Development of Capital Markets in the Countries of the Gulf Cooperation Council [1]

First: Introduction

The world economy has undergone noticeable changes over the past decade, both in terms of the shifting balance of economic and financial power among groups of countries and in terms of structural changes.

Financial intermediation has undergone even greater changes over the period, both in the size of transactions and in the variety of instruments used.

In the past, tight restrictions on institutional entry into certain market segments have led to the development of alternative means of evading these restrictions and allowing market forces to work. In the more recent era of globalization and liberalization, new and ingenious techniques have been developed by markets to optimize performance and reallocate the various risks involved in domestic and cross-border financial transactions. Moreover, the huge capital flows of recent years, and the shifting trends in international investment, have had obvious effects on the financial markets.

(1) Delivered on March 6, 1990, in Manama, Bahrain, on the occasion of the conference on "Finance & Investment in the Middle East".

The overall effect has been to enhance the global intermediation role of the financial markets and to sharpen competition among their institutions, with reduced costs for the investor and thinner profit margins for the intermediaries.

I will try to briefly outline the broad features of recent trends in world capital markets and to explore their implications for the markets of the member countries of the GCC.

Second: The Role of Capital Markets

Capital markets provide a mechanism for intermediation over the long term between financial surplus units and financial deficit units. As such they form the artery for the flow of resources among the various economic sectors.

Healthy capital markets grow from the real needs of the economy, especially the need for long-term financing, and they develop through serving resident and non-resident sectors. These markets thrive within an appropriate legal and regulatory environment and a stable economy.

The international capital markets have undergone a boom during the past decade. Total capitalization of the global securities market was estimated at $19 trillion at the end of 1988. A noticeable phenomenon of the 1980s was the huge growth of foreign institutional investment from the major industrial countries, and equity assets held by foreign investors totalled 6.7% of world market capitalization, and reached a total value of $640 billion at the end of 1988.

Developments in financial markets during recent years have been characterized by four interconnected trends which will continue in the near future. First, deregulation and liberalization of rules governing financial transactions in individual markets have suddenly expanded the scope of activities and operations for financial intermediation and for investment. Second, globalization, or internationalization, of markets has expanded the geographic scope for intermediation and investment well beyond national or regional borders. As a result, now corporate planners and strategists, investment managers, and official policy-makers must keep in mind the various forces interacting in the world markets when making their decisions. Third, there has been intense competition to take advantage of the economies of scale and of specialized niches in financial intermediation and investment. This trend has been most noticeable in the rush toward mergers and acquisitions that have led to the restructuring of many international financial institutions, as various market participants, and some concerned authorities, have worked to position themselves for the future. The fourth trend has been a shift in the major markets toward the securitization of finance.

The above trends have occurred in an environment marked by a high degree of market volatility, partly fueled by interest rate and exchange rate uncertainties in the major industrial countries, and the resultant large and shifting capital flows among markets and sectors. One noticeable consequence of this environment has been the development of new financial instruments, such as options and forward contracts, aimed at reallocating the various types of risks, especially exchange and interest risks. Another consequence is that the concerned authorities in many countries have been reviewing their regulatory and supervisory frameworks, and adapting them to shifts in global capital markets. There is now, for example, more emphasis on capital adequacy requirements for international banks, and there are moves toward international coordination for closer monitoring of the banks' large exposure limits, interest rate risks and securities dealings.

In the past decade, global capital flows have often not only reflected long-term investment opportunities, but have also resulted to a large extent from the disparities among the levels of national savings in the major economies. The fact that capital flows now largely reflect short term domestic imbalances between aggregate demand and supply in the major industrial countries has increased the volatility of capital markets in recent years. Real long term demand for capital investment of course exists in the less developed countries, but several well known factors have affected the flow of real investment into these countries.

Third: Capital Markets in the Member Countries of the GCC

The financial sectors of the GCC countries are dominated by the commercial banks. There is a heavy reliance on traditional bank credit for financing economic activities, and bank shares tend to dominate trading in the stock exchanges. The stock exchanges' quotations are limited to the shares of a few domestic companies in Kuwait, Saudi Arabia, the United Arab Emirates, Oman, and Bahrain. The existing shares markets registered noticeable growth in the early 1980s, but performance has been weak since 1983, although there was good performance during 1989 in the shares of Saudi Arabian and UAE companies.

In Saudi Arabia particularly, share prices recorded a considerable increase. The value of traded shares rose by 70% during 1989, to reach SR 3.4 billion, while the volume of traded shares rose by 5% only. In Kuwait, the stock exchange witnessed a marked decline during the last two years (1988 – 1989). The value of traded shares doubled in 1987 to exceed KD 828 million, then the total value fell to KD 710 million during 1988, and to KD 502 million during 1989. The number of traded shares rose sharply during 1987 and 1988, only to drop by half during 1989.

We find that one of the main problems facing capital markets in the GCC is the absence of an official stock exchange in member countries, save Kuwait, Bahrain and lately Oman. This in turn makes it harder to obtain information and choose appropriate indicators for the securities market.

The capital markets of the GCC countries are characterized by several, basically common, features:

1- The stock exchange is the predominant sector of these markets, as bond issues and other instruments have yet to become common methods of finance.

2- The local stock exchanges are hampered by the absence of major institutional players, who usually form the backbone of such markets. Foreign investors are mostly forbidden from market participation.

3- The stock exchanges lack depth, as the shares listed are limited to domestic companies, mainly banks, insurance companies and a few large industrial companies.

