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Abstract

One objective of the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO) is to achieve financial services liberalization in member countries. We assess the implications of such liberalization in the banking sectors of the Gulf Cooperation Council (GCC) countries. After providing an overview of the GCC banking sector, we discuss the GATS provisions relevant to financial services and present liberalization commitments and exemptions of these countries under the agreement. Using the observation that spikes in oil prices are accompanied with expansion in credit availability, we develop a simple model to formally explore the consequences of opening up the banking sector. Our analysis considers the possible policy impact on the domestic banking industry as well as a non-tradable sector that is driven by local entrepreneurship. Our investigation suggests that while high oil prices facilitate credit availability, they also enable governments to more easily and better subsidize employment in the public sector. This more attractive outside option then serves as a deterrent to risk-taking entrepreneurs and this could stunt the growth of the non-tradable sector. A liberalized banking sector could mitigate this outcome as well as other institutional inefficiencies in lending, but also brings with it the vulnerability to global financial crises. A resulting credit crunch could then lead to retrenchment in the non-tradable sector. The situation could get aggravated if the global financial crisis leads to a collapse in the demand for oil and negatively affects oil prices.

Keywords: Financial services, GATS, private-sector employment
JEL Classification: G2, F00, J21

[*] P.O. Box 506782, Dubai, United Arab Emirates. The opinions or statements expressed herein reflect the author's own and sole opinions and should not be taken as a position of or endorsement by Booz&Co. The author is not representing, giving opinion or otherwise making statements on behalf of Booz&Co.

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Motivation

Mature economies are characterized by a liberalized and developed private banking system that contributes to economic growth by supporting private sector activities through a variety of financial services and channels. Evidence from past studies on liberalization of financial sectors confirms that there is significant increase in efficiency and profitability of banks in developing countries with large government ownership. The evidence, however, is mixed in terms of the expansion of credit to the private sector. This can be a result of limited alternative financial channels or macro-microeconomic factors that disrupt channels such as weak institutional structures, high fiscal deficits, and external financial shocks.[1]

The economies of the Gulf Cooperation Council (GCC) countries[2] share similar economic characteristics. All GCC countries are large oil exporters with vulnerabilities to fluctuating international oil prices; and all aim to diversify their economies through private sector growth. Given the uncertainties surrounding global economic growth, the fiscal and external balances of oil exporting countries are vulnerable to weaker global aggregate demand. Historically high oil prices in recent years have enabled fiscal expansion and low interest rates to provide economic stimulus.

At the same time, however, the GCC banking sector is concentrated in a limited number of domestic players with majority government ownership.[3] Government control of banks adds to the power the government has to set wages and prices in the public, a common feature of natural-resource rich governments (Neary and Wijnbergen, 1985). This highlights the importance of policies to diversify GCC economies away from natural resources. Coupled with proper incentives and regulations, liberalization of the banking sector can help achieve diversification by expanding credit to prospective entrepreneurs and small or medium enterprises.

This paper adds to the literature by focusing on the liberalization of financial services in natural resource-rich developing countries where resource revenues are, in part, used to support a domestic financial sector. The case of GCC countries is used as illustration. The paper argues that liberalization of the financial sector helps strengthen private sector policy initiatives and reduce dependency on government spending. This suggests that commitments made under the GATS should lead to a process of financial liberalization with an aim towards economic diversification led by the private sector.

The rest of the paper proceeds as follows. Section 1 provides a background on GCC economies and the structure of the financial sector. In section 2, we provide a general and GCC-specific discussion of the GATS and financial services. Section 3 presents our model of services trade in the financial sector. In section 4, we discuss the results

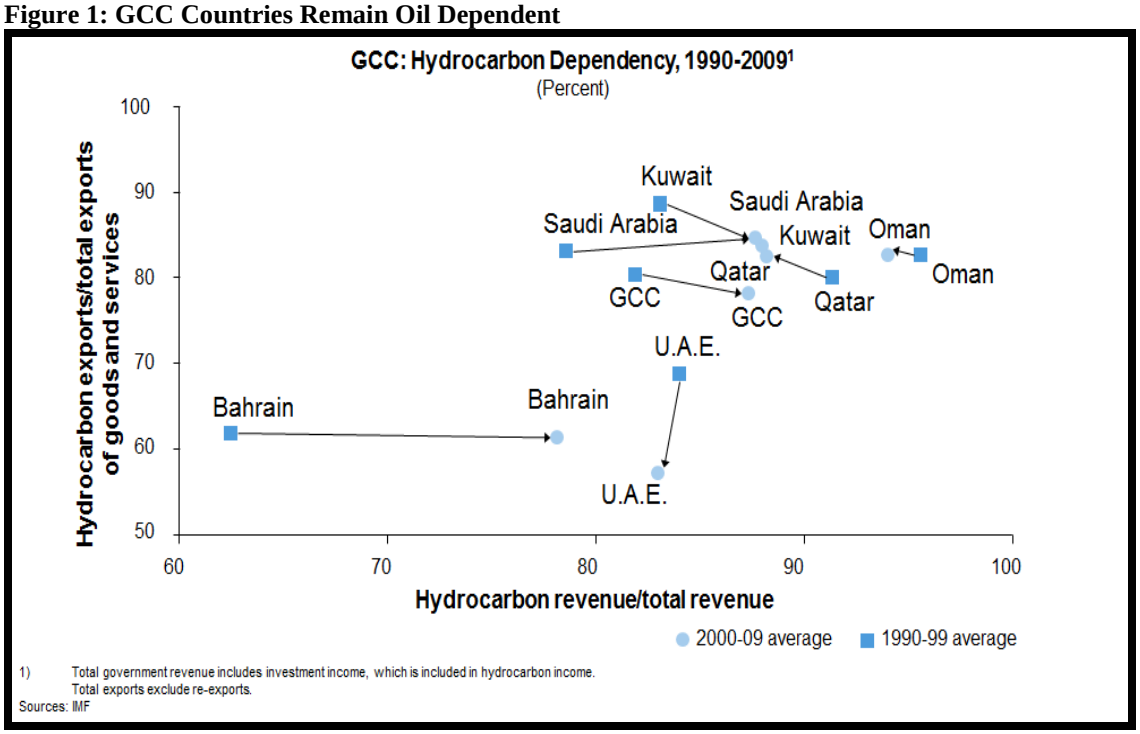
[1] See, for example, Gupta, et al. (2011).
[2] The GCC comprises of Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, and the United Arab Emirates (UAE).
[3] See, for example, Al-Hassan, et al. (2010).

obtained and then conclude by offering a summary and some policy recommendations in section 5.

