

**Financial Systems and
Labor Markets in the
Gulf Cooperation Council
Countries**

Middle Eastern Department

**International Monetary Fund
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Preface

The economies of the countries of the *Gulf Cooperation Council (GCC)* share many features. They are endowed with abundant oil and gas reserves, which have been used to generate considerable wealth, build an extensive network of physical infrastructure, and raise per capita income to more than double the world average. Also, these countries share a long tradition of liberal economic policies, open trade and exchange systems, low inflation, and stable currencies. These positive attributes have created an enabling environment for economic growth and financial stability. At the same time, however, the narrow production and revenue base and heavy dependence on hydrocarbon exports and imports of goods and labor have increased the vulnerability of the GCC economies to external developments and the vagaries of the international oil market.

The key challenges facing the GCC countries are how to sustain a relatively high growth rate and create employment opportunities for a growing number of nationals entering the labor market. Several GCC countries have already begun implementing medium-term reform programs to increase their economies' resilience to adverse oil market developments, strengthen medium-term growth prospects, and create a more conducive environment for private sector activity and employment.

In the aftermath of the 1990–91 regional conflict, remarkable efforts were made to overcome the legacy of the crisis and resume the reform programs that had been interrupted by the war. A premium was put on fiscal consolidation through mobilization of non-oil revenue and expenditure restraint, with most of the GCC countries setting for themselves the target of achieving fiscal balance by the year 2000. Supported by higher oil prices in 1995 and 1996, fiscal consolidation efforts in all GCC countries have reduced significantly financial imbalances, helped eliminate the external debt of Saudi Arabia and Kuwait, and restored private sector confidence. Moreover, a qualitative shift in economic policies toward liberalization, deregulation, and promotion of private sector activity has been taking place throughout the region.

An important feature of the medium-term plans has been the increased emphasis on structural reforms, including government disengagement from commercial activities, privatization, and financial sector reform, as well as a heightened interest in labor market issues and policies. Healthy and dynamic financial intermediaries and deeper capital markets are essential to supporting private sector growth and enhancing the beneficial effects of reforms in other areas. In turn, efficient labor markets would contribute to economic growth and diversification while supporting job creation.

This volume comprises two separate papers on key structural aspects of the reform process in the GCC countries. The first paper addresses issues related to financial intermediation and reform in the context of the evolving economic environment in the GCC countries. The second discusses the labor market challenges and policy issues in the GCC countries and their implications for the Middle East and North Africa (MENA) region.

The authors are grateful for valuable comments and input from colleagues in the Middle Eastern Department. Special thanks are due to V. Sundararajan for comments on the financial systems paper, and to Mohamed A. El-Erian and Susan Fennell for comments on the labor market paper. The authors greatly appreciate the valuable research assistance provided by Sayeed Mahyoub. Martha Bonilla, of the External Relations Department, edited the publication. Maria Llames, Joan Wise, and Anne Yee were helpful in the final preparation of the manuscript. The views expressed in this study are the sole responsibility of the authors and do not necessarily reflect the views of the Executive Directors of the IMF or other members of the IMF staff.

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Financial Systems and Reform in the Gulf Cooperation Council Countries

Abdelali Jbili, Vicente Galbis, and Amer Bisat

Executive Summary

- Since the end of the regional crisis in 1990–91, the Gulf Cooperation Council (GCC)¹ financial systems have witnessed a rapid development and integration with international financial markets, under the effects of profound changes in the economies of the region that stemmed from the impact of the Gulf war and the economic reforms that have been initiated thereafter.

- In the aftermath of the war, bank intermediaries increased their deposit and capital base, improved productivity by acquiring new technology, and enhanced their profits by developing consumer-based services. In addition, the monetary authorities in all GCC countries moved to strengthen prudential regulations and bank supervision.

- However, competition has remained relatively limited, with restrictions applying to bank licensing and foreign participation; domestic capital markets lack depth and diversification; and, in a number of cases, equity investment and financing continue to face supply constraints and restrictions concerning listing and trading.

- Looking forward, the GCC financial systems will also need to respond to a number of challenges emanating from fiscal retrenchment and the strengthening of the role of the private sector, including the need to mobilize private financing for large investment projects in telecommunications, power, transportation, and the petrochemical industry. In addition, financial intermediaries will need to meet an increased demand of more sophisticated financial services by a young and wealthy population.

- The GCC countries have already completed most of the crucial stages of liberalization and financial reform, and unlike many other countries of the Middle East and North Africa (MENA),² their financial systems are not encumbered with distortions. Key reforms, however, should aim at strengthening market forces, opening up the financial sector to foreign competition, strengthening bank soundness by enhancing the regulatory and supervisory framework, and developing the capital markets.

¹The GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

²MENA countries include the members of the Arab League, the Islamic Republic of Iran, and Israel.

I. Introduction

During the 1970s and the early 1980s, the GCC countries made significant progress in financial deepening and in building a modern financial infrastructure. Abundant oil revenue led to the accumulation of sizable official foreign assets and private wealth, part of which were intermediated by GCC financial institutions. Moreover, the GCC countries, which were net providers of savings to the rest of the world until the early 1990s, had little constraint in mobilizing resources for the financing of domestic investment projects, most of which were undertaken by governments. However, activity of the GCC financial intermediaries continued to be centered around their traditional niche consisting mainly of short-term lending to trade, building and construction, and small manufacturing. It was not until the early 1990s that the process of rapid development of financial intermediation and integration with international financial markets started to take hold under the effects of profound changes in the economies of the region, stemming, in particular, from the impact of the Gulf war and the economic reforms that have been initiated thereafter.

With the end of the Gulf war and the return of confidence, banks strengthened their deposit base, and improved productivity by acquiring new technology and developing lucrative consumer-based services (e.g., credit cards, automatic teller machines, consumer lending). Increased capitalization, higher profits, and government assistance, in Kuwait, for example, allowed the banks to compensate for the bad loan problems that had plagued a number of them. Other segments of the financial sector, however, have not made similar progress. Domestic money markets have remained underdeveloped, lacking depth and diversification. Stock exchanges have faced various constraints, despite the existence of a potentially large demand for equity investment; and corporate bonds and secondary markets for government paper have not emerged in a significant manner.

