CHAPTER 1.4

The Gulf Cooperation Council Region: Financial Market Development, Competitiveness, and Economic Growth

SIMON GRAY, Centre for Central Banking Studies, Bank of England

MARIO I. BLEJER, Centre for Central Banking Studies, Bank of England

Developed, well-balanced economies today have, or have access to, developed financial markets. Causality probably goes in both directions: poor countries will lack the free resources needed to support a developed financial market, but it is hard to imagine the process of economic development if the financial markets are suppressed. What is happening in the Gulf Cooperation Council (GCC) region to promote financial market development? And how is this likely to be affected in the future by oil price–induced changes in wealth, and by the planned currency union?

The GCC countries—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—account for less than 15 percent of the population of Arabic-speaking countries (see Table 1),[1] but (with oil prices at current high levels) for some 70 percent of the area's GDP and around 90 percent of the region's stock market capitalization (though only 30 percent of the *number* of listed companies). While there are wide variations in GDP per capita in the GCC region, even the lowest is still twice the level of the next-wealthiest Arabic-speaking country (see Table 2). The relative wealth of the GCC region is in large part a product of its petroleum resources (see Table 3). But it would be unfair simply to dismiss these countries as rentier economies with no significant diversification or scope for economic development outside that supported by the petroleum sector. Some GCC countries are making clear attempts to develop niche markets or exploit relative advantages, both in the real economy and in financial markets. This paper looks at the GCC countries in order to explore their attempt to gain competitiveness by developing and enhancing the financial sector, and touches on the relationship between the financial sector and the real economy. We will look at these issues particularly in the light of monetary policy choices and the planned GCC monetary union.

Table 1: Population (millions)

Country	1995	2000	2005
GCC	**25.3**	**29.5**	**34.6**
Bahrain	0.6	0.7	0.7
Kuwait	1.6	2.2	2.9
Oman	2.1	2.2	2.4
Qatar	0.5	0.6	0.8
Saudi Arabia	18.1	20.5	23.1
United Arab Emirates	2.4	3.2	4.7
Non-GCC	**171.6**	**192.5**	**214.3**

Source: IMF, 2006.

Table 2: GDP per capita, current prices (US$ thousands)

Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GCC													
Bahrain	9.9	10.1	10.2	10.2	9.7	10.0	11.9	11.7	12.1	13.7	15.3	18.4	21.4
Kuwait	16.5	17.3	18.5	13.7	11.4	13.4	17.0	15.1	15.8	18.1	20.2	26.0	31.3
Oman	6.3	6.6	7.2	7.4	6.5	7.1	8.9	8.8	8.8	9.3	10.4	12.7	15.5
Qatar	12.5	16.0	17.4	21.6	18.5	21.1	28.5	27.3	28.9	33.0	37.6	43.1	53.5
Saudi Arabia	7.6	7.9	8.5	8.7	7.5	8.1	9.2	8.7	8.8	9.8	11.1	13.4	15.4
United Arab Emirates	17.2	17.8	19.7	19.9	17.1	18.2	21.6	19.7	19.9	21.8	24.1	27.7	35.1
Non-GCC													
Lebanon	3.0	3.6	4.1	4.8	5.1	5.0	4.9	4.9	5.3	5.6	6.0	6.0	6.0
Libya	5.8	6.5	7.0	7.5	5.4	5.9	6.6	5.6	3.5	4.2	5.3	6.7	8.3
Other (pop weighted)	1.1	1.1	1.1	1.1	1.2	1.2	1.3	1.3	1.2	1.2	1.2	1.3	1.5

Source: IMF, 2006.

Table 3: Oil production per capita (barrels per day)

Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GCC	**0.55**	**0.54**	**0.53**	**0.50**	**0.51**	**0.46**	**0.47**	**0.45**	**0.39**	**0.44**	**0.45**	**0.46**
Bahrain	0.25	0.25	0.29	0.29	0.29	0.27	0.27	0.27	0.27	0.27	0.26	0.25
Kuwait	1.34	1.27	1.18	0.91	0.90	0.83	0.90	0.84	0.72	0.83	0.83	0.90
Oman	0.39	0.41	0.42	0.42	0.41	0.41	0.40	0.39	0.36	0.33	0.30	0.29
Qatar	0.64	0.76	0.76	0.78	1.12	1.04	1.04	0.98	0.83	0.94	1.00	0.96
Saudi Arabia	0.45	0.44	0.44	0.42	0.42	0.38	0.40	0.38	0.33	0.38	0.39	0.40
United Arab Emirates	0.97	0.89	0.88	0.84	0.79	0.68	0.67	0.61	0.51	0.56	0.54	0.51
Non-GCC	**0.03**	**0.03**	**0.02**	**0.03**	**0.03**	**0.03**	**0.03**	**0.03**	**0.03**	**0.02**	**0.03**	**0.03**

Source: OPEC, 2005; IMF, 2006.

The development and strength of the financial sector will depend both on economic diversification in the GCC and the long-term management of petrochemical resources, and on the sector's ability to serve the needs of the wider region. We conclude that the financial sector in the GCC should be able to support continuing, broadly based economic development not only in the GCC itself, but also in the region more widely.

In view of the planned monetary union in the GCC by 2010, some comparisons are also drawn with the experience of the monetary union in the euro area. The euro area has found that the different currencies prevailing before the introduction of the euro constituted just one of many barriers to financial market integration, and there may be lessons for the GCC from this experience. But it may, conversely, be the case that a measure of financial market integration in the region beyond the GCC may be possible without wider monetary union.