I. Background

The GCC has witnessed considerable economic growth over the past four decades. Much of this growth, however, has been carried on the back of higher oil prices that began in the seventies of the last century and continues to date. Despite the rise of non-oil GDP over the past decade oil revenues continue to dominate national income (see figure 1). This has widened the role of the government as the main economic agent and has hindered policy efforts aimed at growing private sector jobs and reducing the role of the government as the major employer.

Figure 1: GCC Countries Remain Oil Dependent



The financial sector in the GCC ranges from 8 percent of GDP in Saudi Arabia to 27 percent in Bahrain[4], figures that are at par with or higher than developed economies like the United States or the UK (see figure 2). However, the structure of the GCC's banking sector differs in three main aspects[5]:

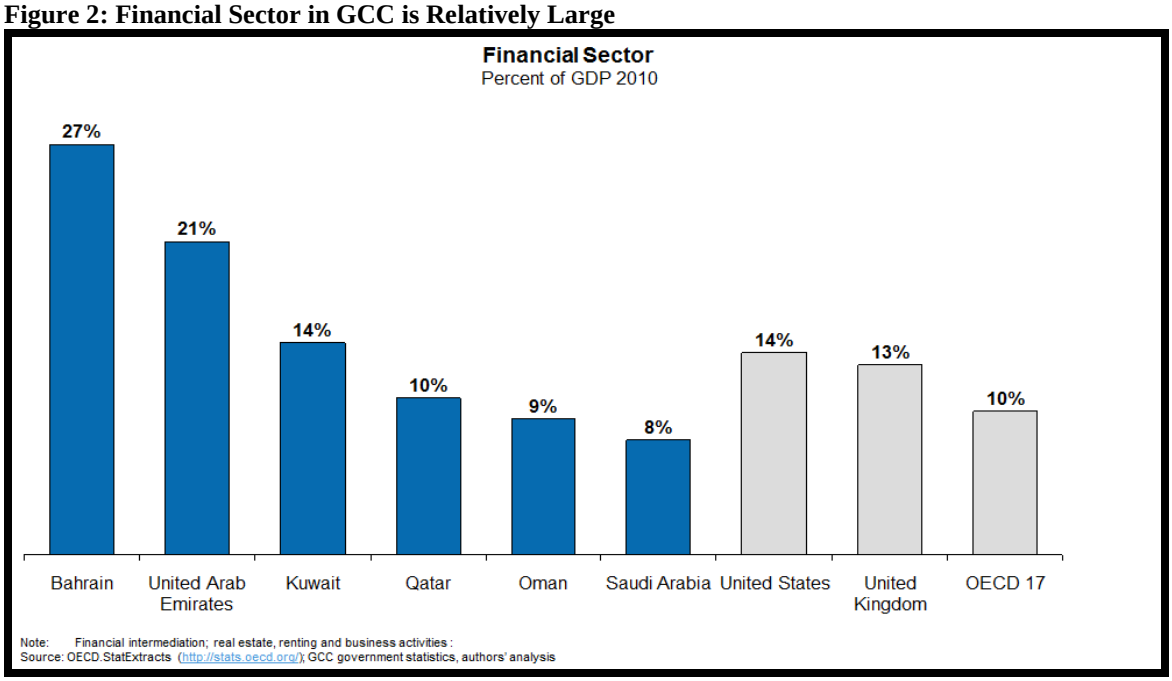
- Dominant domestic banks: In all six countries of the GCC the largest five domestic banks account for 50 to 80 percent of the total banking sector assets.

[4] The Bahraini economy has traditionally depended on the banking sector especially after the reduction of oil revenues over the past four decades.
[5] See Al-Hassan, et al. (2010).

- Large government ownership: Government and parastatal enterprises ownership of banks range between 13 percent in Kuwait to over 52 percent in the UAE.

- Dominance of the banking sector: The financial sector is dominated, for the most part, by the banking sector with limited presence of non-bank financial institutions.

Figure 2: Financial Sector in GCC is Relatively Large



II. The GATS, Financial Services, and the GCC

The General Agreement on Trade in Services (GATS) was formulated to address the growing need for an internationally recognized set of rules to regulate trade in services. Its two main goals are to ensure transparency of rules and regulations, and promote progressive liberalization. The second objective is advanced through improved market access and national treatment to service suppliers. Market access and national treatment requirements are less stringent than the demand for reciprocity that is a feature of the General Agreement on Tariffs and Trade (GATT). While tariffs and quotas often determine market access for goods trade, restrictions on, for example, the number of service suppliers, the value of service transactions, or foreign capital participation, affect market access to services. The absence of discriminatory measures, such as differential tax treatment that puts foreign competitors at a disadvantage, is required under the national treatment provision of the GATS. The scope of the agreement, in terms of the sectors it covers, is broad and includes services as varied as tourism, education, and telecommunications. Not surprisingly, financial services form the core of this list due to their centrality in any modern economy, and because of technological change,

deregulation, and the opening up of financial systems to international competition, all of which have expanded trade in financial services.

