Financial systems in MENA were generally less affected than those in other regions, although they were not spared from the global financial crisis. There were significant differences within the region. The crisis had a stronger impact on countries in the Gulf Cooperation Council (GCC), where financial systems were more globally integrated and banks more overextended. Countries elsewhere in the region weathered the crisis better. Countries that were less integrated and had financial systems dominated by the state were least affected, although these mitigating factors have negatively affected their financial and economic development and will constrain future performance (see chapters 3 and 5).

The political instability unfolding since early 2011, however, has been taking its toll on several countries. Credit started to recover in 2010 in most countries, although the speed and strength of the recovery remain uncertain and could reverse, especially in countries affected by political instability. If previous crises provide any guidance, it will take some time for credit to recover fully.

In addition to questions about its speed and strength, an important issue for long-run growth performance is the scope or breadth of recovery. There is little reason to believe that in the absence of reforms this recovery will be inclusive, expanding finance to a large number of economic units and creating the conditions for a high and sustained growth of output and employment in the long run—the region’s main challenge.

This chapter briefly reviews the impact of the global financial crisis on the region’s financial systems, touches on the effect of the unfolding political turmoil, and assesses the strength of the credit recovery. The chapter is structured as follows. The first section examines the impact of the global crisis and the recent regional turmoil on the region’s equity and bond markets. The second section assesses the impact of the global crisis
on banking systems, identifying the channels of transmission in the main subregions. In the absence of recent data, the impact of the regional political unrest on banking systems cannot yet be quantified. However, the third section assesses the likely pace and strength of the credit and output recovery in light of recent political turmoil.

**Impact on Regional Equity and Bond Markets**

MENA stock markets reacted to the global financial crisis with a lag in comparison to markets in high-income and other emerging economies: as a result of high oil prices, they held up better than markets elsewhere until the third quarter of 2008 (figure 2.1). However, both the GCC and non-GCC stock markets crashed with other stock markets around the world during the worldwide panic in the fourth quarter of 2008, following the bankruptcy of Lehman Brothers. The fall of stock prices in the GCC was more pronounced, reflecting the burst of the real estate bubble and the subregion’s greater openness relative to other parts of the region.

Since early 2009, MENA stock markets have followed the major trends in mature and key emerging equity markets, but political unrest has had a negative impact on several markets. GCC markets and the Arab Republic of Egypt are more globally integrated than their non-GCC peers and have fluctuated more in line with global sentiment. The regional political turmoil that erupted early in 2011 led to a decline in GCC indexes and to government intervention aimed at improving market sentiment in some countries. Markets rebounded slightly in March 2011, but as of April 2011, all GCC indexes, especially the Dubai index, were still well below their peak in mid-2008. The slow rebound partly reflects the fact that stock prices were overvalued in the very high-liquidity environment of the precrisis years.

Non-GCC stock markets also recovered after the global crisis, but the recent turmoil has affected them more significantly. Egypt’s stock market—the largest and most globally integrated in the subregion—showed the highest correlation with advanced and Brazil, the Russian Federation, India, and China (BRIC) markets. Other markets in non-GCC countries are small and insufficiently liquid to draw major global investors; prices in these markets have been driven more by domestic prospects than by global trends. Equity markets rebounded from the crisis more strongly in Tunisia, Morocco, and Lebanon than in high-income countries or the GCC. Jordan underperformed its peers, because its banking sector put the brakes on lending to the economy as the crisis unfolded. The political crisis in the region had major effects on local stock markets, especially in Tunisia and Egypt. Tunisia’s market declined
FIGURE 2.1

Stock Market Indexes in Selected Country Groups, 2007–11

a. Global

b. Gulf Cooperation Council

c. Non-Gulf Cooperation Council

Source: Bloomberg database.

Note: BRIC = Brazil, the Russian Federation, India, and China.
substantially, and Egypt’s market was closed for almost two months. After being threatened with exclusion from the MSCI Emerging Markets index, Egypt reopened its market on March 23, 2011, with a substantial decline in prices.