Looking ahead, the GCC financial systems face a number of challenges stemming from the need to adapt to the rapid globalization and support the policy changes that are currently shaping the region's economies, namely (1) the increased role of the private sector; (2) the strong demand for new financial services and, more generally, the need to better manage domestic savings; and (3) the gradual opening up of activity to foreign participation. Increased competition at the domestic and international levels in the period ahead will put a premium on efficiency and productivity and require enhanced prudential regulation and bank supervision to reduce risks and preserve the soundness of the banking system. Equity markets would need to be developed further to help promote private sector saving and investment.

This paper reviews the structure and key policy issues in the financial systems of the GCC countries. After a brief overview of the main characteristics of the bank intermediaries and the financial system in general in Section II, the key challenges facing these systems are highlighted in Section III in relation with the ongoing changes in the region, including the economic reforms underway. This provides a basis for the subsequent

presentation of the reforms needed in many GCC countries (Section IV) to strengthen capital markets; increase competition; open the markets to new entry, including by foreign institutions; and meet the challenges of fostering dynamic financial institutions and equity and bond markets.

II. Structure of the GCC Financial Sectors

A. Banking Intermediation

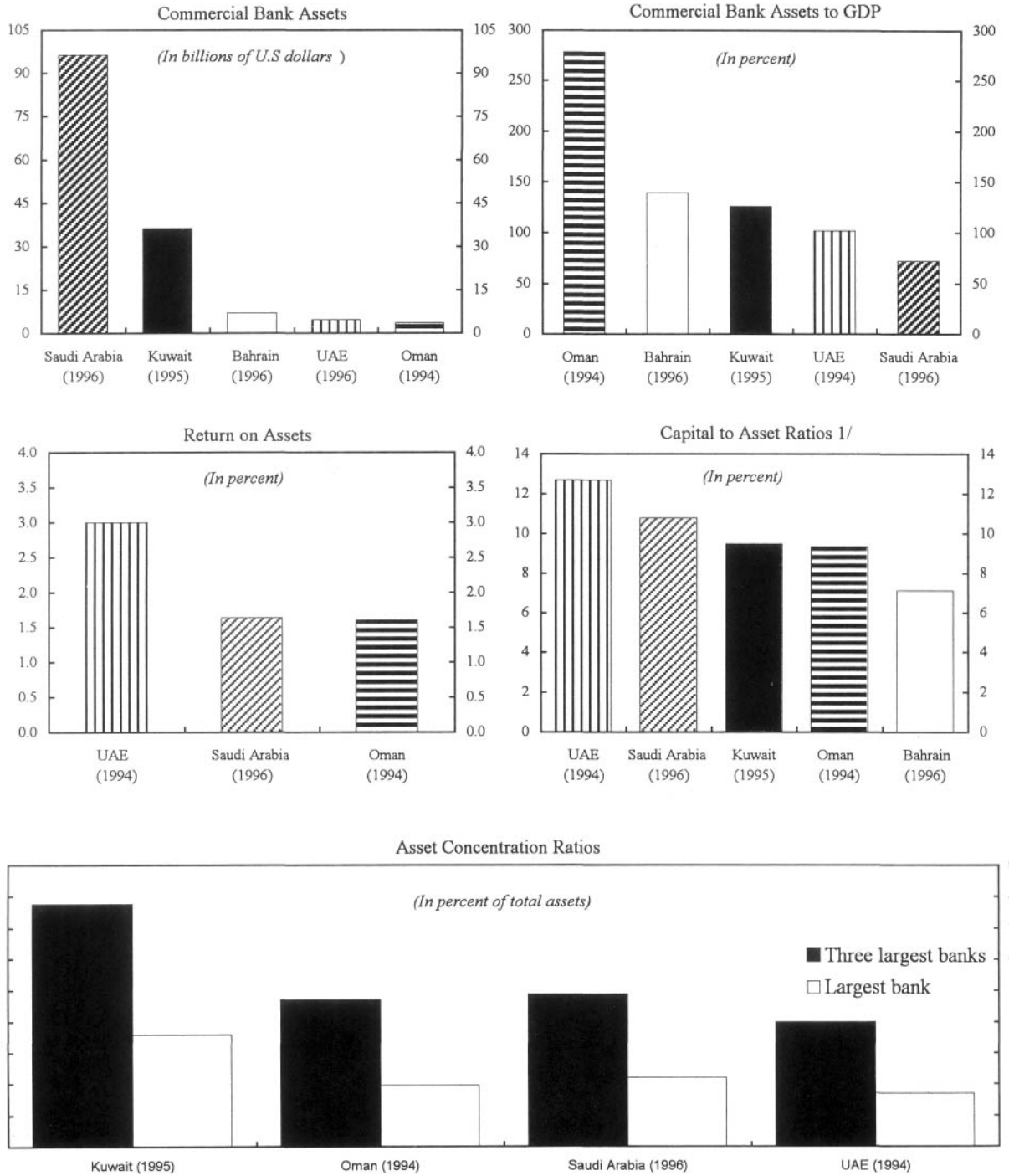
The GCC countries have a fairly large number of banks with extensive networks of branches. Banks are also, with few exceptions, financially strong and well capitalized, with total assets ranging between 70 percent of GDP for Saudi Arabia and 280 percent for Oman, levels that are high by international standards (Chart 1). In 1995, the region boasted 9 banks with assets exceeding US\$5 billion each, of which three had assets of more than US\$10 billion each. Moreover, in most GCC countries, the value added of financial services currently accounts for about 10 percent of non-oil GDP.

Most of the region's banks were originally branches of major international banks until the mid-1970s when foreign banks were required to transfer ownership to domestic residents; at present, foreign banks are permitted only minority ownership of local banks. All GCC countries have moratoria on the licensing of new banks. They have recently agreed to permit local banks to establish branches in other GCC member countries. Although private ownership of banks is predominant in many GCC countries, government equity participation in financial institutions is widespread and a large number of banks and specialized financial institutions are fully controlled by the public sector. Moreover, in many cases, private sector ownership tends to be concentrated in a few shareholders.

Licensing and foreign ownership restrictions may have resulted in a relatively high degree of banking concentration. In Saudi Arabia (1996) and Oman (1994), the three largest banks accounted for approximately one-half of total bank assets, equity, and loans, with one bank accounting for approximately one-fifth of assets and equity. These ratios are even higher in Kuwait, where the three largest banks accounted for nearly 80 percent of the banking sector's total assets and equity in 1995, while the largest single bank accounted for one-third.