The GATS recognizes services trade via four channels, which it refers to as modes. Mode 1 is cross-border trade, where services originate in one country and are consumed in another country. Under mode 2, or consumption abroad, services are consumed by a consumer of one country in the territory of another country. Mode 3 refers to commercial presence of a supplier of the service in the territory of another country. Finally, mode 4, or presence of natural persons, covers labor movement from one country to deliver services in another country. All four modes are clearly relevant to the provision of financial services with mode 3 having particular significance since it directly addresses the physical presence of foreign financial institutions, such as banks, in another country. In fact, recent GATS negotiations have been characterized by attempts to seek ambitious commitments on the supply of financial services through commercial presence abroad.

For designated service sectors, each member country is required to specify its commitments relating to market access and national treatment under each of the four modes of supply. The so-called Schedule of Commitments therefore contains eight entries per sector, listing any limitations on market access or national treatment under each of the four modes of services supply identified by the GATS.

Financial services are critical to the growth prospects of any economy (Levine, 1997). As the GCC region continues to grow and structural reforms are implemented, demand for financial services has increased in tandem. Focarelli and Pozzolo (2005) identify profit opportunities, integration between home and host markets, and institutional and regulatory frameworks as the most important determinants of global bank expansion. The GCC has made consistent progress on all these fronts. However, these countries have had to contend with legitimate concerns over the liberalization of the financial services sector, including (1) the uncertainty surrounding the impact of opening up on the financial sector, (2) the prospects of the domestic financial industry to prosper, and, (3) crucially, the effect on the rest of the economy. Liberalization under the GATS tends to reduce adverse selection and moral hazard problems since better project management and assessment expertise benefits from local knowledge and reduces nepotism- and reputation-based lending. Foreign competition also promotes the wider use of auditing and accounting procedures and establishes more transparency. Since foreign financial services providers tend to have a comparative advantage—due often to tax and regulatory distortions, but also because of underdeveloped financial sectors in developing countries—it behooves economies such as the group of GCC countries to undertake liberalization. Apart from the static benefits of liberalization in the form of lower prices, there are dynamic benefits manifested in enhanced growth prospects.

Quantifying liberalization commitments under the GATS is an inherently subjective exercise. Country commitments are publicly available from the services database of the WTO. Following Harm, et al (2003), we construct an index and assign a value of 0 to "unbound" entries (implying no commitments) under market access and national treatment for each of the four modes in a country's GATS schedule. We enter a value of

1 if the schedule reports "none" reflecting unrestricted commitments. For modes 1, 2 and 4, a value of 0.5 was assigned for the cases of intermediate-level commitments due to the uncertain economic significance of these modes. However, since mode 3 is particularly important in the case of financial services, we employ a more varied approach and assign a value of 0.25 if the limitation is on licensing of new entry, 0.5 if foreign equity is limited to less than 50 percent, and 0.75 otherwise. The process is carried out for the banking and insurance sectors. Note that no limitations (the most open regime) under any mode and under market access and national treatment would correspond to an index value of 8. The most restrictive regime would be associated with an index value of 0.

The results are reported in Tables 1 and 2a-b below. So, for example, since the GATS commitments schedule for Bahrain for the insurance sector shows unrestricted commitments under modes 1 through 3 in both market access and national treatment, but no commitments under mode 4, the index value turns out to equal 6. Similarly, for the banking sector (we restrict our attention to lending and deposit operations only), the index value of 3.5 is obtained for both deposits and lending. Kuwait and the UAE do not have any commitments for insurance services in the GATS schedule and are therefore not numerically recorded in Table 1.

Table 1: Index of GATS Commitments in (Direct) Insurance Services

	Market Access				National Treatment				
Country	1	2	3	4	1	2	3	4	Index
Bahrain	1	1	1	0	1	1	1	0	6
Kuwait	-	-	-	-	-	-	-	-	-
Oman	1	1	1	0	1	1	1	0	6
Qatar	1	1	0.25	0	1	1	1	0	5.25
Saudi	0	1	0.75	0	0	1	1	0	3.75
U.A.E.	-	-	-	-	-	-	-	-	-

The information in the tables shows that the GCC countries maintain a considerably liberalized regime as far as national treatment is concerned. However, policy commitments toward the provision of market access displays more nuance. While consumption of financial services abroad by GCC consumers is free of restrictions, cross-border trade (mode 1) and commercial presence (mode 3) have more limitations. In banking, for example, GCC members other than Qatar and the UAE retain the right to impose restrictive measures on mode 1 trade. This could be a reflection of concerns over consumer protection, capital transfers, and regulation of suppliers that lack a solid reputation. Insurance services under mode 1 fare better probably because these services are highly internationalized and less risky to regulate. Mode 3, which is highly important for financial services, is the least open channel across the GCC, with every member listing limited commitments. Not unexpectedly, mode 4, which covers foreign labor

flowing in to deliver services, remains the most tightly controlled channel across all countries of the GCC under both market access and national treatment.

Table 2a: Index of GATS Commitments in Banking Services - Deposit

	Market Access				National Treatment				
Country	1	2	3	4	1	2	3	4	Index
Bahrain	0.5	1	0	0	1	1	0	0	3.5
Kuwait	0	1	0.5	0.5	0	1	0.5	0.5	4
Oman	0	1	0.5	0	0	1	1	0	3.5
Qatar	1	1	0.25	0	1	1	1	0	5.25
Saudi	0	1	0.75	0	0	1	1	0	3.75
U.A.E.	1	1	0	0	1	1	1	0	5

Table2b: Index of GATS Commitments in Banking Services - Lending

	Market Access				National Treatment				
Country	1	2	3	4	1	2	3	4	Index
Bahrain	0.5	1	0	0	1	1	0	0	3.5
Kuwait	0	1	0.5	0.5	0	1	0.5	0.5	4
Oman	0	1	0.5	0	0	1	1	0	3.5
Qatar	1	1	0.25	0	1	1	1	0	5.25
Saudi	0	1	0.75	0	0	1	1	0	3.75
U.A.E.	1	1	0	0	1	1	1	0	5

Overall, the countries of the GCC, at best, display only moderate commitments to financial openness, particularly in banking. Protection of the sector and the consequent lack of competition are further evidenced by the difference in the lending and deposit rates in the GCC. Information on these rates is presented in Table 3 below.

