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GCC financial markets

Long-term prospects for finance in the Gulf region

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DB Research Management
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High aspirations with a chance of realisation: Developing financial markets has been a policy objective in many countries of the Gulf region over the past decade. The global environment in which these strategies have been pursued has changed dramatically since the onset of the financial crisis, but the GCC (Cooperation Council for the Arab States of the Gulf) countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates – stand a solid chance of succeeding in developing their financial markets and promoting their competitiveness.

Market environment remains fragile: Economic conditions in GCC markets in the wake of the global financial crisis are resilient, corroborated by the comfort of the region’s wealth in oil and gas supplies. At the same time, the past years of financial turmoil pointed at the challenges on the way to larger and more mature financial markets. Low market liquidity, large price swings, funding issues in prominent state-owned enterprises, and a considerably cooler sentiment are obstacles to faster financial development. Political and geostrategic imponderabilities in the wider region add to market uncertainty.

Financial market development: Most GCC nations have made the promotion of finance as an industry a priority on their political agendas. Starting from modest bases, finance in the GCC has grown to be a vibrant industry. But, at below 1% of global assets, GCC financial markets remain small and behind their potential. There is considerable room to grow, but by international standards, the region faces tough challenges in competing with established markets in Europe and America and with their highly dynamic peers in the emerging world.

Important necessary reforms: There are a number of important structural factors which are likely to determine the development prospects of financial markets in the GCC in the coming years. These factors include (i) raising the competitiveness of domestic banking markets, (ii) broadening and deepening local equity markets, (iii) promoting efficient corporate debt markets, (iv) developing Shari’ah-compliant financing as a competitive market pillar, (v) providing suitable conditions for a reasonable range of derivative financial instruments, (vi) stimulating private institutional investments.

International market and regulatory integration: Effective financial market regulation and oversight as well as a strong grip on market abuse and financial fraud are top priorities of policymakers around the world, especially in the G20 context. The GCC economies have made important strides in this regard. Intensifying that commitment, not least by ensuring full participation in the reform processes but also by committing the resources needed to achieve optimal consistency and effectiveness in regulation and market supervision will be key to achieving the goals of financial development and economic diversification.

Note: This study was finalised by the author on June 30, 2012. He would like to thank Daniel Rahmann for valuable research assistance, and Jan Strasky and Maria Lanzeni for their comments.

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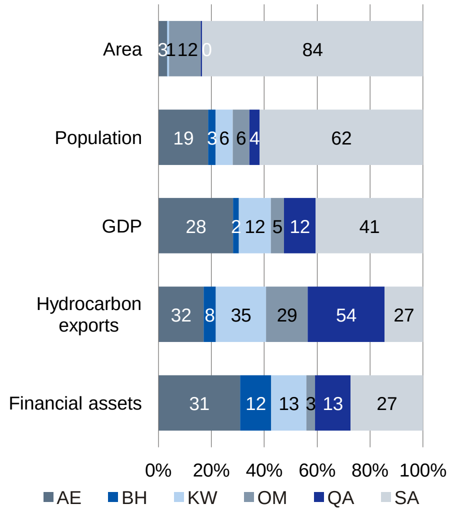
The GCC – comparative overview 1

		US Total	EU Total	GCC Total	GCC % of EU
General					
Area	m sq km	9.7	4.3	3.2	74
Population	m	313	503	41	8
GDP					
GDP	USD tr	16	17	1.1	6
GDP per capita	TUSD	51	34	24	70
Government					
Expenditure	% of GDP	38	51	36	
Budget balance	% of GDP	-11	-6.6	6.1	
Gross debt	% of GDP	78	80	14	
External					
Exports	% of GDP	13	16	65	
Imports	% of GDP	16	16	48	
Current account	% of GDP	-3.2	-0.8	13	
External debt	% of GDP	98	85	43	
Finance					
Bank assets	USD tr	14	42	1.2	3
Debt securities	USD tr	33	31	0.2	1
Stock markets	USD tr	17	11	0.7	7

Note: All data for 2010.
Sources: IIF, IMF, DB Research



Note: Area, population, GDP, in % of total GCC. Financial assets as sum of bank assets, debt securities outstanding, stock market capitalisation, in % of GCC. Hydrocarbon exports in % of domestic GDP. All data for 2010.

Sources: IIF, IMF, DB Research

Introduction

Developing financial markets has been a policy priority in many countries of the Gulf region over the past decade. Aspirations for financial centres have been high. Visions reach from promoting local financing in support of the development of domestic GCC economies to building true financial hubs for the region on the Arab peninsula, the MENA region, or even with a global dimension.

At the beginning of the last decade, this strategy looked highly promising. In light of depleting oil and gas reserves, economic diversification was a key answer to many questions. Finance was considered to kill two birds with one stone: A thriving financial business would be an attractive high-productivity sector by itself, and would – through easier financing and better asset management – help develop business activity in other sectors, too. Even better, opening up to the global financial scene promised greater economic weight in the Arab world and beyond.

While the rationale of these arguments is as valid as any time before, the international environment in which these strategies have been pursued has changed dramatically in the past five years. Thus, the global financial crisis has taken the edge off the magic of the finance business, sent shockwaves through private and public sectors on the Arab peninsula and has taken its toll on business sentiment and growth prospects. While many emerging economies especially in Asia and Latin America have weathered this storm extraordinarily well and enhanced their economic and political clout on an international level, the Gulf region has not made positive headlines in a long while. And as the global economic environment remains fragile, political uncertainty has increased in the MENA vicinity.

This paper reviews the achievements so far and assesses the prospects for further financial market development in the Gulf region in light of the contemporary challenges. The analysis covers the following topics:

— GCC financial markets: Coping with a challenging economic environment

— Financial market development: Rapid ascent on a long journey

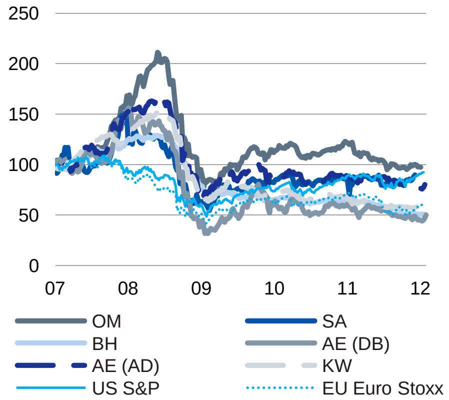
— International integration: Growing financial ties, but substantial barriers

— GCC financial centres in global competition

— GCC monetary union – slowed down, but feasible

GCC financial markets: Coping with a challenging economic environment

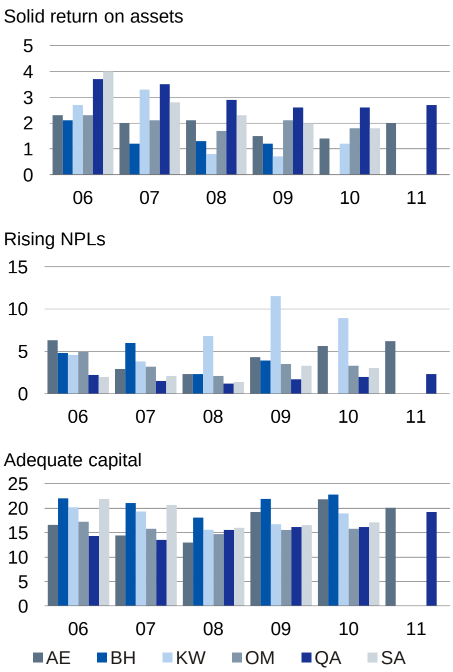
Stock markets: Modest stabilisation 2



Note: Main domestic stock indices. DB=Dubai. AD=Abu Dhabi. S&P=U.S. S&P500 Composite. Jan 07=100.

Source: DB Research

Banking sector recovers 3



Note: Top - returns on assets, %. Middle - non-performing loans, % of total loans. Bottom - capital adequacy ratios, % of risk-weighted assets.

Sources: IMF, DB Research

Prior to the financial crisis, optimism prevailed regarding the dynamism and growth prospects of the GCC economies and their financial hubs. GCC economies expanded at rates well above the global average, and financial sectors experienced double-digit growth throughout the last decade. The GCC economies have not escaped the global downturn that followed. Financial markets were shaken by the events in Europe and America and economic dynamism has been lost. But – first and foremost thanks to continued and reliable income streams from hydrocarbons – GCC economies have emerged stable from the turmoil of the past five years.

GCC financial markets after the crisis – shaken but stable

GCC financial markets have experienced two major setbacks in the course of the ongoing economic and financial crisis from which they have recovered moderately so far.

— First, markets had reacted sharply to the banking crisis in the US and Europe since the latter half of 2008, as evidenced by the drastic drop in stock markets indices reaching a trough in the first quarter of 2009. At that point, GCC stock market indices had – compared with their levels at the beginning of 2007 – fallen by one-fifth in the case of Oman, around one-third in Bahrain, Kuwait and Abu Dhabi, almost 50% in Saudi Arabia, and as much as two-thirds in Dubai.

— Second, markets responded sensitively to the debt problems of individual state-owned enterprises in Dubai and Saudi Arabia, which culminated in a USD 10 bn bail-out of Dubai by neighbouring Abu Dhabi in December 2009. In particular, state-funded investment firms had suffered from the severe decline in real estate and property prices in the region that had ensued in the course of the financial crisis.

The turmoil around these two events, together with other factors, has had a profound impact on local financial markets. Not only had factors external to the region left investors in GCC assets uncertain, but also domestic problems were brought to the surface. Thus, part of the price collapse of key financial assets has been ascribed to previous exuberance especially in the Emirates, as stock market and real estate prices in particular had skyrocketed in preceding years and by 2007 had reached levels widely regarded as out of sync with fundamentals. As a consequence, GCC financial markets have – despite decisive political action and some moderate business recovery – not regained the dynamism they had benefitted from prior to the crisis.

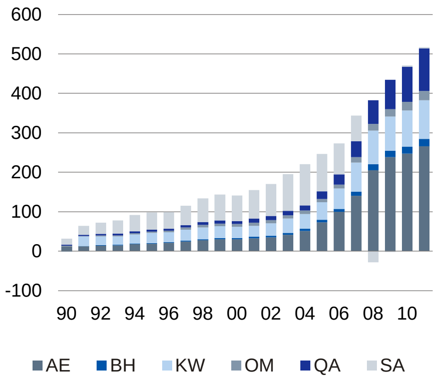
Banking markets

GCC banking sectors remain strained by the crisis. Even if no major bank in the region failed as a result of the financial turmoil, especially the crisis in real estate weighing heavily on many institutions. On a positive note, levels of bank capitalisation and return on assets have, at well above 10%, been reasonable in an international comparison, and – after crisis-induced dents in 2007 through 2009 – improved markedly (see chart 3). Bank liquidity, too, has improved since 2008, supported by a decline in loan-to-deposit ratios and strong government support which is anticipated to continue for some time.

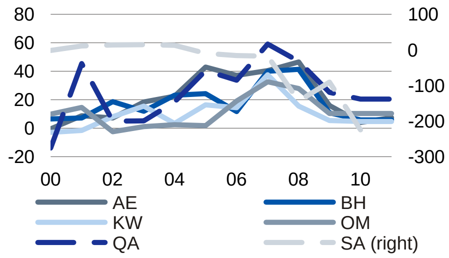
The deterioration of bank asset quality remains a serious issue, though, after the share of non-performing loans had, with only few exceptions, doubled between 2008 and 2009 and has remained at high levels thereafter. A sustained

Credit growth 4

Credit continues to grow...



... albeit at considerably reduced rates

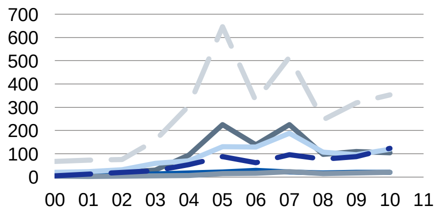


Note: Top - Total credit, net, USD bn. Bottom - Net credit growth, % p.a.

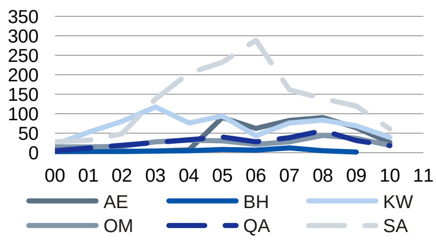
Sources: IIF, DB Research

Sobered-out stock markets 5

Market capitalisation



Market turnover



Note: Market capitalisation on national stock markets, USD bn. Stock market turnover ratio, total value of shares traded in % of average market capitalisation.

Sources: World Bank, DB Research

recovery of bank balance sheets cannot be expected before a solid recovery takes hold especially in the real estate and corporate sector. In the same vein, provisioning requirements remain high, and bank profitability continues to be under pressure.

Net credit volume in the GCC as a whole had continued to grow steadily, albeit somewhat more slowly since the onset of the crisis and with considerable variations across the six member states. As corporate and retail loan demand has fallen and bank risk aversion intensified, especially Saudi Arabia and the Emirates have seen new credit volumes reduced. Throughout the GCC a rebound of credit provision is expected to depend critically on future government spending to stimulate private consumption and corporate investment as well as the speed of the economic recovery.

Stock markets

In response to the crisis, GCC stock markets had collapsed by between one-fifth and two-thirds between early 2007 and the respective trough in late 2008. This compares with an almost 50% decline of the S&P 500 and the MSCI Emerging Markets Index, suggesting that most GCC stock markets had performed better through this period, with Dubai's decline by more than two-thirds as the most notable exception.

Since the critical phase of the financial crisis, GCC stock markets performance has diverged sharply, with Dubai, Bahrain and Kuwait at historically low levels of just over 50% of their index values immediately prior to the crisis. Oman, Saudi Arabia and Abu Dhabi, in contrast, have recovered to 80% to 90% of their pre-crisis index levels, in line with the S&P 500 in the US. However, even the rebound in these three markets has been too weak to keep up with the pace in other emerging stock markets where price levels had risen to 15% above pre-crisis levels.

In line with price developments, the value of firms listed on GCC stock exchanges has declined drastically compared with immediate pre-crisis levels. With the exceptions of Bahrain, Qatar and Oman, where capitalisation was close to pre-crisis levels or even higher by end-2010, all other stock markets continue to suffer from low market capitalisation comparable to the valuations seen in the early phases of GCC financial market development around 2004. Market turnover, too, has remained sluggish.

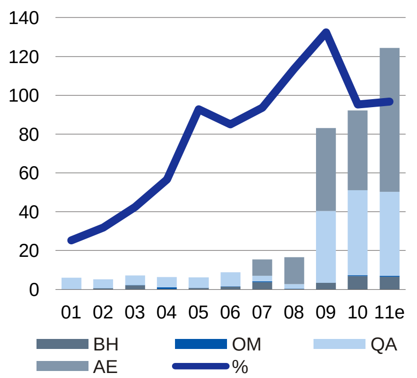
Bond markets

GCC bond markets, whether public or private, have not enjoyed a similar dynamism in their development as observed in other market segments over the past decade. Their heterogeneous development was in most economies interrupted by the financial crisis, but issuance activity revived in 2009 and 2010. In Bahrain, Qatar, and the Emirates, where bond markets have actually grown to significance over the past years, bond trading continued to grow throughout the crisis, and based on data for the first half of the year, 2011 may again have seen an increase in market activity.

Taking Bahrain as an example, new issuance focussed on regular Treasury Bill issuances as well as discretionary sales of government Development Bonds. Use of Islamic debt instruments by the government expanded, too, and traditionally makes up the largest portion of debt outstanding.

Discussions over greater emphasis on the development of local bond markets have been reignited by the crisis. As the largest part of government debt is issued as USD-denominated international bonds, placement turned out to be particularly challenging when international markets dried out and bank liquidity

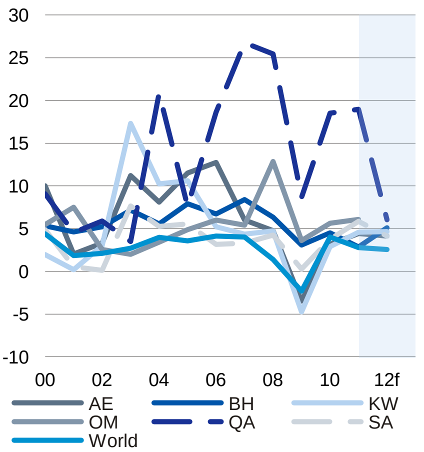
Bond market trading 6



Note: Annual bond market trading turnover, USD bn, and AE, BH, OM, QA share in total emerging markets bond trading in % (right).

Sources: EMTA, DB Research

Decade of high but volatile growth 7



Note: Growth in real GDP, %.

Sources: IIF, DB Research

Policy measures during the crisis 8

	AE	BH	KW	OM	QA	SA
Deposit guarantee	×		×			×
Central bank liquidity support	×	×	×	×	×	×
Government deposits	×	×	×	×	×	×
Capital injections	×		×		×	
Bank asset purchases					×	
Stock market purchases			×	×		
Monetary easing	×	×	×	×		×

Sources: IMF, DB Research

diminished. Promoting deeper private and public local currency debt securities markets is widely regarded an important policy objective across the GCC, as a result.

Decelerating macroeconomic dynamics

Economic growth and monetary and financial conditions

The global financial crisis has interrupted a decade of high but volatile growth for the GCC during which average GDP growth had almost double compared with earlier periods. Between 2003 and 2008, the GCC economies grew by 6.6% annually, carried by high energy prices, mounting hydrocarbon revenues and strong government spending.[1] By 2008, government spending had contributed more than 50% to non-oil GDP and through a wide range of investment projects had contributed significantly to economic diversification in GCC states whose political objective is to diminish their long-term dependence on hydrocarbon exports.

The years prior to the crisis were used wisely in some respects. Especially the government sector took advantage of the benign conditions and consolidated public accounts. Between 2003 and 2008, government debt of GCC countries was reduced from 66% to 12% of GDP, while current accounts improved from a 7% to 24% surplus in the same period. As a result, it was possible to stack up official reserves of USD 515 bn, up from just over USD 70 bn half a decade before, and assets held by GCC-based sovereign wealth funds at end-2008 were estimated to amount to as much as USD 1 tr.

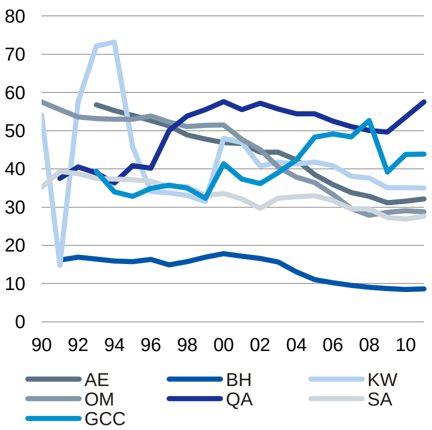
The downside of the rapid development of the last decade was inflation and growing exposure to financial risks. By 2008 inflation across the GCC had reached double-digit figures, fuelled by booming real estate markets, growing domestic demand, rising commodity prices and a weakening US dollar to which national currencies are pegged. These price pressures were complemented by surging credit demand, with a rising share of loans going into real estate financing. While the share of foreign liabilities in total liabilities doubled in most GCC economies between 2003 and 2008, most of the credit growth was financed by the domestic banking sector, increasingly marked by higher leverage and maturity and currency mismatches in their balance sheets.

The financial turmoil in America and Europe spilled over into the GCC region reaching its maximum impact in 2009, with key channels of transmission including the dried-out liquidity in international inter-bank markets and other financial market segments, the collapse of asset price, especially on stock exchanges and in the real estate sector, exacerbated bank funding conditions, tighter lending conditions, and uncertainty over oil sales. The blow was mitigated, however, by the favourable fiscal situation already mentioned, continued high hydrocarbon revenues, and decisive action on the part of policymakers which included a wide range of fiscal stimulus measures, easing of monetary conditions, and rescue measures in the banking, financial, and real estate industries (see chart 8).

As a consequence, the global downturn at the end of the last decade left considerable scars on the GCC economies, and the recovery from the financial stress is widely expected to be protracted. After solid figures for 2011, which likely represented the peak of the current cycle, GDP growth is forecast to remain clearly below that of earlier years, at about 4% in 2012 and 2013.

[1] For a detailed analysis of the impact of the financial crisis on the GCC region see May Khamis and Abdelhak Senhadji, "Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead", International Monetary Fund, Washington, 2010.

Dependence on hydrocarbons 9



Note: GDP based on revenues from hydrocarbonds, % of total GDP.

Sources: IIF, DB Research

Hydrocarbon exports – continuity in a volatile world ...