By traditional measures of financial deepening, the region is well monetized. In most countries, the ratio of money supply to GDP is high, ranging between 50 percent and 90 percent, and has been relatively stable over the years reflecting the banking sector's ability to attract increased deposits (Chart 2). The extent of monetization and the banks' success in mobilizing longer-term financial assets are also evidenced by low ratios of currency and short-term deposits to broad money (27 percent on average in 1996), and of ratios of currency-to-deposit (average of 10 percent in 1996). The high degree of monetization is a testament to the increased confidence in banks and the ability of the latter

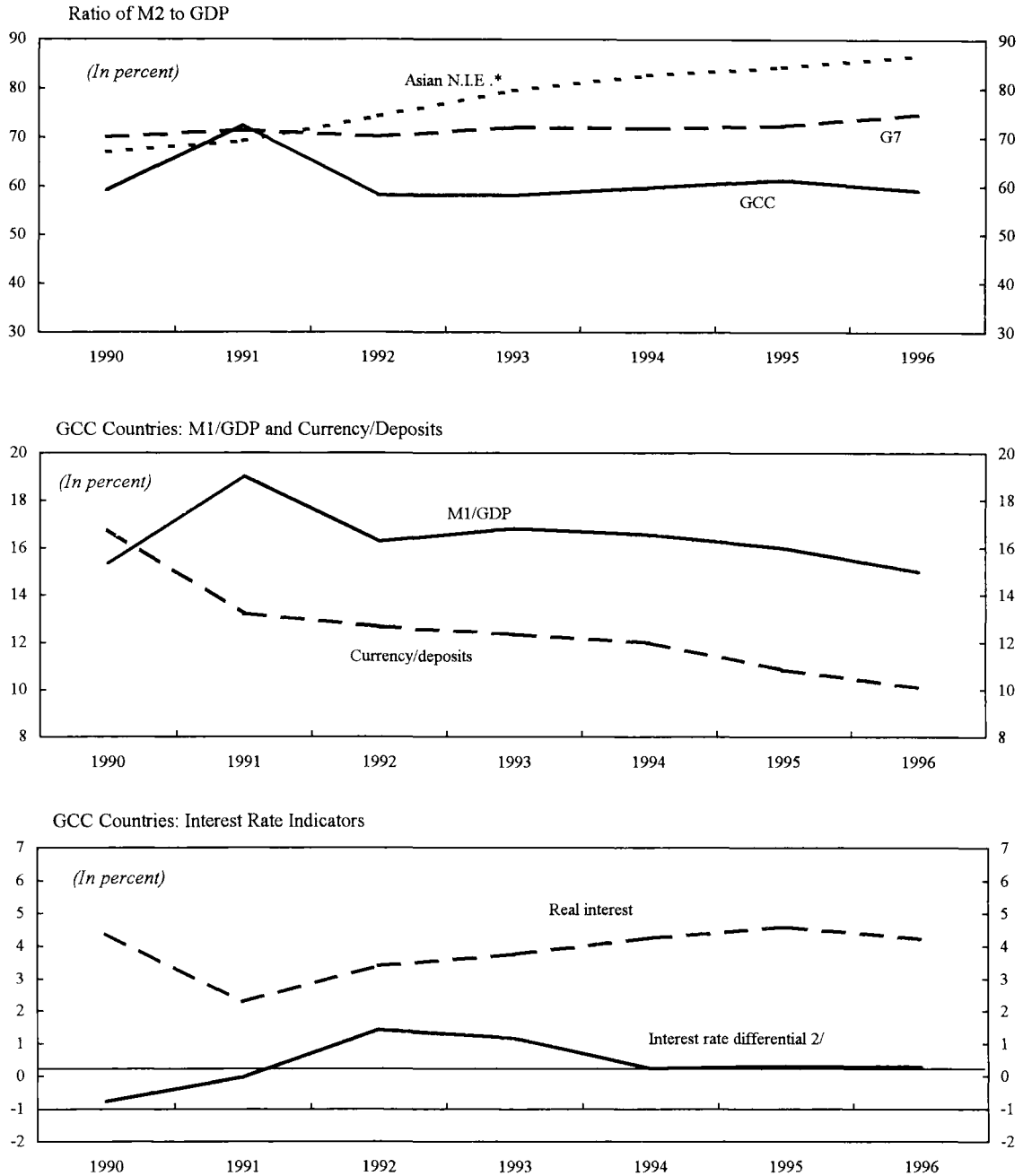
Chart 1. GCC Countries: Banking Sector Indicators



Sources: Data provided by the authorities; Middle East Economic Digest (MEED); MEED MONEY.

1/ Assets are not risk-weighted.

Chart 2. GCC Countries: Financial Indicators, 1990-96 1/



Sources: Data provided by the authorities; International Monetary Fund, *International Financial Statistics*; and *World Economic Outlook*.

1/ All indicators are regional averages.

2/ Interest rate differential between domestic interest rate and similar maturity U.S. dollar LIBOR rate.

* Newly industrialized economies of South East Asia.

to utilize advanced consumer banking technologies. Usage of automated teller machines and point-of-sales technologies is widespread; tele-banking services and the usage of credit and debit cards are expanding. Such technologies have been supported by advanced computerized payment and settlement mechanisms.

Reflecting the relatively limited—albeit expanding—share of the private sector in economic activity in the GCC countries, bank lending to the nongovernment sector has remained modest in most countries.³ Notwithstanding problems of private/public sector distinctions in the statistical accounts (especially in monetary data), credit to the nongovernment sector averages less than 40 percent of GDP for the GCC countries and less than two-thirds of total credit, shares that are lower than those in the G-7 industrial countries and the fast growing economies of East Asia (Chart 3). By contrast, the region's banks have been generally active lenders to the government sector, with Kuwait and Qatar having the highest shares.

The relative importance of lending to the government sector reflects the increased recourse to bank borrowing to finance the large fiscal deficits that emerged as a result of the Gulf crisis and the subsequent decline in oil prices, as well as other factors such as the floating of government bonds to finance payments to farmers in Saudi Arabia, the taking over of bad debts by the Kuwaiti government under the Debt Collection Program (DCP), and the financing of large gas and petrochemical projects in Qatar, to mention only a few examples. While the share of credit to the private sector has been increasing since 1990 in all GCC countries, part of the private sector's financing needs (especially for investment) has been met either through liquidation of private assets held abroad, or through borrowing from foreign banks and off-shore banking units.

