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The Gulf Economies: A Speedy Recovery or Lingering Effects from the Global Crisis?

Vanessa Rossi and William Jackson

Summary

- The Gulf economies – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) – should see a strong recovery in 2010 and continued robust growth thereafter as increasing energy revenues should be able to fund further development in infrastructure and the non-energy sector as well as covering the rising cost of the large public sector.
- The benefits of pursuing prudent fiscal policy, increasing national savings during the pre-crisis boom, were evident during the global crisis: this “insurance policy” worked well, enabling domestic development and overall economic growth in the region to continue smoothly during the last couple of years in spite of turbulence in oil markets.
- Against a background of burgeoning emerging markets and thus strong revenues from energy exports, growth in the Gulf region should be well supported for the next five years at least – this is the main reason for consensus forecasts pointing to steady GDP growth in the 4-5% range while inflation is expected to remain low, a relief after the inflation scare in 2007-08.
- The implied rise in household incomes suggests that the region could see substantial increases in consumer spending, including demand for financial services and insurance, over the next 5 years.
- The total value of the general insurance market in 2015 is estimated to be \$27.6bn if the GCC’s demand for general insurance approaches the international trend, and \$20.6bn if demand maintains its current trend. Furthermore, if demand for life insurance were to accelerate towards the international trend, the potential value for this market could reach \$30 billion in 2015.

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CII Introduction: One year after Vanessa Rossi of Chatham House wrote about the global implications of the financial crisis in CII thinkpiece no.13 'Coming up for air', the author returns to the theme to provide an in-depth analysis of how the Gulf economies are faring. Ms Rossi's forecasts show much promise for significant growth in insurance and financial services markets over the next five to ten years – crucial if the Gulf economies are to find a sustainable alternative to oil.

This article reviews how well the Gulf region has weathered the global crisis and prospects for further economic growth and development, including expansion in the retail financial services sector, where demand could be at the point of a rapid take-off. It is important to recall that, although the six individual states that make up the Gulf Cooperation Council (GCC)¹ are relatively small, the bloc as a whole represents an important force in the world economy, particularly in energy markets but also in terms of general economic activity, GDP, trade and finance, ranking among the top ten global economies.

1. Steady growth maintained as governments dip into their cash reserves

If countries experience a crisis but successfully manage it, this can actually serve to boost confidence and encourage policies that ensure resilience in the future.

While the global crisis of 2008-2009 was hardly welcome, it has served this purpose for the Gulf region – demonstrating its ability to maintain steady growth and overcome the inevitable failures that occur in times of stress within any economy, such as problems in local property and financial markets.

It also reinforces the reason for financial prudence and fiscal discipline and tests out just how robustly the economic plan performs under varying conditions. In fact, much as we predicted in an earlier article from February 2009,² the Gulf economies have generally come out of the crisis well for a number of reasons:

¹ The GCC was set up in 1981, with six founding member countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). The organisation's primary objective is to achieve "coordination, integration and inter-connection between Member States in all fields in order to achieve unity between them". An Economic Agreement was formed in 2001 with a GCC customs union in force from 2003 and a GCC common market established in 2008.

² CII Thinkpiece no. 12: ['The Rising Influence of the Gulf in Financial Services'](#) by Vanessa Rossi and Ruth Davis of Chatham House (February 2009).

The safety net of savings: During the pre-crisis boom, much of the surge in export revenues (chiefly driven by energy prices) was used to decrease debt and raise national savings – government budgets and external balances moved into substantial surplus and the value of Sovereign Wealth Funds (SWFs) soared. Spending did increase but investment was carefully targeted and there was generally less of a consumer boom than in the oil spikes of the 1970s – most assessments point to more of the "windfall" being saved than "last time".

Spending their way out of recession: Despite the crisis dampening energy revenues in early 2009, governments continued to fund both public sector jobs and investment programmes, keeping domestic demand steady. Weaker net exports contributed negatively to GDP growth and implied reduced savings (or dissaving) in the worst affected period. Financial market turbulence, the costs of maintaining economic growth as well as the provision of finance for problem projects (in particular property development in Dubai) meant a tough year for SWFs but they stepped up to the plate when needed.

