The Gulf as a Global Financial Centre

Growing Opportunities and International Influence

A Chatham House Report

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Chatham House
10 St James's Square
London, SW1Y 4LE
T: +44 (0) 20 7957 5700
F: +44 (0) 20 7957 5710
www.chathamhouse.org.uk

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Preface

This report examines the prospects for the Gulf Cooperation Council (GCC) economies and the potential development of the region as a Global Financial Centre (GFC) over the next decade, focusing primarily on the economic underpinning, current standing of the financial sector and the region's potential to overcome existing weaknesses in terms of product offering and the scale of operations.

The GCC's global economic status is impressive, yet remarkably for economies of such high standing, they are typically still treated as 'developing countries', for example in the IMF classifications. So far, none of these countries has joined the OECD and there is notably no representation at the world's top table, the G8 summits. However, the continued development of the region's economic and financial power suggests an urgent need for this status to be reviewed by all parties and new channels of communications, discussion and influence to be opened up. This review should also acknowledge the importance of Gulf finance and the aspirations for development of the region's financial sectors.

The report is organized in three sections:

- Section 1 examines the development and current status of the GCC economies, the rationale for diversification into financial services and the possible risks to future growth.
- Section 2 reviews the current standing of the GCC financial centres, their shortcomings and the potential for progression up the rankings to the top tier.
- Section 3 considers the spread of financial products and activities and the scope for improving this coverage, ultimately to complete the necessary range and depth of business across all the major areas of securities trading and origination.

Chatham House undertook this study in conjunction with the leading financial centres in the Gulf region, namely Bahrain, Dubai and Qatar. The project forms part of the cooperation effort across these centres and reflects their joint efforts to foster further progress in the area of finance and development. The report focuses on issues pertinent to the economic renaissance of the region, rather than examining the political dimension. The views expressed in this report remain those of the Chatham House authors.

Executive summary

Ambition is high. Just a few years ago, the claim that the Gulf represented an important financial centre, let alone an aspiring Global Financial Centre (GFC), would have been seen as optimistic. However, it should be recalled that in the late 1990s, and even up until 2003, few analysts expected oil prices to move above the $20–30 range – yet by early 2008 oil was trading well above $100 and rising. The GCC economies have approximately tripled in size in just five years and their combined GDP will be well above $1 trillion in 2008, while their external financial wealth in the form of sovereign wealth funds (SWFs) and foreign exchange reserves alone is more than double this figure. These trends are not, of course, uncorrelated. Nevertheless, it is easy to see the region's comparative advantage from the swing in oil prices, whereas the scope for developing a significant advantage in global finance remains tentative. To develop and mature, the Global Financial Centre concept will require considerable effort and nurturing, chiefly by GCC governments, banks and fund managers but including cooperative ventures with leading GFCs and financial services companies.

The main conclusions and recommendations of this report focus on four key areas: the development of the GCC 'brand', the scope to leverage the GCC position to improve visibility and credibility in financial markets, the potential to address debt market development within the context of global asset imbalances, and the benefits of GCC cooperation in areas such as regulation, supervision and training.

Each of these four points can be summarized as follows:

The GCC 'brand':

- The GCC 'brand' has been very successful in promoting the visibility and image of the region and should be actively pursued to further enhance market power and credibility.
- Economic growth and wealth creation will continue to provide the big punch behind the 'brand' – as oil prices soar well above $100 per barrel, the GCC may surpass Japan to become the world's fourth largest exporter after the EU, US and China. Regional GDP will comfortably exceed the $1 trillion mark in 2008, moving the GCC further up the top 10 in terms global GDP rankings. The GCC states must coordinate efforts to highlight and leverage the region's strong position in the global economy.
- The tendency for observers to view the GCC as a 'developing economy' is misleading and this also needs to be corrected more aggressively by the states. This tends to occur because the GCC is often grouped within MENA (Middle East and North Africa), none of the individual countries belongs to the OECD and there is no GCC seat at the G8 or similar summits; moreover, the GCC does not fit within the IMF's definition of 'industrialized countries' and hence is placed in the 'developing country' group. However, the GCC's average GDP/capita is now almost on a par with many developed economies such as Spain – even excluding the energy sector, non-energy GDP/capita is well above emerging-market levels.
- Policy-makers should avoid ad hoc experimentation in terms of policies that could endanger growth and the 'brand' – for example, any changes in the exchange rate system should be carefully coordinated to enhance confidence and avoid potential confusion and volatility in regional cross rates which might be both distracting and damaging to the image of GCC cohesion. The move to a common currency would avoid such pitfalls and offer a significant boost to financial-market activity.

Leveraging the GCC ranking in financial markets:

- Using the GCC's economic power and 'brand' as an umbrella should enable the region's financial centres to move more quickly up the IFC rankings according to a number of measures, including economic status as well as survey evidence.

- In principle, the GCC's position in the world economy indicates there is scope for it to reach the top rankings of IFCs, certainly as a regional player but potentially as a GFC – a large economic power base is a necessary, but not a sufficient, condition for such success. In principle, the GCC could overtake both Australia and a weakened Tokyo in the IFC rankings over the next decade.
- Key to reaching and sustaining a high rank will be international cooperation and the fostering of franchises in areas such as fund management, foreign exchange (FX) and securities trading, management of IPOs, M&A deals and innovation.

Debt market development:

- A critically important development to meet both investor needs and the GCC's financial market aspirations would be the creation of a larger, deeper debt market, whether based on Western-style bonds or the Sharia model, building on the region's strength in Islamic finance. This will require a radical departure for the GCC authorities in terms of how they view the role of government debt and project finance, its potential in promulgating activity and broadening the base of the financial sector and asset management activities.
- If successful, this move could open up a much larger role for the GCC in global debt markets, especially across the Middle East and Asia. This would be sufficient to provide a massive 'hinterland' within which the GCC's financial markets could operate, allowing them to succeed in achieving the target of becoming a GFC. It is a grandiose vision but would also help the global community to meet the task of coping better with the surge in wealth from the new growth areas of the world economy. It would provide a means of channelling more of these funds back into the development needs of economies across the whole of the MENA and Asia region as well as boosting the GCC's position as a key hub in global financial markets. Tentative steps in this direction are already emerging but need to accelerate.

GCC cooperation:

- To reach the top rankings of GFCs requires the financial sector to move up the skills curve and into higher value-added activities – and weaknesses in regulatory and supervisory systems, human capital and the socio-political arena need to be addressed. In this sphere, there is considerable scope for further 'soft' and 'hard' cooperative efforts across the GCC and also in association with organizations in London, Europe, Asia and the US, building on existing successful relationships. Such cooperation builds confidence and connectivity. It also serves to improve efficiency by reducing costs, duplication and potential mismatches in systems as well as advancing the GCC 'brand' image.

The Gulf Cooperation Council (GCC) – a brief overview

The Gulf Cooperation Council (GCC) was set up in 1981, with six founding member countries – Bahrain, Kuwait, Oman, Qatar, the United Arab Emirates (UAE)[1] and Saudi Arabia. Yemen is seeking to join as well. The organization's primary objective is to achieve 'coordination, integration and inter-connection between Member States in all fields in order to achieve unity between them'.[2] Although the six GCC members (to which the term 'Gulf' tends to be applied) are a heterogeneous set of independent countries and jurisdictions, they have a strong sense of common purpose and a mutual benefit in promoting an image of solidarity.

The context in which the alliance formed was one of regional strife and insecurity – the Islamic Revolution in Iran, war between Iran and Iraq, as well as volatility in the oil market. The GCC fulfilled a need for mutual reassurance, standing for collective defence from external threats. Despite the emphasis on unity there are inevitably some internal divisions and rivalries within the organization which impede decisive collective action. One area of dispute has been the region's dependency on the US for defence and, more generally, its close relationship with the US.

The GCC's defining ethos has shifted over time. As regional security improved and oil revenues increased, economic priorities came to the fore and replaced previous military concerns. In 2001, a new Economic Agreement was formed, to update and revise initial arrangements made in 1981. The Agreement posits that the GCC should deal with economic affairs 'in a collective fashion', in order to secure better terms in international economic and trading relationships.[3] The GCC customs union came into force in 2003 and the GCC common market was established on 1 January 2008. The GCC is not as tightly knit as the EU but this is a relatively close proxy; within the GCC borders are fluid and GCC nationals can enter any of the other states without needing a visa.

As a regional bloc, the economy is relatively important in the world rankings. With a total of just over 36 million inhabitants (around 24 million excluding migrants), and GDP of nearly $1 trillion dollars in 2007, this put GDP/capita at just over $22,000. Around half of this is generated by the non-energy sector where growth has more or less kept pace with the rapid gains seen in energy-related GDP.

The GCC states have maintained their own national currencies although these have virtually fixed parities as all the units have been pegged to the US dollar (with the recent exception of Kuwait, which broke ranks and adopted a limited basket float in March 2007).

Country	Currency	Rate against US$*, end April 2008
Bahrain	Bahraini Dinar (BHD)	2.66
Kuwait	Kuwaiti Dinar (KWD)	3.77**
Oman	Rial (OMR)	2.60
Qatar	Riyal (QAR)	0.27
Saudi Arabia	Riyal (SAR)	0.27
UAE	Dirham	0.27

* US dollars per local currency unit reported here.
** The only basket float, the KWD, was trading at 3.45 in April 2007.

However, there is a stated aim to develop a new common currency – possibly to be called the Khaleeji. This could have a sizeable positive impact, especially on the development of the financial-services sector, as markets and investment flows would become seamless and there would be expanded activity in the single currency versus other global units. While it is not clear whether such a move would mean a free float against other world currencies, the GCC are being urged to move to such a system.[4] In March 2008, the UAE Central Bank set up a committee to look into the option of revaluation or depegging. However, the UAE has also suggested that it would only revalue as part of a harmonized regional move – unilateral changes could be undesirable and a threat to regional cohesion. In addition, contrasting with opinion in favour of floating rates and the move of Kuwait to test out a limited float, a recent IMF report expressed the view that the dollar peg arrangement has worked well for Bahrain and should be maintained, certainly until full currency union.[5]

The 2001 Economic Agreement acknowledged that the move to a single currency would require 'a high level of harmonization' in fiscal and monetary policy between member states. However, in terms of the region's ability to adjust to asymmetric shocks and adapt to the convergence process, this should be much easier than it was in the Eurozone because the GCC area is much more homogeneous and structurally similar.[6] Many observers viewed the original deadline of 2010 for a single currency as over-ambitious and unlikely to be met. This view was officially confirmed at the Doha meeting of GCC central bankers in June 2008, although the simultaneous announcement of the setting up of a Monetary Council was seen as a positive step towards the eventual creation of a single Central Bank. The statement also confirmed that there would be 'common monetary institutions' before 2010.

There is much optimism in the region about the potential of this new GCC currency, with high hopes of its eventually becoming one of the leading currencies in the world along with the dollar and the euro.

1 The UAE is composed of seven emirates: Abu Dhabi, Ajman, Dubai, Fujairah, Ras al-Khaimah, Sharjah, and Umm al-Quwain.

2 The Cooperation Council for the Arab states of the Gulf Charter: http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=1.

3 The Economic Agreement between the GCC States 2001; see Cooperation Council for the Arab States of the Gulf website: http://library.gcc-sg.org/English/Books/econagree2004.htm.

4 Former Federal Reserve chairman Alan Greenspan added his weight to the argument by recommending, at a conference in Abu Dhabi on 25 February 2008, that the GCC states depegged from the dollar.

5 IMF, *2007 Article IV Consultation with the Kingdom of Bahrain* (2008).

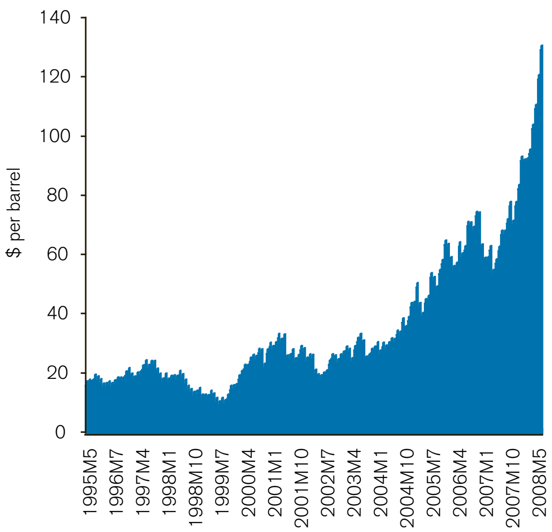
6 Daniel Hanna, *A New Fiscal Framework for GCC Countries Ahead of Monetary Union*, Chatham House Briefing Paper, IEP BP 06/02, May 2006.

1. The GCC economy: the current boom and future prospects

Soaring energy prices and export revenues have been the key drivers of the boom across all the energy-producing economies over the last five years. Oil prices shot up from under $30 per barrel at the start of 2003 to near $100 at the end of 2007 and were trading at $130 by May 2008. With little sign of a cooling off in this trend in mid-2008, analysts are talking about oil reaching $150–200 before it peaks. Even prospects of a recession in the US and a sharp slowdown in the major European economies are having little impact. Oil demand and energy markets in general are being pressured instead by still buoyant economic growth across the emerging markets, chiefly China and India, and expectations of further increases in their oil consumption. In contrast, supply has grown very slowly. This has led to reduced spare capacity, especially if 'oil at risk'[1] is deducted from available supply. Most observers see the market remaining tight with little new supply coming on stream. Gas and coal prices have also risen rapidly, along with a range of commodity prices, including foods. Windfall gains from the commodity boom have fed into government budgets and wealth funds as well as into private-sector spending and wealth.

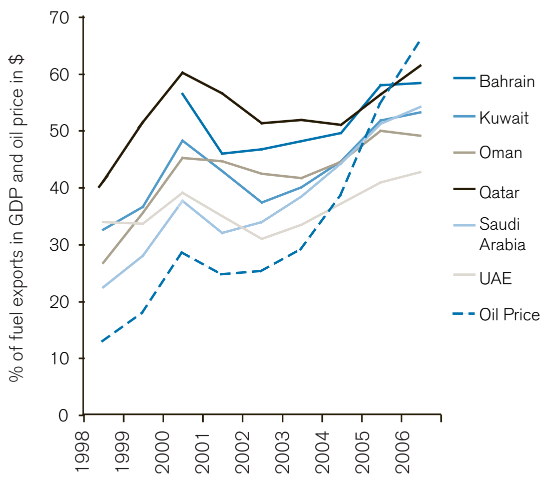
The Gulf region has been a prime beneficiary of this boom. The GCC still generates a large proportion of its GDP from oil and gas production – indeed the very steep rise in oil and gas prices means that the share of energy revenues in GDP at current prices has inevitably risen. Although most countries are successfully diversifying their economies, on average about half of the GCC's GDP is based on energy export revenues,[2] possibly more if related products such as petrochemicals and domestic sales are included. This share was just over a third in 1997–99 when oil prices were weak. However, Dubai's oil economy is very small as most of the UAE's oil reserves are in Abu Dhabi.[3]

Figure 1: Brent oil price, 1995–2008



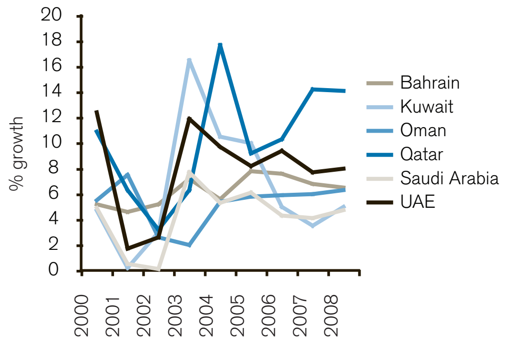
Source: IMF.

Figure 2: GCC fuel exports as % of GDP, versus the $ price of oil, 1998–2006



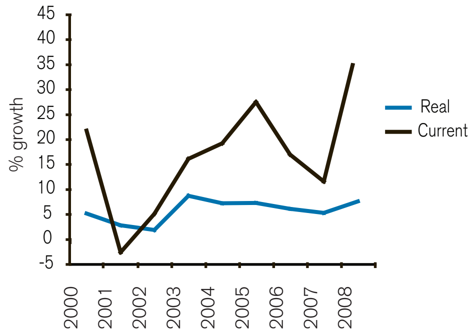
Sources: IMF, WTO, own calculations.

Figure 3: Real GDP growth rates across the GCC countries, 2000–08



Sources: IMF, own estimates.

Figure 4: GCC aggregate GDP growth in real and current $ terms



Sources: IMF, own estimates.

The oil and gas sectors have been able to support high GDP growth across the GCC over the last five years, raising local investment, incomes and consumer spending. Real GDP growth has averaged 6–7% per annum, only slightly below Asia's rapid pace. Indeed, in current dollar terms, GDP has actually increased at rates of 15–20% per annum, broadly in line with the high growth in China; and 2008 growth is likely to be above 35% given the surge in oil prices.

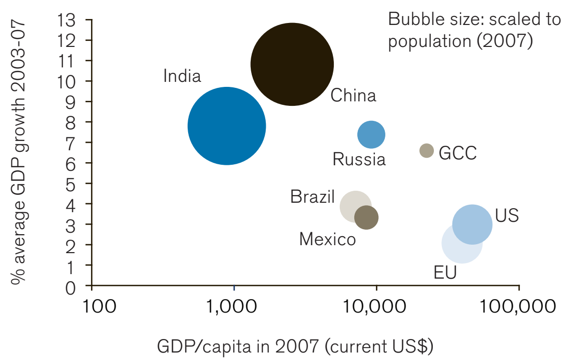
Average GDP/capita in the GCC was over $22,000 in 2007 and looks set to rise to $30,000 in 2008. This is less than the $45,000 average for countries such as the US, UK and Germany but not much below Hong Kong and Spain; it is slightly higher than South Korea and way above emerging-market rates of less than $10,000–12,000 (Russia's GDP/capita was around $9,000 in 2007 while China's GDP/capita is as low as $2,500). 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 the highest in the region at $70,000, not far below Norway and Luxembourg (the top ranked in the world) and similar to high-flyer Ireland. However, perhaps because of the difficulties experienced by international institutions in placing these economies in their classification systems, the IMF still lists Qatar under 'developing countries'.

The performance of the GCC relative to other leading economies can be seen in Figure 5. This positions the GCC in the high-growth range but with GDP/capita fast approaching that of the EU and US (the bubbles are scaled to the relative size of populations, and ultimately show the dominance of China and India in the world economy, although these are still low in the rankings of GDP/capita today). The GCC economy is thus unusual in being fast-growing as well as having a relatively high-income population.

The energy windfall means that the GCC's GDP has more than tripled over the last six years, from around $330–340 billion in 2002 to an estimated $1.1–$1.2 trillion for 2008. Total export revenues have soared from $180 billion in 2002 to an expected $850–900 billion for 2008 (with $600–650 billion likely from oil exports alone).

However, the ability to absorb and spend has lagged behind the rapid gains in revenues, boosting national savings and leaving the trade and current accounts in substantial surplus. In 2008, the GCC is likely to

Figure 5: GCC: a region with fast growth and high per capita GDP



Sources: World Bank and own calculations.

generate a current account balance of more than $350 billion, up from less than $30 billion in 2002 and possibly exceeding China's projected surplus. Governments have likewise seen revenues soar and budgets swing into large surplus as they benefit directly from oil and gas receipts.

In spite of gradual increases in spending, fiscal policy has remained very conservative and much of the oil windfall has been saved (or used to reduce debts built up during the low oil price years up to 2003, for example in Saudi Arabia). As a 2007 UBS Investment Bank report estimated, 'only 25–30% of the accumulated surplus has been spent so far, down from an estimated 75% in previous cycles'.[4] In fact, the proportion saved may be even higher than this estimate suggests. Current account surpluses have seen a steady rise from 2002, as imports, consumption and spending have been rising, but not at the very high rates seen in the 1970s and 1980s.[5] This is a key reason why analysts estimate growth rates of around 20% for SWFs under management as annual national savings have soared to $200–400 billion per annum[6] and money previously held as foreign exchange reserves is now being moved into SWFs as well. The GCC's cumulative current account surplus from 2002 to 2007 totalled almost $1 trillion – representing just under half the current estimated value of the GCC's combined SWFs (although the exact make-up of their growth is not known).

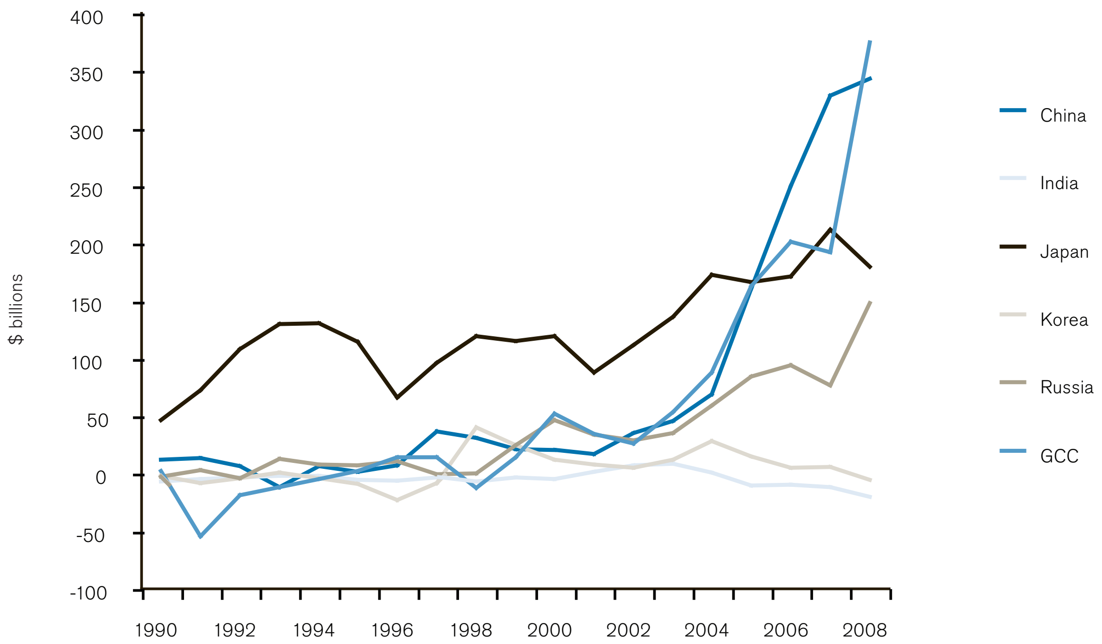
Risks linked to energy markets

As so much of the Gulf's recent spurt of growth and build-up of wealth has been linked to the energy bonanza, there are two obvious issues to examine:

- How vulnerable is the oil market to a downside shock, which would reverberate across the gas and coal sectors as well?
- How would the GCC economies fare in the event of lower energy prices?

Taking the second question first, the threat to the GCC's economic outlook is unlikely to be significant unless oil

Figure 6: Comparison of current account balances: GCC now outpacing China



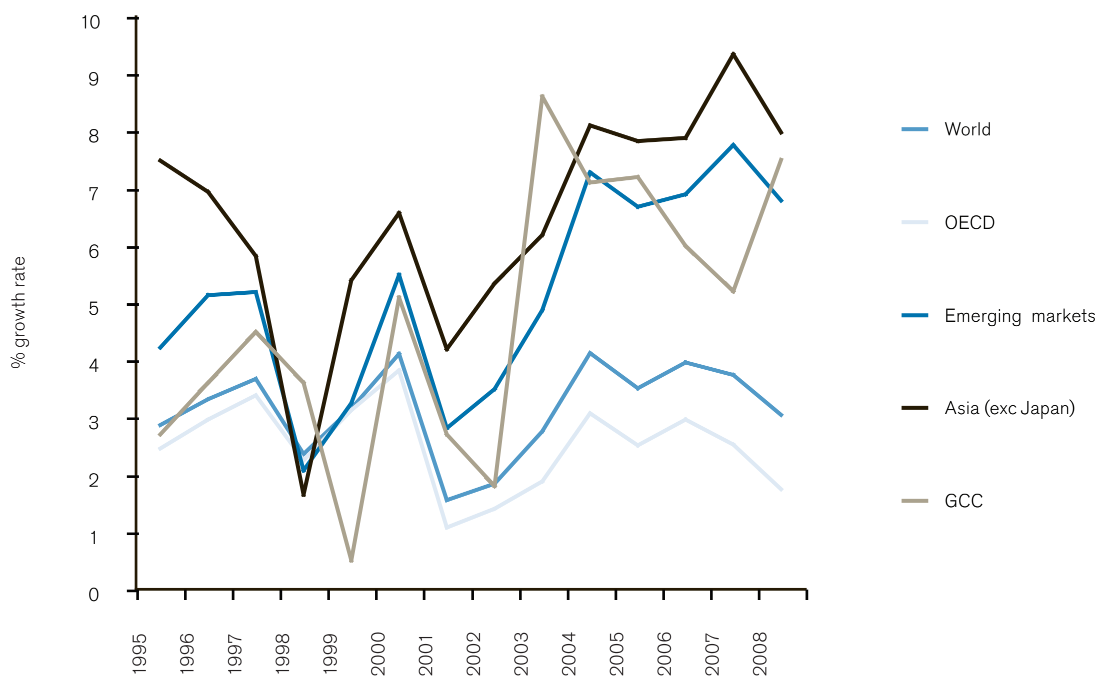
Source: IMF and own calculations.

and gas prices were to fall back very sharply and stay low. Given the present savings surplus, and the strong growth and momentum in the GCC economies seen in 2005–07, it is fairly certain that even an easing back in oil prices to $60–70 (the trading range seen before the price surge in late 2007) would probably leave economic conditions broadly unchanged, with growth prospects still very robust (assuming that gas prices would tend to follow any volatility in oil prices). Fiscal policy is conservative: government planning remains prudent, with oil (and gas) revenue estimates based on very cautious price assumptions, around $40–50 for oil, well 'behind the curve' compared with the sustained surge in market prices. As energy prices have been higher than budget assumptions, the budget surplus has fed into the SWFs. Should prices drop back in line with the planning assumptions, the savings inflow into the SWFs and foreign exchange reserves would take the strain, along with the external trade surpluses. Although governments would probably not need to tap the wealth funds for finance, they would cut back the money channelled into these funds.

