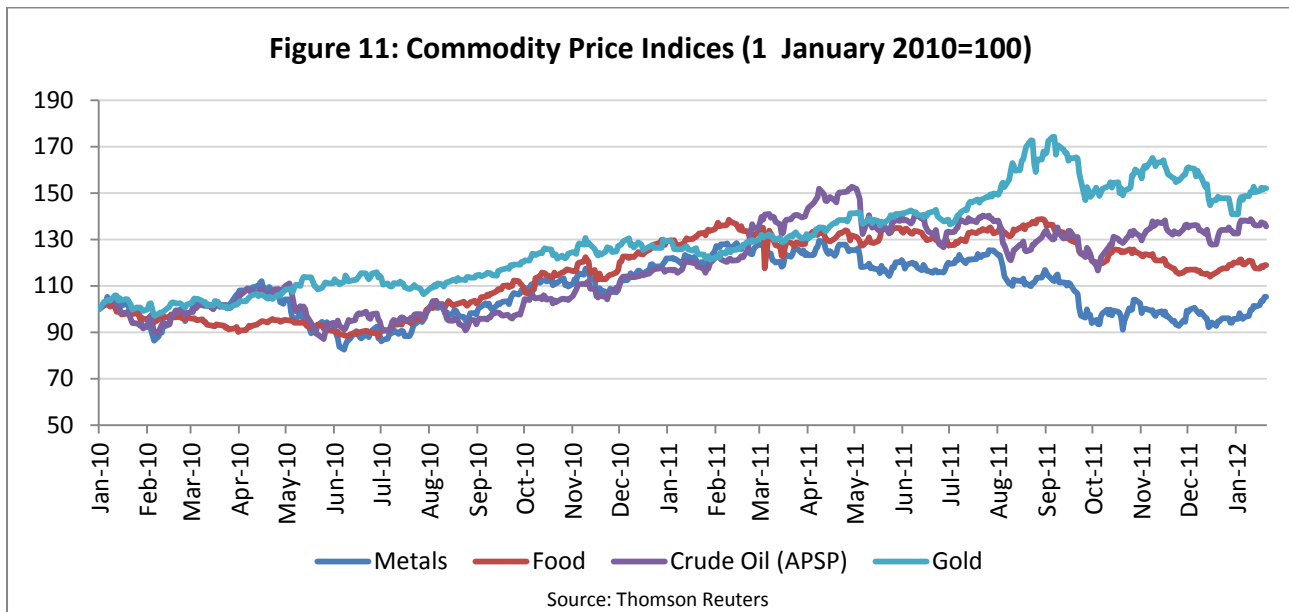
Country	2009	2010	2011	2012	2013
World	-0.7	5.20	3.8	3.3	3.9
Advanced economies	-3.7	3.2	1.6	1.2	1.9
United States	-3.5	3.0	1.8	1.8	2.2
UK		2.1	0.9	0.6	2.0
Japan		4.4	-0.9	1.7	1.6
Euro area	-4.3	1.9	1.6	-0.5	0.8
France	-2.6	1.4	1.6	0.2	1.0
Germany	-5.1	3.6	3.0	0.3	1.5
Greece	-2.3	-4.4	-5.0	-2.0	-1.0
Italy	-5.2	1.5	0.4	-2.2	-0.6
Spain		-0.1	0.7	-1.7	-0.3
Emerging & Developing Economies	2.8	7.3	6.2	5.4	5.9
Brazil	-0.6	7.5	2.9	3.0	4.0
China	9.2	10.4	9.2	8.2	8.8
India	6.8	9.9	7.4	7.0	7.3
Russia	-7.8	4.0	4.1	3.3	3.5
Middle East and North Africa	2.6	4.3	3.1	3.2	3.6

Source: IMF, WEO September 2011 & January 2012.

Impact on commodity prices

The 2009 recession in the advanced economies resulted in weaker global demand and substantial declines in commodity prices. Oil prices in particular fell from a peak of \$147 per barrel in mid-2008 to below \$40 per barrel in early 2009. Non-oil prices fell too to unprecedented lows but precious metal prices rose sharply. Thus, a recession in the eurozone will undoubtedly weaken their demand for goods but may not impact adversely on prices of some commodities, particularly oil and gold prices (Figure 11).

Figure 11: Commodity Price Indices (1 January 2010=100)



