



Workshop 14

The Evolving International Role of the GCC Economies

directed by

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Workshop abstract

In the last few years, Gulf Cooperation Council (GCC) countries have experienced a new pattern of oil revenue recycling: compared with the previous oil boom in the 70s - which was followed by a prolonged period of weak regional economic performance and diminished role of these countries in the international financial arena - the recent oil boom has been associated with significant new developments at the domestic, regional and international levels.

In particular, at the domestic level, major investments have been directed to enable economic diversification and to promote the development of the local financial and banking systems (including Islamic finance).

At regional and global levels, the GCC has emerged as a major FDI investor towards new recipient countries, especially the neighbouring Mediterranean countries but also western economies. GCC Sovereign Wealth Funds (SWFs) played a key role in channelling the reserves in the international financial systems.

In the next phase - probably a post oil price boom phase - the capacity of the Gulf region to contribute to a recovery of the world economy is likely to depend on a number of key factors, including:

1. - the effectiveness of the recent domestic investment boom in broadening the income base and increasing the region's competitiveness;
2. - the quality of institutional progress, particularly in monetary management and financial supervision;
3. - the role that these economies will play in the international monetary system (including the regional project of a monetary union);
4. - the evolution of their role as major FDI investors, both regionally and globally;
5. - the behaviour of SWFs;
6. - developments in their labour markets, with particular reference to remittances.

Against this background, the aim of the workshop is to analyse recent developments in the region's economy and to assess their implications for the prospective role of GCC countries in the global economic and financial arena.

Workshop description

In the last few years, Gulf Cooperation Council (GCC) countries, which provide more than one fifth of global crude oil supply, and control 40 per cent of the world's proven oil reserves, have benefited from the surge in oil prices. Governments in the region have strived to take advantage of this large revenue windfall to move their economies away from their overwhelming oil dependence, through massive domestic investments in the real and financial sector, coupled with some important institutional development, particularly in the monetary field. At the same time, the role of GCC economies in international markets has both strengthened and become more complex, as traditional channels of oil revenue recycling, like remittances, have been joined by the increasing diversification of vehicles (FDI, SWF) and geographical/sectoral patterns of investment abroad.

On the domestic front, the recent expansionary phase, with an average real GDP growth of about 7 per cent between 2003 and 2008, has been, indeed, largely driven by growth in the non-hydrocarbon sector. Non-hydrocarbon activity has benefited from a sharp increase in capital spending aimed at modernizing the industrial infrastructure as well as at developing housing and utilities to match rapid population growth. Private consumption also increased significantly, benefiting from the raise of public sector wages. Government expenditure, both current and capital, has, in fact, been the main transmission mechanism to translate oil/budget revenues into higher domestic demand.

The increased domestic absorption of oil revenues has been also instrumental in containing the widening of global imbalances stemming from the surge of oil prices. Indeed, GCC merchandise imports increased by about 150 per cent between 2003 and 2007, reaching about \$300 billion in 2007; however, merchandise exports grew at a similar pace, moving from a higher base. The current account surplus of GCC countries remained therefore large in 2008, and is estimated at about 30 per cent of GDP.

The room of manoeuvre of monetary policy in containing inflationary pressure was limited by the prevailing exchange rate regimes. With the exception of Kuwait, which opted for a trade weighted currency basket in 2007, the exchange rates of the GCC country currencies are, in fact, pegged to the US dollar. Though this

policy prevents central banks from utilizing domestic interest rates as an independent monetary tool to control inflation, it does have merits, as it serves to stabilize exports as well as government revenues. Moreover, it has a significant role in enhancing the credibility of monetary authorities and restricting currency speculation. However, until mid-2008, the GCC currency peg to the dollar has been under pressure from two fronts. First, the rise in global commodity prices and the weakness of the US dollar have raised imported prices. Second, divergent economic cycles between the US and the GCC economies have led to further inflationary pressures as GCC central banks were forced to follow the easing of monetary policy in the US.

