The Rising Influence of the Gulf region in Global Finance and Business

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Summary

- This article examines the positioning of the Gulf region in the global economy, including the support provided in the present global crisis by savings put aside from the recent energy boom and future strategic development in the services sector, especially in finance and wealth management.

- The effects of the global recession are heavily constraining growth in the Gulf region, exacerbated by the exceptionally sharp drop in oil prices. The Gulf financial sector’s high local deposit base and focus on asset management rather than fully liberalised Western style investment banking was hoped to protect it from the worst of the financial crisis – but the impact is still serious.

- However non-energy sectors in the region may be quick to benefit from a widely expected increase in commodity prices. Development of the financial services industry will continue to be strongly supported as this is seen as a key strategic sector for future development and jobs. The Gulf Cooperation Council (GCC) free trade zone is also becoming increasingly similar to a monetary union given currency near-parity and negotiations towards a central bank.

- The region benefits partly from strong pre-recession economic conditions matching high growth with high per capita GDP; and partly from cautious government fiscal policies matching conservative growth forecasts with saving oil revenues into sovereign wealth funds thus allowing them to weather major drops in energy revenues without making significant adjustments to spending plans.

- Investment in financial sector development and growth will continue to be a priority for the GCC states. This sector still represents a significant opportunity to generate more and better jobs in the long run, especially for younger generations coming through the education and training system.
Introduction: Economic growth in the Gulf states such as the UAE and Bahrain have worldwide attracted attention in recent years with a burgeoning service sector to complement their considerable oil revenues. However many ask whether the current recession will stem this, or whether they are in a position to establish a successful wholesale as well as retail financial services sector. In this second article in our international series of Thinkpieces by Chatham House, Vanessa Rossi and Ruth Davis examine the positioning of the Gulf region in the global economy, including the support provided in the present global crisis by savings put aside from the recent energy boom and future strategic development in the services sector, especially in finance and wealth management.

How is the Gulf region placed in terms of its significance in the global economy and finance? The six individual states that make up the GCC\(^1\) are relatively small but, as a bloc, they represent an important force not only in global energy markets but also in terms of economic activity, trade and finance, ranking in the top ten global economies.

Although there will be serious adverse impacts from the global crisis in 2009, GDP for the six GCC states combined probably reached well over 1 trillion dollars in 2008 with public sector financial wealth in excess of $2 trillion (mostly in the form of Sovereign Wealth Funds, SWFs) in addition to undisclosed levels of private wealth. Around half of GDP is generated by the non-energy sector where growth has more or less kept pace with the rapid gains seen in energy-related business. Even with oil prices a long way below the 2008 peak, driven down by the global crisis, the region is one of the wealthiest in the world, especially including wealth held in the form of energy reserves “below ground” as well as financial wealth “above ground”. Given this substantial backing, the GCC bloc may already be classified amongst the top ten financial centres in the world.

Impact of the global recession

The Gulf states have not been immune from the global recession…

Undoubtedly growth in the Gulf is currently being heavily constrained by the effects of the recession ravaging the world economy, including the exceptionally sharp drop in oil prices.

…and 2008 saw the first bank run in the region’s history…

The Gulf financial sector’s high local deposit base and focus on asset management rather than fully liberalised Western style investment banking was hoped to protect it from the worst of the financial crisis – but the impact is still serious. The Gulf banking sector is unusual in that it has substantial foreign assets (investments abroad) and liabilities (fund inflows from abroad - such as loans from foreign banks) in its balance sheet - using foreign banks as intermediaries. This large two-way exposure has been hit on both sides by the crisis. Local banks have suffered losses worth tens of billions of dollars and Gulf Bank experienced a bank run in October 2008, thought to be the first time this has happened in the region. The Gulf authorities have been injecting liquidity into the system; for instance, Qatar’s sovereign wealth fund has taken 10-20 per cent stakes in local banks. The drying up of international credit is having an effect especially in Dubai, where Western banks have typically been key players in financing property development. International banks have scaled back on staff and operations in the region.

…meanwhile their burgeoning construction industry has suffered from the global property slowdown.

