

# Gulf Cooperation Council



## How Developed and Inclusive are Financial Systems in the GCC?

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I N T E R N A T I O N A L M O N E T A R Y F U N D

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## EXECUTIVE SUMMARY<sup>1</sup>

**Financial systems in the GCC have developed significantly over the last couple of decades, but there appears to be further room for progress.** The development of bank and equity markets has been supported by a combination of buoyant economic activity, a booming Islamic finance sector, and financial sector reforms. As a result, financial systems have deepened and, overall, the level of financial development compares well with emerging markets. However, it still lags advanced economies and, other than for Saudi Arabia, appears to be lower than would be expected given economic fundamentals, such as income levels.

**Financial development in the GCC has relied to a large extent on banks, while debt markets and nonbank financial institutions are less developed and access to equity markets is narrow.** The non-bank financial institutions—pension funds, asset management and finance companies, and insurance—remain small. Domestic debt markets are underdeveloped. While equity markets appear to be well developed by market size, they are dominated by a few large (and often public-sector) companies.

**GCC countries have made progress on financial inclusion, but gaps remain in some important areas.** Access to finance for SMEs, women, and youth, in particular, appears relatively low. This may partly reflect social norms, low levels of participation of women in the labor market and private sector activity, and the high level of youth unemployment.

**Further financial development and inclusion is likely to be associated with stronger economic growth in the GCC countries.** While there is uncertainty surrounding the empirical estimates in the paper, further progress with financial development and/or inclusion is likely to go hand-in-hand with stronger growth. The growth benefits, however, are likely to vary across countries depending on the current level of financial development and inclusion.

**To realize these growth benefits, reforms to strengthen access to finance for SMEs, women, and youth are needed.** Addressing institutional weaknesses and promoting financial sector competition would help boost access to finance for SMEs. Reforms to enhance financial literacy and improve SME governance structures and insolvency frameworks are critical. Other reforms encouraging female and youth employment and the use of emerging technologies in finance also appear promising.

**Additional reforms to foster financial development should focus on developing debt markets and making stock markets more accessible to a larger pool of companies and investors.** To grow domestic debt markets, the authorities should develop a government yield curve, seek to increase market liquidity through secondary market trading, and ensure requirements for private issuance are not onerous. Stock market reforms should focus on enhancing corporate governance and investor protection, removing restrictions on foreign ownership, and encouraging financial market competition. The latter would also help the development of non-bank financial institutions.

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## A. Introduction

**1. Financial development and inclusion are crucial to achieving robust and inclusive growth.** Financial development—which involves improving the financial sector’s key functions of pooling savings, allocating them to productive use, promoting greater sharing of information, and diversifying risks—can help countries grow faster over the long-term (Levine, 2005 and Demirgüç-Kunt, Feyen, and Levine, 2008 and 2012). Improving financial inclusion—the degree to which access and use of the financial sector is disseminated throughout the population—can also have a positive impact on growth (Sahay and others, 2016, 2005, Demirgüç-Kunt and Levine, 2009, and Dabla-Norris and Srivisal, 2013).

**2. GCC countries have made considerable progress developing their financial systems.** Buoyant economic activity, fueled by large hydrocarbon proceeds and abundant liquidity, and booming Islamic finance spurred credit growth and helped strengthen banks’ financial positions over the last two decades. A wave of reforms to modernize financial stability policy frameworks and financial safety nets together with improvements in banking supervision also helped improve banking sector resilience and the development of banks’ balance sheets. Financial market reforms have focused on strengthening stock market regulation and supervisory frameworks, enhancing corporate governance, and easing restrictions on foreign investment.

**3. An important question is whether reforms can help foster additional financial development and inclusion and promote higher, more diversified, and inclusive growth in the GCC.** The 2014 oil price decline has highlighted the importance of reforms to help switch the engine of growth from the public to the private sector, encourage investment away from capital-intensive extractive industries, and foster private sector hiring of nationals. Against this backdrop, financial sector reforms can play a critical role.

**4. This paper assesses the degree of financial development and inclusion in the GCC and identifies possible areas for further reforms.** Given the difficulty in measuring both financial development and inclusion, the paper uses several types of indicators. Indices have been developed that allow for comparisons across countries and time. However, given the potential drawbacks of broad indices, this approach is complemented with an analysis of other indicators, including surveys, to draw fuller overall picture. The rest of the paper is organized as follows. The next section reviews the structure and state of development and inclusion of GCC financial systems.<sup>2</sup> Section C uses benchmarking analysis to compare them to peers. Section D looks at potential growth gains for GCC countries from further financial development and inclusion. Section E discusses reforms to encourage access to finance for SMEs, youth, and women, and Section F, reforms to foster capital market development. Section G concludes.

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<sup>2</sup> The financial system refers to financial institutions and markets. Financial institutions comprise bank and non-bank financial institutions, while financial markets include the equity and debt/sukuk markets. Non-bank financial institutions comprise pension funds, funds management firms, investment companies, insurance companies, and mutual funds.

## B. Structure of the Financial System in the GCC

*GCC financial institutions have developed significantly over the past two decades, but have remained dominated by banks. While equity markets are fairly large, debt market development has remained limited.*

**5. GCC financial institutions are large and are dominated by banks.** With total assets at about \$2.9 trillion (around 196 percent of GDP), relative to GDP, they are somewhat bigger than the average in a group of large emerging market economies, although considerably smaller than financial institutions in the U.S. and Japan (Table 1; Figure 1; Annex I). While the share of non-bank financial institutions (NBFIs) in GCC financial institutions' assets is about 20 percent, broadly in line with the EMs average, it is much lower than in the U.S. and Japan.

**6. While relatively small, NBFIs experienced more rapid growth than the banking sector over the past decade.** The average growth for the GCC financial institutions was around 8.5 percent (y-on-y) during 2010–17 (for which data is generally available on both bank and non-bank financial institutions).<sup>3</sup> However, NBFIs growth averaged around 10.7 percent annually compared with around 7.8 percent for the banking system.

**Table 1. GCC Financial Institutions Assets versus Comparators, 2017**

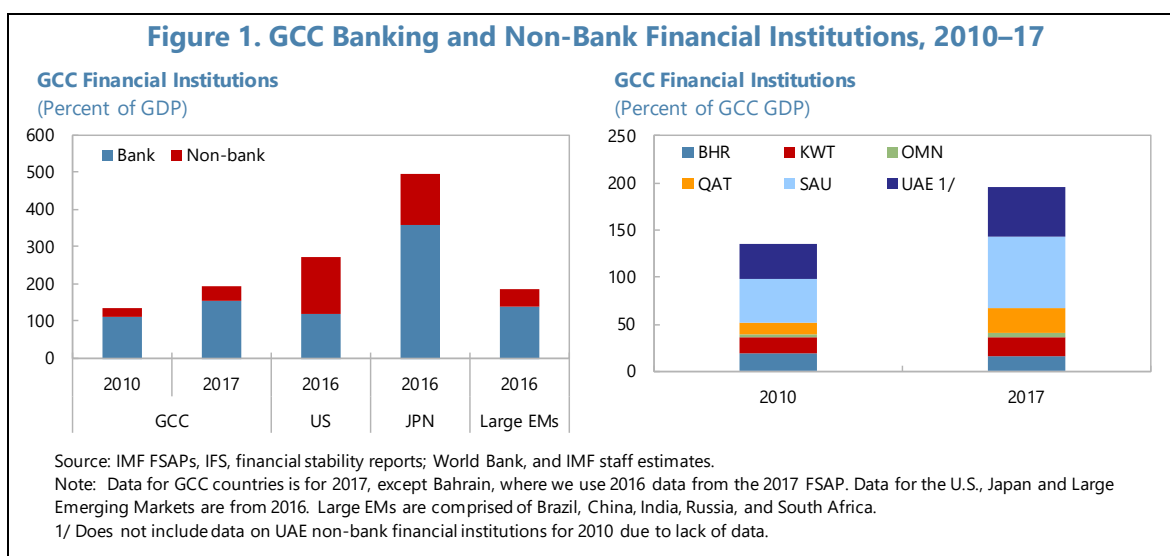
	GCC	USA	JPN	Large EMs 1/
		(\$US billions)		
Financial Institutions	2,855	50,886	24,391	38,687
Commercial Banks	2,282	22,106	17,694	32,138
Non-bank Financial Institutions	573	28,781	6,697	6,549
	(Percent of total financial institutions assets)			
Commercial Banks	80	43	73	83
Non-bank Financial Institutions	20	57	27	17
	(Percent of GDP)			
Financial Institutions	196	273	494	184
Commercial Banks	156	119	358	141
Non-bank Financial Institutions	39	155	135	44
Private Sector Credit	72	53	100	52

Sources: IMF FSAPs, IFS, financial stability reports, World Bank, and IMF staff estimates.

1/ Large Emerging Markets are comprised of Brazil, China, India, Russia, and South Africa. Percent of GDP figures are simple averages.

2/ Data for GCC countries is for 2017, except Bahrain, where we use 2016 data from the 2017 FSAP. Data for the U.S., Japan and Large Emerging Markets are from 2016.

<sup>3</sup> This average growth rate excludes UAE because of lack of data.



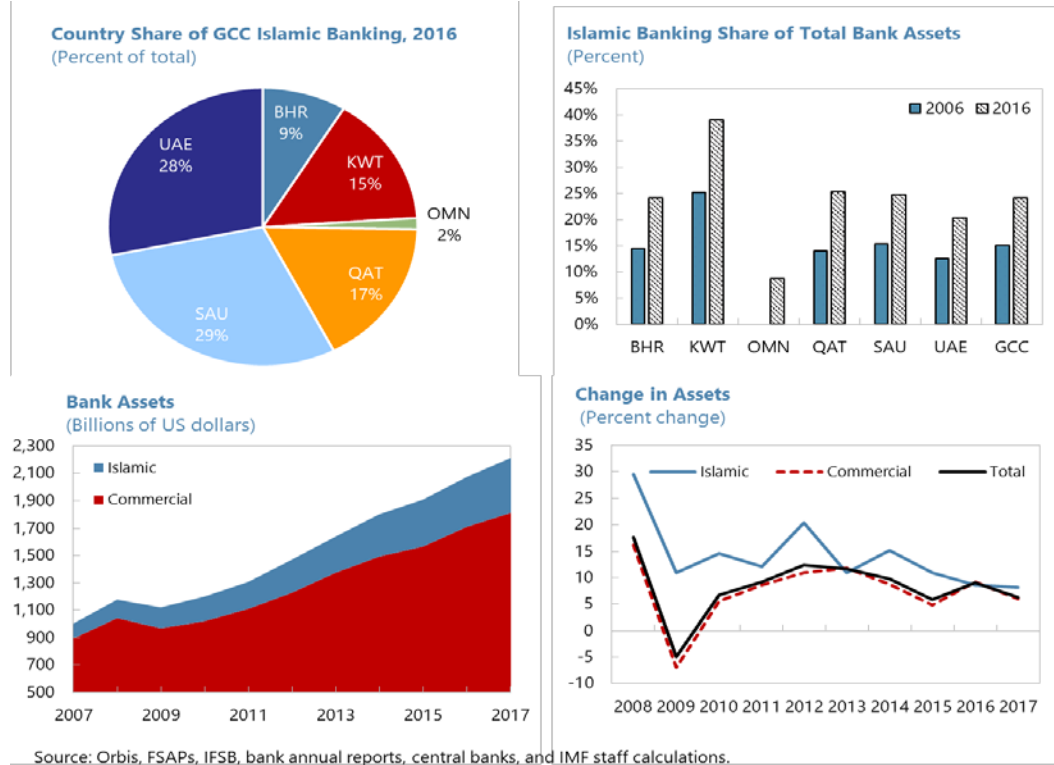
**7. GCC banking systems vary in size and depth.** They are generally well-capitalized, largely domestically owned, and with significant public and quasi-public ownership. UAE has the largest banking system in nominal terms (size) and Oman the smallest (Annex I, Table 1). However, Bahrain (the smallest economy in the region) ranks first in terms of banking system depth (with a ratio of banking system assets to non-oil GDP of 820 percent), and Saudi Arabia (by far the largest economy in the region) has the smallest ratio of banking system assets to non-oil GDP, at 131 percent. Bahrain is the only GCC country that has both wholesale and retail banking.