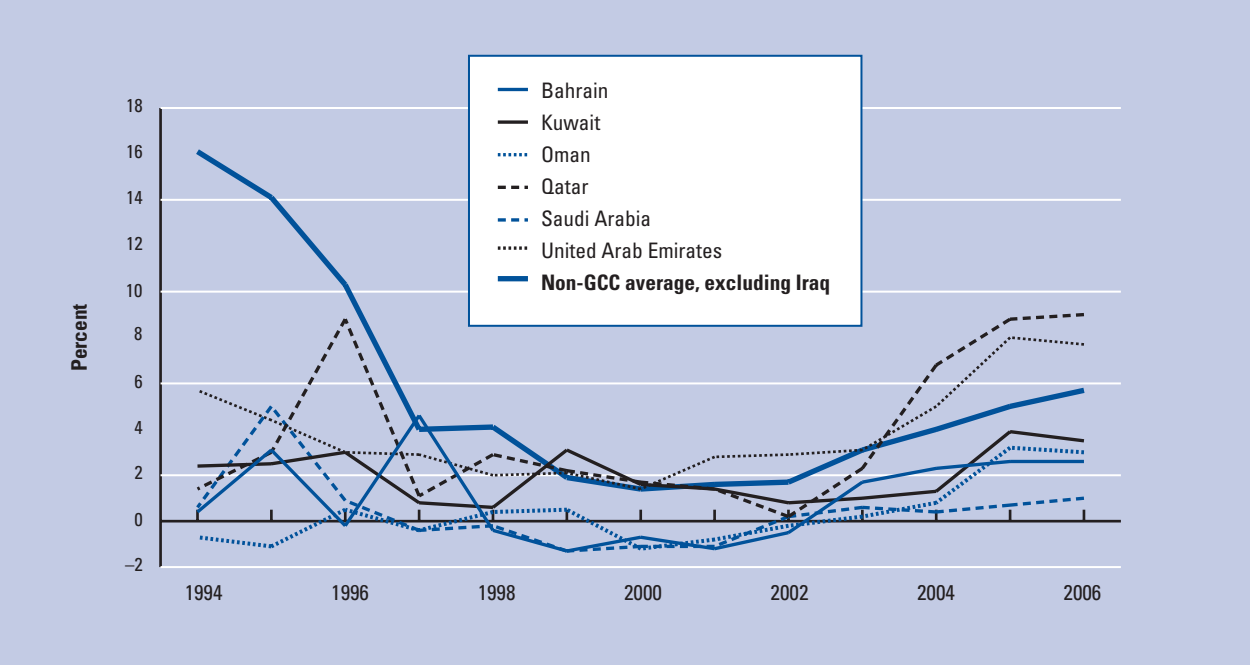
Fixed exchange rates

The GCC countries have pegged their exchange rates to the US dollar before the planned monetary union in 2010. Most of these countries had adopted a pegged exchange rate prior to agreeing on the timetable for monetary union; since 2003 all have adopted this policy. The choice effectively constrains the day-to-day (or even year-to-year) freedom of monetary policy action for the member countries. Domestic interest rates are largely a function of US dollar interest rates, with variations of up to 30 basis points from time to time.[2]

In fact, exchange rate stability is a policy choice broadly adopted by nearly all the Arabic-speaking countries, including two of the three that do not produce oil—Jordan and Lebanon.[3] In common with many central banks around the world, central banks in Arabic countries that adopted exchange rate stability as a policy find that this is an effective way of providing credibility to the domestic currency and delivering low price inflation, at least in tradable goods.

A stable nominal exchange rate does not necessarily deliver full domestic price stability. The GCC countries, together with most countries in the region (and indeed many commodity exporters elsewhere in the world), have found that increased export earnings resulting from the substantial increase in oil prices over the past three years, along with—in some cases—an increase in either remittances or capital inflows or both, has increased the real wealth of the country. In the absence of nominal exchange rate adjustment, relatively high inflation in nontradables (property, and some services where skilled labor supply cannot easily respond to increased demand) has been prevalent.[4] And there is of course some feed-through from nontradables to tradables.

Figure 1: Inflation: Annual percent change



Source: IMF, 2006.

Note: Iraq is excluded because hyperinflation in the early 1990s and relatively high inflation over the past two years distorts the picture for non-GCC countries.

Inflation certainly appears to be positively correlated to oil prices in the GCC region. Domestic demand is boosted when oil prices are high, and incomes are therefore higher; and this feeds through to higher inflation.[5] In the last few years this has helped to push inflation in two GCC countries above the average of the non-GCC Arabic-speaking nations. However, because pegged exchange rates provide a degree of stability to prices and price expectations, thus far the rise in inflation associated with higher demand (to some extent, a real exchange rate adjustment) does not appear to be a problem.[6]

The rising level of inflation does, however, raise an important question for these countries: will the increase in the real exchange rate, reflecting oil wealth, damage competitiveness? This can be particularly important as the oil sector typically employs a relatively small number of people—perhaps 1 percent of the workforce—while continued rapid population growth means that the labor force is showing strong growth. Currently, a large part of the native population of the GCC countries is employed by state organizations, while a predominantly male immigrant workforce—in some countries this accounts for more than half of the population—supplies the labor needs of much of the private sector, whether in construction, shops, or hotels. (Oman is an exception to this, having promoted a policy of "Omanization" since 1988, encouraging and training locals to replace expatriates in both the public and private sectors.) But a strongly growing native population will make it increasingly difficult for the state to provide meaningful work, which in turn indicates that economic diversification and competitiveness will become more important in the years ahead.

At the same time, the fixed exchange rate in the GCC countries has some important benefits. Given that it is a fully credible monetary policy regime in view of the substantial level of foreign exchange reserves held by the relevant central banks (and also by their respective governments in various forms of stabilization funds held offshore), US dollar markets can be used as a proxy for some domestic financial markets. Derivatives markets scarcely exist in the GCC countries. In some cases, this is because they are simply not needed: a foreign exchange forward contract against the US dollar would not be worth buying when the market is fully convinced that the exchange rate will not change in the future. A foreign exchange forward contract against the euro or other currencies might be useful; but the US dollar-euro forward market is a perfect proxy, and being a very liquid market is relatively cheap to use. Similarly, the more complex interest and exchange rate derivative products —futures, options, and so on—can make use of the very liquid US markets without any exchange rate risk. Thus, although it may appear that this area of the financial market is undeveloped, the GCC countries have pretty much full access to a liquid market in these products: the monetary policy decision to peg the exchange rate has allowed an effective outsourcing here. It would be difficult to argue that economic development is in any way being held back by the absence of domestic

derivatives markets; and, as equity markets develop, albeit slowly, the local exchanges are keen to be able to offer derivative products to match them.