Table 3: Lending-Deposit Interest Rate Differentials

Year	Bahrain	Kuwait	Oman	Qatar
2005	4.679354	4.029683	3.766	3.466667
2006	3.605239	3.654492	3.403	2.948333
2007	3.781343	3.089642	3.145	3.003333
2008	6.575961	2.807317	2.619	3.879167
2009	6.359762	3.327233	3.301	2.8075

Source: Authors' calculations based on IMF data.

There is a healthy gap between lending and deposit rates in the GCC. In Norway, Japan, and the Bahamas, the average interest rate spread over the same period was under two percent. In Canada and Israel, it was just over two percent.

The next section presents our model of financial services liberalization and its impact on the relative sizes of the public and private sectors.

III. The Model

We have *N* agents in the economy. Each agent can either become an entrepreneur to produce a non-tradable good *Z* in the private sector, or find employment in the public sector. The agent maximizes profits, which he gets to keep, in the private sector or receives a fixed income $\varphi\bar{y}$ in the public sector. Inefficiency or corruption in the public sector means that only a portion of each dollar the government puts in the public sector makes it into the hands of the agent with φ being a measure of this inefficiency and $0<\varphi<1$. A higher value of φ implies a more efficient public sector or lower corruption.

The non-tradable good *Z* is produced using only financial (banking) services with the production function given by:

$$Z = s^a$$

where *s* is the amount of banking services used in production and *a* is a parameter such that $0 < a < 1$. The price of a unit of banking services is *p*. However, we assume that due to information and other financial sector inefficiencies, the agent faces an additional cost of $c(\theta)$ per unit of financial services, where θ denotes the extent of financial services liberalization chosen by the government, with $0 < \theta < 1$. The additional cost may also be depicted in the interest rate spread. Hence, the agent takes θ as given. A higher value of θ implies a more closed sector. We assume that the introduction of foreign banks into the domestic financial sector reduces inefficiencies in this sector due to the superior business practices these banks bring with them. The process of financial intermediation is likely to improve with the importation of better know-how and lending practices and procedures.

This implies that $c(\theta)$ increases in θ and captures the foreign comparative advantage in the provision of financial services. The agent's profit maximization problem can then be written as:

$$\underset{s}{Max}\,\pi = s^{a} - (p + c(\theta))s$$

The demand for banking services is therefore:

$$s = \left[\frac{1}{a}(p + c(\theta))\right]^{\frac{1}{a-1}} \qquad (1)$$

Note that the price of financial services is less than their marginal product due to inefficiencies in the sector. Also note that this price approaches the marginal product of banking services as θ goes to zero, i.e., as the financial services sector is liberalized.

Given the two options, public and private, to generate income, each agent solves:

$$Y = \max\{\varphi\bar{y}, \pi\}$$

Agents will be found in both the public and the private sectors if $\varphi\bar{y} = \pi(p;\theta)$. Otherwise, all agents will be in the sector that offers a higher return. The equality condition above holds for a unique price p given θ and can be written as:

$$\bar{p} = s^{a-1} - c(\theta) - \frac{\varphi\bar{y}}{s}\ . \qquad (2)$$

This price is lower for lower levels of banking services productivity since demand for services would suffer in that case. High inefficiency in the public sector would also reduce $\bar{p}$.

The domestic supply of banking services depends on how much of its own revenue the government decides to convert to banking services. This domestic supply is enhanced by foreign banks if the financial sector is liberalized. Specifically, the supply of banking services is given by:

$$S = \delta(1-\theta)F + B\,. \qquad (3)$$

Here, S is the total supply of banking services, B is the domestic supply created by the government, and F is contributed by foreign banks. The parameter δ summarizes the instability of the part of the financial sector that does not depend on government support. Alternatively, it could also be thought of as a parameter for the extent to which a global financial crisis impacts the ability of banks to provide services in the domestic market. Hence, δ can be the probability of not experiencing a global financial crisis, in which case

foreign banks provide *F* units of banking services while no banking services are generated from abroad if a financial crisis is realized. A low value of δ implies a severe contraction in banking services provision.

We can determine the equilibrium price of banking services by setting the supply in (3) equal to the demand for financial services in (1). Since (1) is the demand for financial services by a single agent, we multiply it by the number of agents in the banking sector to obtain market demand. The equilibrium price is then:

$$p^* = a\left[\frac{B+\delta(1-\theta)F}{N_z}\right]^{a-1} - c(\theta), \tag{4}$$

where N_z is the number of agents in the private sector. If $p^* > \bar{p}$, then $\varphi\bar{y} > \pi(p^*;\theta)$, and agents move into the public sector. This causes a contraction in the private sector and decreases N_z, reducing p^* as a result. The drop in p^* continues until $\varphi\bar{y} = \pi(p^*;\theta)$. A similar process occurs in the opposite direction for $p^* < \bar{p}$.

The economy is rich in a natural resource, such as oil, that is sold on global markets. These sales are the only source of government revenue. We assume relative inelasticity in global supply for the natural resource so that changes in its price and government revenue move in the same direction.[6] Government revenue is denoted by *R*, which the government than spends on supporting the public sector, creating banking services for the private sector, and its own utility-generating consumption. Banking services are created using a simple linear technology—a unit of banking services is created by each dollar the government decides to spend on it. All things equal, we would expect higher natural resource revenues to lead to more banking services being created by the government. The government's revenue constraint can then be written as:

$$G + (N - N_z)\bar{y} + B = R, \tag{5}$$

where *G* is government consumption and *N* is the size of the labor force. The government maximizes the sum of the returns to all agents and its own utility, G^α, $0 < \alpha < 1$:

$$\underset{\theta,\bar{y},B,G}{Max}\ N_z\pi(p;\theta) + (N - N_z)\varphi\bar{y} + G^\alpha \text{ subject to (5).}$$

The first order conditions establish that:

$$G = \left[\frac{1}{\alpha}\frac{\varphi N}{(N - N_z)}\right]^{\frac{1}{\alpha-1}}, \tag{6}$$

[6] Van Robays (2012) demonstrates that both oil supply and demand are likely to be more inelastic in times of high macroeconomic uncertainty.

which suggests that increasing government consumption reduces the relative size of the private sector. This reduction is less significant if public-sector inefficiencies are substantial, i.e., φ is low. For a given level of government consumption, we would expect to see a larger public sector in countries with lower levels of inefficiency or corruption in that sector.