**8. Islamic banking has been an important driver of banking system growth over the last decade.** Greater availability of Islamic products and instruments in recent years has helped make banking services acceptable to investors and borrowers who were previously non-bankable for religious reasons. Total assets of Islamic banks in the GCC grew over the last decade at an average rate of around 11 percent (y-on-y) compared to about 6 percent (y-on-y) for conventional banks (Figure 2).

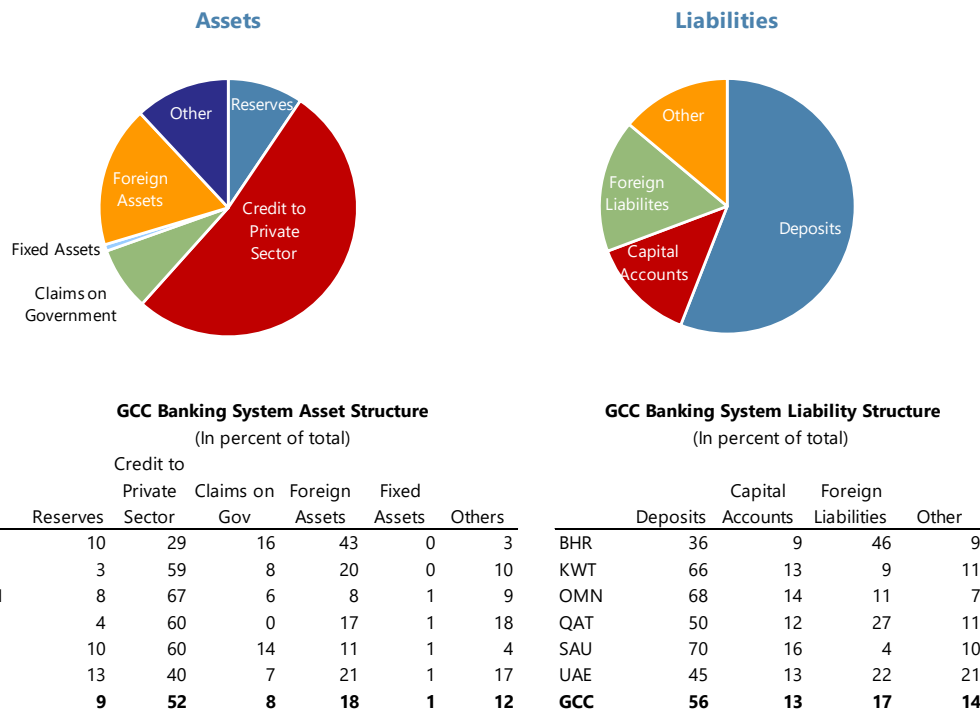
**9. Banks' business models across the region are geared toward financing large companies.**<sup>4</sup> Banks largely mobilize and recycle private sector savings to lend to large corporates. Bank claims on the (domestic) private sector represent (in four of the six-member countries) around 60–70 percent of total assets and primarily finance trade and services and real estate (Figure 3). On the liability side, deposits represent around 60 percent on average of total GCC banking system funding, although this varies widely across the region (Figure 3).

<sup>4</sup> The analysis excludes Bahrain's wholesale banks.

**Figure 2. Evolution of Islamic Banking in the GCC, 2006–17**



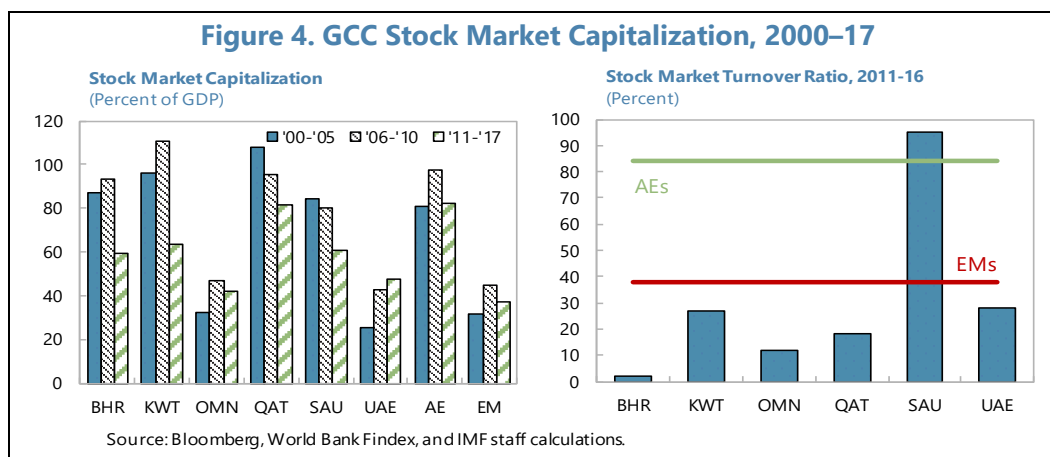
**Figure 3. GCC Banking System Assets and Liabilities, 2017**



Source: Consolidated banking surveys; and IMF staff calculations.

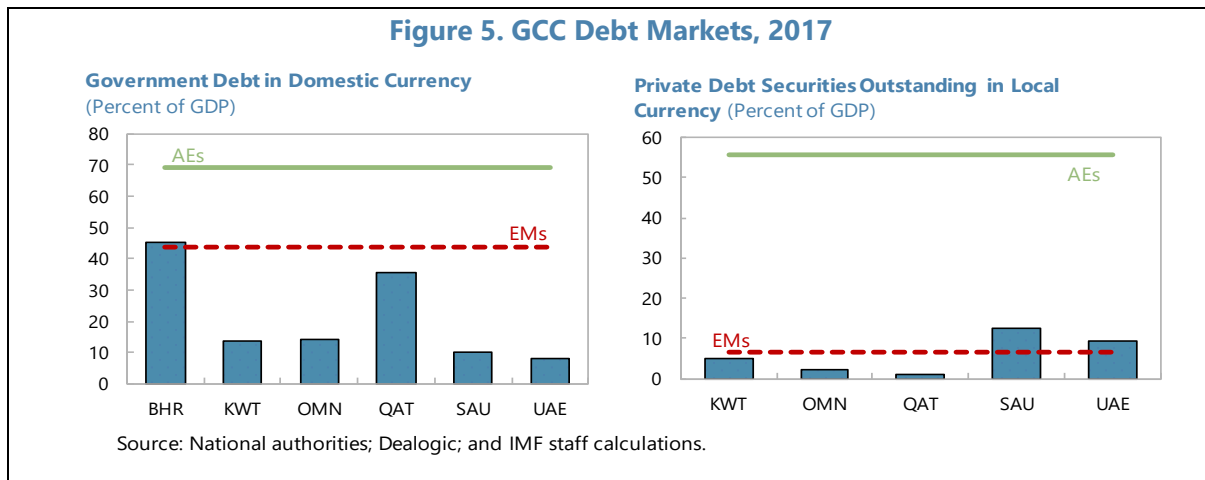
**10. NBFIs have remained relatively small in all countries except Saudi Arabia** (Annex I, Table 1). While a lack of comprehensive data impedes a full analysis, the NBFIs in Saudi Arabia, with assets amounting to around 97 percent of non-oil GDP, are the largest in the region. They comprise two large pension funds and four Specialized Credit Institutions (SCIs). Kuwait and Bahrain are the other two GCC countries having NBFIs with total assets of more than 30 percent of non-oil GDP. The NBFIs in Kuwait are dominated by investment companies while funds management firms dominate in Bahrain. However, NBFIs in both countries have shrunk in size since the 2008 financial crisis because of increasingly challenging market conditions and/or tightening of regulation. The insurance sector remains limited, while investment companies and mutual funds have larger activity mainly in Kuwait and Saudi Arabia (see section F for further details). NBFIs in the region do not include sizable SWFs with assets that are largely invested abroad.

**11. Stock markets in the GCC are relatively well developed.** However, market capitalization remains below pre-global financial crisis levels (Figure 4). At the GCC level, the Saudi stock market accounts for about 50 percent of total market capitalization and has the highest turnover ratio. At the country level Qatar and Kuwait have the largest stock market capitalization relative to GDP.



**12. Domestic debt markets are under-developed, mainly due to the extended absence of government debt issuance.** GCC governments have only recently started to issue new domestic debt to finance the fiscal deficits that have emerged since 2014 (Figure 5). The lack of government debt markets along with subdued activity in money markets have hindered the development of corporate domestic debt markets. Outstanding private sector domestic debt instruments stood at around 5 percent of GDP in 2017. Access to government bonds has been limited to banks, SOEs and pension funds, which has hampered the development of the investor base. In the absence of developed domestic corporate debt markets, a number of corporates have tapped external funding sources. In 2017, private sector total external debt securities ranged from 21 percent of GDP in Saudi Arabia to around 77 percent of GDP in UAE.





### C. How Developed and Inclusive are Financial Systems in the GCC?

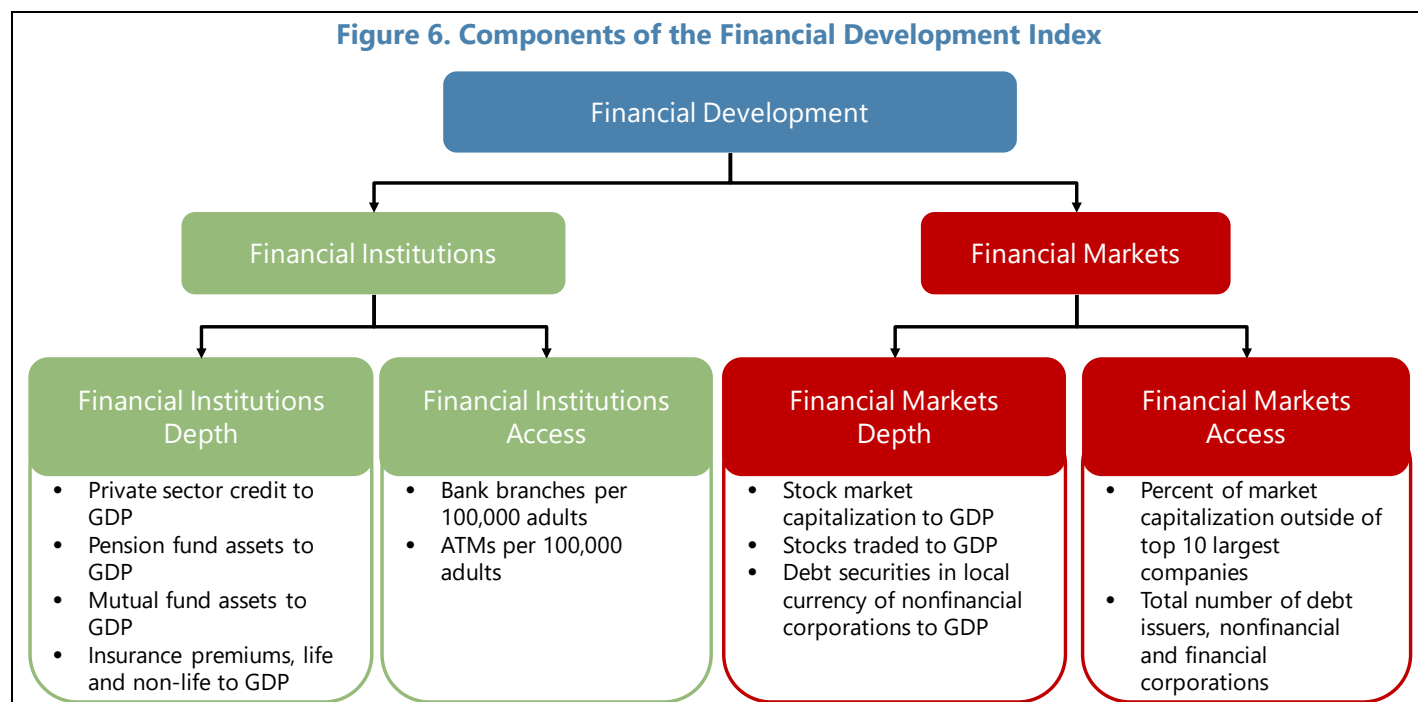
The level of financial development in the GCC compares well with emerging markets, although it lags advanced economies. Banking systems and equity markets are generally well-developed in terms of size, but NBFIs and debt markets less so. Equity markets are dominated by a few large (and often public-sector) companies. Progress has been made in increasing financial inclusion, but there are gaps in terms of access to finance for SMEs, women and youth.