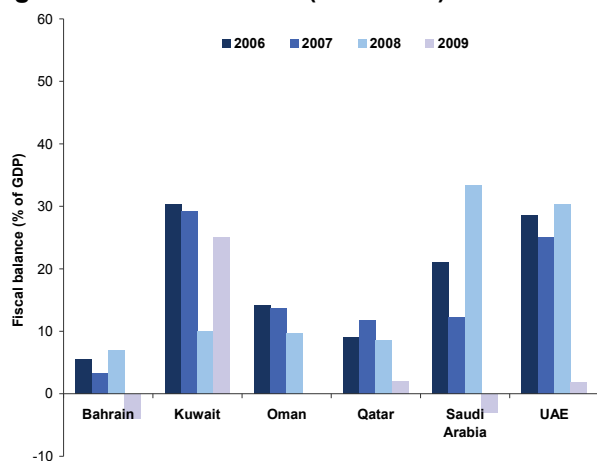
The rebound in oil price: Although oil prices did drop steeply from a peak in mid-2008 to as low as \$30-40 dollars per barrel during the first months of 2009, they swiftly rebounded by the summer to \$50-60 and have been confidently trading in the \$80-90 range in early 2010. Expectations focus on low growth in oil demand and more moderate price increases over the next couple of years, probably taking the oil price to over \$100 by 2012-2013. The associated increase in government revenues means that fiscal stimulus packages enacted to prop up growth in the crisis need not be reversed – unlike the fiscal squeeze facing the US and Europe.

Exchange rate stability: Fortunately for the countries of the GCC, they did not engage in a premature rush to float their currencies in 2007-08, although they were urged to do so by many international financial experts – this meant that the region was spared what would almost certainly have proved a rollercoaster ride in foreign exchange (FX) markets during the last two years.

The Gulf economies are not alone in creating a savings safety net. The newly important emerging market economies of the last decade have all been inclined to save a higher proportion of extra income during boom times in order to secure balance of payments stability, build fiscal reserves (to avoid cyclical disruption to government spending) and grow national wealth for the benefit of future generations and national emergencies.

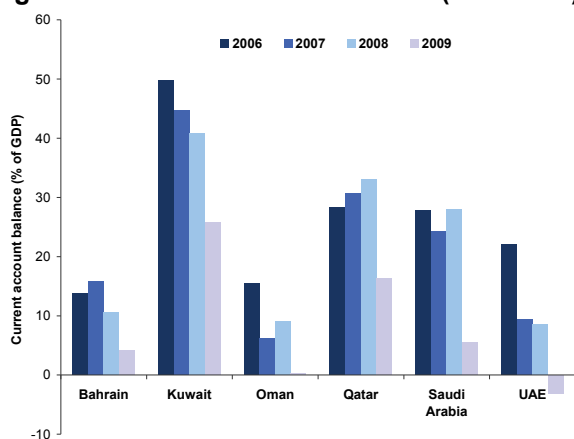
But these factors [creating a savings safety net] are especially important to commodity producers such as the GCC that seek to replace at least part of depleted wealth "below ground" (sold as exports) by a pool of national financial wealth "above ground" in the form of SWFs.

Figure 1: fiscal balances (% of GDP)



Source: Samba

Figure 2: current account balances (% of GDP)



Source: IMF

The collapse in oil prices in 2009 did weaken government revenues, yet large budget surpluses accumulated in the preceding years – alongside current account surpluses of roughly similar magnitudes – provided substantial fiscal reserves largely held in SWFs. This cushion allowed governments the flexibility to run more expansionary fiscal policy in 2009 (except Kuwait, which only belatedly increased infrastructure project expenditure in 2010). Fiscal stimulus packages were particularly significant in Saudi Arabia, by far the region's largest economy, with infrastructure and public services being the main targets of government spending. And similarly expansive policy has been budgeted for 2010, with the government expected to run a small deficit despite recovering oil prices.

The Gulf economies have also shared the preference for currency stability exhibited by many of the leading emerging market economies: volatile currency swings tend to be seen as costly and disruptive to business development and a poor way of tackling fundamental and structural economic imbalances. Since the revival in the GCC's economic fortunes – along with energy prices – from around 2004, the GCC economies have been heavily pressed to consider floating their currencies and have come under close scrutiny regarding the

build up and deployment of their SWFs and FX reserves. Different priorities and perspectives within the GCC clearly created on-going tensions when confronted with the preferences of advanced industrialised nations and global financial markets, typically impatient for change.

