*Viewpoints*
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# GCC Stock Markets: Sliding Toward Relevance?

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Sustained low oil prices and regional volatility have undermined the promising vitality of the stock markets of the Gulf Cooperation Council (GCC). With smart government and regulatory reform, these emerging exchanges have the potential to be the catalysts of economic diversification that the GCC needs.

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After a dismal performance through much of 2015 and 2016, most stock exchanges of the Gulf Cooperation Council (GCC) have stabilized. Although they failed to return solid gains to investors as many did in 2013 and the first half of 2014, when the price of Brent topped $113 per barrel—market indices virtually mirrored the movements of global oil prices—most GCC stock indices have at least halted their decline. This continued lack of vitality reflects the continued softness in oil prices. But at least as important, the political and economic rift with Qatar has thrown a great deal of uncertainty into the market and torn asunder the idea of GCC unity. Qatar's stock prices have fallen by more than 10 percent through the end of September, a plunge that began in earnest after Saudi Arabia, Egypt, the United Arab Emirates, and Bahrain severed ties with Qatar in June.

With civil wars, proxy wars, and rumors of new wars, why even discuss stock prices? Because long-term development can and should continue apace irrespective of geopolitical concerns. Stock markets can help promote economic development and diversification[i] (see the Wilson Center's Viewpoints "The Economics of Financial Market Growth in the Middle East).[ii] Although oil riches have provided the Gulf States amazing wealth and stability, economic growth and income distribution have been uneven, and the private sector is not vibrant enough to absorb the hundreds of thousands of job-market entrants each year. Even though oil can deliver many more decades of substantial export revenue, Gulf States have been gradually diversifying their economies away from commodity export dependence since the 1990s.

Relatively consistent revenues from hydrocarbon exports have been a stabilizing factor for GCC financial markets. Even during epochs of relatively lower revenue—such as during the second half of the 1980s or following the downturn in global economic growth in 1998—export revenue tied to hydrocarbons provided some level of surety to government finances and the broader economy. But since 2014, revenues have not been guaranteed and many energy market soothsayers are proclaiming a new era of oil price moderation, leaving policymakers in the Gulf scrambling for funds, with equity markets in bearish territory or at best flat.

What is needed now is a strong push to further reform the financial sector, combining the best of advanced markets (diversified asset choices, higher liquidity, larger pools of domestic investors, and a transparent regulatory structure) with manageable risks. Equity markets by themselves cannot promote development and, in fact, until GCC governments more rigorously promote privatization programs first discussed in earnest in the 1990s and establish credible and transparent regulatory systems, equity financing will likely remain secondary to bank financing. Moreover, a culture of stock market investing is still in its embryonic stages despite its growth. Even in many developed economies, financing via the stock market takes a back seat to bank lending, but equity markets are crucial to attracting foreign capital inflows and providing greater transparency to the valuation of companies.

**Searching for Vitality**

As measured by stock market capitalization as a percentage of gross domestic product (GDP), GCC stock markets have been more integrated into their broader economies and hence a more important factor in financing development. In 2016, market capitalization to GDP in the GCC averaged around 60 percent, roughly on par with the global emerging market average. (For comparison, the ratio was 95 percent in East Asian and Pacific markets and 36 percent Latin American and the Caribbean markets, according to the World Bank.) No doubt the recent years of conflict and persistently low oil prices have shrunk the values of regional markets, resulting in capitalization/GDP ratios lower than their potential, but the seeds are taking root.

Market dynamism can also be assessed by turnover ratio, but on this front GCC markets (and other markets in the Middle East and North Africa) appear downright phlegmatic. Turnover measures how often shares change hands in the market, an indication (usually) of how vibrant or liquid the market is, and despite glitzy advances in technological sophistication, turnover in GCC markets in 2017 has grown little in the past 10 years.

