VERANSTALTUNGSBEITRAG

Konrad-Adenauer-Stiftung e.V.

AUSLANDSBÜRO JORDANIEN

June 19th, 2010

LEA COLLET

DR. MARTIN BECK

International and Arab Perspectives on the Recent Economic Crisis

Market or State Failure?

Event: International Workshop
Date/Place: June 19th, 2010, American University of Beirut
Conception: Dr. Marcus Marktanner, Dr. Martin Beck
Organisation: KAS Amman, American University of Beirut – Institute of Financial Economics

1. Program Overview

Saturday, June 19th, 2010

Opening Session

Acting Director Institute of Financial Economics American University of Beirut Beirut – Lebanon	Dr. Simon Neaime
Resident Representative of Konrad Adenauer Stiftung Amman – Jordan	Dr. Martin Beck

First Session: Economic Crisis in their Global Context

Economic Crisis in Retroperspect	Dr. Ibrahim Hassan Seif Secretary General Economic and Social Council Jordan
Today's Debt Crisis	Dr. Darius Martin Professor Department of Economics American University of Beirut Beirut – Lebanon
Moderator	Dr. Samir Makdisi Professor American University of Beirut Beirut – Lebanon

Second Session: Global Crisis Spillovers in the Arab World

The Global Financial Crisis and the Dubai Crisis	Dr. Mohamed Ramady Faculty of Finance and Economics King Fahd University of Petroleum and Minerals Dhahra – KSA
Was Lebanon Insulated from the Debt Crisis?	Dr. Youssef Khalil Senior Director Financial Operations Department Banque du Liban Beirut – Lebanon

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Third Session: Perspectives, States, Markets and Crisis

The Ordoliberal Perspective	Dr. Marcus Marktanner Professor Department of Economics American University of Beirut Beirut – Lebanon
Challenges to Economic Crisis Management in the Arab World	Prof. Dr. Fouad Hamadi Beseiso Professor of International Economy, University of International Islamic Sciences Amman – Jordan
Moderator	Dr. Martin Beck Resident Representative of Konrad Adenauer Stiftung Amman - Jordan

2. Objective

The KAS Amman Office and the AUB's Institute of Financial Economics have organized a joint workshop on June 19th, 2010, on international and Arab perspectives on the recent economic crisis. The workshop focused on the question whether the global financial and economic crisis was caused by a market or a state failure.

After three decades of market reforms and liberalization, many developing countries have experienced an increase in allocation efficiency, but not equitable social development. In many places, uneven social development has led to a questioning of economic reforms, even political instability. The effects of the recent global financial and economic crisis have accelerated this process. In the light of the worldwide economic slowdown, the failure of key businesses, declines in consumer wealth, collapse of the US subprime mortgage market and large financial institutions and the downturns in stock markets, governments in even the wealthiest nations had to come up with emergency packages to rescue their financial systems. Now, while the most acute phase of the global financial crisis is passing, also Middle Eastern states are slowly identifying emergency and long-term responses to mitigate the impact of the crisis on their economies.

High-ranking experts involved in both theoretical and practical academic and economic fields as well as analysts, journalists and students participated in the workshop and discussed the different Arab responses to the crisis.

3. Conduct

Dr. Simon Naeime, Acting Director of AUB's Institute of Financial Economics, and **Dr. Martin Beck**, Resident Representative of the Konrad Adenauer Stiftung in Amman, welcomed the experts and participants. Both **Dr. Naeime** and **Dr. Beck** highlighted the fact that the AUB as an academic institution contributes highly to critical thinking and open debate. Dr. Beck also expressed that the topic of the workshop is of utmost importance since it urgently needs to be better understood. For this purpose, KAS and AUB organized this workshop to bring together AUB's academic experts and decision makers from the financial sector.

In the first session **Dr. Ibrahim Seif** gave a brief lecture on the different responses of Arab countries to the financial and economic crisis. At the beginning he stated that as the region is not homogeneous in terms of its economic structure, Arab states have adopted different fiscal, financial, monetary, and sectoral policies to spur economic growth and mitigate the effects of the crisis. Though the crisis has affected the Arab states especially in their external trade volume, workers' remittances, FDI inflow, foreign assistance and grants, real sector and prices of raw materials, the banking sector turned out to be solid and has not been affected much due to its limited integration into global financial markets. **Dr. Seif** underlined that there is, however, a difference between the deficit and surplus countries of the

Arab World in facing the initial impact of the crisis.