The currency issue now seems to be in abeyance, in part due to the continuing reverberations from the crisis and a reduced sense of urgency regarding the build up of financial market capability in the Gulf. In addition, further shifts in exchange rate policy have been postponed. While many aspects of GCC cooperation have been successful, the timetable for establishing a currency union has been delayed by discord over the location for the proposed central bank. Indeed, the UAE recently pulled out of discussions on a common currency and central bank.

However, with all countries (except Kuwait) pegging their currency to the dollar, a de facto currency union already exists.

SWFs also dropped out of the headlines as their fortunes seemed to be waning in early 2009 but they are now showing a strong rebound and new strength, possibly leading to renewed international interest in their fund management operations and direction of investments.

Prospects for new inflows of savings into SWFs of course depend on both the scale of national savings and the financial demands of their own domestic economies and governments. These factors in turn depend not only on the strength of energy markets but also on the regeneration of growth in non-energy sectors. However, with oil prices above \$80, this implies a potential revival in annual inflows to the Gulf's SWFs equivalent to as much as \$200-300 billion.

2. Future prospects – can the non-energy sector keep growing?

While energy prices look set to remain strong – well above estimated break-even levels for the Gulf states' national budgets (estimated at around \$40-60 per barrel for 2010) and probably high enough to maintain new investment in the energy sector itself – the key issue is whether the surplus will be enough to fund further development of the non-energy sector as well. The latter is of immediate concern in order to create new jobs for the young and growing population and to stimulate a broad recovery in economic growth. Moreover, this development of the non-energy sector is important for longer run stability as energy revenues will one day start to decline and new sources of economic growth will be required.

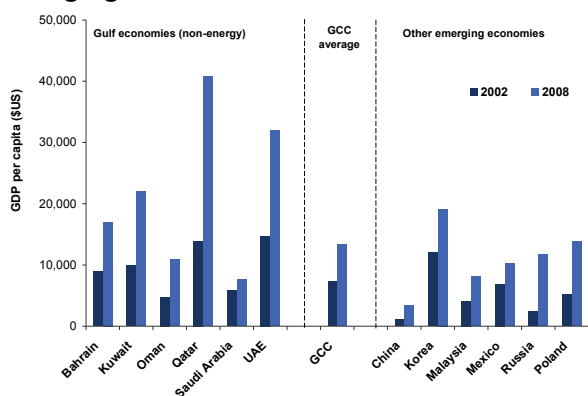
The Gulf faces a race against time to achieve a viable and sustainable development model before the cash flow from energy starts to wane, reducing its ability to invest.

For the next few years, the consensus view is that activity in the region should pick up and maintain an increase in overall GDP of about 4-5% per annum. Indeed, Qatar, which has seen rapid double digit growth in recent years as new gas projects have come on stream, may even enjoy growth as high as 7-8%.

The energy sector is likely to grow only moderately in real terms (with expansion focusing almost entirely on exports to emerging Asia, and China and India in particular) but prices are projected to continue rising. Thus producing countries should remain highly cash generative, with export revenues probably rising by about 10% per annum. Provided local inflation remains low, then this revenue stream should be able to fuel commensurate growth in the non-energy sector of around 6-8% per annum (in real terms), supporting the predictions for robust GDP growth.

In terms of income per capita, the Gulf states rank alongside countries such as Spain and Hong Kong. But taking out the contribution of energy revenues to GDP, income per capita (equivalent to productivity) falls to levels similar to middle income emerging economies.

Figure 5: Non-energy GDP per capita (nominal \$US) places the GCC amongst middle income emerging economies



Source: IMF, WTO and own calculations

There is also significant regional variation, and notably the larger – but lower income – population of Saudi Arabia has a dominating effect in regional statistics.

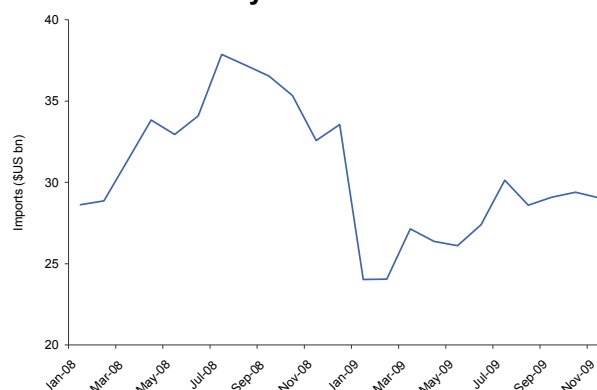
The still low level of productivity in the non-energy sector implies that there is significant scope to expand this component of the economy and achieve higher productivity and income levels across the region and especially in Saudi Arabia.