However, a fall in oil prices to below $40 (and a similar drop in gas prices) on a longer-term basis would create more severe strains. Governments would have difficulties maintaining current spending levels and investment plans over time, especially as private investors would also become concerned about prospects. This implies both cutbacks in projects and, possibly, a substantial drawing down of savings from the SWFs. Long-run GDP growth forecasts for the GCC would be revised dramatically downward, probably to rates of around zero to 2% (at best), if markets believed that oil prices were set to fall sharply and stay at less than $40 per barrel over the long run.

The other possible cause of failure for oil and gas revenues would be a fall in demand and/or output. However, apart from the risks associated with potential conflicts or terrorist attacks, it seems improbable that there would be any significant cuts in supply from present rates. Indeed, moderate growth in output of 1–2% (perhaps as high as 2–3%) is more likely over the next decade. The GCC is expected to benefit from its position as a major oil and gas supplier over the long run as it is home to some 40% of the world's known oil reserves[7] and currently supplies almost a quarter of global oil output. This share is widely expected to rise over the next twenty years. Gas

Figure 7: High developing-country growth supports global growth, energy demand and prices



Sources: World Bank and own estimates.

output is also substantial, with the GCC accounting for nearly 25% of known global reserves.

Regarding the energy demand outlook, global consumption has so far remained robust, in spite of sharply rising energy prices and weakness in the major developed economies. Although there could be a cyclical dip in energy demand, especially if growth in the BRICs were to slow, the trend is still firmly upward; there is moderate growth of 1–2% per annum in the oil market, for example. Growing pressure on world resources is coming from both the rapid rise in incomes and energy consumption across the developing world and the continued increase in world population, which has about doubled over the last 50 years and is projected to rise by as much as another 3 billion by 2050.[8]

Around half of global energy consumption is accounted for today by the richest billion people in the OECD area, chiefly in North America, Europe and Japan. By 2050, if everyone were to consume at the same high rates as today's richest billion, energy demand would be an impossible five times higher than it is today. Even if energy savings were to cut per capita use by 50%, energy demand would still be 2.5 times higher on an 'equal consumption for all' basis. These may be simplistic forms of 'forecasting', and more complex methods can be used,[9] including non-fossil fuels and new technologies, as well as lower energy demand growth because they assume that developing countries make slower progress in catching up. However, crude estimates starkly illustrate the enormous pressure on the outlook for energy markets. Compared with past data and trends, it would seem highly unlikely that there could be any reduction at all in global energy demand. Over the last 25 years, global fossil fuel demand (and total energy demand) has risen by roughly 65% and even OECD consumption has increased by almost 50%. Over the last decade, growth has fallen in the OECD area, with demand up by only 6–7% compared with a rise of 25% in global demand, which has been driven by emerging-market economies. So the OECD area may just about stabilize its energy demand over the coming decade but the developing world will continue to grow.

Nevertheless, over the longer run, oil demand may well stagnate or even begin to fall, if more radical technological changes start to materialize and affect the energy mix. In addition, limits to fuel production will become more apparent[10] and eventually GCC output will decline as oil and gas reserves are depleted (although beyond the 10–15-year horizon; for example, Qatar is estimated to have 200 years of gas reserves). Along with the need to create jobs, this outlook provides a key motivation for the Gulf to build up other sectors in the local economy. However, these long-term issues are unlikely to pose a threat to energy exports, government budgets and economic growth over the next 10–15 years. Financial support and government backing for the development of the broader economy will remain strong and promote continued fast growth, especially in financial services.

Could oil prices fall?

How likely is it that oil prices will tumble? Although the track record for oil price forecasting is poor and far from reliable, this issue has to be tackled. In the early 1980s, forecasters predicted further price rises to follow the 1970s oil shocks, yet prices fell. In the 1990s, many oil experts and forecasters believed oil prices would never rise above \$20–25 for the foreseeable future. This view also proved wildly short of the mark. Since 2003 oil prices have moved rapidly beyond the norms for the 1990s and have accelerated faster than most forecasters' ability to predict. In particular, many analysts (including the IEA) missed the impact on oil demand and market capacity that has been created by high growth in China and other emerging-market economies.

The current mood in the energy markets is still very bullish in spite of the prospect of recession in the US and possibly in Europe too. This mood is backed up by the low level of spare capacity in oil (especially compared with still substantial geopolitical risks – indeed, deducting estimates of 'oil at risk' would more than eliminate any slack in the system). However, given the problems experienced in energy forecasting, opinions are wide-ranging, with market views encompassing oil price estimates ranging from \$50 to \$200 for the next few years alone.[11] Are these extremes equally probable and on what do they depend?

If global growth runs on at current rates – especially in the buoyant and energy-hungry emerging market economies – then energy demand will remain high. It looks highly unlikely that in such conditions energy prices could drop significantly. Indeed, it would be quite possible for prices to continue rising – underpinning the view that oil prices of $150–200 in the next couple of years cannot be ruled out (with gas and coal prices rising in line with oil). This outcome would, of course, underpin further strong growth and rising wealth in the energy economies, including the GCC.

In contrast, the most likely reason for a drop in energy prices would be the prospect of a sharp fall in global growth – not just in the major developed economies but also encompassing the developing world, the key driver of energy. Around 90% of the increase in oil demand over the last five years has come from the developing world (i.e. accounting for about 7mbd out of a total rise of some 8mbd) and if growth in key countries, especially China, were to falter, there would be a marked impact on oil market sentiment and prices. Speculation in commodity markets since late 2007 is also believed to be one factor behind the rise in oil prices from the $60–70 range to over $120, but such speculative pressure could dissipate rapidly if sentiment in commodity markets were to turn negative.

However, even if a cyclical downturn in the global economy were to pull back energy and commodity prices from their current peaks, these prices look unlikely to fall to the low levels seen in 2003–04. Given the long-run re-rating of energy market prospects (and other commodities), lower prices would tend to be only a temporary cyclical phenomenon, especially as capacity in many markets (including oil) will remain fairly tight even in a downturn. As long as the large emerging-market economies such as China and India continue generating the expected rapid growth over the next 10–20 years, the pressure on resources and energy markets will persist. The shift in gear of these energy-hungry 'mega-emergers' is seen as a permanent trend; they have taken over from the small Asian 'tigers' in driving forward economic growth in the developing world. However, unlike the original 'tigers', the mega-emergers are large enough to have a significant effect on global markets and resources. The world economy and commodity markets took a surprisingly long time to wake up to this new reality – indeed the pressure on food resources and prices has only just begun to bite, following on from the shock that has continued to run through energy markets since prices first started to rise rapidly in 2003–04.

Overall, it seems unlikely that pressure on resources will slacken except on a short-term cyclical basis, suggesting that oil prices are unlikely to fall below $50 and that gas and coal prices will also remain high. Indeed, it is far more probable that over the next 10–20 years energy prices will be as high as or higher than the average over the first half of 2008 – that is, well above $100 for oil and at commensurate levels for gas and coal.

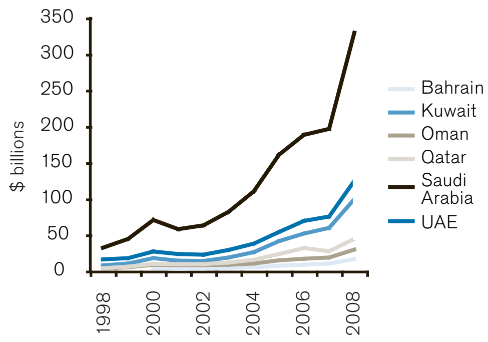
The challenge created by the hunger for energy feeds not only into energy prices but also into the valuation of the Gulf's oil and gas wealth, supporting the generally positive view of the region's economic prospects. Oil markets look unlikely to derail the Gulf's economic progress over the next 10–20 years. However, we cannot overlook other risks to economic prospects, which will be considered at the end of this section.

Success in speeding up development: non-energy GDP doubles in five years

Although the energy boom of the last five years has pushed up the share of energy revenues in GDP, it has also served to accelerate rather than slow efforts to expand the non-energy sectors, aiding long-run diversification and job growth.

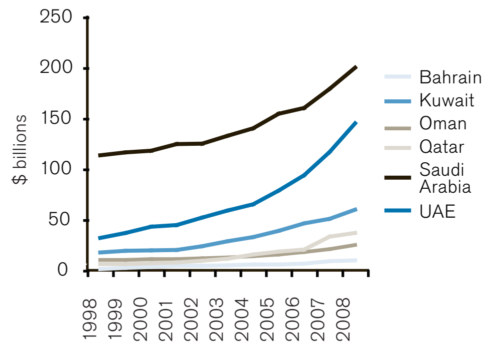
On average, GDP in the non-energy sector about doubled between 2002 and 2007, as shown in Figure 9, whereas it barely grew by 50% during the previous decade when oil prices were low and hardly changed. Indeed, recent growth rates have not been far behind those in the energy sector, suggesting that, at least for the GCC, the latest oil boom has not been a 'resource curse' holding back more general economic development. The non-energy sector is clearly benefiting from related business as well as from the ploughing back of oil revenues into regional development.

Figure 8: GCC fuel exports 1998–2008



Source: WTO and own calculations.

Figure 9: GDP excluding fuel exports



Sources: IMF, WTO, own calculations.

Table 1: Summary of key statistics for the GCC

2007 (estimate)	Bahrain	Kuwait	Oman	Qatar	UAE	Saudi Arabia	Total/average
GDP, US$bn current prices	19.7	111.3	40.1	67.8	192.6	376.0	807.5
GDP/capita, US$ current prices	25,731	33,634	15,584	72,849	42,934	15,481	22,400
CPI inflation rate, %	3.2	5.5	5.9	13.8	10.9	4.1	
Fuel exports as % GDP	56	54	47	52	40	52	49
Export goods & services, $bn,	15	72	24	40	167	233	551
of which oil and gas $bn	11	60	19	35	76	197	398
Current account balance, $bn	3.9	52.7	3.4	23.4	41.7	100.8	225.9
(& % of GDP)	(19.9%)	(47.4 %)	(10.0%)	(34.6%)	(21.6%)	(26.8%)	(28%)
Mid-year population 2007, millions	0.75	2.8	2.6	0.8	4.4*	24.7	36.05
Annual population growth rate, %	1.3	3.6	3.2	2.3	3.8	1.9	2.5

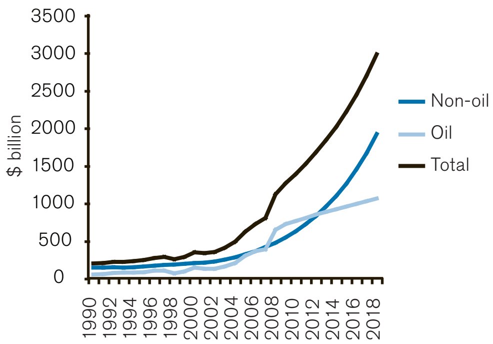
Sources: IMF, WTO, UNCTAD.
* Dubai: 1.3m

In spite of rapid progress, there is still scope for further gains. While average GDP/capita for the region as a whole is now over $22,000 (2007 data), up from $11,000 in 2002 and $9,000 in 1992, the non-energy sector generates only $10,000 per capita, against $7,000 in 2002 and $6,000 in 1992 – showing strong growth but still ample room for improvement. GDP/capita in the non-energy sector is a better measure of the economy's underlying rate of productivity as opposed to geographical good fortune (benefits of large oil and gas reserves); it is also a more suitable measure to use in comparing GDP/capita performance with other non-energy economies. Excluding oil export revenues, the data suggest that the GCC is currently in the middle ranks of developed economies, still well above the developing- and emerging-market economies. It is about on a par with many of the smaller European economies such as Croatia, Hungary, Poland and Portugal, and not far below Asian economies such as Taiwan.

There is clearly scope for the non-energy sector to upgrade further to the levels of productivity seen in, say, Spain or South Korea, where GDP/capita is around $25,000–30,000. Thus a feasible development target for the GCC economies over the next five to ten years should be to approximately double the present rate of non-energy GDP/capita – effectively repeating the performance of the past five years.

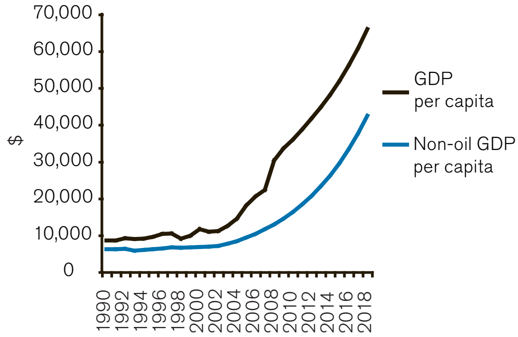
Future potential for the aggregate GCC economy can be illustrated by estimating high- and low-growth scenarios for GDP. In the low-growth case, based on oil output stagnating and oil prices falling back to the average rate for 2007 (around $70), oil revenues drop

Figure 10: A high-growth scenario for the GCC – total GDP ($ current)



Sources: IMF and World Bank historical data, own estimates.

Figure 11: A high-growth scenario for the GCC – average GDP per capita



Sources: IMF and World Bank historical data, own estimates.

back to 2007 levels. Non-energy GDP fails to sustain high growth rates and overall GDP growth tapers off to very low rates, in the range zero to 2%. In this case, GDP/capita would only rise if large numbers of migrant workers left and locals took on more of these jobs themselves: this could mean GDP/capita rising at rates of 2–3% even if GDP itself stayed flat, at around $1 trillion. However, it is more likely that incomes would stagnate in this low-growth scenario.

In the high-growth scenario, energy output is assumed to increase by 2–3% per annum while oil prices steadily climb to $150 per barrel. Non-energy GDP continues to rise at recent rates of 15% per annum and overtakes the oil sector in revenue terms by about 2012–14. Over a decade, non-energy GDP could quadruple to $2 trillion while total GDP might triple to $3 trillion. The GCC's GDP/capita would reach the same levels as wealthy developed countries. Non-energy GDP/capita would also rise steeply, more than meeting the suggested 'target' of doubling over the next decade. Thus even if growth slows compred with the boom of the last five years, it should be relatively easy to double non-energy GDP/capita over a decade: this scenario approximately corresponds to the average of the low- and high-growth scenarios depicted here.

Today, market expectations for the GCC economies are understandably more strongly focused on the high-growth scenario. Not only is oil revenue buoyant but the rapid growth seen in competitive service sectors has served to enhance confidence in the non-energy economy, even if it is currently being largely staffed by expatriates. Many analysts believe that the GCC's economic prospects have significantly improved from just a few years ago, with surging wealth also aiding the rapid development of the property and financial sectors. This success and the pursuit of GCC economic cooperation have created a positive international profile of the Gulf region and its opportunities, including the expansion into global services, from transport hubs and tourism to the media and financial sectors.

The need to diversify and create jobs

Resource-rich regions need to make important choices about their use of the revenue streams and wealth generated by windfall profits. For the private sector, this will include building asset bases and businesses outside, as well as inside, the region, as wealthy investors diversify their portfolios and international expansion (including M&A activity) plays a role in the management and growth of global businesses. However, through ownership structures, royalty payments and/or taxes, much of the revenue stream from oil and gas sales accrues to governments, which then have the responsibility to decide how this revenue should be saved, spent or returned to the population in the form of tax breaks and social payments. In well-managed resource economies, for which the model quoted is typically Norway, the strategy is balanced and includes saving part of the wealth created (in funds for future generations, i.e. SWFs) as well as using government spending to provide modern infrastructure, improvements in education and training, social safety nets and business incentives to ensure that non-resource-sector activities grow and support local jobs. The strategies being adopted in the Gulf are tending to emulate this Norwegian model.

There are few employment opportunities in the resources sector itself – certainly oil and gas generate few direct jobs – and therefore the jobs needed to meet expansion in the workforce have to be created in other sectors. For countries with small, stable populations, local residents could be provided with income guarantees, either directly or through government jobs, although this would not provide incentives for private-sector growth in the broader economy. However, this implies that once the scope for employment expansion in the government sector is exhausted (now accepted to be the case in the Gulf states), much greater efforts have to be made to increase the number of genuine private-sector jobs to meet the requirements of the local population. This creates pressure to build up a vibrant non-energy economy in order to supply jobs – and ultimately the economy of the future, taking account of the long-term prospects for dwindling oil and gas reserves. Over the next fifty years, even the oil reserves of the GCC countries could be depleted. Indeed, for some countries output is already low and declining (Bahrain and the UAE), although the outlook for gas output appears healthier (for example, Qatar's reserves are estimated to be equivalent to 200 years' supply at current rates). The world needs alternative energy sources, and the energy economies will eventually need another way of generating GDP and jobs.

The new sectors and jobs need to attract and retain high-calibre staff to provide the basis for development and the growth dynamic. There is already internal competition in the Gulf region, especially among the more mobile young population. The new centres of gravity are the key city hubs that are aiming to serve the needs of modern populations for social, educational and job opportunities. The urban growth rate in these six states is estimated to be in the 2–3% range for the current period (the counterpart to this urban growth being a commensurate decline in rural populations).[12]

Development strategies across the Gulf countries vary according to local conditions, although they all involve a cooperative effort between the government and private sectors. Saudi Arabia has the largest land mass (although much is uninhabitable) and a large and growing population that urgently needs more jobs and housing, while the smaller countries have low populations and less available land, and therefore need to plan carefully to generate appropriate jobs and selective industrial development. The smaller states tend to have high per capita incomes and have been quicker to identify the potential of high value-added services and technologically advanced sectors – while Saudi Arabia has more opportunity to develop oil-related heavy industries such as chemicals and refining and also needs to step up the rate of construction, including essential home-building. Kuwait seems to be the country that has shown the least enthusiasm to date for expansion and refurbishment of the local economy.

As a recent IMF Consultation confirmed, Bahrain has very low rates of own oil production and is the least oil-dependent of all six GCC states (on the IMF measure for the oil/GDP ratio).[13] Bahrain has been pursuing growth strategies in non-energy sectors for many years, building on its advanced education system and its early efforts to take the lead in regional finance and insurance markets. Although oil still accounts for about 50% of GDP for the UAE, Dubai has very little oil revenue and, like Bahrain, has targeted growth in the service sector to provide both jobs and continued expansion in GDP. As the newcomer in the financial services field, along with Qatar, it is challenging Bahrain's established position in regional finance.

Regional rivalry, acting as a spur to competition, has also broken out in terms of the development, and redevelopment, of property and financial centres. As Dubai and Qatar have unveiled new-build projects, this has started to make the older centres in Bahrain and also Abu

Dhabi appear in need of rebuilding and refurbishment work. The response has been to start upgrading and redevelopment efforts in these places too – indeed Saudi Arabia has also proposed plans to build a coastal development as well as a new financial centre (having kick-started interest in growing the financial sector by reaching a historic agreement to allow a small number of US financial companies to set up local operations). In addition to these projects, Bahrain is committed to extending its regional connectivity by building a new causeway to Qatar. This will provide a matching link to the successful causeway to Saudi Arabia, which has brought short-stay visitors (both business and tourist traffic) and second-home buyers into Bahrain from both Saudi Arabia and Kuwait.

Which sectors offer a comparative advantage?

Historically the strategically located GCC countries served as a hub for the major East–West trading routes for thousands of years before the discovery of oil, creating a strong tradition of trading activity, travel and hospitality. However, over the last century, the rising global importance of oil has transformed their economies. Petrodollars have enabled ultra-modern city states to spring up across desert kingdoms in an impressively short space of time. But this growth has also generated new needs and led to the development of new industries and infrastructure, such as ports and airports, tourism, communications and the media sector, local utilities and services (such as water and power provision), property development and wealth management. This has radically reshaped the expectations of the young and growing population and the education and training needed to meet the new challenges.

Although a few specialized industries may thrive, the GCC countries cannot compete in the world economy in broad-based manufacturing: developing Asia has a massive advantage in manufacturing on the basis of its long-standing experience and trade links, cheap labour and economies of scale. Moreover, the Gulf is clearly unsuited to the expansion of agriculture, even though many people used to live by coastal fishing (and pearling) and this traditional activity still survives (as fishing notably does in Norway). Saudi Arabia has recently announced that it will phase out grain production as water resources are too scarce to expend on this sector. Only 0.6% of land in the UAE is arable and just 2.3% is planted with permanent crops.[14] Oman remains more of an agricultural economy. Local production of some specific products may persist in the Gulf but it will be on a very small scale. Most food and manufactures will continue to be imported.

The local tradition of trade and international relations, built on the historical and geographical advantages of the Middle East, has already acted as a catalyst for the growth in trade-related activities and finance. From the oil booms of the 1970s, Kuwait established financial market operations including a stock market in 1977 (having set up a wealth fund as early as 1953), although it is also well known for suffering a financial crash in 1982. Similarly, Bahrain started to expand in travel and transport as well as financial services in the 1970s and it remains a regional leader in banking and insurance. The work undertaken by the Bahrain Economic Development Board illustrates the importance attached to economic planning and the long-run outlook in Bahrain. Efforts are also under way under the auspices of the Bahrain Mumtalakat Holding Company to reassess state holdings and move more companies into the private domain – another indication of Bahrain's forward-looking commitment to a market economy and private enterprise. Dubai has also been hugely successful by investing heavily in expanding transport networks, port and airport facilities over the last 20 years – it serves as the key hub for the region and as a stepping stone between Asia, Europe and Africa. Building on this success, recent development in Dubai has emphasized travel and tourism and the property sector. Now the latest push is into financial services, with the opening of the Dubai International Financial Centre (DIFC), an onshore free zone for financial services, in 2004.[15] Although the development of gas reserves has been the major driver of double-digit growth in the economy, Qatar has also moved into transport, travel and tourism, and set up the Qatar Financial Centre (QFC) in 2005.[16] QFC comprises the QFC Authority (responsible for commercial strategy) and the regulators, the QFC Regulatory Authority; they are independent of each other. However, the largest economy in the region, Saudi Arabia, has remained less open and is only just starting to develop a financial centre, while Oman has little presence in the financial sector.

The regional tourism industry has taken off on the basis of extensive cross-regional travel together with the Gulf's niche in the international market linked to the creation of luxury resorts and its convenience as a stopping-off point for business and long-haul travel. Apart from Dubai, Doha and Oman have considerably expanded their tourism facilities while Bahrain has built on its direct links to Saudi Arabia and Kuwait – and, as mentioned, more opportunities will come from the causeway to Qatar now under construction. The region has also promoted international events such as sports including racing, as well as cultural exchanges – with warm winter weather adding to the attraction for visitors from Europe.

Encouraging growth and diversification in the financial sector is a logical development based on local needs for banking and insurance, property and project finance, wealth management and other financial services. It is also a means of creating local activity and jobs, especially given the need to build new centres for the expansion and operation of these financial businesses. These financial centres create a large number of complementary businesses and ancillary jobs, including professional services such as law and accountancy as well as hospitality industries and other services. More broadly, financial centres help to create an experienced and enabling environment for M&A activity, privatizations and the growth of small and medium-sized enterprises, offering many positive spillover effects for other sectors of the economy. With so much at stake, there should be continuing political will and commitment to ensure that the expansion of the financial sector succeeds. However, much remains to be done before these nascent centres can become truly competitive at a global level.

Commitment to the development of financial services

How do the GCC financial markets interact with and serve the needs and aspirations of the wider population and, from this, what can we infer about the level of commitment to the success of the sector? How does the high level of expatriate staff impact on perceptions of this sector and job opportunities?

The important opportunity here is to provide more and better jobs for the future, offering greater scope for career development and an international role to younger generations now coming through the education and training system. The GCC states all have very young and still fast-growing, populations. Including immigration, annual population growth varies from 1.3% (in Bahrain) to as high as 3.8% (in the UAE), compared with 0.9% for the US, 0.3% for the UK, and –0.1% for Japan. Even excluding immigration, local population growth is still relatively high. Both the UN and the World Economic Forum (WEF) have called for urgent government action not only in the Gulf but across the Middle East to create jobs for the large number of young people who are entering the workforce.

Unemployment statistics are not easy to confirm, but Dyer and Yousef believe up to 8 million young people in the Middle East and North Africa (MENA) lack formal employment.[17] Such a large pool of unemployed young people could represent a significant threat to social and political stability: all countries in the region are vulnerable and well aware of the need to create jobs[18] to offset the threat. However, for the GCC countries the problems are less acute than for MENA as a whole and MENA statistics should be used with caution in the context of the GCC. Although MENA concerns impact on the GCC economies both directly and indirectly given the regional proximity and cultural similarities, the two are not synonymous or interchangeable.