Bank lending continues to be of a predominantly short-term nature and is heavily concentrated in traditional sectors, such as trade, and construction and real estate activities, which together, account for about 30–45 percent of the total, while the industrial sector's share has generally been less than 10 percent. However, the GCC banking sector has recently experienced a marked increase in personal credits, the share of which in total credit has reached 30–40 percent in some countries. This reflects high demand for consumer loans by an increasingly young and wealthy population, as well as a rising demand for bank loans to finance equity purchases.

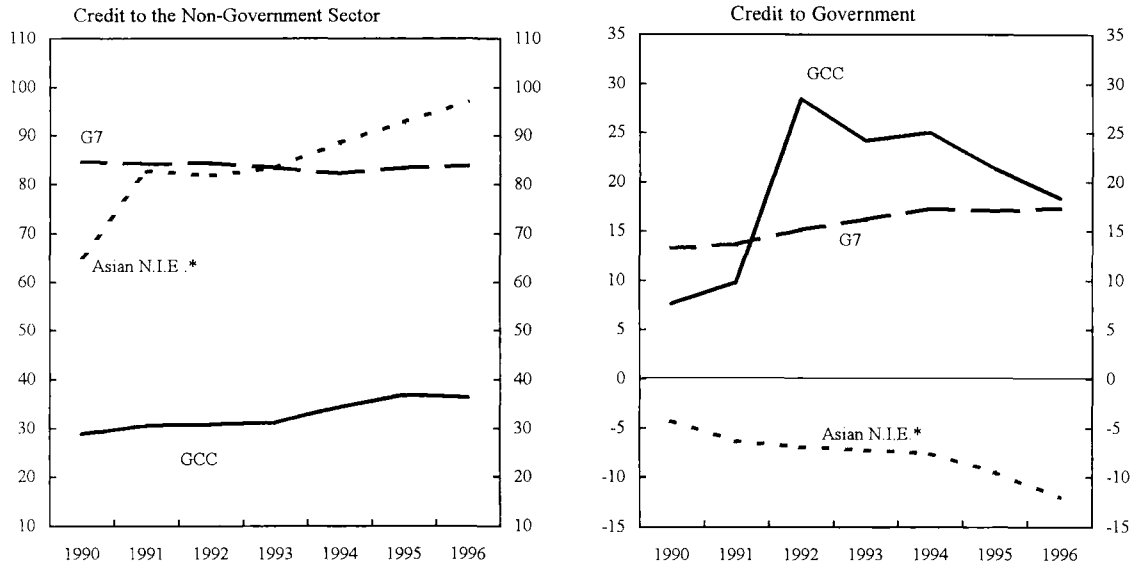
B. Framework and Instruments of Monetary Policy

The GCC countries have open economic systems with free movements of capital and fixed exchange rate arrangements. This institutional setting has implications for the conduct and the effectiveness of monetary policy, which is geared toward maintaining

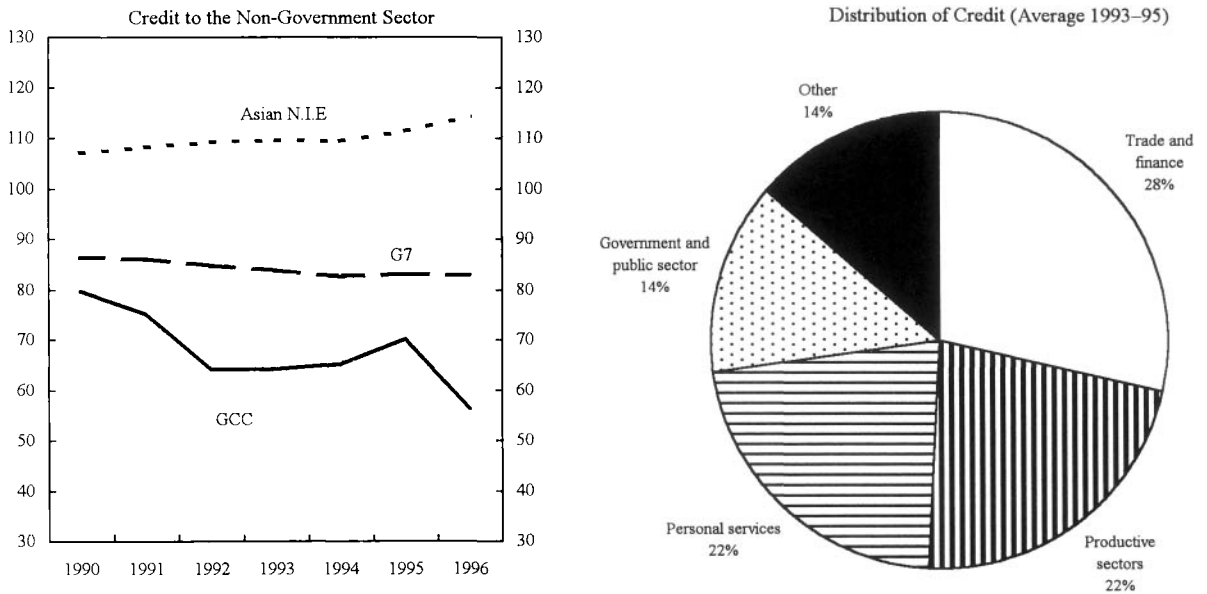
³Since credit to public enterprises is usually aggregated with credit to the private sector, it is more accurate to refer to credit to the nongovernment sector.

Chart 3. GCC Countries: Credit Indicators, 1990-96 1/

(Ratios to GDP)



(In percent of total credit)



Sources: Data provided by the authorities; International Monetary Fund, *International Financial Statistics*; and *World Economic Outlook*.

1/ All indicators are regional averages.

* Newly industrialized economies of South East Asia.