The impact of the global financial crisis on the region’s sovereign debt broadly mirrored global trends, with a sharp spike in credit spreads as a reaction to the Lehman bankruptcy and a rapid decline as the panic subsided. The compressed credit spreads observed in the precrisis period in all major emerging regions increased dramatically in the aftermath of Lehman’s collapse (figure 2.2). However, credit spreads fell in 2009 in all emerging regions, as risk appetite and global liquidity improved.

**FIGURE 2.2**

Debt Spreads in Selected World Regions, 2007–11

(a. Sovereign one-year credit default swap)

(b. Sovereign one-year credit default swap, Middle East and North Africa)

(Figure continues on the following page.)
The Dubai World event in late 2009 had an immediate impact on credit default swap spreads in the GCC and Egypt, but spreads remained wide only in Dubai. Debt concerns related to Greece affected world debt markets in the second quarter of 2010, but spreads stabilized in the second half of 2010.

The political crisis that began in Tunisia in December 2010 and spread to Egypt, the Republic of Yemen, Libya, Bahrain, and the Syrian Arab Republic in early 2011 led to significant market reactions for the

region’s sovereign debt instruments. Contagion from the Tunisian crisis was negligible; from Egypt it was stronger and led to an immediate increase in credit default swap spreads in almost all countries in the region. The effect of the crisis in Libya and Bahrain has been even stronger, because of fears that oil production could be affected.

Domestic fixed-income markets in emerging non-GCC countries in the region have been largely insulated from the global financial crisis, but markets suffered in countries with prolonged political unrest in 2011. Domestic markets for government securities are undeveloped and relatively illiquid, and private fixed-income markets are virtually nonexistent (see chapter 9). Although Egypt, Jordan, Lebanon, Morocco, and Tunisia have sizable domestic government debt markets, their global integration is marginal. Only Egypt has attracted foreign investor interest; low liquidity and other structural problems have made the other markets unattractive to global investors. Unlike the global crisis, the regional political crisis had a major effect on local government securities markets in countries most affected by the turmoil. In Egypt, government securities yields spiked, and foreign investors (who made up about 10 percent of the investor base and invested primarily in short-term securities) withdrew from the market.

The GCC debt/sukuk market grew rapidly between 2003 and 2007; as the global financial crisis erupted, the market, especially its corporate segment, suffered a setback (figure 2.3). The Dubai World event in November 2009 was a major shock to GCC debt markets. The large gap in spreads over the London interbank offered rate (LIBOR) between GCC sukuk and conventional instruments had been narrowing throughout 2009, but the Dubai World and Nakheel standstill announcements caused a jump in all spreads and a widening gap between conventional and sukuk spreads. By early 2011 the spread had largely dissipated (figure 2.4). The spread reflects a premium on sukuk over conventional bonds, as a result of the legal uncertainties regarding sukuk revealed by the Nakheel sukuk debacle. The recovery of the issuance by the United Arab Emirates reflected the continued market access for Abu Dhabi issuers. Nearly three-quarters of GCC issues were internationally syndicated and denominated in U.S. dollars. Only Kuwait and Qatar (since 2011) have nonnegligible local currency government debt.

**Impact on Regional Banking Systems**

**Impact on Credit Growth**

The global financial crisis was preceded by a credit boom in most emerging regions. Credit growth rates were particularly high in the
Europe and Central Asia region, where they averaged about 35 percent a year (figure 2.5). Average credit expansion in Latin America and the Caribbean was also substantial, approaching the levels in Europe and Central Asia in fall 2007. Average credit growth rates in Asia were lower,
FIGURE 2.5
Annual Credit Growth in Emerging Regions, 2006–11

a. Credit growth, year over year, emerging regions

b. Credit growth, year over year, Middle East and North Africa

c. Credit growth, year over year, Gulf Cooperation Council

(Figure continues on the following page.)
Credit growth quickly collapsed around the world following Lehman’s bankruptcy in September 2008.1

In the run-up to the financial crisis, credit growth had been on an upward trend in all three MENA subregions. During the oil boom years of 2003–08, abundant liquidity in the GCC countries led to excessive credit growth that topped 50 percent in Qatar, the United Arab Emirates, Bahrain, and Oman and exceeded 30 percent in Kuwait and Saudi Arabia at the peak (Khamis and Senhadji 2010a). The GCC credit expansion—which entailed a large component of real estate lending and in some countries increasing reliance on foreign funding—accelerated during most of 2008, in contrast with trends in other regions. In comparison with the GCC, credit expansion was moderate in emerging non-GCC countries in the region, where financial systems are less globally integrated, and the

\[\text{FIGURE 2.5 (continued)}\]

Source: IMF 2011.
banks were neither overextended nor reliant on foreign funding for credit expansion. Credit growth averaged about 10–15 percent a year in this subregion, although it was much higher in Jordan in 2006 and Morocco in 2008.

