Towards Economic Growth and International Integration in the Middle East

Dr Nasser Saidi, Chief Economist, Dubai International Financial Centre, UAE

- The Middle East and North African (MENA) region is experiencing an economic renaissance with growth becoming asset-based and self-sustaining rather than oil-based. Meanwhile, the implementation of the Gulf Cooperation Council common market in January 2008 promises to be the kernel of deeper regional economic integration.
- To date, developments of payments and settlements infrastructures have fallen behind the development of the economy, representing a risk both in terms of systemic risk and limiting the scope for growth.
- The Dubai International Financial Centre (DIFC) is working proactively to support the required developments in the region via an initiative called RAPID (Real-time Automated Payments in DIFC).
- As a first stage, subject to relevant regulatory approvals, the plan is to launch an offshore euro and US dollar real-time gross settlement solution from the DIFC, which will be accessible in MENA region and beyond.

These are exciting times for the Middle East and North African (MENA) region, where the economic environment has strongly improved, setting the stage for sustainable growth. However, financial markets and payment systems have not evolved at the same pace, nor has there been sufficient investment to provide the necessary payment infrastructure to support economic growth and development. The lack of development of national financial markets and of payment systems threatens to act as a barrier to sustained growth. Policy reforms and investments are necessary to provide for the regional integration of financial markets and payment systems. As such, the Dubai International Financial Centre (DIFC) plans to develop transactions processing systems to support economic and financial integration and link the financial markets of the region. As a first stage, it is planned to launch an offshore euro and US dollar (USD) real-time gross settlement (RTGS) solution. This will be along the same lines as, and interoperable with, the Hong Kong multi-currency payments solution.

A MENA Economic Renaissance

MENA countries have achieved above-trend average growth in real gross domestic product (GDP) – 6.4% over 2004-07 compared with 3.7% growth in 1998-2002 – with greater integration, both financial and economic, with the global economy. For Gulf Cooperation Council (GCC) countries, average real GDP growth was 7.4% over 2003-07 against 2.5% in 1998-2002, with increased diversification of economic activity, while in nominal terms growth has averaged over 25% a year. As a result, per capita incomes have increased by 75% since 2001.

Importantly, MENA's growth resurgence has been investment-led with increased government spending on infrastructure accompanied by complementary private sector investment. Investment-driven growth is surging at even faster rates in the oil producers, leading to higher total and labour productivity growth and an increase in absorptive capacity. Infrastructure investments with an estimated value in excess of USD1.6tr are planned or under development in the GCC. In the next three years alone, expected infrastructure spending by the UAE,

Kuwait, Qatar and Bahrain alone amounts to an estimated USD150bn. Private investment, including foreign direct investment (FDI), was particularly strong in Qatar and the UAE, as well as in Saudi Arabia and Egypt.

According to the World Investment Report, in 2006 the GCC countries showed a growth rate of 85%, in terms of attracting foreign investment – the best result achieved by any regional group. The UAE alone accounted for more than 34% of total FDI to the Middle East. The rise in FDI in the GCC countries is a reflection of the region's growing openness and international integration, and more importantly, the region's potential to achieve even higher growth rates in the future.

The private sector is now leading and driving regional economic integration in many areas in trade, services, tourism and foreign direct investment, with regional companies, such as DP, EMAAR, Etisalat, Orascom and MTC, rapidly becoming multinationals. This can be reinforced with government financing of infrastructure through the capital markets and securitisation, which can lead to broader private-sector participation in providing public utilities services and facilitate privatisation.

The MENA region as a whole continues to generate high savings, which are reflected in large external surpluses. MENA countries' current account surplus was almost 20% in 2006. The cumulative current account surplus for the GCC countries over the period 2003-08 is expected to be some USD900bn.

Economic expansion and abundant liquidity have fuelled strong growth of the credit, property and equity markets. GCC stock markets have outperformed emerging and developed markets. Indeed, stock markets grew more rapidly than the economies: market capitalisation jumped from an average of some 65% of GDP in the GCC countries to about 95% of GDP between 2002 and 2007. All of this is a reflection of gradual reform in the financial sector and the robust economic growth in the region reflected in initial public offering activity.