#### 13. The level of financial development and inclusion in the GCC is assessed using a combination of broad indices that allow for cross-country and across time comparisons and other specific indicators.

- Financial development.** Typical proxies used to assess financial development, such as the ratio of total assets (or private credit) to GDP and, to a lesser extent, stock market capitalization, do not fully capture all facets of financial sector development. To better capture these, a comprehensive and broad-based financial development index for 129 countries covering 1980–2016 is used (Annex II). The index, which builds on Svirydzienka (2016), contains two major components: financial institutions and financial markets. Each of these is broken into two sub-components: access and depth.<sup>5</sup> The two sub-components are, in turn, constructed based on a number of underlying variables that track development in each area (Figure 6; Annex II). Data constraints across countries mean that some indicators cannot be included in the index. Therefore, the index is complemented with other relevant indicators of financial development, including the number of listed companies per 1,000,000 adults.
- Financial inclusion.** An index of household access to financial institutions based on time series data on the number of branches of commercial banks and ATMs per 100,000 adults is constructed as a proxy for financial access. Beck and others (2007) show that these aggregate measures link closely to detailed survey measures of the use of financial services. This index is

<sup>5</sup> Measures of efficiency in the original index include the net interest margin, non-interest income to total income, overhead costs to total assets as well as profitability measures, such as return on assets and on equity. However, the relationship between these variables and financial sector efficiency measures is not clear as, for example, high net interest margins and returns on assets and equity could be a sign of limited competition rather than efficiency.

supplemented by indicators of financial inclusion that capture access and usage for women, youth, and SMEs, which are not available on a time series basis for GCC countries.



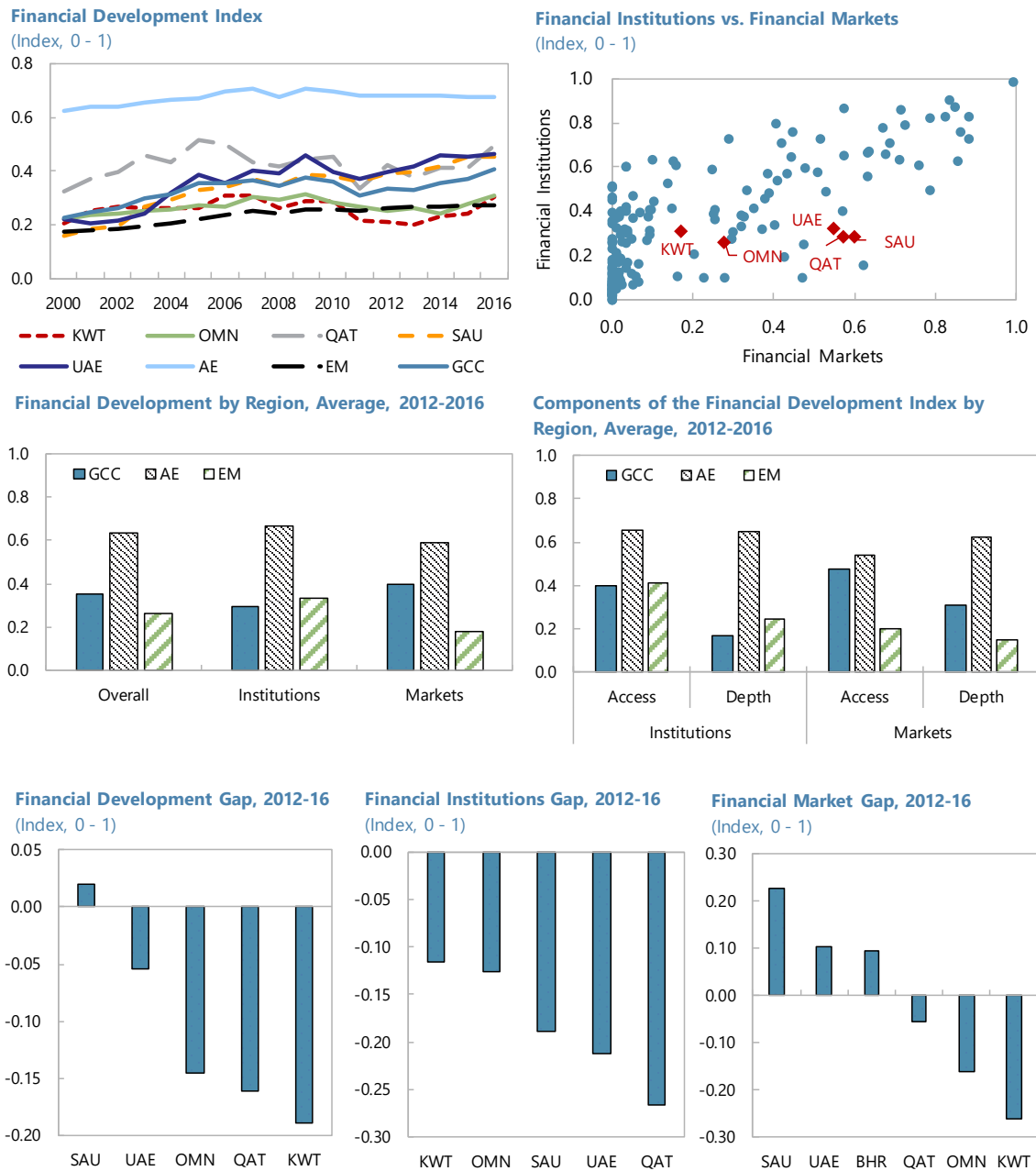
**14. The level of financial development and inclusion in GCC countries is assessed in relation to peer countries as well as economic fundamentals.** More specifically, the benchmarks chosen are: (i) EMs; (ii) AEs; and (iii) economic fundamentals. The latter are statistical benchmarks estimated by regressing the financial development index on a series of structural and economic characteristics, such as per capita income, rule of law, government size, and others (Annex II).

### **Financial development**

**15. GCC financial systems have developed substantially over the past two decades, albeit to varying degrees across countries** (Figure 7). Financial development in GCC countries generally compares well with EMs, although there appears to be further room for progress to catch up with AEs, as well as with the level of financial development expected given economic fundamentals. GCC countries score higher on the financial development index than EMs (Figure 7). This reflects a combination of greater financial market development and somewhat lower financial institutions development. Financial development in the GCC, however, appears to be lagging that of AEs. In addition, the analysis of financial development relative to economic fundamentals points to negative gaps for all countries except Saudi Arabia (Figure 7).<sup>6</sup>

<sup>6</sup> The financial development index is not constructed for Bahrain due to data constraints.

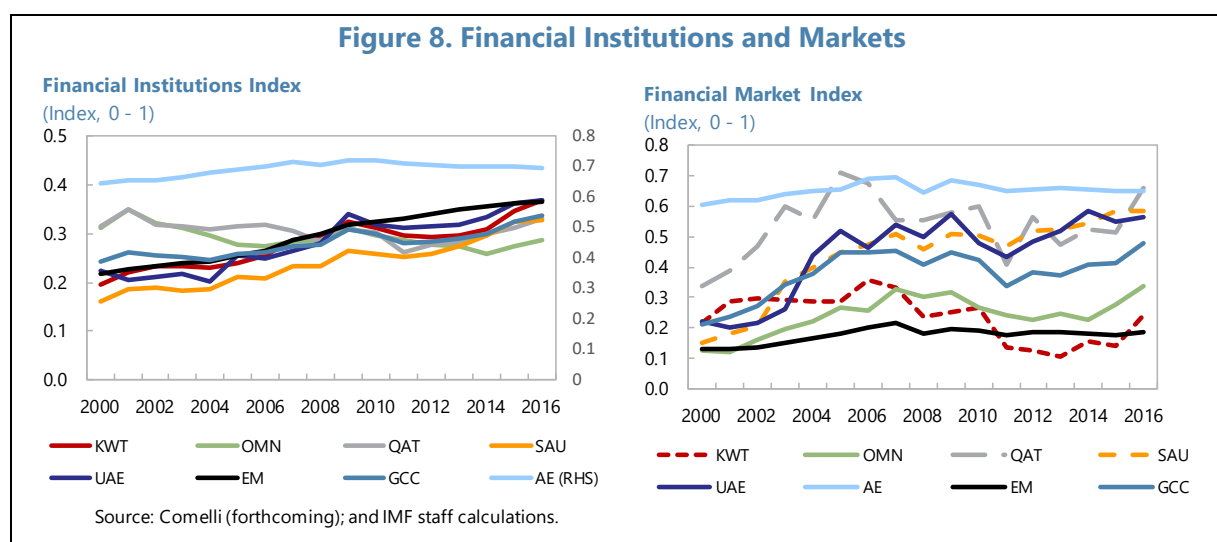
**Figure 7. Financial Development in the GCC**



Source: Comelli (2018); and IMF staff calculations.  
 Note: Bahrain is excluded as data is not available for one subcomponent, so it cannot be calculated for Institutions and Development.  
 Gaps do not change substantially if non-oil GDP per capita is used instead of GDP per capita in the fundamentals.

**16. Financial institutions development is broadly in line with EMs but lags AEs and fundamentals** (Figures 7 and 8). The depth of the banking system has increased, and gaps in the development of financial institutions relative to fundamentals can be largely attributed to the limited role of pension funds, the insurance market, and mutual funds (see section F).