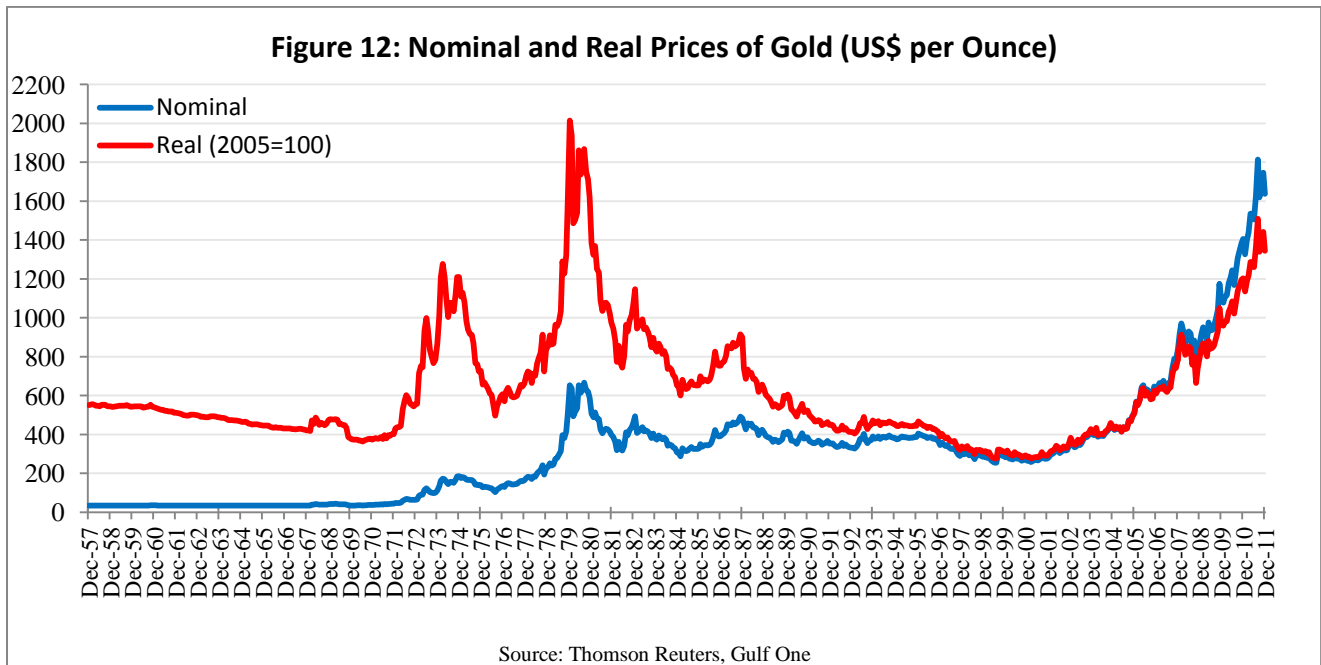
Oil prices have remained relatively high throughout 2011 due to supply-side constraints arising from the Arab Spring which disrupted oil production in Libya and other Middle Eastern countries. Oil prices are likely to remain elevated throughout this year also due to increased geopolitical risks surrounding the Iranian nuclear programme and the oil sanctions imposed on Iran by the Western powers. As the IMF puts it succinctly, “These risks are expected to remain elevated for some time, and oil prices will ease only marginally in 2012 despite less favorable prospects for global activity.”

In the case of non-oil commodities, however, it is likely that prices would plummet due to a combination of weaker global demand and improved supply conditions. Indeed, non-oil commodity prices are projected to fall by 14% in 2012, as the short term risks to prices are to the downside for most of these commodities (IMF 2012, *ibid*). The decline in commodity prices would ease global food inflation albeit to varying degrees across geographical spheres.

Gold appears to be the main beneficiary of the eurozone debt crisis, as investors have increasingly switched to it as a ‘safe haven’ asset alternative to risky equity, and so long as the eurozone crisis lingers on, the price of gold will continue to rise. In the past, at a time of high anxiety, investors have turned to least risky assets, namely government bonds and gold. Those who fear deflation buy bonds; those who fear inflation buy gold. The US sovereign debt market has traditionally provided a “risk-free” basis against other investments, but its loss of the AAA grade, and the recent debt problems in the eurozone where many countries suffered substantial downgrades in their credit ratings, investors now tend to turn to Gold as the sole risk-free asset.

In fact, the gold market has experienced a surge in demand during the worst of the global financial crisis, between January and April 2009 when stock markets hit their crisis lows, and again between April and July 2010 when Greece had to be rescued with its debt service payments. Demand for gold has risen again in recent months pushing the nominal price of gold above \$1700 per ounce in

December 2011. In real terms though, gold price remains well below the over \$2000 per barrel level of the 1980s (Figure 12).