Oil remains a key stabilising factor for GCC financial markets. Oil and gas sales have provided the GCC countries with a constant flow of export income especially in recent years when oil prices multiplied compared with earlier periods and production volumes exported were maintained or even expanded.

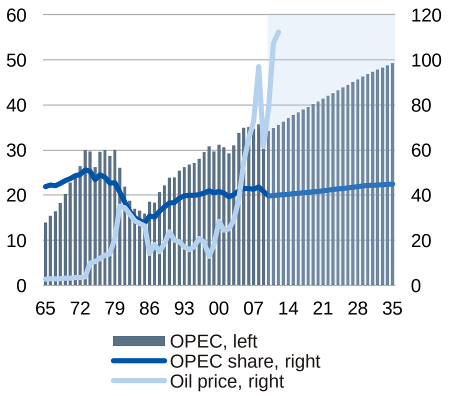
While the region has focused on greater economic diversification and reducing its dependence on hydrocarbon achieving exports (see chart 9) for many years, the recent past has once more underlined the enormous upsides of the windfall income from natural resources at a time of economic and fiscal distress. Even though the share of hydrocarbon exports in GDP varies widely across the region, the majority of the GCC states have been able to generate strong wealth and, more importantly, governments have been able to cushion the impact of the global economic downturn rather effectively.

These trends are expected to continue in the near future, such that hydrocarbon revenues are likely to continue to play a stabilising role for the GCC economies, and also for their financial markets.

... also for public finances

The Gulf states entered the economic and financial crisis with very favourable public finances. All GCC member state budgets were in surplus by end-2007, with balances ranging from just over 3% of GDP in Bahrain to more than 40% in Kuwait. Similarly, public debt had reached a low point at that time at an average 15% of GDP in the GCC. In parallel, public financial assets were accumulated to the extent that, by end-2007, the GCC states were in possession of USD 420 bn in foreign exchange reserves alone. Looking at the total volume of public financial assets, including official reserves as well as assets held by public investment vehicles, the GCC states today dispose of an estimated USD 1.8 tr of which Saudi Arabia and the United Arab Emirates together hold almost 75% between each other. These assets amount to USD 45,000 per inhabitant, which exceeds the per capita public wealth of China, for example, by a factor of 15.

Stable oil sales, high price levels 10

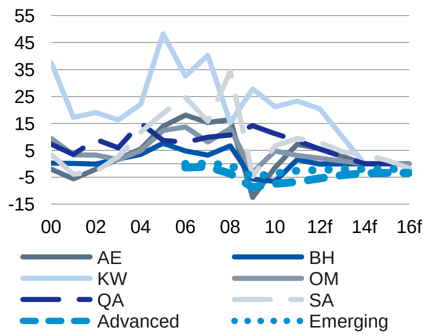


Note: Oil production, million barrels per day. 65-10 real values (BP). 10-35 projections (OPEC). OPEC share in global total, %. Oil price for Brent, USD per barrel (OECD, OPEC).

Sources: OPEC, BP, OECD, DB Research

To be sure, the downturn of global financial markets, diminished economic growth and crisis-related rescue and stimulus expenditures have left recognisable marks on public finances since 2008. As a result, fiscal surpluses nearly halved from 18% in 2007 to just over 9% in 2011 in the GCC. In fact, with the exception of Kuwait and Qatar, the GCC economies for the first time in almost a decade experienced fiscal deficits. Sovereign debt levels, too, increased in individual Gulf countries, but the average debt-to-GDP ratio, at an expected 14% for 2011, is an object of envy in most capitals around the world, including other emerging markets, where average debt ratios are twice as high, let alone advanced economies with an average of 102%.

Fiscal surpluses - massive but declining 11



Note: Central government balance, % of GDP. For GCC countries and averages of advanced and emerging economies.

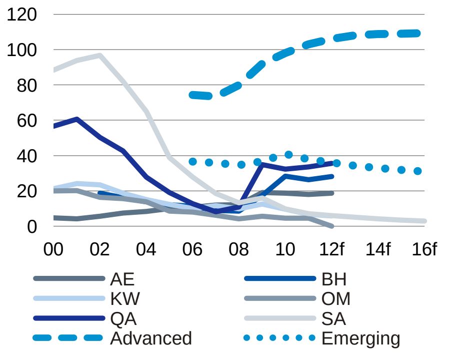
Sources: IIF, IMF, DB Research

Public financial assets, too, were scarred by the crisis, mainly owing to the valuation impact of the decline in financial asset prices especially in Europe and America, where a large share of sovereign and equity portfolios is traditionally invested. In addition, selected sovereign wealth funds have reportedly been tapped to finance fiscal rescue and stimulus operations. However, central banks and other sovereign investment vehicles are generally understood to have emerged in reasonable shape from the turmoil, and asset volumes are estimated to have outgrown the high pre-crisis levels already.

Outlook: economic and political uncertainties

All in all, the Gulf economies have manoeuvred comparatively well through the past years of economic turmoil. As a result, the GCC states have enjoyed favourable ratings on international financial markets. Having risen steadily

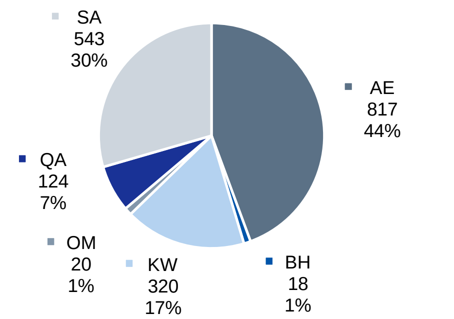
Manageable public debt 12



Note: Central government debt, % of GDP. For GCC countries and averages of advanced and emerging economies.

Sources: IIF, IMF, DB Research

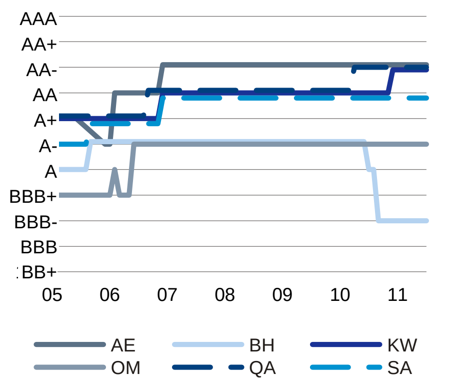
Substantial public financial assets 13

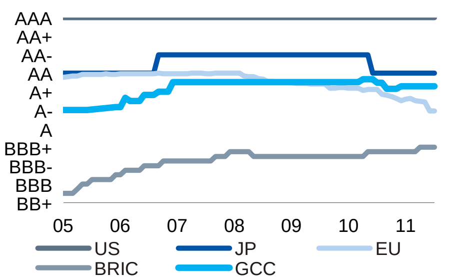


Note: Sum of official reserves excluding gold and sovereign assets held by public investment vehicles. USD bn at end-2011, and % of total USD 1.8 tr. Estimates by DB Research.

Sources: IIF, DB Research

Favourable country ratings 14





Note: Top - Country ratings, foreign currency ratings, S&P, for AE Moody's. Bottom - Country ratings, regional unweighted averages.
Sources: S&P, Moody's, DB Research

before the crisis commenced, ratings remained high throughout the turmoil and for almost all GCC countries have since remain at those levels. In an international comparison, the creditworthiness of the GCC economies has, on average, been superior to those of the BRIC countries, and from mid-09 onwards has actually exceeded the average ratings of EU member states.

A high and stable rating, however, cannot be taken for granted even if hydrocarbon revenues promise a strong income for the time being. In fact, the GCC is currently surrounded by a number of sources of severe economic and political uncertainties:

— EU and US debt crises: Like the global economy as a whole, the GCC is vulnerable to spill-overs from economic turmoil in Europe and America. Oil exporters like the GCC are particularly exposed to these risks as global demand greatly influences their hydrocarbon sales.

— Arab Spring: The struggle for democracy and liberty in parts of the wider MENA region created uncertainties, which are influencing has regional financial markets. With regime transitions in Egypt, Tunisia, and Libya, the upheavals in Syria, and public discontent in parts of the Gulf region, too, political uncertainty remains a critical issue on many financial markets.

— Iran-Israel conflict: The Middle East has been a geo-strategic hot-spot for many decades. As of early 2012, political risks have considerably mounted over a potential military conflict between Israel and Iran. Escalations of that type are a key risk factor on the financial markets in the closer and wider vicinity, especially the GCC.

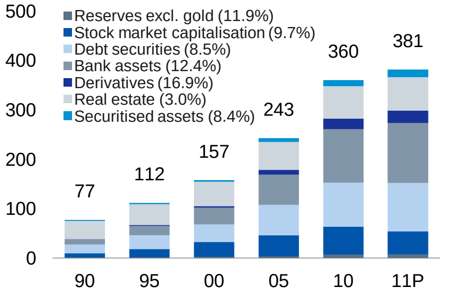
— Domestic economic reform: Economic reform, especially the diversification of income sources has been a key concern of policymakers in the GCC for more than a decade. Attracting business, building infrastructures, and establishing reliable legal and governance frameworks are all issues at the centre of economic development policies in all countries. The extent to which the countries achieve this objective has a long-term impact on the decisions domestic and international investors make, especially in light of the fast and decisive pace with which competing economies in the emerging world have come to create favourable framework conditions for investments. Failure to keep up with that pace is set to limit the speed of financial market development.

With these key sources of uncertainty in mind, the economic outlook of the Gulf region is fairly positive, with an expected GDP growth of around 4% in 2012-13. Even though this is clearly above the 1.5% growth DB expects for the advanced economies, it is weaker than the GCC's peers in the emerging markets whose growth is forecast to be 4.8% and 5.5% in the current and next year, respectively[2].

Driven by oil sales, current accounts remain strongly positive at a surplus for the GCC of around 23% in the coming years. This enables governments to maintain strong fiscal surpluses at around 12%. Inflation has been rising, but is expected to remain moderate, i.e. below 4% across the GCC. Despite key structural commonalities, the economic performance of the GCC states continues to diverge, as Abu Dhabi, Oman, and Qatar are currently perceived as economically more dynamic, while Dubai, Kuwait, and Bahrain have emerged more slowly from the trough of the crisis. Differences also exist when it comes to their exposure to the economic and political risks discussed above. Finally, there is strong variation in the dependence on hydrocarbons as well as in the comprehensiveness and state of economic diversification programmes.

[2] DB Global Markets Research, Emerging Markets Monthly, November 2012.

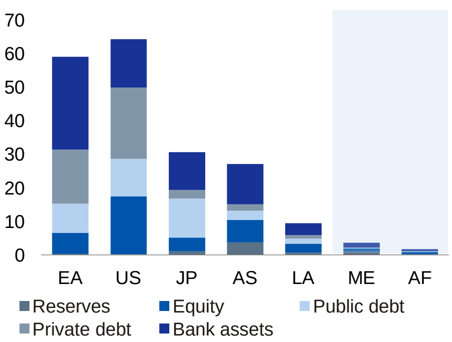
Financial assets worldwide 15



Note: Major financial market segments. Stock market capitalisation worldwide, total assets of banks, volumes of debt securities outstanding, market value of OTC and exchange-traded derivatives outstanding, USD tr, CAGR 90-10 in %.

Sources: DB Research, various public sources

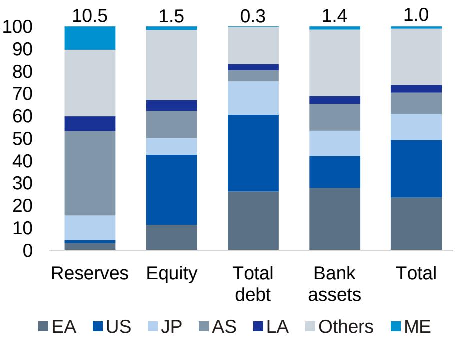
Small market volumes 16



Note: Total volume of official reserves (excluding gold), stock market capitalisation, public debt securities outstanding, private debt securities outstanding, bank assets, USD tr, end-10. For Euro Area (EA), US, Japan, Asia (AS), Latin America (LA), Middle East (ME), Africa (AF).

Sources: IMF, DB Research

Minor market shares 17



Note: Share of Middle East (ME) market in respective world market segment, % for official reserves (excluding gold), stock market capitalisation, public debt securities outstanding, private debt securities outstanding, bank assets. For Euro Area (EA), US, Japan, Asia (AS), Latin America (LA), Middle East (ME), Others. End 2010.

Sources: IMF, DB Research

Financial market development: Rapid ascend on a long journey

In one way or another, all GCC states have made the promotion of finance as an industry a priority on their political agendas. The outcome of the efforts of the past decades is impressive. Starting from modest bases, finance in the GCC has grown to be a vibrant industry with strong growth rates during the boom years, a growing variety of products and markets at the disposal of clients, and more efficient and liquid markets in many parts of the business.

The crisis has dampened the euphoria that prevailed, especially in the financial capitals of Dubai, Doha, and Kuwait. There is still considerable room to grow, but by international standards the region faces tough challenges in competing with established markets in Europe and America and with their highly dynamic peers in the emerging world.

GCC in an international comparison

In a global comparison, finance in the GCC has remained small. Internationally, financial markets have grown spectacularly over the past twenty years. Driven by solid demand, technological progress, and regulatory liberalisation, the volume of financial assets worldwide has grown from just over USD 77 tr in 1990 to more than USD 381 tr today. Over the first ten years of the millennium, worldwide financial assets expanded by 8.6% per year on average, and the development was only slowed down by the crisis in the latter half of the decade.

— Market volumes: With USD 2.6 tr in financial assets, the region clearly lags behind its emerging peers in Latin America and Asia, respectively, and is dwarfed by financial assets in the traditional advanced economies. More specifically, the GCC countries' market volumes amount to only 0.8% of the global total. The comparatively small absolute size of GCC countries in terms of their population is a constraining factor, with indicators clearly yielding better results on a p.c. basis.

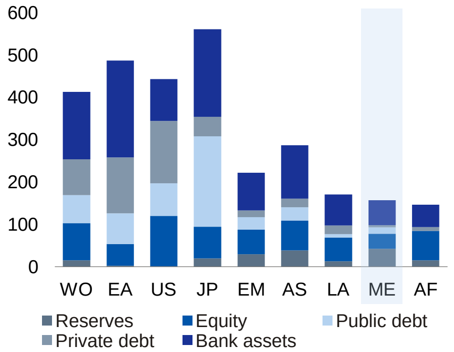
— Market share: In terms of relative market size, the role of the GCC in global finance is even more limited. The Middle East makes up just over 1% of the global total[3]. Moreover, aggregate asset figures for the region are heavily influenced by the high volume of official reserves held by monetary authorities which amount to almost USD 700 bn in the GCC alone and over USD 1 tr in the whole of the MENA region. Their share in the global pool of official reserves assets amounts to more than 10%, reflecting the exceptional volume of public-sector financial wealth among the oil-exporting nations in the Middle East. The shares of equity, debt, and banking markets, in contrast, are much lower, ranging between around one-and-a-half percent of the global total for equity market capitalisation and banking assets, and as little as 0.3% for public and private debt securities. The GCC alone accounted for 1.1% of global banking assets at end-2010, 1.3% of equity market capitalisation and just 0.2% of debt securities outstanding.

— Relative size: GCC financial markets are not only small by international standards, they also lag behind the economic potential of their domestic economies. Thus, the GCC's 0.8% share in global financial markets compares with their 1.7% share in worldwide GDP. But also the relation of financial market size to GDP suggests an imbalance. A widely-used measure of financial market development, the ratio of financial assets to GDP suggests that the economies in the Middle East fare just above the level of development of Africa in that category. Among the GCC states, that

[3] Percentage share based on total of stock market capitalisation, public and private debt securities, and bank assets. Covers region of Middle East and North Africa as defined by the IMF.

GCC financial markets

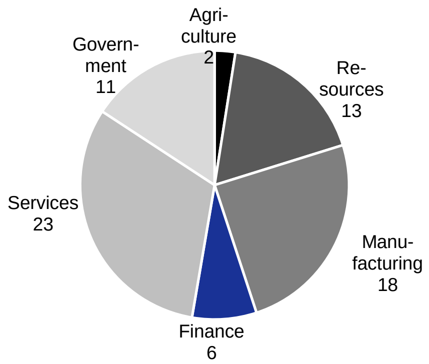
Low relative size 18



Note: Share of market segments in respective GDP, %, for official reserves (excluding gold), stock market capitalisation, public debt securities outstanding, private debt securities outstanding, bank assets. For world total (WO), Euro Area (EA), US, Japan, Emerging Markets (EM), Asia (AS), Latin America (LA), Middle East (ME), Africa (AF).

Sources: IMF, DB Research

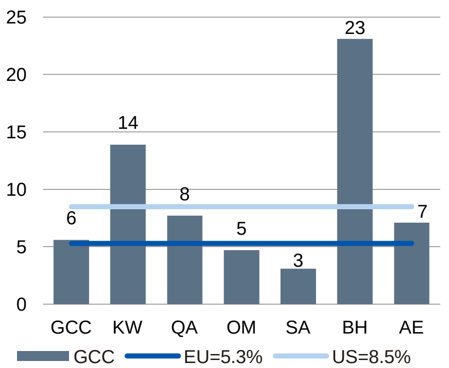
Economic relevance of finance 19



Note: Composition of total GCC GDP by sector in % of total in 2009, for KW 2007. Agriculture: Agriculture, fishing. Resources: Mining, quarrying, oil and gas production. Manufacturing: Manufacturing, electricity, gas, water, construction. Finance: Finance, insurance. Services: Wholesale, retail, hotels, restaurants, transport, logistics, storage, real estate, business activities, other services.

Sources: GCC Secretariat General, DB Research

Weight of financial sector in comparison 20



Note: Share of financial and insurance services in total GDP, %, 2009, for KW 2007. 2010 for EU, US.

Sources: GCC Secretariat General, DB Research

share is considerably higher – around double the ratio of the Middle East in general, and 33 percentage points higher than in Latin America – but at 214% it ranges clearly behind the average of 246% observed in Asia, the roughly 400% global average, and amounts to less than half the level of development measured in the euro area, the US and Japan. Debt markets have been the weak spots in the region's development. At just 17% of GDP at end-2010, public and private debt securities represent an under-developed asset class. The GCC's debt markets are much less than one-tenth in size compared with the advanced economies, around half the size of Asian or Latin American markets, and just 70% of the relative size of these markets in Sub-Saharan Africa. Equity markets fare better, making up 75% of GDP which compares favourably with the 58% observed on average in the emerging economies. The share of banking assets, 123% of GDP also lies above the 89% average of the GCC's peers in the emerging economies.

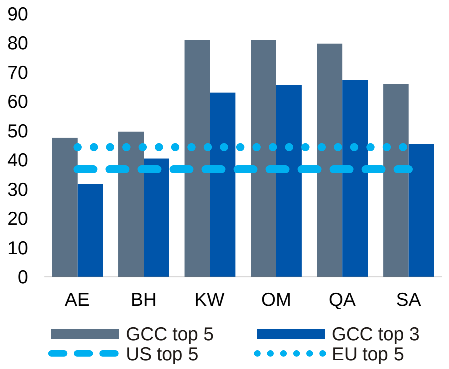
— Economic relevance: Despite the scope for development that can be observed in terms of the size of financial markets, financial services as an industry play a noticeable role in the GCC economies. Regarding the composition of GDP, finance contributes 6% on average in the region, making it significantly less important than other services, manufacturing, natural resources, or the particularly large public sectors in the Gulf countries. However, an output share of that magnitude lies within the range of observations in other emerging and advanced economies, and, for example, matches up to the 5.3% measured in the EU and 8.5% in the US. Not all GCC states lie in that range of financial sector size, however. In Kuwait and Bahrain, local financial sectors play a much more important role, and their share in GDP amounts to 14% and 23%, respectively. In Saudi Arabia, in contrast, finance contributes only around 3% to GDP.

— Catch-up growth and dynamism: The as of yet small market volumes in comparison with advanced and other emerging economies cannot belie the fact that the growth of GCC financial markets was exceptional until interrupted by the crisis. In aggregate, GCC financial markets increased by an average of 18% in market volume per year. They thereby not only managed to outperform GDP in the GCC but also global financial markets, both of which grew by around 10% annually over the same period[4]. The development was particularly dynamic in equities where market capitalisation increased by 21% per year, compared with just over 6% on global equity markets, but also in banking assets, where the GCC outpaced global bank assets by 15% to 12% between 2000 and 2010. Sure enough, strong catch-up growth is not an exceptional phenomenon but is customarily observed in emerging economies. The GCC's overall growth record, however, documents the dynamics that local economic progress in combination with financial market liberalisation and promotion can unfold.