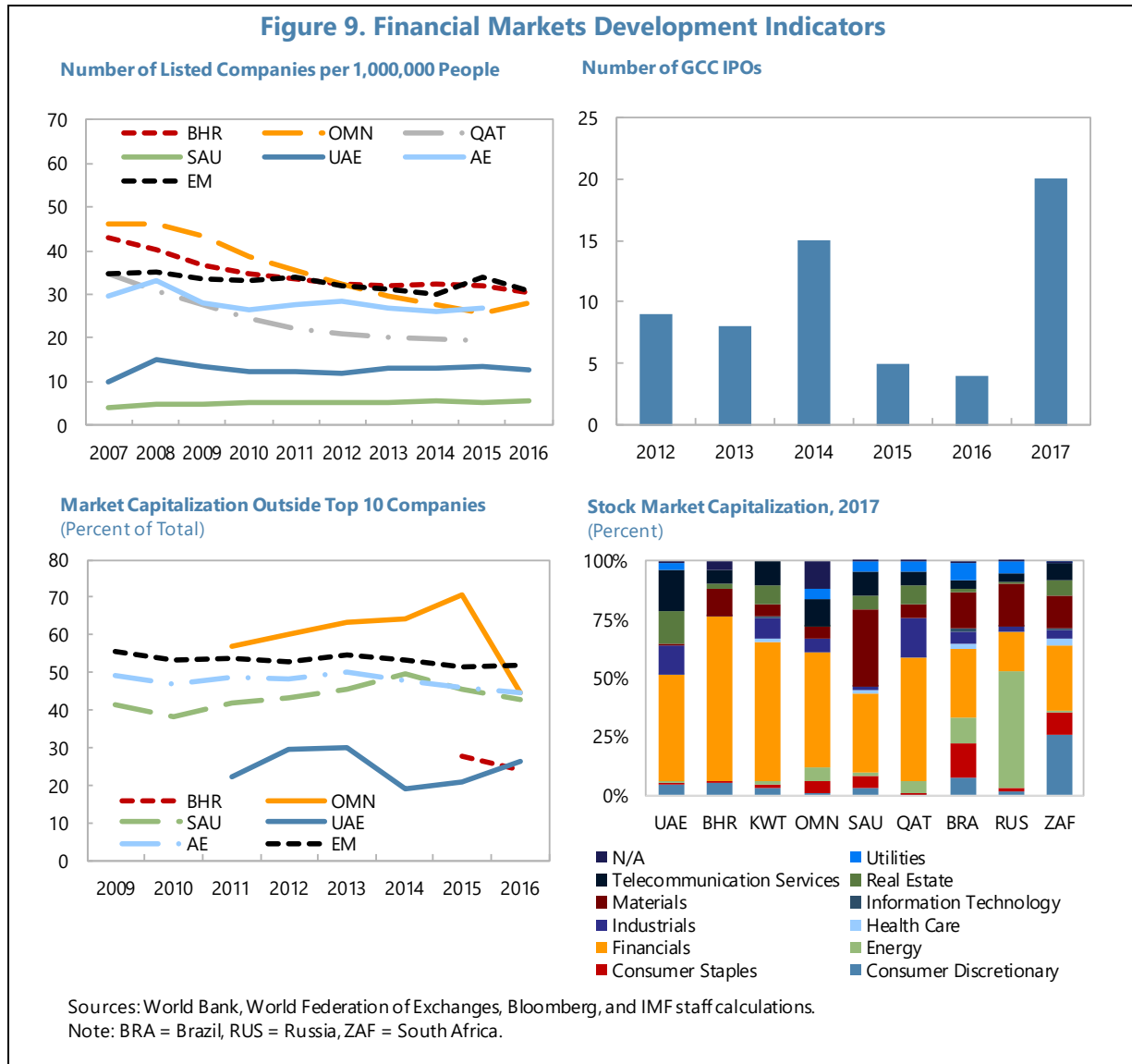
**17. Financial market development indices have improved for most GCC countries over the last two decades, although the domestic private bond market remains small** (Figures 7 and 8). Gaps in the development of financial markets relative to fundamentals are found only in three of the six-member countries. This reflects the impact of the upward trend of oil prices for much of this period—oil prices are highly correlated with the performance of GCC stock markets (Dutta and others, 2017)—and the implementation of a range of legal, regulatory, and supervisory reforms to strengthen stock market transparency. In addition, in the early 2000s, liquidity throughout the region rose substantially, reflecting GCC countries repatriating their investments from western markets to invest domestically. Further, the privatization of a number of state-run companies in some countries has boosted market capitalization. Domestic bond markets, however, remain very small. According to Dealogic data, in recent years, corporate bond issuance is less than 2 percent of GDP in most GCC countries, except Bahrain, due to extended absence of government debt issuance and underdeveloped corporate market (see Section B).



**18. Beyond market size, other indicators of the level of development of the equity market suggest a mixed picture:**

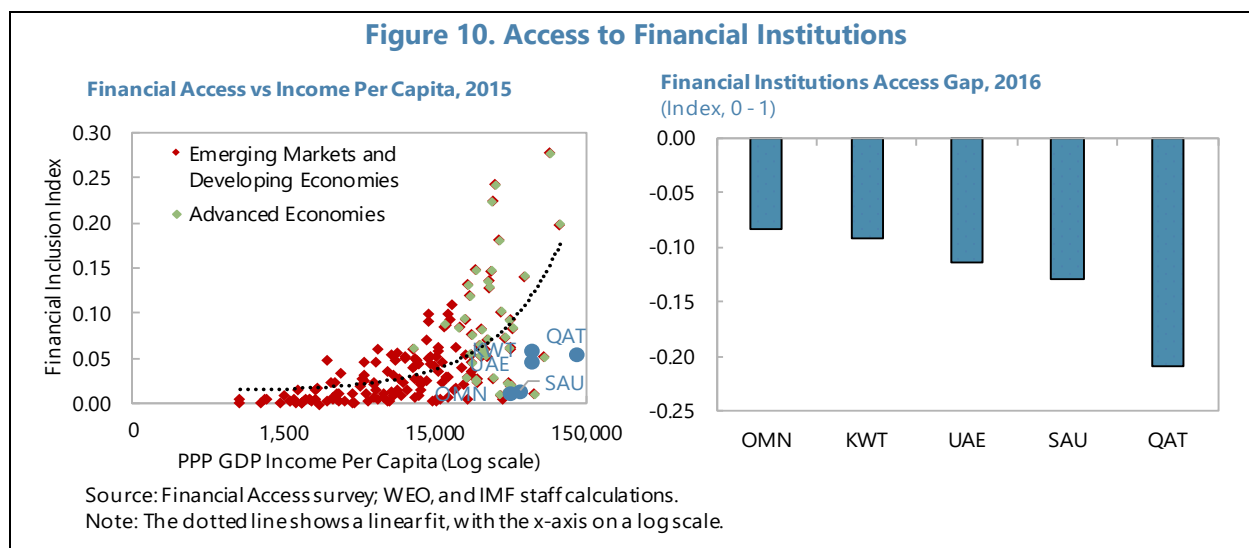
- **The number of listed companies is relatively low compared to peers.** Scaled by population, Saudi Arabia, the UAE, Qatar, and, to a lesser degree, Oman have fewer listed companies than both EMs and AEs (Figure 9). In addition, the number of IPOs remains small, peaking at only 20 IPOs, which raised less than \$1 billion, in 2017.
- **Listings are concentrated in a few large companies and a small number of sectors, and governments and SOEs hold a substantial share of stock markets assets.** In the GCC, the 10 largest listed companies account for more than 60 percent of the total market capitalization on average, above EM and AE averages (Figure 9). Financial service companies account for one-third of market capitalization in Saudi Arabia and more than two-thirds in Bahrain. A large share of the market is dominated by governments and SOEs (in Saudi Arabia, government entities hold about 40 percent of market capitalization) which limits the number of free floating shares.

- Foreign investment is limited in the GCC financial markets.** Foreign investors held between 2 and 8 percent of market capitalization in 2017 in GCC countries. Restrictions on foreign investor participation have been eased more recently, increasing foreign ownership limits to 49 percent in Oman and Saudi Arabia and up to 100 percent in other GCC countries. Low liquidity and high volatility together with a lack of hedging instruments may have discouraged foreign investors from engaging in the GCC stock market.



**Financial inclusion**

**19. Measures of access to financial institutions suggest that GCC countries lag their peers and what would be expected based on economic fundamentals.** According to the financial access index, GCC countries have less inclusive financial sector than countries with similar per capita income and relative to economic fundamentals (Figure 10). Further, while access measured by commercial branches per 100,000 adults is comparable to EMs, it is lower than the average for AEs (Figure 11).

**Figure 10. Access to Financial Institutions**

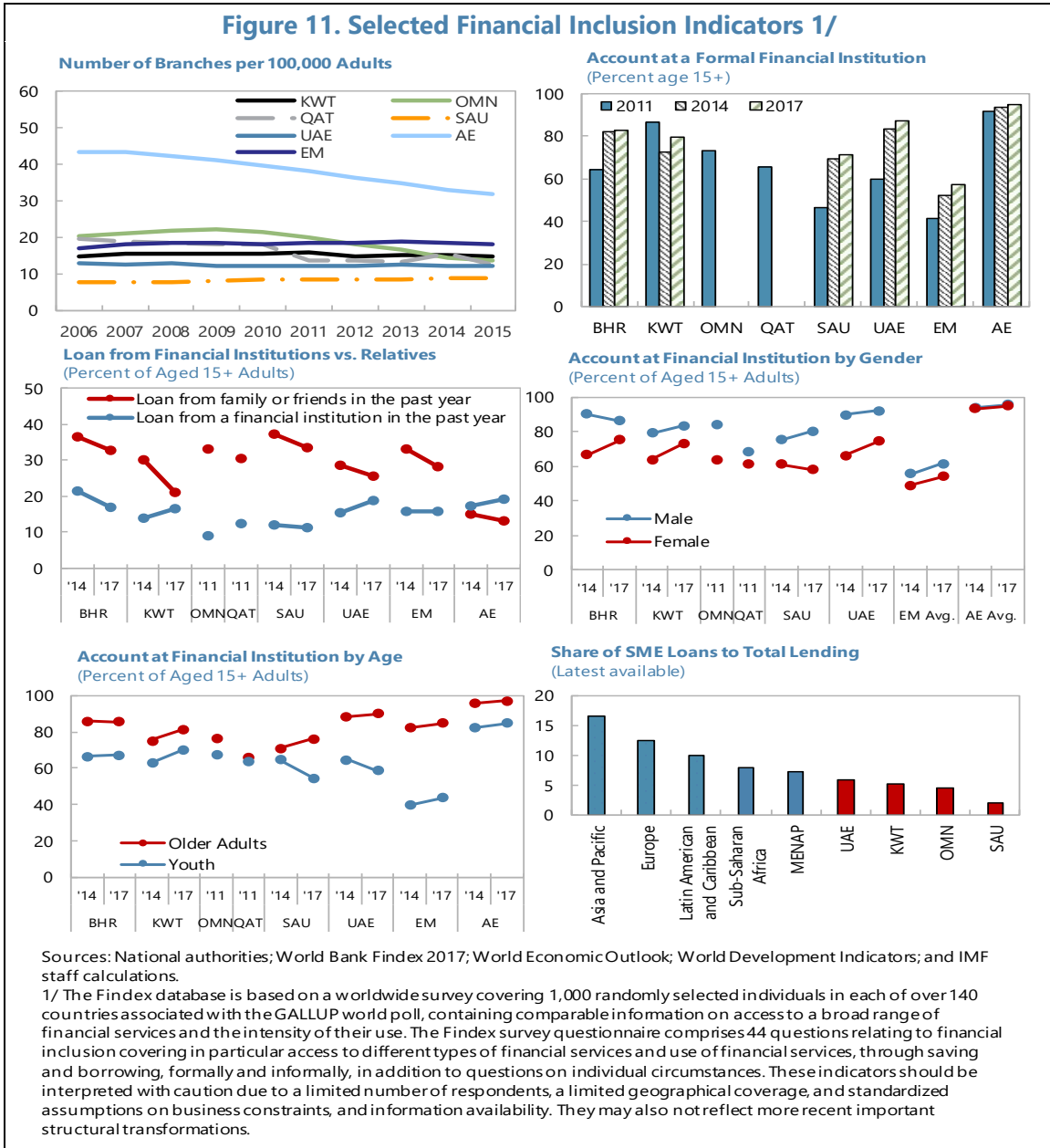
**20. Other financial inclusion indicators suggest gaps in access to finance, particularly for women, youth, and SMEs** (Figure 11). It should be recognized that it is not possible to determine whether these gaps are due to supply (institutions not wanting to service segments of the market) or demand (people do not want the financial service) factors. In particular:

- **The share of the population with access to financial institutions has increased but remains below the average for AEs.** The share of the population with accounts at formal financial institutions increased on average to 80 percent in 2017 from 64 percent in 2011. GCC countries have introduced reforms to promote financial access for the unbanked population (see section E for further details).<sup>7</sup> However, the share of population with access to the banking system has remained below the average for AEs.
- **Informal finance plays an important role in GCC.** The usage of financial services in the GCC is particularly low with the share of population that borrow from a financial institution at around 16 percent in 2017. In contrast, about 26 percent of adults in GCC reported having borrowed informally compared to 13 percent in advanced economies. GCC households rely on informal financing channels, where peer financing (whether inside the work place or within the family) remains the dominant source of financing, with bank loans being the residual.
- **There is also a gender and youth gap in access to finance.** About 86 percent of male adults had an account at a financial institution in 2017, compared to 70 percent of female adults, although gender gaps have decreased in Bahrain, Kuwait, and the United Arab Emirates. The percent of credit card holders among female adults is around one third of that among males. The usage of loans and mortgages by males is also significantly higher than by females. Similarly, only 63 percent of youth (15–24) had an account in 2017 versus 83 percent of adults.