Capital flows and accommodating monetary policies have also resulted in broad money growth rates in excess of 20% a year during 2004-06 and continuing into 2007, by contrast to average growth rates of 14% for the period of 1998-2003. The ratio of domestic credit to GDP is rising and expected to cross 60% by 2008. Importantly, the share of domestic credit to the private sector is growing, a positive indicator of future growth.

However, of late, inflation has become a real concern for the GCC countries with inflationary expectations now building into the wage formation process and asset prices. While the easing of infrastructure bottlenecks, including in the property sector, would help to reduce these pressures, it may not be soon that housing supply starts to outpace demand growth driven by changing demographics and low, even negative, real interest rates. While the increase in non-traded goods and services such as housing have contributed to the headline inflation rate, the depreciation of the USD during 2005-07, to which the GCC currencies are pegged, has also led to imported inflation.

From a broader macroeconomic perspective, pegging to the USD has also meant adopting US monetary policy, which is geared to engineering a soft landing of the US economy and mitigating the risk of a major financial crisis resulting from the housing and the mortgage markets. For the GCC, the macroeconomic policy issues are the opposite of those facing US policy-makers: GCC countries need to use monetary and fiscal policy tools to restrain aggregate demand growth and reduce inflationary pressures. Greater independence of monetary policy will require greater exchange rate flexibility, which in turn can be gained through adoption of a currency basket, helping to stabilise the real exchange rate and protect competitiveness. In the medium term, more important will be a change in the policy stance through adoption of an inflation targeting framework. In turn, this will require building the money and debt markets to enable the conduct of monetary policy operations and exchange market intervention.

The Power of Regional Economic Integration

The rapid growth of the equity markets and emergence of regional financial centres and specialised exchanges throughout the region underscores the need to build a robust and secure, world-class payment infrastructure to ensure the future growth and stability of financial systems around the region. Sound and

efficient payment systems will result in a reduction of systemic and settlement risks and enhancement of financial stability.

In particular, the need for the development of a sound and efficient integrated payment and securities settlement system (SSS) for the GCC is an essential building block of its financial markets and should be an integral component of the move towards a common market and currency. An integrated SSS system compliant with international standards will also promote deeper integration of the region with other economic blocs and financial markets of Europe, the US and Asia.

In most MENA countries, SSS and funds transfer (payment) systems are not adequately integrated, both internally and internationally, increasing systemic risk and potential disruption to the payments and settlements systems and the economy as a whole. The global trend for payment systems is to integrate and consolidate payment processes across borders, such as the case in the European Union (EU), which is moving to link SSS and payments systems in the trans-European platforms TARGET2 and TARGET2 Securities (T2S), facilitating the development of cross-border trading, capital markets activities and settlements, thus contributing to economic and financial expansion.

Given the structural similarities and inter-linkages existing between the GCC and, increasingly, the MENA region countries, the need for such an integrated payment system becomes apparent, especially in light of the declared policy of GCC monetary union by 2010 and the implementation of a common market in January 2008. The move of the GCC towards monetary union and increased economic and financial integration will have a major impact on the development of the payment infrastructure and financial markets of the region over the next decade. The objective should be the development of a TARGET-like system for the GCC. This is especially critical as part of the development of financial markets across the region and the longer-term global positioning of the region. A GCC TARGET can provide the opportunity for cooperation and interlinking between GCC countries, followed by the wider community of Arab countries.

The strategic objective should be for the GCC common currency to emerge as a global currency, alongside the USD, euro, pound sterling, yen and the emerging Chinese yuan. A robust GCC common currency can become the currency anchor for the economies of Central Asia and MENA. By 2025, given structural transformation and growth trends, we forecast that the GCC bloc can become the fifth or sixth largest economic bloc in the global economy, with an even larger share of global assets. With international integration the GCC, with its accumulated international reserves and rapidly growing financial wealth, must develop a multi-currency payment and securities settlement system, with secure, sound and efficient infrastructure that can handle large-value, high-volume and cross-border transactions.

To achieve payments integration, regional countries need to invest in and modernise their national payment systems in compliance with international standards. Economies of scale and network economies are a strong argument in favour of a cooperative approach to developing an efficient and shared payments infrastructure among GCC and other Arab countries, drawing upon the best available practices and technologies from advanced payment and banking systems, and aiming to achieve an agreed balance between unique country requirements versus regional objectives.