The population surge and urgency to create jobs is a particularly serious problem in the larger, poorer countries of MENA, such as Egypt, although Saudi Arabia also faces a considerable challenge, especially as many observers believe unemployment rates to be much higher than official estimates and some 61% of the population are under 25 (compared with 30% of EU citizens).[19]

For the GCC, the target for creating net new jobs may be around 2–3 million, largely in Saudi Arabia. In the smaller GCC countries, the challenge is somewhat different and policies are more specific in their aims. The focus is not so much on more jobs as on provision of better job opportunities to motivate and employ the younger, better-qualified workforce of the future – and many of these jobs must be outside the already bloated public sector. To persuade well-qualified staff to join the weak private sector instead, the offers must be attractive. In this respect, financial and professional services are seen as favoured options, as jobs in these sectors are viewed as close substitutes for government employment in terms of good conditions and style of work. In fact, many jobs in the state sector should be readily interchangeable with those in the financial sector, which also has a strong administrative basis as well as a similar working environment (in terms of modern office facilities).

Aspirations to create international financial centres – and build on previous, mostly successful efforts, to expand in the media, travel and tourism sectors – must be understood in this context of the need for appropriate job creation. When seen in this light – that the long-term social as well as economic stability of the region could hinge upon successful diversification of the economy and the creation of more jobs in areas attractive to the next generation – it is easy to see why so much investment of financial and political capital is being channelled into efforts to build up the financial and professional services sector as well as the media, travel and tourism and other services businesses. These are highly focused, interlocking long-term strategies with strong backing from leaders and governments across the region.

How many jobs does the financial services sector generate?

Why are financial centres seen as an important part of the answer to the region's employment deficit? 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 wide range of spin-off activities. One popular rough estimate is that every job in the financial sector generates two more in other related industries.[20] The UK financial sector accounts for 9–10% of GDP, and direct employment in the sector plus satellite professional services totals some 1.3 million people (around 5% of the workforce). This suggests that, according to the 'rule of thumb' quoted above, some 4 million people (15% of the workforce) may be in jobs created by financial-sector activity. London itself accounts for over 300,000 people employed directly in 'City-type' jobs, with nearly 90,000 in the Canary Wharf area alone. In total, however, London employs some 4.6 million people, with many more of these jobs indirectly linked to the City of London and the financial services sector. The importance attached to these jobs and the financial sector's impact on London is clear from the attention paid to these issues by the UK government.

The GCC labour market is currently around 16–17 million, of which about 5–6 million are domestic residents, mostly employed in the government sector. The target for net job creation may be around 2–3 million over the next 10–20 years. Domestic residents are being encouraged to take up private-sector employment as state-sector jobs cannot expand any further; thus some 2–3 million suitable private-sector jobs will be required to avoid rising unemployment rates. The potential in the financial sector and related services may be for as many as one million extra jobs over the long run,[21] but 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.

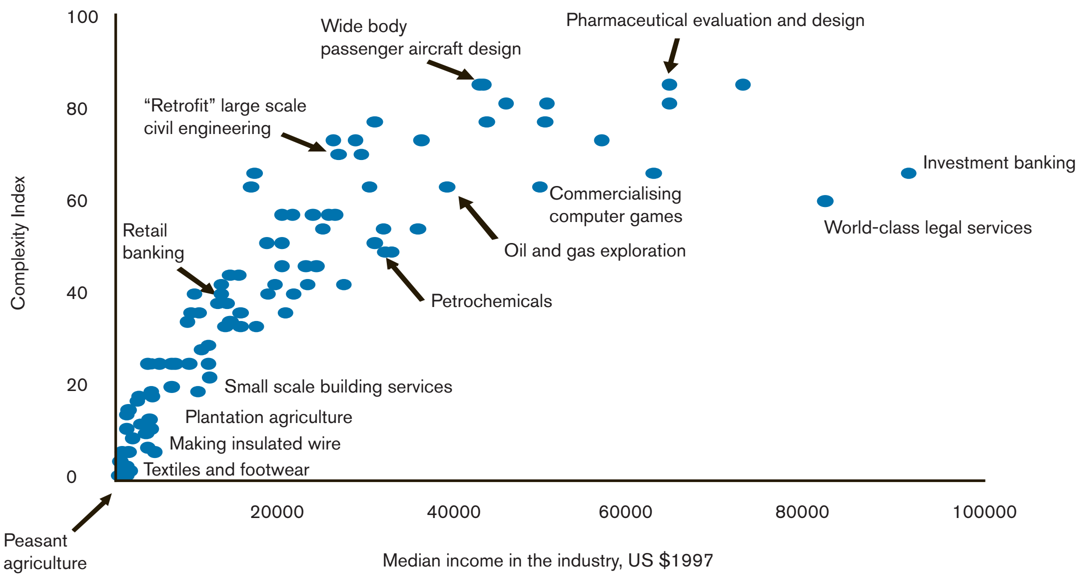
Not only will the development of financial centres create jobs, but many of these jobs will be in professions with high income levels, specifically meeting the aspirations of the smaller GCC states. As Figure 12 illustrates, the trade-off between complexity of tasks in various sectors and incomes is not linear: financial and other professional services offer a very attractive skills/wages trade-off, as do other high valued-added services jobs in the media and property sectors.

Income growth opportunities are highly correlated with sectoral development within an economy and progress into more 'complex' industries and professions. This analysis also suggests that growth in some high-income sectors, such as legal and financial services, depends on other factors besides increasing professional and organizational complexity. For example, these sectors may also depend on a country's economic and financial muscle and the regulatory framework. Identifying potential growth sectors within an economy will dictate the needs for education and skills and the likely rise in income levels as well.

However, importantly, there are high-wage sectors that can be developed without the need to compete at the very top level of complex industries and jobs. This makes the training tasks and organizational requirement appear less daunting. Within a high-income sector, it is also not necessary for all employees (for example, administration and ancillary staff) to move up to a very high skill level – simply deploying the same skills in a higher value-added environment will help support sectoral and economic growth. Expanding higher value-added sectors can be swifter and easier than the slow process of moving large numbers of individuals along the curve. This is important as it shows that the task of raising education and skills standards to meet the needs of higher value-added businesses is less onerous than it might otherwise appear. It is feasible for a country to quickly climb up the complexity and income ladder by carefully selecting sectors and high-level training opportunities for relatively small numbers of professionals.

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. This strategy has been part of the success in Asia, for example, where lead economies have rapidly moved into hi-tech businesses and have tended to 'pull up' key workers to meet higher-grade recruitment needs and 'pull in' the

Figure 12: Industry incomes versus complexity of sector



Source: Sami Consulting and Oxford Analytica, *Scenarios for India and China 2015: Implications for the City of London*, October 2006, p. 19.

general workforce to fill the lower-grade jobs. In addition, expatriate experts can be deployed to 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 – whether in construction or in staffing offices and the service sector.[22] This has avoided delays in the process of development, but 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. Nevertheless, the fact that some sectors are almost 100% staffed by expatriates is causing some concern about progress with the on-the-job training model. It also risks building up resentment in local communities. In response, governments have started to set quotas (albeit relatively low ones) for domestic employment in key sectors.

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. Neither hi-tech industries that employ few people nor industries offering mostly low-grade manual jobs (construction or heavy industry) meet this local requirement. Service-sector industries, such as finance and related professional services, are a better match for labour market profiles, generating a range of jobs from the relatively basic level to the very sophisticated. In fact, many of the jobs involved in running both the financial sector and related services may be relatively similar to employment in the government sector, suggesting that the transition from state-sector- to more private-sector-based employment is feasible. For example, many jobs have a strong administrative bias and the working environment (i.e. modern office-based employment) is also similar.

In terms of encouraging companies to raise employment of nationals and boost training and on-the-job learning, governments have tended to impose quotas. The Ministry of Labour and Social Affairs in Abu Dhabi has set Emiratization quotas in three key sectors: 4% of employees in the financial sector, 5% in insurance and 2% in trade must be UAE nationals. In 2006, the Ministry stopped issuing work permits for secretaries from abroad and called for the employment of UAE nationals as human resources managers. The World Bank and IMF have criticized the quota system, which they deem counterproductive and inefficient – guaranteeing a fixed number of jobs to the resident workforce risks stifling competition and motivation of nationals. These schemes also risk becoming a form of hidden tax. In this respect, Bahrain is taking a different and more transparent approach: from July 2008 companies will be charged 10 dinars ($26) a month for each migrant worker employed, with revenues collected going towards an education fund.

Alongside the introduction of incentives to employ nationals are schemes to develop the skills of the resident population; for example, Dubai Islamic Bank runs a six-month training programme to develop the banking and professional skills of UAE national graduates and help the company reduce its reliance on foreign labour. Boosting training efforts should be more rewarding than simply enforcing quota systems but perhaps a balance of both, if kept in proportion, may be required to push companies into raising local skills and employment opportunities.

Global trends suggest opportunities linked to migration of service-sector jobs

Another reason for the focus on financial services expansion may be to maximize opportunities linked to the global shift in service-sector operations and jobs. Just as call centres and software services have seen significant migration over the last decade, especially but not only to India, so other services functions, including banking and financial-centre operations at various levels, are migrating to new locations too. Indeed, some back-office functions have already moved from very expensive city locations such as Wall Street and the City of London to cheaper local districts or even abroad (including to India).

Apart from their disadvantages in terms of high labour and other costs, the mature economies are slowing down (and possibly sliding into recession) while both the mega- emergers and the energy economies are growing rapidly, creating local needs for expansion in financial services as well as demand for electricity, oil and goods such as cars. Trends favour the creation of more jobs in the financial services sector within these high-growth economies.

Given recent events in the US financial system, which have affected the UK and Europe as well, it is also no longer clear that the existing top-ranked international financial centres, specifically New York and London, will be able to maintain quite as large a lead over other competing centres as they have enjoyed in the past. In this sense, they are victims of the banking crisis, which has shown that even tightly regulated expert systems can suffer major failures. Rightly or wrongly, this undoubtedly makes new centres more confident that they can compete and succeed in financial services. In fact, GCC headhunters will be looking closely at the large numbers of talented people who are being made redundant or disincentivized as a result of financial-sector cutbacks in the West. Such offers will be viewed as increasingly attractive as international market experience is becoming more important and desirable on a financial-sector CV.

However, this picture needs to be kept in perspective when considering the speed of transfer of expertise within the global financial sector. It is far easier for newly competing economies to build up growth in basic industries and to benefit from transfer of technology and economies of scale in manufacturing than it is to take over the lead role of organizer, originator and innovator in financial markets and other high-level professional services. The building up of basic banking and insurance businesses to serve regional needs has progressed a long way and quickly – but this is not the same level of complexity as the role played by the major international financial centres and related professional services in London and New York.

Nevertheless, the current banking crisis has cast a shadow over the importance and skills of the leading GFCs and others will see this as an opportunity for future growth.

In conclusion, there are advantages to be exploited in the financial services sector in the GCC:

- Expertise in the finance sector complements the needs of economies operating in industries such as energy (project finance), trade (finance and foreign exchange management), property development and fund management.
- The sector can benefit from the region's economic and financial muscle.
- It offers a favourable trade-off between the skill sets needed and better job and income opportunities.
- Jobs in the sector should appeal to newly qualified young professionals, attracting entrants who might otherwise have taken up state-sector jobs or moved abroad.
- Financial-services jobs are also seen as an appropriate profession for women nationals in conservative societies.
- The number of jobs that could be created in the financial sector and related businesses may go a long way to meeting the GCC's jobs target over the next 10–20 years, especially in the smaller GCC countries.
- The current international economic climate may speed up opportunities for growth and building of expertise in the sector.

What are the risks to economic growth and job prospects in the Gulf?

The earlier discussion of the risks linked to oil markets broadly concluded that the threat from weaker oil revenues is fairly low. However, there are other risks to the outlook, including the impact of rising inflation and policies to address this problem. As the GCC has previously been an area of very low inflation rates, recent increases seem perhaps all the more worrying. This is unfamiliar territory for policy-makers. Indeed, given the sources of inflationary pressure, it is not clear how best to address this new problem.

Local discussion of the reasons behind the rise in inflation tends to emphasize certain factors, specifically soaring food and commodity prices and rising housing costs, but also links these price trends to the impact of inflows of expatriate workers and the weak US dollar, to which all but one of the currencies are pegged. The Gulf economies are clearly very dependent on imports for almost all their consumer and investment goods – from foods to manufactures of all kinds – and for most of the last twenty years most of these prices were virtually unchanged before they began to rise just a couple of years ago, startling people used to stable prices.

However, the steep increases in housing and local services prices are linked to the booming local economy. In addition, some observers paint a very different picture of this local inflation problem from that reported in official statistics, suggesting that prices are actually rising at much faster double-digit rates. Increases in the cost of living, especially housing costs, are also being passed on into large pay awards to public-sector workers (comprising largely domestic rather than migrant workers). This is a key reason for increasing concern about the inflation threat and its impact on foreign workers.

In response to the outcry over inflation in Qatar, ruler Hamad bin Khalifa Al-Thani has indicated that real-estate market regulations may be introduced to curb the increase in house prices, which were up by 29% (year-on-year) in late 2007.[23] There have also been suggestions that food subsidies (e.g. for basics such as flour) could be introduced. As long as the surge in global prices is temporary, subsidies could be a feasible populist response.

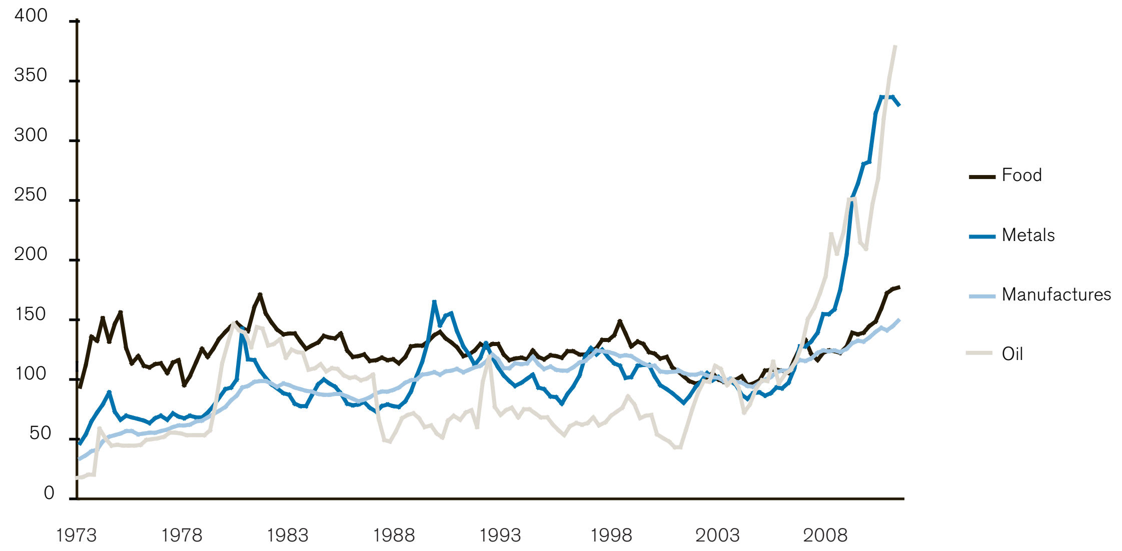
Popular resentment over global price increases of 20–30% in staple foods such as grains and edible oils has been widespread in developed economies as well as in developing economies. Central banks and policy-makers everywhere have been uncertain how to respond. Notably, the impact on inflation in Europe has been almost the same as in the US (with consumer prices up 3–4% in most countries), indicating that the weak dollar has played only a minor role in the global 'hump' in inflation in early 2008.

Nevertheless, a widely touted policy recommendation to reduce inflationary pressure in the GCC economies has been to float regional currencies rather than maintaining the fixed dollar pegs – or, more simply, to repeg at a higher rate. However, a rapid move to drop long-standing currency pegs could be a high-risk strategy, especially if it is uncoordinated, in view of the discussions under way on regional cooperation and the creation of a single currency. This could create confusion over local cross rates and long-run policy goals.

In addition, revaluation typically damages competitiveness, implying losses in net trade and lower investment in sensitive sectors of the local economy. This is a policy trade-off: only an economy with no competitiveness effects can choose its exchange rate with impunity. In the GCC economies, such competitiveness effects are likely to exist and even the most 'oily' economies may not be completely currency-neutral, especially as the scale of revaluations that would be needed to maintain a low local inflation target might be relatively large. By floating their currencies, the GCC countries could risk overvaluation relative to the rate appropriate for the viability of the non-energy sector – in resource economies, this phenomenon is commonly referred to as 'Dutch disease'. The Gulf economies are much more likely to be susceptible to this risk than an economy such as Russia's which is based on energy, metals and minerals. In fact, some important parts of the service sector in the Gulf could be very sensitive to changes in currencies and competitiveness and these functions might even migrate out of the region in the face of steep currency revaluations – this implies losses in the financial, tourism and media sectors and the competitiveness threat might even hit the trading and transport hubs such as ports and airports. As these negative effects started to bite, property prices might begin to fall. This would put an end to the renaissance in the property sector – old developments would not be refurbished as there would be little incentive to upgrade, let alone add new build to the housing stock. Local professionals might think that curbing current increases in housing costs by currency appreciation would help them – but ultimately if this caused the non-energy sector to stall then these professionals would depart for jobs elsewhere, leaving the property sector shabbier and underdeveloped.

Yet another option to curb local inflationary pressure linked to overheating might be to reduce government spending: tightening fiscal policy but also slowing the pace of economic development. But this policy would probably be even more unpopular than the rise in inflation and would set back the development timetable. It would also push even more savings into the SWFs.

Figure 13: World price trends, $ indices (2000=100)



Source: IMF.

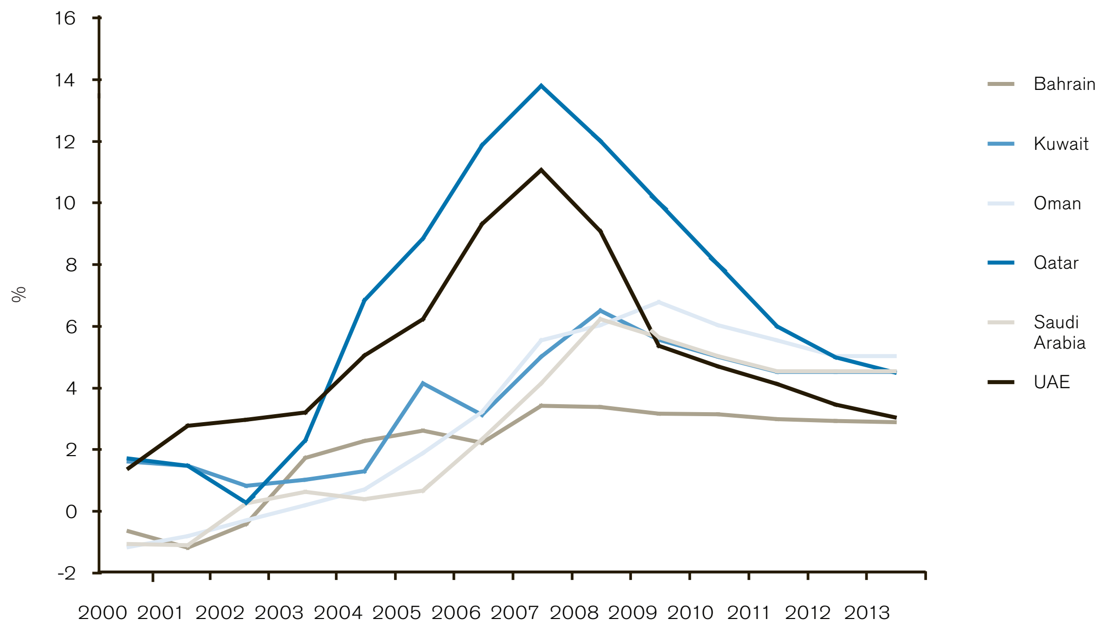
How critical is the inflation problem, and is special action needed or not? According to the official figures, inflation was not particularly high for Saudi Arabia, Kuwait, Bahrain and Oman up to 2007: reported inflation broadly rose from very low rates of 2–3% (or less) during most of the previous decade to around 4–5% in 2005–07 (still relatively modest given the high growth rates in the region and elsewhere in the world). Admittedly, there was a steeper and more worrying rise in inflation, to around 10–15%, in hot spots for growth such as construction activity; this was principally an issue for Qatar and the UAE. But even this pick-up in inflation was quite mild given the dramatic changes under way in these economies and impacts from the massive building boom. Much of this rise in prices, especially for housing, will taper off at a new, higher level. And double-digit inflation has only been experienced during the last couple of years, suggesting that underlying long-run inflationary expectations are probably still under control. From these statistics alone, one could probably conclude that the GCC economies are seeing only a temporary rise in inflation that will dissipate as pressures ease off over the next couple of years.

This seems to be the position adopted in most forecasts. Even recently revised IMF forecasts, reflecting the surge in food prices, continue to point to a sharp decline from the early 2008 inflation 'hump'. And the fall-back in some key food prices, which became visible by May–June as harvests improved (e.g. for wheat and rice), helped bolster the view that the 'hump' is temporary and will ease shortly. Nevertheless, it is possible that both food price inflation and the GCC's local inflation problem will persist far longer than forecasts such as that of the IMF suggest.

In terms of the local price pressures, clearly the regional development plan has been one that has tried to steer a middling course and adopt practical measures to alleviate the underlying problems. In general, key points include:

- adopting a fast track for the supply side, as illustrated by the region's willingness to import large numbers of migrant labourers and other resources to speed project delivery and raise the number of new housing units coming into the market;
- managing demand growth by running government budget surpluses and saving excess revenues in the SWFs: notably finances have been more prudently managed during this oil boom;
- accepting a modest uptick in inflation as the price of rapid development;
- alleviating the impact of inflation on the local population by indexing wages in the public sector (which largely employs domestic residents) and assisting in the provision of housing.

Figure 14: Inflation in GCC countries, 2000–13: IMF sees rates declining



Source: IMF.

Of course, the influx of labour itself causes pressure on local prices but this has to be traded off against gains achieved in boosting the supply side and raising the speed of development. Over time, policies will also need to adapt in order to avoid the risk of boom–bust cycles. For example, as the supply of property is improved, the problem may become one of managing a drip feed of new build into the market to avoid a wave of excess supply and price instability, which would damage both local and international confidence.

Once it was accepted that a moderately higher rate of inflation – and a re-rating of local property prices – would be part of the fast-track development process, the policy problem has been not to stop this but to prevent it building into permanently higher (or accelerating) inflation. Stabilizing out at a higher level of prices is a feasible target – with inflation gradually settling back to an acceptable rate of perhaps 2–4% in the medium term. If the GCC governments can manage such a process of transition and resolve current bottlenecks in the domestic economy, without risking longer-run economic stability, then future prospects for development will be very firmly based. A stronger supply side would allow the economies to cope with continued demand growth in the future, although the pace of growth will need to ease back as well from the recent peak to more sustainable rates of 3–4% in real terms.

Other threats to stability and growth

In addition to the perceived threat from inflation and debate over appropriate measures to contain this, there are other more subtle, less visible, risks that could become important. These other risks to stability and growth should not be ignored.

Speculative capital inflows

Speculative capital inflows to the GCC, reflecting international expectations of large currency revaluations, have surged over the last year and are typically portrayed as exacerbating pressure on money and credit growth in the regional economies, potentially feeding inflation. Low local interest rates, which are 'imported' from the US via the currency peg, are also seen as dangerous because the real cost of local credit is, in effect, negative. This is a form of 'subsidized credit' which risks exacerbating local asset price inflation. If the currency pegs were to be abandoned, it is argued that central banks might be able to decouple from US interest rates and reset local rates to address the problem of the credit and asset price boom.

This is similar to the problem seen in recent years in China, another prime target for speculative inflows based on expected currency revaluations. Inflows of capital to China have caused a build-up of central bank reserves and related management problems in the local banking system (in spite of higher interest rates and increases in banks' prudential reserve requirements). However, in the case of the GCC region, banks channel a large part of their business abroad and most of any surplus on the balance of payments is placed into the SWFs, which then channel capital out of the region again. So speculative inflows in the GCC could simply be matched by SWF operations abroad. Ironically, this has the potential to lead to a situation in which speculators might 'pay' for GCC stake-building and even M&A activity in markets such as the US and Europe.

Losses on investments

Amidst a massive investment and development boom across the region, there is inevitable potential for this very rapid surge to create 'white elephant' projects – that is, investments that fail to serve a useful purpose and go sour. For example, in the midst of a crash in the US property market and fears of similar situations in the UK, Spain and other property markets, the property boom in the Gulf will raise concerns over absorption of so many high-price new developments in such a short time span. Some new build could wind up being mothballed, as seems likely in the US and Spain.

Can the GCC withstand some losses on investments and failures? Given the financial surplus already built up and ongoing inflows of revenues from energy sales, the potential scale of such losses may be relatively small compared with financial resources. In addition, some projects have been financed by foreign rather than local investors, thereby spreading the risks.[24] The construction sector also has little impact on local employment and businesses as much of this project work is undertaken by foreign companies and migrant labour. If the sector suffers a downturn, many of these workers will simply go home (to some extent repeating the cycle seen in the last oil-driven boom of the late 1970s and early 1980s).

Dependency on migrant workers

However, there are also risks directly related to the soaring numbers of migrant workers from expert staff to basic labourers. Up to one-third of the GCC's 36 million population is composed of migrants, mostly people employed and with relatively few non-working dependants. This means that migrants represent as much as 60–65% of the GCC's estimated workforce of 16–17 million, while almost all of the domestic workforce of around 5–6 million are employed in government posts and the state sector. This is quite astonishing and poses a potential threat to the operation of the economy. The commitment of these workers to the region cannot be assured. Should they decide to leave, how would the GCC respond? A reversal of migration could force a slowdown in economic growth if replacement staff could not be found and/or wages had to rise to attract workers. If the level of migrant employment were low this would not matter, but as these workers effectively operate most of the private-sector, non-energy economy, they are critical to the operation of the Gulf economies as a whole.