This benefit, of buying-in the provision of derivatives, is not available to all the other currencies in the region. In some cases, exchange controls restrict the ability of players in the economy to use offshore financial services. In others, the weaker (though not necessarily weak) balance of payments position means that domestic interest rates have to be higher than the US dollar equivalent, and US markets can therefore be only an imperfect proxy.

The real economy

This paper will not dwell at length on the real economies of the GCC countries, but will be restricted rather to a few observations.

The high per capita GDP and the relatively inhospitable climate mean that the GCC countries are unlikely to be able to compete in certain global markets, such as those relying on cheap labor or fertile soil,[7] or on non–petroleum natural resources.[8, 9] This contrasts with, for instance, Egyptian cotton production, which can provide employment in agriculture and in upstream manufacturing. In tourism, the GCC cannot compete with the history of ancient Egypt or some of the ancient cities in the Levant and North Africa.

That said, the GCC countries can of course import relatively cheap labor in order to support a construction boom. In some cases this does strengthen competitiveness, for instance by improving infrastructure, including the provision of top-quality hotels. The United Arab Emirates is developing a niche in certain areas of tourism, taking advantage of its investment strength to develop some top-of-the-market resorts: the Burj Al-Arab hotel is internationally known. And Oman, leveraging off its history and geographical diversity, is also developing niche tourist markets. Here the competitiveness of the GCC region is supported by its ability to invest in high-quality infrastructure. Internet cafés abound in the region from Morocco to Syria, but connection speed and reliability are better in the GCC. The GCC countries also have something to offer to each other: significant differences in culture and governance mean that intra-GCC travel can generate business—which may be as simple as an evening trip across the causeway between Bahrain and Saudi Arabia.

There is also scope for attracting transit, or entrepôt, trade, whether for physical goods—the Dubai gold market is well known, but the range of goods traded is much wider and attracts entrepreneurial merchants from many countries (Russian is often heard in the Gulf region)—or as a hub for airlines. It is not possible for every country to host a regional hub; but by developing high-class airport facilities and running attractive airline operations, the GCC countries are able to compete for global business. As with tourism, they can invest in infrastructure and modern, top-quality equipment (for example, airplanes) in a way that other countries in the region cannot, and in this way can gain competitive advantage leveraged off their strong financial situation.

Financial services

In many countries, the first financial markets to develop are those for foreign exchange and government securities. But, as noted earlier, there is relatively little need for foreign exchange trading when the exchange rate is fixed and when local banknotes can be used in neighboring countries fairly easily.[10] And strong government revenues mean that the GCC governments have little need to borrow at present, so the supply of government securities is bound to be restricted (though several of the regional central banks issue their own securities). The foreign exchange and securities markets in the GCC are consequently relatively thin. In this, again, there is a clear contrast with most other countries in the region, where foreign exchange trading flourishes—in some cases to bypass exchange controls—and where governments are much more likely to have a borrowing need (government securities market liquidity is weak in most of the non-GCC Arabic-speaking countries, for other reasons).

For most central banks around the world, developing robust payment systems is seen as part of their monetary and financial stability remit. Preserving the external value of the currency, and providing high-quality banknotes, is a key part of this. But noncash payment services are also important. Developing a culture of financial intermediation may help in the development of financial markets more generally. The jump from keeping savings in physical assets, such as gold, to an intangible investment in corporate equities is a big one. It may be facilitated by familiarity with reliable financial intermediaries. In this, the GCC countries and their neighbors may have the same goals, but the wealthier countries are more likely to see widespread use of financial intermediation and to see a high enough volume of transactions to justify the development of noncash payment systems.

In the GCC, there is a much stronger demand for the more sophisticated financial services than there is in their more cash-based neighboring economies. There is also sufficient volume of business—a product of higher levels of consumption as well as of savings—to justify the cost of building the infrastructure. The cafés in the Khan el-Khalili or al-Hamidiyeh *souks* may be more picturesque than the sea fronts in Kuwait or Abu Dhabi, but in the latter the air-conditioning works, price-visibility is good, *and* you can pay with a credit card.

Statistics support the picture of financial sophistication in the GCC countries as being much higher than that of their non-GCC Arabic-speaking neighbors. Cash in circulation as a percentage of GDP tends to fall with the growth of financial intermediation, and the figures

Table 4: Currency in circulation (percent of GDP)

Country	1995	2000	2005
GCC	7	6	4
Bahrain	5	4	4
Kuwait	4	4	3
Oman	4	4	3
Qatar	5	3	2
Saudi Arabia	8	7	6
United Arab Emirates	4	4	4
Non-GCC			
Lebanon	6	6	5
Other (excluding Iraq, pop weighted)	14	13	14

Source: IMF *International Financial Statistics*.

for GCC countries are significantly lower than they are in neighboring counties—4–5 percent in GCC countries compared with 14 percent in the non-GCC area—with the (not surprising) exception of Lebanon (see Table 4).

Interestingly, the low cash-to-GDP ratio is not solely a function of recent strong growth in GDP reflecting high oil prices—it has been evident over the past decade and more. There are a number of possible explanations for this: it may be that noncash payment systems developed with the increase in wealth after the first oil-price hike; or that wealth is held in forms other than domestic currency cash (whether gold or US dollars); or more possibly it may reflect a different pattern of wealth distribution. For instance, the increase in wealth in past years may have been skewed toward a relatively small part of the population and so has not increased the general demand for cash; and many of the nonnative workforce send a large part of their savings back to their families, rather than holding it in domestic currency.