These developments have further contributed to the debate over the opportunity of a more independent monetary policy in the area, a goal which could be pursued through the project of a regional monetary union that the GCC authorities have been pursuing since 2001. Five convergence criteria have been agreed, which echoed those adopted by the European Union member states for the euro. In the last few years, the GCC countries have achieved virtually free regional mobility of goods, national labour and capital, adopted a common customs tariff in 2003 (reducing it to 5% of all imported goods) and a common market was launched in 2008, implementation of which is largely complete. While the official deadline for the monetary union remains 2010, its achievement by the target date faces significant technical and policy challenges.

As mentioned, GCC economies have also witnessed in recent years a significant development of their financial systems. In the banking sector (which has still a leading role in the region's financial industry), the share of private sector credit in terms of GDP rose from about 35 per cent in 2000 to 60 per cent in 2008, strongly associated with the growth in the non-hydrocarbon sector. Credit expansion has been increasingly directed to the corporate sector and project finance and less to retail, although this remains a steadily growing area. The rapid rise of credit demand, not matched by a similar pace for deposits, and the necessity to better match the maturities of their assets and liabilities, led to increased borrowing from abroad. The stock of foreign liabilities of commercial banks more than tripled from 2005 to mid-2008, when the loan-to-deposit ratio moved above 100 per cent for the region.

The buoyancy of financial activity has been supported, over the last few years, by a widespread development of financial centers in the region. The three GCC financial centers - the first off-shore banking center established by the Central Bank of Bahrain in 1970s, the Dubai International Financial center (DIFC) established in 2004 and the Qatar Financial Center (QFC) created in 2005¹ – are, indeed, attracting an increasing number of key financial players. The centers are becoming important at a global level too.

The region is also growing as an Islamic financial hub, as it has a comparative advantage both culturally and geographically. Islamic financial assets in 2007 accounted for around \$178 billion (35.6 per cent of the global Islamic financial assets) and the Islamic financial sector represents about 18 per cent of the region's financial system. While most of Islamic financial assets are located in Saudi Arabia (\$70 billion) and Kuwait (\$38.5 billion), Bahrain is striving to emerge as the regional centre of Islamic finance, playing a key role in establishing and hosting regulatory and standard setting bodies (i.e. AAOIFI) and think tank. Dubai is more active in the Islamic capital market as it is home of the DIFX, the largest exchange for *sukuk* trading with a value of nearly \$16 billion, and it hosts some of the largest issuing companies for *sukuk*.

Remittances traditionally have been, and remain, a key channel of international recycling of Gulf oil wealth, mainly throughout the MENA region. About 4.5 million migrants from MENA countries are in the Arab oil producing countries, the majority being concentrated in the GCC countries. The impact of these migration flows is seen in remittances flows: the total outflows of remittances from GCC countries, all resource-rich and labour importing, are estimated at around \$35 billion in 2007.² Some Mediterranean countries (i.e.

¹ Saudia Arabia is also establishing the King Abdullah Financial Centre.

² According to the World Bank in 2000-2005, about 16 per cent of all remittances paid out to migrants in the world originate in the MENA region, essentially the GCC countries and 10 per cent of global remittances are received by resident in MENA countries.

Jordan, Egypt and to less extent Lebanon) are significantly fuelling the diasporas of foreign workers in the booming oil economies of the Gulf. Consequently one of the most intense intraregional remittance corridors are those from GCC countries to Mashreq. For example, in Egypt remittances flows from workers in Saudi Arabia, Kuwait and UAE increased fourfold in four years from around \$1 billion at the end of fiscal year 2003/2004 to \$4 billion in 2007/2008.

As for GCC investments in financial assets abroad, even if tracking GCC capital flows and their destination is challenging due to lack of data, private analysts estimated that over the five years ending June 2008, the cumulative acquisition of foreign assets by the GCC countries exceeded \$900 billion. Among them, the FDI component experienced an increasing trend from 11 per cent of total foreign assets in 2003 to 20 per cent in 2008³. The US has remained the main destination for GCC capital, accounting for half of the total foreign assets accumulated during the past five years, and the interest remained strong even during the current financial turmoil. The substantial share of GCC capital flows to other countries (\$450 billion) has been invested in a variety of asset types and directed toward different geographical areas. The MENA region was among the favoured destination areas accounting for around \$120 billion (13 per cent of the total): most inflows were directed to Egypt, Jordan, Morocco and Lebanon, as the GCC, attracted by reform progress and privatisations, has channelled significant funds into real estate, energy, telecoms, and equity market.