At the very basic level of unskilled labour and workers in the building sector, the threat to the Gulf is probably very low – these migrants often come from very poor countries where large numbers of people remain eager to find work and earn money to send home. In addition, the currently massive building programme will eventually taper off, probably over the next 5–10 years, reducing the need for immigrant workers in this industry. But the Gulf would find it much more difficult to achieve alternative solutions should more skilled expatriates start to leave in other sectors of the economy.

Official plans are to improve local education and training standards, to encourage more local residents to join the private sector and to push forward on-the-job training with a view to creating more local expertise able to take on the higher value-added and technically skilled jobs. This process has operated in the past in the oil industry, where foreign expertise has now been largely replaced by local staff. But the build-up of local expertise in other sectors could be slow, leaving the region very dependent on imported skills and/or imported services for many years to come.

Moreover, the risk posed by dependency on key foreign workers is not uniform across the GCC. At one extreme is the

UAE, which has just 1 million domestic residents and a migrant population as high as 3.5 million which contributes as many as 3 million people to a workforce only a little over 3.5 million in total. In Qatar, out of a population of 900,000, only 250,000 are Qatari. Kuwait also has high multiples of foreign workers, taking up as many as 1.5 million out of an estimated 2 million jobs. Saudi Arabia and Bahrain have a much lower proportion of migrants in their populations but even this has been rising as the construction boom picked up (the proportion used to be around a third but is now as high as 50% in Bahrain). Thus foreign workers represent 50% or more of total employment in these states. Migrants also represent approximately one-third of Oman's population of 3.3 million. These statistics highlight just how large the potential risk to economic activity might be if recent migrant flows reversed.

Risks and opportunities in the economic outlook: summary

Overall prospects for growth in the GCC economies look very robust, based on support from oil revenues and the wealth built up from the boom of the last five years. Good progress in developing the non-energy sector has created more confidence at home and among foreign investors. At these levels of economic activity, including its role in world trade, the GCC has to be seen as an important bloc within the global economy and accepted as part of the developed world. It should be accorded a status commensurate with this ranking, quite apart from its leading role in global energy markets.

Inevitably there are a number of potential risks to the economic outlook and growth that need to be taken seriously. The following key points are worth highlighting:

- Inflation, especially in food prices, may be unpopular but governments should avoid being bounced into rash reactions, including cavalier and possibly confusing changes in exchange rates. A carefully planned transition to a single currency will be beneficial, especially for financial-sector development, but this needs to be well executed, with the full implications and necessary structures assessed well in advance.
- It is almost inevitable that some excess investment will occur during the current boom and massive expansion of activity, with a particular risk of overbuilding in the property market and unsuitable developments – this means that losses and extra financial costs will be incurred in the future. The policy aim should be to identify potential risks, resolve problems if possible and act quickly to limit losses and their impact on other sectors.
- The labour market position reflects a well-known but serious imbalance between local and imported skills, and local participation in the process of building up the non-energy economies needs to be increased steadily. Nevertheless, the fact that there are now some 16–17 million employed out of a total population of about 36 million shows that the jobs do exist in the Gulf economy – indeed the economies are creating more new jobs all the time; the problem is filling them with more local recruits out of the domestic population of 24 million. Even a partial transfer of these jobs would be enough to eliminate most of the existing unemployment and improve job quality.

Even if these risks materialize, they need not destabilize the economic outlook if policy responses remain sensible and effective. And prudent management of wealth during the boom has helped create a substantial cushion, should this be needed in the event of unexpected turbulence. Indeed, according to the scenarios developed here, GDP looks likely to double or even triple over the next decade.

Notes

1 By 'oil at risk' we mean oil that could be rapidly withdrawn from the market at any time owing to various factors including geopolitical risk – this includes uncertainty about supply from Nigeria, for example, as well as Iran or Iraq. 'Oil at risk' could be up to 2–3mbd, which matters more in a tight market than it did in slack markets of 10 years ago.

2 Arguably, revenue data represent a better measure of the significance of oil in the economy given the potentially distorted picture presented using 'real oil' GDP. For example, oil output in barrels may be static, indicating a strongly declining importance of 'oil' compared with rising GDP, but this would fail to acknowledge the enormous revenue and GDP gains generated by rising oil prices, which raise relative purchasing power and help fund local expenditure and wealth creation. Use of 'real oil' in this

case is like counting income in terms of number of jobs or wealth in terms of number of bonds held rather than their market value, or relative value versus average prices. Nevertheless, 'real oil'-to-GDP ratios are often quoted and do typically show a declining trend.

3 Abu Dhabi controls more than 85% of the UAE's total oil output capacity and over 90% of its crude reserves, according to the official website of the UAE government: http://www.uae.gov.ae/Government/oil_gas.htm.

4 Max Castelli, 'Sea roads to prosperity', in UBS Newsletter for Banks and Financial Institutions, *News for Banks*, Summer 2007, p. 3.

5 Comment made at the Chatham House workshop held in Dubai, 25 February 2008 (see Appendix 2).

6 Stephen Jen *How Big Could Sovereign Wealth Funds be by 2015?* (London: Morgan Stanley, 2007); Paola Subacchi, *Capital Flows and Emerging Market Economies: A Larger Playing Field?* (Chatham House Briefing Paper, IEP BP 07/03, September 2007); Florence Eid and Jean-Michel Saliba, 'The New Face of Arab Investment', in Paola Subacchi and John Nugée (eds), *The Gulf Region: The Changing Face of Global Financial Power?* (London: Royal Institute of International Affairs, forthcoming 2008).

7 40% figure taken from *BP Statistical Review of World Energy June 2007* and based on proven reserves of oil – which is generally taken to be reserves that geological and engineering information indicates with reasonable certainty can be recovered in the future from known reservoirs under existing economic and operating conditions.

8 The UN Population Database puts current population at about 6.5 billion and predictions for 2050 world population range from 7.8 billion (low variant) to 10.8 billion (high variant).

9 For example, global energy modelling undertaken by Oxford Economics, the International Atomic Energy Agency (IEA) and Shell. Shell's 'Scramble' scenario prediction estimates a two-thirds increase in primary energy from 2010 to 2050, compared with a 47% increase in its cooperative 'Blueprints' scenario.

10 For more information, see the forthcoming Chatham House report on resource depletion by Paul Stevens and John Mitchell – details at http://www.chathamhouse.org.uk/research/eedp/current_projects/rddd/.

11 In March 2008 Goldman Sachs revised its top-end projections for the price of oil to $200 a barrel; Chakib Khelil, the president of OPEC, confirmed this as a possibility in April and said that OPEC would not be able to do anything to stop it.

12 Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, *World Urbanization Prospects: The 2007 Revision Population Database*, http://esa.un.org/unup.

13 IMF Public Information Notice (PIN) No. 08/39, 'IMF Executive Board Concludes 2007 Article IV Consultation with the Kingdom of Bahrain', 26 March 2008, http://www.imf.org/external/np/sec/pn/2008/pn0839.htm.

14 Library of Congress – Federal Research Division, *Country Profile – United Arab Emirates*, July 2007, available at http://lcweb2.loc.gov/frd/cs/profiles/UAE.pdf.

15 For more information see http://www.difc.ae/index.html.

16 For more information see http://www.qfc.com.qa/.

17 Paul Dyer and Tarik Yousef, 'Will the Current Oil Boom Solve the Employment Crisis in the Middle East?', in Drzeniek Hanouz M. Sh El Diwany and T. Yousef (eds), *The Arab World Competitiveness Report 2007 – Sustaining the Growth Momentum* (Geneva: World Economic Forum, 2007).

18 A 2003 World Bank report estimated that by 2020 the MENA region would need to generate another 100 million jobs, although in 2007 the World Bank reduced this figure to 68 million, highlighting recent rapid progress as well as corrections in statistics. About 36% of the MENA region's total population is under 15 years old (21% in the US; 16% in the EU).

19 Kito de Boer and John M. Turner, 'Reappraising the Gulf States', *McKinsey Quarterly*, Special Edition, 2007, p. 11.

20 Kathryn Wylde, President and CEO, Partnership for New York, at *Financial Times* Conference 'New York View from the Top – the Future of Financial Services', New York, 18 March 2008.

21 Dubai, for example, sees scope for the DIFC housing some 50,000 financial-sector employees in a few years' time, up from an estimated 10,000 today.

22 This trend has been highlighted in recent ILO reports on the labour market for both Bahrain and Qatar.

23 IFSL (International Financial Services London) Research, *Foreign Exchange 2007*, December 2007.

24 In spite of the disaster that has occurred with US sub-prime debt and mortgage-backed securities, and the questions raised regarding the complexity and ratings of the products traded, the concept of spreading financial risks across institutions and countries remains valid and an effective risk management tool.

2. Rising up the ranks of international financial centres

Measuring the performance and potential of financial centres is complex: no single metric can summarize this and some important information (e.g. on the scale of trading and transactions) may not be readily available, especially in the case of the GCC centres. To some extent, performance depends on the goals set – for financial services companies performance may be turnover and profits but for policy-makers it may mean jobs created. Performance should also be seen as relative to that of other centres and the scale of the underlying economy – an IFC can be said to be 'outperforming' if it achieves a better ranking than an IFC in a much larger economy; for example, Hong Kong outperforms versus Japan. In this sense, it is essential to consider the rankings and performance of IFCs against the scale and performance of economies and to examine the type of factors that encourage 'outperformance'.

The financial sectors in the GCC states are growing fast but the IFCs started from a very small base and will therefore not yet be punching with the full weight of the economy behind them. While the positioning of the IFCs may be difficult to gauge, it is clear that the Gulf states have seen a radical and positive transformation in their economic fortunes over the space of just a few years; this can be readily confirmed and quantified on the basis of published economic statistics, as shown in Section 1. However, the rapid speed of change means that not all parts of the economy have moved ahead at the same pace, with money flows, trade and property markets changing fast while local employment and skills appear to be well 'behind the curve', as illustrated by the need to bring in expatriate experts to help staff the new financial centres. This means that perceptions of 'success' and trends may be affected by differential speeds of adjustment. This problem is particularly relevant for any assessment of the GCC's financial sector, where growth has been strong in terms of some clearly defined indicators such as regional banking businesses – covering bank deposits and loans – while international financial market activity is still at the early stage of development. The concept of the Gulf as an international financial centre is new and the future uncertain, with many observers sceptical about the scope for progress. This means that assessments of the Gulf's performance as an IFC and its future prospects are particularly challenging, and any review must rely heavily on information regarding the economic background, indicators of business potential, survey evidence and, finally, judgment concerning how all these factors may come together and impact on the outlook.

Economic and financial statistics (such as money, asset values and wealth) clearly provide one means of measuring financial-sector performance. Of the other indicators available to measure the success and potential of the Gulf as a business and financial centre, surveys are a particularly important source of information. These may focus on the background conditions important in fostering growth of markets and IFCs (what we refer to here as the 'soft indicators' on labour markets, competitiveness, ease of doing business etc.) or they may take a more direct approach to sampling opinions of financial-market practitioners themselves. And there is often important information in such surveys about weaknesses that need to be addressed – they are not simply performance scores.

The only comprehensive survey of market opinion available at present is the one conducted by the City of London, which provides an invaluable source of information on the current status of the GCC centres. However, because of the wide scope of this survey, including all of the multiple US and European markets, results are adapted here to better focus on the rankings of countries and markets outside the two dominant regions. These rankings can then be juxtaposed with the underlying economic performance indicators to assess both the current performance of the IFCs and their future potential.

The City of London survey

The City of London Corporation carries out a continuous market survey on international financial centres, the findings of which are published biannually. This illustrates perceptions and current standing of the GCC centres compared with other centres. However, by extracting country and region rankings rather than taking the results as presented, it is possible to paint an even more favourable picture of the GCC's status in international markets than the survey suggests. The alternative rankings proposed also reveal the close correlation with economic scale and thus support the use of economic statistics in pointing the way to likely future developments.

The first *Global Financial Centres Index (GFCI1)* was published in March 2007, the second edition in September 2007 and the third in March 2008. The Index positions financial centres according to range of criteria: human capital, business environment, market access, infrastructure and general competitiveness. The score for each financial centre is compiled from 62 quantitative 'instrumental' factors (such as size of markets, tax rates, political risk, labour productivity, living costs, quality and availability of office space) as well as 'measuring' the opinions of practitioners: there were 1,236 responses to the last survey.

The survey can capture some of the more subtle nuances of what makes financial centres tick – and also where practitioners think problems lie or where a centre is heading in the future (for instance, high-growth markets may score well even if they are still small by global standards). The more subjective element of the Index – the opinion polling – is valuable in tracking the fluctuating levels of trust and sentiment in different centres, and the survey is therefore a useful starting point in assessing the present rankings of IFCs. However, as the City of London's remit is to promote 'UK based financial and related business services',[1] and is at least in part a subjective assessment, the survey has to be treated with caution not only with regard to the rankings of the top tier but also in respect of the approach taken.

London has come top in all three surveys while New York has been number two each time. London and New York scored 795 and 786 points respectively (out of 1,000) in the *GFCI3* (March 2008), while the number three ranked centre, Hong Kong, scored nearly hundred points less (695). This large gap reflects the fact that London and New York have a long history of operating in financial services and over time have amassed a perhaps unsurpassable set of skills and comparative advantages. The centres which make up the top ten in the *GFCI* have been largely entrenched in their current positions since the first Index was published in March 2007. Any new centre attempting to break into and rise up these rankings faces considerable challenges.

Turning to the Gulf countries' individual rankings, Dubai entered at 25th position in March 2007. Six months later Qatar and Bahrain entered at the bottom of the top fifty (47th and 44th respectively). In the March 2008 survey Dubai ranks 24th, Bahrain 39th and Qatar 47th.

Table 2: Top-ranking IFCs, 2008

Financial Centre	Rank	Score
London	1	795
New York	2	786
Hong Kong	3	695
Singapore	4	675
Zurich	5	665
Frankfurt	6	642
Geneva	7	640
Chicago	8	637
Tokyo	9	628
Sydney	10	621
Dubai	24	585
Shanghai	31	554
Bahrain	39	514
Beijing	46	493
Qatar	47	491
Mumbai	48	481

Source: *City of London Corporation,* Global Financial Centres Index 3.

These results are respectable, although they need qualification. The Index has been evolving, with new criteria and classifications being added every six months. This complicates the comparison of ratings from one survey to the next. Also, the respondents are mostly based in Western markets and therefore do not necessarily provide an accurate reflection of international opinion.

The Index has proved sensitive to recent events and so it should be taken as an indicator of current market sentiment, not as a detached long-term analysis. For example, the negative publicity surrounding the run on the high street bank Northern Rock and debate about the taxation of 'non-doms' in the UK is probably behind the dip in London's score in the March 2008 survey relative to September 2007 (it fell 11 points, from 806).

Among the Gulf states, Dubai has been comfortably ahead in the rankings – largely a consequence of its higher investment levels in a new and high-profile financial centre. In fact, Dubai is cited as being the number one among financial centres that 'might become significantly more important over the next two to three years', as well as ranking number one as a destination where businesses are thinking of opening in the next few years – an indication of how much momentum it has built up.[2] Bahrain and Qatar may be starting from a lower base but they are moving rapidly upwards, having climbed 59 and 51 points respectively in the six months from September 2007 to March 2008. They are among the most significant upward movers in the latest report.[3]

Saudi Arabia Kuwait and Oman are not on the map. Saudi Arabia has begun constructing a major financial centre, to be named the King Abdullah Financial Center, but it remains to be seen how quickly this will actually develop. Oman is unlikely to enter the race to expand financial centres, concentrating instead on sectors such as tourism.

Importance of positioning among IFCs

The City of London survey breaks down its financial-centre rankings into five categories: global, international, niche, national and regional. The top-ranked financial centres, London and New York, are huge and global. London is an excellent example of a natural centre. It has been defined as 'the supranational centre par excellence'[4] with a very long history of trade, finance and legal excellence. Moreover, it has the whole of Europe as a convenient hinterland; it is English-speaking; and it is in a time zone which can catch both Asian and US markets at the beginning and end of the working day.

The top ten ranked IFCs are all large and international. These are followed by the niche, national and regional centres. While some centres have 'naturally', historically evolved as a result of strong economies and leading roles in international trade and finance, other centres have been created in a more 'aggressive' way. Aggressively creating a financial centre might entail targeting a niche offshore segment of the market, by slashing or abolishing taxes for foreign residents and adopting a discreet 'no questions asked' approach towards wealthy investors. However, beyond that, it is not clear that a country can move seamlessly through these categories and up the rankings because the structures and culture necessary to boost one type of business may not be conducive to building business in other areas. This is because a discrete, low-tax environment mainly cultivates private banking and related portfolio management activities – not an obvious springboard for becoming a major centre with global reach across all the main channels of IFC activity.

Dublin is a good example of an aggressive centre, rising from 22nd to 13th on the *GFCI* between September 2007 and March 2008. It has been created in just ten years, helped by having a very low corporate tax rate on new operations, at 12.5%,[5] as well as niche expertise in asset management and insurance. Yet there is no question of its rising further to become a truly global centre and challenger to the top rankings of IFCs. Luxembourg and the Channel Islands are similarly placed niche players. Therefore, any country planning to boost its position as an international financial centre must consider its targets and strategies carefully from the outset as it is not necessarily possible to use entry as a niche player as a means of becoming a full-service global financial centre. It requires different skills and targets to become a top-rank centre and an early focus on niche strategies may divert effort and risk blocking future prospects.

With regard to the long-term plan, the Gulf is clearly not aiming simply at a 'niche' or 'local' role – the level of commitment already made in terms of construction, operations and international partnerships represents a very visible statement of intent. The GCC centres are pitching at a higher goal, at least to be a part of the global financial system and an important centre for a significantly large region. This also shows in the GCC's strategy for tax regimes[6] where rates are being set to be competitive but not aggressively so: Qatar, for instance, has chosen to implement a low-tax (10%) rather than no-tax regime for firms within the QFC.

This clarifies the development objectives of the GCC financial markets and centres: they are thinking and acting international in the short and medium term, with the very long-term aim of becoming an important hub for global finance. Singapore and Hong Kong have shown that this is possible.

Multiple markets can coexist

The GCC financial centres are in a special situation considering both the intense competition and opportunities created by three financial centres (four, counting Saudi Arabia) all trying to get off the ground in the same place at the same time. They must decide where cooperation is mutually beneficial, and where competition serves their interests best. And inevitably the question arises as to whether all these centres can survive or if consolidation will reduce the number over time.

Looking again at the City of London table, the top 20 financial centres in the rankings actually include five centres from the US and eight in the EU: these can be termed 'multimarkets' in a country or region. Two important points can be drawn from this. First, the inclusion of multimarkets means that the top rankings are inevitably dominated by the large developed countries, whereas consolidating these may show a very different picture of 'country' or 'region' rankings: this point is considered further below. Secondly, it illustrates that models for coexistence with close rivals/neighbours already exist and the challenge of a 'multimarket' system is therefore not unique to the Gulf region and need not be unsustainable.

In the US, Chicago, Boston and San Francisco all serve their immediate regions as well as fulfilling specialist functions within the US financial sector. The major US banks and securities businesses have their headquarters in New York, with most of the world's major banks and financial companies also represented there, while Washington houses the specialist legal advisory services upon which the banks depend along with organizations such as the IMF, the IIF and the World Bank. Chicago is a major centre for commodity trading and Boston has a global reputation in fund management.

In other countries, Switzerland is represented by Geneva and Zurich (with smaller centres in other cities such as Basel, Berne and Lugano); Australia by Sydney and Melbourne. The EU bloc has a number of member states in the top ranks. They are, however, dominated by London which is clearly in pole position, serving as the senior market for Europe, while the other centres are either specialist niches (such as Ireland, Luxembourg and the Channel Islands) or mainly regional centres (Frankfurt, Paris).

Table 3: *GFCI* top 20 financial centres

London 1	**Boston 11**
New York 2	**San Francisco 12**
Hong Kong 3	Dublin 13
Singapore 4	Paris 14
Zurich 5	Toronto 15
Frankfurt 6	**Jersey 16**
Geneva 7	Luxembourg 17
Chicago 8	**Edinburgh 18**
Tokyo 9	**Guernsey 19**
Sydney 10	**Washington DC 20**

Source: *GFCI3*.
Note: multiple markets in bold.

Looking at how these neighbours and potential rivals interact should yield lessons for the GCC centres and their potential for cooperation as well as constructive competition. For example, the US model suggests that specialization is one option for maintaining multiple centres. The existence of small, important players in Europe indicates that even when pressured by large, dominant players, centres can survive and grow. However, all these examples benefit from using coordinated systems, methodologies and regulations.

The GCC needs to adopt early harmonization to reap similar benefits and to eliminate the external image of a fragmented set of small markets with variable rules and systems.

Cooperation, competition or 'coopetition'?

The Gulf states are naturally protective of their independence and some observers see the historically tribal nature of the region as preventing, or at least limiting, cooperation and consolidation, including in the financial sector. However, as happened in the formation of both the EU and Eurozone, there were initial historical problems, yet these organizations have succeeded and cooperation has increased. To a large extent, this has been helped by growth in international trade and business interests, which push forward platforms for cooperation and agreement and, if needed, reforms and new legislation. It is also the case that the GCC has been successful in moving ahead on economic cooperation, albeit slowly.

For the GCC at this stage, if it could reach regional consensus on issues such as framework agreements for regulation and governance and form cooperative GCC-level supervisory systems, this would already enhance credibility and increase confidence. Harmonization in these aspects of market regulation is a public good, bringing positive externalities such as raising the profile of the GCC within the financial community and reducing complexity and compliance costs in the long term.

The arguments for cooperation can be summarized as follows:

- Cooperation and exchange of information would help avoid the risk the duplication of projects, unproductive competition and a less effective role at the global level.
- Clearly there are needs common to all states which could be addressed more efficiently by the consolidation of frameworks and setting up of common trading standards, settlement systems and mutually recognized qualifications.
- Cooperation enhances confidence and foreign investor perception of the region: competition can be distracting and confusing to investors.
- Cooperation does not mean there should be just one centre – rather that the sum would become greater than the parts.
- A single GCC framework would enhance the links and balance of power between the Gulf and other major financial centres such as the City of London, Wall Street, Hong Kong, Singapore, Japan and Australia. It would also enhance the opportunity to draw on expertise of counterparts in businesses outside the Gulf region, whether these are banks, exchanges, securities, trading houses, professional services or governments and institutions.

However, constructive competition can be seen as very valuable as well. Certainly 'cooperation' need not mean forced agreements on which centre should specialize in which segments of the market; this would be both unnecessary and potentially damaging.

Overall the most desirable solution is described as 'coopetition' – a popular term for a process of 'selective cooperation' combined with leaving markets free to compete. The most important part of this equation from the point of view of policy is that umbrella framework agreements and systems should be seen as a very important opportunity to enhance the 'GCC brand' and internationally credibility. In addition, this could be beneficial even in terms of costs and staffing given conditions in which the expertise needed is both expensive and in short supply around the world.

In terms of consolidation of financial businesses and exchanges, there are arguments both for and against this trend internationally. But the overall conclusions for the Gulf are that such consolidation is not only unlikely but undesirable at this point – the priorities are elsewhere and such discussion is largely a diversion. After the merger of the New York Stock Exchange and Euronext in 2007, financiers in the East have been debating the need to consolidate in order to enhance cross-border activity, as this would allow for greater technology transfer and greater trading volumes. However, there are plenty of arguments against consolidation (e.g. from Hong Kong) citing problems associated with differences in 'language, culture, market structure, rules and regulations, trading, clearing and settlement mechanisms, oversight, accounting standards and currencies.'[7]

Within the Gulf region, consolidation may even stifle healthy competition and the process of reform via peer group pressure. Saudi Arabia's Riyadh stock market is the largest (effectively because its national economy is still largest) but consolidating regional markets in Saudi Arabia would be unfavourable for other GCC countries and also international investors, at least at this juncture. It is more likely that exchanges will focus resources on prioritizing increasing revenues, widening trading activities and improving their international standing through cooperation and improvements in regulatory frameworks.

Is the GCC punching above or below its 'weight'?

The individual GCC economies and financial centres reap considerable benefits in terms of their international profile and power from the collective 'GCC brand' and this approach could also boost the GCC's positioning in the rankings of IFCs. Indeed, the collective 'GCC' financial centre may already be able to pitch itself into the top ten IFCs by identifying and focusing on its ranking as a region, thereby achieving a similar ranking to that enjoyed by the regional economy.

Using this collective approach, and the backing of its economic power base, one may even demonstrate that there is potential for the GCC's IFC to move up into the top 5–6 in the IFC rankings in the long run based on strengths not just in GDP but also in world trade and wealth. In these rankings, the GCC is are comparable to countries such as Hong Kong and Singapore, which have successfully used their 'hub' status (amongst other advantages) to help leverage their financial power base and move themselves up the IFC rankings.

The City of London survey's findings can be adjusted to illustrate some important points about the GCC's position which may not be obvious from the current format for presenting results. The large number of multimarkets (centres from the same countries), multiplicity of European markets and numerous niche centres in the rankings tend to obscure the international picture. It is useful to look separately at rankings on the basis of regions and also rankings of centres *excluding* the leading areas of the US and EU – indeed this exercise suggests that more targeted survey work could be done along these lines.