According to the World Federation of Stock Exchanges, from January to August 2017, share turnover in Bahrain averaged just 3 percent and in Abu Dhabi only 12 percent, mere fractions of the turnover in Asian markets—China's Shenzhen Stock Exchange averaged turnover of around 250 percent in 2017. The Saudi stock market shows marginally better numbers: in August 2017, share turnover was 42 percent, though this was down sharply from 74 percent at the beginning of the year. Notably, of the nearly 380,000 investor accounts registered on Kuwait's stock exchange in August, only 19,200 had executed a trade within the previous six months; in other words, 0.5 percent of investor accounts were considered "active" by the Boursa Kuwait.[iii]

Not only are the oil and gas sectors the supreme revenue generators for these states—accounting for more than 75 percent of fiscal revenues—they also funnel into stock market returns. At the end of 2016, petrochemical and oil-related stocks accounted for one quarter of market capitalization in Saudi Arabia, and Saudi banks accounted for another quarter. Analysis by the IMF shows that banking sector profits in the GCC are highly and positively correlated to the movement of oil prices, and the dominance of banks on these exchanges and their susceptibility to global oil prices can feed volatility.[iv] The Abu Dhabi Securities Exchange is especially concentrated, with one bank—First Abu Dhabi Bank—alone accounting for 25 percent of total market capitalization following the merger of National Bank of Abu Dhabi and First Gulf Bank.

Although expanding, the private sector in the Gulf remains mostly relegated to operating on the margins of government largesse and contracts. This lackluster economic contribution is mirrored by the limited number of companies listed on GCC exchanges. As of August 2017, 64 companies were listed on the Abu Dhabi Securities Exchange, 44 on the Bahrain Bourse, 60 on the Dubai Financial Market, 110 on the Muscat Securities Market, and 185 on the Saudi Stock Exchange. Tellingly, in Saudi Arabia, government-related entities held 40 percent of shares in June 2017, compared with 27 percent of retail investors (or non-institutional investors), a reflection of the continued dominance of the state in financial markets. Once high-net worth individuals and individual professional investors are removed, the average Saudi household held only 4 percent of shares in the market, not a sign of a stock market culture.[v]

In this writer's assessment, these markets have not yet cast off their status as "frontier markets," more or less a subcategory of emerging markets that includes countries with small, illiquid, and volatile stock markets with low turnover.[vi] To be sure, many would view the Dubai and Abu

Dhabi exchanges as having graduated to emerging-market status, but high volatility still marks them. For instance, from 2006 to 2016 the MSCI GCC Countries Index showed colossal swings in returns—the aggregate index rose by 52 percent in 2007 only to decline by 56 percent the following year—slightly higher volatility than the broader MSCI Frontier Markets Index. The predominance of family-owned companies in the GCC adds more complexity to the policy mix as lessening family ownership and opening the books to scrutiny and transparency can be fraught with suspicion and drive families to safeguard ownership (and at times hide malfeasance). As a result, corporate governance practices have not developed in line with international standards, which is crucial to improving confidence in the markets.

**Smart Planning Can Unlock Potential**

Leaders around the GCC are now fully aware that higher oil prices—if they come to pass and can be sustained—cannot solve the fundamental shortcomings in their economies. Abundant revenues from oil exports cannot by themselves increase the productivity of the public sector, expand the reach of the private sector, improve the legal and regulatory structures necessary to improve the business environment, or diversify economies away from overreliance on the energy sector. The extended oil price doldrums are in fact the singular impetus these countries need to accelerate not just financial market reform but systematic economic reform. Oil price recoveries in the past have boosted spending and reduced current account deficits but they dulled nascent impulses for development.[vii] The question for GCC states is: Can these burgeoning financial centers develop and facilitate financing for economic growth without the cushion of hydrocarbon revenues? The answer is a qualified yes, but only if they accelerate their long-term diversification schemes.

That governments need to intervene less in the economy and hasten more privatization, especially via the stock market, is cliché among development economists. That cliché, however, does not apply to the governments' incomparable role in establishing and modernizing the markets in the first place. GCC government connections are stronger and more influential than in other developing markets, which will make it easier for enlightened policies to become law.

Rather than retreat from financial sector reform, GCC policymakers should stay the course even as they meander from crisis to crisis, manage public expectations, and balance policy sequencing. In lieu of turning back, policymakers must strengthen their domestic financial systems and prudential regulations. Importantly, Gulf States can take long strides to further developing their financial sectors by encouraging financing through their domestic stock markets and helping create a culture of investing.

