arqaam CAPITAL

Publication: Emirates Business 24/7
Description: English Daily – UAE
Circulation: 85,000
Date: 14 February 2010
Page: 13

COMMENT

Greek problems may have wider impact on GCC

DR SALWA HAMMAMI LABIB AND NICK GROENE

There may be major doubts whether Greece will achieve the planned rate of deficit reduction. Whether we believe its alleged recovery path will be over-optimistic or not, we are right to keep a close watch on what is happening there- not least because of the wider impact on the GCC from gyrations in the markets for FX, oil, and credit.

Europe is experiencing a public debt problem to match the private one. It is not quite business as usual for most corporate. Europe which has traditionally relied on loans from (now wobbly) banks and has perforce resorted, over the course of the past year, to its capital markets for refinancing at exorbitant rates. But the end-of-year budget deficit at almost triple the Maastricht ceiling of three per cent has knocked the bottom out of any confidence in Greek's public finances. This sort of revelation has enraged those who will be punished for Greece's budget problems. It has also focused minds on worsening fiscal pressures in, above all, Portugal and Spain and has challenged the single currency on its fundamentals.

As the deteriorating fiscal crisis in Greece came to the fore, flow data showed increased bets on the euro on fears that it will not be able to withstand contagion from Greece's budgetary problems. Prices of Greek debt tumbled and the corresponding yields rose. Credit-default swaps (or the cost to insure the debt securities) of the government of Greece invariably soared and spread to the obligations of Spain and Portugal. Credit-default swaps also on the banks of Portugal and Spain widened because of their significant exposure to their government's credit.

> How and to what extent it [the Greece crisis] will morph into a social and political problem is the next European test

At present, many European governments are outlining harsh deficit-cutting measures – the flipside of which is lower growth – as they claw their way back from this fiscal grip. These measures entail any from VAT hikes to hiring freezes and subsidy cuts, with the pressing need for other European countries to follow suit and remain dedicated to stay the course.

But the reality of the bailout is that while it will appease jittery investors, on commitment to austerity, it will do little to assuage voters and cool social upheavals. The debt problem is only the beginning. How and to what extent it will morph into a social and political problem is the next European test.

The ongoing events in Greece have triggered US dollar strength over the medium term, largely on its safety as a safe haven away from the Club Med debt markets. But euro weakness will not turn into a rout. The dollar may rally against the euro in the short to medium term, but the $1.6 trillion (Dh5.87trn) US budget deficit and record debt loan will anchor expectations (despite the perception that the US growth outlook is more favourable than in the rest of Europe).

On increased strains in the medium term, the effect of the fallout in the euro on the GCC will be felt through the risk premium, and the markets for energy and currencies.

In a curious peculiarity of last week's events, the solvency issues facing Greece almost did not impact upon other GCC credit markets except for Dubai. Credit markets are a major stress point for the emirate. As Greek spreads significantly widened, Dubai CDS jumped to the 590/600bp level from around 430bp two weeks ago, and the sell-off in its paper was felt at length in the first few days.

What's more, we think that with uncertainty over Dubai World astir, Dubai paper will continue to trade down (in sympathy) every time spreads of any peripheral sovereign debt widen, in a move that will not be shared by other GCC credit markets.

With the dollar strengthening, oil is expected to tumble, reinforcing the growth in supply associated with the recent reduction in compliance to Opec's output quotas.

Separately, sustained dollar strength will moderate inflationary pressures in the region. Given the GCC's currencies are pegged or tightly linked (as in Kuwait's case) to the US dollar, an appreciation of the latter will drum down, in local currency terms, the cost of imports denominated in currencies other than the dollar. Tangible signs of deterioration in import prices will make a helpful contribution to lowering inflation, in light of the region's high reliance on imports from the euro-zone.

It is in these distinctive features that the whiff of a contagion in Southern Europe will be most felt in the GCC. When and how the Greek saga will conclude will determine the extent to which these wider implications can be sustained.

■ *Dr Salwa H. Labib is the Senior Economist and Nick Groene Director of Treasury at Arqaam Capital. The views expressed are their own*