Table 4: IFC rankings by main region served (excluding multimarkets)

Rank	Region
1	London/EU
2	New York/North America
3	Hong Kong/emerging Asia (North)
4	Singapore/emerging Asia (South)
5	Switzerland/Europe
6	Tokyo/developed Asia
7	Australia
8	Dubai, Bahrain and Qatar/GCC
9	Caribbean, South Africa
10	India
No ranking	Russia, Latin America

Source: Own assessments based on *GFCI* rankings.

Table 5: IFCs excluding North America and Europe

	IFCs – rest of the world	Original ranking
1	Hong Kong	(3)
2	Singapore	(4)
3	Tokyo	(9)
4	Sydney	(10)
5	Dubai	(24)
6	Cayman Islands	(25)
7	Gibraltar	(26)
8	British Virgin Islands	(27)
9	Melbourne	(29)
10	Shanghai	(31)
11	Bahamas	(36)
12	Bahrain	(39)
13	Johannesburg	(41)
14	Beijing	(46)
15	Qatar	(47)

Source: Own assessments based on *GFCI* rankings.

Individually, the GCC countries currently rank within the top 50 financial centres, with Dubai at 24 and Bahrain and Qatar nearer the bottom end. However, if the numerous multimarkets are stripped out, Dubai moves up to around 14th place. Indeed, if these rankings are reconfigured more radically according to region served rather than individual country, the GCC can be seen to fare even better, scraping into the top ten based on the current *GFCI* score for Dubai alone.

Alternatively, if all the financial centres of America and Europe are stripped out, then Dubai is actually placed fifth in the 'rest of the world' rankings, while Bahrain and Qatar are also in the top 15. This revised ranking also reveals the plethora of niche markets included in the survey – such as the Cayman Islands, Bahamas and Gibraltar. Excluding these niche players and the multimarkets, the three GCC centres would all be in the top ten in this table.

GDP rankings

The reworking of the City of London IFC rankings list according to region demonstrates that there is a natural correlation between these rankings and the size of the economic 'bloc' served by a financial centre. For example, GDP rankings shown in Table 6 are relatively similar to the 'regional' IFC rankings of Table 4.

This correlation is meaningful. One of the reasons for this is the linkage of GDP and the scale of local financial market operations – for example, stock markets may be roughly valued as equivalent to annual GDP and money supply (the scale of banking business, deposits or loans) is also strongly correlated with GDP. Money supply is typically around the same scale as GDP, often slightly higher in underdeveloped financial markets which depend more on banking than other financial instruments. In the GCC, while Saudi Arabia has a relatively low banking/GDP ratio, the average is not far short of 100% of GDP (according to IMF figures and as shown in Section 3). These two basic building blocks of financial wealth and operations are worth roughly double annual GDP and will grow broadly in tandem with GDP growth. At the world level, the third 'leg' of the financial market triangle is the debt market (i.e. broadly government and corporate bonds, accounting for 35–40% of total world wealth); however, within the GCC the debt market is currently very small and rudimentary – an issue discussed in Section 3. From the point of view of this very basic backing for a country's or region's financial markets and services, size matters. GDP rankings act as crude indicators of the potential business of a country's financial sector, although clearly this does not necessarily correlate with the degree of sophistication or presence in *global* financial business.

The huge scale of the EU and US in terms of aggregate GDP is an important reason for the dominance of the US and UK in financial markets, although this ranking is more impressive for the UK, given that it had to succeed against tough competition from a number of well-developed and well-placed European contenders, especially Frankfurt and Paris. To some extent, China's large and booming economy has provided the backing for Hong Kong as well as the rise of China's own financial markets. And economic power still forms the core backing for the reasonably high score of Japan as an IFC, although it is notably slipping slightly below its economic ranking due to failures in addressing other key factors necessary to support a GFC.

Table 6: GDP rankings – the top ten

Rank	Region	GDP estimates 2007 (US$ tr)
1	EU	17
2	US	14
3	Japan	4.4
4	China (including Hong Kong)	3.5
5–7	Canada, Brazil, Russia	1.3–1.4
8–9	India, Korea	1.0
= 10	GCC total, Mexico, Australia	0.8–0.9
	World total	53

Source: IMF.

In terms of GDP, in 2007 the GCC as a bloc ranked joint 10th in the world, alongside Mexico and Australia: all were around $0.8–0.9 trillion. The GCC should comfortably exceed the $1 trillion level in 2008, overtaking Korea and India and probably climbing to 8th place. This measure does not include any additional, looser 'regional' bloc – arguably the GCC might represent the wider MENA region, for example, pushing the GCC further up the economic rankings to fifth place, based on a regional GDP worth around $2 trillion. Of course, in this case, other competitors may be seen as blocs as well. However, of the other countries represented in the top ten, arguably only Russia has a strong claim to own a 'hinterland' of any significance.

The argument the economic rankings make in favour of the position of the GCC as a financial centre is basic but valid. As the *GFCI 3* notes, 'international financial markets are highly interdependent and strongly linked to the real economy'.[8] And on both the reworked IFC rankings and the global GDP rankings, the GCC comes out at about 9th or 10th place with scope to edge up to 8th quite rapidly. This means that the GCC (represented by the highest-ranking centre, Dubai) could challenge Australia (Sydney) before long. However, there is also a case for the GCC eventually performing even better than the GDP ranks suggest based on its higher rankings in world wealth and trade.

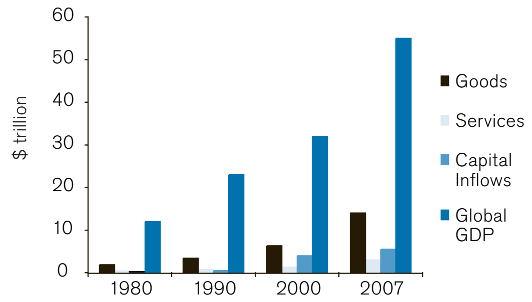
Strength in world trade

Wealth and world trade activity are useful supplementary indicators to GDP as measures of global economic linkages and power: the former generating a need for professional asset management and investment services as well as market power; the latter indicating a high degree of openness and interaction with the rest of the world that is clearly helpful if a financial centre is going to operate successfully as an international hub. Singapore and Hong Kong are disproportionately successful as financial centres relative to the size of their country GDP, but their 'potential' IFC rankings rise dramatically when treated on the basis of their role in global trade – even without including an economic 'hinterland' effect. While it may be argued that goods trade in the GCC, as compared with the Asian hubs, is very narrow in terms of products exported (largely energy-related), this only represents one side of the picture as their import trade is diverse, which is equally important in terms of trade activity and finance. In addition, both imports and exports are fairly broadly spread geographically. The opposite is true in Hong Kong, where trading is wide in terms of the range of manufacturing products treated, but narrow in terms of geographical scope (being largely tied to China).

As can be seen in Figure 16, the GCC performs strongly in trade rankings, actually surpassing Hong Kong and Singapore. It ranked fifth worldwide based on a total of $465 billion in goods exports in 2006 (WTO figure), although the import ranking is slightly lower (around 8th place). Future trends are promising and the GCC could even outpace Japan in the export rankings. The GCC region as a trading bloc is becoming ever more globalized and integrated, also in terms of substantial capital outflows and inflows, reflecting sizeable financial market involvement on many fronts. Indeed, global trade, capital flows and wealth are all growing much faster than world GDP: compared with a rise of just over 75% in GDP over the last decade, world trade has soared by 150%, while wealth has about doubled. GCC exports have grown even faster, quadrupling between 1997 and 2007.

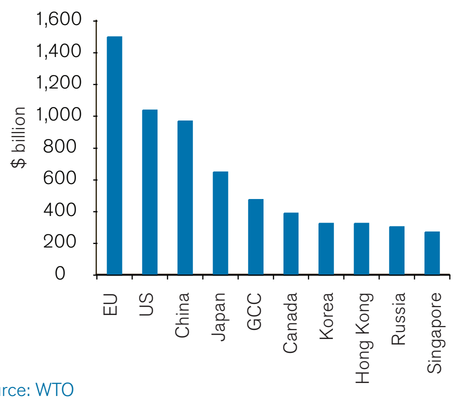
There are clearly some anomalies in the ranking correlations which provide a useful reminder that economic

Figure 15: Global GDP, trade and capital flows – evolution since 1980



Source: IMF.

Figure 16: Value of goods exports, 2006



Source: WTO

scale is not sufficient to reach or maintain a high ranking as an IFC. Once more the 'odd man out' is Japan, which still ranks fourth in world trade and third in GDP but is slipping down the IFC rankings. Notably, Russia and South Korea also score poorly as IFCs, punching well below their potential weight. The lessons here relate to the need to address the non-economic factors that make an IFC successful, including the ability to foster relations and business links with the senior markets.

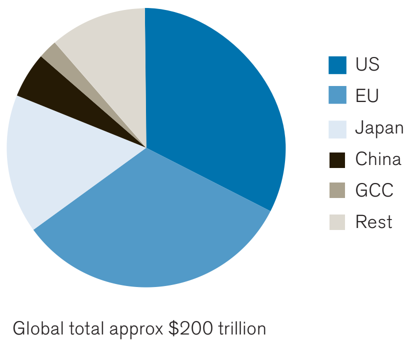
Nevertheless, inasmuch as Hong Kong and Singapore gain top ten status as major trading hubs, helping their financial centres to punch well above their own economy's weight in terms of GDP, this trade status measure of potential as an IFC argues for an even higher placing of the GCC than the GDP measure alone suggests. Apart from trade illustrating a country's important function within the world system and its openness, there is a direct link to potential business related to trading activity. Many financial services and products, such as export finance, foreign exchange trading and insurance, may be strongly correlated with the value of trade. The relatively high positions of international financial centres such as Hong Kong and Singapore to some extent reflect this base – and suggest that the GCC is punching below its potential weight. Clearly, so far, it has failed to develop a presence in financial products in which, arguably, it should be well placed (representation in product terms is discussed in Section 3). However, provided shortcomings are addressed, the backing for the GCC to move up the IFC rankings is strong. Scope for the GCC (represented by Dubai) to overtake Australia (Sydney) in the IFC rankings has been mentioned already but with Tokyo's score slipping back, the GCC might succeed in overtaking Japan as well over the next decade.

Wealth and the rich list

The GCC also represents a sizeable proportion of world wealth:[9] national domestic wealth is probably just over $2 trillion (or double GDP, as indicated above, based on stock market capitalizations and money and banking operations), with substantial holdings of external wealth adding to the total. In addition, official external wealth (chiefly the region's SWFs but also foreign exchange reserves) is estimated to be worth more than $2 trillion but the level of other external private wealth is unknown. This probably puts total known wealth at about $5 trillion for 2008. While world wealth is inevitably dominated by 'old money', the 'new' measurable financial wealth of the GCC still accounts for around 2–3% of global wealth and ranks in the world top ten. Including private wealth, the share would be higher.

Information on private wealth is hard to assess. However, the latest Forbes list of the world's billionaires, published in April 2008,[10] notably included numerous GCC nationals. Some of the wealthiest families in the Gulf can count enormous fortunes: Prince Alwaleed Bin Talal Al-Saud (joint Lebanese and Saudi citizenship) is reported to have a fortune of $21 billion, making him the 19th richest man in the world. His wealth derives from investments in United Saudi Commercial Bank, Citigroup, Arab Radio and Television Network, Four Seasons Hotels and Fairmont Hotel, among others. The Kuwaiti Nasser Al-Kharafi, Chairman of Egypt Kuwait Holding Company, is thought to possess $14 billion, while the Saudi self-made businessman Mohammed Al-Amoudi has earned $9 billion from the oil industry.

Figure 17: Estimated financial wealth by region (2007)

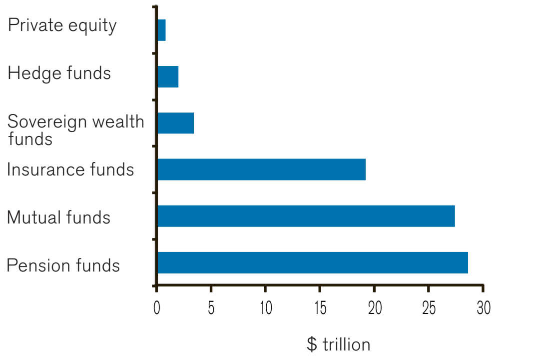


Source: Own calculations.

In terms of official holdings, total petrodollar assets (from the GCC states but also Algeria, Iran, Libya, Syria and Yemen, together with Norway, Russia, Nigeria, Venezuela and Indonesia) accounted for $3.4–3.8 trillion in 2006.[11] Figures for SWFs are slightly lower but broadly these show a similar development with growth averaging around 20% per annum over the last five years. Growth in these funds almost certainly increased even faster in 2007-08 based on soaring oil prices and revenues. As Figure 18 shows, total SWFs eclipse global hedge funds and private equity. In early 2008, the total value was probably running just behind global foreign exchange reserves of around $5.5 trillion, chiefly held in Asia. (However, it must be acknowledged that this figure does involve some measure of double-counting, as SWFs invest in mutual funds, private equity and hedge funds and some SWFs are also doubled-counted in foreign exchange reserves, for example in the case of Russia.) Although petrodollar assets are in turn dwarfed by international, mutual and pension funds, in individual fund terms, the SWFs of the Gulf are in the top rank.

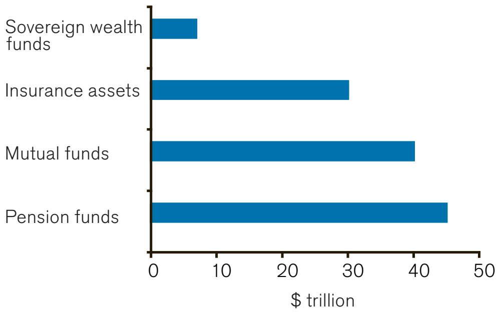
The Abu Dhabi Investment Authority (ADIA) had estimated assets of $875 billion at the end of 2007.[12] ADIA is easily the largest SWF in the world, followed by Norway and Singapore in second and third place. KIA

Figure 18: Assets under management (end-2007)



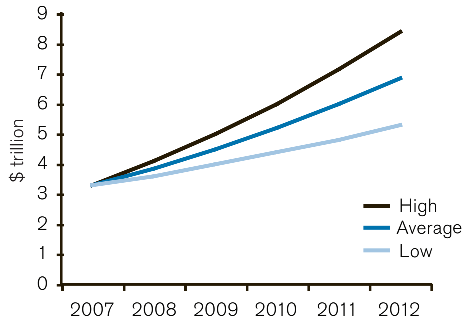
Source: IFSL.
Note: Pension fund and insurance fund figures are based on assumption of 10% growth on IFSL's 2006 estimate; mutual funds figure is an IFSL estimate.

Figure 19: Assets under management – key projections to 2012



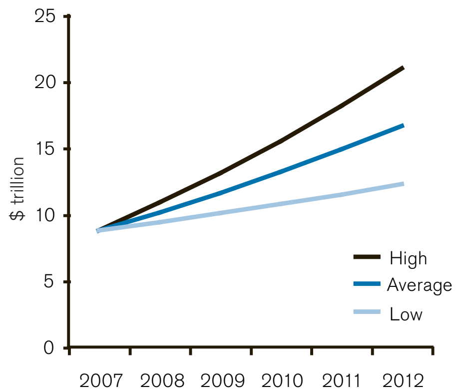
Sources: IFSL, own calculations.
Note: SWF figure based on average estimate (excluding foreign exchange reserves) as in Figure 20; other estimates based on assumption of 10% growth per annum.

Figure 20: Estimated value of SWFs reserves 2007–12



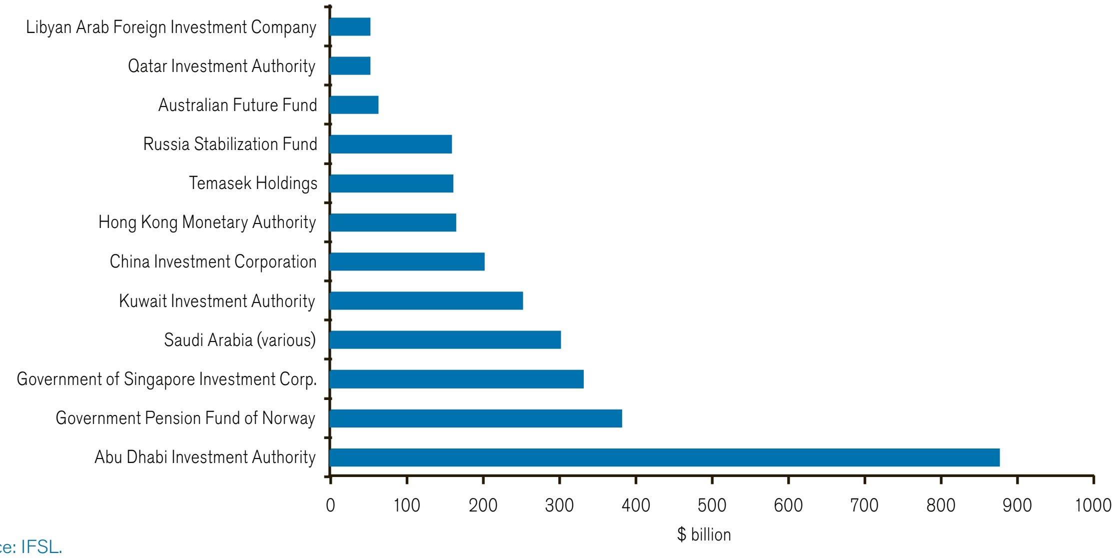
Source: Own estimates.
Note: Assumes existing FX reserves are kept separate from SWFs. High estimates for SWFs based on cash inflows of $500 billion per annum, and investment returns of 10% per annum (by 2015, this methodology produces a forecast of about $12.5 trillion for SWF holdings, just a little above the estimate made by Stephen Jen in 'How big could SWFs be?', Morgan Stanley, 2007). Low estimate based on no further cash inflows (10% investment returns only).

Figure 21: Estimated value of SWFs and FX reserves, combined total, 2007–12



Source: Own estimates.
Note: Based on FX reserves combined with SWF assets. High estimates based on high estimate for SWFs as in Figure 20 plus high estimates for FX reserves based on cash inflows of $1 trillion per annum and investment returns of 5% per annum. Low FX estimate based on no further cash inflows (5% investment returns only).

Figure 22: Assets under management



Source: IFSL.

has $250 billion in assets, QIA $50 billion, and Saudi Arabia $300 billion in various holdings (pension funds, SWFs etc.). The largest Gulf sovereign wealth funds thus accounted for $1,475 billion at the end of 2007, of which more than half comprised foreign assets. ADIA is now one of the top ten asset managers worldwide, just below the People's Bank of China (based on China's total foreign exchange reserves, not SWF funds which are much lower).

This high level of wealth, and the fact that the individual SWFs of the GCC represent some of the largest single fund management operations in the world, endow the Gulf's fund management business alone with a potentially powerful international role. While the international role of the rest of the Gulf's financial markets may be weak or rudimentary, in the case of SWFs the GCC clearly does punch well above its economic weight.

Arguably, on the basis of this factor and the economic power of the region (in GDP and trade), the GCC could already be seen as a major international financial centre. However, this would not be broadly enough based across financial markets and products to enable the GCC to improve its position in rankings such as the City of London survey, for which the focus is much more on financial-market operations and professional trading activity across international as well as local markets.

The 'soft indicators' for competitiveness, business environment and corruption

Arguments based on the development of economic scale tend to point to very positive conclusions regarding the long-run prospects for the GCC's financial sector. However, the City of London rankings already suggest that economic scale is a necessary but not a sufficient condition for the development of IFCs. Other indicators for the business potential and competitiveness of the GCC states should be examined to shed light on the other factors required for success. These indicators point in particular to some of the stumbling blocks for the advancement of the GCC's IFCs into the top ranks.

Competitiveness and human capital

Another useful snapshot of positioning is provided by the World Economic Forum's *Arab World Competitiveness Report*. To summarize the main findings, the UAE (ranked 29), Qatar (32), Kuwait (36) and Bahrain (39) all are included in the top 40 'innovation-driven' countries, the third most highly developed category, after the 'factor-driven' and 'efficiency-driven' stages. 128 countries are included in total. Considering their starting point, the fact that the GCC countries are now closing the gap with (and even surpassing) mature European economies such as

Portugal (31) and Italy (34) is impressive.[13] 'Competitiveness,' of course, is not the same thing as being successful as a financial centre: Finland, Sweden and Denmark may be very competitive but they do not host major IFCs. And notably, the US and UK rank only 6th and 10th respectively in terms of competitiveness, below Singapore and some of the small European countries, yet this does not prevent their high standing as IFCs.

Table 7: Arab world GCI 2007 rankings in international comparison

Country/Economy	Rank	Score
Switzerland	1	5.81
Finland	2	5.74
Sweden	3	5.73
Denmark	4	5.70
Singapore	5	5.62
United States	6	5.62
Japan	7	5.62
Germany	8	5.60
Netherlands	9	5.57
United Kingdom	10	5.53
United Arab Emirates	29	4.67
Qatar	32	4.56
Kuwait	36	4.42
Bahrain	39	4.30

Source: World Economic Forum The *Arab World Competitiveness Report 2007 – Sustaining the Growth Momentum.*
Note: From a list of 14 factors, survey respondents were asked to select the five most problematic for doing business in their country/economy and to rank them between 1 (most problematic) and 5.

For the GCC, the main problem which emerged from the World Economic Forum's *Arab World Competitiveness Report* related to human capital and bureaucracy. Restrictive labour regulations, a poor work ethic in the national labour force and an inadequately educated workforce were cited as problems in nearly all the GCC states. These are important matters and ones which need sustained action over the long run to improve the education system from primary school through higher education and into the job market, nurturing the next generation of the workforce.

Labour market needs can be met by investing heavily in a modern education system and on-the-job training to improve the skills of the local workforce – preferably both. Indicators point to some improvements but also problems in pushing forward skills.

Table 8: Tertiary students in science, engineering, manufacturing and construction (% of tertiary students)

Country	1999–2005*
Hong Kong	31
India	22
UK	22
Oman	20
Qatar	19
Bahrain	17
Saudi Arabia	17
US	16

Source: *UNDP Human Development Report 2007/08.*
* Data refer to the most recent year available during the period specified.

Table 8 shows that Oman, Qatar, Bahrain and Saudi Arabia already have a sizeable proportion of tertiary students enrolled in science, engineering, manufacturing and construction courses – in the 17–20% bracket, comparable to the UK's 22% and surpassing the US's 16%. However, other sources paint a gloomier picture, pointing in particular to the way in which many of the top students in the GCC study in the UK and US but then take jobs in these countries rather than returning to the Gulf.

However, it should be remembered (as discussed in Section 1) that to move the economy up the 'sector' ladder, not everyone needs to climb at the same pace and the key is to focus expert training on those at the very top level while many employees need only have the broad-based skills to function in a modern office environment (for example, administration, communications and IT skills) rather than higher-level professional qualifications. In addition to formal training and on-the-job learning, use can be made of the local media as programmes quickly reach a very wide audience. This helps accelerate bottom-up skills levels to complement the needs of the cadre of skilled professional skills being developed at the top level.

The UAE government has begun a policy known as 'Education 2020' which places major emphasis on science, mathematics, English and providing children with skills to learn independently (rather than by rote) and innovate. Qatar has embarked on a plan (which is now half-complete) to convert its government schools to independent self-management status and to abolish its Ministry of Education. It also set up the Qatar Foundation over a decade ago; this has brought five major US universities to the country to offer degree courses of the same level as the home campus in subjects such as Business, IT, Design, Engineering, and International Relations. The first graduations from these universities took place in early 2008.

These ambitious initiatives should go some way towards meeting educational needs as well as helping to embed the financial sector in the local context by developing suitable skills amongst the resident population. Bahrain has an advantage in this respect as some 72% of its financial staff are Bahraini, and Bahrain's relatively large pool of educated middle class can be relied upon to support and expand the financial-services sector in the future.

The business environment

Apart from the human capital requirements necessary to operate financial-services businesses, the success of an IFC will also be dependent on the following key attributes:[14]

- the ability to attract capital inflows, including long-term investments such as inward foreign direct investment (FDI);
- the ability to attract and establish international financial institutions and business transactions;
- the demand for international fund management, which is based on the build-up of local savings and wealth, the need to diversify holdings across international markets and management skills.

In turn, the ability to attract both capital flows and foreign institutions is dependent on maintaining a friendly socio-economic environment.[15] The 'friendliness' of an environment is not something that can easily be measured, but there are surveys which chart this territory, for instance the Heritage Foundation/*Wall Street Journal*'s *Index of Economic Freedom* and Transparency International's *Corruption Perception Index*.

The *Index of Economic Freedom* 2008 states that 'The highest form of economic freedom provides an absolute right of property ownership, fully realized freedoms of movement for labor, capital, and goods, and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself.'[16] Therefore it is a useful pointer to the ease and security of doing business in a country and it may be expected to correlate with the level of foreign participation in a country's markets and the degree of confidence of investors.

According to this report, Bahrain is one of the 20 freest economies in the world. This is a major leap up from Bahrain's 2007 ranking (20 places lower) and is far ahead of other GCC rivals Kuwait (39), Oman (42), Saudi Arabia (60), the UAE (63) and Qatar (66).[17] For comparison, Table 9 includes India (115) China (126) and Russia (134), other countries with significant government involvement in the economy, and where bureaucracy and corruption are perceived as problems. However, it is clear that the Gulf states fare much better than these 'rivals', possibly aided, in this respect, by the relatively small populations of the GCC.

Table 9 shows that the UAE, Saudi Arabia and Qatar all score very poorly in terms of Investor Freedom. This reflects caps on foreign investment (for instance, there is a 49% limit on foreign ownership of locally listed companies in the UAE and Qatar – although in the former there is talk of an increase to 75% later in 2008). Saudi Arabia has a low score for Freedom from Corruption. All Gulf states have a high score for Fiscal Freedom, which reflects their low tax rates and current budget surpluses.