Revenue that the government does not consume itself is spent on creating banking services and supporting the public sector. The optimal division of funds between banking and the public sector requires that the marginal returns of the last dollar spent in each sector be equal. Therefore,

$$\left((1-a)as\right)^{1/(a-2)}\left(B+\delta(1-\theta)F\right)=\frac{N}{(N-N_z)^{2-a}}. \qquad (7)$$

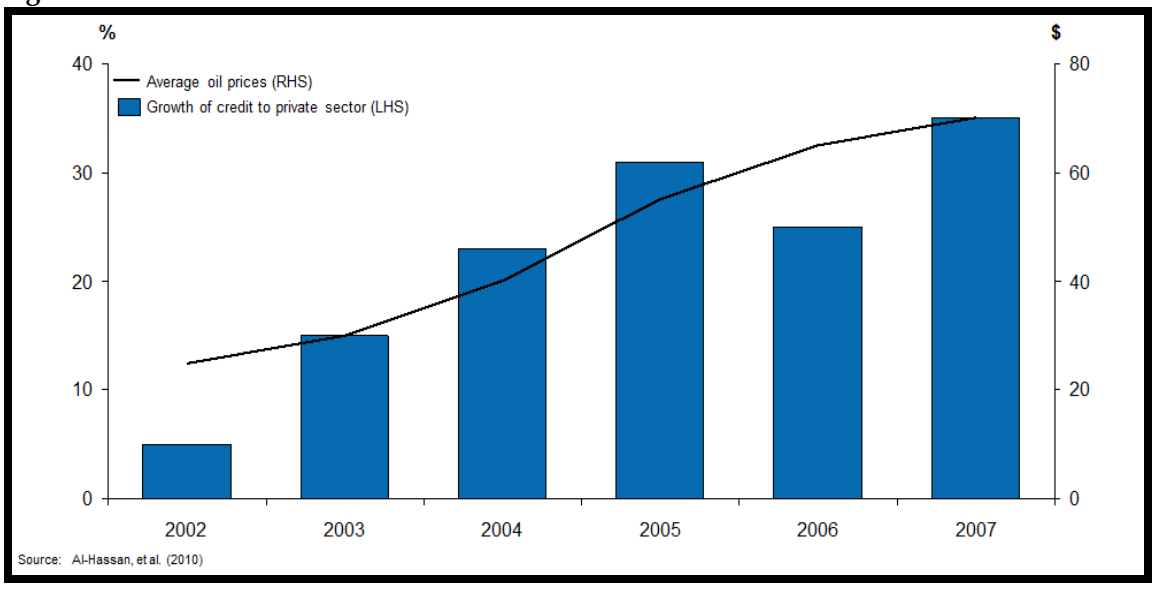
Condition (7) confirms the intuition that the relative size of the private sector shrinks when:

a) the financial sector is more unstable (or the impact of a crisis on the ability of banks to provide services is high, or the probability of a financial crisis is high[7]),
b) the government reduces its contribution to creating banking services,
c) the government increases financial sector protection.

IV. Discussion and Results

The implications of the model can be compared to relevant GCC data. Figure 3 below supports our assumption that the supply of financial services is likely to be higher when oil prices trend up[8].

Figure 3: Oil Prices and Private Sector Credit Growth in the GCC



[7] This is a forward-looking interpretation of the model.
[8] Note that the decline of credit growth in 2006 depicted in Figure 3 is a direct result of the stock market plunge across GCC countries.

One of the implications of our model is that higher banking services provision by the government is associated with a smaller public sector. The information contained in Tables 4 and 5 provide support for this prediction. For example, Table 4 shows only 3.7 percent of the banks in Qatar are foreign. The corresponding number for Saudi Arabia is 13 percent. This is opposed to figures of 37.8 percent in Bahrain. Table 5 reports the proportion of public sector employment in total employment in these countries and shows that public employment is higher in Qatar and Saudi Arabia and significantly lower in Bahrain. Public employment in Kuwait, where no banks had foreign ownership, is also nearly as high as it is in Qatar. Our model suggests the same link. Table 5 also displays the Heritage Foundation index on the lack of corruption.

Table 4: Ownership Structure of the Domestic Banking System in Percent of Total Assets (2007)

	Public				Private Domestic	Private Foreign		
	Total	Government	Quasi government 2/	Domestic Royal Family	Total	Total	GCC	Non-GCC
Bahrain	20.4	9.0	11.4	...	41.8	37.8	34.7	3.1
Kuwait	13.0	12.0	1.0	...	87.0	...	...	...
Oman	30.0	10.0	19.0	1.0	40.0	30.0	14.0	16.0
Qatar	20.7	20.4	0.3	...	75.6	3.7	3.7	0.0
Saudi Arabia	35.0	18.0	17.0	...	52.0	13.0	...	13.0
U.A.E.	52.3	41.5	0.5	10.3	47.6	0.2	0.2	...

Source: Al-Hassan, et al (2010)

Lower corruption levels (a higher index) appear to be roughly associated with higher levels of public sector employment. The model argues that a more efficient government sector ensures a greater portion of each dollar the government directs toward public-sector employees reaches the employees' pockets and is therefore more effective at raising welfare. A government concerned about welfare in the public sector would be expected to support a larger sector. A notable exception to the trend apparent in Table 5 is Qatar, which has the highest level of public sector employment despite also being on top in terms of the freedom from corruption[9].

[9] Though evidence is ambiguous, this may be a result of having small populations which are likely to be associated with lower corruption levels especially given a significant and educated expatriate labor force in the government sector.