With the collapse of asset and commodity prices and the freezing of financial markets, the crisis reached emerging economies and led to a sharp slowdown in lending in virtually all MENA countries, especially those in the GCC. The very sharp credit slowdown in the GCC reflected not only reduced oil inflows but also restricted access to foreign borrowing and domestic banks’ curtailing of real estate lending. The prompt and forceful reaction by the GCC authorities included fiscal stimulus, monetary easing, and exceptional measures to support the financial sector (IMF 2009a, 2009b, 2010a, 2010b; Khamis and Senhadji 2010a). Despite the aggressive measures, the balance sheet adjustment of the banking system was still sizable: credit growth collapsed as a result of both supply and demand factors, as banks had to reduce their high loan-to-deposit ratios and reduce foreign borrowing in some cases. The oil and real estate sectors in particular took a major hit.

The global liquidity squeeze had a milder effect on non-GCC countries. Their much lower loan-to-deposit ratios (averaging less than 80 percent) indicate that these banks were not overextended and relied primarily on their deposit bases (figure 2.6). As an indication of the modest

FIGURE 2.6

Loan-to-Deposit Ratios in Selected World Regions, 2006–11

Source: IMF 2011.
global integration of their banking systems, these countries, especially those with state-run financial systems, had low average ratios of foreign liabilities to total liabilities (figure 2.7). Nevertheless, net lending slowed in all countries during 2009 and came to a halt in Jordan and Egypt. Policy measures by the authorities were more modest than in the GCC. Given high debt levels, the fiscal space allowed for only modest counter-cyclical measures. Monetary easing entailed mainly lower reserve requirements; central banks were cautious to cut interest rates (IMF 2009a, 2009b, 2010a, 2010b). Financial measures included the announcement of a blanket deposit guarantee in Jordan and the reiteration of the existing blanket guarantee in Egypt.

The non-GCC countries with state-dominated banking sectors maintained credit expansion over 10 percent in the wake of the crisis. The credit patterns in these countries reflect the lack of ties to the global financial system and the major role of state banks. In Algeria and Libya, banks smoothed the effect of the global crisis. Banks reacted more strongly in Syria, where credit growth declined substantially in 2009. The lack of global integration may have alleviated the immediate adverse impact of the crisis on the economy and the financial sector, but it has also hindered financial development in these countries, as shown in chapter 3. Moreover, there is evidence that the precrisis performance of state-owned banking systems in MENA was significantly worse than

![FIGURE 2.7
Foreign Liabilities as a Percentage of Total Liabilities in Selected World Regions, 2006–11](image-url)

Source: IMF 2011.
that of private-led banking systems. Sheltering state-owned banking systems from global integration is unlikely to produce sustainable gains in performance (Farazi, Feyen, and Rocha 2011).

Although it is premature to assess the impact of the political turmoil in the region, there are early signs that economic activity and credit growth are being significantly affected. In other emerging regions, credit recovery is gaining momentum. In contrast, there are signs that credit growth has leveled off or declined in most countries in MENA (see figure 2.5).

In summary, the impact of the global crisis on bank lending reflects the distinct characteristics of the three main MENA subgroups. The peak-to-trough contraction in credit growth was the largest, at 45 percentage points, in the GCC countries, the group with the highest financial openness index (as measured by the Chinn-Ito Index [Chinn and Ito 2007]), the highest precrisis loan-to-deposit ratio, the largest share of foreign liabilities in total liabilities, and the smallest role of state-owned banks (table 2.1). Although significant, the decline in the average credit growth rate was much lower, at 21 percentage points, in the emerging MENA group, where financial systems are less integrated but not closed, have lower loan-to-deposit ratios, and rely less on foreign funding, and where, on average, state-owned banks play a moderate role (although with significant cross-country differences). The MENA subgroup with the largest share of state-owned banks, the greatest isolation from the global financial system, and very low loan-to-deposit ratios and foreign liabilities experienced the smallest decline in credit growth rates. However, as shown in this report, the apparent advantages of this group of countries in the face of a crisis represent significant limitations on financial and economic development in the long run.

