What after Banking?

Ladies and Gentlemen,

I have presumed that this question aims at looking beyond and after the current international financial and banking crisis, which played havoc with the system that has been cruising along the path of free markets deregulated stock exchanges, unhindered currency trading, and free exchange of goods. The pillars of this system of running the international economy were devised by the American Treasury, the IMF and the World Bank. Quite often, when this formula was applied, particularly in developing countries, and especially in the Yeltsin years, disaster reared its head. At present, we can say that the so-called Washington Consensus has brought financial and economic devastation worldwide.

What has been happening in the past two months with increasing speed and heightened rhythm, especially in industrialized countries, are desperate attempts to salvage an international financial system which has needed an extensive overhaul since a number of years.

There are many reasons why we have been witnessing this alarming cascade of crises in one country after another. And it is necessary, if we are to glimpse the future, to understand the recent past. First of all, let us provide a crystal clear description of what has happened irrespective of how frightening the developments.

The international financial and banking system, which in recent years has become integrated like an Internet web of international dimensions, witnessed a thermal implosion, just like a nuclear explosion, but the victims are international financial institutions, investors, speculators and innocent bystanders who will suffer the fallout of much higher unemployment.

Certainly, this sub-prime mortgage market in the United States and its various complicated instruments has been at the epi-center of the explosion, but there are other reasons that have been contributing to the strains that finally erupted.

I believe exploration of the causes is very important, and although most of you have been driven to boredom by the flow of commentaries and statistics, it is my hope to introduce a number of factors, which have received scant attention or no attention at all.

<u>First:</u> The first distinctive feature of this crisis is its enormity. No crisis of these dimensions has faced the world economy since the Great Depression of 1929-1933.

Moreover, there is an alarming similarity between the two crises. Both have started in the largest economy and the most developed in terms of products, institutions and presumably regulatory agencies.

In the decade of the eighties, followed by the nineties, financial and economic crises erupted in developing economies; Argentina was first followed by Mexico, then Russia and South Eastern economies including Thailand, Malaysia, Korea, Singapore, etc.

It is true, however, that a major banking crisis surfaced in Japan, the first country to achieve an economic miracle in the twentieth century. The Japanese banking crisis, however, was largely centered in Japan because its market was not as open to foreign banks and foreign investments as it became by the mid-nineties. It is very significant that Japan, since that crisis in the late eighties, has drifted without luster, and its stock exchange has not regained its values of twenty years ago. Perhaps, the Japanese medicine, which involved saving banks and cheapening credit, is not the best remedy. However, Japan was a mature economy, possibly more developed industrially than most countries that are now at the center of the international crisis.

Second: The sub-prime mortgages and the various instruments around them, as well as derivatives were represented by commercial paper incomprehensible by ordinary investors, even by specialists. What seemed most important was achieving substantial profits by speedy marketing of complicated investment instruments, time and time again. The debacle of junk bonds and extinction of investment banks and brokerage companies associated with marketing this defective product did not leave a lasting impression and wisdom was not in evidence in dealing with even more complicated investment instruments.

In the summer of 1998, the LTCM bankruptcy clouded the American scene. Costs to the banking system, in case of the liquidation of LTCM, were estimated to equal $22 billion. Rather than face this loss, major investment banks and brokerage houses allocated $3.6 billion and saved the enterprise.

What is very interesting to observe is that LTCM was headed by a former member of the Fed, and it had two wizards for developing trading programs which were termed as hedge dams. And, although both advisors were econometricians who had won Noble Prizes, the dams broke and did not hold water. Still, lessons were not learned, and in fact, during that year, legislation was passed which broadened deregulation and really put the brokerage houses and investment banks beyond strict governance principles.

Third: After the disintegration of the Soviet Union, America seemed to reign supreme. They acquired an image, which radiated the notion that America was the

Anchor of Righteousness. In fact, Madeleine Albright said as much in one of her interviews.

The image was bolstered by President Clinton who had personal appeal and eloquence in addition to a fair knowledge of international affairs. And, his economic policies, which aimed at renovating traditional industries, increasing exports and eliminating the budget deficit bore fruit.