Table 5: Corruption and Public Employment

	Freedom from Corruption	Public Employment (% of Total)
Bahrain	57	29
Kuwait	48	86
Qatar	60	88
Saudi Arabia	33	72

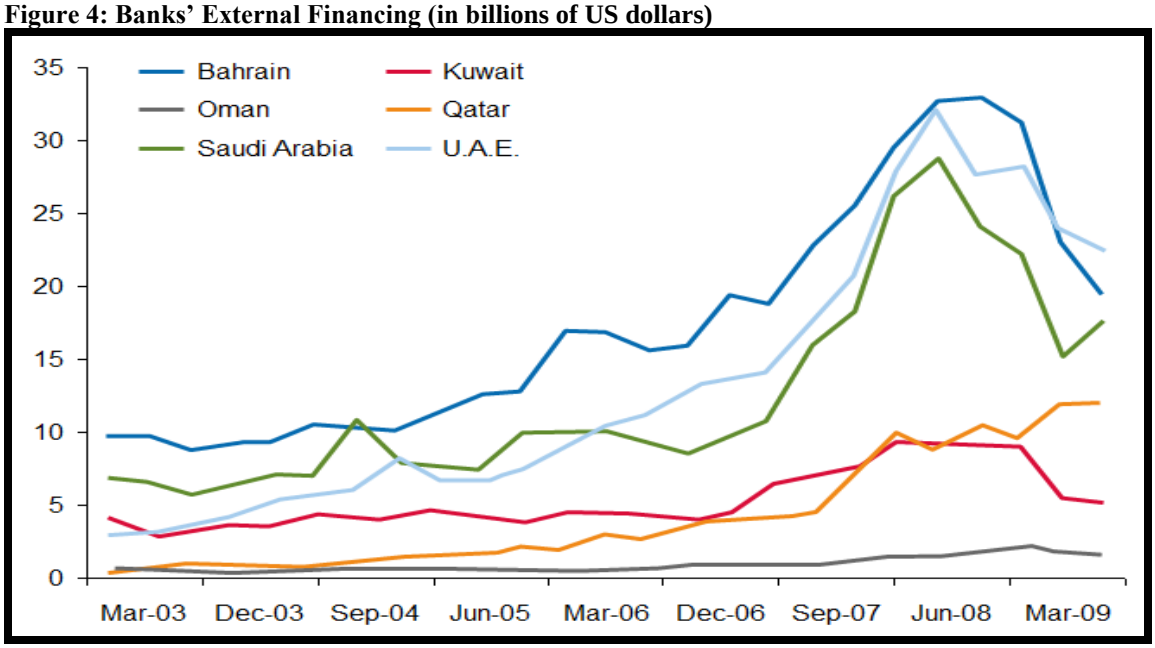
Source: Heritage Corruption Index and government data, 2008.

Our model points toward a positive relationship between financial sector stability and the size of the private sector. This is equivalent to claiming a negative relationship between financial stability and the size of the public sector. Financial stability can be thought of to have two components—external and internal.

The level of external financing is an attractive candidate to proxy for the external level of financial sector vulnerability—high levels of external financing could be taken as an indication of market perception of financial stability. Figure 4 graphs the change in external financing in the six member countries of the GCC. External financing increased rapidly from 2003 to 2009, reaching $103 billion in 2008, but then collapsing with the advent of the global financial crisis. Based on this measure, the financial sector in Bahrain appears most stable while Oman is at the bottom of the list. Our model predicts the highest relative private sector employment in Bahrain and the data lends to support to that conclusion. Although we could not compare model predictions to the case of Oman due to a lack of data, we can evaluate them for Kuwait and Qatar. The levels of external financing in these two countries are only higher than Oman's. The levels of public employment in Kuwait and Qatar, on the other hand, put these countries at the top of the table, confirming the implication of our model that higher levels of public employment are likely to be observed in countries with less sound financial sectors. Saudi Arabia, with a substantial level of issuances also has one of the bigger public sectors in the GCC and does not conform to our model. Qatar is the only country for which data on the relative size of the public sector was available beyond 2008. In 2009, 87 percent of all workers in Qatar belonged to the public sector. Although this is a very small drop from its 2008 level, the trend does follow the prediction of our model since, unlike other GCC countries, Qatar also experienced continued growth in external financing even after its collapse in other countries and regions.

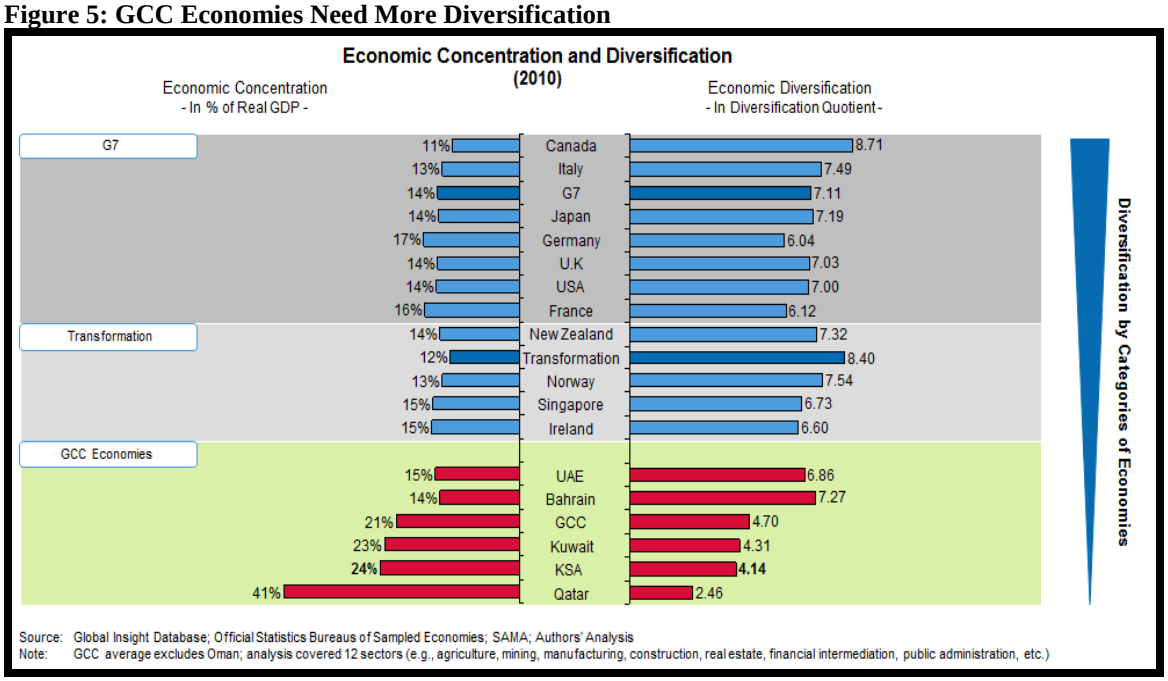
It is interesting to note that Qatar, Saudi Arabia, and Kuwait exhibit the least diversification among the GCC. This could be an indication of a complementary factor promoting a larger private-sector role in countries with a higher diversification ranking (Figure 5). The lack of diversification could be overwhelming the vote of confidence in Saudi banks implied by the high level of external financing in making Saudi Arabia, the largest economy in the GCC, buck the trend suggested by our model.