Stock exchanges

The existence of a stock market, or financial sophistication more generally, are of course not sufficient conditions to guarantee economic growth. But it is hard to think of a competitive economy with strong and balanced growth that does not also exhibit a measure of financial market development. There may be a two-way causality here: a wealthier country is more able to generate savings and support financial intermediation—the necessary infrastructure may simply be too expensive for a relatively poor economy—but at the same time, an economy is unlikely to grow strongly without a supporting financial infrastructure. The growth of the financial sector in the GCC countries—not just Bahrain and the United Arab Emirates—promises well for the future of these economies (although some financial services can be outsourced to the United States and other financial centers, others are more efficiently produced domestically). GCC countries are taking advantage of oil wealth in order to promote diversification.

Again, high oil production by itself does not mean strong capital market growth, but there does appear to be a reasonable correlation between higher oil production per capita and stock market capitalization. This relationship is stronger than the relationship of total oil production vs. market capitalization: beyond a certain point, more income may not generate a need for more locally produced goods and services, and thus there will be no additional need for listed companies.

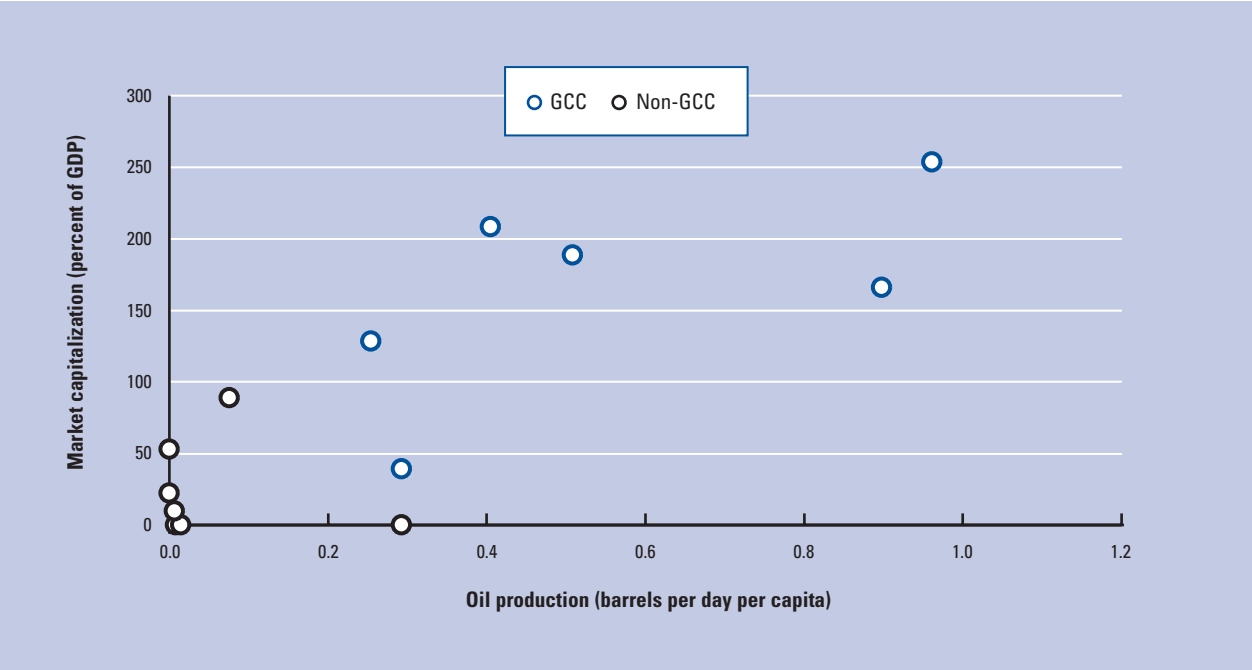
Channeling investment funds in a way that will develop the domestic economy rather than putting them into US government securities, for instance, can occur in a number of ways. It could be that governments, or individuals who have accumulated wealth from the oil or gas sectors, have the vision to make such investments. Or they may choose to employ others—whether as ministers or staff in government, or as private financial advisers—who do have such vision and the skills to implement it. Or the investments can be intermediated by the financial markets—notably stock exchanges, but also investment companies—and possibly drawing in nonresident investors as well as residents.[11] There is a real role in the GCC for financial intermediation in taking advantage of the current economic strength of the region for competitive economic development. Data from the regional exchanges indicate that they are rising to the challenge.

There has clearly been very strong stock market growth in a number of the GCC countries, as well as in other regional exchanges (see Figure 3). In the GCC countries, stock market activity appears to be associated with sharp movements in oil prices (see Tables 5 and 6 for country details).

Turnover in the GCC countries was high in 1997, when oil prices had fallen to a particularly low level; but in the following years—until oil prices rebounded—turnover in the GCC markets was notably lower as a percentage of total Arab market turnover compared with the years of higher oil prices. Some of the trading is speculative—as in any such market—but it is also likely to reflect improved prospects for large infrastructure and service providers when regional income is strong. The sustained high level of oil prices over the past three years has inevitably led to a revision of prospects for investment and demand in the region. The GCC's share of market turnover in the region has jumped from 60 percent in 2000 to around 96 percent over the past three years.