All in all, GCC financial markets have remained way behind their economic potential, both in terms of relative development in the region but also by international standards. The level of development is far from uniform and shows wide variations in overall market activity and across market segments, suggesting that the question of the future of finance in the Gulf deserves a more differentiated look at local market structures and the specific obstacles to a more dynamic development.

[4] Compound Annual Growth Rates (CAGR). Financial market growth reflects stock market capitalisation, debt securities outstanding, and bank assets for the ten-year period 2000-2010. Due to low data quality, calculation includes estimates.

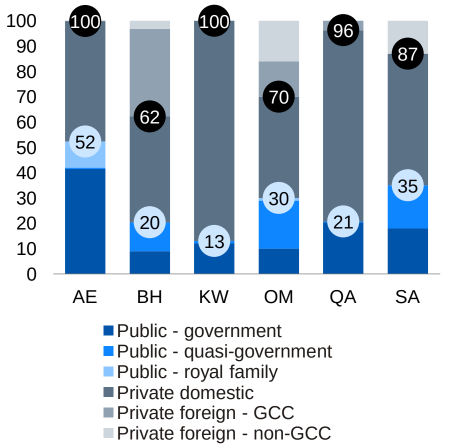
Banking: High market concentration 21



Note: Ratio of total assets of top banks to total bank assets in each jurisdiction. GCC 2007, EU 2009, US 2008.

Sources: IMF, DB Research

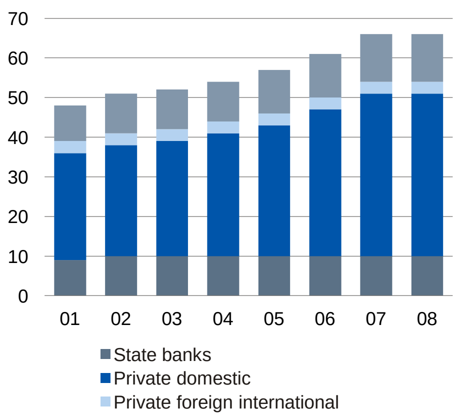
Banking: Strong public ownership 22



Note: Ownership structure of domestic banking system, % of total assets, end-2007. Total domestic includes public and private assets.

Sources: IMF, DB Research

Banking: Rising number of institutions 23



Note: Number of banks by type.

Sources: World Bank, DB Research

Banking, debt, equity, and beyond – heterogeneous development

The above data point to some key structural features that have traditionally been associated with financial markets in the Gulf region. These stylised facts do not apply universally in the region, and the success in improving local markets differs considerably. The following analysis suggests that domestic demand structures, wide-spread state involvement in the economies, and the regulatory and supervisory environment remain the most important determinants of progress.

Banking

Large banking sectors are a central commonality among the GCC economies. The industry has grown over several decades, and experienced a boost in credit provision in the heydays of economic dynamism between 2000 and the peak of the financial turmoil. By international standards, banking in the Gulf region has some specific characteristics which have strongly conditioned its development:

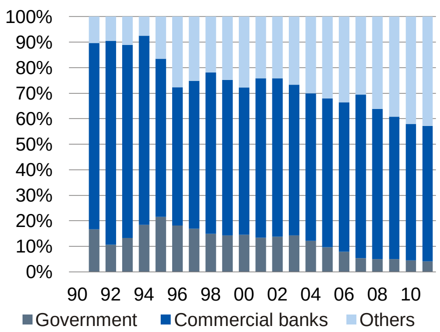
— High industry concentration: National banking markets are dominated by a small number of banking institutions, with concentration ratios for the top 5 banks ranging from 47% to 81%. At just below 50%, banking in the Emirates and Bahrain is slightly less concentrated, but still well above levels observed in the EU and the US. The highest ratios of concentration can be observed in Saudi-Arabia at 66%, and in Kuwait, Oman and Qatar, where two-thirds of the banking assets are controlled by the top-3 institutions alone. High market concentration in the region has been strongly associated with regulatory limitations on market access and favourable funding conditions for publicly sponsored incumbents. As governments have started to liberalise their markets gradually, concentration and the associated risks are likely to ease over time, even though such a process will take time to unfold.

— Strong public and domestic ownership: GCC domestic banking institutions[5] are predominantly controlled by domestic investors, including strong public interests in key financial enterprises. Oman and Bahrain are the most open banking markets where foreign investors hold between 30% and 40% of domestic banking assets. In the other GCC countries, the domestic banking is exclusively owned by domestic investors. Cross-border restrictions on market access and shareholdings apply to GCC as well as non-GCC states so that neither neighbouring GCC investors nor overseas investors hold significant shares in GCC banks. The situation is accentuated by the special role public investors play in the national markets. Thus, governments, government investment vehicles, and royal families continue to play a significant role as investors and owners of domestic financial firms[6], with the Emirates as the most instructive example where more than half of all banking assets are in public hands, Oman and Saudi Arabia as intermediate cases, and Bahrain, Kuwait, and Qatar with lesser public participations. Both domestic and public ownership have resulted from restrictive investment policies in the past. As in the case of industry concentration, liberalisation policies may bring greater diversification, but such a process has yet to be kicked off.

— Weak competition: Concentration and ownership structures weigh heavily on competition, and in the final analysis also on the competitiveness of most national banking sectors in the GCC. Low competition has been reflected in relatively high price levels for financial products, a limited variety of products and services offered by banks, and comparatively low levels of quality in

5 Domestic banks defined as banks which are majority-owned by domestic investors.
6 Abdullah Al-Hassan, May Khamis, and Nada Oulidi, "The GCC Banking Sector: Topography and Analysis", IMF Working Paper No. 87, 2010.

Private borrowing on the rise 24

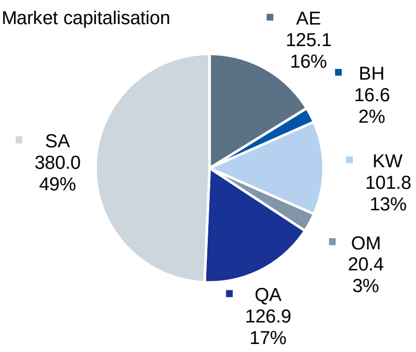


Note: External debt by governments, commercial banks, and others in the GCC economies, in % of total external debt.

Sources: IIF, DB Research

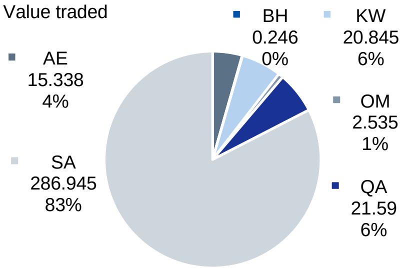
Stock markets: SA dominates 25

Market capitalisation



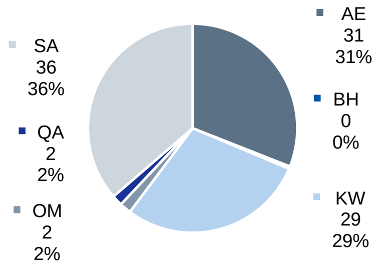
Note: Market capitalisation, USD bn, % of total, Feb 12.

Value traded



Note: Value of shares traded, USD bn, % of total, 2011.

Shares traded



Note: Number of shares traded, m, % of total, 2011.
Sources: Arab Monetary Fund, DB Research

services, e.g. observable in execution times of financial transactions. These effects are mitigated partially where foreign banks have been able to establish operations. Foreign banks have been successful in UAE and Bahrain, and in Oman and Bahrain joint ventures between domestic and foreign banks especially from neighbouring GCC markets have developed.

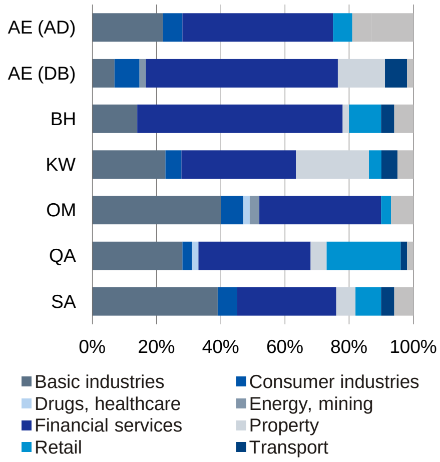
— Favourable funding conditions: Widespread public ownership has led to favourable funding conditions for many banks in the region. Government-backed cheap refinancing has been beneficial for the growth of the banking sectors and the extreme expansion of credit in the past decade. At the same time, the competitive implications of this funding advantage for incumbent banks are evident, and implicit subsidisation of domestic banks may result in misallocation of capital in the domestic economy.

— Concentration risks in lending: As observed above, bank lending accelerated sharply in the last decade, leading, in general, to an elevated level of risk which became visible when growth slowed in the wake of the crisis and credit defaults rose. In particular, the high share of credit handed out to the real estate and construction sectors – between 20% and 50% of total credit in countries like the UAE, Kuwait, and Bahrain – brought considerable concentration risks to the national banking markets concerned. Similarly, lending to households continues to represent a strong share of the credit business, between 20% and 40% in Bahrain, Oman, Saudi Arabia, and the Emirates. Credit to the public sector, in contrast, contracted visibly, partly due to lower public borrowing requirements as oil revenues increased, partly due to the reduction in public project spending after the crisis started.

These characteristics distinguish Gulf financial markets from many emerging and advanced markets in quantitative as well as qualitative terms. An important question is to what extent these regional characteristics will change over time, either due to internally motivated reforms or through external pressures. Market and political dynamics suggest that, indeed, GCC banking sectors may face important challenges to its current set-up in the post-crisis environment:

— Stronger competition, greater competitiveness: High market concentration, widespread public ownership, restrictions on market access, weak competition – what used to be beneficial aspects for the GCC's domestic banks may not be possible and desirable to maintain in the long run. Domestic clients, including the broader public, corporate clients, and high-net-worth individuals may press for broader, higher quality services as well as better choice of products in future. International institutions, such as the WTO, as well as foreign market participants have called for greater liberalisation for a while. Not least, GCC governments themselves have committed to greater financial market liberalisation in the context of their drive towards a single market in the GCC and the introduction of a single common currency. Over time, the specific corporate structure of GCC banking markets may alter, as a result, bringing greater competition, stronger cross-border linkages with neighbouring GCC countries and beyond, wider economic diversification, but also greater exposure to international markets.

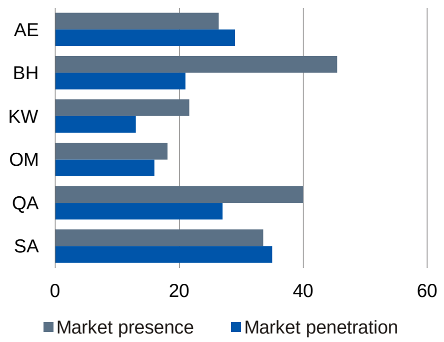
— Changing economic environment: A decisive question for the GCC's financial sector is whether the Gulf states will be able to return to the growth rates seen in the earlier days of the last decade. Governments have worked hard to provide monetary and fiscal stimulus to that end, and the overall economic climate appears to have brightened up recently. Given the exposed role of the state in most GCC economies, governments carry a particular burden in bringing their economies back to higher growth trajectories. The development of state-sponsored enterprises, government-sponsored development projects, but also of the diversification strategies, Stock markets: Industry structure 26



Note: Listed companies by sector, based on number of companies, 2008.

Sources: Grant Thornton, DB Research

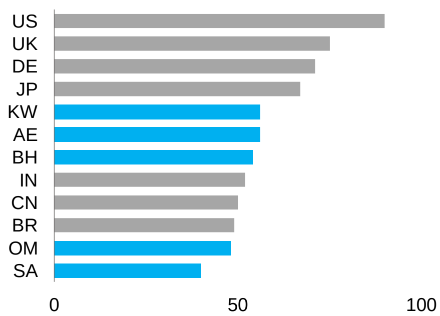
Stock markets: Governments in control 27



Note: Market presence denotes % share of listed companies in each market in which government-owned entities (GOE) maintain interests. Market penetration denotes the % share of market value of GOE holdings in domestic market capitalisation. Data for 61 GOE in GCC, no families included.

Sources: Markaz, DB Research

Stock markets: Limited free float 28



Note: Free float of equity shares, % of market capitalisation.

Sources: NCB Capital, DB Research

the promotion of private business and the evolution of personal incomes strongly influences the demand for credit, asset management and other banking services.

— Evolving business strategies: GCC banks have faced strong challenges in their operations in the course of the crisis, especially the improvement of the quality of their credit and asset portfolios, securing liquidity and maintaining profitability. Additional regulatory requirements agreed at the international level, including the Basel 2.5 and Basel 3 changes to capital and liquidity requirements, and sharpened prudential requirements on risk management and bank resolution are set to raise the cost pressure on the banking sector. In this environment, banks will find it hard to maintain past levels of profitability without reforms to their business strategies. On the one hand, there is a strong logic to bolstering revenues, for example by enhancing products and services to higher-margin segments of the business. On the other hand, cost pressures suggest that operating procedures should be reviewed, for example towards more efficient payment and securities infrastructures.

Stock markets

GCC stock markets have gone through a rollercoaster ride of development in the last decade. Young trading venues by international standards[7], the GCC countries boast equity issuance and trading volumes that started to pick up in the early 2000s, rose dramatically until mid-2008, only to plunge almost as dramatically as a result of the crisis. Markets have stabilised since, even if at significantly lower levels than on the eve of the market turmoil. Attributing these extreme market movements to the dynamism of up-and-coming, non-mature markets and the external impact of global events is an important perspective. But like in the case of Gulf banking, GCC stock markets have a number of specific characteristics which have influenced their development.

— Small size, dominated by one market: GCC stock markets have remained very small by international standards. In addition, a breakdown of the size of the national markets shows that half of the volume is concentrated in the largest market, Saudi Arabia. Bahrain, Qatar and the UAE are the runner-ups, each accounting for under one-fifth of the GCC market volume. Even more extremely, more than 80% of all share trading in terms of value takes place in Saudi Arabia. Stock markets play a major role as financial market segments only in Kuwait and Saudi Arabia – 46% and 61% of total domestic financial assets in 2010 – and in the wider economy – around 100% of GDP in both cases.

The lack of size of these markets has very concrete ramifications. First, it clearly limits the choice at the disposal of investors. With a total of 660 companies listed, the region compares internationally with stock markets such as Israel, Poland, or Scandinavia. Each individual market has between 194 (Kuwait) and 44 (Bahrain) listed companies[8]. The equity universe is now growing more slowly at less than 10 IPOs raising around USD 1 bn per year, compared with more than 20 IPOs between 2005 and 2008 when between USD 6 and USD 12 bn were raised in the region annually. Choice is additionally limited by the fact that in many countries only a fraction of the enterprises listed are actually traded publicly[9]. While this is not so much an

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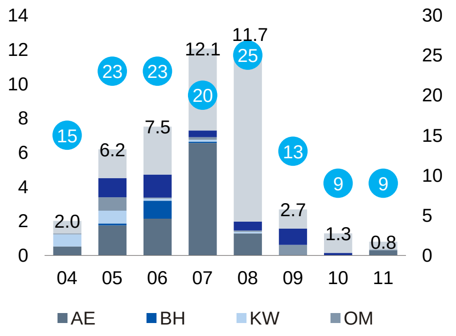
[7] The stock markets of Bahrain, Kuwait and Oman were founded in the 1980, of Qatar in the late 1990s, and of Saudi Arabia and the UAE in the eraly 2000s. For details see Grant Thronton, “MiddleEast: towards innovation and transparency”, Capital Markets Guide, 2009.
[8] Markaz, “The golden portfolio”, Kuwait, September 2010.
[9] Alami, Randa, “Do GCC stock markets support their domestic economies? An analytical overview”, in: Woertz, Eckart, “GCC financial markets”, Gulf Research Center, Dubai, 2011.

Stock markets: Subdued IPO activity 29



Note: Volume of IPO issuance, USD bn, by country and GCC total. Total number of IPOs in GCC.

Sources: IMF, various public sources, DB Research

Stock markets: Investment restrictions 30

	Quantitative limits	Protected sectors
AE	− None for GCC citizens − Max. 49% − UAE partner needed − None in Free Zone	− Negative list
BH	− None − 10% ownership cap per investor	− Selective restrictions
KW	− Max. 49% − 5% ownership cap per investor for banks	− Negative list
OM	− Max. 70%	− Selective restrictions
QA	− Max. 25% − No participation in IPOs	− Negative list
SA	− Max. 25% for GCC citizens − No direct participation in stock markets for non-GCC − Non-GCC access through mutual funds, equity swaps, ETFs	− Negative list

Sources: Investment restrictions for non-domestic investors. Marashdeh, Hazem, Shrestha, Min, "Stock market integration in the GCC countries", International Research Journal of Finance and Economics, No. 37, 2010, pp. 102-114. NCB Capital, "The rise of institutional investors", NCB Capital Economic Research, June 2010. Various public sources, DB Research.

issue in Saudi Arabia and Qatar, most other markets have only around half of the listed shares available publicly, and in Bahrain only ten companies, or one-fifth of the total number, are publicly traded.

Second, lack of size goes hand in hand with low liquidity and turnover, esp. in the UAE, Bahrain and Kuwait. Narrow markets tend to lead to high price variability, thereby affecting the overall stability of equity markets in the region. Thus, the GCC stock markets have not only attracted attention for their large secular swings in valuation over the past years but also for strong short-term price volatilities.

— Listings concentrated in a few sectors: Those companies listed on GCC stock markets tend to be concentrated in a very small number of sectors, especially basic industries and financial services. Strong correlations within and between these sectors, in combination with their limited choice of single stocks, render portfolio diversification within the region for institutional and retail investors difficult. While privatisations and diversification policies have broadened the sectoral composition of the universe of listed companies in recent years, that process will need to continue for a while to bring about a more balanced sectoral structure and a broader range of investment options for investors.

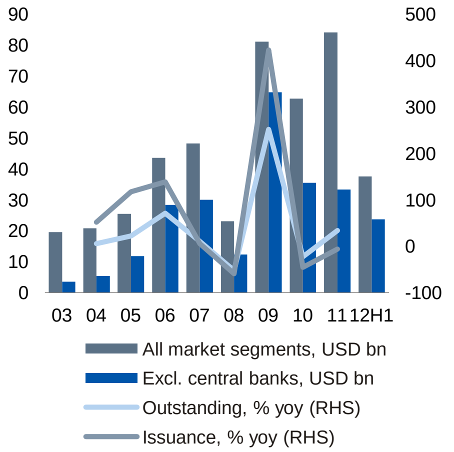
— Governments and families in control: Governments, government-owned entities, and families play an extraordinary role as investors in the region. Governments and investment vehicles they sponsor hold stakes in more than one-third of all companies[10] in the region, with market presence ranging from below 20% in Oman to as high as 45% in Bahrain. In terms of market value held by public authorities, shareholdings range from 13% in Kuwait to 35% in Saudi Arabia and average at 29%. Influential families enter the picture as active investors and important players in the governance of listed enterprises as reflected in their role on supervisory boards: Between 28% (Dubai) and 76% (Qatar) of the listed companies have two or more members of the same families on their supervisory boards, and between 20% and 30% of all supervisory board seats in GCC listed companies are claimed by influential families[11]. Strong presence and penetration by governments and families may, on the one hand, signal stable share-holdership and a long-term interest in the development of the companies in question. Indeed, most of these institutional shareholdings have a back-ground in full state or family ownership in earlier decades, which got dispersed in recent years through privatisations and IPOs. At the same time, public shareholdings, at least in theory, raise important questions as to the objectives of the official investors and the decisiveness with which financial targets are being pursued by management. In addition, public stakes may stand in the way of more far-reaching private investments and further narrow the scope for trading in already narrow markets.

Foreign investor activity remains limited

— Limited access for foreign investors: Investment activity by foreign institutional investors in the GCC has remained highly limited. The lack of market breadth, low liquidity, high volatility[12] as well as existing ownership structures and transparency practices – more than half of the GCC's listed companies do not provide annual reporting in English language[13] – but also the lack of hedging instruments have discouraged a more active engagement so far. In addition, foreign investors continue to face

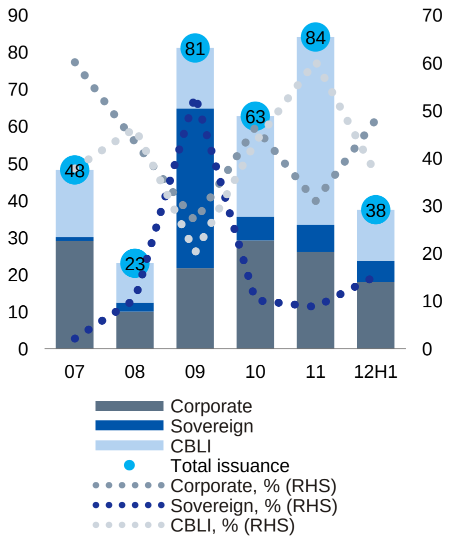
[10] Markaz, "The golden portfolio", Kuwait, September 2010.
[11] Halawi, Amer, and Davidson, Brian, "Power matters: A survey of GCC boards", The National Investor, Dubai, 2008.
[12] GCC equity markets have been argued to be the most volatile in global comparison. Markaz, "Derivatives market in GCC", Kuwait, March 2007.
[13] Alami, Randa, "Do GCC stock markets support their domestic economies? An analytical overview", in: Woertz, Eckart, "GCC financial markets", Gulf Research Center, Dubai, 2011.

