Middle East
NOTES AND COMMENT

FROM THE CSIS MIDDLE EAST PROGRAM | VOLUME III | NUMBER 11 | NOVEMBER 2005

BURSTING BUBBLES

By Jon B. Alterman

For several years now, Middle Eastern stock markets have been on a gravity-defying tear. What happens when they come back to earth could have a more dramatic effect on the Middle East than the U.S.-led war on Iraq, or a decade's worth of democracy promotion plans by the European Union.

Arab stocks have been soaring for several reasons. A better regulatory environment—partly spurred by bids for World Trade Organization accession and Free Trade Agreements with the United States—improved corporate governance, and the privatization of former government monopolies have all improved the regional business environment. So, too, has the growing sophistication of the markets themselves, which had been neglected backwaters for decades.

The overwhelming factor, however, is the sharp hike in regional incomes as a result of higher oil prices. Oil not only broke through the $50 per barrel barrier far more swiftly than most analysts foresaw, but it has stayed high for far longer than expected. The persistent strength of the oil markets disproved skeptics who predicted that high oil prices would spur a global recession, squelch demand, and float back down into its "natural" band around $25 per barrel.

In the 1970s, Arab oil windfalls found their way into Western banks, setting off a frantic search for borrowers that contributed to the Latin debt crisis of the early 1980s. It is different this time around. Chastened by the scrutiny of a post-9/11 world, and more confident in their own investment acumen, a preponderance of Arab investors are keeping their money at home. Gulf Arab governments are taking in three times the oil revenue they were just three years ago, approaching $250 billion this year. Much of that money has been poured into local investments. Governments are suddenly riding large surpluses, which they are putting into local stock markets. Wages for expatriate workers from Jordan, Egypt, and elsewhere have helped boost economies there as well, creating a mini-construction boom that extends around the region.

While Arab investments have certainly become more attractive in recent years, the rise

(continued on page 2)

Ramadan Relief

Arabs have been quick to respond to last month's earthquake in Kashmir, sending hundreds of millions of dollars in assistance in the first weeks after the disaster. This aid stands in sharp contrast to the 2004 tsunami crisis, where Arab donors often seemed slow off the mark. This time, Qatar, Iran, Libya, Saudi Arabia, Bahrain, the UAE and Kuwait all rushed to send monetary and material aid packages directly to the affected areas, while charities such as Islamic Relief and the Red Crescent solicited donations internationally.

The money is not all coming from governments. Saudi television ran a fundraising telethon that raised $8 million in its first ninety minutes. Saudis who preferred to donate in person went to Riyadh's Faisal bin Fahd stadium and put money and jewelry into large glass containers. Jordanians used their mobile phones to donate by sending text messages in a campaign led by the royal family.

One explanation for this generosity is that the earthquake hit Pakistan during Ramadan, when Muslims are called to be especially pious and charitable. Another explanation is that a much higher percentage of the victims of the earthquake were Muslim than were the victims of the tsunami. Still, some critics suggested that aid from the Gulf was insufficient, and represented only a fraction of what these same countries had given the United States after Hurricane Katrina.■ ***-MJB***

Iraqi Election Preview

On November 16, the Middle East Program and the Open Society Institute hosted a briefing at CSIS entitled "Iraq's Elections: Prelude to Dissolution or Last Chance at Nationbuilding?" Program Director Jon B. Alterman moderated a panel that included Yahia Said, Morton Halperin and Eleana Gordon. Panelists discussed the implications that Iraq's parliamentary elections would have on Iraqi politics and on the future of the U.S. occupation. Said focused on the ambiguity of the Iraqi constitution and the potential dangers of a devolved federal system. Gordon took a more optimistic view, pointing to examples that the political situation was improving. Finally, Halperin offered suggestions for U.S. policy. A summary of the meeting is available at http://www.csis.org/media/csis/events/051116_summary.pdf.■

Middle East Program • Center for Strategic and International Studies
1800 K Street, NW • Washington, DC 20006 • Phone: (202) 775-3179 • Fax: (202) 775-3199 • www.csis.org/mideast

in stocks has been so sharp that it is hard to think it is anything other than a traditional bubble. The Saudi stock market is up 96 percent just this year, according to the market's web site, and the Dubai Financial Market's index has risen 335 percent in the last twelve months. So confident are average citizens that the rise will continue, and so fearful that they will lose out on profits, that stories abound of office workers and others desperate to borrow a year's salary or more in order to play the market.

Some day, the dizzying rise will end. Some margin investors will be caught short, and money will flee the markets in search of safety. Prices will collapse. At that point, interesting things will happen.

The region's most infamous previous experience with financial collapse was the scandal over the Kuwaiti investment house Souk al-Manah in 1982. After a run on the market turned $93 billion in checks into worthless paper almost overnight, the government stepped in, bailed out many investors, and swiftly became the largest single investor in the local stock market.

Because of this incident and others, investors seem to have confidence that their flush governments will bail them out again, if need be. Yet, the bubbles may be so large at this point that a crash would overwhelm even wealthy governments' ability to cover the debts. Total capitalization of the Gulf stock markets is in the trillion dollar range, and even a 20 percent correction would wipe out a stunning amount of wealth.

It is at this point that things become deeply unsettling. Paternalistic governments in the Gulf have paid for everything from apartments to electricity to health care for their citizens, and citizens have come to expect government assistance. With such an expectation, they engage in even riskier financial behavior. Yet, such behavior only increases potential governmental liability without providing anything of benefit to the governments. The governments will have a dilemma. They cannot walk away from failed investors, especially since they will likely feel a need to indemnify the wealthiest of the elites who are deeply invested in these markets. At the same time, they do not have the funds to indemnify everyone. The public's anger will not be about theoretical issues like freedom or liberty, but practical ones about livelihood, sustenance, and equity.

Bubbles can deflate in different ways and for different reasons. A gradual decrease in oil prices could lead to a soft landing, and a spectacular terrorist attack could burst the bubble. The markets could tumble for purely technical, financial reasons as well, having domino effects as the evaporation of wealth in one market leads to the undercapitalization of another.

Like the New Orleans floods of last summer, we know that this will happen; we just don't know how or when. At least some investors must be banking on 100 percent annual gains, and those gains cannot be sustained forever. The question we need to ask now is what the regional governments are planning to do to respond, because their citizens will certainly turn to them to do so.■11/16/05

Links of Interest

Program Director Jon B. Alterman's recent op-ed in the *Financial Times*, "Free Market Principles Could Help Arab Reform:" http://www.csis.org/media/csis/pubs/free_market_principles.pdf

"The Idea and Practice of Philanthropy in the Muslim World," a report written by Program Director Jon B. Alterman, CSIS Distinguished Scholar Shireen Hunter and Ann Phillips of US AID: http://pdf.dec.org/pdf_docs/PNADD444.pdf

The Saudi stock exhange's website: http://www.tadawul.com.sa

The Dubai stock exchange's website: http://www.dfm.co.ae

The CSIS Middle East Program

Jon B. Alterman, Director
Haim Malka, Fellow
Edward M. Gabriel, Visiting Fellow
Michael Balz, Research Assistant/Program Coordinator
Nicholas Ingaciola and Chor Li, Interns

Please visit our Web site at *www.csis.org* to learn more about the program's work.