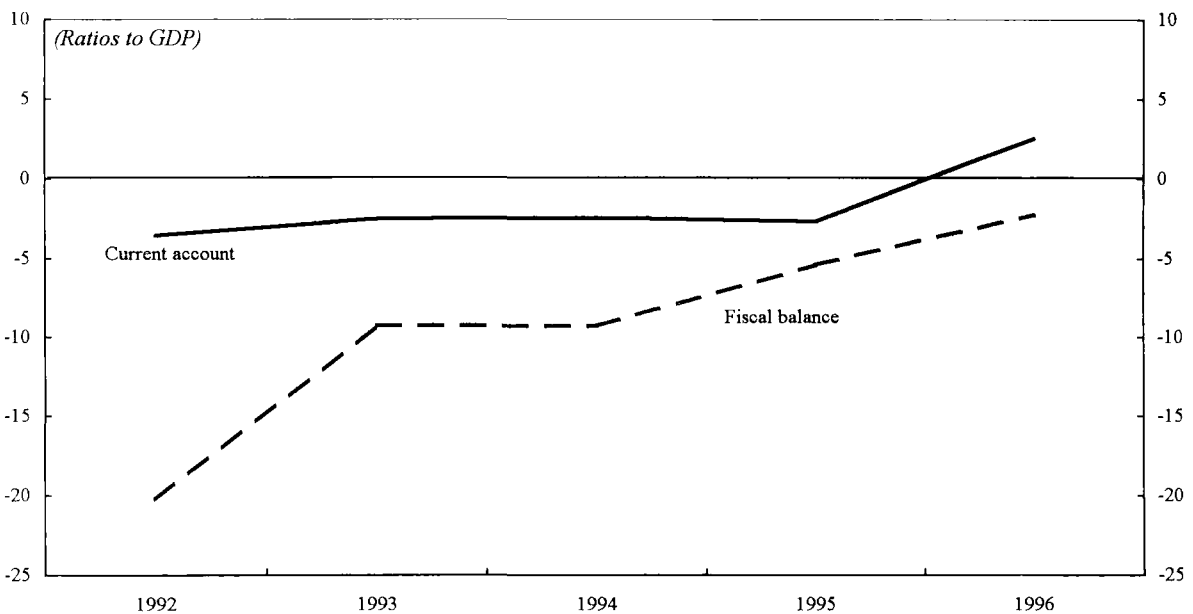
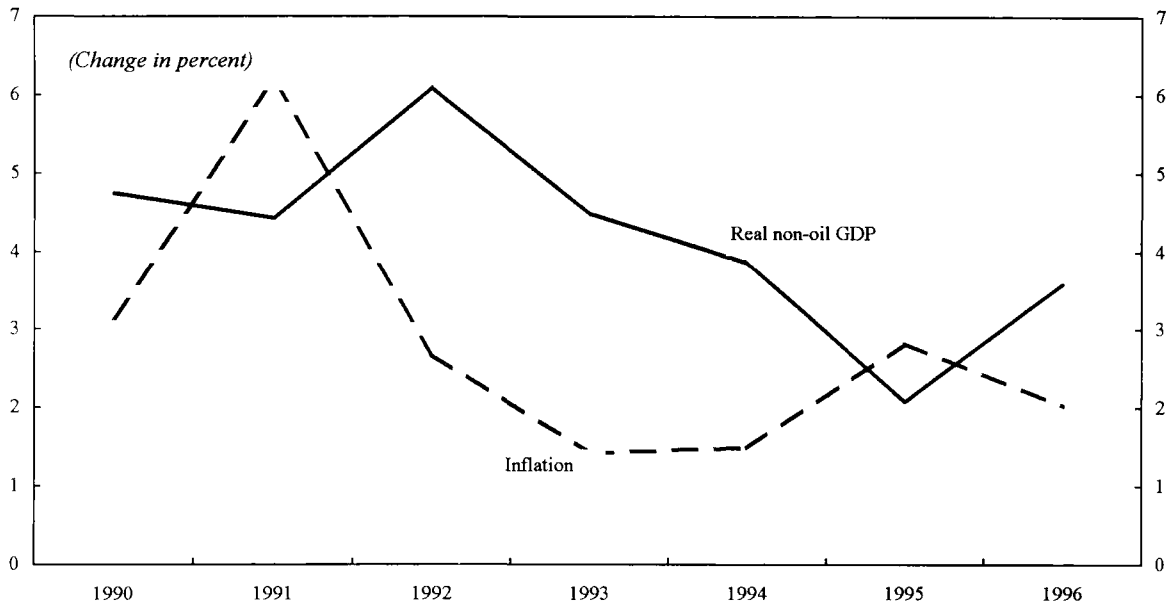
stability of the exchange rate arrangements.⁴ In this framework, demand pressures, created mainly through fiscal deficits, have tended to be absorbed through the balance of payments, thus mitigating the monetary impact of deficits. Thus, during 1985–90, money supply grew by only an average 2.9 percent a year, despite relatively high fiscal deficits. Since then, government deficits have been reduced in all the GCC countries through fiscal consolidation efforts, which have eased the pressures on the balance of payments while permitting money supply to continue to grow at moderate rates (averaging 4 percent a year over the past five years). Under these conditions, the scope of monetary policy is limited to primarily regulating short-term liquidity and smoothing out volatility arising from exogenous shocks, while the burden of adjustment falls on fiscal policy.

The use of instruments of monetary policy by GCC central banks has varied in recent years with increasing reliance being placed on market-based instruments. In Bahrain and Kuwait, the authorities use open-market operations (purchases and sales of government securities, repos of government securities); open-market-type operations (outright sales in the primary market); and central bank-lending operations (overdraft window, overnight lending). The Central Bank of Kuwait also has a “liquidity scheme” in the form of one-month deposits with the central bank at a competitive interest rate, which is used when the ceiling on treasury bills and bond issues is reached. The U.A.E. Central Bank relies mainly on purchases of foreign exchange, although it uses a swap facility and transactions in central bank certificates of deposit. The Qatari authorities also operate a discount window facility. The main instruments used by the Saudi Arabian Monetary Agency (SAMA) to smooth out liquidity and interest rate movements are repo operations in government bonds. Other instruments used by SAMA include foreign exchange swaps and the placement of government deposits in different banks. However, in all countries, the lack of deep and well-structured secondary markets for government paper has hampered the further development and effectiveness of open-market operations. Finally, recourse to certain direct instruments of liquidity management has been maintained mainly for prudential purposes, in the form of mandatory loan-to-deposit ratios, and ceilings on consumer credit and interest rates.

Owing to the existing fixed exchange rate arrangements and the freedom of capital movements, interest rates in the GCC region have usually closely tracked interest rates on U.S. dollar-denominated assets—except for temporary deviations in response to exogenous shocks, and upward deviations explained by transaction costs and risk factors. The recent strengthening of the region’s macroeconomic balances has led to a further decline in interest rate differentials in most countries (Charts 2 and 4). While most GCC countries had maintained restrictive regulations on interest rates in the early 1970s, since then, there has been a progressive easing, with interest rates now largely determined by market forces in most countries. Nevertheless, some restrictions remain in a few countries, such as

⁴Most GCC countries’ currencies are de facto or de jure pegged to the U.S. dollar, except the Kuwaiti dinar, which is pegged to a basket of currencies.