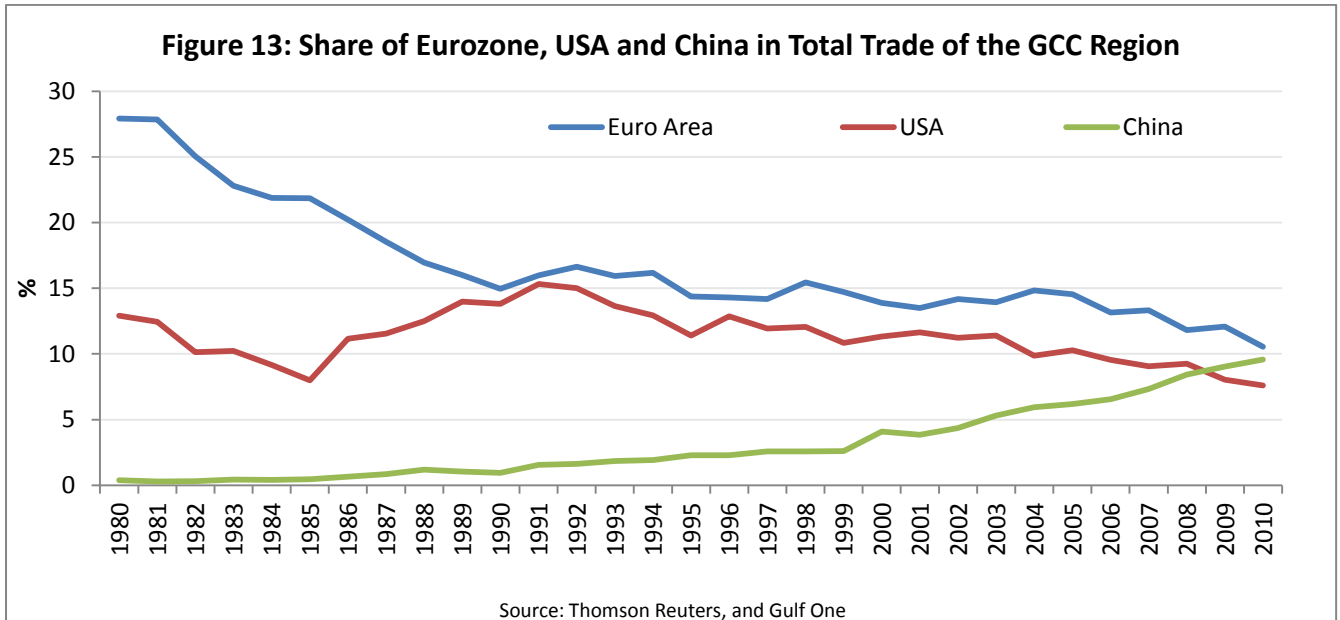
This implies that the nominal price of gold would have to be within the range of \$2300-\$2500 per ounce before the real price reaches the ‘bubble-bursting’ zone! Thus, the year 2012 would therefore see further surges in the price of gold.

IMPLICATIONS OF EUROZONE CRISIS FOR THE GCC COUNTRIES

The transmission channels through which the eurozone crisis could impact the rest of the world are also pertinent to the Gulf Cooperation Council (GCC) countries but to varying degrees: trade, especially oil exports; financial market linkages; and third country (especially emerging markets) effects may be the key routes.

The international trade connection

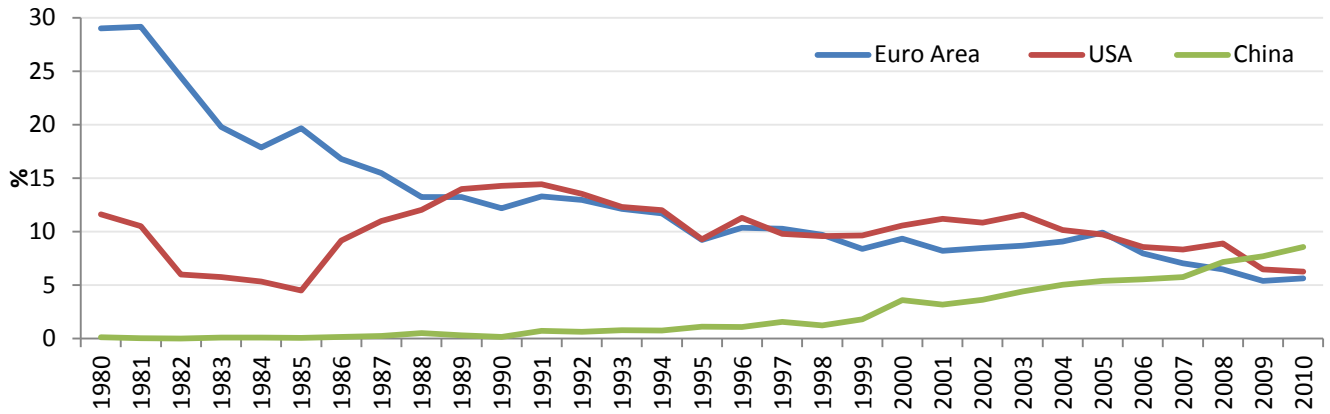
The euro area has been, and still is, the biggest trading partner of the GCC countries despite a substantial decline in total trade shares from nearly 30% in the 1980s to just over 10% by 2010 as China has rapidly increased its share of trade with the GCC region (Figure 13). This suggests that the eurozone crisis will only have limited direct impact on the trade volumes between the GCC and the eurozone countries but there could be some significant indirect linkages arising from the adverse effect of eurozone crisis on China.



Further decomposition of the trade shares shows that the eurozone is still the largest source of GCC imports although China is now the largest single destination of GCC exports (Figures 14 and 15). On the exports side, the eurozone's share of GCC exports is less than 6%, so the effect of recession in the eurozone on the volume of exports to the region will be negligible. However, the greatest concern relates to the impact of eurozone crisis on oil prices, as weaker demand in the eurozone could drive oil prices down. Even so, and as stated earlier, elevated geopolitical concerns in the Middle East would keep oil prices close to \$100 per barrel, which is well above the break-even prices of budgetary expenditures of many GCC countries.