**TABLE 2.1**

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<td>97.1</td>
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<td>−1.37</td>
<td>49.5</td>
<td>4.3</td>
<td>86</td>
</tr>
</tbody>
</table>

Resiliency of the Banking Sector

Standard indicators of banking system soundness and the lack of systemic consequences underscore the resiliency of MENA banking sectors to the global financial crisis. Banking systems in GCC countries were highly capitalized in the precrisis years, and capitalization increased further in 2009 (figure 2.8). The authorities’ forceful measures to support the banking systems following Lehman’s bankruptcy contributed to the rise in capital adequacy ratios (CARs). Average CARs were significantly lower in non-GCC countries. The minimum regulatory CAR is on average lower in the non-GCC than in the GCC, and some non-GCC banking systems have been struggling with high percentages of nonperforming loans and reduced ability to generate and retain profits. Bank ratings confirm the resiliency of MENA banking systems in the face of the global crisis (figure 2.8). Ratings in GCC countries have been significantly higher, in line with their higher CARs, although the impact of the crisis was generally stronger, as reflected in the decline in ratings. Ratings in non-GCC countries are generally lower, in line with their lower CARs, but the impact of the crisis was more moderate, as reflected in their stable ratings. The crisis reinforced the presumption of government support (no bank failure policies), especially in the GCC.

The immediate impact of the crisis on asset quality and profitability was more significant in the overextended and more globally integrated GCC banking systems than in non-GCC countries. Before the global crisis, assets were highly leveraged and deeply integrated with global financial markets, particularly in the GCC. The global financial crisis exposed these vulnerabilities, leading to significant declines in asset quality and profitability. In contrast, non-GCC banking systems, which had lower leverage and were less integrated with global markets, were less affected by the crisis.

FIGURE 2.8

Average Capital Adequacy Ratios and Bank Ratings in the Middle East and North Africa, 2006–10

Source: World Bank staff compilation based on data from IMF 2011 and Moody’s.
crisis, nonperforming loan ratios had declined significantly, to 1–3 percent, as a result of high credit and output growth, and return on assets had been relatively high. Rapid credit growth, especially in the retail segment, has been the main driver of profitability in the GCC. Between 2006 and 2008, nonperforming loan ratios declined in non-GCC MENA banking systems as well, although some Egyptian and Tunisian banks were still undergoing restructuring and struggling with nonperforming loan ratios of more than 15 percent.3 Profitability indicators were less favorable in the emerging MENA group than in the GCC, especially in Egypt and Tunisia.

The regional political crisis and the unwinding of countercyclical measures will test the resiliency of emerging MENA banking sectors. There has been significant disruption in economic activity in countries experiencing long protests and turmoil. These disruptions will lead to reduced lending activity and deteriorating asset quality and profitability of banks, to different degrees across countries.

Impact on Islamic and Conventional Banks

Although it is still too early to draw definitive conclusions about the final impact of the global crisis on Islamic and conventional banks, the immediate effects indicate that certain characteristics worked in favor of Islamic banks. The financing activities of Islamic banks are tied more closely to real economic activities, Islamic banks avoided direct exposure to exotic and toxic financial derivative products, and Islamic banks in general kept a larger proportion of their assets in liquid form (Ali 2011). The better performance of Islamic banks’ stocks is an indication of their advantages in the crisis so far (Beck, Demirgüç-Kunt, and Merrouche 2010).

