The GCC’s commercial banking sector reflects a particular pattern of economic development reliant on state investment and ownership.

Market Watch Blog AGSIW | Karen E. Young | Jan 29, 2016

The commercial bank sector across the Gulf Cooperation Council is a product of a particular pattern of economic development that has relied heavily on state investment in, and (at least partial) state ownership of, major industry. That industry, as the key driver of economic growth within the Gulf states, is tied to commodity export markets. As oil and gas prices increased in the boom periods of 2003-14 (with a short gap during the global financial crisis of 2008-09), governments have been able to invest in infrastructure and real estate, as well as the traditional commodity export industry.

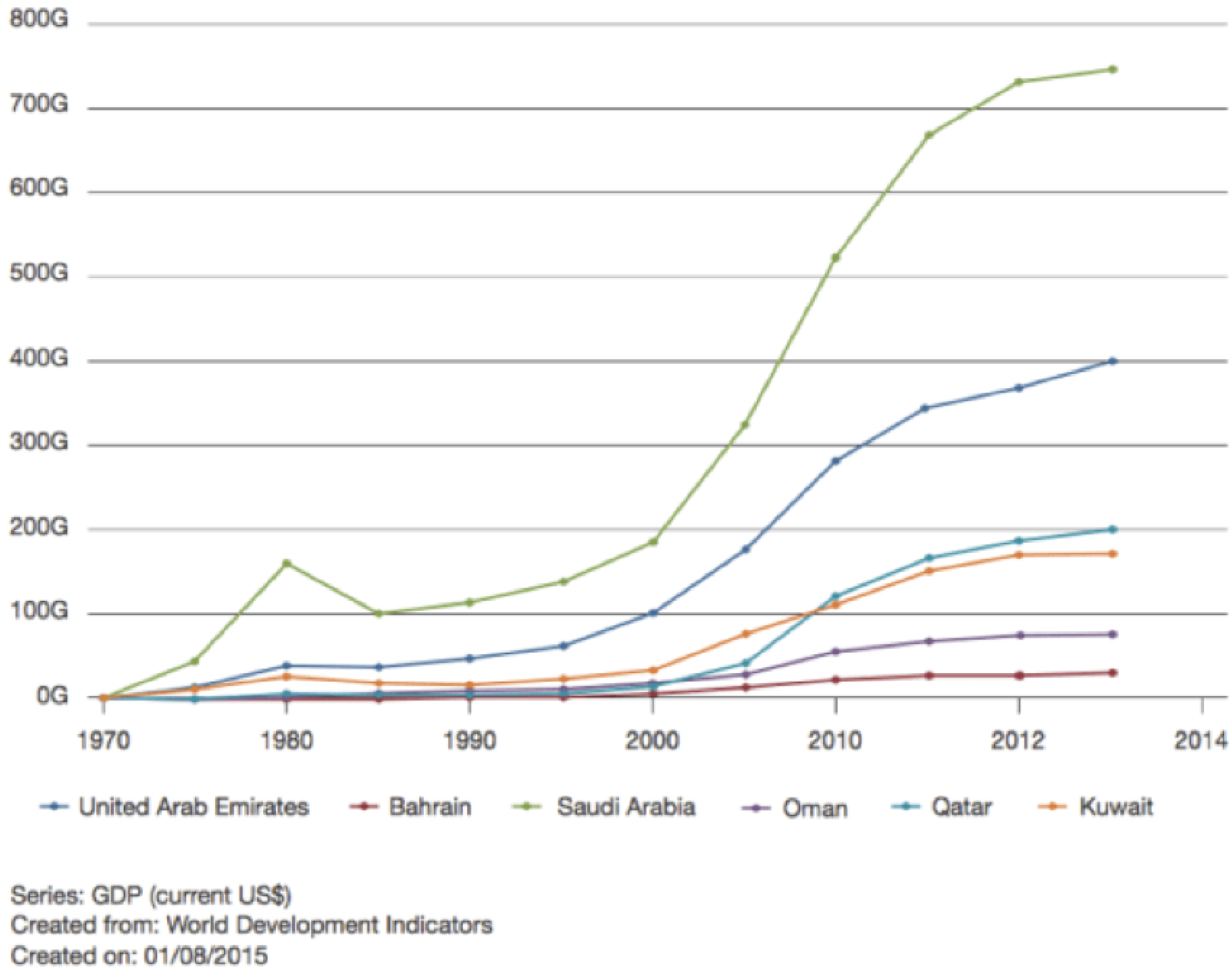

Chart 1: GDP Growth in the GCC 1970-2013. Source: World Bank

Local banks in the GCC have benefited from these economic booms as governments and their related entities have used them to hold large deposits. (Read more about the development of banks and financial governance in the GCC here.) These deposits, in turn, have fueled domestic lending to businesses as well as for personal loans that have enabled the construction of many new homes, the sale of cars, and the Gulf “lifestyle” as we now know it.

Chart 2: Brent Crude Oil Price, $ per barrel. Source: Thomson Reuters, Economist

Times are changing; oil prices have been in sustained decline for a year now. Ripple effects on the bank sector are beginning to emerge. According to economists at HSBC, the governments of Kuwait, Oman, Qatar, and the United Arab Emirates hold more deposits in commercial banks than they do in their own central banks (see Chart 3). Data for Bahrain was not reported by HSBC, though given Bahrain's current fiscal situation, it may be facing a difficult position in maintaining both central bank deposits and government deposits in commercial banks. The local bank sector in each of these states has depended on the government as a major depositor, which has enabled lending and likely guaranteed some preferential lending for government-related entity projects. Saudi Arabia is somewhat of an exception in that most government deposits are held in SAMA, the Saudi Arabian Monetary Authority. However, SAMA's foreign currency reserve assets fell by $19.1 billion in December 2015, putting reserves at their lowest level since mid-2012.