The property and construction sectors have entered into a slowdown as the extraordinarily prolonged rise in property prices has clearly come to an end. There are doubts whether all of the new and planned developments can be absorbed and even trophy projects are experiencing delays such as the Al Burj, the world’s tallest building, and the Nakheel Harbour and Towers in Dubai. Major real estate players in Dubai and Abu Dhabi will be bailed out by the government, although the smaller unlisted developers might not fare so well. But the important question is whether the

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\(^1\) The Gulf Cooperation Council (GCC) was set up in 1981, with six founding member countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). The Yemen is seeking to join as well. The organisation’s primary objective is to achieve “coordination, integration and inter-connection between Member States in all fields in order to achieve unity between them”. An Economic Agreement was formed in 2001 with a GCC customs union coming into force in 2003 and the GCC common market being established in 2008.
Looking ahead to a global economic recovery, commodity prices are widely expected to pick up sharply and other non-energy sectors of the Gulf economies will also be quick to benefit. Development of the financial services industry will continue to be strongly supported as this is seen as a key strategic sector for future development and jobs, complementing the position of the region in terms of wealth and project management, trade and tourism, property development and international business management.

The GCC bloc: close economic cooperation, moving towards monetary union

Why should we view this region as a bloc rather than as a set of independent economies? This is partly due to the common characteristics of the states and their economic trends but also because of the agreements that have been reached on the formation of an economic union and moves towards adopting a single currency. The GCC is a free trade zone not dissimilar in style to the European Union in its early years, before enlargement and the advent of the euro. While there is not yet a common currency among member states, there are virtually fixed parities due to exchange rates being pegged to the U.S. dollar, which also implies interest rate settings in the region tend to follow a common path – albeit one that currently tracks the US. This system is therefore already close to a common monetary policy, which suggests that transition to a full monetary union could be relatively smooth once the necessary institutional arrangements are in place.

Negotiations are already well advanced in terms of setting up common monetary institutions, such as a central bank (fixing upon the bank’s location may prove contentious), with the aim of achieving a single currency regime. The original timetable for the single currency is 2010, although this may slip; in the more distant future this currency may be allowed to float freely on international markets. This last step remains difficult and the subject of much debate both in the region and abroad. As discussions over the last couple of years have made clear, the region does not intend to be “bounced” into a hasty move towards either currency union or to floating the individual exchange rates. Only Kuwait has tested out a limited managed float. Indeed, having resisted considerable pressure to move to floating rates in early 2008, when inflation was seen as a serious threat in part linked to a weak US dollar, the GCC states must have been relieved in late 2008 that they had stuck with the pegs. In the midst of a major global crisis, with oil prices crashing, the impact on Gulf exchange rates would have been harsh and with unknown, possibly disastrous, consequences. Indeed, the region is already facing a considerable challenge as energy revenues swing from boom to bust and any additional instability could have made coping with this present crisis even more difficult.

The GCC economy: coping with huge cycles in energy markets?

Up until the crash in commodity prices in late 2008, soaring energy revenues were clearly stoking an enormous economic boom across the Gulf region. The energy windfall meant that the GCC’s GDP roughly tripled over the period 2002-2008, from around $330-340bn at oil prices of $20-30 per barrel to an estimated $1-$1.2 trillion in 2008 as oil prices soared to a peak of nearly $150 at mid-year before starting to pull back sharply. Total export revenues soared from $180bn in 2002 to an estimated $750-800bn for 2008 (with as much as $550-600billion from oil and gas exports alone).

Over this boom period, real GDP growth averaged 6-7%, only slightly below Asia’s rapid pace and well ahead of not only the US and EU but also other emerging market regions such as Latin America. At current prices, arguably a better measure of growth in energy economies, national income has actually been increasing at rates of 15-20% per annum, broadly in line with high growth China. Given the

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2 Kuwait modified its fixed peg regime to a managed float in 2007 but has allowed only a relatively small adjustment in parities to take place.
GDP growth was in line with countries like China, whilst average GDP per head in the region reached nearly Spain/Hong Kong levels.

region’s small population, this means that GDP/capita for the GCC averaged around $25,000 in 2008, less than the $40,000-45,000 average for countries such as the US, UK and Germany but not much below Hong Kong and Spain. This is well above emerging market rates of less than $10,000-12,000 (for example, China’s GDP/capita is as low as $2,500, India around $1,000). Qatar has been a particularly strong performer in the GCC, with real GDP growth hitting double digit peaks as new gas export facilities have come on stream. GDP/capita in Qatar is now one of the highest in the world, around $100,000.