<sup>7</sup> Averages include Bahrain, Kuwait, Saudi Arabia, and United Emirates, as Oman and Qatar do not have surveys for 2014 or 2017. These numbers are based on the Global Findex Survey, which includes GCC nationals, Arab expatriates, and non-Arabs who were able to participate in the survey in Arabic or English. There is no available information on financial access for GCC nationals only.

Low female and youth employment and the fact that many households use a single account could be among the explanatory factors (see Section E for more details).

- **Bank lending to SMEs is low.** It averages around 4.5 percent of total loans, lower than the average in the Middle East and North Africa (MENA) and other regions. Several institutional constraints may help explain low access to finance for SMEs (see section E for further details).



## D. Financial Development and Inclusion and the Impact on Growth

*Further financial development and inclusion would help generate stronger and more inclusive growth in the GCC, albeit to varying degrees across countries.*

**21. To what extent could GCC countries reap growth benefits from further financial development and inclusion?** GCC countries are all aiming to achieve higher, sustainable, and inclusive growth to accommodate their rapidly expanding labor forces. Financial systems play a fundamental macroeconomic role by pooling savings and channeling them to productive investments. Financial development and financial inclusion are key building blocks of broader strategies to achieve these growth and employment goals (Box 1).

**22. GCC countries would benefit from further financial development, but to varying degrees.** While it is difficult to definitively establish a causal link, regression analysis finds that financial development is associated with stronger growth up to a point, but beyond this point the effects on growth turn negative. There is, however, considerable uncertainty around where this estimated turning point lies, (Figure 12; Annex II; Sahay and others 2015a). In the case of the GCC, further developing financial systems to the estimated turning point in Oman and Kuwait could increase annual per capita growth by 0.4 and 0.7 percentage points, respectively. The growth benefits appear much smaller for Qatar, which is already close to the turning point. The United Arab Emirates, and Saudi Arabia are found to be slightly beyond the turning point, although they are well within the range of uncertainty in which it is not possible to say if further financial development would be positive or negative for growth.<sup>8</sup> It is also important to remember that the financial development index used in the estimation is only one way to capture the level of financial development—it does not capture all aspects of financial development and the omitted factors could be important for the development/growth nexus.

**23. Comprehensive financial development could yield larger growth benefits in all GCC countries than suggested by the analysis above.** The index of financial development shows that GCC countries have undergone substantial financial deepening in recent decades. However, well-developed financial systems do more than aggregate savings. The productive allocation of these savings, while crucial, is difficult to capture quantitatively and is not reflected in the index, which focuses on size. While GCC financial systems appear large—boosted by considerable savings generated by their hydrocarbon sectors—there still appears to be substantial room to further enhance competition and allocative efficiency. Stock markets are dominated by large state-owned companies, particularly in United Arab Emirates, Saudi Arabia, and Qatar (Figure 9). Debt markets and NBFIs are also underdeveloped, and the presence of foreign investors and SME finance are limited (Section B).

<sup>8</sup> Figure 12 uses the average level of financial development for GCC countries from 2012-2016. As noted in Section C, this index is not constructed for Bahrain due to data constraints.



### Box 1. Financial Development, Inclusion, and Growth: Literature Review

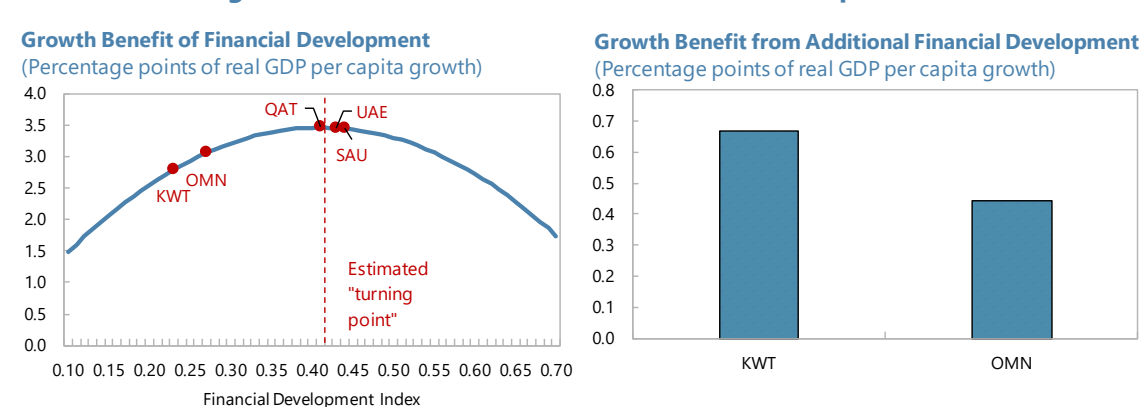
**An established literature associates financial development with economic growth.** Better functioning financial systems help accumulate capital and allocate it productively. Indeed, the literature shows that economies that start with more financial depth grow faster, accumulate capital faster, and crucially, become more productive (Goldsmith 1969, King and Levine 1993, Levine 2005). More productive allocation of capital is a key aspect of financial development: a large growth accounting literature finds that, without improved productivity, capital accumulation alone does not drive long-run economic growth (Jorgenson 2005). The literature also attempts to address concerns that more economic growth causes more financial development (reverse causality), or that both economic growth and financial development are driven by other omitted variables. One approach finds a similar impact of financial development on economic growth with instrumental variables and GMM estimators (Levine and others 2000, Beck and others 2000).<sup>1</sup> Another approach shows that sectors more dependent on external finance (requiring more leverage) grow faster than sectors less dependent on external finance (requiring less leverage) in countries with more financial depth (Rajan and Zingales, 1998).

**Important caveats remain regarding the persistence of the impact of financial development, and how financial development occurs.** Some argue that while financial development may support growth in the short and medium-term, its impact may not be permanent (Aghion and others 2005). Furthermore, how credit grows seems to matter. Credit may grow too fast (Loayza and Ranciere 2002) or too much (Reinhart and Rogoff 2009, Jorda and others 2011, Dell’Ariccia and others 2012, Sahay and others 2015a, Arcand and others 2015), and deteriorating credit quality may lead to vulnerabilities (IMF 2018, Kirti 2018). These caveats pertain more to size than other aspects of financial development. Sahay and others (2015a) find that improved efficiency continues to be beneficial at high levels of financial development.

**A more recent literature looks at the impact of more inclusive financial systems.** This work suggests that greater financial inclusion not only supports growth but can help reduce inequality and poverty, after controlling for financial development (Burgess and Pande 2005, IMF 2018b, Bruhn and Love 2014, Demirguk-Kunt and others 2017, Sahay and others 2015b).

1/ These authors use Arellano and Bond (1991)-style GMM estimators, along with instrumental variables including the effectiveness and origin of legal systems.

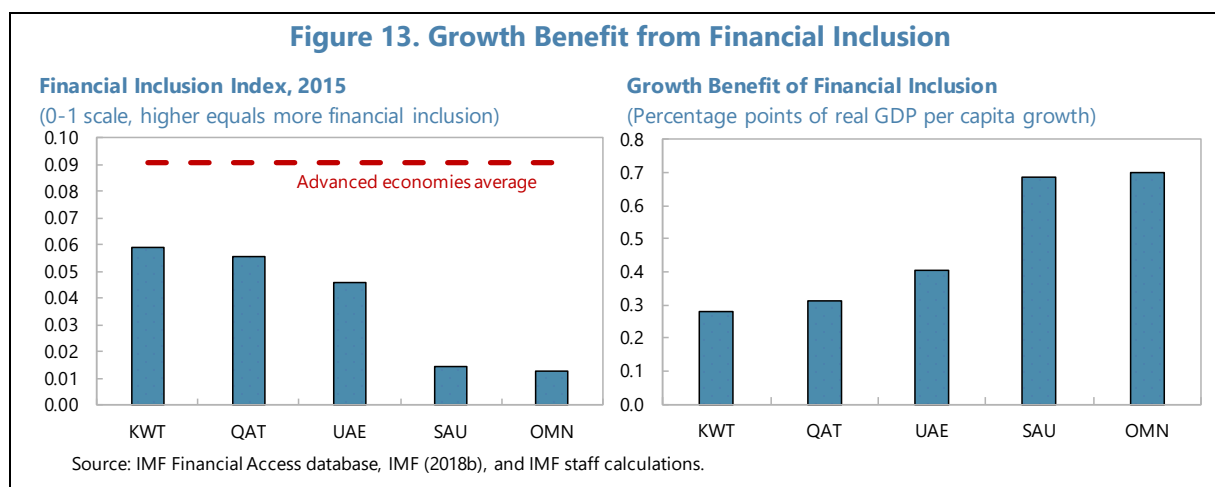
Figure 12. Growth Benefit from Financial Development 1/



Source: Comelli (forthcoming); and IMF staff calculations.

1/ The growth benefit of financial development (FD) in the left panel is constructed as a quadratic curve using the estimated coefficients for FD and FD<sup>2</sup> from the first specification in Table 1 (Annex II).

**24. Fostering greater financial inclusion would support growth and help reduce inequality in GCC countries.** Consistent with the analysis of financial inclusion and access in Section C, a composite index constructed following Mialou and others (2017) suggests that GCC countries are less financially inclusive than the average for AEs (Figure 13).<sup>9</sup> IMF (2018b) estimates that, in high AEs, each percentage point improvement in financial inclusion can increase growth by 0.09 percentage points (after controlling for financial development). Based on this estimate, Figure 13 shows that increasing financial inclusion to the average level observed in AEs could increase annual per capita growth by 0.3-0.7 percentage points. The above analysis focuses on the growth impact of improved financial access for households. IMF (forthcoming) finds that growth gains from closing the SME financial inclusion gap in the MENA region could be of comparable magnitude, although the lack of detailed data on the SME sector in GCC countries means more detailed estimates of the growth impact in the GCC cannot be provided. IMF (2018b) also finds greater financial inclusion is associated with less inequality as measured by the Gini coefficients and income gaps. This suggests that more inclusive financial sectors would support inclusive growth in GCC countries.



