

Neighboring Investments

Gulf oil producers are investing petrodollars in other Middle East countries—a trend that should continue even as oil prices fall



Mahmoud Mohieldin

Oil storage tankers at a refinery in Egypt.

THESE has been extensive coverage of the impact of expensive oil on inflation and growth in both developed countries and energy-scarce nations. But the largely beneficial impact of petrodollar surpluses on Arab economies has been a neglected topic. Although oil prices have come down dramatically since their peaks in the middle of 2008, the surpluses oil-producing countries have available for investment are still considerable.

As a result, the flow of petrodollars has not only improved the economic prospects of the six oil-producing countries in the Persian Gulf, but, because many of those petrodollars are being invested in the region, it has also improved the outlook for neighboring Arab nations. The accumulation of financial wealth and the search for higher yields have led the Gulf Cooperation Council (GCC) investors to diversify their investment strategy, geographically and across asset classes.

The GCC states have become more strategic about investing their wealth, generated from the increase in oil revenues. The six oil producers that comprise the GCC—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates—have learned from the bad experiences of the boom-bust cycles of the 1970s and 1980s. Moreover, the investment restrictions that the United States began to impose after the attacks of September 2001 have encouraged GCC states to diversify the investment of their surpluses regionally. Instead of investing revenues in U.S. treasury bills or depositing earnings in Eurodollar accounts at multinational banks, the oil producers are now using their oil to accumulate foreign exchange reserves, to reduce public debt, and to build up sovereign wealth funds (SWFs) and a variety of state-controlled but sophisticated investment institutions.

Neighbors feel the impact

Despite the recent price declines, GCC oil revenues are expected to exceed \$600 billion in 2008 and remain sizable in 2009. There are three major channels through which such revenues could affect both the Gulf states and neighboring countries.

- **Trade in goods.** This remains a relatively unimportant area. Trade among Arab countries grew to 11.2 percent of their total trade in fiscal year 2006–07, but at that level does not play a major role in cross-country benefits. During the 2006–07 period in Egypt, for example, Arab trade accounted for only 9.6 percent of Egypt's total trade.

- **Trade in services.** This produces a much greater regional revenue flow—through both remittances and tourism. Egyptians working abroad—including those in GCC countries—have significantly increased their remittances, contributing positively to the balance of payments position and to the welfare of the household sector in Egypt. According to the Central Bank of Egypt, remittances from Egyptian workers in GCC countries rose 160 percent between 2003–04 and 2006–07, from \$1.21 billion to \$3.13 billion. Their share of total remittances from Egyptians abroad rose from 40 percent to 50 percent during that time frame. Tourism has increased almost threefold since 2002, reaching \$10.8 billion in 2007. About 20 percent of the tourists are Arabs. The Egyptian Ministry of Economic Development estimates that each tourist dollar spent ultimately generates \$4 or \$5 in income, which suggests a strong impact on incomes and the standards of living of workers in the tourism sector and sectors linked to it.

- **Investment.** Some of the GCC capital that had been invested in the United States and Europe has been redirected to Arab countries, making it the most effective channel between the GCC and neighboring countries. Countries such

as Egypt, Jordan, and Morocco have benefited, becoming attractive investment destinations for GCC states (Institute of International Finance, 2008). Large current account surpluses, along with investments by corporations and wealthy individuals, have allowed a significant portion of GCC investments to take place through SWFs (see table). Gulf-based SWFs have shown an interesting appetite for hybrid financial instruments, in addition to their traditional use of reserve surpluses to make longer-term private equity investments.

Foreign direct investment (FDI) is the avenue of choice for most of the funds GCC states invest in their neighbors—much of it linked to privatizations, large infrastructure projects, and new equity investments. The share of GCC funds in total FDI in Egypt—the largest recipient of FDI from GCC states—increased from only 4.56 percent in 2005 to 25.2 percent in 2007.