However, there are a number of anomalies and erratic changes in the Index which cast doubt over the overall results. For instance, it is hard to explain how any country could alter its structural and financial environment so dramatically within a single year that it climbs 20 places in the rankings, as Bahrain managed to do in 2007–08. Another is the ranking of Saudi Arabia and the UAE equally at 62.8 points – although the Dubai freezone is far

Table 9: Economic Freedom Index (EFI)

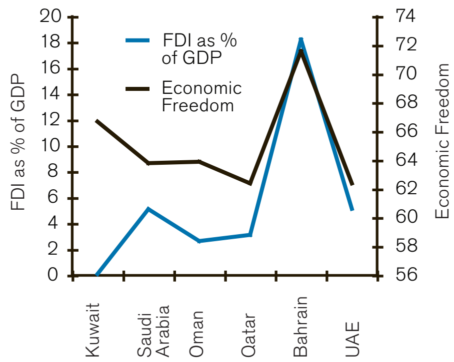
	Country	Overall Score	Business Freedom	Trade Freedom	Fiscal Freedom	Gov't Size	Monetary Freedom	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption	Labour Freedom
1	Hong Kong	90.25	88.18	95.0	92.8	93.07	87.21	90	90	90	83	93.3
2	Singapore	87.38	97.79	90.0	90.3	93.87	88.86	80	50	90	94	99
3	Ireland	82.35	92.22	86.0	71.5	64.5	84.91	90	90	90	74	80.4
4	Australia	82	89.32	83.8	59.2	62.83	83.68	80	90	90	87	94.2
5	United States	80.56	91.69	86.8	68.3	59.81	83.67	80	80	90	73	92.3
6	New Zealand	80.25	99.9	80.8	60.5	55.99	83.67	70	80	90	96	85.5
7	Canada	80.18	96.74	87.0	75.5	53.67	80.98	70	80	90	85	82.9
8	Chile	79.79	67.48	82.2	78.1	88.24	78.82	80	70	90	73	90
9	Switzerland	79.72	83.89	87.2	68.0	61.55	83.57	70	80	90	91	82
10	United Kingdom	79.55	90.79	86.0	61.2	40.06	80.75	90	90	90	86	80.7
19	Bahrain	72.2	80.0	80.8	99.7	80.3	74.3	60	90	60	57	40.0
39	Kuwait	68.3	68.5	81.0	99.9	74.6	73.8	50	50	55	48	82.1
42	Oman	67.4	55.8	83.6	98.5	60.7	74.7	60	60	50	54	77.2
63	UAE	62.8	47.9	80.4	99.9	80.2	70.9	30	40	40	62	76.2
60	Saudi Arabia	62.8	72.5	76.8	99.7	69.1	76.7	30	40	50	33	80.6
66	Qatar	62.2	60.0	70.8	99.8	72.1	69.4	30	50	50	60	60.0
115	India	54.2	50.0	51.0	75.7	73.5	70.3	40	30	50	33	68.6
126	China	52.8	50.0	70.2	66.4	89.7	76.5	30	30	20	33	62.4
134	Russia	49.9	52.8	44.2	79.2	69.5	64.4	30	40	30	25	64.2

Source: *Index of Economic Freedom 2008.*

more open and 'business-friendly' than Saudi Arabia, where some sectors are still off-limits to foreign investment (the overall score for the UAE is not necessarily the same as Dubai's but it would be surprising for the rest of the UAE to rank so poorly to weigh down the average). Lastly, the relative scorings of Saudi Arabia (quite high at 80.6) and Bahrain (quite low at 40) in the Labour Freedom category are counter-intuitive; Bahrain employs a higher proportion of nationals (as opposed to expatriates) than its GCC neighbours and this should not be taken as an indicator of unsympathetic labour laws. Indeed, Bahrain prides itself on being one of the best countries in the region for freedom of expression, movement and work. A high degree of employment of nationals should be seen not as a weakness but as reflecting the strength of local society and the economy. This is the result of a long-standing commitment to universal education and the successful cultivation of skills in the resident labour force, providing a stable long-term foundation for society and the economy, including its financial sector.

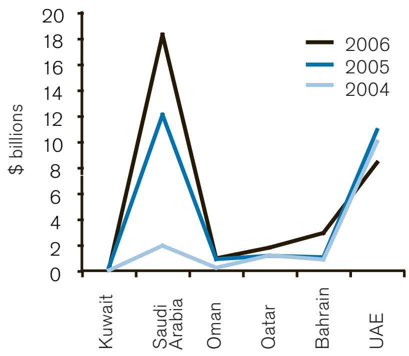
Another test of 'Economic Freedom' and a general indicator of the ease of doing business, the level of foreign participation in markets and market confidence is FDI. Figure 23 plots the Economic Freedom Index (EFI) against FDI inflows, which effectively demonstrate how investors are 'voting with their feet' on investment conditions within each economy. Although the GCC countries are capital-rich, and generate a savings surplus, they nevertheless have seen FDI inflows rise in recent years to a GCC aggregate of almost $35 billion in 2006 from previously very low levels (Figure 24). While some of this inflow could be related to the boom in the energy sector (especially within Saudi Arabia, the largest economy), FDI inflows are important in promoting trade links and generating non-energy business. They are generally a sign (often an early sign) of rising international investor confidence.

Figure 23: Correlation of FDI inflows with the Economic Freedom Index (2006)



Source: UNCTAD, Heritage Foundation/*Wall Street Journal*.

Figure 24: FDI inflows into GCC countries



Source: UNCTAD, Heritage Foundation/*Wall Street Journal*.

The snapshot cross-country analysis crudely demonstrates that there is little evidence of a close correlation of FDI (in $ billion) with the EFI, although when FDI is scaled by the size of the recipient economy, the correlations are somewhat closer (for example, the Saudi Arabian FDI score is scaled back, while Bahrain's is high). The potential mismatch in action (FDI) versus opinion (as surveyed for the EFI) is also demonstrated by the case of China, which has persistently scored poorly in many 'soft' surveys in spite of enjoying one of the highest rates of FDI inflow in the world, typically in the $50–100 billion per annum range. Clearly, qualitative surveys have a role to play but should not be relied upon as the sole source of evidence.

Indicators of corruption

The legal system and corporate governance in the Gulf, especially in state-owned enterprises, has not yet reached a high standard and confidence will take time to develop. This is reflected in the results of the Transparency International *Corruption Perception Index* which relates to perceptions of the degree of corruption as seen by business people and country analysts. Scores are compiled from 14 opinion surveys (including the Asian Development Bank, African Development Bank, Economist Intelligence Unit, World Economic Forum and other international organizations) and scores range between 10 (highly clean) and 0 (highly corrupt). Of the 180 countries included in the survey, the GCC countries fare moderately well, with Qatar (ranked 32) and UAE (34) leading with the lowest levels of perceived corruption, and Saudi Arabia (79) trailing the group. According to the *Index*, the perceived levels of corruption in Bahrain (46) and Oman (53) showed a significant deterioration in 2007. The small Gulf states, while not as 'clean' as the Scandinavian countries, nevertheless do far better than China and India (joint 72), and significantly better than Russia (143).

Table 10: Corruption Perception Index, 2007

Rank	Country	2007 CPI score
1	Denmark	9.4
1	Finland	9.4
1	New Zealand	9.4
4	Singapore	9.3
4	Sweden	9.3
6	Iceland	9.2
7	Netherlands	9.0
7	Switzerland	9.0
9	Canada	8.7
9	Norway	8.7
32	**Qatar**	6.0
34	**United Arab Emirates**	5.7
46	**Bahrain**	5.0
53	**Oman**	4.7
60	**Kuwait**	4.3
72	China	3.5
72	India	3.5
79	**Saudi Arabia**	3.4

Source: Transparency International, 2007.

According to Transparency International, the high scores of European countries are a product of their 'relatively clean public sectors, enabled by political stability, well-established conflict of interest and freedom of information regulations and a civil society free to exercise oversight'.[18] As Anoushiravan Ehteshami and Steven Wright point out, the Gulf states do not have a tradition of participatory and pluralistic civil society, in which the people and free media serve as a watchdog over their government. There is a tradition of ruling dynasties whose power has been guaranteed by the presence of an effective army.[19] This has stifled the development of transparent and open governing structures and means the Gulf continues to be an environment in which corruption may escape public exposure.

The occasional incidence of corruption or rogue trading is damaging to the reputation of a financial centre – for example the Enron scandal in the US in 2001, or the collapse of Barings Bank in the UK in 1995, or the damage done to Société Générale by the Paris trader Jerome Kerviel's £3.7 billion losses in early 2008. New York, London and Paris have proved robust enough and their reputations strong enough to sustain occasional rogue trading. However, such incidents would prove more fatal to emerging markets, and regulators need to be seen to guard against them (even if vigilance sometimes fails). Also, in the long run it is much more damaging if these incidents are happening and are widely believed to be covered up, so the GCC must be seen to actively increase the transparency of financial markets.

The Gulf region has significant volumes of foreign money flowing through its banking system and is therefore susceptible to hazards related to this, such as charges of money-laundering. A largely unregulated *hawala* system (informal remittances outside the conventional banking system – which can be used for both legitimate and illegitimate purposes) flourishes in the Gulf. Many of the numerous construction workers from the Indian subcontinent feed the system, using it to send wages to relatives at home. With such a high volume of transactions, it is difficult to pinpoint those that may be suspicious. Coupled with this, Dubai has a thriving gold market, and gold – for its versatility and stable value – is a much-used commodity in money-laundering operations. This seemed to be confirmed by reports following the 9/11 terrorist attacks in the US, when links were detected between a UAE branch of Citigroup and the terrorist hijackers' bank accounts (not to mention the fact that a number of the hijackers took flights from Dubai airport to the US before carrying out the attacks).

Since then, measures have been taken to crack down on illegal activity and regulate *hawala* operations. All countries have taken steps to comply with Financial Action Task Force (FATF) anti-money-laundering regulations although they have stopped short of making full provisions to the Money Laundering Directive.[20] In 2002, new anti-money-laundering legislation came into force in the UAE which introduced restrictions on transfers, raised the maximum jail term for money-laundering offences to seven years and put up the maximum fine to 10 million dirham (US$2.72 million).[21] In February 2007, after an 18-month investigation, the UAE Central Bank began a major assault on *hawala* dealers, freezing bank accounts and arresting dozens of individuals in an attempt to curb the tide of money-laundering. This was a confidence-enhancing move, but to gain the full trust of the international financial community, all the GCC states will have to visibly keep up the pressure on illegal and illicit money-laundering operations.

Corruption is partly a product of excessive state control – an uneven playing field typically benefits government-linked firms over private enterprise. The state and private sector must be separated to avoid criticism and risks of 'crony capitalism'. Some analysts argue that crony capitalism was a significant factor in the 1997 Asian financial crisis, as it defied otherwise sound macroeconomic fundamentals, fiscal balance and responsible monetary policies. Market mechanisms were thwarted by a too close relationship between government and business, the implicit government 'guarantee' of bail-out to financial bodies and absence of adequate supervision. The GCC needs to ensure that it is not tarred with the same brush, by focusing heavily on corporate governance, disclosure and transparency.

Recommendations based on the 'soft indicators'

In terms of the survey evidence reviewed, this offers a number of recommendations for ways in which the GCC countries can improve their standing, gaining trust and credibility in the international business world and – as a by-product – rise up the IFC rankings. These recommendations can be summarized as follows:

- Continue to progress in improving the 'friendliness' of the socioeconomic environment, which includes increasing freedom for investors and employees and expanding property rights.
- Continue to shrink the role of the state (including its role in the shareholding structure of many leading companies) and cut government bureaucracy and red tape.
- Continue moving down the road to full democracy and a participatory civil society, including promoting media freedom.
- Concentrate on rooting out corruption and the perception of corruption.
- Improve and focus investment in education and training of the domestic workforce, both at the top level and to better meet skill requirements on a broader basis.
- Continue to develop infrastructure, including office, housing and leisure facilities, to attract the best possible international workforce but also to benefit and integrate the local population.

Political and legal reforms

Political and legal systems are important determinants of any country's standing in the international community and markets. Reforms to address weaknesses need to be pursued rigorously – with the emphasis on clarity.

One of the perceived obstacles holding back the transition to a market economy with the highest levels of corporate governance is the dominance in the Gulf economies of prominent families, which often hold the reins of both political and economic power. Given this culture of family ownership, it is difficult to ensure a meaningful separation of power among key officials, a genuinely active shareholder culture and rigorously enforced disclosure standards.

However, two trends – greater economic success and globalization – are increasing the appetite for more representative and democratic institutions. As Ehteshami and Wright point out, as countries become more integrated into the global economy there will have to be more accountability in decision-making. The GCC governments will have to conform to international best practice. 'Pressure for economic reform holds the potential to change business culture in the long term, which in turn will lead to pressure for changes in the traditional system of governance.'[22]

Bahrain has maintained a relatively progressive stance for many years and the constitution already permits women to stand as candidates in municipal elections, parliamentary elections and for the consultative council, the Majlis Al Nuwab. In Qatar too there has been progress. Press censorship has ended, the Ministry of Information's role has been minimized and women were able to participate in recent elections. Kuwait and Oman are leading the way in terms of female representation on the boards of public companies, with 2.7% and 2.3% respectively, compared with 2.0% in Italy.[23]

Because the Gulf states are both independent and interdependent, it will be hard for some rulers to maintain curbs on civil freedoms when these are being offered by rival neighbour states. Ehteshami and Wright conclude that the GCC states are likely to follow each other's lead in offering reforms and democratic participation, a process they call 'bandwagoning'[24] – in much the same way that the states are emulating and following each other's financial and even architectural development.

Corporate governance and transparency

Improvements in corporate governance should be facilitated by the political changes under way. The report *Power Matters* analyses the composition of the boards of 582 companies in the Gulf and reveals how the large companies in the GCC are still dominated by multiple members of the same family. Certain families have 100% board ownership in some of the GCC's public companies, especially in Kuwait – and this is likely to be more often the case in private companies. The Al-Thanis, the Qatari royal family, chair 76% of all public company boards in that country, and in other states boards are dominated by the leading merchant families. The picture varies across the GCC, however: in Dubai the problem is not so severe as no family holds over 50% of board seats.

Progress is being made. Hawkamah, the Institute for Corporate Governance, was launched in February 2006 as an organization for the promotion of corporate governance in the MENA and Central Asia regions. The association has been lobbying for the development of corporate governance standards in the region, with an emphasis on institution-building and corporate-sector reform and special task-forces for the banking sector and state-owned enterprises. This has ensured that awareness of the importance of corporate governance, and of the current shortfall between current standards and international best practice, has been raised. Other factors driving improvements in this area are increased foreign participation in GCC stock markets, greater private equity activity and more GCC corporations operating in international markets. These developments are exposing GCC investors to international standards and raising expectations of best practice. In addition, as the legal systems governing the financial sectors in GCC countries are being reformed and brought into line with international norms, there is greater confidence regarding, and scope for, legal redress following accounting and corruption scandals.

Practices are already improving, with financial services and the wider economy opening up. In Qatar the financial markets will be open to all investors in 2014 regardless of nationality.

As a reminder of the benefits of a fully open economy, it is possible to argue that the reason why London has gained over New York as an IFC in recent years is its superior openness and liberality. This is demonstrated by the UK government's smaller presence in financial services, principles-based legislation and a more relaxed attitude towards foreign capital and takeovers as well as inflows of foreign staff. The UK has the least restrictions on inward foreign direct investment of any of the main OECD countries, as shown by some recent major deals that have included the DP World's purchase of P&O for £3.3 billion and the Spanish company Ferrovial's takeover of BAA for £10.3 billion. Meanwhile, consternation caused by DP World's potential takeover of some US ports (via P&O) demonstrated unease in some quarters in the US over foreign ownership of strategic assets; and in the *GFCI3*, the restrictiveness of Sarbanes-Oxley Act was cited as 'the most outstanding negative factor' regarding financial services in New York. As mentioned previously, taking FDI inflows as an indicator, the GCC is clearly becoming more favoured as an investment location and more integrated in the world economy.

Legal and regulatory provisions

As well as economic and political reform, the Gulf is undertaking substantial legal reform and modernization specifically with respect to financial services, which have benefited from fast-track change to spur growth. While an internationally acceptable and clearly defined regulatory framework is essential for building any presence in international financial markets, the world's most successful financial centres are governed by a variety of different systems such as Anglo-Saxon common law, administrative European law and state communism. While financial centres are able to function under most regimes, the Anglo-Saxon common law culture is seen as conducive to innovation in financial services, allowing greater scope for interpretation and freedom of movement than Continental Europe's administrative law culture.[25]

The greater attractiveness of the Anglo-Saxon system over other legal systems can be corroborated in part by the vitality of Hong Kong as a financial centre. A former British colony since 1842, Hong Kong has a legal system that follows common law, which has given it greater credibility and attractiveness over other regional centres, including Shanghai.[26]

Qatar has implemented a Western-style legal system within the jurisdiction of the QFC and a mixture of Sharia for matters of personal status and civil courts for civil and criminal matters. Bahrain's legal system incorporates elements of both English and Islamic law. Saudi Arabia is governed by Sharia law, while in the UAE a Western-style, chiefly UK-orientated legal system operates within the boundaries of the DIFC only. Dubai and Ras Al-Khaima have their own separate judicial systems, while the other Emirates are part of a UAE federal system which uses Sharia law for personal matters, criminal cases, labour and commercial matters.

Market regulation

Until summer 2007, there was a broad consensus which believed the UK's FSA was a model of international best practice. Yet this model was to some extent discredited when the tripartite relationship between the UK's FSA, Bank of England and Treasury broke down in the wake of the Northern Rock crisis, with confusion over responsibilities and a rift over policy. The Gulf must now consider whether it would be better served by the US or even European model, where the concept of a single regulator does not exist.[27] In the wake of the banking crisis in the West, many countries are reviewing their supervisory systems.

Perfecting financial regulation is a difficult if not impossible task, requiring flexibility to match shifts in market operations and new product streams. Regulation needs to be stringent enough to prevent abuse (and avoid public outcry), yet not so exhaustive that it proves unnecessarily burdensome to business, adding to costs and constraining growth. Addressing new problems as they arise may mean that legislation has to change and be refined, perhaps several times over, before the right framework can be established. Yet it is necessary to curtail the temptation to continuously update and fine-tune regulation. Certainly the industry needs a degree of certainty that legal conditions will not keep changing arbitrarily. The balancing act is tough.

Whether or not there is single or split responsibility, simplicity and clarity are of crucial importance, which means that one clear set of rules appears a preferable strategy to multiple regimes. However, this is not the case for Dubai. Here the authorities are actively pursuing a dual-track approach, which is being encouraged as a means of moving ahead in important areas of financial activity at a faster pace than could otherwise be accepted. So 'targeted inequality' may work well under these specific (essentially transition) circumstances. The DIFC is a separate jurisdiction from the UAE: if financial institutions are located in the concentrated area of the DIFC they come under DIFC laws; if not, they are governed by the Central Bank based in Abu Dhabi. However, space in the DIFC is running out and provisions have been made for companies to be ruled by DIFC law even if located outside the physical boundaries. This arrangement of multiple jurisdictions risks becoming confusing and creating divisions between different firms in the same country.

Qatar Financial Centre (QFC) was set up in 2005, and two years afterwards announced that from 2009 it would be bringing in a new single regulator to supervise all financial services – comprising the banking and supervision department of Qatar Central Bank, the Qatar Financial Centre (QFC) Regulatory Authority and the Qatar Financial Markets Authority that supervises the Doha Securities Market. QFC can bring any business in Qatar under the QFC legal and business umbrella. The single regulator plan, which will apply the higher standards introduced by the QFC to the entire financial sector, has proved far-sighted and the clarity of this arrangement is compelling. Qatar will gain a competitive advantage from the clear-cut system of a single regulator with a single set of regulations for all.

In September 2006 the Central Bank of Bahrain became the single regulator of the country's financial services. The Saudi Arabian system is notably less coordinated, with SAMA regulating the insurance, and a separate authority for the capital markets. There are significant divergences between the GCC states, suggesting potential for streamlining of arrangements and cooperation.

In terms of setting up its own legislation and regulatory and institutional framework for IFCs, the GCC is still at an early stage and can learn from mistakes that have been made in other markets, cherry-picking the best regulation, legislation and market practice. However, following the banking crisis that began in August 2007, rules are in the process of being rewritten in the leading financial centres themselves and there is even talk of a move to more global regulation and oversight of the banking system, reflecting the reality of the global nature of this industry. The Gulf can bide its time while these deliberations continue but it would be advisable to examine the ways in which GCC systems could dovetail with the newly emerging consensus on regulations and regulators.

Table 11: Regulatory arrangements

	Banking	Securities	Insurance	Pension Fund
Bahrain	Central Bank of Bahrain	Central Bank of Bahrain	Central Bank of Bahrain	Central Bank of Bahrain
Hong Kong	Hong Kong Monetary Authority	Securities and Futures Commission (SFC)	The Office of the Commissioner of Insurance (OCI)	Mandatory Provident Fund Schemes Authority (MPFA)
Kuwait	Central Bank of Kuwait	Kuwait Stock Exchange (market committee)	Ministry of Commerce and Industry (insurance department)	Information n/a
Oman	Central Bank of Oman	Capital Market Authority	Capital Market Authority Ministry of Economy	Information n/a
Qatar*	Qatar Central Bank	Doha Securities Market (DSM) regulator	QFC's Regulatory Authority (for activities within QFC)	Information n/a
	QFC's Regulatory Authority (for banks within QFC)	QFC's Regulatory Authority (for activities within QFC)		
Saudi Arabia	Saudi Arabian Monetary Agency	Capital Market Authority	Saudi Arabian Monetary Agency (Insurance Supervision Directorate); health: also Council of Cooperative Health Insurance	Information n/a
UAE	Central Bank of the UAE, Banking Supervision and Examination Department	Securities and Commodities Authority	Ministry of Economy (Insurance Companies Division); Insurance Commission established recently	Information n/a
UAE/Dubai	Dubai Financial Services Authority (for activities within DIFC)	Dubai Financial Services Authority (for activities within DIFC)	Dubai Financial Services Authority (for activities within DIFC)	Dubai Financial Services Authority (for activities within DIFC)
UK	Financial Services Authority	Financial Services Authority	Financial Services Authority	Pension Regulator
USA	OCC, FRB, State Bank Supervisors, FDIC	Securities and Exchange Commission	State Insurance Commission	Department of Labour

*The plan is to create one supervisory body in early 2009.
Source: Alexander Böhmer, OECD; taken from his chapter 'Institutional Arrangements for Financial Regulation and Supervision – OECD Experience and Emerging Practice in the Gulf Region', in Paola Subacchi and John Nugée (eds), *The Gulf Region: The Changing Face of Global Financial Power?* (London: Royal Institute of International Affairs, forthcoming 2008).

Measuring and improving financial-centre performance: conclusions

The existing survey evidence from various sources tends to suggest that in terms of both measures of current performance and factors that influence performance of IFCs, the GCC countries already score relatively well in the middle to upper segment. This is across a wide range of indicators from financial-market standing to competitiveness and economic freedom. A number of weaknesses are identified in the surveys, which, if addressed, could move them quickly up the rankings. Political and legal reforms are currently under way and are being favourably received. In addition, GCC cooperation in terms of financial institutions is moving ahead, with the setting up of a GCC Monetary Council (the nucleus for the future GCC Central Bank) being announced in June 2008.

The GCC countries' rankings in the City of London survey indicate the rising potential of the region's leading IFCs. However, this potential is, to some extent, being obscured by the all-inclusive coverage, particular emphasis and format of this publication, which might benefit from examining more closely particular subsets of markets, especially across the mid-rank international centres. For example, a specialist survey covering upcoming centres and 'frontier markets' might be warranted. It is important to re-examine the current survey's rankings, as shown in this report, to offer a more transparent comparison of the world's regional markets and also the relative positions of the markets outside the large US and European blocs. Indeed, the tables presented here demonstrate that the GCC's position as an IFC could be much stronger than the existing survey information suggests. And these tables also suggest what the next 'targets' may be for IFCs rising up the ranks.

Apart from the lack of other surveys from which to judge financial-centre rankings, research in this area is hampered by an absence of consistent and comparable statistics for market activity from which to assess the role and scale of the financial centres. These problems should be addressed through improved supply of information and the possible extension of the survey work undertaken on financial markets. These data are particularly important for tracking the progress of IFCs, especially for the GCC as there should be considerable scope to raise trading volumes from relatively low levels.

On the basis of economic theory and also the evidence available, as assessed in this section, it is not surprising to find a broad correlation between the performance of IFCs and their economic backing. The GCC's current economic environment is clearly strong and the region looks well positioned for further rapid expansion. Therefore, we can be confident that this will provide a powerful launch pad for the financial sector if the GCC takes full advantage of the opportunities on offer.

In terms of the GCC's standing in global financial markets, the size of the region's SWFs also add important support for its current status and future development. Indeed, it can be argued that the combination of SWF wealth, the region's strong economic performance and positive outlook means the GCC already represents an important force in international financial markets. According to the rankings examined here, based on the City of London survey, the GCC could well challenge financial centres such as Tokyo and Sydney for a place in the top tier over the next decade.