The crisis of 2008-2009 not only impacted on the energy sector but also caused a slump in many of the private sector businesses operating in the non-energy economy, especially those most exposed to cyclical swings in demand. While energy revenues quickly picked up with world

prices, the non-energy sector has had to be sustained by government support. Fiscal stimulus packages maintained economic growth during the worst of the downturn but this has led to disproportionate government involvement in the economy. For example, in Saudi Arabia, out of overall growth in non-energy output (around 3%), almost half was due to the government sector, compared to about a quarter in previous years. Thus, to maintain economic development and reduce the government's role, the private sector needs to be reinvigorated.

Unfortunately, data for merchandise imports, a proxy for indicators for the real economy, point to a still weak recovery in private sector demand, with only a modest rebound visible versus the early 2009 trough.

Figure 6: GCC monthly imports (\$US billions) show weak recovery



Source: IMF

One reason for the sluggish performance of the Gulf's non-energy economy has been the depressing effect of the global recession on non-energy trade, which tends to focus on logistics, travel and transport, all cyclical sectors that were severely affected by the crisis. This cycle should be picking up now as global trade and demand improve. However, an additional depressant has been the slump in the property market: this sector is likely to play a much weaker role in economic growth over the next few years. Real estate and construction in the GCC reached the headlines during 2009 because, having been dynamic sectors of the non-energy economy pre-crisis, house prices experienced steep falls in 2009 – by over 30% in Kuwait, Qatar and the UAE but less in Oman and Saudi Arabia where supply did not increase so rapidly and demand was more reliant on the local population, thus remaining more stable. Some recovery in house prices is expected during 2010 and fears of persistent over-supply of housing stock are probably exaggerated in part because of project cancellations, although Dubai remains a key concern.

In summary, the non-energy sector should be picking up but may take a couple of years to fully recover to its peak growth rate

An upcoming spurt of fast growth could also be fuelled by rapidly rising household demand and the development of local markets and trade across the region. A key motor for this is the view that income levels in the region are reaching the critical point at which demand for consumer goods, including retail financial services, typically enter an accelerated period of growth. This concept is investigated in more detail below.

3. Potential for retail financial services: reaching a take-off threshold?

S curve³ estimates demonstrate that there appears to be a rapid take-off in demand for retail financial services when GDP per capita reaches about \$10,000, with a high growth rate up to income levels around \$35,000, before demand flattens off again.

The level of GDP per capita in the GCC varies from \$20,000 to \$90,000 (although nominal figures dropped sharply in 2009), which is high compared to the estimated threshold for accelerated demand for retail financial services. However, the inclusion of the energy economy distorts the picture for the GCC – it’s not clear how much of this cash flow actually enters the disposable income of the GCC’s population. A more appropriate metric for household demand analysis in the Gulf region could be the non-energy sector GDP per capita, which is roughly half the level of the overall figure.

We demonstrate this by looking at insurance markets in the GCC region. Figure 7 shows the demand for general insurance with GDP per capita based on the total economy and then Figure 8 shows insurance demand based on the non-energy GDP per capita measure.

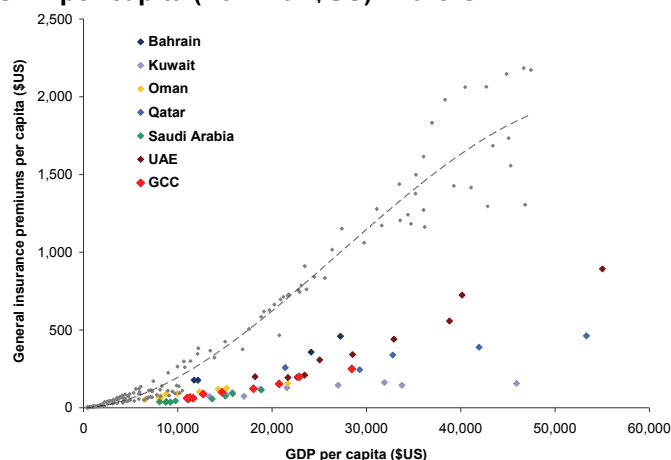
We should therefore expect growth in demand for insurance to start outstripping that of the non-energy economy (itself expected to grow rapidly) over the next five to ten years.