Bond markets: Gross issuance 31



Sources: Markaz, DB Research

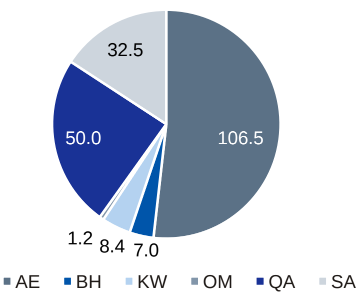
Bond markets: Changing weights 32



Note: Gross issuance of corporate, government, and central bank (Central Bank Local Issuance) debt securities, USD bn and % of total.

Sources: Markaz, DB Research

Bond markets: AE, QA most active 33



Note: Bonds outstanding at end-2011 and issued in 2011, USD bn.

Sources: Markaz, DB Research

restrictions on their activities in individual GCC states. This applies to investors from neighbouring GCC countries which are still subject to investment restrictions, despite the progress made towards a common market in the region. But it applies in particular to investors from outside the GCC whose share in stock market trading in the key markets has, as a consequence, remained below 5%[14]. Free zones, such as the Dubai International Financial Centre, offer unlimited access to foreign investors and have flourished in past years owing to highly attractive economic, regulatory, and operative framework conditions. Nevertheless, access from the offshore world of DIFC to the onshore world in Dubai is subject to said entry conditions.

Clearly, GCC stock markets have come a long way in terms of development. But the development of stock markets still lags behind in an international comparison. If the GCC continues to pursue an integrated market – which forms part of the single market project adopted by the GCC in 2000 – the face of national stock markets will change considerably, featuring greater openness to neighbouring GCC and possibly international investors, more harmonised rules and greater competition among a more diverse lot of listed companies. At USD 23.7 bn, issuance in H1 2012 of sovereign and corporate bonds and Sukuk issuance was 54% higher than in H1 2011.

Debt markets

Debt securities markets have remained the least developed financial segment in the GCC. Still, the market is on an upward trajectory. In particular, the corporate bond market made some important advances in the crisis environment. Structural features of the market suggest that there is considerable room to grow for bonds in the coming years.

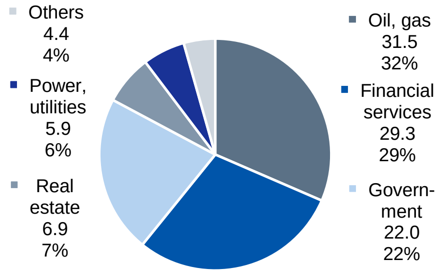
— Small private corporate segment, yet: The growth of GCC bond markets in recent years has essentially been driven by public authorities even though the share of corporate bonds has edged up over time. On the one hand, local central banks act as issuers with the aim of regulating domestic liquidity. So called Central Bank Local Issuances (CBLI) have been expanded forcefully since the peak of the crisis, amounting to more than 40% of the total volume of bond issuances in the past five years, and as much as 60% in 2011, and featuring an increasing share of Sukuk-type instruments, more than 20% of CBLI issuances in 2011.

Government bonds peaked in 2009 when the segment accounted for 53% of all bond issuances. That share has fallen since, and with a 20% share in new issuances over the past five years it remains the smallest market segment in the fixed income universe. In addition, government debt issuance in the GCC is intermittent. Given high and regular government revenues from the hydrocarbon sector, debt financing is used primarily to finance individual projects or dedicated funding purposes which leads to irregular issuance patterns. Issuance calendars have no ongoing or regular scheme and often have gaps of several months when no activity takes place in individual countries.

Corporate bonds have contributed just under 40% of new issuances during that period with a, by and large stable volume of between USD 20 bn and USD 30 bn per year. In H1 2012, though, issuance was brisk at USD 18 bn, setting the market on course for a new record. This may sound sizeable, but the majority of issuers in this segment have a government background, too. In 2011 alone, 57% of the total value of corporate bonds was issued by

[14] NCB Capital, "The rise of institutional investors", NCB Capital Economic Research, June 2010.

Bond markets: Issuance by sectors 34



Note: Gross bond and Sukuk issuance by sector of issuer, USD bn and % of total, 2011.

Sources: Markaz, DB Research

Shari'ah-compliant finance – the basics 35

Islamic banking refers to financial activities consistent with the body of Islamic law, the Shari'ah. The Shari'ah prohibits certain market activities customary to conventional financial markets:

— Shari'ah compliance: Qur'an-based rules of (i) the prohibition of fixed or floating payment or acceptance of specific interest or fees for loans of money (Riba), (ii) the prohibition of contractual uncertainty and gambling (Gharar and Maysir), (iii) of certain industries such as those related to pork products, pornography, or alcoholic beverages (Haram), and (iv) the obligation to pay part of the profits incurred to benefit society (Zakat). In addition, practitioners and supervisors must observe principles to comply with Islamic jurisprudence, including compliance with the wider body of Islamic law, segregation of Islamic and conventional funds, Shari'ah-compliant accounting standards, and awareness campaigns.

To comply with these principles, market participants can take recourse to a wide range of Shari'ah-compliant financial products and services, including:

— Sukuk: Financial certificate, Islamic equivalent of a bond

— Takaful: Islamic insurance structured as a charitable collective pool of funds based on the idea of mutual assistance

— Ijarah: Islamic lease agreement

— Mudarabah: Investment partnership for financing business activities

— Murabahah: Purchase and resale agreement, instead of lending money

— Musharakah: Profit- and loss-sharing partnership

The Shari'ah-based financial system is overseen by an increasingly sophisticated system of regulatory and supervisory bodies:

— Islamic Financial Services Board (IFSB), based in Kuala Lumpur, Malaysia

— Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Manama, Bahrain

— Islamic Development Bank (IDB), based in Jeddah, Saudi Arabia

Sources: Imam, Patrick, Kpodar, Kangni, "Islamic Banking: How Has it Diffused?", IMF Working Paper No. 195, 2010. Solé, Juan, "Islamic Banking Makes Headway", IMF, September 1997. Deutsche Bank, "Global Islamic banking - No longer unconventional", Global Markets Research, November 2011.

enterprises that are either fully or largely owned by GCC governments[15]. Taking this into account, only USD 73 bn or 13% of the bond issuance in 2011 can be associated with private enterprises. Reflecting the minor role private enterprises play in most GCC economies, the private corporate debt market thus remains a very small segment, and its development potential is closely associated with that of the private sectors in these economies. Issuer demand for debt security finance has remained comparatively low: Local credit financing through banks has a strong tradition.

— Strong geographic and sectoral concentration: Just like equities, GCC bond markets exhibit a strong geographic and sectoral focus. Geographically, more than half of the debt securities outstanding have been issued in the UAE, while Qatar and Saudi Arabia account for 24% and 16% of the market share, respectively (data as of H1/12). For Bahrain, Kuwait, and Oman, in contrast, debt securities financing still plays a negligible role.

In terms of industry background, corporate issuers mainly come from the hydrocarbon sector, financial services, or are directly government-owned enterprises. Together, these industries accounted for 83% of all new issuances in 2011. Again, other sectors, such as power generation, utilities, transport, and construction play a very limited role.

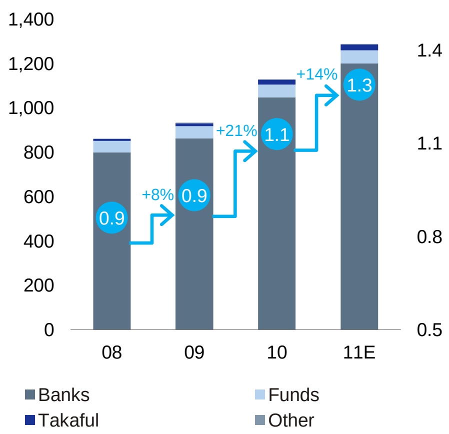
— International access through cross-border issuance: Despite their relatively small size and early stage of development, debt instruments from the GCC have an important role to play from an international perspective in as far as investor access to these instruments is relatively unimpeded. In order to tap a broad base of financiers, a large number of debt instruments of the GCC are co-listed in international markets. In 2011, almost 70% of all issuances were reported to have been co-listed on international exchanges, with Germany, the UK, and Luxembourg as the most important locations for secondary listings. International placements are further facilitated by the wide use of the US dollar and the euro as currencies of denomination for debt securities. This applies to two-thirds of all new issues, with around 60% by value listed in US dollar and 16% in euro in 2011. As GCC currencies have been firmly pegged to the US dollar, currency diversification is not a central determinant of investments in the region and the exchange-rate risk exposure for issuers from issuing in US dollar, in particular, is negligible. At the same time, a USD or EUR listing in US and EU jurisdictions contributes to transparency and alleviates the risk management of investors. International investors have an opportunity of diversifying into the region on the basis of international listings and without the obstacles observed in local stock markets.

Shari'ah-compliant financing

In addition to conventional equity, bond, and bank assets, Shari'ah-compliant finance offers a wide range of financial products and services in the Gulf region. Islamic finance is more developed in this region than in other parts of the world and has grown to be the basis of a large share of financial activity in the GCC. Whether Islamic finance forms a financial system *sui generis* has been debated. For the purposes of this analysis, Shari'ah finance represents an important complement to conventional financial products and services, adding to the options for financial diversification, and it provides access to clients who in the absence of this market would – for religious beliefs – have had very limited access, if any at all, to financial services. The use of Islamic financial practices

[15] Markaz, "GCC Bonds & Sukuk Market Survey", Kuwait, January 2012.

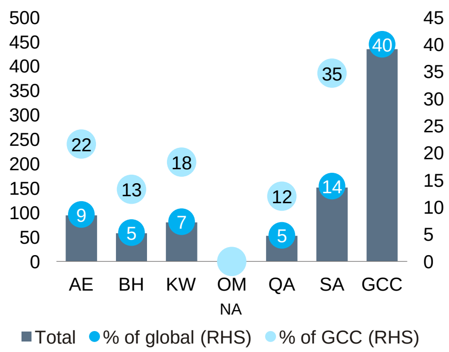
Islamic finance: Rising global assets 36



Note: Global Shari'ah-compliant assets, USD bn.

Sources: CityUK, DB Research

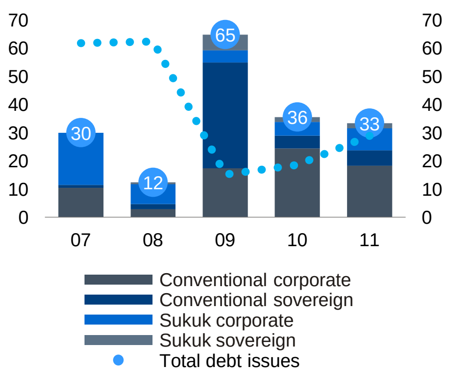
Islamic finance: GCC at the centre 37



Note: Islamic finance assets. USD bn. % of GCC and global total. No data available for OM. 2010.

Sources: CityUK, DB Research

Islamic finance: Sukuk issuance 38



Note: Gross issuance of conventional and sukuk corporate and sovereign debt securities, USD bn and % of total debt issuance.

Sources: Markaz, DB Research

in the GCC has a number of characteristics which can be summarised as follows[16]:

— Dual system: Finance in the GCC can be regarded as a dual financial system distinguishing between conventional and Islamic finance, and in which market participants compete freely. Officially, financing must be provided on the basis of conventional pricing and terms, even though governments in the GCC have introduced dedicated legislation to provide suitable legal frameworks for Islamic finance.

— Customer freedom: Islamic finance is regarded as a matter of customer choice.

— Practice: A large part of the population is understood to have a preference for Shari'ah-compliant products and services, but take recourse to conventional banks in particular for overdraft facilities, which Islamic institutions cannot offer in that form. Typically, Islamic bank clients would also maintain an account with a conventional bank to secure access to services only they can provide.

Islamic finance represents a comparatively novel development of the past fifty years, with Bahrain as one of the pioneering countries promoting the establishment of Islamic financial institutions and laying the foundations for this market segment by establishing the necessary legal framework as early as the 1970s. Only in recent years, however, has the market expanded rapidly in the GCC region, with asset volumes rising by as much as 21% annually in Saudi Arabia, 27% in the UAE, and 43% in Qatar over the latter half of the last decade[17]. In addition, Islamic finance has spread from the GCC, and from Malaysia as the second pioneering economy besides Bahrain, to international financial centres in Asia, Europe, and Africa. Globally, this expansion has made Islamic finance a USD 1 tr business segment, dominated by Islamic commercial banks, but also with sizeable shares of investment bank assets, Sukuk issues, and Islamic investment funds. This figure, however, also illustrates how small this market still is relative to conventional finance – it makes up 0.4% of global financial assets.

Despite spectacular growth elsewhere, the GCC remains the hub of the global Shari'ah finance market, with more than 130 financial institutions active in this market and a share of 42% in total Islamic assets worldwide. Saudi Arabia and the UAE capture the largest regional share with 37% and 23%, respectively. Compared with conventional finance in the GCC, Islamic finance accounts for 18% of total assets and thereby constitutes an important part of the financial market in the region.

The assets of the Islamic banks amount to USD 352 bn and form the basis of a large network of dedicated banking institutions in the six GCC members with a wide range of retail and commercial operations. They do so either in the form of stand-alone Islamic institutions, solely dedicated to offering Shari'ah-compliant services, or as so-called window banks, i.e. conventional institutions with separate operations in the Shari'ah market. The Sukuk market also plays an important part, being the most important traded assets class among Islamic instruments. Over the past five years, more than USD 52 bn of Sukuks have been issued in the GCC, with corporate issuances making up 80% of the market, and sovereign paper accounting for the rest.

16 A comprehensive discussion can be found in Wilson, Rodney, "Approaches to Islamic banking in the Gulf", in: Woertz, Eckart, "GCC Financial Markets", Gulf Research Center, Dubai, 2011.
17 Deutsche Bank, "Global Islamic banking - No longer unconventional", Global Markets Research, November 2011.

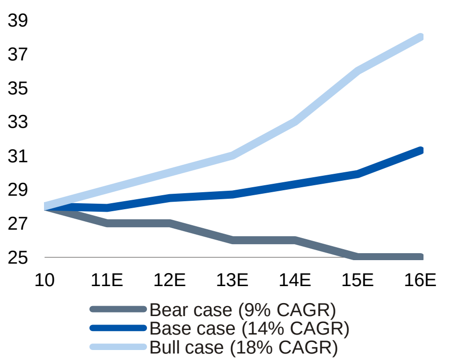
Islamic finance: Key prudential issues 39

Key prudential issues identified by the IFSB and the IDB:

— Development of a set of comprehensive, cross-sectoral prudential standards and supervisory framework covering Islamic banking, takaful (insurance) and capital markets.
— Development of a robust national and international liquidity infrastructure that encompasses the potential for monetary policy and money-market operations.
— Strengthening of the financial safety net mechanism, namely lender-of-last-resort facilities and emergency financing mechanisms as well as deposit insurance.
— The development of a reliable crisis management and resolution framework in addition to financial safety nets, which includes bank insolvency laws and the arrangements for dealing with non-performing assets, asset recovery and bank restructuring and recapitalisation.
— Introduction of accounting, auditing and disclosure standards for institutions offering Islamic financial services and their counter-parties.
— Development of a macro-prudential surveillance framework and financial stability analysis.
— Review of the rating process for Islamic institutions or instruments to encourage greater transparency with regard to the risks involved.
— Need for international Islamic supra-nationals and developmental bodies to consider more involvement in capacity building to promote global financial stability.

Sources: Recommendations from Islamic Financial Services Board, Islamic Development Bank, Islamic Research and Training Institute, "Islamic Finance and Global Financial Stability", April 2010, as summarised in Parker, Mushtak, "Issues in regulating Islamic Finance", Central Banking Journal, February 18, 2011.

Islamic finance: Positive outlook 40



Note: Projections for growth of Islamic banking assets, % of GDP.

Source: Deutsche Bank, "Global Islamic banking - No longer unconventional", Global Markets Research, November 2011

As dynamic as the market has been in recent years, it is widely believed to have remained below its potential. While economic growth in the region has been benign, and demographics are favourable, with a growing and young population of increasingly wealthy Muslims many market participants have yet to be convinced that Islamic banking as currently practiced provides suitable solutions. Market uncertainties, especially from the perspective of international investors, primarily emanate from three sources:

— Shari'ah compliance: Whether products comply with the standards of the Shari'ah requires verification on an individual basis. However, there is no uniform interpretation of the Shari'ah, and criteria for verification differ across the globe, within the GCC, and even within individual jurisdictions. Shari'ah advisors or consultative boards have been established in supervisory authorities and in Islamic financial institutions. But licensing remains heterogeneous, and legal uncertainty over the compliance of a product may persist even after the approval of such bodies given competing interpretations and the absence of final instances of judgement.

— Regulation and supervision: Islamic financial laws and practices differ across countries. Some countries have introduced separate legal frameworks for Islamic finance, others do not provide formal regulation or oversight. The Islamic Financial Standards Board (IFSB) and the Islamic Development Bank (IDB) are working on establishing common standards for national regulation and supervision. In the same vein, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) establishes accounting, auditing, governance, ethics and Shari'ah standards for Islamic financial institutions and industry. The progress on convergence, however, has been limited.

— Prudential issues: Islamic finance does not correspond to prudential standards across of whole range of regulation criteria. There is no cross-border market infrastructure, and instruments for managing bank liquidity risks are limited. Similarly, international authorities have expressed concern over the absence of bank rescue and resolution regimes in the Gulf region and beyond. Key issues and recommendations have been identified in this regard, most importantly by the IFSB and the IDB (see box 39), but in this area, too, decisive steps still need to be taken.

The problems identified are very fundamental and represent a serious shortcoming that clearly stands in the way of the attractiveness of Islamic finance as a complementary segment to conventional financial markets. Even though Islamic financial institutions have avoided important risks[18] in the past due to the restrictions they face on getting involved in structured finance, derivatives instruments, and complex trading practices, there is a strong rationale for the GCC countries – and other economies with large Islamic markets – to improve investor confidence and protection and work on improved regulatory and supervisory standards to safeguard the stability of the sector. Success in this area is expected to greatly influence the future of Islamic finance. In terms of market growth, the prospects for Islamic finance are promising as baseline growth is expected to outperform global financial markets at an annual growth rate of 14%.

[18] For example Imam, Patrick, Kpodar, Kangni, "Islamic Banking: How Has it Diffused?", IMF Working Paper No. 195, 2010.

Derivatives markets: Almost none 41

Overview

GCC
- Generally, no derivatives markets permitted or established
- Very limited OTC derivatives transactions
- Islamic banks prohibited from trading in derivatives
- No short selling permitted
- Complex or structured financial products prohibited or not used

Country specific market structures

AE
- Commodity derivatives (Dubai Multi Commodities Centre, DMCC)
- ETFs (Abu Dhabi)

BH
- Establishment of derivatives and structured products markets planned (Bahrain Financial Exchange, BFX)

KW
- Stock options and futures

OM
- None

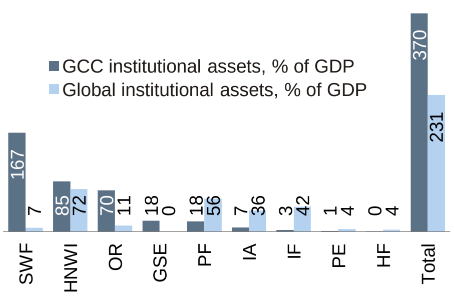
QA
- Plans to establish market for energy derivatives abandoned

SA
- None

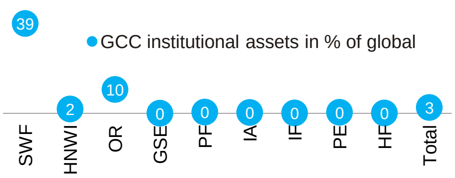
Sources: Woertz, Eckart, "GCC Financial Markets", Gulf Research Center, Dubai, 2011. Markaz, "Derivatives market in GCC", Kuwait, March 2007. DB Research

Institutionals: Unique structures 42

Overall, high volumes of assets



Unbalanced structures



Financial assets held by institutional investors, % of GDP, end 2011.

