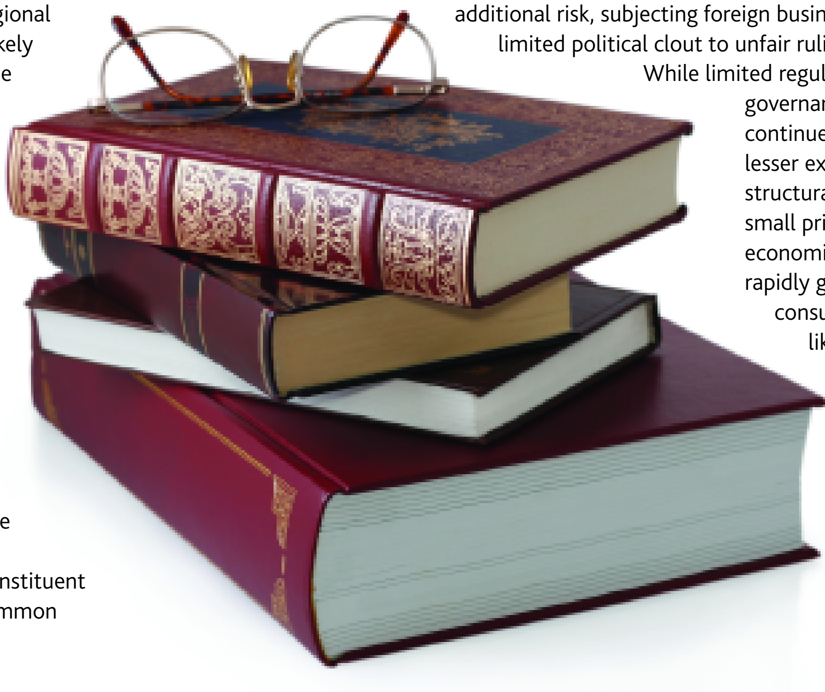
Diverted by discontent

TORBJORN SOLTVEDT ASSESSES THE IMPACT OF THE ARAB AWAKENING ON REGULATORY REFORM IN THE GCC STATES.

With the exception of Bahrain, the direct impact of the Arab Awakening on Gulf Cooperation Council (GCC) member states appears to have been limited. Nonetheless, the leaders of the other GCC states – Saudi Arabia, Qatar, the UAE, Kuwait and Oman – have all felt compelled to increase government spending significantly in order to mitigate the risk of social unrest.

This has in turn drawn attention to the need to develop the private sector in many Gulf states. Encouraging private sector investment is essential if the GCC states are to reduce their heavy dependency on revenue from hydrocarbon resources. At the same time, the need to mitigate the risk of social unrest could reinforce patronage structures, which are in many ways incompatible with strong corporate governance and regulatory reform.

Progress towards greater regional economic integration is also likely to shift down the agenda as the unrest seen in several GCC states in the past 18 months takes precedence. The GCC's decision to set up a US$20bn fund over 10 years for Bahrain and Oman highlights that stability in member states is likely to remain the top priority also in the longer term.



Encouraging significant private sector growth will require regulatory reform. Although important differences exist in terms of the strength of the regulatory framework within the GCC, constituent members face a number of common challenges. Low levels of transparency and weak anti-corruption laws and implementation continue to pose a risk to investors. Shortcomings in these areas highlight the need for further reform despite considerable progress in recent years.

Of all GCC members, Saudi Arabia has made the most headway in improving corporate governance standards in recent years. Following its accession to the World Trade Organization in 2005, regulatory reform has remained a priority in the kingdom. This is clearly reflected in its increasingly higher ranking in the World Bank's Doing Business report. Ranked 24th in 2008, the country ranked 12th in 2012. Nevertheless, prohibitive labour regulations, slow progress towards greater privatisation, and a lack of effective dispute settlement and contract-enforcement mechanisms continue to concern investors. Low levels of judicial independence constitute an additional risk, subjecting foreign businesses and individuals with limited political clout to unfair rulings.

While limited regulatory and corporate governance reform is likely to continue in Saudi Arabia, and to a lesser extent in other GCC states, structural weaknesses such as a small private sector, lack of economic diversification and rapidly growing domestic consumption of energy are likely to complicate efforts to improve the business environment. The Arab Awakening has affected many of these areas strongly. Essentially, the sharp rise in public welfare spending across the GCC to dampen public discontent has

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amplified existing weaknesses and left all GCC states more vulnerable to a fall in oil and gas prices.