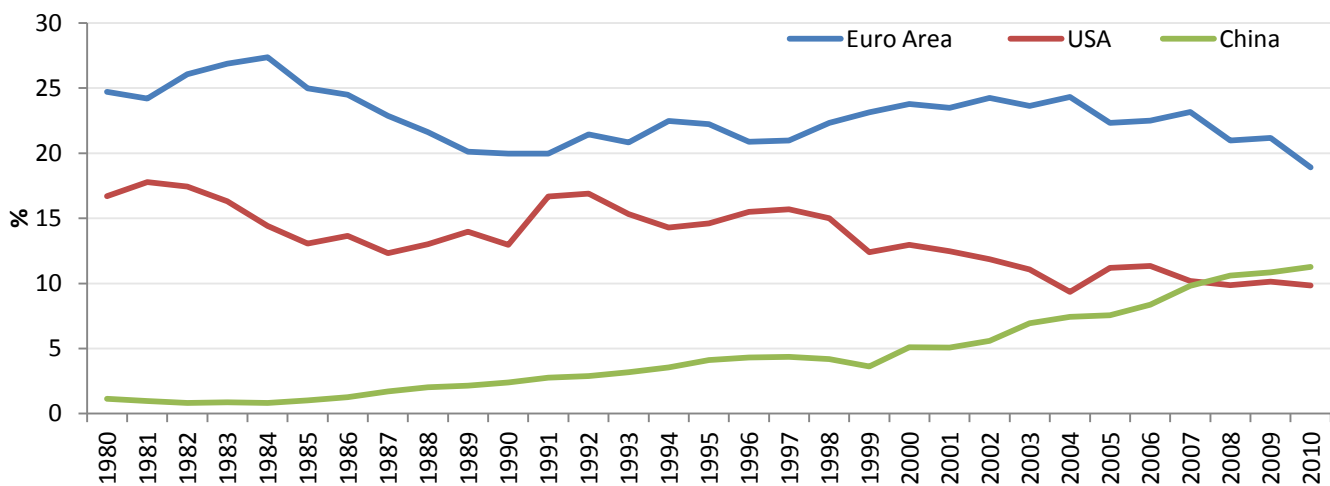
From the imports side, however, the eurozone accounts for nearly 20% of the total GCC global imports, so a contraction of economic activity in the euro area could cause supply constraints and shortfalls in imports into the GCC, which could drive domestic prices of imported products.

Figure 14: Share of Eurozone, USA and China in Total Exports from GCC Region



Source: Thomson Reuters, and Gulf One

Figure 15: Share of Eurozone, USA and China in Total Imports of GCC Region



Source: Thomson Reuters, and Gulf One

Correlations between GCC and Global Capital Markets

Capital markets in the GCC region are not isolated from their global counterparts, and in so much as the eurozone debt crisis could unsettle stock exchanges in the Western countries, it will also adversely impact the GCC markets, as demonstrated by the 2008 global financial crisis. After all capital markets in the advanced countries are positively correlated with stock markets in the GCC countries (Table 4).

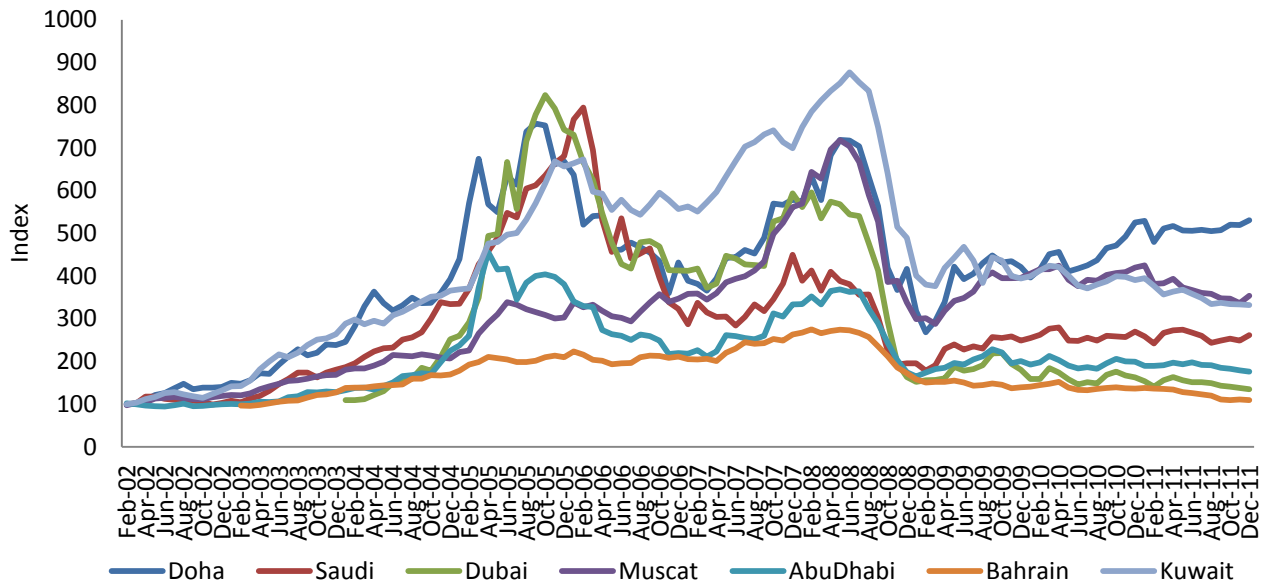
Table 4: Correlations Between Capital Markets in the GCC Region and the Advanced Countries (January 2002 to December 2011)