Notes

1 Quote taken from the City of London Corporation website, http://cityoflondon.gov.uk/Corporation/business_city/promoting/International+promotion.htm.
2 *GFCI3*, pp. 57–8.
3 *GFCI3*, p. 13.
4 This is the phrase of US economist Howard C. Reed, quoted in Youssef Cassis, *Capitals of Capital: A History of International Financial Centres, 1780–2005* (Cambridge University Press, 2006).
5 For comparison, the UK's corporate tax rate is 28% .Hong Kong's 17.5%; Singapore's 20%; Bahrain's 0% (except for within the petroleum industry where a tax rate of 46% applies); Qatar's 35% (no tax applies to local and GCC firms and the rate for firms within the QFC is 10%); the rate in the UAE varies in the different Emirates and generally only applies to foreign banks and oil companies, according to *KPMG's Corporate and Indirect Tax Survey 2007* (KPMG, 2007).
6 This is also the thinking behind the planned development of Mumbai as a financial centre; a recent report reveals that their strategy is to 'leapfrog' to a global centre status from the outset, rather than first developing as an offshore location, or a regional hub. *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*, Ministry of Finance, Government of India, 2007, p. 7.
7 Quoted in Sundeep Tucker, 'Rival Asian bourses blush at merger talk', *Financial Times*, 25 June 2007.
8 *GFCI3*, p. 1.
9 World financial wealth is approximately four times world GDP and comprises equity holdings (just under one-third), bonds (just over one-third) and cash holdings. See Paola Subacchi, *Capital Flows and Emerging Market Economies: A Larger Playing Field?*, Chatham House Briefing Paper IEP BP 07/03, September 2007.
10 Luisa Kroll (ed.), 'The World's Billionaires', Forbes.com, April 2008.
11 McKinsey On Finance: *The New Role of Oil Wealth in the World Economy*, p.16.
12 IFSL Research, *Sovereign Wealth Funds* 2008, April 2008.
13 For comparison, India and China are included in Group 1, factor-driven economies, and many fellow MENA countries (Tunisia, Oman, Jordan, Libya, Algeria) rank in Group 2, efficiency-driven economies. Saudi Arabia is not included.
14 Kate Phylaktis, CASS Business School, at Chatham House workshop held in London on 9 April 2008.
15 Ibid.
16 Heritage Foundation/*Wall Street Journal*, *Index of Economic Freedom*, http://www.heritage.org/research/features/index/faq.cfm.
17 Caroline Allen, 'Bahrain wins endorsement for its economy', *Global Investor*,

21 January 2008,. http://www.globalinvestormagazine.com/default.asp?Page=2&PubID=61&ISS=24475&SID=701039&SM=ALL&SearchStr=gcc.

18 Transparency International 2007 *Corruption Perceptions Index* Press Release: http://www.transparency.org/news_room/latest_news/press_releases/2007/2007_09_26_cpi_2007_en.

19 Anoushiravan Ehteshami and Steven Wright, 'Political change in the Arab oil monarchies: From liberalization to enfranchisement', *International Affairs* 83: 5 (2007), pp. 913–32; p. 914.

20 Assessment of AML/CFT standards in other countries, 07 Sep 2006, Joint Money Laundering Steering Group, British Bankers' Association website http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=77 0&a=9814.

21 Meena Janardhan, 'UAE aims to stop dirty money traffic', *Asia Times Online*, 21 March 2007, http://www.atimes.com/atime/Middle_East/IC21Ak14.html.

22 Ehteshami and Wright, 'Political change in the Arab oil monarchies', p. 932.

23 TNI Market Insight, in association with Hawkamah and IOD Mudara, *Power Matters: A Survey of GCC Boards*, 13 May 2008.

24 Ehteshami and Wright, 'Political change in the Arab oil monarchies', p. 922.

25 John Willman, 'To be the biggest you need diversity', *Financial Times*, 19 November 2007.

26 ' All shapes and sizes', *The Economist,* 13 September 2007.

27 Comment made at Chatham House workshop held in Dubai, 25 February 2008.

3. Development across the spectrum of financial markets

The previous sections have examined both the economic power of the GCC and its rankings in financial markets using the City of London survey as well as other 'soft' indicators. However, another way of looking at how successful the GCC has been in the financial sector is to examine the scale and form of actual operations in various segments of financial activity, from banking to stock markets, FX trading and the debt market. This illustrates the strengths and weaknesses of these businesses and considers how far financial activity is commensurate with the scale of economic activity and position of the Gulf, how much room there is for expansion and in what ways development could be pursued in the future.

Clearly the GCC economies are generating large savings surpluses and capital outflows. However, it is important to note that there are capital inflows as well (this has already been remarked on with respect to FDI inflows in examining the potential bias of 'soft' indicators). These capital inflows not only reflect international business confidence but also represent substantial two-way banking flows.

Savings high but regional investment opportunities need further development

The national savings surplus means that there is excess demand for financial assets within the GCC, implying an overall net outflow of capital and build-up of SWFs and FX reserves. Moreover, there is also a poor match and lack of breadth in local (and regional) asset supply *vis-à-vis* the demand for different asset classes amongst investors and institutions. There are shortages of both expertise and appropriate investment vehicles within the six countries and regional markets. This means that even more capital flows out, primarily to the US and Europe, which offer large liquid markets in instruments such as government bonds and a wide spread of international equities as well as financial services, such as fund management. This is not an economic problem *per se*. The large surplus on the trade and current accounts means that the GCC countries can easily support such outflows – and there are also capital inflows to partly offset investment abroad – but the important point is that this reflects a lack of breadth and expertise within the home markets. This impacts not only on local investment decisions but also on the scope for local experience and involvement in key aspects of international financial markets. For countries aiming to become important players in *global* finance, this is a serious obstacle to progress. Expertise and experience need to be built up.

The GCC countries are actively addressing such shortcomings but traditionally the growth of new financial markets, and ability to improve their standing and ratings, take time.

As Blejer and Gray point out, the first financial markets to develop tend to be foreign exchange and government securities linked to trade and commerce on the one hand and government and project finance on the other.[1] Yet in the GCC case, in spite of aspirations to become important as an IFC, there is virtually no presence in these two key markets.

GCC governments do not need to borrow because of their large excess revenues and financial reserves. This has limited their issuance of debt instruments; in other words, there is hardly any presence in one of the most important financial markets – government securities. This also makes debt finance in general difficult as there is no liquid government benchmark (whether Sharia or Western-style) to provide an anchor for the private sector. Even though project finance in the Gulf is now a huge market, partly backed by state or partially state-owned company activity, the financial sector will find it hard to tap into this opportunity without such government support for the market. Arguably, this lack of a government securities market will also prove a stumbling block to the creation of a single, floating currency and its importance as a key global currency.

This problem over the development of the debt market could be addressed. Governments could 'over fund' and issue debt, for example (as Singapore does), and discussions are taking place on how to develop benchmark issues (for example, the US government is assisting in talks with regional central banks). But building a significant presence will take time – and some observers are sceptical about how far the process could go given concern over Sharia law and how this might apply to expansion in debt and bond markets.

In principle, these concerns could be overcome by issuance of bonds in foreign markets or the use of a Sharia-compliant benchmark (this is feasible – after all the UK government has now issued such a bond for the first time) but the key factor is to establish a sufficiently large, liquid benchmark to enable other issuers to price deals and trade securities.

In addition, the GCC has little presence in the huge global market for forex trading. Arguably, this is partly because exchange rates are pegged, so there is a limited need for and involvement in forex trading. However, this argument is weak given the financial market position of Hong Kong (a pegged currency) and Singapore (which operates a basket float). Nevertheless, a single currency could well stimulate GCC activity in FX and other markets.

GCC markets active but need more institutional backing

GCC investors are far from backward – they have long since made 'the jump from keeping savings in physical assets, such as gold, to an intangible investment in corporate equities'.[2] The shift to equity investment and a risk-taking culture based on a modern, non-cash, electronic economy accelerated even during the 1970–80s during the last oil boom. Although the free floats are seen as small by international investors, GCC investors are actively involved in local stock market trading as well as international market investments. International securities companies have already founded profitable businesses in the region based on the opportunities for arbitrage across the regional markets.

In principle the total stock market capitalization of the GCC region is well developed and about equal to total GDP, around the $1 trillion mark. This is what might be seen as a rough 'fair value' level. In international ratings, these markets still classify as 'frontier' markets and none of the seven GCC exchanges was represented in the World Federation of Exchanges' top ten in 2006. This is not surprising considering that many of these exchanges are relatively newly formed, and it will take time for them to attain a reputation for stability, build credibility and attract new listings.

Table 12: GCC stock markets

Country	Market	Year formed
Bahrain	Bahrain Stock Exchange	1987
Kuwait	Kuwait Stock Exchange	1977
Oman	Muscat Securities Market	1988
Qatar	Doha Securities Market	1995
Saudi Arabia	Tadawul	1984
UAE	Abu Dhabi Security Market	2000
UAE	Dubai Financial Market	2000

Source: IMF Working Paper, *IPO Behavior in GCC Countries: Goody-Two Shoes or Bad-to-the-Bone?*, July 2007.

The GCC stock markets have a history of high volatility. As documented in a 2007 IMF Working Paper, in 2003 many of the GCC countries' stock prices shot up; the GCC weighted price index increased by 480% in 2003–05.[3] GCC market capitalization leapt from $117 billion to $1.1 trillion in the same period. However 2005–06 brought a severe correction to the markets, particularly in Saudi Arabia, the UAE and Qatar. The report found that 'GCC investors tended to be widely driven by market sentiment (bullish or bearish) and the regulated nature of the IPO's economic sector, rather than by risk, expected demand for the stock, or the firm's "signaling"'.[4] Following the market correction, however, local investors' expectations became more cautious and volatility has eased.

The structure of the market and holdings is also a deterrent for foreign institutional investors. Stocks are either small or, for the largest stocks by capitalization, the 'free float' is low (because of large state shareholdings, for example). The largest company in the GCC is Saudi Arabia's Aramco, but this is state-owned, while the two large listed companies, SABIC and Saudi Telecom, have large state shareholdings.[5] Thus, on both counts, liquidity in the markets tends to be poor, adding to the risk of price volatility. A deeper market with more, larger cap stocks and a higher proportion of non-state shareholdings (increasing the share of institutional shareholders in particular) would help reduce volatility and damp down speculation. It would also offer scope for substantial increases in trading activity and volumes, including larger-size deals, creating more business opportunities for the new financial centres.

The IMF report offers a number of policy recommendations aimed at improving pricing and reducing volatility:

- bring in incentive systems to encourage participation of institutional investors with a long-term investment profile;
- provide education for retail investors to reduce the risk of swings in sentiment and over-optimism in bull markets;
- strengthen regulation and compliance;
- end the practice of underpricing IPOs (as a mechanism to share oil wealth with the population): shares should be distributed in a way that does not distort market prices.[6]

It is important to make stock markets and trading more open, transparent and attractive to foreign investors and institutional buyers, who could provide more stability through less speculative investments and also less oil-dependent flows of funds (reducing the tendency to excessive pro-cyclical swings in markets). Such investors also tend to raise the average dealing size, creating more professional-scale business opportunities for the market traders.

In terms of international comparisons, in Hong Kong and Singapore there is considerable foreign participation in the stock market, while in Saudi Arabia there is none. However, this is not the case elsewhere in the Gulf. Bahrain allows non-Bahrainis to participate fully in owning and trading shares and at end-2006, 60% of the shares of Bahraini public companies were estimated to be owned by foreign investors[7]. Since 2005 foreign investors have been welcome to trade on the Doha stock market, up to a limit of 25% ownership. This may soon rise to 49%. Dubai-established companies must be 51% owned by UAE nationals. Global economic conditions have also helped to drive the growth of the GCC stock markets as investors see the Gulf as being largely unaffected by the 'credit crunch' and economic downturn.

Apart from trading in equity markets, efforts have been made to introduce trading in other areas. In 2007 the Dubai Mercantile Exchange started to list the Oman Crude Oil futures contract in partnership with the government of Oman. The hope was to move this business from Singapore to the Gulf. This should be one of the most traded products in the world. However, the region has not been able to build expertise sufficiently to attract trust and credibility. Expert opinion suggests that the Gulf has not yet been successful in providing 'better tools for risk management, enhancing price transparency and constituting the basis of a new benchmark'.[8] These weaknesses need to be addressed if the financial centres are to grow into significant trading hubs for financial products.

Foreign exchange trading

The foreign exchange market is the largest and most liquid financial market in the world, as IFSL Research points out, with London capturing by far the biggest single share of this market. The Gulf states are seen as very active FX traders in the major currencies, both in the nature of their business relationships and in terms of financial market investment activity.

However, the level of foreign exchange trading that takes place in the GCC itself is minimal, even though it is a major hub for goods and services trading. As Table 13 shows, it does not feature in the top ten countries for forex activity. This low level of activity cannot be blamed on

Table 13: Country share in world foreign exchange trading

No.	Country	% share
1	UK	34.1
2	USA	16.6
3	Switzerland	6.1
4	Japan	6.0
5	Singapore	5.8
6	Hong Kong	4.4
7	Australia	4.3
8	France	3.0
9	Germany	2.5
10	Denmark	2.2

Source: BIS *Triennial Survey* 2007.

Table 14: Foreign exchange turnover by currency (April 2007)

Rank	Currency	Daily average % share
1	US dollar	86.3
2	Euro	37.0
3	Japanese yen	16.5
4	Pound sterling	15.0
5	Swiss franc	6.8
6	Australian dollar	6.7
7	Canadian dollar	4.2
8	Swedish krona	2.8
9	Hong Kong dollar	2.8
10	Norwegian krone	2.2
11	New Zealand dollar	1.9
12	Mexican peso	1.3
13	Singapore dollar	1.2
14	Korean won	1.1
15	South African rand	0.9
16	Danish krone	0.9
17	Russian rouble	0.8
18	Polish zloty	0.8
19	Indian rupee	0.7
20	Chinese renminbi	0.5
21	New Taiwan dollar	0.4
22	Brazilian real	0.4
	All currencies	200
	Emerging-market currencies	19.8
	Asia	7.2
	Latin America	1.8
	Central and eastern Europe	2.2

Source: BIS *Quarterly Review*, December 2007, p. 67.

fixed-peg currencies, although, arguably, a GCC currency floating against the other major currencies might create somewhat greater FX trading activity. Hong Kong ranks at number 6 despite having a currency pegged to the dollar; and Singapore, at number 5, notably operates a currency basket. In principle, FX trading activity could take place in the major currencies (as it does in Hong Kong and Singapore) as well as in the regional units, but in practice the business flow through the GCC dealing rooms has been low.

Nevertheless, a change in forex rankings may soon be visable. Standard Chartered opened a new trading floor with 200 trading seats at the DIFC in late April 2008, shifting a proportion of its forex trading from London to Dubai. The plan is for 7-day-a-week trading in the Gulf and, eventually, 24-hour trading. It remains to be seen whether others will follow this initiative. It could prove an important step forward in enlarging a broader range of trading activity in the GCC and especially in establishing the style of DIFC operations.

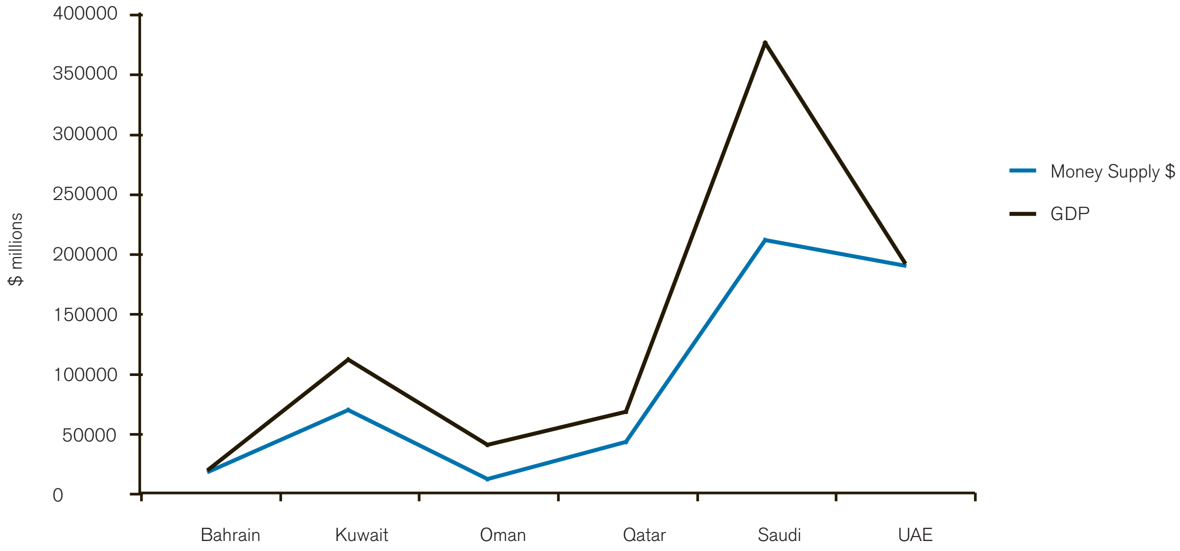
Banking sector increases domestic loans

Statistics on regional retail banking show that this sector is well developed and the overall scale of operations is roughly in line with countries' levels of GDP, as shown in Figure 25.

However, throughout the GCC (and the wider MENA region), banks' balance-sheet data show that there is a significant flow of funds out of the region's financial institutions (typically into the established centres such as New York and London) – even though much of this flow ends up back in the Gulf at the end of the cycle (in other words, both foreign assets and liabilities are large, reflecting a large two-way flow).

Outflows (into foreign assets) are relatively easily explained given the limited capacity of the GCC economies to quickly absorb large revenue gains but, according to expert opinion,[9] the two-way flows also reflect the fact that the local banking system is still relatively weak at processing and completing business transactions itself, especially for more complex operations; it

Figure 25: Scale of the GCC's money and banking operations comparable with GDP (all data in current $m)



Sources: Central bank websites, IMF.

still prefers to conduct such deals through external expert counterparties. As well as being a legacy of traditional practice, this may be related to the very small scale of most regional banks and inability to support complex business, teams of local experts and necessary adjunct functions such as legal and accounting practices.

However, historical data suggest that the trend has been changing. The banking sector has expanded domestic private credit more rapidly in recent years, with flows of foreign assets (and also liabilities) becoming a smaller part of overall balance-sheet operations.[10] At the top end, Bahrain saw foreign assets fall from around 44% of banks' balance sheets in 1995 to about a third by 2005. It bounced back to 44% in 2007 but this latest blip undoubtedly reflected the unexpected surge in oil revenues from late 2007 rather than a true trend reversal. Qatar and the UAE also have high shares of foreign assets but these shares have been falling or stable. At the lower end, the share of foreign assets in the Saudi Arabian banking sector has fallen into the 10–15% range, from over 30% in 1995, and remained low even in 2007.

The GCC banking industry is currently fragmented into small markets and banks. For the large US and European banks, balance sheets typically show total assets of around $1–2 trillion. By contrast, total assets in the GCC banking sector were only $500–600 billion in 2005 and have probably risen to around $1 trillion today. Saudi Arabia represented over 35% of this total, the UAE around 30% and Kuwait 20%; Oman had the smallest share, at about 2.5%. The biggest banks in the GCC region, NCB and Samba, report asset holdings of only around $56 billion (end-2007) and $34 billion (end-2006) respectively.

The consolidation process across the fragmented banking sector has been slow and uneven, with limited prospects for the issuance of licences region-wide. The best route for expansion is through M&A but there are barriers impeding the progress of these deals, such as regulation and curbs on foreign participation. Banks in the Gulf tend to be predominately owned by major families or governments, and this has significant repercussions for the style of management and transparency of decision-making, as well as willingness to move to a system with a smaller number of larger banks.

To raise business opportunities, skills and local processing of transactions, GCC banks need to develop the infrastructure for risk assessment and pricing. They have tended to be cautious, with substantial lending to govern-

Table 15: Shares of foreign assets and liabilities in banks' balance sheets, sample years

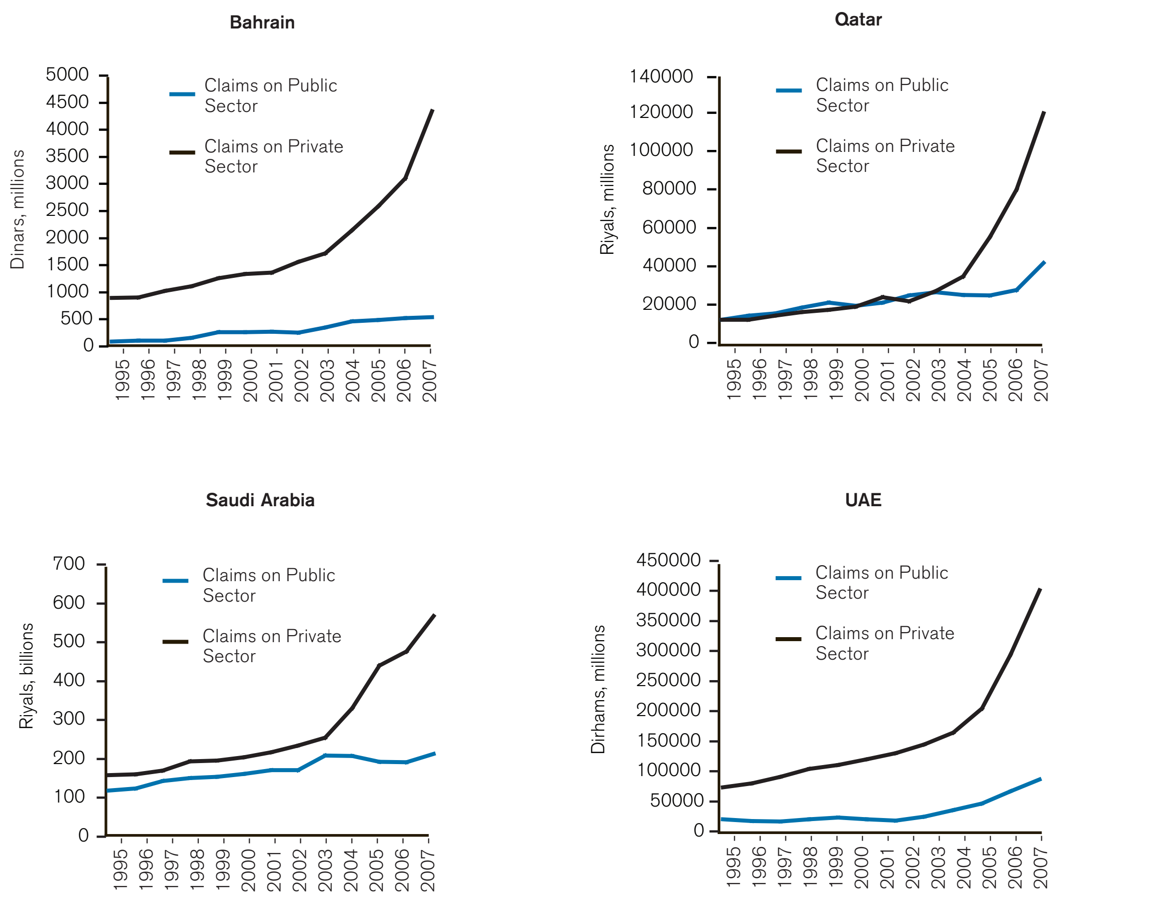
	2007 foreign assets %	2005	2003	2000	1995	2007 foreign liabilities %	2005	2003	2000	1995
Bahrain	44	33	36	41	44	27	20	19	20	19
Kuwait	24	19	16	16	20	20	12	13	10	6
Oman	22	19	12	12	20	13	5	11	17	9
Qatar	32	34	27	24	34	24	8	5	5	20
Saudi Arabia	14	13	15	24	32	10	9	8	15	13
UAE	23	29	32	35	38	25	14	8.5	20	17

Sources: IFS (IMF) data and own calculations.

ment-guaranteed and low-risk enterprises such as the state sector. However, recent statistics show that behaviour has been changing and the private-sector loans business has grown strongly in recent years: small to medium-sized enterprises will benefit from this growth as well as the big companies, and in this sector local banks may be more progressive. In addition, both Standard and Poor's and Moody's have recently opened up operations in Dubai, which should help accelerate this process.

If the banks can successfully improve pricing mechanisms, they can capitalize on the substantial local demand for large-scale project finance. The Gulf boasts

Figure 26: Bank loans to private and public sectors



Source: IMF.

the largest project finance market in the world, and Gulf banks benefit from the significant advantages of local knowledge and shared culture, language and history in this marketplace. The IMF has estimated that there are currently some US$700 billion worth of developments under way or in the pipeline in the GCC (up from $7 billion in 2001) but other comments suggest that this could be as high as $1.5–2 trillion.[11] The variation in quoted data is partly explained by the fact that this investment is, of course, intended to run for several years (and project starts and completions may be slow). The figures are not surprising given that the GCC's total GDP is now around $1 trillion, with the annual investment rate in the $200–300 billion range. To put it in context, this is about half the annual rate of India and 10% that of China.

Table 16: Top 10 banks in region, ranked by fees

	Bank	Net revenue ($m)	Market share (%)
1	Citigroup	103	7.7
2	Deutsche Bank	93	6.9
3	Goldman Sachs	83	6.1
4	JP Morgan	78	5.8
5	HSBC	75	5.6
6	Morgan Stanley	63	4.7
7	UBS	52	3.9
8	Barclays Capital	52	3.8
9	Merrill Lynch	50	3.7
10	Credit Suisse	43	3.2

Source: Dialogic.