Chart 4. GCC Countries: Macroeconomic Indicators, 1990–96 1/



Sources: Data provided by the national authorities.

1/ All indicators are averages for the region.

ceilings on deposit rates and caps on lending rates or on consumer loans. Some of these ceilings are either nonbinding or affect a small share of overall financial transactions. Because of the region's low rates of inflation, interest rates have generally been positive in real terms, with real rates ranging in most countries between 3 percent and 5 percent. Most GCC banks have a deposit interest rate yield structure with rates that fluctuate across maturities and provide a premium for longer-term deposits; however, the term structure of lending rates has remained generally less wide.

C. Banking Soundness, Regulation, and Supervision

Since the early 1980s, the GCC financial sectors faced a number of difficulties, including the 1982 crash of the informal stock exchange (*Souk Al-Manakh*) in Kuwait, and the property market collapse of the 1980s. With the drop in international oil prices and the cut in government expenditures in the mid-1980s, a number of banks faced difficulties as sizable loans turned nonperforming. However, since then, banks have increased their "general" provisions and capitalization in response to the introduction of stricter prudential regulations, and also partly reflecting improved management practices and higher profits. Banking problems have also been resolved through mergers and closures and, in some cases (notably Kuwait), government assumption of bad debts.

A key factor behind the improvement in the region's bank soundness indicators has been the strengthening of prudential regulations and central bank supervision. All GCC countries have established provisioning and capital adequacy requirements that are generally stricter than those prescribed under the Basle rules. Moreover, all central banks carry out on-site inspections and off-site analysis of banks. While prudential regulations vary across countries (e.g., foreign currency exposure limits; credit concentration ratios; limits on consumer lending; and liquid asset ratios), few countries have guidelines for bank management standards, and only a few systematically regulate and supervise nonbank financial activities (e.g., derivatives; Islamic banking; mutual funds; and brokerage houses). International accounting and risk evaluation standards and early warning systems for the identification of bank difficulties exist in only a few countries. Some countries have introduced a deposit insurance scheme, while others are preparing the necessary regulations.

Partly as a result of the strengthened regulatory and supervisory standards, the GCC banks tend to be well capitalized (in absolute terms and when measured against the Basle requirements). For instance, the region's (simple) equity-to-asset ratio ranges between 7 percent in Bahrain and 13 percent in the United Arab Emirates. When assets are risk weighted, the capital adequacy ratios reach levels that are among the highest in the world (22 percent in Saudi Arabia and 21 percent in the United Arab Emirates); these ratios partly reflect the large share of lending to government, which has a low risk weight. However, the situation of individual institutions with regard to capitalization varies substantially.

D. Nonbank Financial Intermediation

Despite the moratoria on new (and foreign) banks, the financial structure of the GCC countries has diversified over time with most of the expansion accounted for by branching activities, money changers, and investment offices. Most GCC countries are home to investment banks, insurance companies, foreign exchange- and money-brokers, representative offices of foreign banks, and general “financial service units.” Investment banks engage primarily in securities underwriting, investment advice, and portfolio management. Money brokers are typically affiliates of established international firms and facilitate transactions in financial instruments (primarily, negotiable certificates of deposit and foreign exchange). Representative offices are essentially agencies set up by foreign financial institutions to gather economic, financial, and commercial information for their principals and to provide general assistance to local and regional customers of these principals. Some countries (e.g., Bahrain) have recently licensed mutual funds that are separate from banks.

Government securities issued by GCC countries are mostly held by banks, pension funds, and specialized institutions. There are no active secondary markets in these securities and there are usually limits on bank purchases of treasury bills. With the aim of strengthening secondary markets, some GCC commercial banks have been allowed to issue negotiable certificates of deposit (CDS) (Oman in 1994, and the United Arab Emirates—dollar-denominated CDS—during 1993/94).

All GCC countries possess large public sector specialized banks focused on sectoral lending at below market interest rates (e.g., agriculture; industry, and small- and medium-sized companies). Their operations are financed by budgetary transfers rather than deposit-taking activities.

One area that has recently experienced rapid growth relates to Islamic financial operations. Islamic banks and Islamic investment institutions have now over US\$70 billion of assets worldwide. The origin of such activities in the GCC countries dates back to the early 1970s when institutions were set up with the objective of recycling the oil-related surplus in accordance with the Islamic *Sharia*. Early operations focused on trade-related financing and leasing operations and tended to mobilize funds of individuals who shunned interest-bearing bank accounts. By the early 1990s, many GCC commercial banks (as well as nonregional institutions) had started Islamic banking operations. A number of new Islamic investment funds have been launched during the past two years to manage wide-ranging portfolios of shares in companies whose activities are compatible with Islamic principles. Returns on Islamic operations have, so far, been high. A major policy issue in this regard is how to strengthen regulation and supervision of such activities (Box 1).

Equity markets in the region are expanding as the scope for private enterprise is increasing and demand for equity investment is rising (Chart 5 and Box 2). Saudi Arabia’s equities market is by far the largest in the Arab world in terms of capitalization, but transactions are exclusively handled by the banks and trading is relatively modest. The Kuwait Stock Exchange is the most active in the GCC area and one of the largest in the

Box 1. Regulation and Supervision of Islamic Banks

The growing size of Islamic finance raises the important issue of how best to regulate and supervise Islamic banks.¹ In general, depositors in such banks share in the risk of the investment that their deposit is financing; neither the deposit's principal nor its return is guaranteed. This mode of operation suggests that Islamic banks need close supervision and regulation.

Islamic banks are subject to the same risks facing conventional banks (adverse shocks; mismanagement; etc.). These risks have effect on solvency and profitability and could have a systemic impact on the economy.

Since Islamic banks are under no legal requirement to safeguard the depositors' base, they have no incentive to hold collaterals. This suggests that such banks can be more risk-prone than conventional banks.

Islamic banking operations involve complex modes of financing, which are accentuated by shortages of relevant skills, and the absence of uniform accounting and tax standards.

Most "best practices" developed by the Basle Committee are broadly appropriate for regulating and supervising Islamic banks. In addition, such banks could conceivably be subject to lower liquidity requirements than conventional banks. However, there are three areas where stricter rules may be required.