Despite their resilience in the early stages of the crisis, Islamic banks have not been immune to the second-round effects of the crisis. As the global financial crisis turned into a global economic crisis, Islamic banks and financial institutions started to be indirectly affected. The business model of many Islamic banks—which relied on murabaha financing and invested predominantly in the real estate sector and in the previously growing equity markets—has been facing higher risks (Ali 2011). Although this business model helped contain the adverse impact on profitability in 2008, weaknesses in risk management practices—related in particular to high sectoral and name concentration—led to larger declines in profitability compared with conventional banks in 2009 (Hasan and Dridi 2010). These weaknesses highlight the regulatory and supervisory challenges the Islamic finance industry is facing today.
Challenges to the Fragile Credit and Output Recovery

Recovery from the global crisis has been less vigorous in MENA than in regions that experienced sharper contractions; political turmoil, as well as rising food and commodity prices, adds to downside risks for several countries. Although the recovery was under way everywhere in the region in 2010, prospects were different across countries (figure 2.9).4

FIGURE 2.9

Actual and Projected GDP Growth Rates in Selected World Regions, 2008–11

GCC countries were hardest hit by the global crisis, but they recovered quickly on the back of strong fiscal stimulus, exceptional financial sector measures, and the increase in demand for oil, which picked up as a result of the rapid recovery in emerging markets. With rising oil prices, government spending and growth in the GCC are expected to accelerate in 2011, although the sluggish credit recovery may slow the full recovery of the nonoil sector. Bahrain, which has experienced prolonged political unrest, is likely to be negatively affected. However, GCC countries have ample fiscal space to respond to political unrest and rising food and fuel prices with increased spending (figure 2.10).

Non-GCC countries were less affected by the global crisis. They recovered in 2010, but current prospects for a sustained pick-up in credit and output growth look challenging. Prospects for countries with strong ties to Europe (for example, Morocco, Tunisia, and Egypt)

**FIGURE 2.10**

Fiscal Balance and Government Debt as a Percentage of GDP in the Middle East and North Africa

![Bar chart showing government debt and fiscal balance](image)

(Figure continues on the following page.)
have been dampened by anemic growth and sovereign debt problems there, which will reduce exports, remittances, tourism revenues, and foreign direct investment. The regional political turmoil is expected to exacerbate the situation of several non-GCC countries, hindering their recovery. Oil-importing emerging countries in the region do not have the fiscal space for further stimulus. Lebanon has been an outlier in terms of recovery, experiencing a boom in construction and trade driven by foreign inflows into the real estate and banking sectors (the Lebanese Diaspora views the banking sector as a safe haven in times of crisis). Nevertheless, continued instability in the region, as well as higher food and fuel prices, are expected to have a negative impact on Lebanon as well.

Recovery has been weak in non-GCC countries with state-dominated banking systems, which are especially vulnerable to oil price volatility. Real GDP growth recovered only moderately in 2010; as a result of severe political instability, it may not pick up in 2011, even with higher oil prices. Credit activity will probably remain subdued throughout 2011, as a result of political and economic uncertainty, dampening further the prospects of a pick-up in output.
The full recovery of credit and output is an important policy objective for countries in the region in the short and medium runs, but there is no guarantee that even a full recovery of credit will benefit a wide range of economic agents. As argued in chapter 1, if credit remains as concentrated as it has been in the past, MENA economies will probably continue to grow below their potential and fail to generate the required number of jobs for the region’s young and growing population. A sustained and broad recovery will require substantial progress in implementing a financial reform agenda that addresses the structural factors that have blocked access to finance in the past, namely, a very deficient financial infrastructure, weak bank competition, and the dearth of nonbanking financial institutions, markets, and instruments. This agenda also needs to ensure that financial systems remain resilient as access is broadened. These issues are discussed in more detail in the following chapters.

Notes

1. China was a notable exception, experiencing a vigorous credit expansion during 2009 that was driven by state banks.
2. Between 2006 and 2008, capital adequacy ratios (CARs) declined in all GCC countries except Qatar, albeit from a high base. This decline was driven primarily by high credit growth, which increased the volume of risk-weighted assets. In addition, GCC banking systems have a relatively large share of Sharia-compliant banks, which tend to have higher capitalization than conventional banks. As GCC countries are generally advanced in the implementation of Basel 2, in some cases extra capital charges weighed on their CARs.
3. Financial soundness indicators are less straightforward to interpret in the state-dominated banking systems of Algeria, Libya, and Syria, because state-bank accounts are generally not audited according to international standards.
4. This section draws on IMF (2010a, 2010b); Khamis and Senhadji (2010a, 2010b); and World Bank (2011).

References