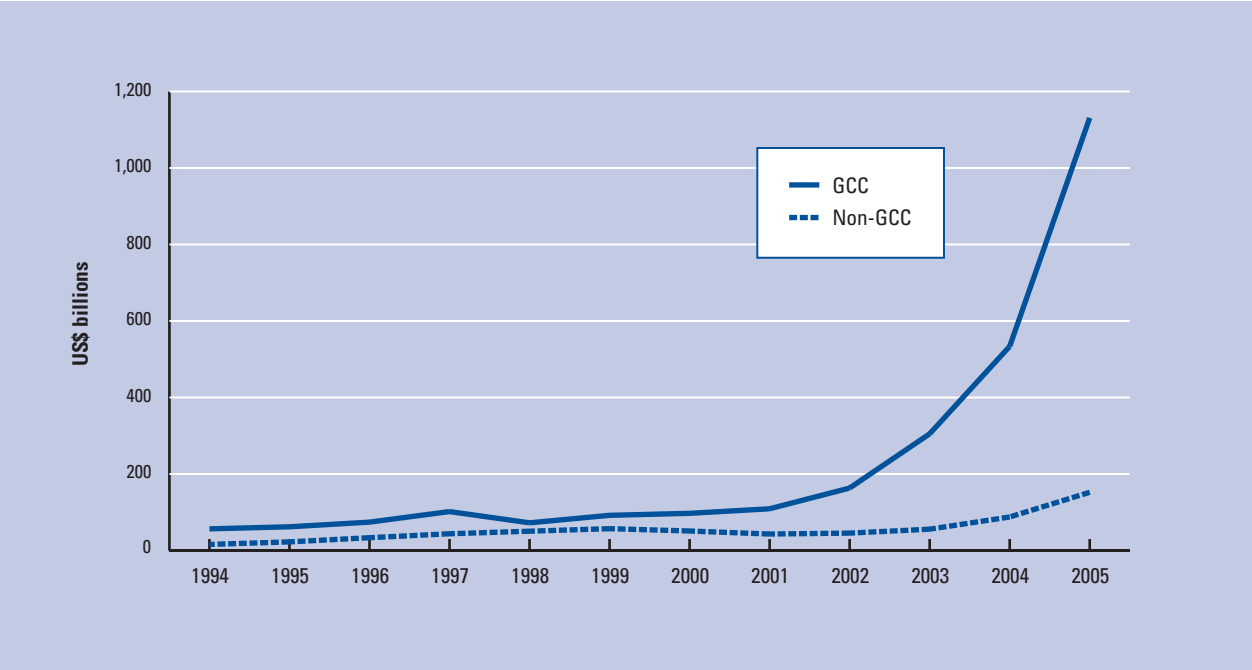
Equities tend to be concentrated in property/construction and petrochemicals; some of the other listed securities are investment funds operating in the same spheres. It is interesting to note that Egypt, with by far the largest population amongst the Arabic-speaking countries (one-third of the total Arabic-speaking population of the region), also has the largest number of companies listed (around 45 percent of the total) but—reflecting the relative wealth of the country—a low

Figure 2: Oil production per capita vs. market capitalization (percent GDP)



Source: OPEC, 2005; IMF, 2006; Arab Monetary Fund, data available at www.amf.org.ae/venglish/default.asp.

Figure 3: Stock exchanges: Market capitalization



Source: Arab Monetary Fund; Federation of Euro-Asian Stock Exchanges.

Table 5: Market capitalization (US$ billions)

Country	1995	2000	2001	2002	2003	2004	2005
GCC	**62.0**	**97.2**	**109.1**	**163.3**	**305.1**	**533.7**	**1,131.0**
Bahrain	4.7	6.6	6.6	7.7	9.7	13.5	17.4
Kuwait	14.4	19.8	26.7	35.1	59.5	73.6	123.9
Oman	2.0	3.5	2.6	5.3	7.2	9.3	12.1
Qatar				10.6	26.7	40.4	87.1
Saudi Arabia	40.9	67.2	73.2	74.9	157.3	306.3	646.1
United Arab Emirates				29.8	44.6	90.6	244.4
Non-GCC	**22.6**	**51.0**	**43.1**	**45.5**	**55.8**	**87.7**	**152.2**

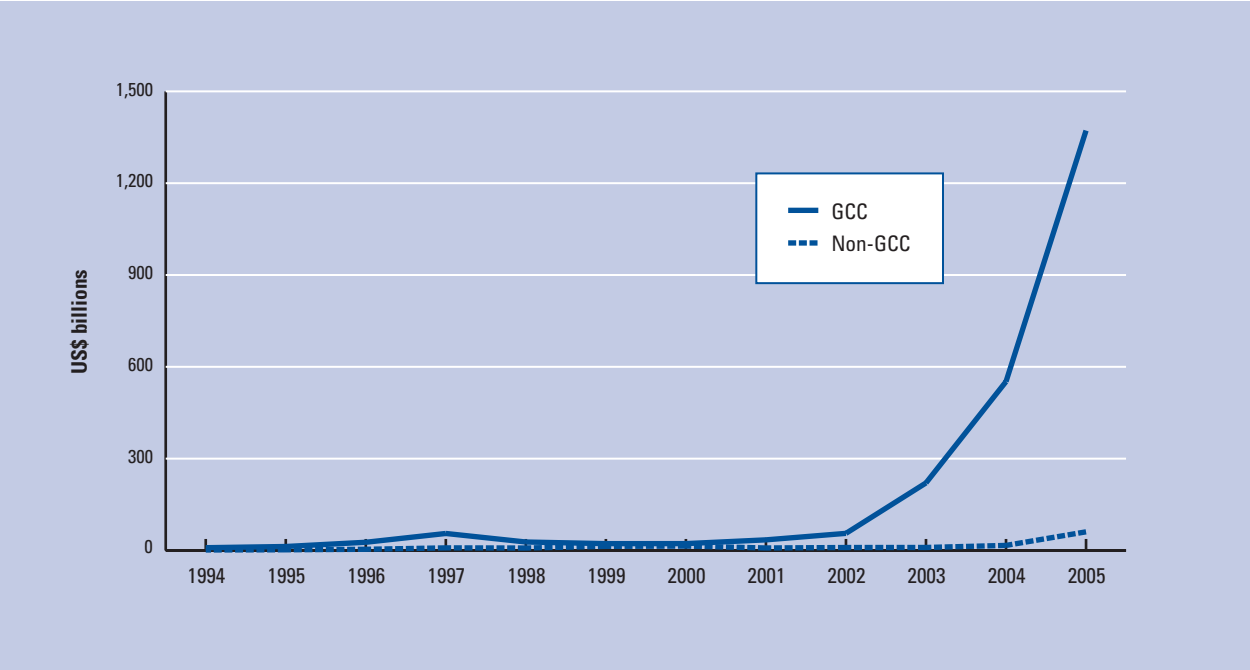
Source: Arab Monetary Fund, available at http://www.amf.org.ae/venglish/default.asp.