The Gulf Cooperation Council (GCC) oil exporting countries, such as Saudi Arabia, Qatar, Bahrain or the UAE, entered the crisis in an exceptionally strong position due to their large financial capacity and relatively small populations.

Less wealthy courtiers, such as Iran, Algeria or Syria, faced a sharp decline of their fiscal and current account surplus because of their weaker fiscal and external positions. Those countries which depend on import for consumption and investment, FDI, remittances, tourism and export were hit hardest in the crisis. Therefore, the responses to the financial crisis varied considerably amongst Arab states and were highly uncoordinated. The various governments focused on only a few sectors and designed resue plans with minimum engagement from the private sector. Furthermore, those plans lacked a long-term vision and the general cooperation between the Arab countries was weak. **Dr. Seif** concluded that governments have to better coordinate monetary and fiscal policies in the future to successfully deal with long-lasting challenges of the financial crisis.

Dr. Darius Martin lectured on the collapse of the US subprime mortgage market and the great recession. He first stated that the subprime crisis came about because of financial instruments such as securitization where banks would pool their various mortgages and resell them to SIVs (structured investment vehicles). The SIVs would finance these mortgages by turning them into securities, i.e. issuing sellable assets (Asset Backed Securities) such as CDOs (Collateralised Debt Obligations). He said that in this way the banks tried to distribute credit risk to investors through mortgage-backed securities. US real estate prices peaked in 2005 but declined quickly thereafter. The refinancing of mortgages became more difficult for clients such as single family households as the ARMs (adjustable-rate mortgages) started to reset at higher rates.

Hence, the mortgage delinquencies increased and the securities lost most of their value. Many banks which owned these CDOs got into enormous liquidity problems and other banks like Lehman Brothers went into bankruptcy.

Dr. Martin then focused on the problems of the originate-to-distribute model and mentioned some reasons why mortgage originators have an incentive not to lend recklessly. The mortgage originators have to warehouse the mortgages prior to securitization since the assets have to be originated to a sufficient level to make the securitization economically viable.

The originators also retain valuable to give a mortgage servicer the responsibility for collecting loan payments from borrowers and for remitting these payments to the mortgage lender after deducting a fee.

Nevertheless, there was an increase in the risk characteristics of subprime borrowers (those borrowers with a less-than-perfect credit rating and who have a greater risk of defaulting) until the peak of the housing boom in 2005. **Dr. Martin** argued that this increase, however, was not the main cause for triggering the crisis. It was caused, instead, by a run in the repurchasement agreements market in late 2007. As securitizations got more complex, investors were unsure whether they were exposed to subprime risk or not. This led to the collapse of SIVs and to a run on repurchase agreements.

In these agreements one party sells the other a security at a specified price with a commitment to buy the security back at a later date for another specified price. Most repos are overnight transactions, with the sale taking place one day and being reversed the next day.

There is, however, the risk that the repo seller defaults on his obligation. Consequently, the buyer keeps the security and liquidates it to recover the cash lend. The security may have lost value since the outset of the transaction as the security is subject to market movements. Not only the solvency of the counterparties were a problem to lenders, but also the location and size of subprime risks held by counterparties in the repo market.

Dr. Martin concluded that this uncertainty led to increases in the repo haircuts, i.e. massive withdrawals from the banking system, and triggered the financial crisis.

In the following discussion **Dr. Beck** highlighted the importance of the state to provide regulation mechanisms in order to prevent financial crisis of this magnitude. He challenged **Dr. Martin's** approach in so far as it explained the nature of the global financial and economic crisis as incurable.