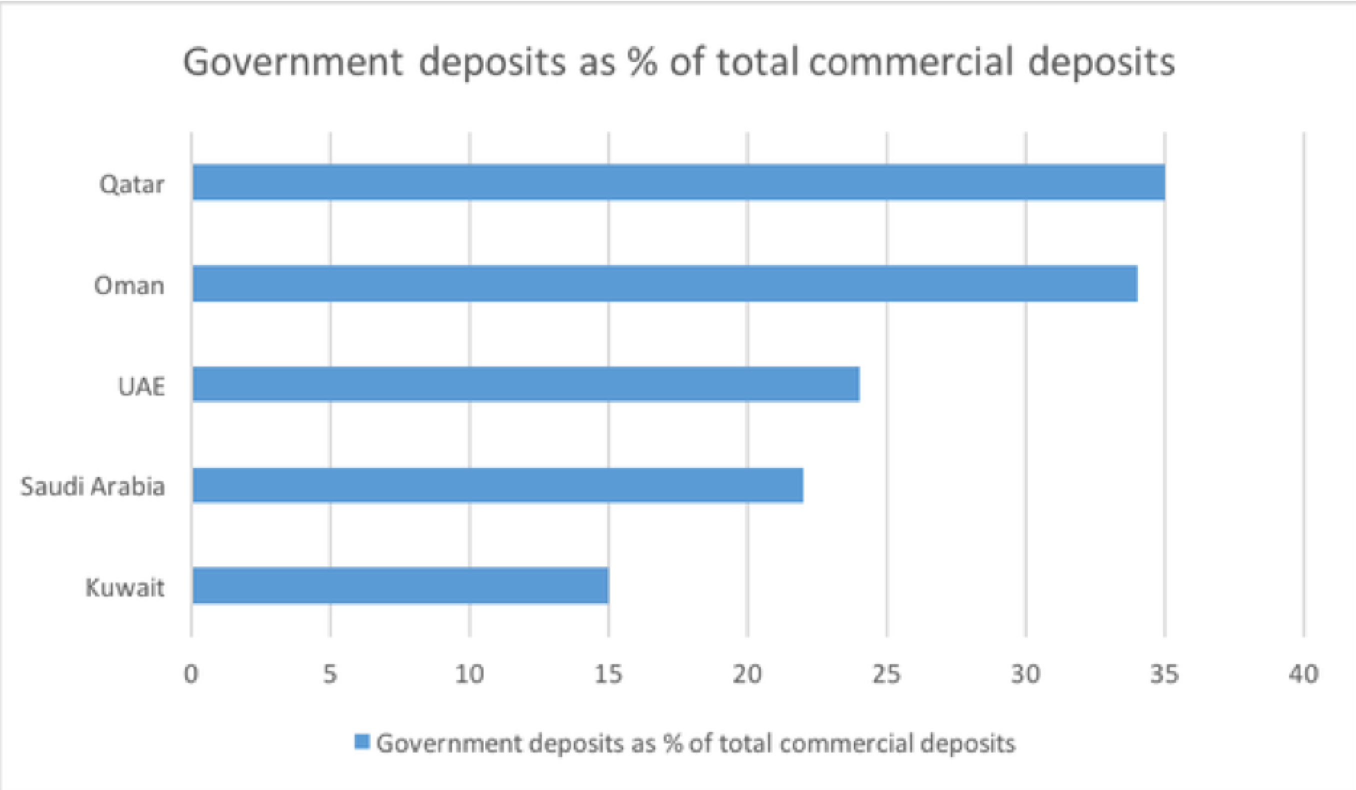

Chart 3: Government Deposits as a Percent of Total Commercial Deposits, GCC.
Source: Central Banks, HSBC Research. Data for November 2015 for KSA, UAE and Qatar; October 2015 for Kuwait and Oman.

The traditional role of a central bank is to hold government deposits and foreign reserve currency and then lend to the local bank sector as a source of liquidity. What analysts see now is that government deposits and foreign reserves in central banks are down across the GCC, to varying degrees. For example, according to data from regional central banks and HSBC research, government deposits in

Qatar's central bank were $1 billion in November 2015, dropping from $9 billion in 2014. In Saudi Arabia, government deposits were $318 billion in November 2015 dropping from $425 billion in 2014. In Oman, interestingly, deposits have not changed substantially, and there are increases in bank loans and government bond holdings in central bank balance sheets. In some cases, foreign reserves are down as well, as governments have sold currency to pay for increased expenditure (e.g. Saudi Arabia,see Chart 4).