According to income measured by GDP per capita, the GCC states are vastly under-insured. However, using non-energy GDP per capita, the GCC states conform more closely to the international trend. Indeed, the largest deviations from the trendline occur in years when income levels have grown at exceptionally high rates (with annual non-energy GDP per capita increases of more than 30% in nominal terms not uncommon). In such “hot spot” years, household consumption patterns may lag

³ S curve analysis is widely employed to examine and predict consumer trends in developing countries: this is based on evidence that demand for sophisticated products tends to be flat at very low income levels but then undergoes a radical boost beyond a certain income threshold, before stabilizing out again at a higher income level.

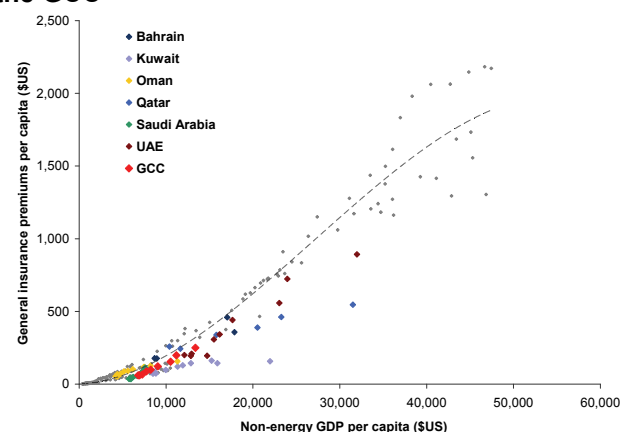
behind increases in incomes and purchasing power. Given that the non-energy GDP per capita of the GCC region as a whole is approximately \$13,000, the region should just be entering the steeply accelerating slope of the S curve.

Figure 7: Demand for general insurance and GDP per capita (nominal \$US) in the GCC



Source: Swiss Re, IMF and own calculations. The trendline represents observed data from 17 advanced and developing economies between 1999 and 2008.

Figure 8: Demand for general insurance and non-energy GDP per capita (nominal \$US) in the GCC



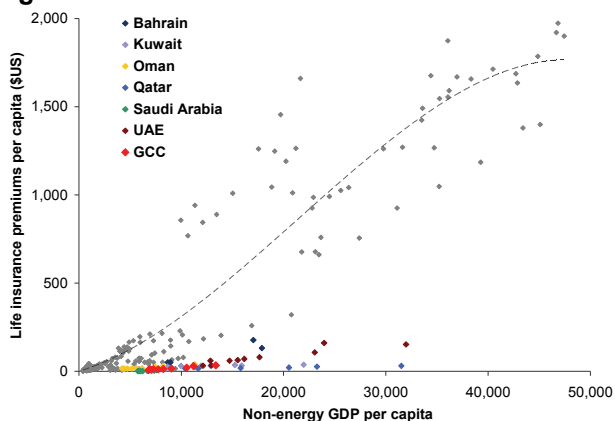
Source: Swiss Re, IMF and own calculations

In terms of life insurance, demand in the GCC is much weaker, although this can be attributed to a number of factors, for example, the emergence of Sharia compliant insurance (Takaful) may have been slow, encouraged by the fact that the Gulf states tend to have extensive welfare systems that diminish the need for private life insurance. The extent of life insurance ranges from almost 40% of the value of general insurance in Bahrain, to only 1-5% in Saudi Arabia. However, a number of studies have put forward that awareness of insurance in the region is growing,⁴ suggesting that changes in market

⁴ For example: Swiss Re (2008) *Insurance in the Emerging Markets: Overview and Prospects for Islamic Insurance*; Standard and Poor’s (2010) *United Arab Emirates Insurance Market Delivers Strong Technical Performance through the Economic Downturn*.

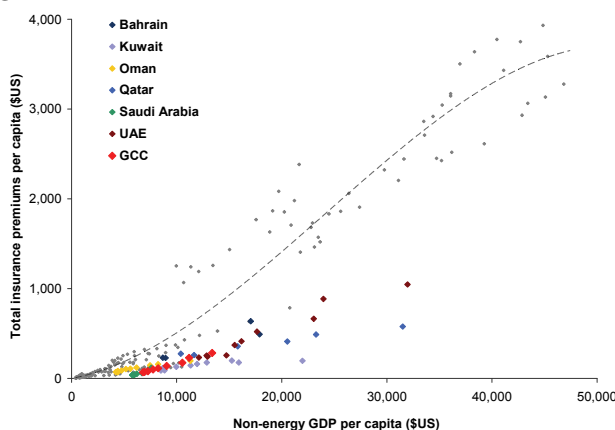
characteristics will now act as a stimulant for insurance demand.