Table 6: Turnover (value traded/market capitalization)

Country	1995	2000	2001	2002	2003	2004	2005
GCC average	**0.21**	**0.23**	**0.32**	**0.34**	**0.72**	**1.03**	**1.21**
Bahrain	0.02	0.04	0.04	0.03	0.03	0.03	0.04
Kuwait	0.44	0.21	0.44	0.63	0.92	0.70	0.79
Oman	0.11	0.16	0.16	0.11	0.18	0.21	0.28
Qatar				0.08	0.12	0.16	0.32
Saudi Arabia	0.15	0.26	0.30	0.41	1.01	1.54	1.71
United Arab Emirates				0.04	0.05	0.20	0.57
Non-GCC average	**0.1**	**0.3**	**0.2**	**0.2**	**0.2**	**0.2**	**0.4**

Source: Arab Monetary Fund, available at http://www.amf.org.ae/venglish/default.asp.

Figure 4: Stock exchanges: Value traded



Source: Arab Monetary Fund; Federation of Euro-Asian Stock Exchanges.

share of turnover. Indeed, although market capitalization in Egypt has grown strongly over the past three years and turnover has increased, its share of turnover in the region is now only 2 percent.

A more efficient capital market infrastructure should make it easier for borrowers and investors to operate; this in turn should support stronger, and more diversified, economic growth. Cross-border activities clearly happen already. GCC investment funds are looking for investment opportunities in the region, especially in the countries with a stronger development need. Importantly, the countries with larger populations—Egypt, Iraq, Morocco, Syria, Tunisia, Yemen—have the lowest per capita GDP figures, and so are likely to be capital importers, neatly matching the (current) capital exporting needs of most or all of the GCC.[12] But a greater measure of harmonization and transparency in rules and regulations, mirroring the "common market" approach of the GCC itself, might make it easier for borrowers to link in to investors.

Specialization

Specialization and relative advantage are key concepts when thinking about competitiveness. But not all countries can successfully specialize in the same area. In the GCC region, two centers stand out as seeking to carve a niche in financial markets: Bahrain (since the mid 1970s, but re-launched more recently with the Bahrain Financial Harbour development since in 2002) and the Dubai International Financial Centre (since 2004). Bahrain initially developed strongly as a financial center to handle recycling the so-called petro-dollars in the early 1970s. The substantial increase in oil prices over the past three years means that there is once again a strong impetus to the growth of financial intermediation services, and both Bahrain and Dubai are benefiting from this. They are not alone in seeking to develop financial centers: Qatar and Saudi Arabia also have plans for Doha and Riyadh respectively. Bahrain has more recently sought to develop a niche as an Islamic financial center, while still working in conventional markets. Issuance of *Sukuk* bonds by the government was part of this strategy. But Bahrain faces competition here not just from other regional financial centers, but also from markets in Indonesia and Malaysia, and even London, where "Islamic" products have been developed.[13] The more recent Dubai International Financial Centre aims to offer a broad range of financial services, and in part aims to attract business by doing this in a free trade zone, offering zero tax rate and allowing full foreign ownership and free repatriation of profits.

There is still plenty of scope for other markets to develop. For instance, the Riyadh Stock Exchange is dominant in terms of size, reflecting the larger size of the Saudi economy, and might be able to attract more business from neighboring countries, especially as currency union looms. This could mirror a pattern seen in other regions, where trading tends to converge to large centralized exchanges, reflecting the fact that dominant investors often have an international portfolio and prefer to trade (and clear) their investments on one regional platform rather than a number of small national exchanges. Future privatizations and large-scale infrastructure investments should provide more assets to be traded on the exchanges.

There is certainly more business being generated—notably project finance and wealth management, both at a government and an individual level—and it makes sense to develop local expertise.

The strong growth of the financial sector in recent years, stimulated by the oil price increase, has drawn more participants into the market, often from other countries, and has inevitably put some pressure on the labor market.[14] The requisite human infrastructure takes time to develop, while cultural differences may make it harder for some centers to attract nonlocals (indeed there are indications that some centers do not particularly want to do so).[15] There can be particular difficulties in developing Islamic financial products, since to the normal design and approval process for new products must be added approval by a competent shari'a board. Since there is an element of textual interpretation involved, boards will reach different conclusions about what it acceptable, and they may revise their opinions from time to time. For instance, a savings product was developed in one GCC country that gave (uncertain) prizes to some savers, rather than a fixed return to all; but after operating for some time this was deemed *haram*. Such uncertainty may make some people reluctant to participate in new markets, thus delaying their development.

One question for the region's financial centers, in view of the strong cyclicality in the markets in recent years (reflecting the importance of the [cyclical] oil sector), is whether the market growth and deepening can be sustained for long enough to train and retain the quantity of skilled professional staff required for the peak times.

As the market deepens, this should become less of a problem. One factor that could be important in reducing the strong cyclicality of the GCC markets is the increasing use and sophistication of oil stabilization funds. Kuwait was the first to formalize this, in 1976, and Kuwait's model may still be the most sophisticated and transparent; but all the GCC countries have a stabilization fund in one form or another. The use of such funds can help to reduce the cyclicality of fiscal operations: budgets are much less likely to respond to short-term movements in the price of oil. This may support a less cyclical pattern of demand growth and so allow for more stable development of the financial markets.

Taxation

The GCC states, in their efforts to attract larger volumes of foreign investment, are increasingly willing to enter into and conclude bilateral foreign investment treaties, including bilateral investment treaties, free trade agreements, and double taxation agreements.

In general, taxation rates are low as governments have strong income from petrochemicals. In Saudi Arabia, for instance, no income tax is levied on GCC nationals (others may have to pay income tax), though GCC nationals are subject to *zakât*.[16] Bahrain and the United Arab Emirates are also low-tax countries, where most companies outside the petroleum and petrochemical sectors do not pay tax. There are, at least formally, some taxes on nonresident investments (but also tax incentives provided in certain areas such as the Dubai International Financial Centre). But these do not appear to be a significant problem, and it must be said that the region does not need to import capital.