Sources: Various public sources, DB Research

Derivatives markets

Derivatives markets have yet to develop in the GCC. None of the member economies disposes of a comprehensive exchange or OTC-based market in derivatives or complex structured financial products captured by statistics. Regulatory limitations on these product categories are a major obstacle to the development of such markets. Most GCC countries have not handed out licenses for the necessary product registration, trading, and clearing infra-structure. In addition, Islamic financial institutions are not in a position to trade in derivative instruments.

Beyond regulatory issues, there are, however, important economic reasons for this gap in the financial landscape. Conditions in the underlying markets have not been conducive to the development of complex financial instruments. As observed above, national equity and debt markets are not sufficiently deep for the evolution of derivatives, and they often lack the breadth to justify the development of meaningful index or synthetic exchange-traded products.[19] Limited market liquidity also discourages the application of trading strategies such as short selling. The absence of derivatives markets, in turn, withholds important liquidity impulses from underlying markets. In the wake of the financial crisis, complex financial instruments are viewed with greater caution by policymakers, regulators, and even market participants. However, a prudent development of derivatives instruments in GCC markets may bring benefits in terms of greater liquidity and underlying markets, better risk management for investors, and wider scope for diversification.

Governments and markets have addressed these issues in past years with limited outcomes. In Kuwait a market segment for options and futures on equities has been established, providing derivative contracts on a number of individual stocks. In the UAE, the Dubai Multi Commodities Centre offers commodity derivatives, while in Abu Dhabi a range of Exchange Traded Funds has been listed. For the future, there is an initiative to license a broad range of derivatives and structured products on the Bahrain Financial Exchange, which, in cooperation with the International Swaps and Derivatives Association, has developed global standards for Islamic derivatives in 2010. A Hedging Master Agreement is intended to provide a structure under which institutions can trade derivatives such as profit-rate and currency swaps. Qatar's plans for introducing a market for energy derivatives, in contrast, have been shelved.

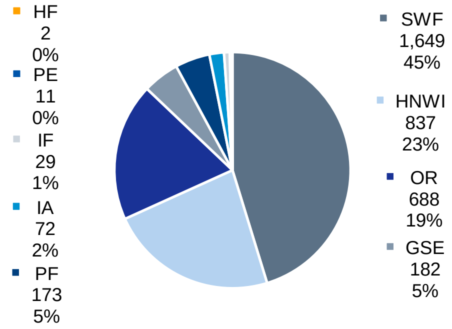
Progress on the derivatives front therefore remains isolated, and the develop-ment of broad and liquid markets will certainly take a number of years. The upside: The late starting point for these market segments gives local regulators the chance to establish a modern market environment in line with the current reforms of OTC and exchange-traded derivatives markets and infrastructure as coordinated by the FSB. There is, thus, a unique opportunity to start cutting-edge structures from scratch.

Institutional investors – low private-sector participation

Important gaps to internationally observed market structures also prevail on the buy-side. Institutional investors play a central role in this regard, with assets under management of more than USD 216 tr worldwide which is equivalent to almost three-and-a-half times the global GDP (USD 63 tr in 2010) or more than half of global financial assets (estimated at USD 381 tr at end-2011). In advanced economies, institutional investors play a particularly important role, in particular in the form of investment and pension funds or insurance companies. Large private portfolios are also held and managed by hedge funds, private

[19] For details see Woertz, Eckart, "GCC Financial Markets", Gulf Research Center, Dubai, 2011, and Markaz, "Derivatives market in GCC", Kuwait, March 2007.

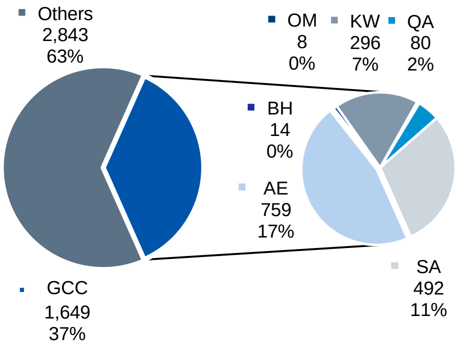
States and families: Dominant role 43



Note: Assets of major classes of institutional investors, USD bn and % of total institutional assets. Based on estimates for assets under management at end-2010 or latest available. SWF: Sovereign wealth funds. HNWI: High-net-worth individuals. OR: Official reserves. GSE: Government-sponsored enterprises, no global data available. PF: Pension funds. IA: Insurance company assets. IF: Investment funds.

Source: DB Research

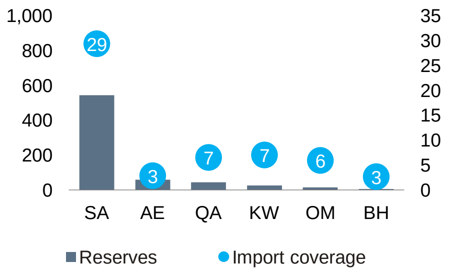
SWFs: Large international players 44



Note: Assets under management by sovereign wealth funds (SWF). USD bn, end-2011, estimated.

Sources: Various public sources, DB Research

Official reserves: Varying stocks 45



Note: Official foreign exchange resereves excluding gold, USD bn at end-2011. Coverage of imports in months.

Sources: IMF, IIF, DB Research

equity firms, and non-profit foundations and endowments. In addition, family offices administer large portfolios of private, often high-net-worth, individuals[20].

In the GCC economies, the overall volume of assets managed by institutional investors is large and compares with global institutional assets. Their total value stands at an estimated[21] USD 3.6 tr, which corresponds to around 370% of GDP in the region, i.e. significantly above the global average of institutional assets to GDP of around 230%. GCC institutional assets amount to 2.5% of the institutional assets under management globally, two-and-a-half times the region's share in global GDP.

The distribution of this very high volume of institutional assets in the GCC follows a pattern that underlines the continued strong presence of the state and wealthy families in the region: More than two-thirds of all institutional assets are held by state-sponsored vehicles. Another 23% of assets are invested by wealthy families. In contrast, only 8% of the institutional assets are managed by private collective investment vehicles.

— State-sponsored investors: State-sponsored investment vehicles are the backbone of the GCC's institutional investor landscape. 69% of the institutional assets in the region are administered by state-sponsored investors, including 45% held by sovereign wealth funds, 19% in official reserves, and 5% by other government-sponsored enterprises. These assets largely reflect the accumulation of public reserves by governments from oil and gas-related revenues over past decades. USD 1.6 tr alone of these assets have been collected in sovereign wealth funds. 37% of the world SWF assets are thus held in the GCC, with funds in the UAE – more than USD 750 bn – and Saudi Arabia – almost USD 500 bn – not only as the largest players in the Gulf region but also among the biggest and most influential sovereign investors worldwide. The majority of the funds administered by SWFs are understood to be earmarked[22] for investments in neighbouring economies and overseas, i.e. not for domestic development purposes[23].

  The second largest pool of public assets in the region is held in the form of official reserves, valued at nearly USD 700 bn. Conventionally held for precautionary purposes to intervene in international foreign exchange markets in case of pressure on domestic currencies, the size of reserve cushions varies considerably, with the vast majority of the assets concentrated in Saudi Arabia where they cover for almost two-and-a-half years of imports. Other GCC members hold far lower levels of reserves, for between three and seven months of imports. Reserves funds are invested in foreign assets, especially in sovereign paper denominated in US dollar and euro as the most important global reserves currencies.

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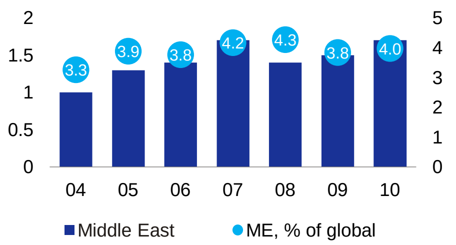
[20] Whereas not necessarily collective in nature, high-net-worth individuals (HNWIs) and family offices are considered large and active market participants, often at eye-level with institutional players.

[21] Owing to limited availability and low quality, data on institutional investors in the GCC region presented here may not be complete and are in single cases based on estimates.

[22] GCC SWFs continue to be among the most intransparent institutional investors in an international comparison. In particular, their portfolio distribution and strategies have not been disclosed to the public, even though Bahrain, Kuwait, Qatar, and the UAE have supported the work of the International Working Group of Sovereign Wealth Funds (IWG) and the International Forum of Sovereign Wealth Funds (IFSWF) towards a better understanding of SWF activities. For an introduction to the issues around SWFs see Kern, Steffen, "Global capital flows and international investment policies", in: Das, Udaibir et al., "Economics of Sovereign Wealth Funds", International Monetary Fund, 2010, Kern, Steffen, "Sovereign wealth funds – state investments on the rise", Deutsche Bank Research, 2007, Kern, Steffen, "SWFs and foreign investment policies", Deutsche Bank Research, 2008.

[23] Individual funds in the region have been used to channel funds into domestic economies to support business activities in the wake of the crisis.

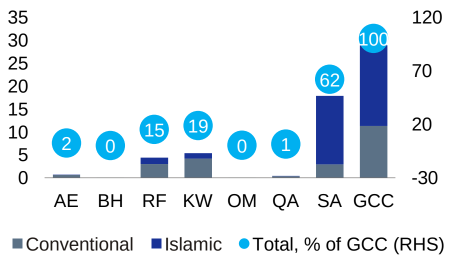
HNWI: Rising private wealth 46



Note: High-net -worth Individuals (HNWI), defined as individuals with investable assets of USD 1 m or higher. Assets under management, USD tr, in Middle East. Middle East HNWI in % of world total.

Sources: Cap Gemini, DB Research

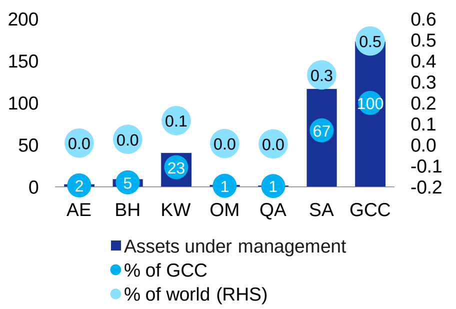
Funds: Minor markets in most GCCs 47



Note: Assets under management by investment funds, USD bn, 2010. Total country asstes in % of GCC total. RF denotes region-wide GCC and MENA funds.

Sources: Markaz, DB Research

Pensions: Systems in early stages 48



Note: Assets under management by public pension funds, USD bn and % of GCC and world total, 2010.

Sources: NCB Capital, DB Research

Sovereign wealth and official reserves funds are two key channels through which Petrodollars leave the Gulf as investments abroad. Over the past decades this process – often referred to as Petrodollar recycling – has enabled governments and also private investors to invest excess hydrocarbon revenues where local markets were not sufficiently large to absorb the magnitude of funds[24].

Other government-owned entities, in contrast, are focused on domestic investments. As discussed above, they are estimated to own more than USD 180 bn worth of domestic shares in the national markets of the GCC, absorbing around one-third of the market value of shares listed.

— High-net-worth individuals: Wealthy families belong to the most potent asset holders in the region, and continue to represent a fast-growing segment in the universe of large investors. Figures for the Middles East suggest that the volume of assets held by high-net-worth individuals has grown by 9% per year on average between 2004 and 2010. Their share in global HNWI assets amounted to an over-proportional 4% at end-2010. Wealthy individuals and families in the GCC countries, in turn, can be assumed to represent a large share of the Middle Eastern HNWI population with portfolios diversified between domestic, regional and international assets.

— Investment funds: Compared with public and wealthy private investors, collective investment schemes are in an embryonic state of development in the GCC. With USD 29 bn in assets under management, the GCC fund industry stays far behind the importance funds have in other developed or emerging regions in the world, making up just 0.1% of the fund assets managed worldwide. Measured against the region's GDP, assets under management amount to 4.7%, a share which is barely above one-tenth of the global average. In addition, fund assets are distributed highly unevenly as almost two-thirds are managed from Saudi Arabia, 19% from Kuwait, while the remaining countries have no significant fund business[25]. 61% of the funds in the GCC, and 84% of those in Saudi Arabia, are Shari'ah compliant. The majority of assets are reportedly held in shares (44%) or money market instruments (50%), whereas fixed income and other instruments play a minor role in their asset allocation (3%, respectively)[26].

— Pension funds: A very similar picture emerges in the case of pension provisions. With an estimated USD 170 bn of assets, the nine public pensions and insurance organisations in the GCC are small by international standards, and their private-sector counterparts are described as being of marginal significance[27]. As most of the public schemes are designed as partially-funded pay-as-you-go systems, the region faces similar problems observed elsewhere, including declining birth rates, higher life expectancy, and imbalances between insufficient contribution rates coupled with relatively high replacement ratios. Initiatives have been taken in some GCC countries to reform the systems in light of emerging systemic challenges albeit with limited results so far, again reflecting similar political issues

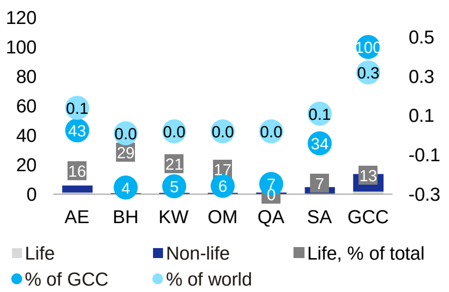
[24] For a discussion see Saleh M. Nsouli, "Petrodollar Recycling And Global Imbalances", International Monetary Fund, 2006, and Johannes Wiegand, "Bank Recycling of Petro Dollars to Emerging Market Economies During the Current Oil Price Boom", International Monetary Fund, Working Paper 180, 2008.

[25] 15% of the fund assets in the GCC are managed as regional funds and are not clearly assigned to a single country. See Markaz, "GCC Asset Management 2011", Markaz Sector Report, Markaz, Kuwait, 2011.

[26] Markaz, "GCC Asset Management 2011", Markaz Sector Report, Markaz, Kuwait, 2011.

[27] Funds typically exist as unfunded liabilities on the balance sheets of local corporations. For details see NCB Capital, "The Rise of Institutional Investors", NCB Capital Economic Research, Riyadh, 2010.

Insurance: Small market, little life 49



Note: Insurance premia, 2010. USD bn. % of GCC. % of world total (RHS). Life in % of total.

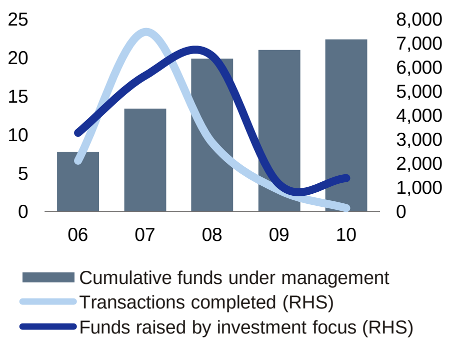
Sources: Insurance Information Institute, DB Research

observed in European and other systems. Not least against this background, investment returns are gaining in importance as a source of income. As a result, some funds are understood to have started to diversify their portfolios, albeit cautiously. Key trends are reported to include the reduction of bank deposits and an increasing use of local equity and debt products to improve portfolio profitability. As foreign assets do not yet play a significant role, pension fund investments – especially in case of future reforms, potentially towards defined contribution schemes – have substantive potential to support the development of local capital markets.[28]

— Insurance companies: The insurance sector, too, represents a small segment in the institutional market by international standards. Total premia written amounted to USD 14 bn in 2010, at around 0.3% of the global total like other private institutional investor classes clearly below the region's share in overall financial market activity or GDP. As regards the regional structure, the UAE and Saudi Arabia have the most sizeable markets which make up 43% and 34% of the regional total. Market structures, in turn, exhibit a strong concentration in the non-life business which contributes nearly 90% to the business, a remarkable aberration from international markets where the life business traditionally dominates[29]. Investment income has been measured to play a particularly important role in the accounts of insurance companies in the Gulf, and the sector is considered a small but active part of the investor community on local capital markets. In Oman and Saudi Arabia, in particular, their activities are nevertheless limited by a number of regulatory investment restrictions[30]. Opportunities for future development of the market are seen in the rising affluence of citizens in the region, potentially rising demand for insurance – especially life insurance – products in light of demographic change, and the emergence of Shari'ah-compliant insurance products.

Private institutional investor classes of minor importance

Private equity: Severe downturn 50



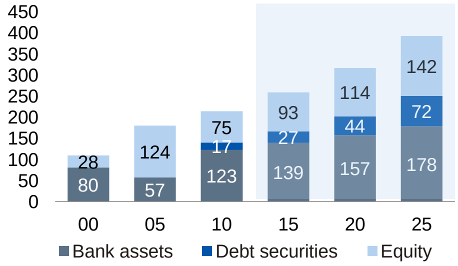
Note: MENA region. Cumiulative funds under management, USD bn. Funds raised and transactions completed, USD m.

Sources: Zawya, MENA-PEA, KPMG, DB Research

— Alternative investment vehicles: Of all private institutional investment classes alternative investments constitute the least developed market segment. Robust figures on the size of domestic alternative markets are not available, but the GCC's private equity market can be estimated to be just over USD 10 bn in size[31], while hedge fund assets invested in the GCC may be as low as USD 2 bn, the vast majority of which represents foreign capital invested by non-GCC overseas hedge funds with no domestic hedge fund managers involved[32]. Even though countries like Bahrain have in recent years encouraged the establishment of locally-based alternative investors, limited liquidity and high volatility in the domestic and neighbouring GCC markets have so far discouraged the development of a significant market segment. Client demand for alternative assets in the region, is high, though, and capital outflows into internationally invested foreign-domiciled funds are understood to be significant.

[28] NCB Capital, "The Rise of Institutional Investors", NCB Capital Economic Research, Riyadh, 2010.
[29] For an analysis of the causes see NCB Capital, "The Rise of Institutional Investors", NCB Capital Economic Research, Riyadh, 2010.
[30] For details see NCB Capital, "The Rise of Institutional Investors", NCB Capital Economic Research, Riyadh, 2010.
[31] Private equity assets under management amounted to an estimated USD 22 bn at end-2010, as reported in MENA Private Equity Association, "Private Equity and Venture Capital in the Middle East Annual Report 2010", Tunis, 2010. The figure presented above for the GCC represents an estimation based on the GCC's GDP share in MENA.
[32] Hedge fund assets invested in the MENA region are estimated at just over USD 4 bn in mid-2011, as reported in Hedge Fund Net, "Regional Focus Report – Middle East and Africa Focused Funds", New York, June 2011. The figure presented above for the GCC represents an estimation based on the GCC's GDP share in MENA.

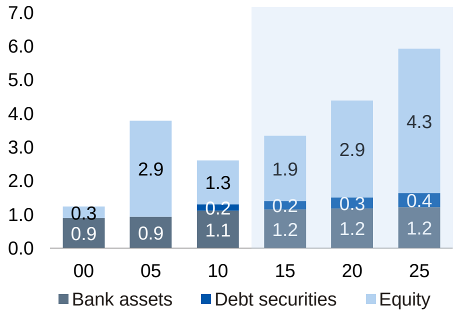
Outlook GCC financial market size 51



Note: Projected size of financial markets, all GCC, % of GCC GDP. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

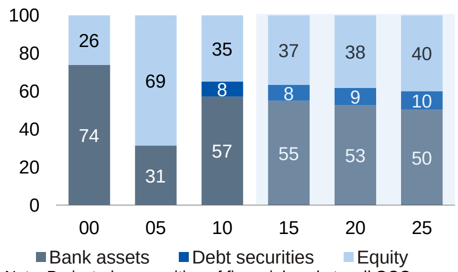
Outlook GCC finance in global markets 52



Note: Projected share of GCC financial markets in respective global markets, all GCC, % of global market segments. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

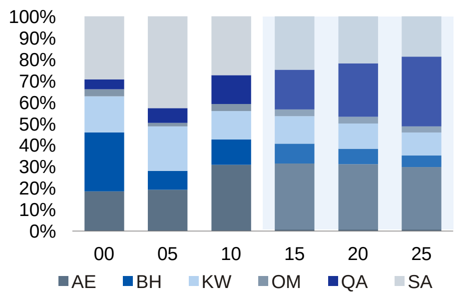
Outlook GCC financial market structure 53



Note: Projected composition of financial markets, all GCC, % of total. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

Outlook GCC financial market structure 54



Note: Projected composition of financial markets, by country, % of total. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

Prospects for GCC financial market development

A number of important structural factors are likely to determine the prospects for development of financial markets in the GCC in the coming years. These factors can be summarised as follows:

— Raising the competitiveness of domestic banking markets: The GCC countries' success in promoting a competitive private banking industry based on effective regulation and oversight in line with international standards.

