Rasheed Mohammed Al Maraj: Current financial situation in Bahrain

Address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the American Chamber of Commerce luncheon, Manama, 11 February 2009.

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Ladies and Gentlemen:

Thank you for inviting me to join you for lunch today, and for your excellent hospitality. I would particularly like to thank Mr. Al Zayani and the other Members of the Board of Directors for their kind invitation to speak to you today.

I have been asked specifically to talk to you about the current financial situation in Bahrain, particularly in comparison to international developments in the GCC region.

There is general agreement that the turning point in the current crisis was the collapse of the American investment bank Lehman Brothers on September 15, 2008. This event forced economists and policy-makers to revise their assumptions about the course of the financial crisis. After mid-September the financial crisis became an event of global proportions and for the first time in living memory, the global financial system was shaken to its foundations. For several weeks after mid-September, it seemed that no financial company was so strong that its failure was unimaginable, and no financial market was remote enough or secure enough to be unaffected by the events.

It was at this point that ripples from the failure of Lehman Brothers began to affect us here in Bahrain. The effect was as much psychological as it was financial.

The psychological impact was felt by both households and businesses. Ordinary people read their newspapers, watched television or surfed the internet and saw stories about the exceptional measures governments around the world were being forced to take to support their banking systems. Understandably people became nervous. There was a great deal of anxiety about the possibility of bank failures, and in this environment rumours were commonplace and often widely exaggerated.

Some people also began to ask whether Bahrain should announce a general guarantee of deposits as so many other countries did in the weeks after the collapse of Lehman Brothers.

Our view in the Central Bank was that a general guarantee of deposits was not needed. We were confident in the soundness and stability of Bahrain's banking system. We were also confident in the strength of our prudential regime. CBB rules and regulations and our directions to banks have constrained excessive risk-taking and we have, for example, ensured that banks are not over-exposed to any particular economic sector. Our rules and regulations were not always popular when we introduced them, but we knew that controlling banks' risk-taking would be in the long-run interests of the Kingdom.

The fear and anxiety of the last weeks of September and early October began to subside as people came to recognise that the banking system was continuing to function normally. People who had taken money out the banks began to return, and for the last several months banks' deposits have been very stable. We have also seen banks continuing to report solid profitability, despite the impact of the crisis in the final quarter of 2008.

The second impact of the Lehman collapse was on the liquidity of global markets. There was a massive rise in risk aversion, reflected in a variety of indicators, including a rise in risk premiums, the rising cost of credit default swaps, and steep falls in global stock markets. Activity in interbank markets virtually ceased.

The shortage of global liquidity had an impact even here in the Gulf. As recently as July 2008 the liquidity position of the GCC had never been stronger. In part, this was due to the high price of oil, but it also reflected large speculative inflows of capital betting on a possible of revaluation of GCC currencies.

As the financial crisis worsened in September, we began to see rapid acceleration in the outflow of capital. Speculative positions were quickly reversed as the banks which had placed those bets now discovered that they needed the liquidity closer to home. The result was a liquidity squeeze on banks throughout the GCC, from which those in Bahrain were not immune.

Recognising the liquidity pressures on Bahrain's banking system, the Central Bank took action to alleviate the problem. We extended the range of collateral that we would accept in our lending operations with the banking system, so that this now includes long- and short-term Ijara Sukuk issued by the Kingdom of Bahrain. We are also looking at extending the scope of acceptable collateral still further.

Our main policy initiative, however, was to establish a foreign exchange swap facility. This allows banks that have US dollars to bring them to the Central Bank to swap for Bahraini dinar at no cost. As the Federal Reserve and other leading central banks had taken measures to provide US dollars to financial markets in almost unlimited quantities, banks in Bahrain could obtain dollars and swap them for dinar whenever needed. The result has been to offset to a large degree the liquidity impact of capital outflows. We have done so in a way that is consistent with maintaining our currency's peg to the US dollar, which is key to maintaining confidence in the economy more broadly.

The issues that I have been discussing so far have mainly affected the financial system. However, as liquidity has dried up and international bank lending has been sharply reduced, this has affected the financial system's ability to provide credit to the real economy, the producers of goods and services. One result has been that the economic forecasts for the global economy have been sharply downgraded in recent months. For example, the IMF predicts that the advanced economies will shrink by two percent this year, while the emerging economies will enjoy their slowest growth in the last 10 years. Overall, the IMF expects the global economy to grow by only half a percent, effectively at a standstill.

Although the Bahraini economy will continue to grow, the rate of growth will slow down, in line with the rest of the GCC. It seems reasonable to assume that the impact will be similar to those of previous economic slowdowns. In particular, we anticipate declines in bank profitability as business opportunity shrinks. The supply of credit is also likely to remain constrained at least until advanced country banking systems are able to resume their role as suppliers of credit to the rest of the world.

I would like to end by stressing that the Government and Central Bank remain committed to doing all in our power to maintain economic and financial stability in Bahrain. It may sometimes appear to an outsider that little is actually happening. Let me assure that this is far from the case. The Central Bank has monitored and will continue to monitor the financial situation in Bahrain very closely. We have already taken a number of measures to protect the stability of the financial system.

Our initiatives may not have received a great deal of publicity, but they have nonetheless been effective.

Thank you for your attention.