

THE IMPACT OF COVID-19 on Arab Financial Systems



Shared Prosperity Dignified Life



الاتحاد المصرفي العربي
Union of Arab Banks

E/ESCWA/2020/Policy Brief.8



Introduction

The combined impact of COVID-19 and a historic drop in oil prices has placed some Arab countries' financial systems on the brink of collapse. The Arab region is experiencing an unprecedented drop in demand for equities and commodities, tightened financial conditions, higher risk premiums, and low banking sector resilience. This requires immediate measures by Arab Governments and central banks to sustain financial sector liquidity and facilitate necessary credit at any cost during the relief period tailgated by additional financial measures during recovery.

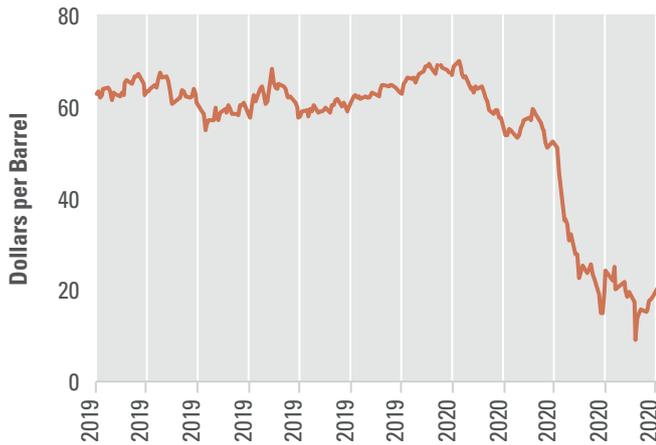
Impact Assessment

1. Heightened volatility in oil markets is expected to reduce the appetite for risk and alter capital market investments, especially in oil-rich economies. Comparing induced uncertainty for the first three weeks of post-peak for both the period 2008-2009 and

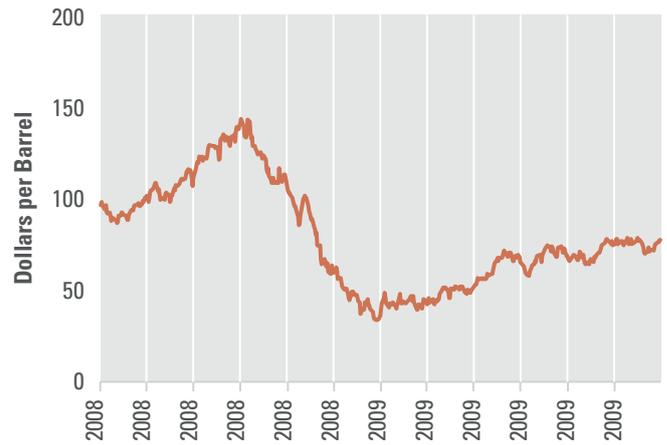


©istock.com/designer491

Brent oil prices during the COVID-19 pandemic



Brent oil prices during the 2008-2009 financial crisis



Source: U.S. Energy Information Administration, Crude Oil Prices: Brent - Europe [DCOILBRETEU], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DCOILBRETEU>, May 11, 2020.

for the current crisis shows that the variability in the current downturn is almost 10 times higher than that of the Great Recession. This high uncertainty is expected to create an unfavorable environment for investments, especially in Gulf Cooperation Council (GCC) markets. The indirect impact of low oil prices on oil-poor economies will be transmitted through lower than expected remittances and low tourism and investments from GCC countries.

2. **The drop in oil prices and the COVID-19 pandemic resulted in a 23 per cent average loss for major Arab stock markets by the end of the first quarter of 2020.** The COVID-19 pandemic and the decline in oil prices have shattered the stock market in Arab countries, putting the performance of financial markets below the 2008-2009 collapse, especially in oil-dependent economies. GCC countries have recorded their highest capital market losses in decades, with the United Arab Emirates bearing the highest cost. Non-GCC countries, such as Egypt, Morocco and Tunisia, are in a similarly precarious position. In these countries, interruptions to key economic activities, including a decline in investment, tourism and remittances inflows, and low future growth prospects have caused an equally severe stock market shock.
3. **The twin crises also decreased the share price values of the largest GCC banks by 25 per cent in the first quarter of 2020.** The impact is even larger for banks relying heavily on government deposits. For instance, GCC government-owned banks witnessed a significant decline in share prices during the first quarter of 2020, with the biggest declines recorded by the largest two banks in the United Arab Emirates. The twin crises will also result in a considerable fall in deposit growth in all Arab economies. A harder shock to bank deposits is

Bank share price losses in GCC countries



Source: Calculated by ESCWA and UABs.

expected in more vulnerable countries, such as Algeria and Iraq, owing to little cash reserves, an absence of sovereign wealth funds, and high dependence on oil revenues for financial sector liquidity.

4. **Capital flight and low portfolio flows will lead to a widening yield spread and will place additional pressure on exchange rates.** According to the International Monetary Fund, portfolio flows to the region dropped by \$2 billion between mid-February and the end of March 2020. Moreover, the region is required to pay \$35 billion worth of maturing foreign lending in 2020. Looking forward, foreign direct investment is expected to drop by \$17.8 billion, and exports by \$88 billion in 2020. All these factors will raise additional exchange rate risks in the region. Major economies' zero interest rate rule might not help Arab countries with a high yield spread, owing to decreasing macrofiscal stability in most countries prior to the COVID-19 pandemic and obscure post-emergency planning.