Dr. Ramady opened the second session with a lecture on the impact of the financial crisis on the GCC and the Dubai factor. Though the GCC members were strongly affected by the unfolding global financial crisis, most countries ignored the initial effects, given that these countries have benefited from the reserves accumulated during the 2003–2008 oil price boom.
Crude oil prices reached a record high of 147 US$ per barrel in July 2008, however, as of August 2008, oil prices plunged rapidly. The Arab oil-exporting countries are suffering now from a marked slowdown in economic growth and therefore a lower demand for oil. Due to a lack of co-coordinated response in terms of monetary tools, or explicit government support for depositors, the GCC states were not able to prevent the impact of a global crisis.
The GCC State interventions varied and precipitated a restructuring and standstill of the banking system. Middle Eastern governments and institutions invested heavily in Western markets. Due to the cross-linking of Western markets and the GCC States, governments were not immune against the crisis.
Dr. Ramady pointed out that especially Dubai is most vulnerable to international financial markets which periled the other GCC States. Dubai's shock statement of November 25th, 2009, expressed clearly that Dubai is most vulnerable to international financial market crisis compared to others. When markets have stabilized again they started to differentiate between Dubai risk and other GCC risk. This reaction to Dubai's crisis was reflected by the Dubai Credit Default Spreads that jumped up by 160 basis points as Abu Dhabi helped its banks.
Dr. Ramady made clear that Dubai's financial reputation was heavily affected by a lack of transparency in the team play of Dubai and Abu Dhabi. For instance loan reports turned out to be 5 billion USD instead of 10 billion USD and influenced strongly the trust of investors. Thereby the GCC States quickly learned to adapt their banking system to a centralization of credit policies. They tried to restore the public confidence by stimulating the local stock market and accommodating the government role and fiscal expenditures. The GCC States realized that domestic borrowing would be of key importance to the country in the future. **Dr. Ramady** concluded that another lesson learned the financial crisis is that the GCC will support active state interventionism and stress the regulatory role of the state. The GCC states have to disengage from laissez-fair economic policy shifting to a more transparent regulated policy.
Dr. Ramady also underlined the importance of GCC's economic links with East Asia. After the UAE withdrew from the proposed Gulf Monetary Union in May 2009 a common currency was out of the question. The different pegs used by the GCC States also impeded a common monetary union. Thus the GCC States should now focus more on customs union, labour mobility and the regulation of financial institutions.

Dr. Youssef Khalil, Senior Director of the Financial Operations Department of the Banque du Liban, discussed the situation of Lebanon's economy since the beginning of the global financial and economic crisis. He pointed out that Lebanon's economy has been able to avoid the impact of the recent global crisis despite the country's vulnerabilities, mainly on the political and fiscal levels. The economy has grown at exceptionally high rates with stable prices, while witnessing an unprecedented expansion of the size of its banking deposits and a record high surplus in its balance of payments. This has been due to various factors, such as a prudent monetary policy. Furthermore, FDI significantly increased in Lebanon reaching 3.61 billion USD in 2008, constituting an increase of 32% from 2.73 billion USD in 2007. After the bankruptcy of Lehman Brothers more investment kept on flowing into the country.
Dr. Khalil stated that the key to the investors' confidence is the Lebanese remarkably safe investment environment and the reputable banking sector which is strictly regulated by the Central Bank that keeps high foreign reserves. The central bank forecasts an average

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annual growth of 6% in 2011 in Lebanon, while growth might even reach 8% in 2010.
The country's economy is also benefiting from additional global capital inflows since non-resident Lebanese invest their money in Lebanon due to rising concerns about global banking institutions. Furthermore, the Lebanese Central Bank issued a prohibition of investing in structured products in 2007 in order to protect local banks from the credit crisis. For this reason banks did not invest in hedge funds and still enjoyed high levels of profit.
Dr. Khalil said that the Central Bank predicts Lebanon's public debt to GDP to fall further in 2010 thanks to the continued drop in interest rates and growth in the size of the economy. The debt to GDP ratio fell to 140% in the beginning of 2010 from 170% in 2007. Lebanon's public debt now stands at more than 49.5 billion USD. He then pointed out to other structural problems such as the low productivity level, the obsolete infrastructure and the high construction share in the public sector.
Dr. Khalil concluded that Lebanon has, nevertheless, the capabilities to finance its public debts.
Dr. Marcus Marktanner opened the third session by lecturing on the basic ideas of the concept of ordoliberalism as the philosophical foundation of the Social Market. He based his analysis on the hypothesis that economic crisis are not caused by market failure. Rather, government failure precedes market failure. Therefore, a well designed market structure (as prescribed by ordoliberalism) is of crucial importance.
He then focused on the main features of ordoliberal thought. He said that according to ordoliberalism, the state has to create and to maintain the conditions necessary for competitive free markets. By developing a legal framework, the government secures the conservation and protection of free competition by preventing concentrations of power in both public and private spheres.
Along with these anti-monopoly policies, the government's economic policies are directed at a stable system of reflective prices and the equitable distributions of wealth.
Ordoliberalism combines therefore constitutive principles (functioning price system, free market competition, stabilizing the value of money by monetary policies, private property, freedom of contract and no public bail outs) and regulatory principles (monopoly control, redistribution, internalization of externalities, antitrust policies and supply anomaly intervention to prevent non normal labour supply).
The concept includes also state constituting principles that define how the state is supposed to be organized and supplementary principles which define the governmental interaction with the private sector.
By taking the example of the global food crisis of 2007 which afflicted the world's poor in South Asia, Africa, and the Middle East, **Dr. Marktanner** explained government failure which preceded the crisis. By subsidizing their agriculture, countries drive down the price of commodities and try to protect their agricultural industries from outside competition. By artificially driving down world prices for agricultural goods, other countries' non-subsidized exports are not competitive and small local farmers are forced out of the market. The same applies to bio fuel subsidies which encourage farmers to shift production away from food and towards ethanol, thereby decreasing the supply of food and driving up prices. **Dr. Marktanner** pointed out that without farm and bio fuel subsidies the crisis would not have assumed the same dimension and provoked global trade restrictions.
He concluded that ordoliberalism provides a set of principles of economic policy which identify governmental weaknesses and state failure.