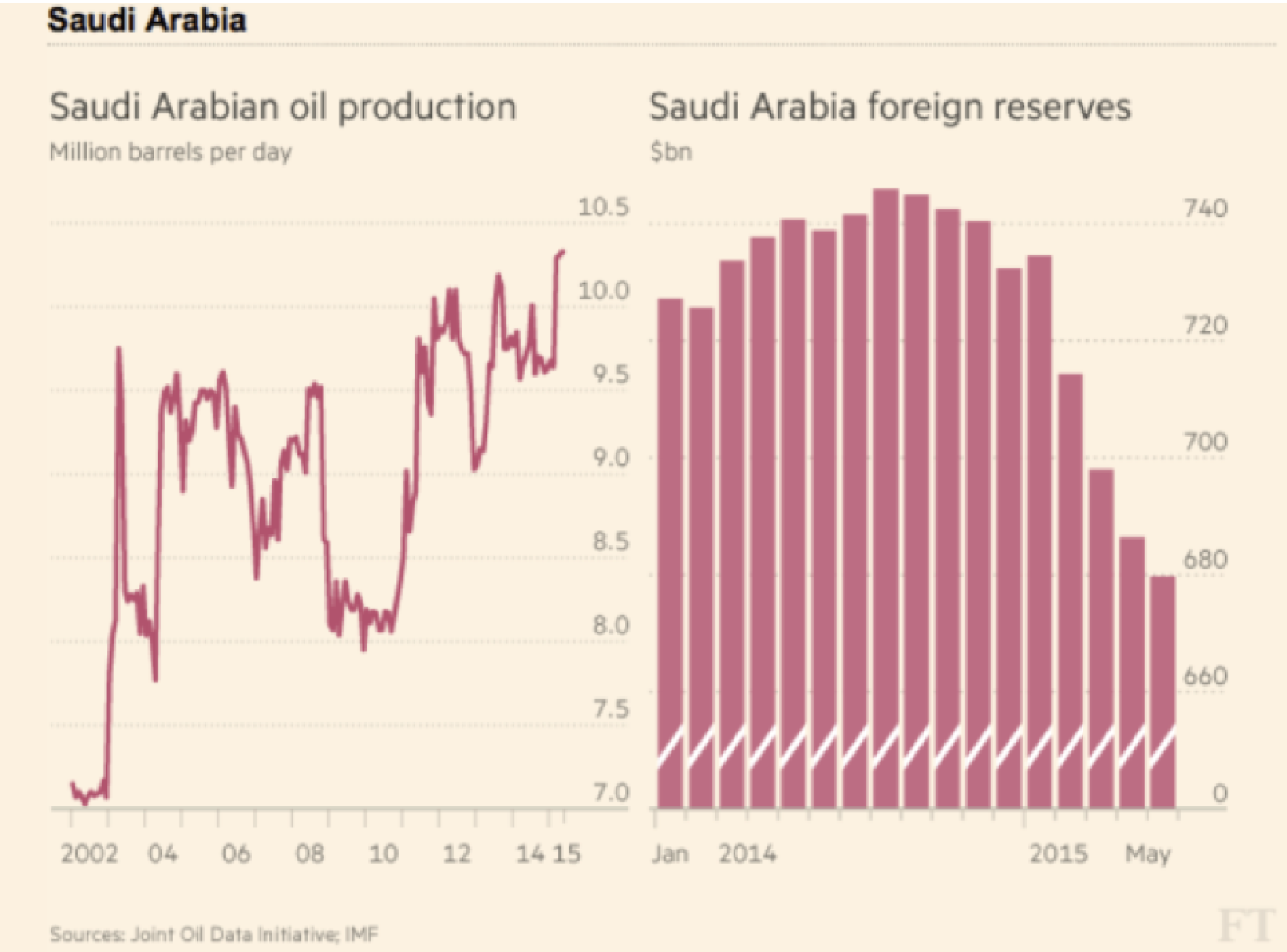

Chart 4: Saudi Arabia Foreign Reserves. Source: Financial Times, IMF

Governments have, for now, sustained deposit levels in local commercial banks—likely a political decision to support continued lending, but that too could change. Two situations emerge as possible risk scenarios: If government deposits in commercial banks are required elsewhere, for example, to pay government salaries or to account for budget shortfalls in fiscal expenditure, commercial banks will face a liquidity problem and a contraction in their ability to lend, which would drive up borrowing costs; or if commercial banks require liquidity, it is unclear if the central banks will be able to provide it, given that government deposits are now already low (in some cases more than others). Further, central banks may be under increased pressure to sell assets of foreign reserves or bond holdings. Sovereign wealth funds would be the next source of available assets. Reliance on injections to central bank holdings from third party government loans or bonds could also prove unreliable.

The health and stability of the commercial bank sector is vital to weathering the current oil slump. Governments in the Gulf will be under increasing pressure to be sure that their central banks have sufficient reserve assets and deposits to protect the commercial bank sectors from any liquidity crisis. The balance between fiscal and monetary policy will be challenging for the region, but is also an important (if often overlooked) policy area to watch.

This article was originally published by the Arab Gulf States Institute in Washington (AGSIW)
https://agsiw.org/market-watch-gcc-bank-sector-under-pressure/

Dr Karen E Young is a former senior resident scholar at the AGSIW. She is a resident scholar at the American Enterprise Institute in Washington and a senior advisor at Castlereagh Associates.