	S&P500	Dow Jones	NASDAQ	NIKKEI225	CAC40	FTSE100
S&P500	1					
Dow Jones	0.978***	1				
NASDAQ	0.873***	0.910***	1			
NIKKEI225	0.792***	0.686***	0.487***	1		
CAC40	0.872***	0.794***	0.593***	0.942***	1	
FTSE100	0.932***	0.925***	0.880***	0.734***	0.852***	1
Doha	0.611***	0.585***	0.681***	0.417***	0.438***	0.624***
Saudi	0.550***	0.430***	0.449***	0.636***	0.565***	0.535***
Dubai	0.508***	0.347***	0.152	0.713***	0.694***	0.473***
Muscat	0.559***	0.600***	0.659***	0.343***	0.434***	0.646***
Abu Dhabi	0.564***	0.480***	0.471***	0.552***	0.555***	0.546***
Bahrain	0.630***	0.546***	0.326***	0.750***	0.789***	0.590***
Kuwait	0.668***	0.626***	0.575***	0.682***	0.680***	0.672***

Data Source: Thomson Reuters. Calculation of Correlations by Gulf One
Note: All correlation coefficients are statistically significant at the 1% level except that between Dubai and Nasdaq

The statistically significant correlations between the global and GCC capital markets demystify the decoupling link between GCC capital markets and their global counterparts, and can be vulnerable to global turbulence in financial markets. This can be seen from the historical movements in the GCC stock markets (Figure 16), which tend to mirror the trends in the global stock markets (cf. Figure 9).

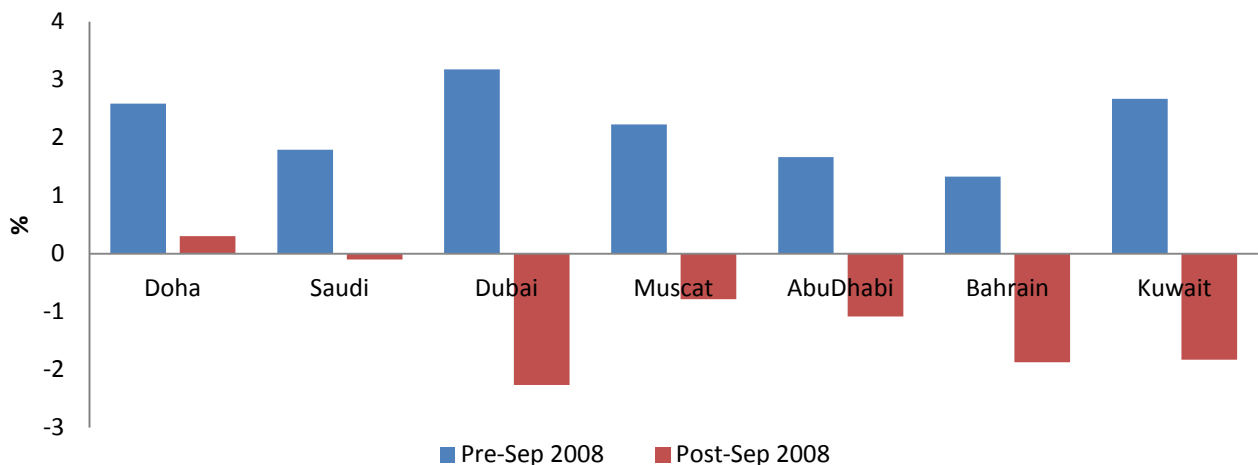
**Figure 16: Indices of Capital Market Value in the GCC Countries
(January = 100)**



Source: Thomson Reuters, Kuwait stock exchange and Gulf One

As was the case with the international capital markets (Figure 10), the recovery in the GCC stock markets since the slumps of 2009 have also been hampered by the eurozone's crisis, and have not yet returned to the pre-2008 levels (Figure 17).