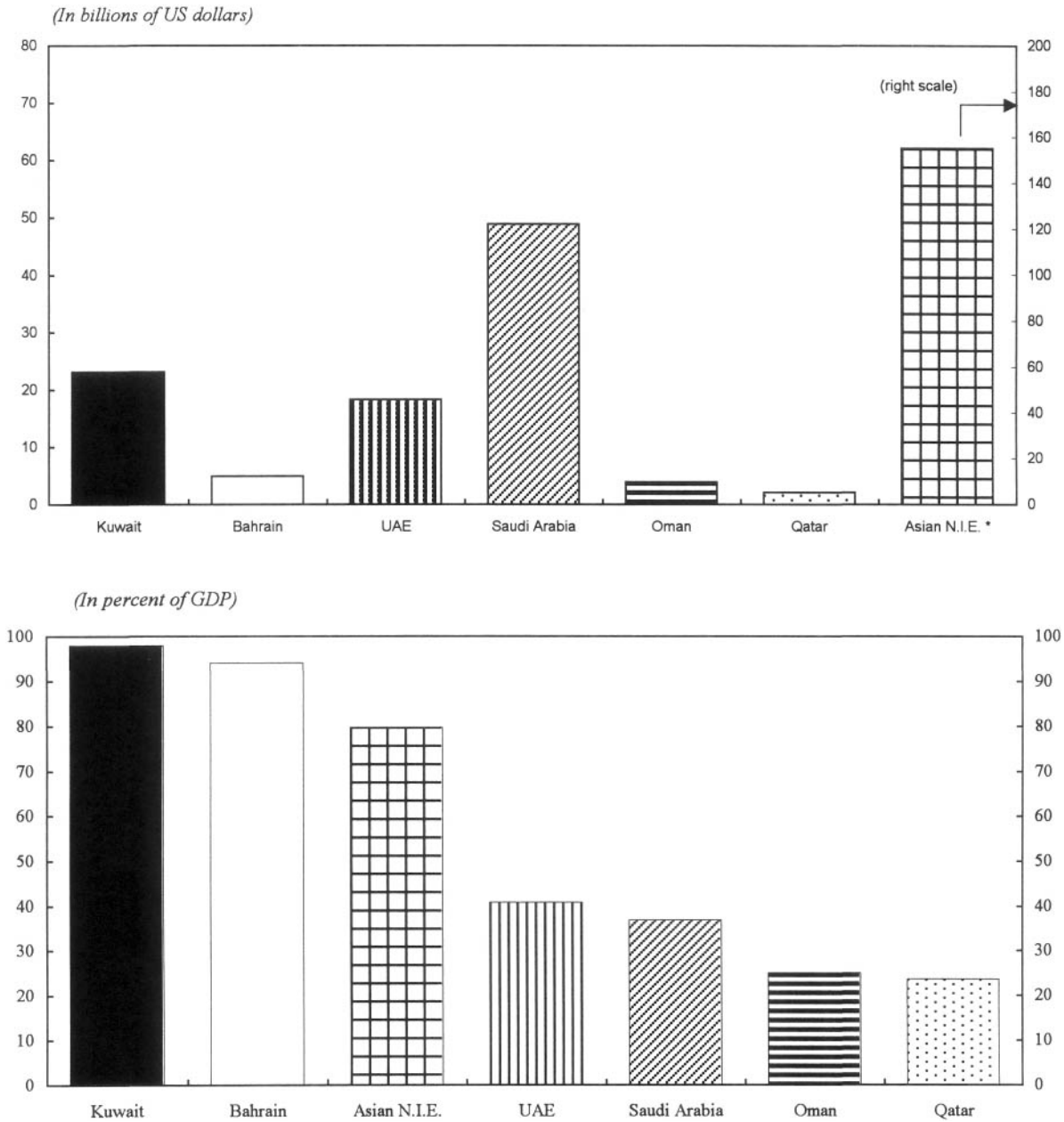
Islamic banks' incentive to engage in risky activities and the absence of an incentive to use the "security buffer" of a collateral suggest the need for higher risk-weighted capital asset requirements.

Stricter information disclosure requirements and close monitoring are also important since deposits are not protected and depositors tend to allocate funds across banks according to their risk preferences.

Islamic banks face a strong "investment risk" since projects are the main source of return for depositors and given banks' reduced use of collateral. Regulators need to ensure that banks have adequate capabilities for project evaluation, appraisal, selection, auditing, and monitoring.

¹This box draws on Errico (forthcoming).

Chart 5. GCC Countries: Equity Market Capitalization (1996)



Sources: Data provided by the authorities; International Finance Corporation, "Emerging Markets Factbook;" and *Middle East Economic Digest*.

* Newly industrialized economies of South East Asia.

Box 2. The Main GCC Equity Markets

Bahrain. Capitalization in the Bahraini Stock Exchange amounts to 100 percent of GDP; however, the number of traded companies stands at only 37. Limited trading in the market by non-Bahrainis is sanctioned (especially GCC residents and by non-Bahraini residents in Bahrain).

Kuwait. The Kuwait Stock Exchange (KSE) has existed since the early 1970s. Its capitalization amounts to slightly above 80 percent of GDP with 66 companies traded; bonds are also traded on the market, but in low volumes. The volume of trading at the KSE is twice as large as in other GCC countries taken together, but is second to Saudi Arabia in terms of capitalization. In 1996 and early 1997, activity on the KSE expanded, as large shares of government enterprises were sold to the private sector. About 60 percent of transactions are executed by institutional investors. The KSE is supervised by the Stock Exchange Commission consisting of 11 members appointed by the Ministry of Commerce, the Kuwait Investment Authority, the Central Bank of Kuwait, and the chamber of commerce. To facilitate transactions and encourage participation of foreigners, the KSE has established two international clearing schemes (Kuwait-Egypt-Lebanon and Kuwait-Bahrain-Oman).

Oman. The Muscat Securities Market (MSM) was established in 1989. Its capitalization in 1996 stood at 172 percent of GDP with nearly 100 companies traded. The removal of restrictions to GCC investment in 1992 contributed importantly to the increase in capitalization of the MSM. Recently, Omani companies were allowed to take in foreign investors without jeopardizing their tax status.