— Broadening and deepening local equity markets: The ability of GCC countries to encourage equity capital raising across a broad range of domestic industries based on wide private shareholdership among domestic and international investors.

— Efficient corporate debt markets: Progress in GCC member states on supporting the use of privately issued corporate debt instruments as an alternative means of corporate financing and an attractive investment asset for domestic and foreign investors.

— Islamic finance: The success of the GCC in establishing the region as a global centre for the production and distribution of Shari'ah-compliant financial products which complement the range of conventional instruments, based on a generally accepted set of rules and oversight principles, institutions and procedures.

— Derivative products: Providing suitable conditions for a reasonable range of derivative financial instruments to promote the efficiency of underlying spot markets, allowing the development of instruments to hedge effectively against the high levels of risk and volatility in regional markets, and raise the attractiveness of local markets for sophisticated investors.

— Promoting private institutional investments: Supporting the development of private institutional investment vehicles, channelling more effectively existing domestic public and private funds into the domestic financial system, thereby facilitating the development of local capital markets as well as a more diversified base of domestic private industries.

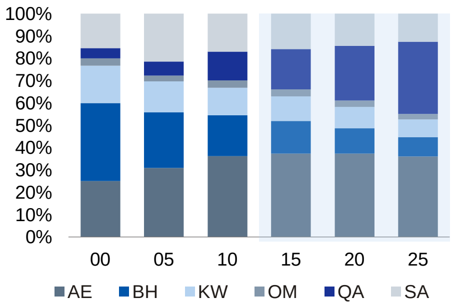
Positive growth outlook

A projection of future financial market growth based on past performance and reasonable assumptions about forthcoming developments[33] suggests some encouraging progress ahead, but also significant structural change:

— Growing size and importance in global arena: Continued financial market growth is likely to lead the GCC to a level of maturity comparable to today's levels in advanced economies by 2020 with an asset-to-GDP ratio higher than 300%. By 2025, that ratio will grow to more than 400%, i.e. about twice as high as today. By that time, the GCC's share in global financial markets will have risen from 2.6% to around 6%, marking a significant rise in the GCC's role in global finance. As a result, GCC financial markets are likely to have an enhanced capacity to finance domestic growth and industrial diversification, and offer a wider range of investment opportunities, including for high-volume investors.

[33] Projections discussed in this section are based on market data available from public authorities and private providers and reflect an average projected rate of market growth weighted according to three scenarios for long-term financial market growth over the next 15 years in the region with ten-year compound averaged growth rates (CAGR) between 2000 and 2010 for local financial markets, GDP by country, and international financial markets growth as parameters. Given the long-term nature of these projections and the lack of reliability of data from the region, these projections are illustrative in nature and must be treated with caution.

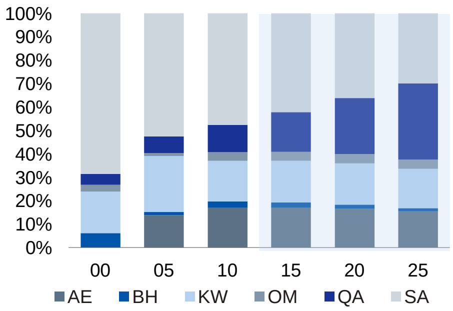
Outlook GCC banking market structure 55



Note: Projected composition of financial markets, by country, % of total. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

Outlook GCC equity market structure 56



Note: Projected composition of financial markets, by country, % of total. Main scenario.

Sources: DB Research, IIF, Zawya, WFE, national central banks, other public sources

— Capital market financing on the rise: Bank-based financing activities will gradually give way to funding through capital markets. While banking markets continue to grow in absolute terms, their share is set to fall from currently almost 60% to 50% by 2025, while equity markets will rise to 40% of total financial assets, whereas debt markets will see only a modest increase in their share to around 10%. The foreseeable shift in market structures underlines the above observations on rising competitive pressure in banking markets and promises large-scale nominal growth in the capitalisation of equity markets.

— Qatar and the UAE in the lead: Qatar could benefit most from forthcoming growth dynamics, more than doubling its share in GCC financial assets by 2025 to around 40%. It would then be at eye-level with the UAE which would enhance its current position only marginally. Saudi Arabia, Kuwait, and Oman would maintain their share in the GCC, while Bahrain could substantially lose market share under this scenario. Whether and to what extend such a shift will occur and to what extent this would actually matter to the real economy critically depends on the GCC's future moves on integrating these markets, i.e. the extent to which they succeed in removing barriers to market access and regulatory differentials, in establishing common regulatory and supervisory practices, and in coordinating their monetary policies more closely[34].

— Strong shift in equity and banking markets: The expected structural change is likely to be strongest in equity and banking markets where, extrapolating from past experience, Qatar could make strong advances, and the UAE will consolidate its existing strong position. The strongest challenges may arise for Saudi Arabia's position in the equity business, and to Bahrain's banking sector. In these two cases, existing positions are likely to be hard to defend on the basis of the past, comparatively moderate growth in the two countries, and the dynamism observed in neighbouring economies.

Opportunities and risks for future financial development

Growth projections subject to considerable uncertainty

None of the above projections may, in the end, materialise in practice. GCC financial markets are subject to a wide variety of influences that may significantly change the underlying growth dynamics, for better or worse. The region remains politically and economically volatile and financial markets are particularly sensitive to any seismic shifts in and around their operational perimeter.

Long list of potential game-changers

Not surprisingly, the list of potential game-changers is long and includes factors whose nature is complex and cyclical as well as structural in nature, political and economic, short-term and long-term, external to the GCC as well as home-made.

Global finance and economy

— The post-crisis global financial and economic environment remains fragile and volatile. The West, especially the US and the EU, keep struggling with severe debt and deficit problems and are not in a position to fill their traditional role as drivers of the global economy. Their financial systems remain fragile and are undergoing profound structural and regulatory changes with unknown outcomes, while emerging market financial centres remain secluded and cannot yet be regarded as global sources of funding, or as pillars of financial stability. Any future turmoil in global financial markets would, on balance, also destabilise GCC markets given their interconnectedness with the world through the oil connection as well as the low level of development of local financial markets.

[34] For a detailed discussion see the chapters on financial centres and GCC monetary union below.

Oil and gas

— Hydrocarbons remain a cure and curse at the same time. Their revenues provide the region with unprecedented levels of private and especially public wealth and cushion the countries against many economic risks. At the same time, they represent a strong concentration risk, exposing GCC economies to economic uncertainty from supply, demand and price disruptions that are largely beyond the control of the GCC.

Political and geo-strategic uncertainties

— Political risks remain the sword of Damocles for the Gulf region: Potential domestic social unrest, political instability in the wider MENA vicinity, and geo-strategic hotspots across the Middle East, as well as continued uncertainty over terrorist and extremist threats are salient risks that discourage domestic business and foreign investments.

Fragility of domestic financial system

— The early stages of development of many parts of GCC financial markets remains a potential risk considering that it may diminish their resilience in the face of turmoil.

Opening financial markets to the region and beyond

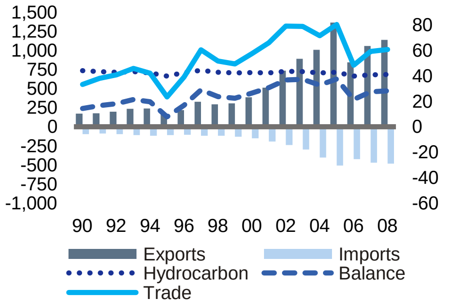
— Opening domestic markets to the world of global finance – a strategy pursued with some caution in the GCC – remains a promising road to travel. Despite recent concerns of contagion risks in open market environments, the merits of free trade and investments and open markets in financial services remain undisputed. A superior allocation of capital, lower prices and transactions costs, and a beneficial exchange of technology and expertise are the conventional rewards for market liberalisation, if managed prudently. Exposure to adverse global capital flows and market disruptions are the obvious downsides that can materialise if not managed prudently.

Ensuring market stability and efficient regulation and oversight

— To avoid the latter, efficient markets and effective regulation and oversight for financial markets are today considered a *sine qua non*. Coordinated internationally at G20 level, regulators and supervisors even in emerging and developing economies have a strong toolbox at their disposal to promote a seamless functioning of their domestic financial markets. Appropriate national regulatory and institutional frameworks, based on global standards, and equipped with the required implementing and enforcement powers represent the basis for stable financial systems in the region.

Shifts in any of these factors can influence the success of the GCC countries in promoting strong domestic financial markets. The wider political and economic conditions, in particular, are difficult to account for and lie beyond the scope of this study. The prospects for regulatory reform and market integration, on the other hand, are of immediate relevance to finance in the GCC, and so are the strategies for financial development and competition in the region. We will therefore consider international integration, financial regulation, financial centre competition, and the project of GCC monetary union in greater detail in the following chapters.

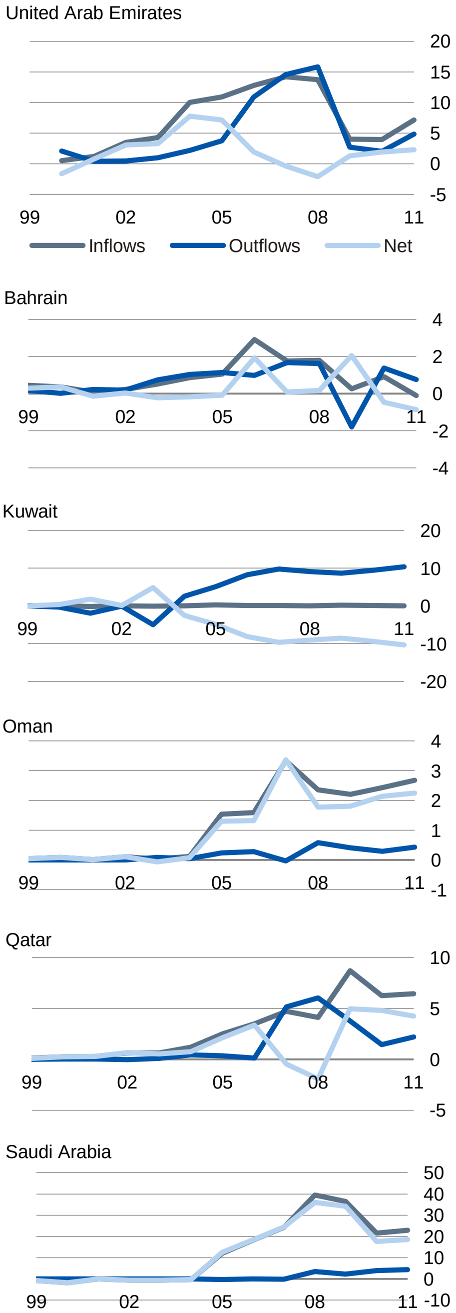
Trade: Rising interdependence 57



Note: Total exports and imports in USD bn. Hydrocarbon exports as % of total exports (RHS). Total trade and trade balance as % of GDP (RHS).

Sources: IIF, DB Research

FDI: Growing but volatile 58



Note: Net foreign direct investment inflows and outflows, net direct capital flows, USD bn.
Sources: IMF, national central banks, DB Research

International integration: Growing financial ties, but substantial barriers

One central determinant for the future development of GCC financial market is the degree of integration into the international financial system. Integration has two important dimensions. For one thing, market integration documents the degree to which economies are effectively engaged in cross-border trade in financial services and the flow of capital. Regulatory integration, on the other hand, captures the obstacles to trade and investment arising from legal, regulatory, oversight and other statutory rules that influence the extent to which market integration can actually develop.

Evidently, there is a strong relationship between market and regulatory integration. Regulatory obstacles can discourage market integration, and their removal can set free considerable trading and investment activity. A strong existing exchange of goods and services, in turn, can exert pressure on policymakers to address existing regulatory barriers to integration, while turmoil and contagion may trigger the tightening of regulatory requirements.

Evidence for the GCC suggests that market integration between the Gulf and the global financial system is progressing, but that a number of regulatory barriers still impede an efficient flow of services and capital, which policymakers may find useful to address going forward.

Market integration: Stronger ties with the global economy

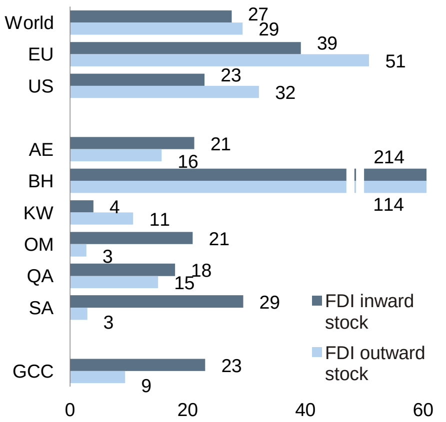
The GCC countries' integration with the global economy has progressed rapidly over the past decades, but remains volatile and has particularly suffered from the impact of the financial crisis on international trade, investment, and financing flows.

Trade and investments are an important basis for financial flows and the development of financial services. The former typically leads to large-scale flows of funds, requires foreign exchange transactions, and is, in the majority of cases, backed up by trade financing and hedging instruments. The latter, in addition, usually involve sophisticated financing and advisory arrangements. In both areas, the GCC has made considerable strides in the past two decades. The volume of exports has risen sevenfold from its 1990 level, imports have increased fivefold, yielding a substantive surplus over the years. The share of oil and gas exports is exceptionally high at 40% of all exports, but has remained stable during that period, with merchandise and services exports actually growing faster than hydrocarbons. Especially exports were hit hard by the impact of the financial crisis, but have recovered in the recent past.

Similarly, the importance of foreign direct investments to the region has grown dramatically, especially in the past ten years. Especially the larger GCC economies have benefitted from a strong growth in incoming investments both from within the region as well as overseas. Capital inflows, especially in the UAE, Bahrain, and Saudi Arabia, have reacted sensitively to the financial turmoil, and, despite some recovery, have remained volatile. With the notable exception of Kuwait, GCC economies are by and large net recipients of FDI capital. The GCC inward FDI stock amounts to 23% of GDP. This is slightly below the international average of 27%[35], but significantly lower than the 39% in the EU, the world's most open economic area[36]. Direct investments of domestic capital in overseas companies and projects is a comparatively novel and little

[35] Latest available figures, 2010, data by UNCTAD.
[36] Notably, there are wide variations in the absorption of international FDI, ranging from 4% of inward FDI stocks to GDP in Kuwait to more than 210% in Bahrain. The other GCC economies range between 20% and 30%.

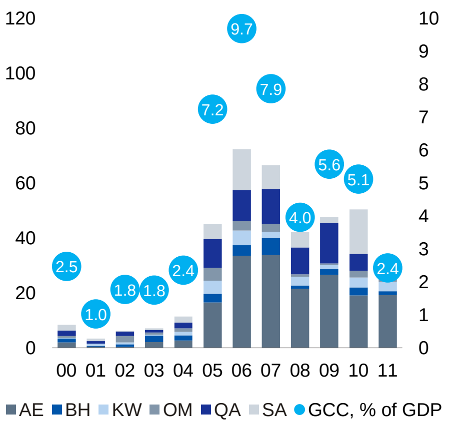
FDI: Structural imbalances 59



Note: Inward and outward FDI stocks, % of GDP, 2010.

Sources: UNCTAD, DB Research

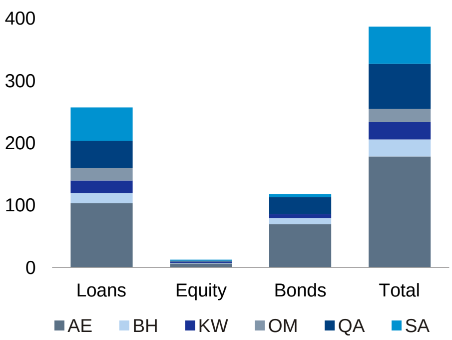
GCC external financing 60



Note: Total external financing, including equity, bonds, loans, in USD bn. Total GCC external financing, % of GDP (RHS).

Sources: IMF, IIF, DB Research

External financing: Foreign loans key 61



Note: External finaning by type, in USD bn.

Sources: IMF, DB Research

developed way of employing private surplus funds. In this case, stocks amount to just 9% of GDP, well below the 29% observed worldwide and 51% in the EU, pointing at reduced market integration with the global business and financial environment in key countries of the GCC[37].

In line with trade and foreign investments as important underlying factors, market integration with overseas financial markets has remained limited, even if the volumes of cross-border transactions have grown rather consistently over the past decades. Overall external financing flows into the GCC – starting from very low levels at the turn of the last decade – reached a maximum just prior to the financial crisis with a total of USD 72 bn flowing into the regions equity, bond, and banking markets from abroad in 2006, equivalent to nearly 10% of GDP or 17% of all external financing flows into emerging economies worldwide. As discussed earlier, the financial crisis and subsequent events in the region have led to a contraction in foreign commitments. Most recent figures indicate that foreign financing now amounts to just 2.4% of GDP, or 5% of all external financing to emerging markets. In other words, market integration in this respect is now back at levels observed in the pre-liberalisation era of the 1990s.

Furthermore, opening up to financial flows from overseas has remained concentrated in the three dominant financial markets, the UAE, Qatar, and Saudi Arabia. Of the more than USD 380 bn of external funds that went into the GCC between 2000 and 2011, 46% were committed in the UAE, 19% in Qatar, and 16% in Saudi Arabia. Also, foreign investment flows illustrate the limitations on investments in individual asset classes. Thus, limitations on market access, instruments available and market depth are reflected in the very small volumes of funds invested in GCC equity from overseas. Loans and bonds, where access to individual assets has been much more seamless in the past, have been the dominant target for foreign investors in the past. Again the Emirates, Qatar and Saudi Arabia have been the main recipients of loan and bond funding.

One key question is to what extent and when international financial market integration will return to the favourable levels seen in the middle of the last decade and possibly even beyond that. Importantly, investors and other market participants will keep an eye on the economic dynamics in the region. Sectoral recovery from the crisis, a return of greater confidence to financial markets, and a resumption of growth of key market segments, especially equity and bond markets will obviously be central determinants of investment behaviour, domestically and abroad.

Possibly no less relevant than the market environment, foreign investors will pay close attention to the evolution of the regulatory environment in the GCC markets. As noted above, direct or indirect legal limitations on financial transactions remain a concern for investors, especially from outside the region. Progress on regulatory integration will therefore be an important policy tool by means of which GCC policymakers can facilitate foreign commitments in the region and promote the financial development in their economies.

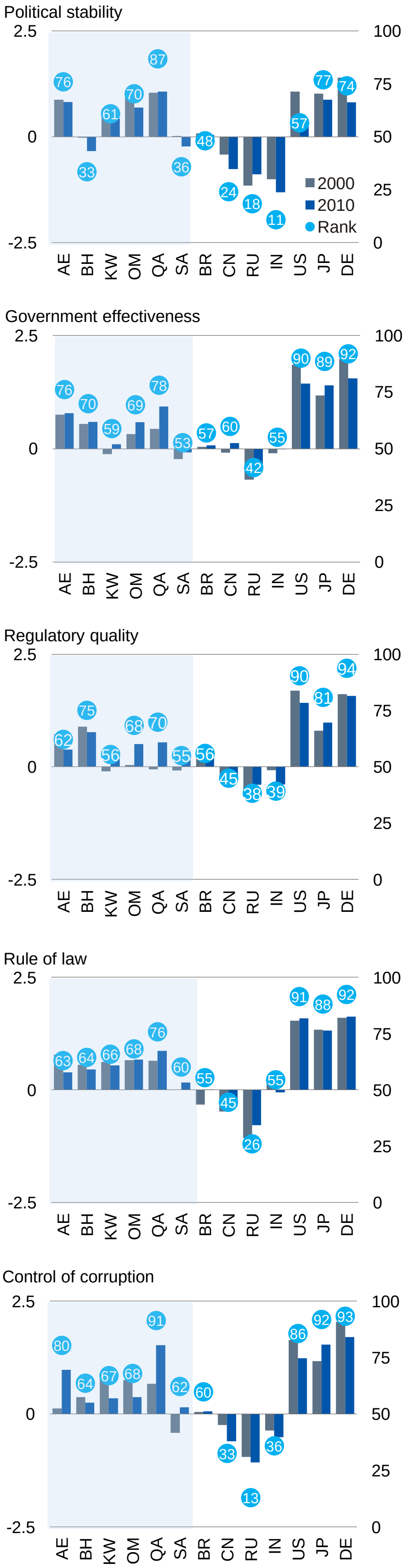
Regulatory integration: Governance issues and post-crisis reform

The attractiveness of markets for investors and financial services providers crucially depends on their assessment of the political and legal certainty with which they pursue their projects. Concerns over political and legal risks can discourage expectations regarding returns and profitability of transactions.