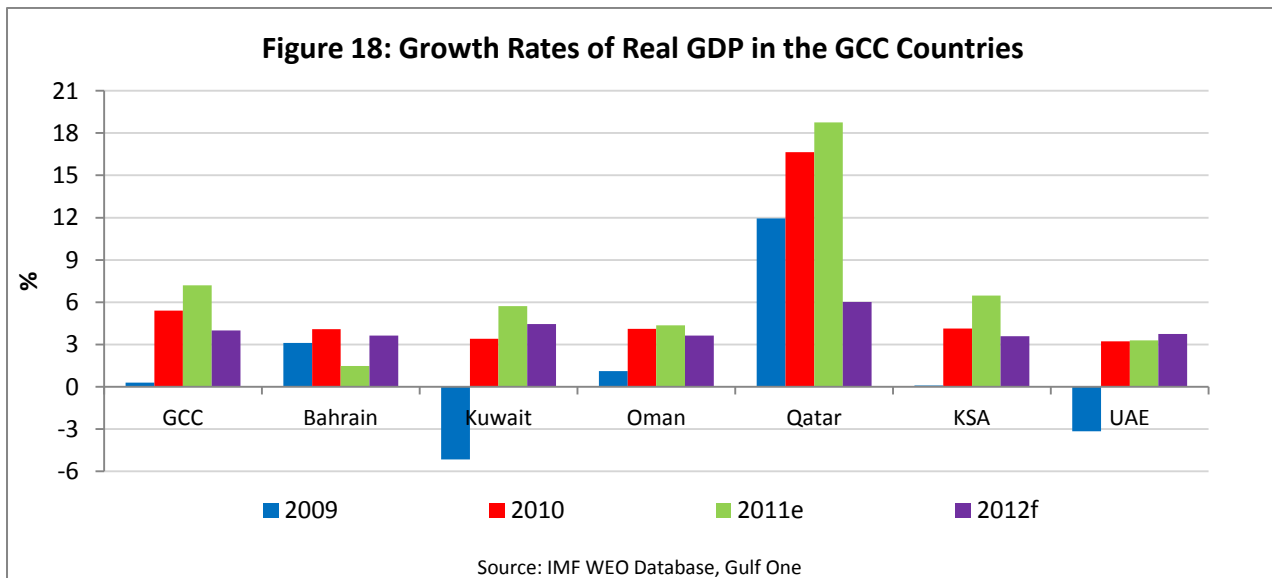
Figure 17: Average Percentage Change in Stock Market Values in the GCC



Source: Thomson Reuters, Kuwait stock exchange and Gulf One

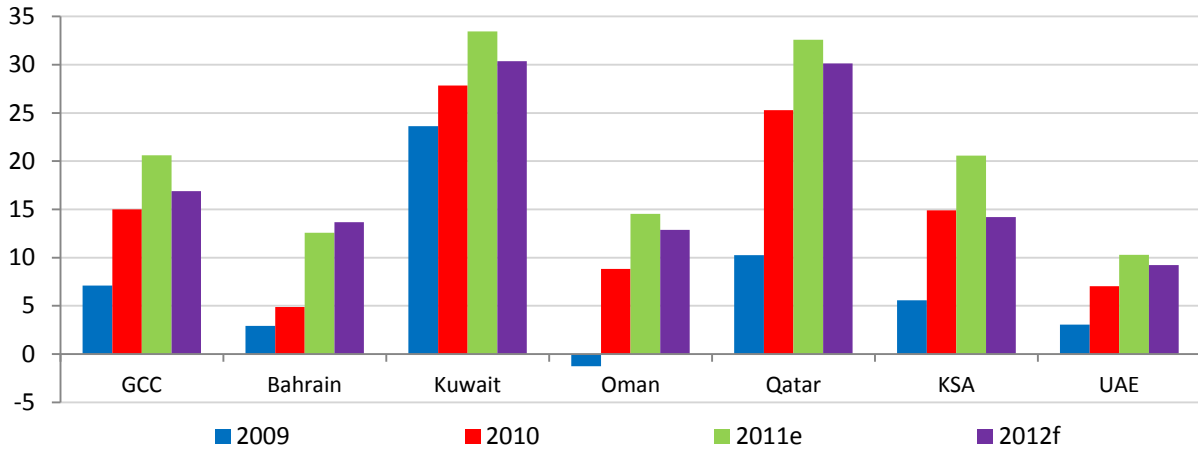
Effects on Economic Fundamentals

While the direct effects of the eurozone crisis on the GCC countries via the various channels may be limited in scope, the indirect effects from sluggish growth in other advanced economies, such as the US and Japan, and economic slowdown in major emerging economies, such as China and India, may pose serious challenges. As a result, the average growth rate of real GDP in the GCC region in 2012 is expected to be lower than that achieved in 2011. Only Bahrain (and to a lesser degree the UAE is expected to see a slight improvement in growth as the country begins to recover from the aftermath of the 2011 uprising (Figure 18).



As international oil prices are expected to remain at relatively high levels due to geopolitical concerns, all GCC countries would continue to record current account surpluses in 2012. However, due to anticipated moderation in oil prices in the second half of the year, such surpluses would be marginally smaller than in the previous year but much higher than what obtained during the global recession of 2009 (Figure 19).