## E. Encouraging Access to Finance for SMEs, Youth and Women

*The preceding empirical analysis shows that GCC countries could enhance growth by further increasing financial inclusion. To do so, efforts to increase SME, women, and youth access to finance are needed. Key reforms to achieve this include strengthening regulatory frameworks and supporting institutional infrastructure to increase SME access to finance. Policies that encourage women and youth to join the workforce and participate in the private sector and promote fintech are critical.*

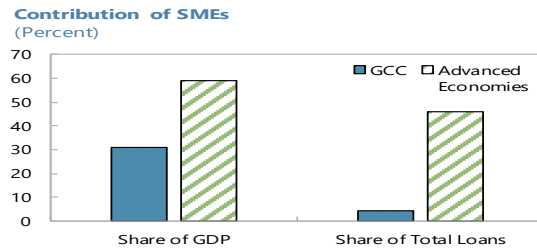
### **SMEs and financial inclusion**

**25. Improving access to finance for SMEs is a key priority in the GCC.** In dynamic economies, young, growing firms are important contributors to job creation (Haltiwanger and others, 2013),

<sup>9</sup> We thank the authors for sharing their STATA code.

even though small firms as a group need not be efficient (Bloom and Van Reenen, 2007). Ensuring effective access to finance for small, growing, firms in the GCC will help growth and job creation (Figure 14). This is an important part of national agendas to stimulate private sector growth and employment. While earlier reforms to develop SMEs have yielded some results, there is a consensus that more is needed (Box 2).

**Figure 14. Share of SMEs in GDP and Loans**



Source: MSME; OECD; and IMF staff calculations. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints, and information availability. They may also not reflect more recent important structural transformations.

### Box 2. Challenges of Growing SMEs in the GCC countries

**SME access to finance is generally low around the world because of shared challenges characterizing this sector** (Bibolov and others, 2010):

- **SMEs are generally riskier and lack proper collateral.** They are generally less diversified and have a higher probability of failure. In addition, assets and loans can be used interchangeably by SMEs and their owners, making loan monitoring and recovery more difficult.
- **SME's financial information is limited.** SME owners often lack finance and accounting skills, and SME accounts do not meet bank accounting and disclosure requirements. The widespread use of cash prevents SMEs from building relationships with banks, which generally prefer customers that have audited financial statements and documented turnover.
- **SME coverage by credit bureaus is generally low.** The lack of credit history and low coverage prevents differentiated lending. Credit bureaus have started just recently covering SMEs in the GCC.
- **Costs of serving SME accounts is high.** Banks need to follow AML/CFT procedures when onboarding SMEs to avoid loss of correspondent banking relationships. However, returns on SME lending may not be sufficiently high to cover those costs.

**There are other hurdles in the GCC that further undermine SME lending:**

- **Transitory nature of SME owners.** Nationals are less willing to join SMEs where wages are less certain than government jobs. Expatriates comprise most of SME employees in Saudi Arabia and UAE (IMF, 2018a and OECD 2016). Further, stringent regulation (criminalization of loan defaults) have led some expatriate SME owners to flee the region rather than resolve their debts.
- **Lack of competition in the financial sector.** GCC banks—many of which are state-owned and serve large companies—enjoy stable interest margins thanks to their good ratings and largely stable and cheap deposits. IMF (forthcoming) finds that GCC banking systems on average are less competitive than other regions of the world. As a result, banks are less interested in SME lending (World Bank Forum, 2016; and Calice and others, 2016). For example, in the UAE, up to 70 percent of SME loan applications are rejected compared with less than 20 percent in the UK (OECD, 2016).
- **Lack of working insolvency frameworks.** While most GCC countries now have bankruptcy laws, these are either recent (the UAE adopted its law in 2017 and Saudi Arabia in 2018) or have not been tested in courts, which has prevented loan workouts, with banks recovering only 30 to 40 percent on defaulted loans compared to an average of 72 percent for advanced economies (World Bank Doing Business Guide, 2018). Insolvency regimes in the MENAP region (MENA, Afghanistan and Pakistan), which includes the GCC, are among the weakest in the world (IMF, forthcoming).

**26. IMF (forthcoming) identifies a number of reforms that could help address constraints on SME lending in the MENA region, including GCC countries:**

- **Operationalizing and digitizing central collateral registries for movable and non-movable assets.** Working collateral registries for movable assets are shown to increase access to bank finance for smaller and younger firms (Love and others, 2013). In the GCC, the expansion of the coverage of movable collateral registries will help SMEs to use their assets as collateral.
- **Insolvency frameworks to help decrease risks for lenders.** Bankruptcy laws need to be operationalized. In particular, there is a need to modernize the court systems, including through training of judges. In addition, appropriate decriminalization of loan delinquencies would potentially improve loan workouts and encourage amicable solutions between lenders and SMEs. Introducing out-of-court restructurings can help decrease losses on SME loans.
- **Expanding the coverage of credit bureaus to SMEs.** Credit bureaus are rapidly improving their coverage of households in the GCC, but SME coverage has been lacking. Saudi Arabia's Financial Sector Development Program (FSDP) includes a plan for establishing a local rating agency for SME credit assessment. Expanding credit bureau coverage of SMEs will help decrease credit information gaps and lower credit risk for banks.
- **Reducing market distortions and increasing financial market competition.** In particular, governments should minimize direct interventions such as imposing interest rate caps for banks, as these have proven ineffective, resulting in suppressed SME lending (Ferrari and others, 2018). They should also avoid relaxing risk weights for banks on SME loans as this amounts to forbearance on credit risks. However, reforms to increase competition, including through new lenders/alternative types of financial institutions could also be considered. For example, in the US, community banks play an important role in SME finance in rural areas, while microfinance institutions play a similar role in other countries. These institutions can be better positioned to target SMEs by being smaller and more local, which enhances their understanding of SME businesses and challenges.

**27. Financial literacy programs for entrepreneurs would also support SME financial inclusion.** Governments could team up with the private sector to offer courses in finance and doing business to educate SME owners in finance and accounting and improve the quality of their financial reporting. Examples of such programs already exist in the region, including Dubai Entrepreneurship Academy by Dubai SME and NBAD bank SME academy. Saudi Arabia's FSDP also envisages developing a program to improve financial literacy for SMEs. Such programs could be increased in scope.

***Women and youth financial inclusion***

**28. Female and youth owners of SMEs may find it particularly difficult to access finance.** Muravyev and others (2009) found that women entrepreneurs are 5 percent less likely to receive a loan and equally more likely to pay higher interest rate on their loans. To help overcome these challenges, Klapper and others (2010) argue that including nonbanking credit information, such as

utilities and cell phone payments, in credit registries would benefit women in particular. In addition, increasing the range of accepted movable collateral could also benefit women and youth, who do not own as much real estate and property in the GCC. Similarly, promoting leasing could help women and youth entrepreneurs as they have lower access to capital than adult men.

**29. With the expected increase in the participation of youth and women in the workforce, financial access is also likely to improve.** The limited participation and employment of women in the GCC has made them less likely to hold a banking account and access financial services (Demirguc-Kunt and others, 2013, Delechat and others, 2018). Banks prefer customers with stable employment and incomes, as many of their products, such as credit cards, are specifically designed for people with a verifiable income source. To borrow funds, individuals need to present collateral and/or evidence of income, which makes it conditional on employment or existing wealth. As GCC governments make efforts to boost female and youth labor force participation—including by providing affordable child care, encouraging maternity and paternity leave, and other measures focused on the youth—the gender and youth access to finance gap is expected to decrease.

**30. Financial education programs for women and youth would also support financial inclusion.** Numerous successful programs around the world focus on educating youth about saving and managing money through financial institutions. For example, YouthInvest helped educate 50,000 youth in Egypt and Morocco about innovative financial products; girls' Saving and Financial Education Programs in Mongolia and the Dominican Republic focused on providing access to financial services for girls and women, age 7–24 years; and, the Silatech initiative in Qatar, aims to create jobs and improve economic opportunities for youth in the Arab world (Reinsch, 2012). In Saudi Arabia, the FSDP envisages enhancing financial literacy and awareness, including through two stand-alone government programs, the Financial Literacy Entity (FLE) and a government backed retail savings scheme. Such interventions could help to teach important skills to GCC women and youth and increase their access to finance.

**31. Use of financial technology (Fintech) can help solve existing problems with SME lending and bring new ways to boost financial inclusion of women and youth in the GCC.** Fintech can help decrease information asymmetry, improve competition, and decrease costs of lending to SMEs. Fintech credit scoring systems powered by big data analytics enables lenders to source information from alternative sources to quickly generate a real-time credit score on SME borrowers. Fintech can also keep ownership data and online collateral registries using blockchain, and increase competition between traditional fund providers. Consumers are increasingly able to compare banking services, credit cards, insurance, and other products for SMEs online. Fintech companies are already reducing costs of AML/CFT and Know-Your-Customer (KYC) procedures which is particularly important for SME loans. GCC countries, and the UAE in particular, are home for successful SME crowdfunding platforms.

**32. Fintech does not come without risks and these to be carefully managed.** They are mostly related to the use of unseasoned technology such as big data analytics for credit assessment (privacy, consumer protection) and crowdfunding platforms (fraud). Hence, policy makers need to plan regulations that will help to minimize these risks. Regulatory incubators such as at the ADGM in

the UAE can serve as examples of developing Fintech regulations in consultation with companies. Regulated properly, Fintech holds great promise to spur financial inclusion for SMEs, women, and youth in the GCC.

## F. Fostering Capital Market and Non-Bank Institution Development

*Access to equity and debt markets and development of non-bank financial institutions could be increased. Key reforms include enhancing the regulatory framework and investor protection, promoting secondary market development, encouraging competition, and improving resource pooling and market allocative efficiency.*

**33. The development of domestic capital markets and non-bank financial institutions may offer benefits to investors and borrowers alike.** Well-developed domestic capital markets can provide more efficient capital allocation along with better risk sharing. This would also promote growth by increasing private sector access to financing sources and provide finance to strategic infrastructure projects. Efficient domestic capital markets can also help improve the conduct of fiscal, monetary, and exchange rate policies (Laeven, 2014).

**34. GCC countries have made good progress developing their stock markets, but there remains room for progress in some areas and more can be done to strengthen debt market infrastructure and the regulatory framework.** Since 2000, GCC countries have stepped up efforts to better regulate stock markets—introducing new capital market laws (Saudi Arabia, Bahrain and Qatar), establishing new regulatory bodies (the UAE, Saudi Arabia, Qatar and Kuwait), enhancing corporate governance, and easing restrictions on foreign investors. These reforms have paved the way for the inclusion of Qatar and the UAE in the MSCI Emerging Market Index in 2014 and Saudi Arabia more recently (Box 3).

**35. A closer look at stock market institutional infrastructure shows variation across countries in the region.** While GCC countries have relatively well developed (main) stock markets, there is need to develop the (parallel) stock markets for smaller companies in Bahrain, Qatar and UAE, ease restrictions on access for foreign investors and foreign listing in four out of the six countries. In addition, weak implementation of existing investor protection and corporate governance frameworks have hindered the development of capital markets (Annex III).

GCC Stock Market – Institutional Infrastructure and Regulatory Framework		Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
<b>Infrastructure Requirements</b>	Primary (main) stock market	✓	✓	✓	✓	✓	✓
	Stock (parallel) market for small companies	X	✓	✓	X	✓	X
	Trading, clearing and settling system	✓	✓	✓	✓	✓	✓
<b>Regulatory Framework</b>	Capital market law	✓	✓	✓	✓	✓	✓
	Access for foreign investors	✓	✓	✓	✓	✓	✓
	Foreign listing	✓	X	X	X	X	✓
	Investor protection	✓	✓	✓	✓	✓	✓
	Market makers	X	X	X	X	X	✓

Source: Country authorities; and IMF staff.  
 "✓" indicates that the requirement is satisfied but not necessarily efficient. "X" not satisfied.

### Box 3. Recent Capital Market Reforms in Saudi Arabia

**The Saudi capital market has witnessed significant reforms over the period 2014 to 2017.** In 2014, the Capital Market Authority (CMA) developed a comprehensive strategic plan to foster capital market development, promote investor protection, improve the regulatory environment, and enhance its role.

