Finance in the GCC: Policy and Developments Overview

by Rachel Ziemba, Theme Editor

Broadening and deepening local financial markets is a precondition and facilitator of the economic diversification plans underway in the Gulf Cooperation Council (GCC) countries. Deepening and broadening access to capital markets, debt, equity, bank and non-bank finance are a critical part of employment plans and local economic diversification, which are the top political and economic priorities across the GCC. Not only are financial institutions an important source of potential employment as part of service sector development, but they can provide important capital to new projects, either by channeling foreign funds or considerable local savings to new platforms. There are important challenges ahead: ensuring adequate access to capital (especially to underrepresented groups), regional competition, gaps in the assessment of credit and other risks and governance issues. This issue of *Gulf Affairs* highlights the experience to date, lessons learned from practitioners, academics and policymakers involved in analyzing and shaping regional capital markets to meet these critical political economy goals.

The financial development of regional capital markets, bank and non-bank financial institutions, Islamic and conventional, public and private sources of finance has been underway for many decades. After all, the region is home to the world's oldest sovereign wealth fund (Kuwait's Investment office was launched in 1953), some of the world's largest pools of capital (ADIA, KIA, and QIA regularly rank in the top 5 of global sovereign funds), and the locus of significant financial hubs (UAE).

However, in 2019, financial development seems to be switching gears to different extents across the region—either speeding up or recalibrating. Policy is kicking up a notch across some markets, notably Saudi Arabia, with its existential focus on job creation, is now open for portfolio investment. Policies seem to be shifting to a new, lower, but steadier gear in some of the well-developed and perhaps overbanked regions such as the UAE and Qatar—here focus is shifting to leveraging new markets, while trying to absorb past oversupplies. In others, including Bahrain and Oman, the financial sector is trying to avoid the risk of government-led borrowing which could crowd out local developments. Across the GCC, economic policy changes have sped up their entrance into global equity and debt markets. Saudi Arabia has followed the UAE and Qatar into the EM equity indices.

This edition of *Gulf Affairs* thus comes at a critical time to assess these new gears and the interconnections between the financial sectors of the GCC nations and those outside of the region. Our contributors survey the changes in the GCC financial markets, their links with the macro and social goals and their ability to foster new sectors including renewable energy or provide capital to underrepresented groups including women and migrants. Opportunities in Islamic finance, for example, provide an opportunity for differentiation across the GCC and allow institutions to take advantage of a growing interest in environmental, social and governance (ESG) investment around the globe. Investing with burden and risk sharing, with interests aligned has been shown to outperform (and especially minimize losses). With global returns in public markets set to be lower over the next few years, assessing these risks and avoiding principle-agent problems will be key to financial and economic goals.

The last few years have brought a shift in the direction and focus of GCC finance especially regarding portfolio inflows. Rather than just being a major supplier of capital abroad (over $3 trillion in government-owned assets abroad in central banks and sovereign wealth funds), now GCC sovereigns are all major borrowers. This shift partly reflects lower savings due to lower oil prices and higher domestic demand.

But it also reflects a policy shift to better target these revenues. The shift has been most extensive in Saudi Arabia or in countries that produce relatively little oil revenue per person like Oman or Bahrain.

The focus on attracting more local and foreign private capital to support economic goals brings challenges and opportunities, including new investors who are less familiar with the region. In 2018, the GCC accounted for over 25% of global USD denominated EM/Frontier sovereign bond issues (Egypt and other MENA countries take the tally to 40%). Several GCC countries recently entered global bond indices, while Saudi Arabia has followed some of its neighbors into the global equity indices. These trends can increase the region's exposure to global financial catalysts through channels other than oil prices and raises political and governance questions. For now the bulk of inflows have come from portfolio investors. Attracting more than just index-weighted flows will require a clear and compelling macro story, more transparency and governance.

Even some of the region's global investors are becoming more focused on local development goals. The largest sovereign wealth funds in the region—those of Abu Dhabi, Kuwait and Qatar continue to be sizeable players abroad, and have now been joined by a large activist fund from Saudi Arabia, the Public Investment Fund (PIF), which takes a more extensive role in investing for development at home and abroad. While development funds are not new—Abu Dhabi's Mubadala has been around for more than a decade, and most GCC countries had some local development investment vehicle—the shift in capital allocation has been geared towards local development projects, including investment in regional and international projects which are aligned with domestic economic development goals. Examples include Saudi Arabia's PIF whose global investments in technology and infrastructure are consistent with domestic economic development goals. Past efforts can provide cautionary tales.

With some of these funds taking on debt in order to finance these projects—either because it is routine for the sector (property, project finance, private equity) or because investment and development plans are so extensive that debt is preferred to drawing down sovereign assets—there are new questions of accountability and access, many of which have yet to be clarified: Will the governments alone be responsible for repaying the debt? What will be the return on capital? Who decides on what projects are to be funded?

The region has long been an active market for project finance and funding for state-led and public private partnerships, helping finance extensive property development and infrastructure. However local needs and global focus on private markets are creating new opportunities. Meanwhile concerns about governance (after some corporate governance scandals including the Saad-Gosaibi and Abraaj cases) have created a greater push for transparency and alignment among local investors, asset managers and other stakeholders.

One challenge that emerges from the region is increased competition—a plethora of banks, international financial centers and local capital markets. While competition is not the only factor limiting local liquidity and trading volume, it is unlikely to help. Greater coordination and expanding access will be key to future development, not just of capital markets, but also to make progress towards economic and political goals.

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