Figure 9: demand for life insurance in the GCC



Source: Swiss Re, IMF and own calculations

Figure 10: demand for total insurance in the GCC

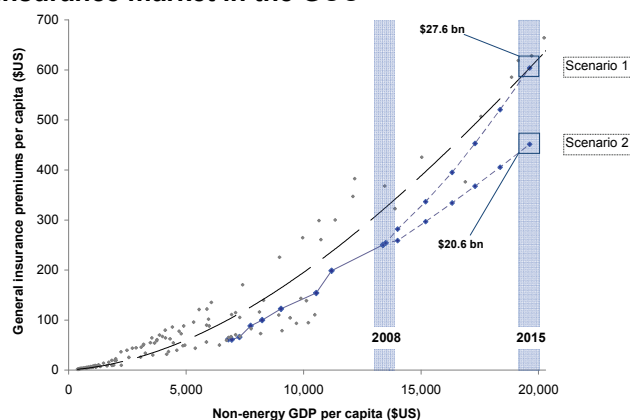


Source: Swiss Re, IMF and own calculations

To demonstrate the rapid growth potential in retail financial services now that the GCC has entered the steep slope of the S curve, we forecast two scenarios for the general insurance market up to 2015: in the first, demand accelerates to the international trend and, in the second, demand accelerates, but follows the previous years' trend in remaining lower than the international norm. The non-energy GDP per capita is estimated using consensus forecasts for the Gulf states' total economic growth as well as the oil price and oil demand. According to this methodology, non-energy GDP per capita in the GCC could be around \$19,600 in 2015. The results for general insurance demand are shown in Figure 11.

The total value of the general insurance market in 2015 is estimated to be \$27.6bn if the GCC's demand for general insurance approaches the international trend, and \$20.6bn if demand maintains its current trend.

Figure 11: forecast scenarios for the general insurance market in the GCC



Source: Swiss Re, IMF and own calculations

This represents growth of 190% and 120% respectively over the 2008 market value of just \$9.4bn. Furthermore, if demand for life insurance were to accelerate towards the international trend, the potential value for this market could reach \$30 billion in 2015 (from a value of \$1.3 billion in 2008). Given that non-energy GDP per capita is forecast to grow by less than 50% during this period, this analysis suggests that insurance, as well as other retail financial services, are likely to be extremely dynamic markets over the next 5 years.

Giving new impetus to the non-energy sector?

In order to reap the benefits of accelerating demand for retail financial services, intra-GCC trade needs to be encouraged. Several of the smaller Gulf states – notably Bahrain and the UAE – have well developed financial companies and regulatory systems.

However, the bulk of demand for these services should come from Saudi Arabia because of its large population and scope for improvement in still low income levels (implying potential for demand to rise rapidly on reaching the take-off threshold).

Fostering intra-regional services trade could therefore act as a catalyst for the development of the intra-regional non-energy economy by increasing the overall size of the market as well as opening up previously slow moving markets in key countries. And providing access to such services could further stimulate domestic demand and regional integration.

Consolidating economic strength and consumer markets will encourage regional industries and trade to grow and enhance integration. Specifically, if its internal market for financial services increases, the Gulf will be better positioned to compete with other emerging Islamic financial hubs, for example Malaysia, and to gain a foothold in markets with large Muslim populations and low, but increasing, income levels such as Egypt, India and Indonesia.

More importantly for the overall economy, the financial sector constitutes just one part of a

potential consumer boom across the GCC states: demand for other services and consumer durables could also enter a period of accelerated growth. Such a development, along with increasing integration and the expansion of training and cultural links, might encourage a rise in regional products and trade, boost industries in the non-energy sector and create jobs, while also mitigating the exposure of the GCC economies to any future global economic cycles and volatility in the energy sector. A more stable, diversified base for the regional

economy, especially one that offers more professional and technically skilled jobs and improves regional integration, would be widely welcomed.

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