**The reforms that have taken place can be summarized in four groups: organization/operations, regulations/regulatory frameworks, infrastructure, and corporate governance and investor protection:**

*Organization/operations:* CMA introduced a new organizational structure and separated task and functions between itself and the Saudi Stock Exchange (Tadawul). In addition, CMA has applied a unified framework of internal policies and procedures and adopted the "FinTech Lab" initiative. Furthermore, CMA signed MOUs with other government entities concerned with the financial sector to increase coordination and harmony of government policies.

*Regulations/regulatory framework:* CMA reviewed a number of regulations and rules, enabled securities lending and short selling, and amended the timeframe for settling transaction for securities to "T+2". In addition, it has amended merger and acquisition regulations, and eased Qualified Foreign Investors (QFIs) criteria to enable more foreign investor participation.

*Infrastructure:* CMA introduced "Nomu", a parallel stock market for SMEs, and established a regulatory entity to supervise the auditors of listed companies. CMA also established a financial academy specialized in training and qualifying financial sector employees. "Edaa", a securities depository center company was established to operate and maintain the depository and settlement system.

*Corporate governance and investor protection:* CMA introduced corporate governance regulations in 2017 and enacted an accelerated process to decide upon violations of the capital market law. In addition, it launched an electronic investor protection system, and applied an obligatory electronic voting in general assembly meetings of listed companies. Moreover, all listed companies have adopted IFRS.

**Saudi Arabia will be included in the FTSE/Russell and MSCI indices.** The inclusion of Tadawul in MSCI will take place in two stages, one in May 2019 and another in August 2019, while the inclusion in FTSE/Russel will happen in several stages between March and December 2019. It is expected that the inclusions will bring substantial passive and active inflows to the Saudi stock market.

**Steps are also being taken to develop the bond market.** Domestically issued government bonds have been registered at Tadawul stock exchange and have been traded since April 2018. Additional steps underway include establishing a primary dealer system, increasing the flexibility of government debt issuance, and extending the yield curve by issuing shorter and longer-dated bonds.

**36. Debt markets in all GCC countries are still at an early stage of development.** All countries have active money markets. However, there is room to further develop repo transactions for both government and corporate bonds; ease restrictions on participation in the primary market for government debt; and encourage competitive bond pricing (using auction systems). Reforms are also needed to encourage the growth of secondary markets and the development of benchmark yield curves and the corporate bond markets, including through developing a disclosure and information system, a credit rating system, and bankruptcy laws.

		Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
<b>GCC Debt Market – Institutional Infrastructure and Regulatory Framework</b>							
	<b>Money market</b>						
	• Interbank money market	✓	✓	✓	✓	✓	✓
	• Repo transactions	X	X	X	X	X	✓
	<b>Primary market of government debt</b>						
	• Access to all potentially significant investors	X	X	X	X	X	X
	• Competitive price based auction	X	X	X	X	X	X
	• Reference yield curve	X	X	X	X	X	X
<b>Infrastructure Requirements</b>	• Depository infrastructure	✓	X	✓	✓	✓	✓
	• Regular publication of auction calendars	X	X	X	X	X	X
	<b>Secondary market of government debt</b>						
	• Market infrastructures for trading, clearing and settling transactions	✓	X	✓	✓	✓	✓
	• Market markers in government debt	X	X	X	X	X	✓
	<b>Corporate debt and Sukuk market</b>	✓	X	✓	✓	✓	✓
	<b>Credit ratings and rating agencies</b>	X	X	X	X	X	X
<b>Regulatory Framework</b>	<b>Investors protection/ Corporate governance</b>	✓	✓	✓	✓	✓	✓
	<b>Capital market law</b>	✓	✓	✓	✓	✓	✓
	<b>Access for foreign investors</b>	X	X	X	X	X	X
Source: Country authorities; and IMF staff.							
"✓" indicates that the requirement is satisfied but not necessarily efficient. "X" not satisfied.							

**37. Further development of the nonbank sector is constrained by concentrated ownership of equities and poorly developed debt markets.** While a detailed examination of and specific policy recommendations for GCC nonbank financial institutions are beyond the scope of this paper, constraints to financial development outside the banking system are briefly discussed (Box 4). Local capital markets and nonbank financial services develop in a self-reinforcing manner. However, the public ownership of a large share of equities in the GCC and limited trading have constrained stock market liquidity. The absence of developed debt markets means that fixed-income focused institutional investors must hold foreign assets, which reduces their contribution to local capital market development. In addition, limited financial literacy and generous pension funds lower demand for asset management and insurance.



#### Box 4. Constraints on Development of GCC NBFIs <sup>1/</sup>

**Pension funds for nationals offer generous benefits and hold most of their assets abroad.** All GCC countries maintain pension funds for nationals (the Saudi public and private pension funds being the largest by far). These pension funds offer generous benefits at relatively early retirement ages. Some GCC pension funds have large domestic equity holdings, limiting scope for other institutional investors. As local debt markets are not developed, fixed income assets are largely held abroad. GCC institutional investors face little currency risk from holding dollar denominated assets, given their countries' pegged exchange rate regimes. Expatriates are typically offered severance pay in lieu of pension coverage.

**Facing low stock market activity (except in Saudi Arabia), limited debt markets, and low financial literacy, GCC asset managers remain small.** Asset management remains small in GCC countries, typically below 5 percent of GDP. Outside Kuwait, mutual funds account for most assets under management. Bahrain's mutual fund sector is comparatively large, at nearly 25 percent of GDP. Concentrated ownership of (large) equities by pension funds and other government entities limits free float, trading, and liquidity. In combination with poorly developed fixed income markets, this narrows the scope for asset managers to grow. Demand may be low partly because retail investors are unaware of the benefits of investing through mutual funds. Outside Kuwait, large banks dominate institutional access to retail clients.

**Beyond motor and health insurance, demand for insurance products seems to be low in GCC countries.** Gross written premiums are below 2 percent of GDP on average. Activity is limited to, and competitive for, motor and health insurance. Life insurance remains negligible, given cultural reservations and a dearth of long-term fixed income instruments outside real estate. Generous pension funds for nationals also lower the demand for insurance. GCC countries are moving, at varying paces, towards putting regulatory frameworks addressing issues including capital requirements and the treatment of Islamic products (Takaful) in place.

**Finance companies' activities remain modest.** GCC countries have more than 80 finance companies with a total loan portfolio of around 3 percent of GDP in 2017. Their loans are concentrated mainly in real estate, SMEs, and personal and microfinance loans. Non-performing loans (NPLs) have increased lately, reaching around 12.8 percent, 10.3 percent, and 5 percent in the UAE, Saudi Arabia, and Oman, respectively. While the regulatory frameworks for finance companies appear sufficient in most of the GCC, lack of public awareness and high cost of funding are among their main challenges. Funding sources are mainly debt and paid-up capital, which puts them at a disadvantage relative to banks which have access to interest free deposits. GCC countries, except the UAE, do not allow finance companies to accept customer deposits. Recently, Oman has started allowing finance companies to raise six-month term deposits from corporates to ease their funding pressures.

1/ IMF FSAPs, and financial stability reports and annual reports of GCC central banks.

### 38. Reforms to further help develop GCC equity markets should focus on improving market access and liquidity. In particular:

- Improving corporate governance could enhance stock market efficiency and reduce equity prices sensitivity to shocks (IMF, 2016).
- Developing secondary stock markets would enhance trading activities/market liquidity and enable greater access to SMEs.
- Reducing restrictions on foreign ownership in stock market and enhancing investor protection (through reforms such as better financial fraud regulation and stronger disclosure requirements) could diversify the investor base and increase financial integration by attracting foreign capital.

**39. The following reforms would help deepen debt markets:**

- Further developing public debt management frameworks with a clear issuance strategy and calendar to help anchor investors' expectations and increase participation.
- Introducing repo transactions for government bonds and allowing potential investors to participate in primary issuance could increase market size and access and diversify the investor base.
- Establishing secondary markets for government debt could help build a benchmark yield curve. Creating rating agencies to provide an independent credit risk assessment could help develop local corporate debt markets and better manage risks.

**G. Conclusion**

**40. GCC countries have made considerable progress in developing their financial systems, aided by strong economic growth and wide-ranging reforms.** Nonetheless, there remains more to do. Most notably, financial systems in the GCC are reliant on banks, with NBFIs and debt capital markets generally less well developed. SMEs, women, and youth have lower access to the formal financial system than would be expected.

**41. Closing these remaining financial development and inclusion gaps would support growth.** While there is considerable uncertainty, the estimates provided in this paper suggest that further financial development could be associated with higher annual per capita income growth of 0.4-0.7 percentage points in some GCC countries and increased financial inclusion could be associated with higher growth of some 0.3-0.7 percentage points.

**42. To realize these potential growth benefits, continued reforms are needed to further develop financial markets and the non-bank sector and increase financial inclusion.** Priority reforms include developing a yield curve and increasing market liquidity through secondary markets trading. There is also a need to focus stock market reforms on enhancing corporate governance and investor protection, removing restrictions on foreign ownership, and encouraging financial market competition. These reforms would also help the development of non-bank financial institutions. Improving SME governance structures, improving the availability of financial information through credit bureaus, strengthening insolvency frameworks, and ensuring competition in the banking system is adequate will all help increase SME access to finance. Reforms encouraging female and youth employment, increasing the availability of financial literacy programs, and using Fintech to overcome other constraints to financial sector usage will also help close the financial inclusion gap.

## Annex I. GCC Financial System

**Table 1. GCC Countries Financial System, 2017**

	BHR 1/ 2/	KWT	OMN	QAT	SAU	UAE	GCC
	(In billions of US dollars)						
<b>Financial System</b>	<b>244</b>	<b>279</b>	<b>83</b>	<b>368</b>	<b>1104</b>	<b>776</b>	<b>2855</b>
<b>Commercial Banks</b>	<b>234</b>	<b>254</b>	<b>77</b>	<b>349</b>	<b>634</b>	<b>734</b>	<b>2282</b>
Domestic	...	243	72	338	616	636	1905
Foreign	...	11	5	11	18	98	143
Conventional	178	159	70	261	481	584	1733
Islamic	57	95	7	89	152	150	549
<b>Non-bank Financial Sector 3/</b>	<b>9</b>	<b>25</b>	<b>6</b>	<b>19</b>	<b>470</b>	<b>42</b>	<b>573</b>
Pension Funds	...	...	...	...	337	...	337
Mutual Funds/Investment Companies	7	25	1	3	29	5	70
Specialized Credit Institutions	...	...	...	1	79	...	80
Insurance	2	...	2	12	15	26	58
Other	...	1	3	3	10	12	28
	(Percent of GDP)						
<b>Financial System</b>	<b>756</b>	<b>231</b>	<b>117</b>	<b>221</b>	<b>161</b>	<b>203</b>	<b>196</b>
<b>Commercial Banks</b>	<b>727</b>	<b>210</b>	<b>109</b>	<b>209</b>	<b>92</b>	<b>192</b>	<b>156</b>
Domestic	...	202	102	203	90	166	130
Foreign	...	9	7	7	3	26	10
Conventional	551	132	99	156	70	153	119
Islamic	176	79	10	53	22	39	38
<b>Non-bank Financial Sector 3/</b>	<b>29</b>	<b>21</b>	<b>9</b>	<b>11</b>	<b>68</b>	<b>11</b>	<b>39</b>
Pension Funds	...	...	...	...	49	...	23
Mutual Funds/Investment Companies	23	21	1	2	4	1	5
Specialized Credit Institutions	...	...	...	1	11	...	5
Insurance	6	...	3	7	2	7	4
Other	...	1	4	2	1	3	2
	(Percent of non-oil GDP)						
<b>Financial System</b>	<b>851</b>	<b>418</b>	<b>181</b>	<b>326</b>	<b>228</b>	<b>261</b>	<b>275</b>
<b>Commercial Banks</b>	<b>818</b>	<b>380</b>	<b>168</b>	<b>309</b>	<b>131</b>	<b>247</b>	<b>220</b>
Domestic	...	364	157	299	127	214	184
Foreign	...	16	11	10	4	33	14
Conventional	620	238	153	231	99	196	167
Islamic	198	142	15	78	31	50	53
<b>Non-bank Financial Sector 3/</b>	<b>32</b>	<b>38</b>	<b>14</b>	<b>17</b>	<b>97</b>	<b>14</b>	<b>55</b>
Pension Funds	...	...	...	...	69	...	33
Mutual Funds/Investment Companies	26	37	2	3	6	2	7
Specialized Credit Institutions	...	...	...	1	16	...	8
Insurance	6	...	5	11	3	9	6
Other	...	1	6	3	2	4	3

Sources: IMF FSAPs, central bank financial stability reports, and IMF staff estimates

1/ Commercial bank totals for Bahrain include wholesale banks, with assets of \$127 billion, which provide offshore, investment banking, and project finance services to the rest of the region.