Figure 4: Banks' External Financing (in billions of US dollars)



Source: Al-Hassan, et al. (2010)

Figure 5: GCC Economies Need More Diversification



A robust financial sector is essential for a diversified economy capable of exporting goods and services other than natural resources (Kletzer and Bardhan, 1987; Beck, 2002). Diversification needs to be supported by a banking sector not dependent on government support since various projections for the oil price suggest that the GCC is likely to lose crucial fiscal space in the coming years. For example, oil prices are expected to dip below $100 by 2015. According to the World Economic Outlook, with current levels of

government spending, GCC fiscal surpluses are projected to turn into fiscal deficits by 2017.

Internal stability of the financial sector is manifested in banking data such as capital-asset ratios, the proportion of non-performing loans, and profitability. Based on these criteria, GCC banks seem to support the notion that the financial sector is quite stable with impressive rates of capitalization and profitability (Table 6). However, given the active role that GCC governments play in supporting the banking sector—not surprisingly, solid bank performance has dovetailed high oil prices—these numbers do not necessarily indicate the sector's maturity. Although variation across countries in these numbers is limited, countries whose construction and real estate sectors were hit particularly hard by the financial crisis, have slightly more distressing levels (for example, on provisions to NPLs). Even though concerns have been raised in the past about the readiness for liberalization of the financial sector (for example, Wahba and Mohieldin, 1998), Table 6 suggests that the time to expand the level of openness may have arrived.

At first glance, Figure 6 does not imply a concrete relationship between financial sector liberalization and the size of the public sector. However, if we disregard the set of observations on the extreme right—these are the points depicting Qatar[10]—the remaining points, namely Bahrain, Kuwait, and Saudi Arabia, indicate a roughly negative relationship between public employment and openness. This is in line with the prediction of our model that financial sector openness is likely to increase private sector employment by increasing the supply of financial services. The figure shows public sector employment levels for 2006 and 2008. Note that public sector employment is at least slightly higher in 2006 than in 2008 for all pairs of data. The drop in public sector employment is a further affirmation of our model since the continued growth in private sector credit until 2008 is in line with the expansion of the private sector.

Table 6: GCC Financial Soundness Indicators

	2003	2004	2005	2006	2007	2008	2009
Capital Adequacy Ratio							
Bahrain	23.8	25.7	26.9	22.0	21.0	18.1	...
Kuwait	18.4	17.3	21.3	21.8	18.5	16.0	...
Oman	17.6	17.6	18.5	17.2	15.8	14.7	15.5
Qatar	25.3	24.9	24.8	13.5	12.2	15.1	15.7
Saudi Arabia	19.4	17.8	17.8	21.9	20.6	16.0	...
United Arab Emirates	18.9	16.9	17.4	16.6	14.0	13.3	18.6
Capital to Assets							
Bahrain	...	...	...	...	...	...	...
Kuwait	10.7	12.1	12.7	11.7	12.0	11.6	...
Oman	12.6	12.9	13.7	13.2	14.1	15.5	...
Saudi Arabia	8.8	8.0	8.8	9.3	9.9	10	...
United Arab Emirates	11.4	11.1	11.4	11.1	9.4	10.6	...
Return on Equity							
NPLs to Total Loans							
Bahrain	10.3	7.6	5.8	4.8	2.3	2.3	...
Kuwait	6.1	5.3	5.0	3.9	3.2	3.1	...
Oman	12.8	11.0	7.0	4.9	3.2	2.1	2.8
Qatar	8.1	6.3	4.3	2.2	1.5	1.2	2.0
Saudi Arabia	5.4	2.8	1.9	2.0	2.1	1.4	...
United Arab Emirates	14.3	12.5	8.3	6.3	2.9	4.0	4.6