Of prime importance, owners of capital in the GCC—from small retail investors to government institutions—need to reorient their historical preference for sending their capital abroad and investing it locally. This of course requires a domestic financial system that is capable and competitive enough to turn their savings into returns. Asset management in the GCC has largely channeled oil revenue funds into a narrow range of assets in Europe and the United States, and many in the Gulf fret about their reliance on Europe and the United States for the financial services needed to manage their investments. The ability of these oil-exporting countries to recycle foreign earnings into local financial markets has existed for years, but historic economic rents have fed government largesse, disincentivized private sector dynamism, and reduced the need for greater options in financial products.

Local stock markets can be the engines of innovation, private-sector growth, and diversification, but they need local managers, traders, and technicians to integrate their markets into the broader population. Many of the more affluent are educated abroad, but there is a chronic shortage of junior staff to perform the regular tasks in financial institutions and exchanges. Rather than continue to have these markets viewed locally as little more than enclave economies run by elite foreign fund managers, governments and institutions can play a larger role in incentivizing higher education in finance for locals and gradually reducing the dependence on outsourced Western expertise.

Although the label of "regional financial hub" is alluring to some GCC countries, the Gulf's leadership can promote a deepening of its financial sectors without becoming the proverbial "hub." Competition is never a bad thing for pushing economies to be more efficient, but the density of financial centers in the GCC is needlessly high as five cities—Abu Dhabi, Doha, Dubai, Manama, and Riyadh—are competing to be the region's hub in a combined GCC economy smaller than that of New York City's metropolitan area. Rather than spending resources on becoming the next big thing, exchanges and policymakers should focus more on developing an equity-ownership culture at home and incentivizing a savings and investment mentality among their citizens. A similar mentality exists in the GCC's military: At the expense of training and development of a capable cadre of enlisted men and junior officers—the less glamorous side of running an effective fighting force—governments have consistently prioritized the bank-busting modern hardware that may not be the most sensible for their needs.

Lastly, a country need not pursue exotic derivatives to deepen and grow its financial sector. Arguably, the marginal benefits that could theoretically accrue with the advent of complex financial products are years away, run counter (at least for now) to the ethical standards of Islamic finance, and probably cannot justify the additional risk. At least as important is the thin and underdeveloped regulatory infrastructure that would foster derivative products as they are more complex contracts than standard bank loans, bond, and equities, and it remains to be seen whether regulators are up to the challenge at this point.

A decade or so ago, as Gulf markets were returning sizeable returns and dazzling exchanges were being built, some analysts predicted that GCC markets—especially those of Saudi Arabia and the UAE—would soon rival markets in East Asia. Clearly, these predictions were premature. But sustained low oil prices and rising debt and unemployment have made diversification, in this writer's opinion, the most important long-term policy for maintaining socioeconomic stability in the Gulf. Developing and promoting stock markets and embedding a culture of investment can be a key catalyst in this policy mix.

*The author is an employee of the United States Government, which is funding his fellowship at the Wilson Center. All statements of fact, opinion, or analysis in this work are those of the author and do not reflect an official position or views of the Government or of the Wilson Center.*

[i] Samy Ben Naceur, Samir Ghazouani, and Mohamed Omran, "The Determinants of Stock Market Development in the Middle Eastern-North African Region," Managerial Finance, Vol. 33, No. 7, 2007.

[ii] Michael Gordon, "The Economics of Financial Market Growth in the Middle East," https://www.wilsoncenter.org/publication/the-economics-financial-market-growth-the-middle-east

[iii] https://www.boursakuwait.com.kw/A/Default.aspx

[iv] Tigran Poghosyan and Heiko Hesse, "Oil Prices and Bank Profitability: Evidence from Major Oil-Exporting Countries in the Middle East and North Africa," IMF Working Paper, 2009.

[v] "Monthly Stock Market Ownership and Trading Activity Report," Saudi Stock Exchange, June 2017.

[vi] G.N. Gregoriou and M. Wu, "An Application of Style Analysis to Middle East and North African (MENA) Hedge Funds, Handbook of Frontier Markets Vol. 2, 2016.

[vii] Henry Azzam, The Emerging Arab Capital Markets, 1997.

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