Large-Value Systems: Building Tomorrow's Financial Markets Today

Securities settlement systems, with their close links with payment systems, are an integral part of the settlement infrastructure of an economy. Together they have become "systemically important payments systems" for the MENA countries, particularly as a result of the growth of the stock markets. The aggregate volume of the shares traded rose from 7.9 billion in the year 2000 to 100.69 billion traded by 2006, while market capitalisation is about USD1.1tr.

Despite the development of the securities markets, there has also been little investment to date in the payment infrastructure for large-value, high-volume payment systems and networks – only a few countries have invested in the backbone of modern payment systems, RTGS systems with robust legal and regulatory underpinnings as required by the Bank of International Settlements' Core Principles for Systemically

Important Payment Systems (CPSIPS). With a few exceptions (mainly Saudi Arabia), most markets in the region have some way to go in terms of implementing secure electronic payment and security settlement systems that can handle large-value, high-volume transactions.

Payment systems in commercial bank money (rather than central bank money) are still prevalent across the MENA region. Payment system rules, standards and business practices have yet to be harmonised in the MENA countries, resulting in a fragmentation of regulation, and market practices and systems. Hence, payment and settlement transactions costs are higher in and between the MENA countries than in developed regions. High clearing and settlement costs and non-harmonisation of payment rules and standards are acting as a barrier to the development of financial markets, and impeding cross-border clearing and settlement operations.

The MENA countries have to modernise and remedy the absence of clearing and settlement legal and regulatory frameworks to provide for oversight powers of clearance and settlement systems by the central banks. This should result in legal and technical finality and certainty for payments, in compliance with CPSIPS. In particular, there needs to be work to ensure the legal underpinnings are in place to assure legal finality of payments in the event of the insolvency of parties involved in the payment systems, if international best practice is to be complied with.

The rapid growth of the equity markets and the emergence of regional financial centres and specialised exchanges throughout the MENA region underscore the need to build a robust and secure, world-class payment infrastructure to ensure the future growth and stability of financial systems around the region.

Role of the Dubai International Financial Centre

The strategy of the Dubai International Financial Centre (DIFC) includes investing in and becoming the hub of a regional financial market. It aims to link and integrate existing fragmented financial markets into a single electronic market, with a common trading platform, harmonised listing rules and regulations, and a central securities depository.

DIFC's strategy is to enable and promote the economic and financial growth of countries across the region by providing dynamic, efficient and sound financial markets, building on its existing SSS platform, the Dubai International Financial Exchange (DIFX), laws and regulations (including being the only jurisdiction in the region with a data protection law), and providing payments infrastructures accessible by the whole region. The aim is to facilitate the centralisation, investment, management and control of the region's rapidly growing financial wealth, now exceeding USD2.1tr within the region. The strategic objective is also to ensure the security and safety of the region's assets.

Consequently, DIFC is cooperating with international, national and regional stakeholders and regulatory authorities to develop a regional payment system that will service not only DIFC's financial community but will also create a successful financial infrastructure for the future benefit of the GCC and the wider region.

As the first stage in this initiative – referred to as RAPID (Real-time Automated Payments In DIFC) – it is planned to launch an "offshore" euro and USD RTGS system. The solution is modelled on, and plans to be interoperable with, the offshore solution in Hong Kong. RAPID will be open to eligible direct and indirect participants from throughout the region and internationally, creating an important payment facility between New York, London, Frankfurt, and Hong Kong and Tokyo.

RAPID will use SWIFT as the communication network and will be supported by a legal and regulatory infrastructure compliant with CPSIPS. Following regulatory approvals, the system is planned to be launched in 2008 with the euro and USD RTGS system. Thereafter, the development will include:

- Delivery-versus-payment (DVP) services to facilitate debt sales and repurchase activities within the region.
- Payment-versus-payment (PVP) services to facilitate foreign exchange settlements without temporal risk.
- Other automated interfaces for initiatives within the region where it is useful to have confirmed real-

time finality achieved within the GCC time zone. The operating hours will aim to benefit from Dubai's positioning and its eight-hour time zone spanning Asia and the EU.

1. The views expressed are those of the author and do not necessarily represent those of the DIFC Authority or DIFC Authority policy.