In particular in the aftermath of the financial crisis, sound legal framework conditions have become a decisive criterion for the assessment of the quality of

[37] Again huge variations can be observed, ranging from 3% of stocks to GDP in Saudi Arabia and Oman to more than 110% in Bahrain.

Governance: Scope for improvement 62



Note: World Bank Governance Index. Scale: +2.5 to -2.5, higher index values denote better governance. Indicator values for 2000 and 2010. Global percentile ranking for 2010 (right).
Sources: DB Research, World Bank

business locations. The establishment of minimum standards for financial regulation and oversight has been agreed by the leading advanced and emerging economies as a central objective of their G20 reform agenda, and non-compliance with global standards is increasingly regarded as a risk factor by financial market participants.

In both areas – domestic governance and compliance with international financial market standards – the GCC have committed to promoting high-quality operating conditions for financial markets. Successive changes to national regulatory regimes have greatly improved legal frameworks and oversight practices. Even if the GCC member states compare favourably with their peers in the emerging economies in many respects, the – perceived and real – gap to highest standards set by advanced economies in America and Europe remains significant.

Domestic governance: Concerns regarding legal and regulatory frameworks

As measured by the World Bank's Governance Index, the performance of the GCC countries on key indicators of good political and economic governance is remarkably high, but reveals important variations across the member states and in comparison with other emerging and advanced economies. Typically, the scores GCC countries achieve are remarkably positive, have improved over the past decade, range higher than the most relevant competitors in the emerging economies, but stay behind the standards set by advanced economies. This is consistently reflected in the World Bank's ratings for governance indicators for the overall political environment and the quality of the legal system, as presented in the charts on the margin[38].

These indicators point to a number of challenges that will certainly require additional attention at the political level on the way to a fully developed financial system.

— Government effectiveness[39]: The effectiveness of governments in steering and regulating their economies stays clearly behind that observed in advanced economies. Especially Kuwait and Saudi Arabia are found to lag behind in terms of general economic management, even if some progress has been achieved in the past decade.

— Regulatory quality[40]: More precisely, the ability of governments to provide high-quality legal frameworks for economic activity has been observed to be sub-optimal. The UAE and Bahrain, in their efforts to attract business from neighbouring and overseas economies, had reached encouraging levels in the past. Oman and Qatar have achieved important improvements in regulatory quality in the past decade, by 2010 coming close to the upper 70-percentile in a global comparison.

— Rule of law[41] and control of corruption[42]: In terms of the application and enforcement of legal requirements, the GCC countries consistently range in

38 The indicators presented here compare the metrics of 2000 and those of 2010.
39 Defined as "[...] perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies", see World Bank Governance Index 2010.
40 Defined as "[...] the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development", see World Bank Governance Index 2010.
41 Defined as "[...] the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence", see World Bank Governance Index 2010.
42 Defined as "[...] the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests", see World Bank Governance Index 2010.

the upper half of the economies surveyed by the World Bank. The UAE and Qatar have made particularly great strides in their fight against corruption, and are now at eye-level with countries like the US, Japan, and Germany in this category. Others are strong, too, in their application of laws, even if their scores have declined between 2000 and 2010. Saudi Arabia, in contrast, is still considered to have deficits when enforcing national rules, even if clear improvements have been observed in that period.

Greater efforts needed to attract businesses

These and other indicators of economic governance are both encouraging for most GCC member states, given the relatively high level of governance reliability already achieved, and an important reminder of the profound change still required to gain even greater confidence among investors and businesses in the quality of the business location[43].

Global standards: Towards international compliance

Compliance with G20 reform agenda is key

Especially in the post-crisis environment, effective financial market regulation and oversight as well as a strong grip on market abuse and financial fraud are now a top priority of policymakers around the world. Ensuring compliance with the G20 reform agenda, but also with existing international agreements and standards regarding financial markets has therefore become a priority for governments around the world, including the GCC member states.

— International institutions: Institutionally, the GCC states have been members of the most important international organisations in the area of financial regulation and oversight for a long time, laying a solid basis for international cooperation and coordination. This most importantly includes the IMF, the World Bank and UNCTAD. All six countries are subject to the IMF's and World Bank's surveillance activities and most have undergone IMF Financial Sector Assessment Program investigations as well as World Bank Financial System Stability Assessments in past years. For most GCC countries new rounds of surveillance are scheduled for the foreseeable future. Saudi Arabia has become a full member of the G20 and, by extension, of the FSB and the Basel Committee.

GCC regulatory integration has come a long way ...

— Banking law: Regarding banking supervision, and in particular bank capital and liquidity requirements, all GCC countries have ensured compliance with Basel II requirements, and have announced their intention to fully implement Basel III rules within the time schedule prescribed by the Basel Committee on Banking Supervision (BCBS). Past financial surveillance programmes have confirmed sufficient adherence to BCBS Core Principles for Effective Banking Supervision by the Basel Committee on Banking Supervision for the UAE, Bahrain, and Saudi Arabia.

— Securities market law: All GCC states except Kuwait are full members of IOSCO, the international organisation setting standards for securities market legislation, and have committed to adhering to the body of standards established by that institution, in particular the Objectives and Principles of Securities Regulation.

— Accounting standards: All GCC countries apply the IASB's International Financial Reporting Standards with minor exceptions for small and medium-sized enterprises. Most GCC countries do not have separate accounting principles.

— Financial crime: The GCC countries are party to the Financial Action Task Force and have implemented the Recommendations on Money Laundering

[43] For a detailed discussion of the parameters of financial centre competition in the post-crisis environment see Kern, Steffen, "Global financial centres after the crisis", DB Research, 2010, and Kern, Steffen, "Financial market competition in the wake of post-crisis regulatory reform", Journal of Financial Transformation, No. 4, 2010.

and Special Recommendations on Terrorist Financing. In addition, the UAE, Bahrain and Qatar have committed to implementing the Internationally Agreed Tax Standard by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes.

— Corporate governance: All GCC countries, except Saudi Arabia, participate in the MENA-OECD Initiative on Governance and Investment for Development.

— Sovereign investments: The UAE, Bahrain, Kuwait and Qatar are members of the International Working Group of Sovereign Wealth Funds (IWG-SWF), and have committed to implementing the Generally Accepted Principles and Practices (Santiago Principles). Oman and Saudi Arabia have remained on the sidelines and observe the GAPP and IFSWF processes.

... but strong progress to be made in key policy areas

Participation in these fora and initiatives marks an important commitment made by the GCC countries to international cooperation and coordination in the area of financial market policy. Their support of these processes, however, remains subject to challenges that will need to be addressed in future:

— Sovereign debt: Participation in the global initiatives on standards for the issuance of sovereign debt has remained limited. With the exception of Abu Dhabi's and Kuwait's associate membership in the Paris Club which has formulated principles on sovereign debt policy , and the UAE's and Saudi Arabia's support of the IIF and its Principles for Stable Capital Flows and Fair Debt Restructuring, the region does not formally support the ongoing coordination processes. While none of the GCC countries participates in global debt markets as a major sovereign issuer and obligations have always been honoured so far, standards for sovereign debt issuance and trading are attracting increasing attention in light of the sovereign debt crises in the US and Europe. As international negotiations on standards may intensify in the future, formal participation in these processes may become interesting for GCC states, too.

— Insurance and infrastructure: Adherence to the standards established for insurance companies and financial infrastructure providers, the IAIS' Insurance Core Principle and Methodology and the Core Principles and Recommendations issued by CPSS and IOSCO, has remained weak.

Consistent implementation ...

— Consistent implementation of international standards: National deviations from global standards weaken the effectiveness of regulation and oversight by triggering regulatory arbitrage and distort the competitive environment. Even though important commitments have been made by GCC members to support many of the new global benchmarks, particular vigilance should be applied to implementing G20-related regulatory and supervisory guidelines in a most systematic and consistent way.

... and effective enforcement needed

— Application and enforcement: The governance assessment documented above suggest that the GCC region still faces issues with regard to legal application and enforcement. The latter will be of particular sensitivity when transposing G20 crisis response measures. As regulatory and oversight frameworks become more detailed, intricate, and far-reaching, ensuring consequential application of the new rules will require additional efforts. Effective transposition of complex pieces of regulation such as the new Basel framework, new derivatives rules, or reformed financial reporting requirements may require the commitment of additional resources to regulators and supervisors, the promotion of additional expertise in the executive branches, and the support of additional information technology infrastructure to handle exponentially growing inflows of reported market data. In their pursuit of financial development and competitiveness, it will be useful for GCC member states to consider taking the necessary measures decisively and at an early point.

Outlook: Towards stronger international integration

Logic of regulatory integration stronger than ever before

In the post-crisis era, the logic of good governance, consistent regulation and effective supervision is likely to be even stronger than before and will be a key determinant of the competitiveness of financial market players and financial centres at large. The GCC economies have made great strides in this regard in the past. A review of the commitments made by the member states to key international initiatives for regulatory cooperation shows that there is a strong determination to stay on top of the fast-moving international reform agenda pursued at the G20 level. Intensifying that commitment, not least by ensuring full participation in the reform processes but also by committing the resources needed to achieve optimal consistency and effectiveness in regulation and market supervision will be key to achieving the goals of financial development and economic diversification.

GCC financial governance – international cooperation and compliance with global regulatory and supervisory standards 63

Area		AE	BH	KW	OM	QA	SA
International organisations	G20						– Full member
	IMF	– Full member	– Full member	– Full member	– Full member	– Full member	– Full member
	World Bank	– Full member	– Member, except IDA	– Full member	– Full member	– Member, except IDA	– Full member
	UNCTAD	– Full member	– Full member	– Full member	– Full member	– Full member	– Full member
	BIS	– Full member					– Full member
Official surveillance	IMF-World Bank Surveillance	– FSSA 2007 – IOSCO FSAP 2007	– FSSA 2006	– FSSA 2004 – IOSCO FSAP 2004 – FSSA 2010	– FSAP 2010	– FSAP 2007	– FSSA 2006 – FSAP 2011
Banking supervision	Basel 2	– Implemented	– Implemented	– Implemented	– Implemented	– Implemented	– Implemented
	Basel 3	– Implementation underway	– Implementation in progress	– Implementation underway	– Implementation intended	– Implementation underway	– Implementation underway
	BCBS	– Sufficiently strong adherence	– Sufficiently strong adherence				– Sufficiently strong adherence
Securities markets	IOSCO	– Full member	– Full member		– Full member	– Affiliate member	– Full member
Accounting	IFRS	– IFRS as published by IASB required – No local GAAP – IFRS not in use for SMEs as yet	– IFRS as published by IASB required – No local GAAP	– IFRS and IFRS for SMEs as published by IASB required	– IFRS as published by IASB required – IFRS for SMEs prohibited	– IFRS and IFRS for SMEs as published by IASB required – AAOIFI FAS reporting permitted	– IFRS as published by IASB required IFRS is prohibited for SMEs
	AAOIFI	– AAOIFI FAS adopted	– AAOIFI FAS adopted			– AAOIFI FAS adopted	– Guidelines based on AAOIFI
Insurance	IAIS	– Full member – Signatory MMoU	– Full member			– Full member	– Full member
Infrastructure	BIS CPSS						– Full member
Corporate governance	MENA-OECD	– Participant	– Participant	– Participant	– Participant	– Participant	
Financial crime	FATF	– Full member of MENAFATF	– Full member of MENAFATF	– Full member of MENAFATF	– Full member of MENAFATF	– Full member of MENAFATF	– Full member of MENAFATF
	OECD	– Substantially implemented	– Substantially implemented			– Substantially implemented	
Sovereign investments	GAPP	– IWG-SWF member	– IWG-SWF member	– IWG-SWF member	– IWG-SWF observer	– IWG-SWF member	– IWG-SWF observer
	IFSWF	– Full member	– Full member	– Full member	– Permanent observer	– Full member	– Permanent observer
Sovereign debt	Paris Club	– Abu Dhabi is associated member		– Associated member			
	IIF Principles	– DIFC represented on Principles Consultative Group					– SAMA represented on Group of Trustees of the Principles

Note:
- World Bank: World Bank Group, including International Bank for Reconstruction and Development (IBRD), International Development Association (IDA) , International Finance Corporation, Multilateral Investment Guarantee Agency (MIGA), International Centre for Settlement of Investment Disputes (ICSID)
- FSAP: IMF-World Bank Financial Sector Assessment Programme
- FSSA: IMF-World Bank Financial Sector Stability Assessment
- FSA: IMF-World Bank Financial Sector Assessment
- Basel: Framework for banking regulation and supervision by the Basel Committee on Banking Supervision
- BCBS: Core Principles for Effective Banking Supervision by the Basel Committee on Banking Supervision
- IOSCO: Objectives and Principles of Securities Regulation by the International Organization of Securities Commissions
- IFRS: International Financial Reporting Standards by the International Accounting Standards Board
- AAOIFI: Financial Accounting Standards (FAS) by the Accounting and Auditing Organization for Islamic Financial Institutions
- IAIS: Insurance Core Principle and Methodology by the International Association of Insurance Supervisors
- MMoU: IAIS Multilateral Memorandum of Understanding on Cooperation and Information Exchange
- BIS CPSS: Core Principles for Systemically Important Payment Systems, CPSS/IOSCO Recommendations for Securities Settlement Systems and CPSS/IOSCO Recommendations for Central Counterparties issues by the Committee on Payment and Settlement Systems at the Bank for International Settlements
- MENA-OECD: MENA-OECD Initiative on Governance and Investment for Development
- FATF: Recommendations on Money Laundering and Special Recommendations on Terrorist Financing by the Financial Action Task Force
- OECD: Internationally Agreed Tax Standard by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes
- GAPP: Generally Accepted Principles and Practices (Santiago Principles) by the International Working Group of Sovereign Wealth Funds (IWG-SWF)
- IFSWF: International Forum of Sovereign Wealth Funds
- Paris Club: Principles by the Paris Club on sovereign debt policy
- IIF: Principles for Stable Capital Flows and Fair Debt Restructuring by the Institute of International Finance

Sources: BCBS, IMF, World Bank, OECD, BIS, FSI, IOSCO, IASB, AAOIFI, IAIS, FATF, FATF-MENA, OECD, PWC, national central banks, national regulatory and supervisory authorities, other public sources, DB Research

GCC financial centres in global competition

Developing financial markets key political concern

Four out of the six GCC member states – namely Bahrain, Qatar, Saudi Arabia, and the UAE – have devised dedicated programmes for promoting their financial market places.

Promoting GCC financial centres

Global financial centre ranking 64

	Global ranking	Profile
Qatar	30	Transnational financial centre with relatively deep and specialised markets
Dubai	36	Global financial centre with relatively deep and specialised markets
Bahrain	55	Transnational financial centre with emerging financial markets
Riyadh	66	Local financial centre with emerging financial markets

Sources: Z/Yen Group, GFCI 10

The logic behind promoting financial market activity in GCC countries has been closely associated with the idea of economic diversification in the past two decades. Financial markets play a central role in these strategies: For one thing, a thriving financial sector generates growth and high-skill employment and thereby contributes to economic diversification. More important, however, a competitive financial sector can help promote economic activity in other parts of the economy, most importantly through credit, equity, and debt financing of entrepreneurial activity, an efficient allocation of savings and investment assets, and reliable and cost-effective infrastructures for payments and securities transactions. In that sense, promoting the development of strong financial markets promises a particularly strong return on public investments in the long run.

While the underlying rationale is comparable across the GCC economies, the strategies of financial market development have differed markedly in the past.[44]

Different strategies for financial market expansion

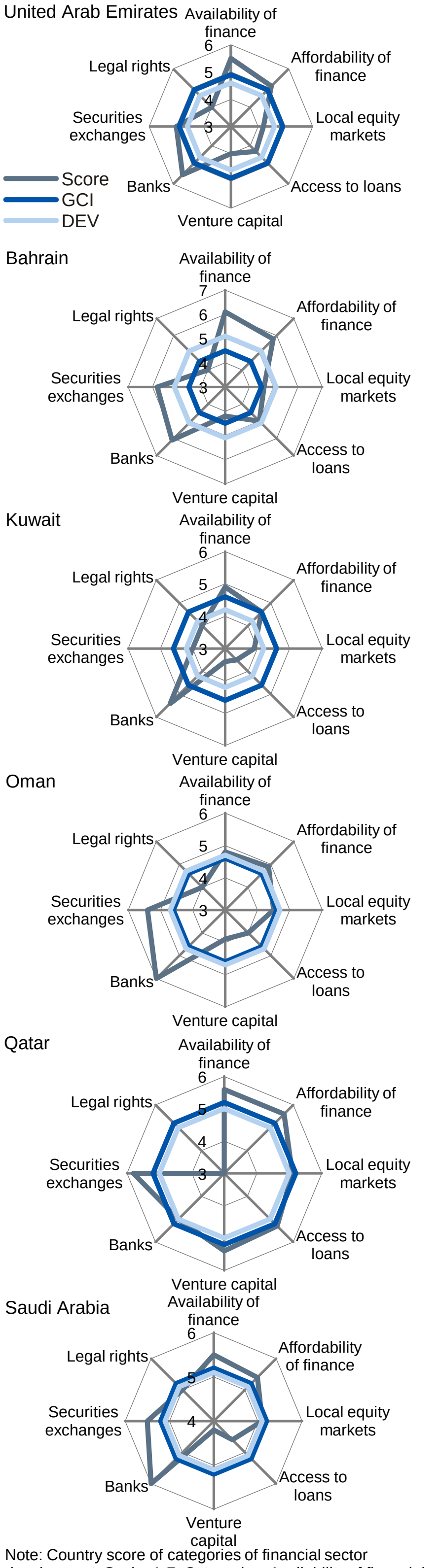
— Bahrain: Efforts at attracting financial business date back to the late 1970s when the country started to serve as an offshore location for banks from the MENA region. Strategic strengths encompass Islamic finance, asset management, the fund and insurance businesses, and a multi-asset securities exchange. Institutionally, financial market regulation and oversight are considered well-developed and concentrated in the Central Bank of Bahrain. In addition, the country is home to the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI).

— United Arab Emirates: Development commenced in 2004 with the establishment of the Dubai International Financial Centre (DIFC) as an offshore market place with a dedicated extraterritorial jurisdiction as well as preferential tax and regulatory conditions. Strategic strengths include investment and corporate finance, securities trading, and fund business. Institutionally, financial market regulation and oversight are considered well-developed and lie in the hands of the Emirates Securities and Commodities Authority (SCA) and the Central Bank of the United Arab Emirates. Dubai hosts Hawkamah, the region's leading institute established to promote corporate sector reform and good governance.

  Abu Dhabi has recently made financial market development part of its 2030 Economic Vision. In particular, the development agenda includes the promotion of debt and equity markets, private equity, and IPOs.

[44] Detailed discussions can be found, for example, in Eckart Woertz, „Prospects of the banking and finance sector and the development of financial centers", Gulf Research Center, 2011, and Chatham House, „The Gulf as a Global Financial Centre: Growing Opportunities and International Influence", Chatham House Report, 2008.

Competitiveness in comparison 65



Note: Country score of categories of financial sector development. Scale: 1-7. Categories: Availability of financial services, affordability of financial services, financing through local equity markets, ease of access to loans, venture capital availability, soundness of banks, regulation of securities exchanges, legal rights index (1-10). Compared with score for entire economy (GCI) and overall financial market development (DEV).
Sources: World Economic Forum, GCR 2011-2012

— Qatar: The Qatar Financial Centre has been developed since 2005 as an onshore market place with favourable tax and regulatory conditions. The strategic objective is the creation of a global business hub for three core markets, asset management, reinsurance and captive insurance. Institutionally, financial market regulation and oversight are considered well-developed and lie in the hands of the Qatar Financial Centre Regulatory Authority and the Qatar Central Bank. To promote market infrastructure, the Doha Securities Market (DSM) entered into a strategic partnership with the NYSE which holds 25% of DSM, while the Qatar Investment Authority (QIA) maintains a 21% stake in the London Stock Exchange (LSE).

— Saudi Arabia: With the objective of making Riyadh the major financial centre in the Middle East, the government launched the King Abdullah Financial District initiative in 2006, boasting custom-built quarters for the financial industry. Strategically, the initiative aims at improving the general framework conditions for finance. Institutionally, financial market regulation and oversight are considered well-developed and responsibility lies in the hands of the Capital Markets Authority (CMA) and the Monetary Authority (SAMA).