America created more jobs during Clinton's presidency than it had done in any similar previous period. By the time George W. Bush came to power, the projected budgetary surpluses were in the order of $1600 billion. And, feeling comfortable about this position, Bush promised in his inaugural speech to reduce the public debt—which stood at $5 trillion then—and to increase the benefits of Medicare.

<u>Fourth</u>: With religious zeal, Bush believed in America as the Anchor of Righteousness and he embarked on dangerous policies. The first National Security Council meeting of the new Bush administration was held on January 31, 2001, long before the 9/11 attacks which shocked the American psyche.

At the meeting, as the book of Ron Suskind, a Pulitzer Prize author entitled "The Price of Loyalty" which narrated the experiences of Paul O'Neill, Bush's First Secretary of the Treasury, the discussion centered on a plan to occupy Iraq, partition its forty discovered oil fields among American oil companies, and drive out the French, Chinese and Russian interests. The sponsors and authors of the plan were Cheney, Rumsfield and Wolfowitz. As O'Neill recounts in later chapters of the book, the Bush administration was searching for a reasonable justification to attack Iraq.

It is useful here to stop and remind the audience that before Saddam Hussein became a monstrous figure after 9/11, the American administration provided him during the Iraq-Iran war of 1980-1988 with intelligence satellite photography showing Iranian concentrations and fortifications. Certainly, limited success by the Iraqi forces around Basra and Chatt al Arab few months before the war's end were due to the availability of satellite intelligence.

The most shameful aspect of American involvement with Saddam was represented by the delivery of Anthrax to him under the supervision of Donald Rumsfield in 1986. This chemical weapon was used by Saddam against Iranian forces and Kurdish tribesmen, women and children.

In spite of this background, after September 11, 2001, the Bush administration was concerned with two objectives only. The economy and the budgetary deficits were

forgotten. A consensus of fear from Al-Qaeda was drummed up with the setting up of a special agency to protect Americans from terrorist attacks, and plans for attacking Iraq on the pretence of Saddam's alliance with Al-Qaeda, and presumably his program for developing Weapons of Mass Destruction. Both pretexts were proven false long before the American forces attacked Iraq in March 2003.

Fifth: To ward against an American public opinion rejection of a preemptive war against Iraq, Bush endorsed a plan for tax reductions, which were definitely going to contribute to a widening deficit.

He has support from an accommodating Federal Reserve Chairman, Alan Greenspan, who testified before the Congress that America could well afford the costs of war in Iraq and tax cuts. Moreover, he started reducing the discount rate and most dangerously encouraged financing of mortgages even up to 100 percent of the costs. His logic was that continual discount rate cuts and fast growth would increase the value of mortgaged properties. The virus was let loose in the American system.

In fact, loose, late, unimaginative and political collaborative policies by Alan Greenspan contributed to form bubbles during his long tenure. The Savings and Loans crisis of 1990-1991, which cost $400 billion, and George Bush father the election, the LTCM debacle, the technology bubble of 2000-2001, and he laid the ground for the current devastating crisis. His damaging role has been dissected by respected figures like Paul Volker, Warren Buffet and Paul Krugman, the late Nobel Prize winner for economics. Lately, this oracle of unintelligible statements admitted that he committed many mistakes.

Sixth: Deregulation and separation of brokerage investment banking and commercial banks by legislation in 1998 led to a situation where financial assets and liabilities of brokerage firms, investment banks, insurance companies, mutual funds and hedge funds were subject to few governance regulations and rare supervision.

In this manner, more than 65 percent of all financial assets and liabilities were beyond regular observance. In addition, account mangers and CEOs took leave of discretion and endorsed greed. Very few tried to keep the semblance of conservative choices and protection of the investments of their clients. Rampant profiteering became the mode and most of the decision-making participants chased profits and bonuses no matter the risk.

This is how a young trader cost Société Générale in Paris losses of 5 billion euros, and four traders with UBS, working essentially the American instruments, lost a whopping $45 billion, and why the Caisse d'Epargne in France, a financial

institution designed and established to preserve pension dues of savers, suffered at the hands of one trader nearly $1 billion two weeks ago.

Seventh

As 65 percent of total financial assets and liabilities escaped adherence to the Basel Recommendations and the remaining 35 percent were supervised by a laggard Fed which contributed to uncertainty, evaluation of risks associated with the bulk of financial assets and liabilities was delegated to rating agencies.