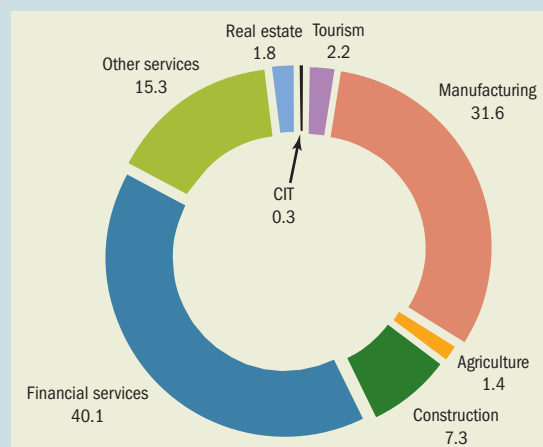
But it is not just the increase in volume of FDI that was notable during this period. The pattern of Gulf investments and their diversification in the neighboring economies changed as well (see chart). In the 1970s and 1980s, Gulf investments were more concentrated in real estate development and activities associated with the hydrocarbon sector. Higher oil revenues allowed GCC governments to diversify their economies away from hydrocarbons and adopt more ambitious investment behavior, which included spending generously on domestic infrastructure as well as buying stakes in companies in developed and emerging markets. Even with the diversification moves, however, hydrocarbon industries still represent more than 80 percent of total government revenues, and the share of hydrocarbons in the GDP of GCC countries has actually risen—from 36 percent in 2002 to about 50 percent in 2007. Currently, through partnerships with companies based in industrial countries and their accumulated cooperative experience in GCC countries, Gulf investments in Egypt have expanded beyond their traditional areas to include manufacturing, organic farming, communication and information technology, financial services, and logistics.

In addition to FDI, some neighbors have benefited from foreign portfolio investment in companies listed on stock exchanges. Foreign investors account for about one-third of

Expanding horizons

Gulf countries have expanded their Egyptian investments beyond real estate and hydrocarbons to include financial services, communications and information technology (CIT), and services.

(non-oil sector foreign direct investment in Egypt, 2007–08, percent of total)



Source: Balance of Payments Statistics, the Central Bank of Egypt Quarterly Reports (FY 2007–08).

market capitalization in Egypt and Morocco, and close to half of the Amman, Jordan, stock exchange. Of those foreign holdings, Arab investors are estimated to account for one-half of those in Egypt and three-fourths in Jordan.

The region is vulnerable to fluctuations in energy prices, which is magnified when regional geopolitical risks are considered. Moreover, inflation and associated currency appreciation are adding to the challenges facing the GCC economies. However, oil price scenarios do suggest that the Gulf countries' wealth will grow significantly in the coming 10 years. Even in a scenario in which oil is at \$50 a barrel, a price that seems lower than is likely over the longer run, the GCC countries would accumulate approximately \$5 trillion by 2020, which is equivalent to 2.5 times their earnings over the past 15 years (McKinsey & Co., 2008). Such wealth, carefully managed, will enable the GCC countries to continue the implementation of their development strategies and benefit their neighbors. ■

Mahmoud Mohieldin is the Minister of Investment of the Arab Republic of Egypt.

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- International Group of Sovereign Wealth Funds, 2008, "Sovereign Wealth Funds Generally Accepted Principles and Practices" Santiago Principles Report, p. 2.
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Major investors

Sovereign wealth funds (SWFs) maintained by Gulf Cooperation Council states account for more than 40 percent of the assets of all such funds.

Country	Fund	Assets (billion dollars)	Inception	Rank
United Arab Emirates (UAE)	Abu Dhabi Investment Authority	875	1976	1
Saudi Arabia	SAMA Foreign Holdings	365.2	1990	3
Kuwait	Kuwait Investment Authority	264.4	1953	6
Qatar	Qatar Investment Authority	60	2003	12
UAE - Abu Dhabi	Mubadala Development Company	10	2002	29
Bahrain	Mumtalakat Holding Company	10	2006	30
Saudi Arabia	Public Investment Fund	5.3	2008	32
Oman	State General Reserve Fund	2.0	1980	39
UAE - Ras Al Khaimah	RAK Investment Authority	1.2	2005	40
Gulf Cooperation Council SWF assets		1,593.1		
Percentage of total global SWF assets				41.6

Source: Sovereign Wealth Fund Institute, August 2008.

Note: The United Arab Emirates, Kuwait, Qatar, and Bahrain are member countries in the International Working Group of Sovereign Wealth Funds; Saudi Arabia and Oman are permanent observers.