In the following **Dr. Beseiso** spoke about the challenges that the Arab economies have been facing since the onset of the ongoing financial and economic crisis. He first highlighted that the crisis began as a financial crisis, then deepened to become an economic one and finally it evolved into a human development crisis.
He then listed challenges facing the sustainable development in ESCWA member states (Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Oman, Palestine, Qatar, Saudi Arabia, the Sudan, the Syrian Arab Republic, the United Arab Emirates and Yemen). Not only social and political stability, good and effective governance, environmental management and financing, but also structural weaknesses have significant

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impacts on the progress to achieve sustained development in the region. Confronting these challenges, Arab countries have struggled over the past decade to put into place effective institutions and instruments to address the obstacles to sustainable development in the region.

Many indicators show, however, that the crisis' impact on the Arab economies has been quite severe. There was an overall slow down of economic growth which reached 2-9% growth rates in 2009 compared to 6% in 2008. The private sector faced financing problems because of the new trend of conservative banking credit policies and the drastic decrease in oil prices from 150 USD per barrel in mid 2008 to 40 USD at the end of 2008 which let to a sharp decrease in oil export. He added that the FDI flows are estimated to have declined sharply in 2009 by 32% to 19.2 billion USD and the more diversified economies of the region, including Egypt, Jordan, Lebanon, Morocco and Tunisia, were directly affected by the recession in key export markets in the European Union.

Dr. Beseiso cited IMF managing director Dominique Strauss-Khan who said that the economic and policy makers should seize the opportunity to attain a virtuous cycle of peace and prosperity, and avoid a vicious cycle of conflict and stagnation by addressing key weaknesses in the financial sectors.

He reasoned that to achieve post-crisis sustained development, Arab decision makers should effectively formulate, integrate and implement multi-sectoral sustainable development strategies. Furthermore, they should formulate policies to address the inherited structural human development problems from the pre-crisis era. These strategies should take into account the social, economic, political and cultural sensitivities that are specific to each area.

Dr. Beseiso stressed that this would be particularly important for Arab countries given the need to encourage and adopt locally designed approaches to sustainable development that are innovative, appropriate, gradual and applicable to the region.

In the final discussion round the experts discussed the role of the IMF and its methods. Some experts noted that the IMF claims that its procedures and aid plans fit all countries. However, they argued that most IMF measures are not adapted to specific problems in the various countries.

4. Conclusion

The workshop of KAS in partnership with the Institute of Financial Economics of the American University of Beirut revealed that conflicting views prevail on the question whether the ongoing global financial and economic crisis was caused by a market or state failure. Some experts such as **Dr. Marktanner** argued that there is no economic crisis without previous ordoliberal deviations and that they are caused by a lack of proper regulation by the state. Others, such as **Dr. Martin** argued that the financial crisis was mainly caused by new financial instruments (mortgage backed securities, collateral debt obligations, credit default swaps) that resulted in the stock market crash in the US and subsequently affected other economies world wide. According to **Dr. Martin**, the causes and effects of crisis are inevitable and must be accepted as such.

The workshop brought together academic experts and expert from the financial sector. The audience included scholars from other academic institutions, representatives of relevant stakeholder groups, analysts, journalists and AUB students. They actively participated by raising questions on the causes and impacts of the financial and economic crisis on the Arab countries. The experts provided the participants with background information on the crisis and strategies of different Arab states to address the crisis' impact on their economies and societies. Furthermore, the workshop highlighted the importance of such in-depth discussions about the global financial and economic crisis to asses its impact on the region and to debate policy changes needed to address global imbalances. The overall assessment of the workshop's outcome was highly positive and participants and experts appreciated the open debate.