Well known rating agencies such as Moody's and S&P failed to assess changes overhanging complex products and derivatives. They accorded, for example, AIG with a triple A rating when its insurance coverage of complex mortgage backed bonds was very shaky. The same applied to the rating of Lehman's and investors were never clear about the significance and accuracy of ratings.

In this manner, the bulk of financial assets and liabilities in the American market was not assessed or evaluated properly and ignorant investors were the victims.

Eighth: The Americans, in their stampede to realize profits irrespective of risk, dragged with them major financial institutions in Western Europe. It was to be expected that the British, the closest collaborators with Wall Street, would be the first to suffer. And actually, and in spite of Gordon Brown's repeated statements that the crisis emerged in America, the first substantial losses were declared by North Rock, the fifth largest British bank, in August 2007. These losses occurred first and foremost in relation to investments in American instruments and their total amounted to 52 billion Sterling or $104 billion at the time. The first crisis-related nationalization of a bank occurred in Britain.

For reasons far more subtle and damaging, the Swiss banks avoided surveillance regulations, which originate with the Bank of International Settlements in Basel. Swiss banks devised the system of fiduciary accounts, where depositors who have to be non-Swiss, sign agreements leaving the banks concerned with freedom to manage the funds for the account of the depositor who has no right to interfere with the choices of investments unless he chooses to play this role in the original agreement. UBS used to advertise that they were the safest bank in the world.

This method of handling wealth from all over the world succeeded as the Swiss promoted a reputation for excellence in money management and prudence. And fiduciary accounts were not subjected to the Basel Regulations. These accounts, which must be in the hundreds of billions, cannot be verified. Losses by UBS and other Swiss banks exceeded, according to their statements, $60 billion of the banks' assets. The losses of clients are not declared and can only be a multiple of the

losses by the banks. And these losses, of most of the capital of UBS and an important part of the capital of Credit Suisse, could have only resulted from risk taking in pursuit of high profits.

Nineth: this reason which has contributed largely to the crisis in finance and banking is not yet mentioned in the voluminous coverage in the specialized press of the reasons behind the crisis.

All rich countries, other than the United States, have been suffering from birth rates that do not make up for deaths. In other words, population numbers in rich countries have been decreasing, and better health care contributed to longer lives. In turn, the proportion of the working population has been on the decrease.

Most European industrialized countries have invested in heavy infrastructure sufficiently to meet the needs of their populations. This is the case in respect of roads, railroads, electricity grids, schools, water supplies, etc. With reduced pressures for financing infrastructure and clear tendencies for reducing the numbers of civil servants and soldiers, the accumulation of wealth has been essentially in financial resources. Banks had too much money on their hands and too few projects to invest in. Consequently, banks and bankers suffered from two wrong choices.

They directed a large part of their resources to America, because it was and remains the largest economy, and they adopted more risky choices in purchasing American investment instruments. There was too much liquidity and money became really cheap. Mystical doors for investments in derivatives, mortgages packages, futures, precious metals, etc. were opened up and European bankers jumped in blindfolded by greed or immature expectations.

This is why Europe's burden of allocating resources for bringing about salvation and readjustment has been higher. In pure financial terms, the Europeans have pledged so far $2600 billion to which should be added $220 billion by Russia, and $25 billion from the IMF to help the Ukraine and Hungary.

By contrast, the American authorities have pledged some $1800 billion dollars, which could increase by $650 billion or $1300 billion in case 10 percent of the mortgages guaranteed by Fannie May and/or Frederic Mac fail, and the upper range of the liability comes about if the rate of the failure reaches 20 percent

The second wrong choice was blind acceptance of the evaluations of soundness of the American Financial institutions provided by rating agencies.

What of the Future?

Developing countries in the Middle East such as Egypt, Syria, Lebanon, Jordan and the Palestinian territories, will be affected to a small degree by the financial and banking crisis. Greater damage will result from the impact of the economic crisis that has commenced in Western industrialized countries. Recession will impact all developing countries particularly oil producing countries and Russia. A brief explanation could be helpful.

