Adjusting to a changing landscape

GLOBAL FINANCIAL STORMS LOOK TO BE SUBSIDING BUT DIFFERENT WAYS OF WORKING WILL PLAY A KEY PART IN THE RETURN TO NORMALITY, SAY **LAKSHMAN RANGANATHAN** AND **SHARAD AGARWAL**.

The Middle East and North Africa (MENA) is an economically diverse region that includes the oil-rich economies in the Gulf, such as Saudi Arabia, the United Arab Emirates (UAE), Kuwait and Qatar; resource-abundant, populous countries, such as Algeria and Iran; and countries that are resource-scarce relative to population size, such as Egypt, Morocco, and Yemen. The region's economic fortunes over much of the past 25 years have been influenced by the price of oil, the prevalence of latent and open conflict, and the legacy of economic policies and structures that emphasised a leading role for the state.

MENA countries, and in particular those of the Gulf Co-operation Council (GCC), have experienced exceptional economic growth, buoyed by high oil prices until recently. Over the past three years, economic growth in the Middle East has averaged 6.1% a year, the strongest growth in the region in nearly three decades. This is an increase from the average annual growth of 3.7% in the 1990s.

The rising oil price over 2003-2008 was an important factor in the surging economy of the Middle East, particularly for the six neighbouring oil-producing countries of the GCC – an association of Saudi Arabia, the UAE, Kuwait, Qatar, Oman and Bahrain. Most of the GCC nations were building up additional refining capacities to boost oil production and spending money on infrastructure until the current economic crises emerged. Business activities, real estate development, infrastructure, investment, spending, trading, tourism, etc, all were booming with unprecedented growth.

However, the world changed after September 2008 and it looks likely that the impact of global recession will last for some time. The economic environment, rules for business, trust and dependency and – most importantly – banking have been changed forever.

With the current crises and economic environment, the rules for doing business have been redefined, and it is becoming extremely difficult to arrange for the working capital needs to manage the business activities.

TRADE AND SUPPLY CHAIN FINANCE The Middle East is a major trading hub and a re-export market catering to the requirements of the MENA region. Many multinational corporations along with a number of SMEs have set up bases in the various free trade zones in the GCC countries, establishing trading offices which import goods from their parent companies to sell in the local market. This has created an opportunity for trade financing and a demand for new and structured ways to finance receivables in the market.

Trade finance has been and is one of the most attractive and sought after methods of raising short term finance. It has played a key role in the development of GCC economies, especially the UAE. The UAE continues to be a vital link between Asia and the West and this has given sufficient impetus for growth in the trading sector in the UAE and within the GCC. Strategically located on the Arabian

Peninsula, the UAE has ports both on the Persian Gulf and the Gulf of Oman. The Strait of Hormuz is a narrow, strategically important waterway between the Gulf of Oman and the Persian Gulf and is the only sea passage to the open ocean for large areas of the petroleum-exporting Persian Gulf. More than 25% of the world's oil trade traffic passes through the Strait of Hormuz almost every day. Dubai, the second largest emirate in the UAE, is a major banking and trading centre – not only in the Persian Gulf and the Middle East, but around the world.

Trading in this region has traditionally been on the back of documentary credits and documentary collections. Documentary credits account for more than 60% of cross border trade flows in this region and mitigate the risk of non-payment to a large extent. However, the current economic squeeze has seen more and more clients moving away from documentary credits. Documentary collections and open account trade appear to be favorable to traders as they do not require credit facilities per se. Supply chain financing solutions like factoring contribute to managing the supplier's working capital and cash flows more efficiently.

CREDIT SQUEEZE Financial markets in the GCC have witnessed economic decline and market turmoil for more than a year now. The demand for oil and gas has reduced, with oil prices and revenues in this region taking a hit. The credit squeeze has had a significant impact the UAE property market, which was a major driving force in this growing economy.

The tight liquidity position of the local market forced the banks to cut down their lending book which, coupled with the delays and defaults in payments across all industry sectors, further deteriorated the market conditions and caused a chain reaction of liquidity freeze.

IT'S A SELLER'S OR BUYER'S MARKET Historically, the GCC, and particularly the OPEC where oil and gas reserves were abundant, were primarily a seller's market. Over the last two decades or so, suppressing prices of oil and gas combined with depleting reserves have gradually turned the GCC, and in particular the UAE, into a buyer's market.

Liberal business and fiscal policies coupled with world class facilities have attracted people from all over the world to do business, particularly in the UAE. We are witnessing trading houses, commodity traders and intermediaries setting up offices in the UAE and conducting business across the globe. Most of these traders are looking for expertise in structuring solutions for their business requirements and this gives banks plenty of opportunity to offer their services and establish relationships with both traders and their counter parties.

RISING DEMAND FOR CREDIT INSURANCE During this credit crisis, there is a shift in business towards letters of credit or advance payment terms as far as possible and a resistance in sales on an open account basis both in domestic and export markets. However the importance of open account trade cannot be ignored as in many industries and countries it has become a norm for trade.

No corporate has yet come out openly and asked for non recourse factoring facilities in Middle East. A few years ago factoring was welcomed only among large multinational companies who have realised the potential of the product. However with the ongoing crises and risk of defaults increasing, the demand for credit insurance has increased and companies are willing to look into insurance coverage of their open account receivables.

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However, the credit appetite of most insurance companies is declining in line with default rates, high claims, and negative industry/country ratings. Even with the declining credit appetite, there is a possibility of covering certain portion of the risk.

Yet because of the economic crisis, the need for credit insurance would now be considered a fundamental requirement in future, unless trade is done on documentary credit. This trend will also lead corporate clients of all sizes to open up their books of accounts and financials to the banks, credit insurance companies and other rating agencies to access them better in terms of ratings and credibility.

LOOKING FORWARD As in any normal cycle, the wheels of growth and boom will turn again and there will be normality in the trade and business environment. Hopefully the worst is behind us.

The business seems to have regained much stability in past few months, although volumes are down in view of decreased demand and the price of the commodities. Many lending institutions have started offering credit facilities: although limited to certain sectors or trades, the trend is positive.

The GCC and UAE are seen to recover from the economic turmoil with minimal losses. GCC and state owned banks have not faced any major hurdles while real estate and related markets continue to face challenges ahead of them. Steady rises in oil prices, return of confidence in stock markets and renewed interest in foreign direct investment in the region are some indicators that reflect the path to recovery.

Trade finance plays an important role in the sustenance and growth of GCC economies and it is important that importers and exporters benefit from the infrastructure and facilities which are available in this mature international trade market.

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