Another important development in international financial investment of GCC surpluses is given by the increasing importance of Arab Sovereign Wealth Funds (SWF) – government-owned investment funds, set up for a variety of macroeconomic purposes, commonly funded by the transfer of foreign exchange assets that are invested abroad and with a long term perspective. The Gulf SWFs, entirely financed by oil and gas revenues, grew in the last five year at 24 per cent annually and are estimated to overall manage over \$1.1 trillion⁴; including the assets managed by central banks (approximately \$460 billion) the combined portfolio reaches more than \$1.5 trillion, around 40% of total assets managed by SWFs globally.⁵

In the recent juncture, the global crisis is affecting the GCC economies mainly through the large fall in the oil price and the deep asset price correction. Recent forecast by market analysts estimates a real GDP growth in the GCC countries close to zero in 2009 and the large surpluses in current account and fiscal budget almost completely vanishing (the latter even turning into deficits). In many countries, government could refer to available buffers accumulated during the boom years to adopt supportive policies and filling the void left by the retrenchment of private sector activity, especially in the investment projects.⁶ It remains an open question whether and to what extent the recent growth pulled by non-hydrocarbon sector could be sustained.

In a period of reversal of capital flows and drastic fall of asset prices, the reliance on foreign funding and the high exposure to the real estate and construction activities have appeared as the main vulnerability of the banking sector. Even if recent indicators of bank soundness and performance appeared positive (high capital adequacy ratios, low shares of non performing loans, high profits), GCC governments intervened to respond to the global financial crisis with liquidity support, bank's recapitalisation and selective bailouts.

The prospect of the financial sector will depend on strengthening the regulatory framework, continuing innovation, and making improvement in human capital and business environment.

Moreover, although the proliferation of financial centers could contribute to create a healthy competitive environment in regional markets, the question arises as to whether all these centres can survive, seeking for cooperation and specialisation, or if consolidation will reduce the number over time.

³ According the last UNCTAD World Investment Report, FDI outflows from the GCC almost doubled last year and were six times the figures in 2004.

⁴ As GCC SWF do not disclose detailed figures on the assets under management, different market estimates are available but their exact size, their strategies and their actual returns are unknown. In the following data from the SWF Institute are mainly used.

⁵ The Abu Dhabi Investment Authority (ADIA) is the largest global SWF, with assets estimated at \$627 billion. The Saudi Arabian Monetary Agency is assumed to manage \$431 billion, followed by the Kuwait Investment Authority (KIA) with more than \$200 billion.

⁶ The total value of delayed or cancelled projects is estimated at around \$100 billion, mainly in real estate and energy sectors.

While the credit crunch creates turmoil throughout the global banking industry, the risk-sharing approach offered by the Islamic finance industry is attracting increasing attention. It is still, however, a niche sector and its prospects depend on a number of factors, including policy and regulatory issues to be addressed and its capacity to integrate into the conventional financial system.

With reference to the external orientation of GCC countries, there are concerns that the expected slowdown of the economic activity, together with policy restrictions on immigration flows to GCC countries, could lead to reduction of remittances outflows, especially towards the MENA region.

The GCC's sovereign wealth funds will remain important investors, but their future development will depend crucially on the future path of the oil price, the impact of the current financial downturn on the accumulated assets, as well as on their own strategic investment decisions.

To sum up, the capacity of the Gulf region to contribute to a recovery of the world economy is likely to depend on a number of key factors, including:

7. - the effectiveness of the recent domestic investment boom in broadening the income base and increasing the region's competitiveness;
8. - the development of the financial sector, including the role of international financial centers and Islamic finance;
9. - the quality of institutional progress, particularly in monetary management and financial supervision;
10. - the role that these economies will play in the international monetary system (including the regional project of a monetary union);
11. - the evolution of their role as major FDI investors, both regionally and globally;
12. - the behaviour of SWFs;
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