Projects include real estate, port and airport expansions – most of which are within the private, not state, sector. There is a driving sense of ambition in this market; for instance the Burj Dubai, currently under construction, is due to be the world's tallest building, while the Dubai Mall will be the world's largest shopping centre with 9 million square feet of facilities (both of these are in the hands of Emaar, the biggest listed property developer in the Middle East). Some of the largest deals may require financing risks to be spread internationally but this business could also originate locally given the aim to move up the curve in financial-market operations.

Islamic banking and Islamic product development

Islamic banking and Sharia-compliant products have an obvious comparative advantage both culturally and geographically as the GCC constitutes the key crossroads between the Middle East and Islamic Asia. In addition, such products are becoming more widely accepted around the world. This is partly linked to their attractiveness for certain investors but also based on the merits of the structure of the products themselves. A recent benchmark issue has been initiated by the UK government and there are likely to be new issues for the Hong Kong Airport Authority (indeed Hong Kong has expressed a general interest in expanding use of Islamic finance) and for development programmes in Africa. Products are already actively used for home finance in the UK and US, illustrating their wide appeal to small-scale as well as large-scale borrowers.

The most obvious potential for this market is nevertheless most often linked to the large worldwide Muslim population, numbering around 1.2 billion. Rasheed M. Al Maraj, the governor of the Central Bank of Bahrain, explicitly recognizes Islamic finance as a growth area: 'Wholesale banking does not represent strong growth potential, so we are focusing on other activities such as Islamic banking, insurance, asset management, wealth management, private equity and mutual funds.'[12] Bahrain is already often cited as the number one centre for Islamic finance. However, Dubai hosts some of the largest issuing companies (e.g. DP World, Nakheel, Aldar Properties), which raise money in the sukuk market; and the Dubai International Financial Exchange (DIFX) is the largest exchange for sukuk trading (see below), with a value of nearly $15.59 billion (it overtook Luxembourg in late 2006 as the largest platform). However, the high growth in this sector has been from a small base. To put this in perspective, the sukuk bond market is estimated at just $100 billion.[13] There is clearly very significant long-term potential across most of the region and into Asia, which, if successful, need not be restricted to the Islamic segment. Arguably, India, as well as Pakistan and Bangladesh, may have considerable interest in Islamic finance, for example.

A sukuk is a 'bond-like' form of debt security issued as a financial instrument when the market requires Sharia

Table 17: Muslim populations worldwide

Region	Population (m)	% of total	GDP ($bn) represented by Muslim population*
North America	7	0.6	86
MENA	461	37	667
Malaysia, Singapore and Indonesia	212	17	134
Bangladesh, Pakistan, India	506	41	538
Europe	51	4	634
Total	1237	Approximately 20% of world population	Approximately 4% of world GDP

Sources: Unicorn Presentation by David Pace, CFO, Unicorn Investment Bank at FT Conference: 'View from the Top – the Future of Financial Services', New York, 18 March 2008; IMF; own calculations.
* Assuming share in GDP same as population share.

compliance. It is not a 'bond' in the conventional sense as Islamic law does not condone interest-based income. Islamic bonds are asset-based and issuers gradually repay the debt along with a form of 'rent' on the portion of the asset not owned. In practice, the payment system is not dissimilar to a traditional bond although some differences may relate to ownership rights and the guarantees for repayment in the event of, say, company failures or loan defaults. As traditional Western bond markets have also developed a wide spread of opportunities including 'zero coupon' issues, the differences are not really substantive; perhaps sukuks can be viewed as a bond/equity hybrid. Confidence in the future of the Sharia 'bond' market has been boosted by the UK government's recent issue of such a debt instrument (reported as the first such government issue).

There is scope for subjectivity and interpretation in the course of the Sharia approval process. This 'in-built flexibility'[14] generates business opportunities – first in the area of innovation and product development, and secondly for the scholars, the lawyers and consultants in the sanctioning process. However, the subjective element can also create long delays and uncertainty; for instance, boards of Sharia scholars are liable to reach different conclusions on the same questions or change their judgments over time. The lack of clarity means a large number of Islamic investors are not fully tapped into or committed to this market, unsure what products really are Sharia-compliant.[15] As Farhan Bokhari commented in the *Financial Times*, 'for too long, Islamic finance has remained a subject of discussion among the intellectual elite in addition to the selective community of those directly involved with its usage, notably individuals from the financial sector'.[16] This means that, at present, most sukuk bonds are being bought by Western-based investors, not by local high net worth individuals (HNWIs). In addition, the Islamic inter-bank market and secondary trading activity are still in their early stages of development.

As the industry started up quite recently by bond market standards (in 1953 in Egypt or, according to other reports, in the UAE in the 1970s), it may be too early for enforced standardization, and this could, in any case, hinder innovative advances at this stage. Nevertheless, broadly speaking, Sharia scholars are now in agreement on product design and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is taking some steps in the direction of harmonization. This should help create greater trust and clarity among ordinary potential clients, generate more demand and help the industry to expand more widely. At the moment all sukuks are traded on the DIFX but trade is by appointment only, and once or twice per week. The aim is to eventually emulate London, where these bonds are traded daily.

Personal finance and insurance: scope for substantial expansion

In terms of use of the banking system and mortgage products to fund home purchases, the position in some Gulf countries is being hampered by the laws regarding collateral and property rights (for instance, relating to the enforcement of repossession orders), rather than problems with access to Sharia-compliant finance. The governor of the Saudi Arabia Monetary Authority, Hamad Al-Sayari, says 'there is a pent-up demand for housing finance but it has not developed partly because of the legal framework that constrains the banks and partly because the banks do not have the long-term deposits to match their mortgage lending needs. A law is being prepared to address the former problem. Once it is in place I expect the banks – and other institutions – will develop this market.'[17] Indeed, such products are widely available in the UK and the US and are very actively used for home purchases within the Islamic community. They also claim a good track record in terms of repayment and low default rates.

Insurance is another underexploited sector in the GCC. Ajmal Bhatty, head of Takaful at HSBC Amanah, estimates that Saudis spend $1 per annum on average on life insurance, compared with a world average of about $1,400.[18] This is for a number of reasons: low demand, little product knowledge and awareness, perceived incompatibility with Sharia principles, and demographics. The populations in the Gulf are young and this has a significant bearing on the take-up of life insurance: 57% of the insurance market outside the Gulf is accounted for by life insurance, but only 2% in Saudi Arabia (admittedly the figure is higher in other states such as Bahrain). Also, it is possible that the dominant role of the state reduces the perceived need for insurance.

Insurance businesses are not permitted to operate from the DIFC (although reinsurance is permitted) and in Bahrain insurers are regulated by a mix of local and international law. Qatar, however, has sought to gain an advantage over its neighbours in this sector by welcoming retail insurance firms to set up in the QFC; they will come under Qatar's single regulator.

According to anecdotal evidence, there are the first glimmers of an insurance marketplace as members of the insurance community are forging links and getting to know each other. Economic development and population growth together with enforced corporate insurance schemes, privatization of pensions and compulsory health insurance in the UAE all also point to a big expansion; the *Financial Times* quotes a prediction of the market quadrupling by 2013. In Saudi Arabia in 2006 the insurance sector grew by 35%; the number of insurers rose from 1 to 18; predictions for growth are from $1.5 billion to $8 billion by 2017.

Developing regional debt markets and the potential for a 'hinterland'

Even taking on board the burst of growth in the sukuk market, the reality is that the GCC currently has very small 'debt' or 'bond' markets broadly defined – this is also clear from the (patchy) information available on the very low levels of trading. This reflects first the lack of government debt (especially as government budgets have moved into substantial surplus as oil prices have risen), secondly lack of experience given the traditional use of bank finance, thirdly local preferences (relating also to the question of Sharia compliance) and, lastly, the difficulty in creating a corporate debt market in the absence of a meaningful (sufficiently large and liquid) government securities market and benchmark. However, even without taking into account the question of Sharia compliance, this is very similar to the situation across Asia, excluding Japan. Japan has a very large government bond market although there is little international trade in this market, which is largely held by domestic institutions. But across other countries, many have low government deficits and debt levels (or, like Hong Kong, no debt at all) and most of the government and corporate funding requirements are financed through the banking sector, short-term borrowing and stock markets.

This lack of a substantial debt market across a very large and wealthy part of the world economy – from the Middle East to the Far East – also plays a key role in the serious 'imbalance' in world financial markets. While stock market capitalizations are broadly commensurate with GDP shares – with the US accounting for about 25% of each, for example – bond markets are unbalanced. The US alone accounts for more than 40% of the global bond market, while the US and EU together represent about two-thirds of the government debt market. In the US and

EU, government debt typically averages around 50–60% of GDP, about in line with the Eurozone's prudential guidelines.

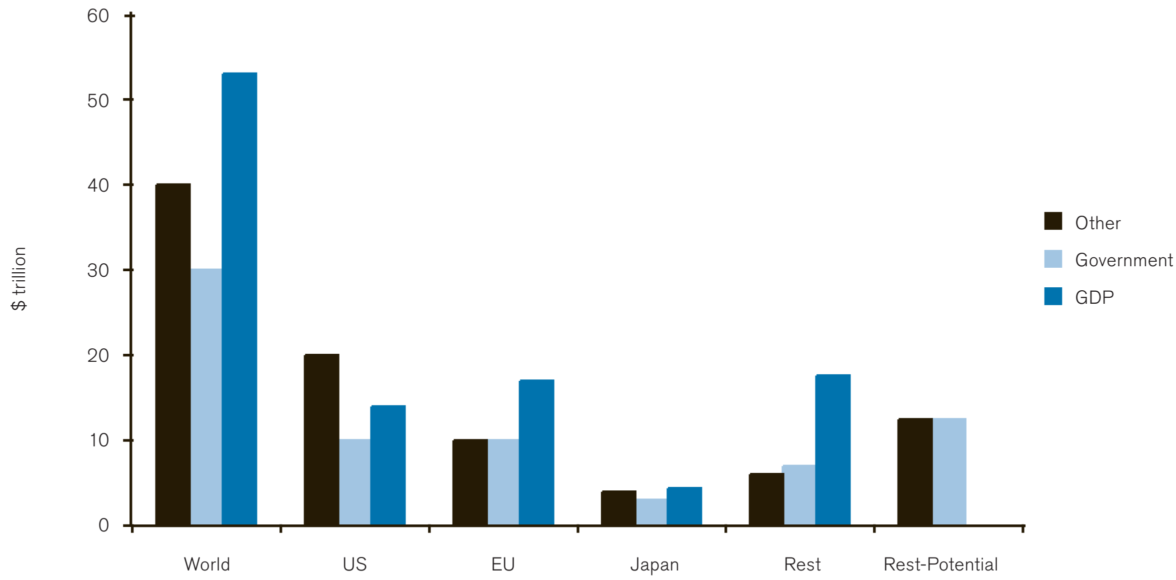
As bond holdings typically form the basis of central bank foreign exchange investments as well as representing the core of most institutional portfolios and asset allocation strategies, then a substantial proportion of global funds is inevitably placed in the US and Europe – there is little choice for bond (debt) investors. The underdevelopment of global supply compared with potential investor demand has helped reduce risk premia (the price of debt) in emerging markets and these lower interest rates should encourage more borrowing, helping to redress the imbalance. But this process will be very slow unless governments and leading institutions play an active role in promoting expansion.

A larger, deeper debt market across MENA and Asia would be beneficial in reducing the tensions caused by global bond market imbalances, redistributing savings flows and recycling more of the 'new' wealth back into MENA–Asia and other developing-country projects. For example, the 'savings glut' has been blamed for inflows of capital and 'cheap money' into the US, which some see as the root cause of the US's build-up of consumer debt and the housing-market boom–bust cycle over the last five years. Yet arguably, this US cycle might have been less pronounced had other suitable investment opportunities existed outside the US. Developing countries in MENA and Asia could have benefited more from the 'savings glut', helping accelerate infrastructure improvements, had the appropriate investment vehicles been available to utilize this money instead of it being diverted to the US.

In addition, the lack of local bond market activity is one of the key reasons why a number of countries in Asia, as well as the GCC, are not punching as high as they could do in financial markets and as IFCs. They have insufficient trading activity and experience in debt markets and issuance.

There is clearly considerable potential across the entire MENA–Asia region for much greater growth in debt markets, perhaps doubling 'the rest of the world' market size, as illustrated in Figure 27. After the US, EU and Japan, the representation of the 'rest of the world' in global bond markets is currently estimated to be low at a total of $12–15 trillion; yet, looking forward, it could become a market worth around $25–30 trillion (based on current economic statistics). Roughly speaking, while the US bond market total is around double GDP, the 'rest of the world' has a bond

Figure 27: World bond markets



Source: IMF.
Note: 'Rest – potential' based on average government debt/GDP of 60% and similar for corporate debt.

market total less than its GDP when it could be up to double this figure. Looking ahead over the next decade, expansion of the government debt market in China, India and the GCC alone could add as much as $10 trillion to global bond markets based on the operation of a prudent government debt/GDP ratio of about 50–60% – and the opportunity to leverage this in corporate finance might add another $10 trillion or more.

This issue is interlinked with another frequently quoted problem for the development of the GCC as a GFC – its lack of a large hinterland. Although London (like other financial centres) houses a geographically concentrated cluster of services, actually one of its strongest assets is its interconnectedness within an even wider network. London is locked into the EU with 490 million residents and a GDP of nearly $20 trillion; similarly, the US has a resident base of 300 million and GDP of around $15 trillion. The GCC countries, however, have a limited immediate hinterland – Iran, Iraq and North Africa, for instance, do not constitute a substantial launch pad for a major financial centre. MENA GDP, while about double that of the GCC alone, is still very much smaller than that of the US, EU or Asia.

These two weaknesses for the GCC – the lack of a bond market and hinterland – could be resolved simultaneously by tackling the problem via the expansion into MENA–Asia debt markets. It would be helpful not only for the GCC but for Asia and the global imbalance in asset markets if the GCC were to turn its attention and financial muscle to developing this potentially large debt market – launching new issues that could serve in the context of both MENA and Asia, particularly India.

By setting up a system based on a new GCC model, this debt market could become a major vehicle for finance and investment across the Middle East and a large part of Asia. On this level, therefore, it is a major opportunity. Building a large and liquid new 'eastern debt' market, with wealthy governments to act as backers and provide a benchmark, would be a significant step for global development and towards the resolution of the 'global imbalances' problem.

India alone clearly has massive financing needs – its shortage of capital is one reason why it is struggling to match China's growth rate. China's annual investment is around $1 trillion per year; India's $200–300 billion. The latter needs to move up by many billions per annum to meet the development challenge. Apart from India, many other developing countries (including the poorer MENA states as well as countries such as Pakistan and Bangladesh) could benefit and prosper through this development. It would also serve to benefit the GCC by aiding the establishment of the region as an important global financial centre.

To kick off this development and seize the initiative, the GCC countries could follow the Singapore model, i.e. using a dual approach to government financing to foster the emergence of a local debt market, which could be based on the Sharia model rather than conventional Western-style bonds. The GCC could step up debt-financed infrastructure projects as well.

It may seem counter-intuitive for 'surplus' countries to aim to reach a level of indebtedness commensurate with a sizeable debt market; and indeed to develop debt markets on the scale of the major developed countries would be a huge leap. The US has a level of government debt at about 60–70% of GDP and a total bond market, including corporates, of about double GDP. If the MENA–Asia region aims to reach anything like this scale over a 10–20-year timeframe, this would be equivalent to as much as $1 trillion per annum in new issuance for the next decade.

A major challenge is to convince GCC governments to use debt and the local financial sector more extensively to fund projects, although this would clearly encourage local market growth and activity in the financial sector. It should also lead to greater transparency, scrutiny of the financial viability of projects and accountability. Government debt markets would also offer a way of managing sterilization and liquidity.[19]

The creation of a meaningful and active GCC debt market is already challenging – the vision of a wider market across the MENA and Asia region undoubtedly seems way beyond the immediate horizons and scope of the GCC centres. And it raises critical questions over the way this market could be developed and managed, and how such debt may be rated in global markets – as high-grade government-backed securities on a par with the US and EU, or as 'frontier'-class debt? However, without such a grand design, both locally and on the wider regional level, there is unlikely to be a serious challenger in investment terms to the hegemony of the US and

EU in both bonds and currencies (the two being inextricably interlinked).

If 'global imbalances' are important, the serious 'imbalance' in asset availability and demand around the world has to be addressed – indeed, this is arguably the piece of the jigsaw that needs fixing most, not trade balances. The surge in wealth in an important part of the world's economic geography without the assets base in which to invest this money has led to some unforeseen repercussions. Under a more balanced development of asset markets and classes, with a larger, deeper alternative debt market in the MENA–Asia region, more of these savings could have gone back into the region instead of into the US. And more business could have been done in the GCC's centres.

Could the GCC succeed in becoming an important financial centre without developing a substantial 'own' debt market? If it remains a very small local market, this puts the focus on developing more sophisticated banking-sector business, increasing equity and FX trading and enhancing fund management operations. After all, the major Asian financial centres have limited involvement in terms of their own, or regional, bond markets, yet this has not prevented them from reaching the IFC top ranks. A key difference, however, is that these are established centres with existing links to China and the greater Asia region. Moreover, their lack of expertise in bond finance may still be holding them back from competing with London and New York. The lack of activity in leading centres in Asia offers the GCC the chance to enter a market in which it can compete, and possibly innovate, in terms of offering a wider market the opportunity to use Sharia-compliant products as well as other specifically designed debt securities aimed at fulfilling needs in regional emerging markets.

The imbalance in wealth formation and asset demand relative to assets on offer needs to be addressed. Talk of alternative global currencies will never come to anything without the resolution of this underlying imbalance, specifically the lack of a large and liquid MENA–Asia debt market.

The new Sharia-compliant debt issues forthcoming in London and also Hong Kong demonstrate that if the GCC does not pursue the opportunity to expand such products in international debt markets, then other players will. On a wider scale, the opportunity to be part of the reshaping of MENA–Asia financial markets should be ideally suited to creating an important and expanding role for the emerging GCC financial centres.

Notes

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2 *Ibid.*
3 Abdullah Al-Hassan, Fernando Delgado and Mohammed Omran, *IPO Behavior in GCC Countries: Goody-Two Shoes or Bad-to-the-Bone?*, IMF Working Paper, Washington, DC, 2007, p. 5.
4 *Ibid.*, p. 28.
5 According to its website, SABIC is the largest and most profitable non-oil company in the Middle East and one of the world's ten largest petrochemicals manufacturers. The Saudi Arabian government owns 70% of SABIC's shares; the remaining 30% are held by private investors in Saudi Arabia and other countries of the GCC. About one-fifth of Saudi Telecom's shares are privately owned.
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Appendix 1: Chatham House project team and list of participants

Project team, Chatham House

Project Director: Vanessa Rossi

Research Assistant: Ruth Davis

Project Administrator: Amalia Khachatryan

Editor: Margaret May

Participants

Hussain Al-Abdulla	Qatar Investment Authority
Abdulla Hashim Al Sada	Qatar National Bank
Rawan Abdelrazek	US Department of Treasury
George T. Abed	Institute of International Finance (IIF)
Saleh Alnabit	General Secretariat for Development Planning
Umar Aziz	Clifford Chance LLP
Elaine Brown	Independent Economic Consultant
Darren Cullen	Endeavour Capital Management Ltd
Jeffrey Culpepper	Merrill Lynch
Ruth Davis	Chatham House
Stephen Day	Former British diplomat
Nigel Dudley	Writer on Middle East business and finance
Ghaleb O. Faidi	ILMAM LIMITED
Mohammad Farhandi	Chatham House Foundation
Paul Farrow	Merlin PR
Nadim M. Fattaleh	Boeing Capital Corporation
Bassam Fattouh	SOAS, University of London
Edward J. Ferraro	Sidley Austin LLP
David S. Fredsall	New York State Banking Department
Guy Gantley	UK Foreign and Commonwealth Office
Francesco Garzarelli	Goldman Sachs International
Anna Gaworzweska	Lloyds TSB Bank
Karim Ghachem	State Street Global Markets

Chris Gibson-Smith	London Stock Exchange
John Gilchrist	Sovereign Strategy
Caroline Grady	Deutsche Bank
Anthony Harris	Robert Fleming Insurance Brokers (RFIB)
Rebecca Hellerstein	Federal Reserve Bank of New York
Michael Hume	Lehman Brothers
Michael Kahn	State Street Global Markets
Amalia Khachatryan	Chatham House
Richard Koss	Chatham House Foundation
Kurt I. Lewin	Chatham House Foundation
Sarah Lewis	Standard Chartered Bank
Max Linnington	Bloomberg L.P.
Marios Maratheftis	Standard Chartered Bank
Alexis Marinof	State Street General Advisors (SSgA)
Heloisa Marone	United Nations Development Programme
Steve McMillan	International Mercantile Exchange (IMEX)
Mohamad Moabi	Qatar National Bank
Edward Morse	Lehman Brothers
John Nugée	State Street Global Advisors (SSgA)
Kate Phylaktis	Cass Business School
Marion Riddle	UKTI
Vanessa Rossi	Chatham House
Nasser Saïdi	Dubai International Financial Centre Authority
Fabio Scacciavillani	Dubai International Financial Centre Authority
Stephanie Segal	US Department of Treasury
Al-Harith Sinclair	DLA Piper
Shashank Srivastava	Qatar Financial Centre Authority
Paola Subacchi	Chatham House
David Tamburelli	Bloomberg L.P.
Michael Thomas	Middle East Association
Mina Toksoz	Standard Bank
Scott Urban	Oxford University
Sir Kenneth Warren	Adviser International Marketing
John H. Welch	Chatham House Foundation
Lilian Yong-Babani	Standard Chartered Bank

Appendix 2: Workshop programmes

Workshop 1: The Gulf as a global financial centre: scenarios for growth and diversification

Dubai, Jumeirah Emirates Towers, 25 February 2008, 09.30–15.15

09.30–09.40	Welcome and Introduction	
		Paola Subacchi, Chatham House
09.40–10.40	1. Setting the scene: the economic development of the region	
	Panel discussion	
	Chair:	**Nasser Saïdi**, Dubai International Financial Centre Authority
	Panel:	**George T. Abed**, Institute of International Finance (IIF)
		Vanessa Rossi, Chatham House
11.00–12.00	2. Expanding markets and developing products	
	Chair:	**Alexis Marinof**, State Street Global Advisors (SSgA)
	Presenter:	**Vanessa Rossi**, Chatham House
	Discussants:	**Francesco Garzarelli**, Goldman Sachs International
		Steve McMillan, the International Mercantile Exchange (IMEX)
12.00–13.00	3. Sustainability and risks	
	Chair:	**Alexis Marinof**, State Street Global Advisors (SSgA)
	Presenter:	**Paola Subacchi**, Chatham House
	Discussants:	**Shashank Srivastava**, Qatar Financial Centre Authority
		Marios Maratheftis, Standard Chartered Bank
14.00–15.00	4. One centre or many? Regional specialization and global offering	
	Panel discussion	
	Chair:	**Francesco Garzarelli,** Goldman Sachs International
	Panel:	**Ghaleb O. Faidi**, ILMAM LIMITED
		John Gilchrist, Sovereign Strategy
		Anthony Harris, Robert Fleming Insurance Brokers (RFIB)
		Al-Harith Sinclair, DLA Piper
15.00–15.10	Concluding Remarks	

Workshop 2: The Gulf as a global financial centre: boom or bust? The US perspective

New York, Bloomberg L.P., 17 March 2008, 08.30–15.00

08.30–08.40 Welcome and Introduction

David Tamburelli, Bloomberg L.P.
Kurt I. Lewin, the Chatham House Foundation

08.40–10.10 1. Setting the scene: is overheating threatening to derail the boom?

Panel discussion

Chair: **Kurt I. Lewin**, the Chatham House Foundation
Panel: **Edward Morse**, Lehman Brothers
Nadim M. Fattaleh, Boeing Capital Corporation
John H. Welch, the Chatham House Foundation

10.25–11.45 2. Developing the markets and moving up the IFC rankings

Chair: **Mohammad Farhandi**, the Chatham House Foundation
Presenter: **Vanessa Rossi**, Chatham House
Discussants: **Karim Ghachem**, State Street Global Markets
Elaine Brown, Independent Economic Consultant

11.45–13.10 3. Integrating into the global financial network – cooperation versus competition

Panel discussion

Chair: **John H. Welch**, the Chatham House Foundation
Panel: **David S. Fredsall,** New York State Banking Department
Edward J. Ferraro, Sidley Austin LLP
Karim Ghachem, State Street Global Markets

13.10–13.25 Concluding Remarks

Workshop 3: The Gulf as a global financial centre: can the GCC reach the top ten?

London, Chatham House, 9 April 2008, 09.00–14.30

09.00–09.05 Welcome and Introduction

Paola Subacchi, Chatham House

09.05–10.15 1. Developing financial markets and moving up the IFC rankings

Chair: **Mina Toksoz**, Standard Bank
Presenter: Vanessa Rossi, Chatham House
Discussant: **Kate Phylaktis**, Cass Business School

10.30–11.45 2. Integrating into the global financial network

Chair: **Stephen Day**, former British Diplomat

		Michael Thomas, the Middle East Association
		Jeffrey Culpepper, Merrill Lynch
		Nigel Dudley, Writer on the Middle East business and finance
11.45–13.00	3. Is London's place in the IFC rankings at risk?	
	Panel discussion	
	Chair:	**John Nugée**, State Street Global Advisors (SSgA)
	Panel:	**Bassam Fattouh**, SOAS, University of London
		Michael Hume, Lehman Brothers
		Umar Aziz, Clifford Chance LLP
13.00–13.15	Concluding Remarks	

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CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org.uk
F: +44 (0)20 7957 5710 www.chathamhouse.org.uk

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