4- The shares markets are also characterized by the small size and limited activities of the companies listed.

5- Bonds and other instruments are limited in size and the range of maturities, but the issuance of public debt instruments in the form of treasury bonds and bills in the past few years has added important new financial instruments to domestic markets. During the period since November 1987, public debt issues in Kuwait exceeded a total of about KD 10.6 billion (of which KD 8.3 billion had matured, and the outstanding balance is KD 2.3 billion) and no doubt such a volume within this period provides good opportunities for investment and trading in these instruments. Unlike the case of the shares markets, institutional players have dominated dealings in the secondary markets for public debt issues in Kuwait, and the outstanding balance of these instruments exceeds two billion dinars. As for private sector bonds, their number and total volume has been limited. For example, the total value of KD bonds registered in the Kuwait Stock Exchange since 1985 was KD 206 million, of which KD 121 million were issued by Kuwaiti companies. Total nominal turnover of these bonds in 1989 reached about KD 16 million and there were only 20 transactions during the year.

The importance of financial transactions in the GCC countries goes back to the pre-oil period. This region has always had a strong commercial tradition, and there is usually a strong link between trade-related services and finance. Moreover, in some of the Gulf countries there already exists the foundation for a capital market of the future, based on past experience in developing financial institutions and in dealings and investment in the international markets over the past quarter century. In fact, during the late 1970s some of the GCC financial markets seemed to be on the edge of a take–off period, as activity was booming and domestic institutions enhanced their international profile in the capital markets.

Developments in the early years of the 1980s brought out the inconsistencies and problems faced by the local GCC economies and, as a result, by the financial markets. First, the issue of economic instability, as a result of heavy reliance on a single primary resource, was re-emphasized by developments in the international oil markets and their severe impact on the domestic GCC economies. These developments have underlined the need to develop alternative economic sectors as sources of high value–added and stable activity. Second, the crisis faced by domestic financial markets has brought out the need for review and re-assessment of market rules and regulations, and perhaps of the institutional structure of the markets. Third, during the same period when our domestic capital markets were trying to overcome the crisis of the early years of the 1980s through retrenchment and application of stricter and sounder rules, international capital flows and fund management operations gained increased importance on a global level. Hence, many of our institutions missed out on the opportunities provided by this significant expansion of world capital markets.

Now, the possibilities and potentialities of the GCC capital markets are great. They are based upon the traditional capital–exporting role of the region and the wide experience acquired in finance and investment over the past quarter century. However, our capital markets are adversely affected by several features that need to be dealt with quickly.

For example, the public sector dominates the domestic economies and affects the method of financing activities. Financing major projects is not done through the market, as many activities are undertaken by public sector institutions and financed through the state budget. In addition, state ownership or control of many companies reduces the equity available for private sector investment. Moreover, many of these companies depend on direct or indirect state subsidies, and hence there is no incentive to finance or raise capital through the market. Finally, the markets are further weakened by the limited number of shares transacted and the absence of market makers. This tends to have an impact on the liquidity of assets and on the expected return. Moreover, other factors such as the lack of adequate published information on the traded companies, and the limited activity scope of these companies, tend to limit serious investor interest in these shares.

Now, what are the pre-requisites for developing the capital markets of the GCC countries? I believe that work should be done in several directions, and at different levels, in order to bring our markets to the point where they can expand and develop in a very competitive and volatile international environment:

First, the legal–regulatory framework of financial transactions should be reviewed, and steps should be taken to ensure that they do not discourage capital market development. The rules should also provide the basis for sound institutions and practices, while retaining a degree of flexibility that allows for such measures as the conversion of good private companies into public shareholding companies and the creation of various investment funds. In view of the globalization of markets, and the liberalization of rules regarding financial transactions, this legal-regulatory framework should be in line with the rest of the world. This is an important issue, as our financial markets and our institutions will have to compete more intensively with foreign centers and institutions.

<u>Second</u>, attitudes toward the methods of financing certain activities, especially by institutions owned by the public sector, should change. There are various activities that in most market economies are carried out by the private sector, but various factors have in the past led to our governments' assuming the responsibilities for them. I believe there are several sectors that private initiative should take over, including housing and some public utilities. Any changes that rationalize the relationships among the various economic sectors and the allocation of our limited resources will tend to encourage the development of capital markets.

<u>Third</u>, the process of privatization of large public sector holdings of shares is very important over the medium term. This will release new assets for market dealings, and will lead to an increase in the financing of activities through the capital market. The total effect would benefit the overall economy in terms of performance.

Fourth, complementary markets, such as futures markets, should be encouraged to develop within an adequate regulatory framework.

Fifth, linkages among the national stock exchanges of the GCC and the major world markets should be encouraged, including the listing and eventual trading of the shares of the major international companies and high-rated international bond issues.

Sixth, some of the above changes would offer new challenges, and exert new pressures on the institutional structure of the financial system. It is most likely that there will be a need to look carefully into the existing institutional structures and revise them if necessary.

Finally, we come to a crucial factor that could determine the course of development of our capital markets. As we all know, monetary policy plays a major stabilizing role in the capital markets. The experience of the major world markets in 1929, 1987 and 1989 have under-lined the important role of monetary policy in the management and containment of market volatility.

Hence, it is important that the central banks of the region have the appropriate tools to influence liquidity and the cost of funds in a diversified capital market, and that they have the mandate to use these tools.