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Seven Pillars of Folly

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The oil exporters of the Persian Gulf are flush with cash. Some of that money is going towards acquiring P&O, the British shipping concern, thus sparking off the heated controversy over foreign control of U.S. ports. This has led people to worry that Arab petrodollars might be scared away from the U.S. In fact, unlike during the last oil boom of the late 1970s, relatively little of the current Arab oil surplus has been directly invested in U.S. assets or even deposited in the international banking system. This time much of the oil money has remained at home where a classic speculative mania is now being played out.

Lawrence of Arabia took the title of his celebrated book from a passage in the Book of Proverbs: "Wisdom hath builded her house, she hath hewn out her seven pillars." In homage to Lawrence, we identify the seven pillars of folly upon which the Great Arab Boom has been weakly constructed.

€ The first pillar is liquidity: OPEC members have earned around \$1.3 trillion in petrodollars since 1998, according to the Bank for International Settlements. The extra liquidity injected into the Gulf economies by the oil price hike since 2002 is estimated at around \$300 billion by HSBC. Some of this money has been spent on building up foreign currency reserves and on the acquisition of foreign companies, such as P&O. Arab takeovers of European and U.S. firms totaled \$30 billion last year. Some money has even been invested in hedge funds and gold. However, a great deal has stayed in the Gulf region.

This has contributed to an extraordinary explosion of bank credit in Saudi Arabia and its neighbors. Since the member countries of the Gulf Cooperation Council link their currencies to the U.S. dollar, they have also enjoyed the Federal Reserve's easy money policy. The Saudi government has recently repaid around \$100 billion of outstanding debt, further contributing to domestic liquidity.

The deposit base of Gulf commercial banks has increased by over 60% since 2000, according to a recent report from Credit Suisse. Bank loans have financed business investment, personal consumption, property development and stock margin loans, thereby boosting both the economy and asset prices.

€ The second pillar is the new economy: The Gulf economies are growing rapidly, along with corporate profits. Returns on equity in the region are approaching 20%, calculates Credit Suisse. Saudi Arabia has recently joined the World Trade Organization. Kuwait is selling off some state-owned businesses. A new era of permanently high oil prices and perpetual prosperity has been hailed.

The Gulf rulers are seeking to reduce their economies' dependence on oil. This is spurring a massive investment boom. Dubai is attempting to transform itself into a leading financial center and tourist resort. Saudi Arabia intends to become a world leader in fertilizer production. A

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bridge costing \$3 billion is proposed to span the Red Sea. A new economy is coming into being. The current oil boom, unlike former ones, won't be followed by a bust, say the believers. This time it's different.

€ The third pillar is the stock market: The recent performance of Arab stock markets makes the Nasdaq of the late 1990s look like a slouch. Since January 2002, the Egyptian, Dubai and Saudi stock markets are up respectively by over 1,100%, 630% and 600%. Only four years ago, Gulf companies were priced at around twice book value. Today they trade on an average of 44 times historic earnings and at over eight times book value. Gulf banks are valued at over nine times book value, according to Credit Suisse.

Sabic, a Saudi conglomerate, is currently ranked among the world's 10 largest companies by market capitalization. The Saudi stock exchange has a market cap of around \$750 billion. That's roughly three times the country's GDP. By comparison, the U.S. stock market reached a peak of 183% of GDP in March 2000. In fact, the relative overvaluation of the Saudi stock market is even greater than these figures suggest. Nomura analyst Tarek Fadlallah points out that as the oil industry remains in state hands, a far smaller fraction of Saudi economic activity is captured by the stock market than in the U.S.

€ The fourth pillar is an IPO boom: In the late 1980s, the Japanese authorities kindled a speculative mania by floating telecom giant NTT. In unconscious imitation, the Gulf states have stimulated their mania with privatizations and IPOs at bargain prices. It is not unknown for stocks to climb 500% on the first day's trading. Applications for new issues have been oversubscribed by up to 800 times. One IPO in the United Arab Emirates attracted aggregate subscriptions greater than \$100 billion, a larger sum than the UAE's GDP.

€ The fifth pillar is a property boom: Dubai is the fastest-growing city in the world. Hundreds of new buildings are under construction, including what is planned to be the tallest building ever, the Burj Tower. Cynics point out that the capping of the world's highest property, from the Empire State Building to the Petronas Towers in Malaysia, has occasionally in the past coincided with economic crises. Reports suggest that the majority of new Dubai properties are being acquired for speculative purposes, with only small deposits put down. They are being flipped in the contemporary Miami manner.

€ The sixth pillar is market inefficiency: Financial information in the Gulf is totally inadequate. The Saudi megacap conglomerate Sabic attracts no domestic financial analysis, says Nomura's Mr. Fadlallah. Companies report their results in a rudimentary fashion. It is against the law to sell short overpriced stocks in the Saudi market. And foreigners' financial sophistication is absent since only Gulf nationals can purchase Saudi stocks. Instead, speculators operate in an information vacuum in markets reportedly dominated by insider trading and practiced manipulation.

€ The seventh pillar is the madness of crowds: Newspapers gleefully report stories of police called to protect banks from overeager IPO subscribers. A Saudi woman is said to have been divorced by her husband for no reason other than that he'd had lost money in the stock market. Up to two million of the 16 million Saudi population are said to be playing the market.

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Interest-free loans are commonly available. Saudi bank foyers are lined with LCD screens showing stock movements. A local TV station has started to provide stock market reports. The education minister has warned teachers to stop day-trading at schools. People are quitting their jobs to trade.

This is a familiar tale of folly, similar in certain aspects to the global technology bubble of the late 1990s. And like the tech bubble it is set to burst. The current Gulf prosperity is a mirage created by a haze of liquidity. The Federal Reserve, which inadvertently caused the Arab bubble when it slashed interest rates in 2002, is currently mopping up that liquidity. The Gulf Arabs are likely to be rudely awoken from their speculative dreams. In fact, the Arab markets are beginning to crack: Dubai has fallen 40% from its November peak, and the Saudi market is down by around 12% in the past few days.

There are several implications of the coming Arab crash. Speculative booms lead to capital being mis-allocated. Many of today's investments in the Gulf region may appear, in retrospect, as extravagant as U.S. fiber-optic expenditures in the late 1990s. As for Dubai's desire to become an international financial center, it is spookily reminiscent of Tokyo's ambition to rival New York and London in the 1980s. Japan's ambition was shattered by the collapse of its bubble economy.

The political consequences could be more serious. Arab rulers have deliberately encouraged the boom in the hope that rising asset prices and a strong economy would distract their youthful populations from religious fundamentalism. This strategy could backfire. History teaches that when speculative bubbles burst and the public loses large sums, there is normally a political backlash. This was true of the U.S. in the 1930s, and to a lesser extent in the early 2000s, and of Japan in the 1990s. It's not hard to imagine Islamists capitalizing on a future bust with denunciations of stock-market gambling. Some of today's young Arab day-traders could well turn into tomorrow's al Qaeda recruits.

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