The strong performance of the GCC versus other leading economies can be seen in the bubble chart (Figure 1) which positions the GCC in the high growth range but with GDP/capita fast approaching the levels enjoyed by the EU and US. The scale of the bubble shows the relative size of population and ultimately the dominance of China and India in the world economy in the long run. Clearly, on this measure, the GCC bloc is very small but this highlights why it is so important for such a wealthy region to focus on creating more jobs in skilled professional and services activities, including financial services.

The recession will dent this performance, but the crisis will mitigated by three factors

1) cautious government estimates of GDP growth in their budget assumptions

Firstly, governments have tended to be very cautious in terms of budget assumptions and spending plans, for example, basing estimates of energy revenues on oil prices below actual market rates. In spite of gradual increases in spending, fiscal policy has remained very conservative and as much as half of the oil windfall has been saved into SWFs (or used to reduce debts built up during the low oil price years, for example in Saudi Arabia). As governments have been “under spending” their revenues in the boom years, this means they can weather a large drop in energy revenues without making significant adjustments to spending plans, indeed they may even be able to spend more. The “break even” oil price for budgets is widely believed to be $50-60 per barrel, possibly a little higher, as indicated by the market view that Saudi Arabia would like a reference rate for oil of $70-80. The impact of the fall in energy revenues will mostly be felt in terms of reduced savings (into SWFs and FX reserves) and a lower trade surplus.

2) the jobs most affected by the recession have been filled by immigrant workers (80% of the Gulf’s total workforce)…

Secondly, local employment, incomes and spending may be less affected by the swing in oil revenues than many expect. During the boom years between 2002 and 2008, many new jobs were created in the private sector. However, immigrant numbers also surged: out of a total population of about 40 million in 2007-2008, some 16 million were estimated to be immigrants, making up a large part of the Gulf’s total workforce of about 20 million. These figures demonstrate that growth can...
...whereas the local population remains in the more stable public sector. Finally…

3) governments have stockpiled savings from the boom years which they could draw on to fund counter-recession policies.

create many more jobs, from construction labour to professional services, although more of the local population needs to be attracted into these private sector employment opportunities in the future. While the small gains in local employment may seem a negative factor, it does imply a limited impact from the present downturn on residents’ jobs, which remain predominately in the more stable public sector. This will cushion local incomes and spending from the full impact of the recession, although the effect on migrants and their home countries could be severe.

Lastly, governments could draw on the stockpile of savings accumulated during the boom years to fund additional fiscal expansion to support the economy during the global crisis. The use of SWF funds for the purpose of supporting crisis-related economic programmes may be justified by the expected profile for energy prices: most forecasters expect there to be a strong rebound in prices as soon as global sentiment improves and expectations start to gear up towards an economic recovery. In this case, government “borrowing” from SWFs should be temporary and could be paid back once energy revenues pick up again.

**SWFs now at risk: Will this affect the Gulf’s status as a financial power?**

The region’s savings in the form of SWFs have suffered in the economic downturn…

Having built up formidable holdings over a very short time span, SWFs are now under pressure for three reasons:

- losses linked to the slump in global asset prices
- reduced inflows of new cash as large savings surpluses fall back along with oil prices; and
- as we highlighted above, the understandable temptation to dip into SWF funds to provide fiscal support in the face of the exceptional global recession.

While investments in government bonds did well in 2008, benefiting FX reserves held by central banks, SWFs were much more exposed to the most turbulent equity investments. Equity prices have plummeted around the world and some $20-30 trillion was wiped off the value of global equities from January to December 2008. Market performance was disastrous, with declines of around 50% and little discrimination across markets worldwide.

While losses in asset values may have been offset by the high levels of savings still flowing into SWFs in 2008, thanks largely to high energy prices persisting up to the autumn, the situation in 2009 implies less scope for any additional cash flow into these funds. Indeed, cash strapped governments, hit by the steep drop in energy-related revenues, may even tap into savings surpluses to fund spending and counter-recession policies. So prospects for the value of SWFs in 2009 are flat at best.

**Figures 3 and 4: SWF inflows are the “cream” on the top of energy revenues**

...meaning that the value of savings in them will be reduced considerably.
Given the lower level of oil revenues expected in the next few years, scenarios for future SWF values have changed markedly compared with projections made just a year ago. Pre-crash forecasts now look far too high, for example, Morgan Stanley predicted SWFs assets to be worth $12 trillion by 2015 (the revised estimate made in November 2008 was $9.7 trillion) while Merrill Lynch predicted $8 trillion by 2011.