- 5. Credit is expected to shrink in all GCC countries, and risk premium is on the rise.** Credit growth is expected to range between -9 per cent (a \$14.5 billion decrease) and -4 per cent (a \$6.5 billion decrease), depending on whether oil prices settle between \$35 and \$45 per barrel in 2020. Risk premium will also range between 4.8 and 5.7 per cent for the same range in oil prices. The hike in risk premium owing to record low oil prices will increase the borrowing cost, and induce credit quality reassessment in GCC countries.
- 6. Non-oil middle-income countries, such as Egypt, Morocco and Tunisia, will experience tighter banking sector liquidity and significantly higher credit risk compared to GCC countries.** Credit growth in non-oil middle-income countries is expected to range between -16 per cent (a decrease of \$11.3 billion) and -13 per cent (a decrease of \$9.2 billion), reflecting subdued investment prospects. Risk premium is expected to stubbornly stay at 11 per cent, owing to high debt levels and low overall expected macrostability in 2020-2021. The positive impact of low oil prices in oil-poor economies will be outweighed by a drop in remittances, investments and tourism.
- 7. Default rates are expected to increase from 5 per cent in 2019 to 10 per cent in 2020, on average, and nonperforming loan (NPL) ratios will more than double to reach around 6 per cent.** GCC Islamic banks are expected to be affected more than conventional banks since they have higher exposure to the real sector, which they adopted as their asset backing principle. Based on ESCWA estimates, bank profits in GCC countries are expected to decline as the increase in credit risk and default costs will not be offset by the considerable decline in bank cost of funds.

Regional Policy Response

- 1. Encourage Arab sovereign wealth funds to participate in boosting regional economic recovery.** Shifting part of these funds' global investments towards investing in Arab economies may ease the pandemic's repercussions and reduce rampant unemployment in the Arab region. Doing so will also limit the exposure of these funds to the volatility of international financial markets.
- 2. Establish an emergency swap line between Arab reserve-poor and reserve-rich countries.** This will provide countries with limited reserves the required liquidity to support their balance of payments, and enhance the capacity of central banks to help fragile financial systems maintain their required reserves. It will also ensure that dollar-dependent economies stay functional during the emergency period.
- 3. Establish Arab specialized funds to provide lending incentives in sectors employing the working poor and women,** especially in agriculture, tourism, low productive services and less sophisticated manufacturing. Such investments will help maintain food security, and also sustain the livelihoods of small earners in the Arab region.



©istock.com/Roman Stavila

Risk premium and credit growth projections

GCC countries	
	Range for 2020
Risk premium	From -9% to -4%
Credit growth	From 4.8% to 5.7%

Non-oil middle-income countries	
	Range for 2020
Risk premium	From 10.8% to 11%
Credit growth	From -16% to -13%

Source: ESCWA and UABs projections



4. In countries with limited monetary regime interventions, foreign currency support is necessary, especially in countries with dual currency regimes.

Regional and international support to countries with limited fiscal and monetary space, heavily indebted

middle-income countries and LDCs, is required to maintain currency stability and lower the risk of financial sector default on foreign borrowing, especially since matured foreign borrowing in the Arab region totals \$35 billion for 2020.

National Policy Response



Arab central banks should continue providing adequate liquidity to the financial system at any cost during the relief period and during recovery.

This measure will allow banks to stay solvent and facilitate corporate credit, especially to small and medium enterprises, to avoid mass bankruptcies. The prolonged uncertainty related to the COVID-19 pandemic necessitates accommodating low long-term interest rates in countries with flexible exchange rate regimes. It is also important that central banks facilitation of additional liquidity should outweigh large credit draws as a result of the pandemic by large firms and investors.



Loan restructuring for firms, especially small and medium enterprises, is essential to eliminate default risks.

Debt restructuring is expected to ease credit repayments during the relief period, and reduce default rates as long as borrowers are willing to make their payments on time. This should not be accompanied by any loan risk reassessment, since such assessment would be viable only during the recovery period and not during the relief period. Beyond debt restructuring, deferring loan payments reduces the financial burden, especially for highly leveraged investors.



Arab Governments should provide targeted stimulus packages to micro, small and medium enterprises and to households in general by securing liquidity.

This could be done by supporting credit guarantees for short-term liquidity needs (bridge loans at zero interest rates). In addition to debt repayment deferrals, Governments should be aware that micro, small and medium enterprises are also in need of cash flow to cover short-term expenses vis-a-vis payment deferral. This requires banks to provide temporary cash flow facilitation and subsidy reliefs to households and companies until the state of emergency is lifted.



Crisis management and contingency plans are vital, especially for small and medium enterprises.

Most small and medium enterprises in the Arab region lack contingency plans and the ability to modify their business and production models, even in times of stability. Governments should therefore provide them with technical assistance on crisis management in order for them to survive the current recession and better manage the recovery period.



Shared Prosperity Dignified Life



VISION: ESCWA, an innovative catalyst for a stable, just and flourishing Arab region

MISSION: Committed to the 2030 Agenda, ESCWA's passionate team produces innovative knowledge, fosters regional consensus and delivers transformational policy advice.

Together, we work for a sustainable future for all.

www.unescwa.org