Currency union: New opportunities?

Will the planned GCC currency union have an impact on intra-GCC competition, and on the competitiveness of the region vis-à-vis other regions? The services sector, and in particular the financial sector, may be the area that benefits most from the intra-GCC common market, as the similar nature of output on these economies reduces the scope for intraregional trade in physical goods.

Currency union will also mean that monetary operations undertaken by the GCC central banks will need to be harmonized. The current structures are quite varied, with some putting more emphasis on providing incentives for market development than others. Central banks are typically also interested in financial sector stability as well as monetary stability. There is a strong awareness of the need for supervision of banks and other financial intermediaries to meet international prudential standards, and for transparency and clarity in the appropriate legislation, if the financial markets are to be attractive and compete internationally. But more probably needs to be done in this area.

Currency union could also raise the opportunity for the region to de-couple the exchange rate from the US dollar, although this is certainly not necessary. In Europe, a number of smaller countries linked their exchange rate to the Deutschemark prior to the introduction of the euro, but now, as part of a larger currency zone, have a floating exchange rate. The parallel with the GCC is not exact, of course. But it is conceivable that, just as high oil revenues are leading to some real exchange rate appreciation in the GCC at present, a future cyclical weakening of the economies might, for competitiveness reasons, make a depreciation attractive. This might be easier to achieve by nominal exchange rate adjustment than by negative inflation (though negative inflation in property prices and skilled labor rates has a number of precedents).

Against the background of the planned currency union in 2010, the recent strong growth in GCC stock exchange trading begs the question: should the financial infrastructure follow the currency harmonization? In general, currency areas require a unified, or at least interlinked, payment system in order to avoid segmentation in liquidity leading to varying interest or exchange rates in different regions.[17] But it is less clear whether there should be a regional stock exchange with centralized settlement. Would this support stronger financial development? Should the central banks of the region, and the financial sector authorities more widely, promote such regional integration?

There are a number of facets to this question. Reference to a parallel situation in what is now the euro zone may be illuminating. Currency union undoubtedly made it easier for investors in the euro area to broaden their portfolios, since currency risk that had previously inhibited some cross-border investments was eliminated. A number of major financial intermediaries found that they could unify aspects of their investment management, and their dealing rooms. This permits economies of scale, allows for better diversification of risk, and so on. But currency risk does not exist between the GCC countries now: the exchange rates have been firmly pegged to the US dollar, and therefore to each other, for years. A unified currency in the GCC will not affect risk, but it should eliminate some frictional costs—moving from one currency to another—and also some of the costs of segmented liquidity.

In other respects, the euro area found that currency union was not a sufficient condition for the free flow of cross-border investments. Stock exchanges, clearing, and settlement systems were not unified just because the currency was.[18] Since the introduction of the euro, there have been a wide range of initiatives to break down the barriers. Even legal barriers can take a long time to overcome—do exchange controls, prudential regulations, or restrictions on the nationality of investors constrain cross-border activity? Where the market segmentation reflects an institutional structure in the private sector, the problems can be much greater. If there is to be a single stock exchange, which exchange survives? In which country should it be located? What problems are raised if settlement of a security is not in the same legal jurisdiction as the issuer or as those using it as collateral? Is there a risk that a single infrastructure will so reduce competition that it is in fact bad for the market?

These are all questions that will need, at some point, to be addressed by the GCC countries as part of their desire to promote financial sector development. But since many of these questions do not relate directly to the choice of currency, they could be extended beyond the GCC. Is there a case for facilitating cross-border investments throughout the whole region? If

companies in other regional countries wish to raise funds in the capital markets, whether via bonds or equity issuance, could they use a regional exchange instead of their national exchange, or both simultaneously?

Some countries in the region still give preferential treatment to investors from other Arab countries. In practice this may simply mean that non-Arab investors have to set up front-companies to make an investment; but it will put off some participants in the market. Regional investors are clearly happy to invest outside the region; most welcome investment from other areas. Economic efficiency and the demands of competition in the global economy may indicate that such artificial barriers should be removed. Some of the GCC authorities may not be fully convinced of this. There is still some legislation that favors nationals in particular, and residents of Arabic-speaking countries in general. There is also some employment legislation that promotes the use of national labor, for instance through differential labor taxes penalizing non-nationals. But this form of protectionism may not have a serious impact on competitiveness. Indeed, one might argue that protectionism has historically worked for countries with a strong economic position, although it demonstrably fails for those who need to compete aggressively to win market share.[19]

Conclusions

It may be that the combination of an appreciating real exchange rate (because of higher inflation than in the country of the anchor currency, the US dollar) together with high aspirations of the native population implies a need for increased education and efficiency if the economies are to be competitive—at least in terms of providing attractive employment opportunities for the growing national labor force. Fortunately, oil wealth allows the GCC countries to fund these educational needs and to invest in infrastructure that will boost economic efficiency as well as the quality of life; it is important that this opportunity be well used.

The GCC countries have more-developed financial markets than the other Arabic-speaking countries in the region. To some extent, this is a function of greater wealth. But it also reflects clear policies of using (some of) that wealth to promote economic diversification and to strengthen the non-oil economy. In some areas, the GCC makes use of parallel—predominantly US dollar—financial markets, as this is more efficient than trying to create independent domestic markets. But capital markets, investment, and project management services have been developing strongly, and appear sufficiently competitive not only to serve the needs of the GCC but also to export such services to other countries in the region. The planned currency union will enhance the strength of the financial sector, but is unlikely to be sufficient on its own to give a substantial boost to these economies.

Table 7: Oil dependence, proxied by oil as a percent of total exports

Country	1995	2000	2005
GCC average	**75**	**81**	**79**
Bahrain	72	72	79
Kuwait	95	93	93
Oman	77	79	83
Qatar	78	92	84
Saudi Arabia	85	91	89
United Arab Emirates	43	55	47
Non-GCC average	**16**	**26**	**27**

Source: World Trade Organization.