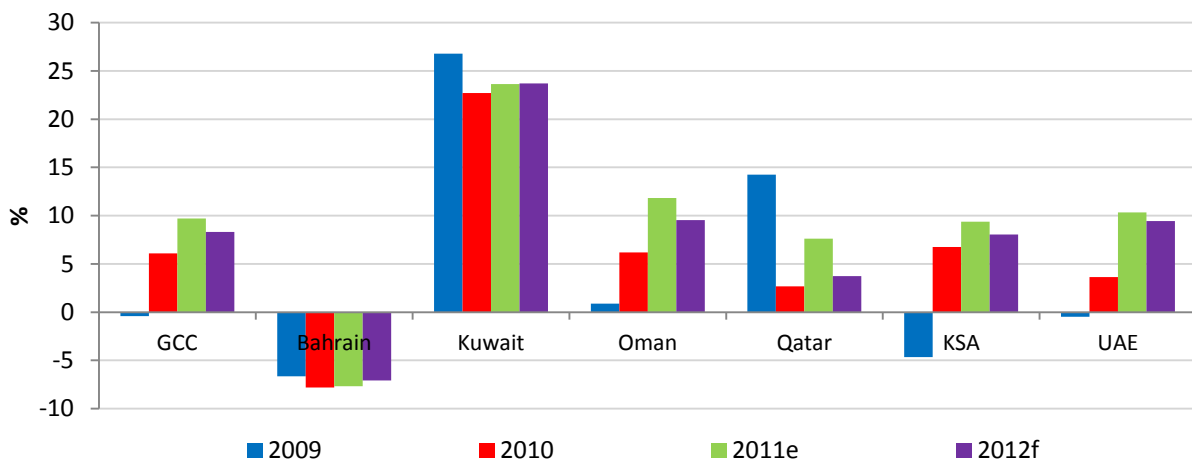
Figure 19: GCC Current Account Balances (% of GDP)



Source: IMF WEO Database, Gulf One

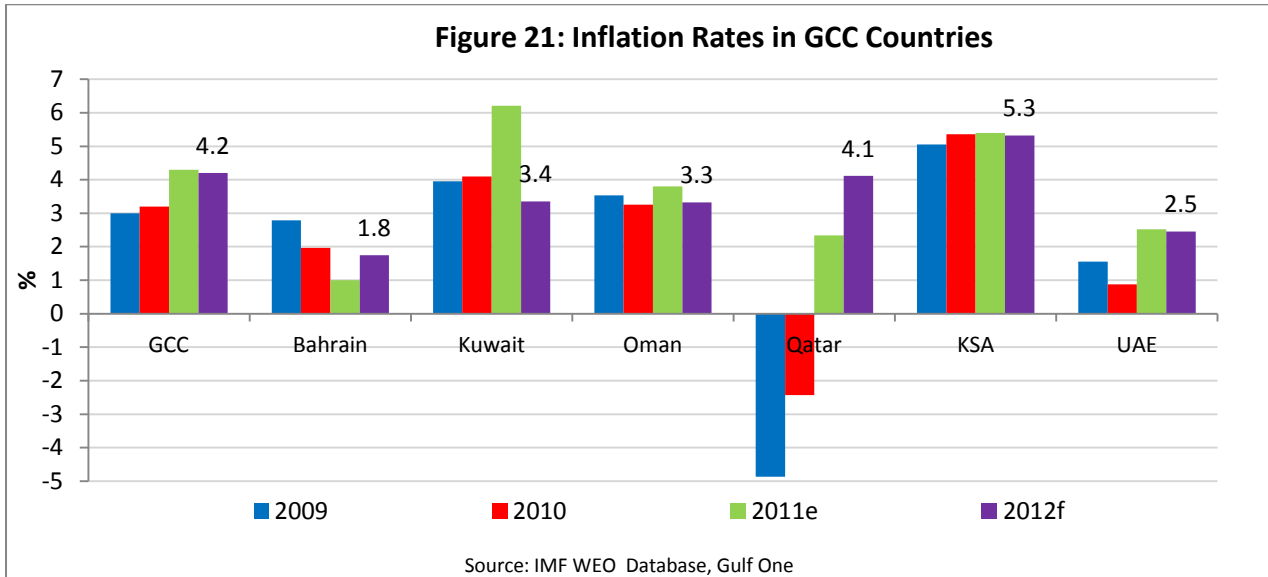
On the domestic fiscal front, oil revenues would be sufficient enough to support the planned expenditure programmes of governments in the GCC countries with only one exception, Bahrain, which is expected to see a budget deficit of around 7% of GDP. All other GCC countries, however, will enjoy healthy fiscal surpluses (Figure 20), as oil prices are likely to exceed budgetary break-even oil prices.