Despite some progress, a more detailed analysis of factors of competitiveness[45] suggests that each of the GCC member states faces challenges in providing a conducive environment for financial activity (see graph 65). Most importantly, only Bahrain and Oman are found to offer financial market conditions that actually excel the competitiveness of the home economy as a whole[46]. All other countries have financial markets whose competitiveness is considered to be below that of their overall economy.

In a global comparison, financial market development in Bahrain, Saudi Arabia, and Qatar has been found to be particularly well advanced, with these countries ranking 14, 16, and 19, respectively[47] (see also graph 66). Oman, the UAE, and Kuwait follow at ranks 30, 33, and 59. These positions compare favourably to the rankings of the GCC peers in the BRIC economies, and clearly outperform neighbouring economies in the MENA region.

Strategic options for future growth and stability

The advances made over the past decade by the key financial centres in the Gulf are remarkable. At the same time, it has been evident that none of the aspiring cities has grown to be a global hub which in terms of market size and economic importance can compete with large traditional financial centres. And even a number of emerging financial centres in China, India, or Brazil have outpaced the Gulf region, especially in terms of market size, but also on competitiveness. Even within the region, none of the centres has assumed a robust leadership role while intense rivalry exists between the core financial cities in the GCC continues.

At the same time, the challenges GCC financial centres will face in the coming years are set to be tough. As the financial crisis has led to higher volatilities,

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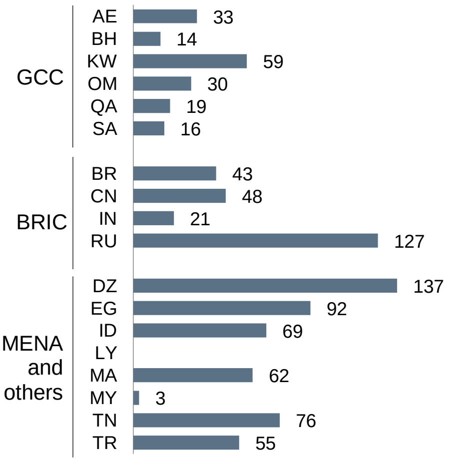
45 Competitiveness rankings as provided in World Economic Forum, “Global Competitiveness Report 2011-2012”, World Economic Forum, Geneva, 2011.
46 For an illustration see chart on the left. In the case of Bahrain, the light blue indicator for financial market development has a higher rating than the dark blue indicator for overall economic competitiveness. The specific ratings for financial market development, shown by the grey line, suggest a relatively positive performance in the areas of availability and affordability of finance, the soundness of the banking sector and the quality of regulation of securities markets. The ease of access to loan financing, access to local equity markets as well as the quality of legal rights are found to be relatively less developed.
47 Ranking by the World Economic Forum, out of total of 142 countries examined.

Financial development: GCC and peers 66



Note: Global ranking of financial markets by state of development, 2011. LY: Not available. MY: High ranking due to high legal rights score.

Sources. WEF, DB Research

greater market uncertainty, and tighter regulatory standards, four drivers of financial centre competitiveness can be identified[48]:

— Market size: Traditional global financial centres, such as London, New York, Hong Kong, and Singapore, are set to remain strongholds of global finance after the crisis, building on existing market strength and favourable economic conditions.

— Multi-polar financial industry: In the long-run, emerging financial centres are likely to succeed in establishing the scale and scope in their market environment that will help them advance into the top group of global locations. The crisis may accelerate this trend.

— National focus and smaller centres: Local and regional financial market places may hope for continued relevance owing to the re-focusing of market participants and policymakers on their national markets. However, this tailwind will probably be of limited duration.

— Good regulation: Providing a good regulatory framework will be a key determinant of competitiveness going forward. Financial centres not compliant with international rules are faced with increasing political pressure and stigmatisation. Well-regulated financial centres may be considered as safe havens. But increasing regulatory density may also give rise to regulatory arbitrage. Financial centres need to analyse the impact of regulatory developments and decide which types of business and business practices they wish to host in their location.

Key strategic issues

In the aftermath of the financial crisis, these trends together with the fast emergence of hubs in Asia have given rise to a number of strategic questions that financial centres in the GCC and elsewhere have to address:

Role of finance in the economy

— In the GCC, financial market development is closely associated with the objective of diversifying economic activity. Finance can contribute to achieving this goal directly by becoming a key sector in the economy, and indirectly by promoting the growth of other sectors through financial intermediation. Both developments are closely related. In the GCC, widespread state-ownership of assets and enterprises and ample liquidity from hydrocarbon revenues have limited the dynamism of financing activities. Further promoting a diversified, private-sector based economic development therefore remains one of the key concerns for the GCC regions.

Identification of comparative advantages

— A key strategic challenge for GCC hubs remains to develop and cultivate comparative advantages in specific areas of the business. Pursuing distinctive strategies can greatly contribute to regional or global standing.

Benefits of cooperation between financial centres

— GCC financial centres compete with each other across the whole range of the business. Although the large market places of Abu Dhabi, Dubai, Bahrain, Kuwait, Qatar and Riyadh have identified fields whose development has priority there is overlap in activity. This competition is positive and will drive market development in each member state. In addition, competition is set to intensify once decisive steps towards a single financial market, especially regulatory convergence and monetary union, will be accomplished.

However, in as far as Gulf financial centres have not only national but also regional or even global ambitions, this competition also brings challenges. After all, the density of financial centres is unusually high. With six aspiring market places all within less than one flight hour, servicing an economic area whose GDP is barely higher than that of the Netherlands or Turkey and

[48] For details see Steffen Kern, "Global financial centres after the crisis", Deutsche Bank Research, Frankfurt, 2010.

a population of the size of Poland, the GCC is a rather crowded place. In addition, credit and debt financing, market trading, fund management, infrastructure and other parts of the finance business are subject to strong economies of scale and scope. In future, it will therefore be increasingly difficult for the six hubs to pursue larger international strategies alongside each other. At least for the international part of their expansion plans, closer cooperation and coordination may prove an important strategic step for these centres.

In aggregate, the driving forces behind financial centre development suggest that having a clear strategy for promoting domestic markets in coming years will be even more important than in the past. A central role in the development of the local real economy, advancement of comparative advantage to neighbouring hubs, a convincing joint strategy for their regional and international projection, as well as a continuation of the improvement of legal and regulatory framework conditions will be indispensable elements if the GCC and its main financial hubs want to narrow the gap with the top ranks of global financial centres.

GCC monetary union – slowed down, but feasible

Milestones of GCC integration 67

— Gulf Cooperation Council: The establishment of the Cooperation Council for the Arab States of the Gulf (GCC) in 1981 with the objectives of political coordination and integration, deeper and stronger political and economic relations, and of converging legal and regulatory conditions in economic and financial affairs, commerce, customs and communications, education and culture.

— Unified Economic Agreement: The Unified Economic Agreement which entered into force in 1982 and laid down the principles of a GCC free trade area, the free cross-border movement of citizens and the coordination of banking, financial and monetary policies.

— Free Trade Area: Establishment of the Gulf Free Trade Area (FTA) in 1983 eliminating tariffs between the member states.

— Economic Agreement: The Economic Agreement of 2001 formulating more ambitious integration targets, including the creation of a fully integrated common market and the preparation of monetary union.

— Currency Peg: Joint adoption of the US dollar as a common anchor currency in 2003.

— Customs Union: Completion of the GCC Customs Union in 2003, including common external tariffs and a common customs law.

— Common Market initiative: Launch of a Common Market initiative in 2007 aiming to complete the free movements of goods, services, capital and citizens. Moves towards the Common Market have been incremental, and the project has not yet been concluded.

— Common Currency initiative: Adoption of convergence criteria for GCCMU membership in 2005. Approval of a method for calculating the financial and monetary standards of the convergence criteria in 2007. Conclusion of the GCC Monetary Union Agreement (MAU), laying down the legal and institutional framework for a Monetary Council and a GCC Central Bank, to be located in Riyadh, Saudi Arabia, in 2009.

The member states of the GCC decided in 2000 to explore concrete steps towards a common currency. Establishing a single currency area, it is hoped, would bring substantial benefits for financial markets and the wider economy.

Since then, the GCC has made considerable progress towards this goal, including some remarkable economic convergence as well as first measures to create the required institutional infrastructure and legal prerequisites. At the same time, the project has been marred by setbacks, especially the opt-out by Oman and the UAE. Furthermore, the recent difficulties in the euro area have highlighted the numerous challenges such an undertaking can meet.

Nevertheless, monetary union in the GCC is feasible as the economic merits of the project are convincing and the political determination among the key member states remains strong.

The state of affairs

GCC Monetary Union (GMU) would mark the culmination of several decades of economic integration in the Gulf. On this way, the six GCC states have already passed a number of important milestones, including the establishment of a Free Trade Area, the completion of the GCC Customs Union, as well as important measures in the context of the GCC Common Market project, which promises the free movement of goods, services, capital and citizens.

With the 2009 Monetary Union Agreement (MAU) the GCC has laid the legal and institutional foundations for moving ahead with monetary union, comparable to, albeit less concrete than, the EMU Protocol of 2002 Maastricht Treaty in Europe. Importantly, the MAU devised the principles which will govern the single currency, and the basic institutional setup of GMU:

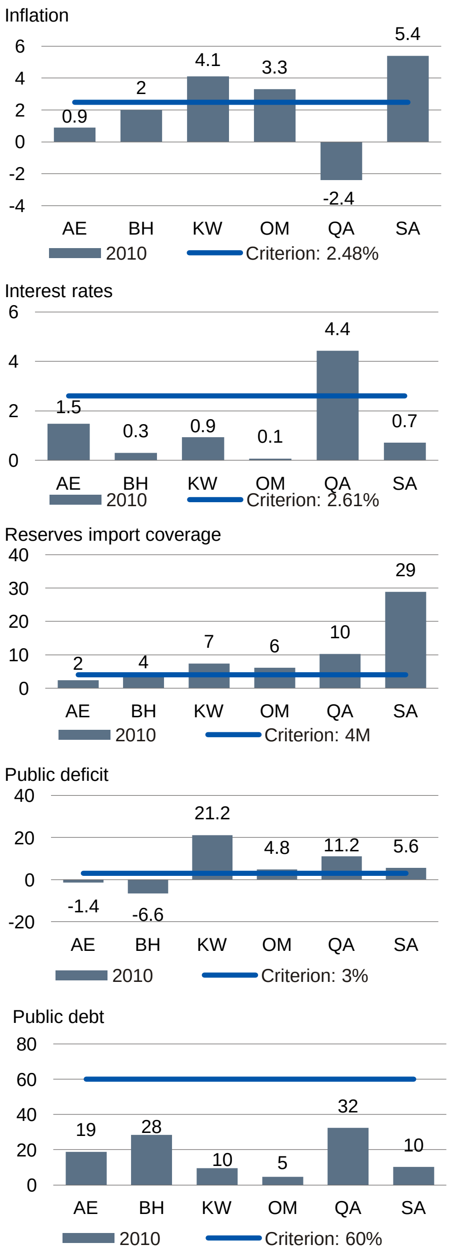
— Principles: The participants in the project committed themselves to coordinating their economic policies, providing payment and settlement infrastructure, adopting uniform banking legislation and common rules on banking supervision, and finally introducing a single currency.

— Monetary Council: To lay the groundwork for the single currency, a newly established Monetary Council was mandated to prepare the necessary infrastructure, especially for establishing a central bank and its analytical and operational capacities. Key tasks include the facilitation of coordination between national central banks and their monetary and exchange-rate policies for national currencies, monitoring the economic convergence of member states and their adherence to the prohibition on central bank lending to public entities, and drawing up the legal and organizational framework for the central bank, including statistical systems, the physical new currency, payment and settlement systems and timelines. In these functions, the Monetary Council can be compared to the European Monetary Institute, which had been mandated with the strategic planning of EMU between 1994 and 1998.

— Central Bank: The MAU stipulates the creation of an independent GMU Central Bank (GCB) whose objectives would be securing "price stability in the single currency area through optimal utilization of the economic resources that would ensure economic stability"[49]. Its tasks would entail the definition and implementation of monetary and exchange-rate policies, management of foreign-exchange reserves, issuance of the currency, overseeing the financial market infrastructure, and developing general rules

[49] The Cooperation Council for the Arab States of the Gulf, „Agreement Establishing the Monetary Union of the Cooperation Council for the Arab States of the Gulf", Muscat, 2009.

GCC convergence criteria 68



Note: Inflation rates in %, criterion of no more than 2 percentage points above GDP-weighted average. Short-term interest rates in %, criterion of no more than 2 percentage points above average of 3 lowest performers. Official reserves in months worth of imports, criterion of no less than 4 months. Public deficit in % of GDP, criterion of no more than 3% of GDP. Public debt in % of GDP, criterion of no more than 60%.
Sources: IMF, national central banks, IIF, DB Research

for prudential supervision on financial institutions. The GCB would enjoy a high degree of independence and would be prohibited from lending directly to public entities. Finally, as the MAU requires member states to adopt economic policies aimed at macroeconomic convergence, the GCB would be mandated to lay out procedures and mechanisms for monitoring and assessing the convergence criteria devised by the Monetary Council.

As preparations for GMU progressed over the past decade, the project has also experienced setbacks which may significantly impact the future path of action as well as the final shape of the monetary union:

— Membership: Initially, GMU had been conceived as a project by the GCC and including all GCC members. However, Oman and the UAE have, in the meantime, opted out of the project, reportedly for political reasons. While the remaining four GMU participants – Bahrain, Kuwait, Qatar, and Saudi Arabia – are understood to encourage Oman and the Emirates to return to the negotiating table, the two have declined re-entry so far.

— Time schedule: 2010 as the initial entry target for GMU was abandoned in light of delays in the preparatory work. The Monetary Council has been asked to work on a new plan for the introduction of the single currency.

The economics of GMU – pros, cons, and the need for convergence

The creation of large single monetary areas remains a controversial issue among academics and policymakers, and the difficulties in steering EMU through the debt crisis of its member states has alerted policymakers to the many challenges a monetary union can face.

The GCC has decided to pursue GMU on the basis of the economic benefits a single currency promised for the member states. Advantages typically include the elimination of transactions costs and accounting costs, the elimination of foreign-exchange risk and their associated costs, greater price and wage transparency, a more credible monetary and exchange-rate regime, and ceteris paribus lower susceptibility to speculative attacks. These benefits have to be weighed against the costs of abandoning national currencies, which mainly implies the loss of monetary autonomy as well as the direct costs preparing and managing the transition to the single currency[50]. Abandoning control over domestic monetary policy can bring substantial challenges, the greater the real economic divergence between the participating economies, the higher the market rigidities, and the more dissimilar the external shocks to the economies are expected to be.

In response to this logic, the GCC states have made economic convergence an integral part of their single market project, based on convergence criteria[51] which are largely comparable to those applied to EMU. Current economic conditions suggest that – as of today, and despite the recent economic turmoil – the GCC member states stand a fair chance of meeting these criteria.

Convergence criteria for GMU participation

— Inflation: To become part of the single GMU currency area, GCC member states have to set themselves an inflation limit of no more than 2 percentage points higher than the weighted average, based on GDP size, of the inflation rate in all GCC countries. In 2010 that average was around 2.5% which was

[50] Summaries of the economics of creating a monetary union can be found in Ahmed Al-Kholifey and Ali Alreshan, „GCC monetary union", Bank for International Settlements, IFC Bulletin No. 32, Basel, 2009, and Michael Sturm and Nikolaus Siegfried, „Regional monetary integration in the member states of the Gulf Cooperation Council", European Central Bank, Occasional Paper Series No. 31, Frankfurt, June 2005.

[51] The criteria are spelled out in Ahmed Al-Kholifey and Ali Alreshan, „GCC monetary union", Bank for International Settlements, IFC Bulletin No. 32, Basel, 2009.

missed by half of the GCC members. As proven in the past, however, it is reasonable to expect that all member states are in a position to pursue the necessary monetary policies and achieve acceptable inflation rates.

— Interest rates: The limit on interest rates has been set at no more than 2 percentage points higher than the average of the lowest three short-term interest rates among the GCC members. The calculated limit in 2010 was just over 2.6%, and was met by almost all GCC members.

— Public deficits: Similar to EMU, GMU also encompasses convergence criteria for the fiscal performance of the aspirants. For annual public deficits, the threshold has been set at no more than 3% of GDP. Given the strong fiscal performance, this limit is not an urgent concern for most oil-exporting GCC economies at this juncture.

— Public debt: The limit for central government gross debt has been set at 60% of GDP. Again, the GCC members are not expected to fail on this score, based on recent experience.

— Official reserves: In addition to the above criteria, which had already been applied in Europe's EMU, the GCC decided to ensure a certain minimum threshold for official reserves at their monetary authorities. Given the strong dependence of their economies on the US dollar, including their system of currency pegs, holding a critical volume of reserves can help promote the stability of the currency system. The minimum for foreign reserves has been set at no less than four months worth of imports. Again, the criterion has been met by most GCC economies in the past and can be considered to be within reach for the others.

Fulfilment of criteria not unrealistic

In principle, it should therefore be possible for all GCC member states, and in particular for those four currently preparing for GMU, to fulfil the criteria established for admission to a joint currency area. How important real economic convergence is for the achievement and operation of a single currency area has been underlined by the experience in Europe, for better or worse.

A single Gulf currency and its implications for financial markets

Basic elements of a single financial market 69

— Free movement: Free movement of goods, services, capital, persons.
— Regulatory and supervisory integration: Single set of financial market rules replacing national provisions, or at least far-reaching harmonisation and convergence on the basis of mutual recognition of existing national rules and home-country control of cross-border businesses.
— Institutional framework: New institutional framework for market regulation and oversight of entire single market, or at least central institutions coordinating the work of national regulators and supervisors.
— Single currency: Single currency replacing national moneys and eliminating bilateral exchange rates.

The impact of a monetary union on financial markets in the Gulf would – once it is finally achieved – be profound. The effects will originate not only from the immediate consequence of introducing a single currency, i.e. the elimination of bilateral exchange rates and the operation of a single monetary policy. They will primarily derive from the underlying efforts of creating a single financial market.

A single currency is not an end in itself. Rather, it marks the final phase of a broader campaign of economic integration, especially the integration of financial markets. Integration, in turn, is intended to facilitate trade and investment and to enable citizens to move more freely in a larger economy. The final objective of integration is a single economic and financial market, characterised by full liberalisation of the movement of goods, services, capital and people as well as the elimination of indirect barriers such as differential market regulation and ultimately also taxation. A pure single market is an ambitious goal that even the EU and the US have achieved only partially. But decisive progress on these targets is essential so citizens and companies can actually reap the benefits of economic integration, and in order to achieve the necessary economic cohesion and avoid imbalances within the single economic area which in unfavourable circumstances can destabilise a common currency.

Effects of single market on financial business

A single financial market, including a single currency, will essentially have three effects on the participating economies:

— Cost reduction and growth potential: Eliminating bilateral exchange rates and integrating financial markets promises lower transaction and hedging costs within the single market and reduces related risks and uncertainties. Trade and investment transactions become relatively cheaper, and the allocation of capital to equities, bonds, funds and other assets can be optimised. This ultimately benefits economic growth and employment.

— Stronger competition and competitiveness: The growing permeability of borders also implies that competition between financial services providers is set to intensify across the whole range. With a larger single market at their disposal, financial firms can better explost economies of scale and scope, which may result in additional downward impulses on prices for financial services, and can lead to growth in the size of financial institutions in the region. It may also lead to the spread of a larger number of financial products for which previously sufficient market size had not been achievable. With larger product markets and more economically-sized financial institutions, participants in the single market also stand a chance of competing in the wider regional and the global financial market places.

— Better financial oversight: Assuming an adequate framework of institutions and processes is established, a single financial market can also facilitate regulation and oversight. National regulators and supervisors are finding it increasingly hard to track the activities of their markets as business operations have become increasingly international in past decades while systemic shocks abroad spill over more easily and faster into domestic markets. Creating a single financial market with a strong oversight infrastructure helps strengthen regulatory and supervisory capacities and eliminate regulatory arbitrage in the single market.

Promising benefits suggest GCC should move ahead

Financial market integration has been a declared objective as part of the 2003 GCC Common Market initiative, and more concretely of the 2009 MAU, which specifically calls for the adoption of uniform banking legislation and common rules in the field of banking supervision, as well as the provision of an integrated infrastructure for payments and securities. These are important plans towards the final goal of a single market and the basic elements such a market requires[52]. The benefits of going down this road are promising, but policymakers and markets should be realistic that this ambitious plan deserves sufficient time, thorough preparation, and can benefit from learning from the experiences made recently in EMU.

Steffen Kern

[52] See textbox 69.

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