Egypt, Syria, Jordan, Lebanon and the Palestinian territories are not likely to witness bank failures. This is because banking in all these countries and areas is regulated according to the Basel recommendations. Moreover, the banking sector is still small—except relatively in Lebanon. In Syria, total deposits in privately owned banks are in the order of $7 billion. Use of foreign exchange resources is particularly free for financing imports and regulated for travel and foreign investments programs. Trading on international markets is still nebulous, as the stock market has not started to function in Syria.

In Egypt, the picture is slightly different. Banking as an activity, has been gradually privatized, and the Egyptian stock market was growing in importance due to privatization and flows of foreign direct investment, particularly Arab investments.

Interaction with foreign markets, particularly Gulf markets, was significant, and to the extent that Gulf markets suffered, the Cairo stock exchange witnessed steep declines. If tourism falls off by 10 percent or more due to the international crisis in 2009, many Egyptian enterprises would suffer. And if Arab investments peter out, there could be serious setbacks in the real estate market with increasing bad debts in the banking sector.

In Lebanon, the banking sector is well developed and, with insurance and financial intermediation, it constitutes 10-12 percent of GDP. A setback in major banking enterprises, or bankruptcy of international insurers active in Lebanon, could impact the economy strongly. So far, the banking system with capitalization in the order of $7 billion and total resources in the order of $90 billion seems to hold strong. Losses of $100-200 million in the system would not dent the credibility of banks. Fears of recession, however, have driven stock prices sharply down.

The Palestinian territories do not have all that much to lose. The Palestinian leadership fears the decline in the availability of foreign aid, which is necessary to maintain health and schooling services as well as imports of food and utensils.

Jordan, with a significant banking sector, as it is the base of the Arab Bank, the fourth largest bank in the Arab world, and an ultraconservative institution, will suffer little from the international financial crisis. Already, the Arab Bank, by far the largest in Jordan with an impressive international network, declared losses of $20 million with Lehman as opposed to achieving profits of well over $800 million in the first nine months of 2008.

Enough for immediate loss consequences of the international financial crisis. Now to the more serious consequences of an international recession.

There is a general agreement that the recession, which has started in Ireland, Britain, France, Italy, Spain, Germany, Portugal, Sweden as well as the US and Mexico, will persist for at least two years. Also, oil prices, unless OPEC musters a severe program of controlling production and deliveries together with Russia, will remain on the low side. Losses for OPEC members and Russia, because of an oil price drop from $147/barrel to $60/barrel, exceed $1.5 trillion per year.

In conclusion, the international financial and banking crisis will impact the Arab world to a non-catastrophic extent in the financial field. Real hard losses will come about from the consequences of a worldwide recession accompanied by restricted capital flows for investments.

Lower oil prices and extended credits in Gulf countries, especially Kuwait and Dubai, will contribute to recessionary waves, particularly in banking and real estate sectors. Thousands of Lebanese, Syrian, Jordanian and Palestinian employees will lose their jobs. This eventuality will contribute to significantly lower transfers to the countries concerned. Moreover, contracting enterprises with bases in Lebanon, Syria and Jordan will, within a year or two, witness the winding down of projects in the Gulf and smaller opportunities for securing important projects. Finally, investments by Gulf nationals in Lebanon, Syria and Jordan will taper off. A recessionary climate will settle on the region as early as the end of the first quarter of 2009.

Change of the international financial system will not be easy. The IMF regulations, quotas and philosophy have to change, and America must cede part of its authority in international circles to Europe, Japan, China, Russia, Brazil, Turkey and important oil producing countries. This process will not be easy and will take time. During this time—at least two years—banks should be regulated properly, but bank lending should not be suffocated. Regional cooperation must be developed, and Arab oil producing and exporting countries must nurse their financial resources and tailor down grandiose projects.

Russian-Arab cooperation is imperative in respect of oil and gas policies. We have witnessed the emergence of such cooperation but more developed policies and agreements have to be reached. The biggest losses being thrown on the shoulders of OPEC producers and Russia are in consequence of the forthcoming recession, which could cut petroleum and gas demand by 10 percent in the short run and 20 percent in the longer term. It is of extreme importance for the economic and financial health of the region that oil and gas-pricing policies be coordinated with Russia, the biggest hydrocarbons producer in the world.

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