Figure 20: GCC Fiscal Balances as Percentage of GDP

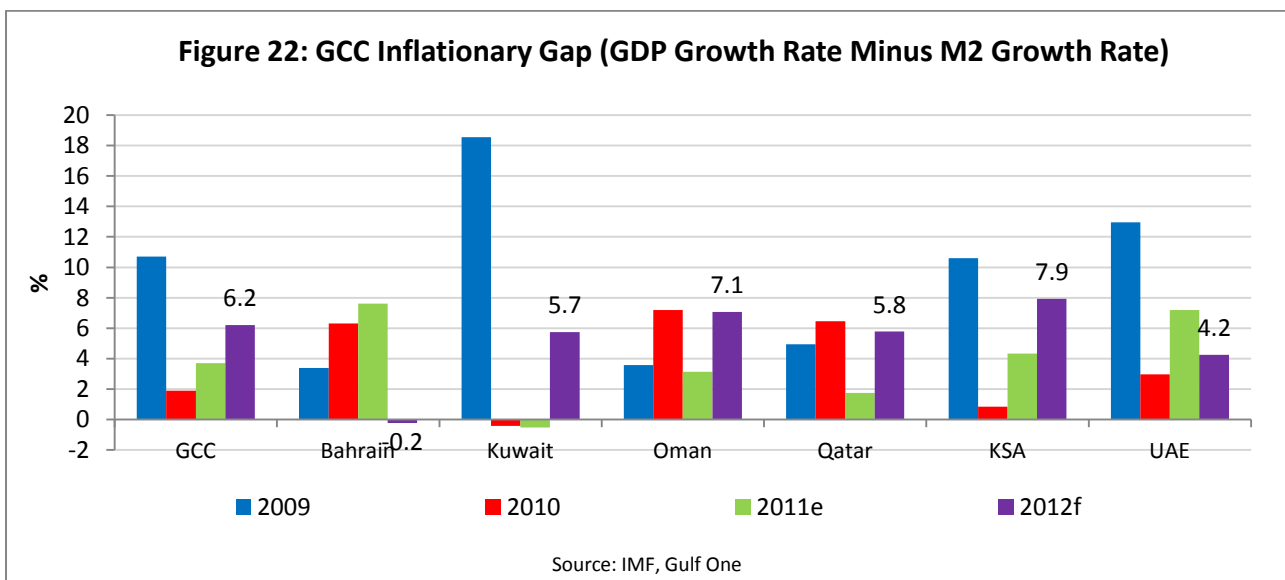


Source: IMF WEO Database; Gulf One

As the eurozone crisis is likely to depress non-oil commodity prices, including cost of food, inflation in the GCC countries is likely to be lower in 2012 than in the previous year. Here again, the exception is Bahrain where inflationary pressures will set in as economic recovery gathers momentum. Even so, inflation will still be much lower than in the pre-Uprising years (Figure 21).



However, using the concept of inflationary gap – the difference between growth rate of real GDP and growth rate of broad money supply (M2) – one can see that the official inflation figures in GCC countries tend to understate the magnitude of changes in consumer prices. For example, inflation measured by the inflationary gap is expected to be 7.9% in 2012 in Saudi Arabia (Figure 22), while inflation based on official estimates is put at 5.3%, implying actual inflation could be understated by at least 2.6%. The good news is that the gap between official inflation and “implied inflation” (inflationary gap) in all GCC countries has narrowed since the 2008 global financial crisis compared with the boom period of 2003-2008 when the gap was in double digits.



CONCLUSION

The lingering eurozone debt crisis has created widespread uncertainty, eroded consumer and investor confidence, and rattled markets across the globe. The problem was exacerbated by policy dithering and lack of decisive action on the part of Eurozone leaders to nip the crisis in the bud, which has allowed it to spread from Greece to other peripheral countries, and is undermining not only the economies of the euro area but the entire global economy. The eurozone economy is slipping into recession in 2012 with serious consequences for the rest of the world through a number of transmission channels, including the financial market channel, international trade flows and commodity prices.

It is feared that a disorderly default by Greece and other peripheral countries in the eurozone could unleash yet another international financial crisis through a complex web of sovereign debts owed to international banks. However, the banking transmission channel is likely to have a limited impact as the share of non-euro area banks in debt outstanding of these countries is relatively small. The greatest risks to global and GCC economies, however, revolve around international trade linkages and commodity prices. On the global scale, the transmission mechanism of the eurozone crisis could come from China, the principal driver of global growth and the biggest trading partner of the euro area. A recession in the eurozone will hit China's exports badly and could slowdown the growth rate of the economy, with attendant consequences for the rest of the world. The problem will be further exacerbated by the fact that intra-eurozone trade is relatively high, which means that contraction in the region could create supply-side constraints and a collapse in trade within the region that could undermine the economies of the bigger regional countries such as Germany and France.

In the case of the GCC, the EU is their major export destination and import source, and the volume of trade between the two regions could be slowed by the eurozone crisis. A weaker demand from the eurozone could dent commodity prices, but it will hit non-oil commodities more than oil prices due to the heightened geopolitical tensions in the Middle East resulting in relatively high oil prices throughout most of 2011, and this could work to the advantage of the GCC countries. As a result, anticipated revenues would be sufficiently high enough to warrant a healthy fiscal and current account position in the GCC region. Inflationary pressures would also ease due to lower global inflation and non-oil commodity prices, including food prices which had in the past accounted for the bulk of imported inflation in the GCC countries. Overall, the region would weather the potential impacts of the eurozone crisis with a favourable economic outlook for 2012 albeit at a slower pace than in the preceding year, due to indirect effects from slower growth in the emerging economies, but a much brighter economic prospect awaits the region in 2013 and beyond as the world economy emerges stronger out of the eurozone economic debacle.

Gulf One Investment Bank B.S.C. (c) is a Bahrain registered bank whose vision is to be the leading knowledge-based infrastructure investment bank in the MENA (Middle East and North Africa) region. Its mission is to mobilise local and global capital to accelerate the execution of infrastructure projects via innovative custom made financial solutions.

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