Growing public spending has raised the "break-even" price of oil and gas for GCC member states, highlighting the need to address the structural weaknesses that inhibit further improvements to the regulatory and business environment. With Saudi Arabia announcing a US$130bn spending package in 2011, the country needs the oil price to rise from around US$68 in 2010 to an estimated US$90–100 to avoid a budget deficit.

Other GCC states have introduced comparable spending packages. The UAE raised public sector wages in most federal departments by between 35% and 100% in January 2012. Similarly, the Kuwaiti budget for 20012/13 is 13% higher than the previous year even before the cost of the public sector wage hikes announced in March 2012 has been factored in.

Reducing the vulnerability of GCC members to a fall in oil and gas prices will require more concerted efforts to strengthen the private sector and to diversify economies away from an overreliance on revenues from hydrocarbon resources. While most of the GCC states have introduced programmes and initiatives to facilitate greater national participation in the private sector, little significant headway has been made. Furthermore, with participation in the private sector as low as 0.5% of the workforce in the case of Qatar, the task of fostering a private sector which could significantly reduce national dependency on hydrocarbon revenue will be taxing and require strong political will. Kuwait, Saudi Arabia and the UAE face similar challenges with private sector participation rates of 10% or lower.

Despite the need to foster greater participation in the private sector, there is a risk that unrest in several GCC states in 2011 and 2012 could hamper current initiatives as the emphasis may shift towards strengthening the "social contract", which acts as a buffer to unrest. In most GCC states, the lack of political freedoms is countered to a great extent by a cradle-to-grave welfare system in which the population expects and receives heavy subsidies and access to well-paid public sector jobs. Proposals in Saudi Arabia to increase salaries in the public sector, create an additional 60,000 jobs in the Ministry of Interior, implement a poverty reduction scheme, and construct half a million new houses can be seen as an attempt to maintain and strengthen the social contract.

While the emphasis on stability across the GCC may slow initiatives to encourage private sector participation, pressure on the public sector and government resources will almost certainly increase as a result of the youth bulge. As such, the need to ensure a greater role for the private sector in the region will become more urgent in the medium to long term.

Saudi Arabia faces the biggest challenge among the GCC states. Its overwhelmingly youthful population stands in stark contrast to the country's ageing ruling elite. The only GCC state with a lower median age than Saudi Arabia (25.3 years) is Oman (24.1 years). However, the Omani participation rate in the private sector is almost twice as high as in Saudi Arabia, giving the country more flexibility to absorb new jobseekers entering the labour market. Although funds for future generations – which also exist in Qatar and Kuwait – will prolong the viability of expensive welfare programmes, they do not offer a sustainable long-term solution. Developing the private sector must be a long-term essential.

Although the Arab Awakening has been obvious in such Arab countries as Bahrain, the rulers of most GCC members have come under greater pressure, even if subtle in many cases. For example, tensions between the Kuwaiti government and the country's national assembly have long acted as a brake on economic and regulatory reform, and the political turmoil in 2011 and 2012 has accentuated these problems. The strong election victory of the Islamist-led opposition in February 2012 has also enhanced the parliament's ability to constrain the cabinet's operational freedom and is likely to further reduce the prospect of legal and regulatory reforms.

While the ratification of a capital markets law in 2010 forms a central part of the Kuwaiti government's plan to become a regional trading hub over the next two decades, further reforms are likely to be necessary to achieve this vision. Despite reforms in recent years, legal corporate governance standards in Kuwait remain the weakest in the GCC. As tensions between the national assembly and the government are likely to remain high, comprehensive reform on the lines of Turkey's proposed new commercial code is unrealistic in the short and the medium term – and arguably the long term too.

With a significant loss of investor confidence as a result of widespread unrest, Bahrain has been more strongly affected by the Arab Awakening than any other GCC state. Although the ruling al-Khalifa family saw the F1 Grand Prix in April as an opportunity to restore investor confidence and boost government revenue, political activists in Bahrain successfully exploited media attention to show that the underlying factors which triggered widespread unrest in 2011 remain unresolved.

Despite the conclusion of a "national dialogue" and an investigation into human rights violations in 2011, Bahrain's majority Shi'ite population remains underrepresented in positions of power. Given the potential for yet another large-scale uprising in Bahrain, investor confidence is likely to continue to be negatively affected. Furthermore, ensuring stability will almost certainly remain the main political priority for Bahraini authorities in the foreseeable future, with poor prospects for legal and regulatory reform in the short to medium term as a result.

Political considerations and concerns related to stability are likely to trump those related to corporate governance and the private sector throughout the GCC. Regulatory reforms in recent years have been incremental at best, with significant obstacles reducing the prospects for major change. Despite a growing need to develop the private sector in individual GCC states, the will to push through serious reform is likely to remain limited or weak.

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