2/ Data for GCC countries is for 2017, except Bahrain, where we use 2016 data from the 2017 FSAP.

3/ Data not provided for some non-bank financial institutions may reflect missing data for GCC countries.

## Annex II. Financial Development and Inclusion

### *Financial Development Index*

- 1. The paper uses a financial development index developed by Svirydzienka (2016),** using a standard three-step approach found in the literature to reduce multidimensional data into one summary index. The three steps are: (i) normalization of variables; (ii) aggregation of normalized variables into the sub-indices representing a particular functional dimension; and (iii) aggregation of the sub-indices into the final index.
- 2. The focus here is on a set of sub-indices, which assess how developed financial systems are across countries.** These sub-indices measure depth and access of financial institutions and markets. These sub-indices are aggregated into two higher level sub-indices, financial institutions (FI) and Financial markets (FM), which measure how developed financial institutions and financial markets are overall. Finally, FI and FM sub-indices are aggregated into the overall measure of financial development – the Financial Development (FD) index. The data sources noted in Table 1 were supplemented with data from national sources where necessary.
- 3. Data quality is an important contributor to uncertainty surrounding the empirical analysis.** As in prior work, missing variables are treated as zeros. This index may therefore show countries with better data availability to be more financially developed.

<b>CATEGORY</b>	<b>INDICATOR</b>	<b>DATA SOURCE</b>
<b><i>Financial Institutions</i></b>		
<b>Depth</b>	Private sector credit to GDP	World Bank FinStats 2017
	Pension fund assets to GDP	World Bank FinStats 2017
	Mutual fund assets to GDP	World Bank FinStats 2017
	Insurance premiums, life and non-life to GDP	World Bank FinStats 2017
<b>Access</b>	Bank branches per 100,000 adults	World Bank FinStats 2017
	ATMs per 100,000 adults	IMF Financial Access Survey
<b><i>Financial Markets</i></b>		
<b>Depth</b>	Stock market capitalization to GDP	World Bank FinStats 2017
	Stocks traded to GDP	World Bank FinStats 2017
	Debt securities of nonfinancial corporations in local currency to GDP	Dealogic corporate debt database
<b>Access</b>	Percent of market capitalization outside of top 10 largest companies	World Bank FinStats 2017
	Total number of issuers of debt (domestic and external, nonfinancial and financial corporations)	World Bank FinStats 2017

### *Financial Development and Inclusion Gaps*

- 4. Financial development is driven mainly by macroeconomic and institutional fundamentals.** Economic theory along with empirical studies suggest that real income growth along with stable inflation and exchange rates can foster financial market development. Financial

development gaps are derived from regressions linking financial development (FD), institutions (FI) and markets (FM) development indices to the following fundamentals:<sup>10</sup>

- Economic development — measured by GDP per capita
- Population growth
- Openness— capital account openness and trade openness,
- Institutions—rule of law

**5. Income per capita, the rule of law and trade openness are found to be important determinants of financial developments, consistent with previous studies** (e.g., Beck and others 2008). Financial development gaps are calculated as the difference between actual financial development and the level predicted by fundamentals. For financial institutions, population growth is found to be an additional determinant while the size of the government is also a determinant of financial market development.

**Table 2. Financial Development Regression Results**

VARIABLES	(1) WFD OLS	(2) WFI OLS	(3) WFM OLS	(4) WFI Access OLS	(5) WFI Depth OLS	(6) WFM Access OLS	(7) WFM Depth OLS
<i>Log of initial GDP per capita</i>	<b>0.0734***</b> (0.00948)	<b>0.0662***</b> (0.0101)	<b>0.0797***</b> (0.0121)	<b>0.0998***</b> (0.0116)	<b>0.0294**</b> (0.0122)	<b>0.0988***</b> (0.0169)	<b>0.0595***</b> (0.0130)
<i>Log of government consumption, % of GDP</i>	-0.0251 (0.0247)	0.0280 (0.0220)	<b>-0.0780**</b> (0.0334)	<b>0.0637***</b> (0.0238)	-0.00893 (0.0309)	<b>-0.0991***</b> (0.0327)	-0.0557 (0.0404)
<i>Population growth</i>	-0.00709 (0.00572)	<b>-0.0230***</b> (0.00563)	0.00886 (0.00704)	<b>-0.0295***</b> (0.00559)	<b>-0.0153*</b> (0.00781)	<b>0.0173**</b> (0.00813)	0.000288 (0.00822)
<i>Log of imports and exports, % of GDP</i>	<b>-0.0698***</b> (0.0222)	<b>-0.0540***</b> (0.0188)	<b>-0.0848***</b> (0.0300)	<b>-0.0899***</b> (0.0193)	-0.0156 (0.0258)	<b>-0.0783***</b> (0.0288)	<b>-0.0900**</b> (0.0423)
<i>Financial openness</i>	0.00379 (0.00604)	0.000572 (0.00589)	0.00697 (0.00881)	0.00198 (0.00880)	-0.000864 (0.00808)	-0.000314 (0.00921)	0.0141 (0.0110)
<i>Rule of law</i>	<b>0.153***</b> (0.0150)	<b>0.152***</b> (0.0152)	<b>0.152***</b> (0.0195)	<b>0.107***</b> (0.0193)	<b>0.190***</b> (0.0181)	<b>0.141***</b> (0.0249)	<b>0.161***</b> (0.0251)
<i>Constant</i>	-0.0130 (0.130)	-0.0747 (0.135)	0.0490 (0.166)	-0.224 (0.151)	0.0776 (0.168)	-0.0782 (0.187)	0.175 (0.204)
Observations	634	634	634	634	634	634	634
R-squared	0.766	0.782	0.635	0.710	0.685	0.573	0.530

Note: Robust standard errors in parentheses. Time and legal system origin dummies were also included.  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

<sup>10</sup> Indicators of governance (rule of law) and financial openness should be interpreted with caution due to a limited number of respondents, limited geographical coverage, standardized assumptions on business constraints, and information availability. They may also not reflect recent important structural transformations.

**Financial Development and Growth**

**6. Table 3 shows regressions, following Sahay and others (2015a), assessing the growth impact of financial development.** The index of financial development described in Section C is used. The specifications use five-year averages over non-overlapping periods for Arellano and Bond (1991) GMM estimation. Time dummies, rule of law, and legal origin are used as instruments.

**7. The second specification in Table 3 includes a banking crisis dummy based on Laeven and Valencia (2018).** The regression results are qualitatively similar. The reported growth impact is based on the first specification.

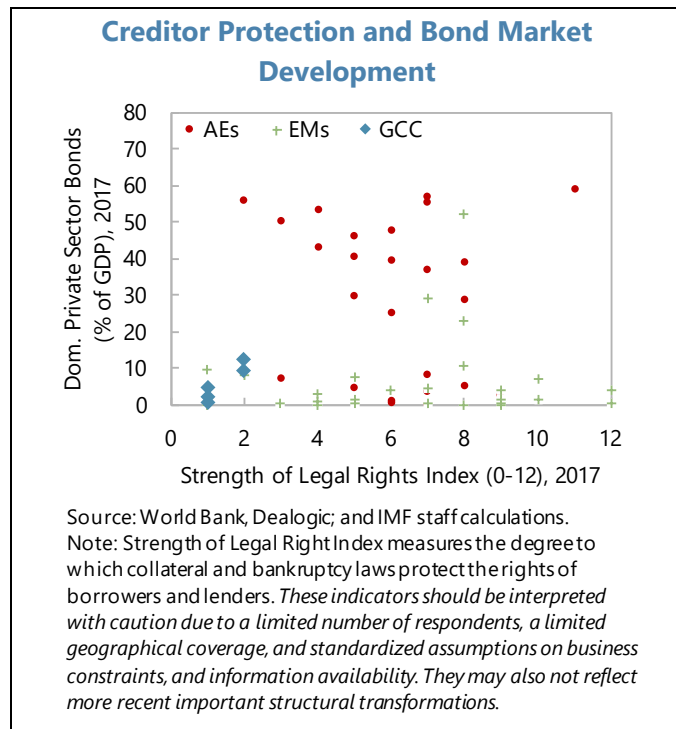
<b>Table 3. Finance and Growth: GMM Estimation, 2001-2016</b>		
FD = Financial Development Index		
Dependent variable: Real GDP per capita growth		
Additional controls: Initial GDP per capita, secondary education attainment, government consumption/GDP, population growth, inflation rate, trade openness/GDP, financial openness (Chinn-Ito Index), rule of law index.		
Variables	(1)	(2)
<i>FD</i>	<b>16.85**</b> (6.938)	<b>15.52**</b> (7.625)
<i>FD</i> <sup>2</sup>	<b>-20.52***</b> (6.956)	<b>-20.73***</b> (7.698)
Banking Crisis		<b>-7.847**</b> (3.056)
Banking Crisis x <i>FD</i>		<b>6.774</b> (4.241)
Observations	374	374
Number of countries	129	129
Robust standard errors in parentheses		
*** p<0.01, ** p<0.05, * p<0.1		
Source: Laeven and Valencia (2018); Chinn-Ito, World Bank, IMF.		

## Annex III. Status of Investor Protection and Corporate Governance in the GCC

**1. Strong investor protection and corporate governance help promote deeper and more liquid capital markets and increase financial systems resilience (IMF 2016).** Corporate governance and investor protection encompass rules and practices at both the country and firm level and deal with ways in which suppliers of financing to corporations ensure that they get a return on their investment. Therefore, it is critical to develop corporate governance and investor protection frameworks as a part of overall development of capital markets in the GCC countries.

**2. Investor protection remains weak which hinders capital market development.** Measured by the strength of legal rights index published by the World Bank, investor protection scores record 1 and 2 out of 12. Increasing investor protection should encourage creditors' willingness to purchase debt securities and investors' interest in equities.

**3. Corporate governance has improved in the GCC countries but there is room for further improvement.** Corporate governance is still a nascent concept in the GCC countries. For example, corporate governance regulations were introduced in 2017 in Saudi Arabia. Ineffective boards have hindered GCC companies from achieving growth and maximizing the existing potential (Pillai and Al-Malkawi 2016). The lack of mandatory yearly performance appraisal for directors along with lack of transparency related to credit ratings, engagement in corporate social responsibility and yearly publication of "Corporate Governance" reports are the main weaknesses in corporate governance in the GCC countries.



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