Post crash, SWFs look more likely to reach just $6 to 7 trillion by 2012 – and could possibly stabilise at only $3 to 3.5 trillion if the economic recovery is protracted, leaving oil prices stuck in the $30-50 range. To resume growth, SWFs will need oil prices to be above governments’ break even budgets: in view of the need to sustain economies through the recession, savings may not restart until oil prices are once more above the $60-70 range. However, once a recovery gets firmly underway, the governments’ savings flows together with rising asset prices, should rapidly restore growth in SWFs.

Figure 5 and 6: SWF projections set to fall in wake of crisis and collapse in oil prices

The economic recovery will bring a pick-up in Asia-Middle East growth, higher energy demand and prices

By 2010-2011, a recovery should begin to emerge, promoting yet another round of high growth across the emerging market world. The upturn will probably be led by the twin forces of the US and Asia, stimulating energy demand and prices. Commodity prices are likely to pick up very sharply from the present trough in response to the first signs of recovery in the global economy. Indeed, once a firm upturn in demand gets underway, energy prices may possibly have to return to their 2008 peaks, or beyond, if there are only limited opportunities for further supply expansion (for example, if the “peak oil” theory proves to be correct).

Growth in financial sector will remain a target in the Gulf

Financial sector investment will remain a priority for Gulf states. Governments in the Gulf and elsewhere are under pressure to create jobs for local younger people entering the workforce…

…and this might also be a favoured sector for that

Their recovery will depend largely on what oil prices do.
The key for new sector development is a steady flow of workers up the professional skills ladder... while still creating broad-based job opportunities suited to the local workforce at various skill levels.

Financial sectors also require other professional services as well as other services many of which have already been developed in the Gulf states...

A mass retail financial services market will also grow as household living standards improve.

The key to succeeding in the initial stages of new-sector development is to move just enough of the workforce up the professional skills ladder to enable viable businesses to start up in the high-value-added sectors, leaving others to follow by on-the-job training and through expansion in the next generation. The explosion of foreign international firms in the region has acted as a catalyst in this respect. Expatriate experts are helping provide a rapid boost to skill levels and on-the-job training. Within the Gulf states, large numbers of expatriate staff have been employed with the intention of achieving rapid development of the economy, and these staff tend to rapidly switch jobs, facilitating the transfer of skills and best-practice. Past experience (e.g. in the oil sector) also indicates that on-the-job training for local staff does work over time, creating longer-term career opportunities for the domestic population. The strategy in the Gulf region needs to focus on moving the economy up the skills and income ladder while still creating broad-based job opportunities suited to the local workforce at various skill levels. Indeed, service-sector industries, such as finance and related professional services can provide a range of jobs from the relatively basic level to the very sophisticated.

While relatively few people are employed directly within the narrow range of international financial market operations, the industry requires physical and technological infrastructure (bringing in construction and IT projects and services), ultra-modern communications, accounting and legal professional services, hotels, restaurants, and travel – to name just some of the spin-off activities. Popular rough estimates suggest that every job in the financial sector generates two or three more in other related industries. The potential in the financial sector and related services in the GCC may be to create as many as one million extra jobs over the long run. And improved local skills may also mean that expatriate staff can be replaced gradually, raising the potential number of extra jobs for residents to perhaps 1.5–2 million over the next decade. This would go a long way to meeting job targets for the GCC.

Of course, apart from creating more interesting jobs over the next decade, the financial services industry is valued for other reasons. It is a necessary complement to other activities in the economy, with a powerful function especially in a region with such high levels of both private and “sovereign” wealth as well as substantial international business operations, a large travel and tourism sector, property development and project management. Demand for a wide spread of financial services will also grow rapidly amongst households as incomes and living standards accelerate to European levels.

Clearly this expected rise in energy prices, and demand, in the future also provides a strong underpinning for the view that the halt to growth and development in the Gulf region will be short-lived. The region should be an early beneficiary of any signs of the global economy and energy demand firing up again.

If you have any questions or comments about this publication, please contact the CII Policy & Public Affairs team on 020 7417 4783 or thinkpiece@cii.co.uk

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