The dominance of oil in total GDP (see Table 7) may indicate that economic diversification in some of the GCC countries (Bahrain and the United Arab Emirates are probably furthest along the road of economic diversification) is not sufficient to support a vibrant stock market under all conditions. While oil prices are high, and consequently the prospects for infrastructure investment are good and there is a surplus of capital for investment abroad, the financial sector is likely to thrive. But if oil prices weaken, it is not clear that the rest of the economy would generate sufficient business to maintain the financial sector. All financial sectors will face cyclical peaks and troughs, but the GCC region may for some time have to cope with stronger cyclical swings than other centers.[20] This cannot necessarily be avoided, although fiscal smoothing through the well-planned use of oil stabilization funds can be a powerful countercyclical instrument—but it can be managed more easily with some advance planning.

Whether any of the GCC financial centers will be able to become truly global centers is not yet certain. Some elements of protectionism—favoring nationals and restricting the role of foreign investors—may militate against this. Nevertheless, the level of financial sector development and the credibility of the currencies will be important factors in supporting further economic diversification. Without bureaucratic constraints, the financial sector in the GCC will probably be able to support continued broad-based economic development, not only for the GCC countries but also for the entire region. But the development and strength of the financial sector will also depend on economic diversification in the GCC and long-term management of petrochemical resources, as this will reduce exposure to the strongly cyclical oil sector, and on its ability to serve the needs of the wider region. The relationship between the financial sector and the broader economy is symbiotic. For the GCC, this suggests both considerable opportunities and real risks. This is particularly the case if there is insufficient diversification in the real sector, but also if remaining barriers to cross-border activity become more of a constraint.

Notes

1 The non-GCC Arabic-speaking countries included here are Egypt, Iraq, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia, and Yemen.

2 A sustained spread of more than 25 basis points tends to generate capital flows.

3 Egypt, Morocco, and Tunisia have a more flexible exchange rate policy. The unofficial rate for the Iraqi dinar showed strong movements until 2003; the Iraqi dinar has been very stable from early 2004 until late 2006, when the central bank encouraged an appreciation of the dinar.

4 Banks do lend for property purchase, but in the GCC security often relies on future salaries (civil servants have a job for life) rather than the property itself, so banks are not so exposed to property price shocks as they are in other regions.

5 It is not clear to what extent property prices are reflected in the consumer price index (CPI) data for the region. Anecdotal reports indicate property and skilled labor (services) inflation in recent years in the region has been much higher than the CPI series might suggest.

6 There are, however, indications that official measures of inflation in some GCC countries may understate the real level.

7 The use of desalination plants in a region with limited fresh water supplies and growing demand from a growing population does mean that some agricultural production can take place in addition to the traditional production—for example, a wide variety of dates.

8 For instance, pearl fishing in Bahrain, at one time very important to the local economy, is now a matter of history.

9 If the international response to global warming affects demand for hydrocarbons in future decades, the GCC countries would be well placed to make use of solar energy.

10 . . . and occasionally unscrupulously: a taxi driver in Manama tried once to persuade one of the authors that 10 Saudi riyals was equivalent to 10 Bahraini dinar.

11 Some GCC markets still place restrictions on nonresident investment.

12 Saudi Arabia is the only GCC country with a large population, accounting for some two-thirds of the GCC total.

13 In a speech to the Middle East/North Africa Forum on October 30, 2006, the Economic Secretary to the (UK) Treasury noted: "we also want to do more to make Britain the gateway to Islamic trade and the City a global centre for Islamic finance" (Balls 2006).

14 One employment market website noted in early 2006: "Areas with the greatest demand-supply mismatch reportedly include private banking, corporate finance, compliance and certain specializations within Islamic banking."

15 See, for instance, comments in Fasano and Iqbal (2003) and Arab Monetary Fund (2003).

16 *Zakât* is one of the five pillars of Islam—the required giving of a proportion of one's wealth. The Wikipedia definition is: "The payment of zakât is obligatory on all Muslims. In current usage it is interpreted as a 2.5% levy on most valuables and savings held for a full lunar year, if the total value is more than a basic minimum known as nisab (3 ounces or 87.48g of gold). At present (as of 3 March 2007), nisab is approximately US $1922.40 or an equivalent amount in any other currency."

17 The United States introduced the Fedwire payment system in order to harmonize the yield curve across the country; the Eurosystem central banks interlinked their wholesale (RTGS) payment systems (in TARGET) in order to ensure that a single monetary policy could be delivered across the whole region.

18 Neither were the retail payment systems.

19 See Chang (2002).

20 See, for instance, *Financial Times* (2006).

References

Arab Monetary Fund. Available www.amf.org.ae/venglish/default.asp.

Arab Monetary Fund. 2003. *Contribution of the Arab Monetary Fund to the Development of Arab Capital Markets*. June. Abu Dhabi: Arab Monetary Fund. Available at http://www.amf.org.ae/venglish/storage/other/EPI%20DEPT/PUBLICATIONS/Econnomic/Arab%20Capital%20Market-Eng.pdf.

Balls, E. 2006. Speech to the Middle East/North Africa Forum, London, October 30. Available at http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/econsecspeeches/speech_est_301006.cfm.

Chang, H.-J. 2002. "Kicking Away the Ladder: How the Economic and Intellectual Histories of Capitalism Have Been Re-Written to Justify Neo-Liberal Capitalism." *Post-Autistic Economics Review*. 15 (September 4), article 3. Available at http://www.paecon.net/PAEtexts/Chang1.htm.

Fasano, U. and Z. Iqbal. 2003. *GCC Countries: From Oil Dependence to Diversification*. Washington, DC: IMF.

Financial Times. 2006. "Gulf Markets." November 21.

IMF (International Monetary Fund). *International Financial Statistics*. Washington, DC: IMF.

IMF (International Monetary Fund). 2006. *World Economic Outlook Database*, September 2006. Washington, DC: IMF.

OPEC. 2005. *Annual Statistical Bulletin 2005*. Available at www.opec.org/library/Annual%20Statistical%20Bulletin/pdf/ASB2005.pdf.