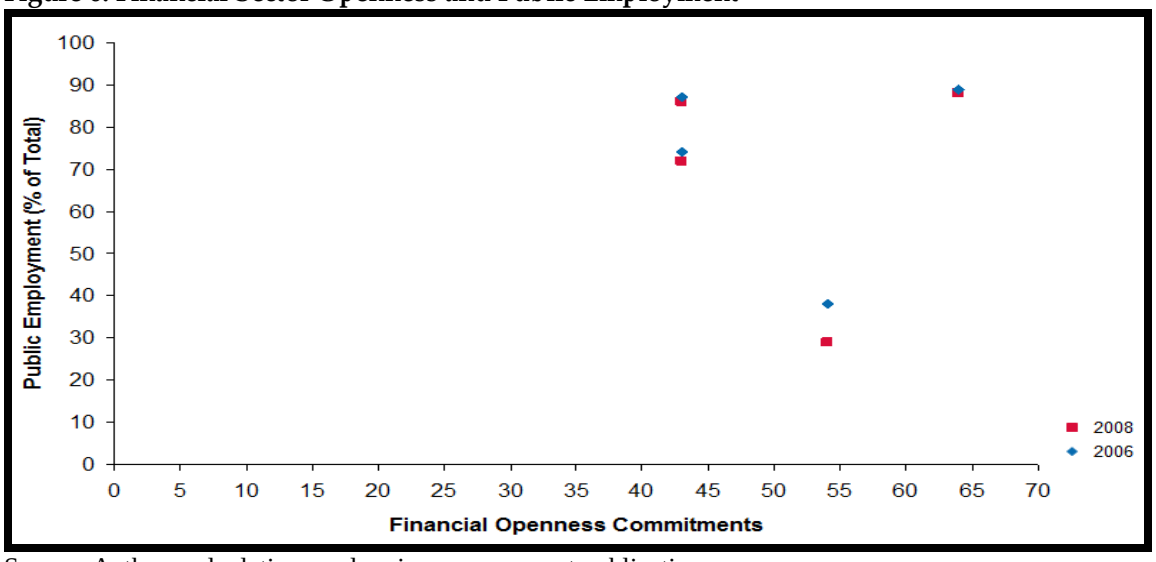
[10] The significantly high level of public sector employment in Qatar is driven in large part by the presence of an unusually high number of foreign workers in the public sector, and this could be the reason for Qatar being an outlier in Figure 6.

Table 6: GCC Financial Soundness Indicators (continued)

	2003	2004	2005	2006	2007	2008	2009
Provisions to NPLs							
Bahrain	67.7	68.0	67.7	68.5	74.0	84.0	...
Kuwait	77.7	82.5	107.2	95.8	92.0	84.7	...
Oman	78.3	87.1	97.4	109.6	111.8	127.3	113.8
Qatar	85.4	87.6	84.3	94.0	90.7	83.2	...
Saudi Arabia	128.2	175.4	202.8	182.3	142.9	153.3	...
United Arab Emirates	88.5	94.6	95.7	98.2	100.0	103.0	79.0
ROA							
Bahrain	1.9	2.2	2.1	2.1	1.2	1.3	...
Kuwait	2.0	2.5	3.0	3.2	3.4	3.2	...
Oman	0.2	1.7	2.3	2.3	2.1	1.7	2.2
Qatar	2.5	2.8	4.3	3.7	3.6	2.9	2.6
Saudi Arabia	2.2	2.4	3.4	4.0	2.8	2.3	...
United Arab Emirates	2.3	2.1	2.7	2.3	2.0	2.3	1.5
ROE							
Bahrain	18.3	20.8	14.3	15.4	18.4	16.9	...
Kuwait	18.6	20.9	22.9	27.1	28.1	27.8	...
Oman	1.8	13.5	15.6	17.8	14.3	12.6	14.2
Qatar	20.8	20.8	28.5	27.2	30.4	21.5	20.7
Saudi Arabia	25.9	31.7	38.5	43.4	28.5	22.7	...
United Arab Emirates	16.4	18.6	22.5	18.0	22.0	21.1	12.1

Source: Al-Hassan, et al. (2010)

Figure 6: Financial Sector Openness and Public Employment



Source: Authors calculations and various government publications

V. Conclusion

Countries of the GCC have largely weathered the storm of the global financial crisis better than most other regions of the world. While exposure to global markets is not trivial, it remains relatively lower than in many developing countries. Historically high oil prices have helped put economic growth on a firmer footing, although growth has not necessarily been inclusive (Arezki and Nabli, 2012). This provides policymakers with an unparalleled opportunity to unequivocally put the GCC on the path to robust and viable growth characterized by diversified economies that are led by the private sector. Salehi-

Esfahani and Squire (2007) have pointed out that countries of the Middle East and North Africa have, in the past, been able to maintain trade openness during periods of high oil prices. For the private sector in these countries to continue to compete in a globalized economy, even when oil prices trend downward, the financial sector needs to play a leading role in promoting private-sector led growth and reducing over-dependence on the oil sector.

The GCC banking sector exhibits considerable government ownership and limited openness to foreign banking services. With government spending linked to rising oil prices, this structure has not affected the stability or profitability of the banking sector. Indeed, in the wake of the global financial crisis, the banking sectors in countries like Saudi Arabia, Qatar, and Kuwait managed to weather the world's financial storm. This, however, also points to the fact that such countries exhibit less private sector activities than generally perceived or indicated by the data. In fact private sector activities in several sectors such as construction, which depend on banking services for funding, are a direct result of government spending. In terms of profitability measures, therefore, this means a high degree of stability for countries where governments play a larger role in the economy. Despite this, however, the GCC countries—with varying degrees—remain the least diversified among high income economies reflecting the lack of opportunities of the private sector to grow and expand its economic base.

Our model shows that as government consumption increases the relative size of the private sector declines. This is also aided by increases in public corruption or less efficient government operations. An important policy implication for the GCC, therefore, is enhanced governance of public institutions and introduction of higher level of competition in banking services in order to increase private sector activities and promote a more diversified economy. These steps are essential to reduce vulnerabilities and ensure long term growth.

Our model also demonstrates the link between financial sector openness, the sector's subsidization, and government support of public sector employment. Future research could explore the role of political economy considerations in determining the level of GATS commitments in the financial sector, the extent of public sector jobs subsidization, the share of the non-tradable sector in national income, and the existence, or lack thereof, of entrepreneurial activity in the economy. This approach is likely to uncover deeper connections between these variables by focusing on the unique structural characteristics of the GCC economies. Another important avenue to explore is dynamic effects in an economy characterized by our model. A dynamic approach is likely to shed light on the longer term impact on policy of oil price volatility, likelihood of global crises, and possible compromises in WTO negotiations.

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