Saudi Arabia. Saudi Arabia's equity market is over the counter (OTC) where commercial banks have been granted the exclusive right to trade for their clients. At end-1996, total capitalization was about US\$40 billion—a level larger than all of the Arab stock markets put together—although only 70 companies are traded. There is a large concentration of holding of shares and of market capitalization, with the 10 largest companies accounting for 60 percent of total capitalization in 1993 compared to 15–20 percent in developed economies and 30 percent in emerging markets. While GCC nationals can trade in the Saudi equity market, restrictions apply to foreign (non-GCC) participation. However, non-GCC residents can invest in the stock market through mutual funds. In March 1997, the Saudi American Bank launched the Saudi Arabian Investment Fund (SAIF), a closed-end fund that is listed on the London Stock Exchange and is open to institutional investors.

Arab world in terms of volume of trading. Stock exchanges in Oman, Qatar, and the United Arab Emirates are relatively new. In general, the GCC stock markets are well capitalized with ratios to GDP (1996) ranging between a high of 98 percent in Kuwait and a low of about 24 percent in Qatar. However, both the number of traded companies and the turnover ratios are considered low compared with stock markets in industrial countries and in rapid growing emerging markets. The number of listed companies is also relatively low.

The region's equity markets face a number of important constraints: there is a lack of brokers and market makers; foreign access to the markets is generally restricted to GCC nationals; a number of large corporations remain under government control; and there is a general weakness in transparency requirements and the provision of information. Also, private shareholders have been reluctant to move away from traditional bank financing and open their companies' capital to new investors. These issues are discussed in Section IV.

III. Main Challenges Facing the GCC Financial Markets

A key challenge facing the financial sector in the GCC countries is to respond to the new demands arising from the strengthening of the role of the private sector and the governments' gradual disengagement from economic activity. Fiscal retrenchment is likely to continue for the foreseeable future, and the private sector is expected to be the main engine of growth. Under this scenario, large investment projects in the petrochemical industry, in ports, power generation, airline transportation, utilities, and health care will have to be carried out with private sector participation and financing. External borrowing may be an option, as is currently the case for a number of large gas-related projects in Qatar, but there are obvious limitations to this policy, including mainly the reluctance of governments in the region to accumulate external liabilities. Therefore, there will be strong incentives to mobilize resources from the domestic market (including through the issuance of long-term financial and corporate paper) and to encourage foreign direct investment. In any case, domestic financial intermediaries will be under pressure to compete for this large and lucrative business, or run the risk of being marginalized.

It is clear that for GCC financial institutions to play an important role in this changing environment, they would have to strengthen further their deposit base and increase their capital to absorb the risk emanating from financing megaprojects. This, in turn, may lead to mergers among banks or associations with regional or international banks. More important, financial markets would have to gain depth and sophistication both at the national and regional levels to allow for the mobilization of large financing packages at competitive conditions. This can be achieved through concerted efforts to increase the volume and attractiveness of corporate bonds and government paper, encourage equity investment by pension funds and by small savers through mutual funds, and make further headway in reforming stock markets. In all these areas, efforts should focus on establishing a regional financial market in which saving and investment flows can be pulled together under homogenous and market-determined conditions.

Another challenge facing the GCC financial systems is to further open up to foreign participation and competition. While the recent good performance of the region's banks was largely due to improved overall economic conditions and enhanced efficiency in the provision of financial services, it is clear that the prevalence of quasi-monopolistic situations and insufficient competition from foreign banks had also been an important factor. Opening up the financial sector to foreign investment, be it in banks, in mutual funds, or in investment advisory services, would add depth to the GCC markets, help strengthen management practices and the provision of financial services, foster the transfer of technology and know-how, and through increased competition, help raise productivity and lower the cost of financial services.

A related issue is the need for GCC financial institutions to respond to the demand for new financial services by domestic clients. GCC nationals are increasingly taking a more active interest in innovative financial instruments that can help them manage their savings or provide them with appropriate investment tools. Wealthy individuals and corporations have had access to these services either locally or through international banks; however, in the next few years, strong demand for these services is likely to emanate from a wider segment of the population as evidenced by the public's enthusiastic response to initial public offerings of shares at GCC stock markets. To a certain degree, the GCC financial intermediaries have been already developing fee-based services, including mutual fund investments, but they would need to strengthen their ability to meet the demands of a larger segment of the population at competitive conditions.

Increased diversification of instruments, of market participants, and intensified competition among financial intermediaries will be beneficial to the region's economies by enhancing efficiency and lowering the cost of financial services. Diversification, however, will also involve added risks that should be minimized through adequate prudential regulation and bank supervision, supported by more stringent international standards of dissemination of information and transparency.

Finally, financial sector reform can play a key role in meeting the challenge of maintaining macroeconomic stability in a changing economic environment. Reforms aimed at deepening domestic capital markets could provide the authorities with added instruments of monetary management and more room for maneuver in enhancing the effectiveness of monetary policy. Obviously, fiscal policy will continue to be key in maintaining financial stability and preserving the credibility of the exchange rate arrangements. In recent years, fiscal deficits in all GCC countries have been reduced and government spending has been brought under control (Chart 5). Inflation rates have been maintained below those in industrial countries, and exchange rate variability has been virtually nonexistent. While the region's economies are likely to remain dependent on volatile oil revenue for many years to come, government spending will need to be brought under control, and ongoing privatization and deregulation efforts must be enhanced to help decouple non-oil activity from government stimulus and accelerate economic growth. In this respect, privatization and the development of domestic capital markets are closely interrelated and must be carried out in a coordinated manner.

IV. Remaining Reform Issues

As highlighted above, the GCC countries have already completed most of the crucial stages in their gradual process of liberalization and reform of their financial sectors. Nevertheless, there are some outstanding issues in the reform process and further measures are needed to reinforce stability and efficiency within the region's changing economic and social environment. Key reforms should aim at strengthening market forces, reducing government participation in financial intermediaries, opening up the financial sector to foreign competition, strengthening bank soundness by enhancing the regulatory and supervisory framework, and developing the capital markets.

A. Strengthening Market Forces

Efficiency could be raised through lifting the few remaining obstacles that exist in some countries to the free market determination of interest rates and the allocation of financial resources; taking measures to promote further market competition and integration; and diversifying financial instruments. Remaining regulations on maximum lending rates and spreads (Kuwait and Oman) and deposit rates (Qatar) would need to be eliminated as soon as possible. Although apparently nonbinding at the present time, the elimination of such regulations would have an important signaling affect and would ensure the free working of the markets, should conditions change.

To enhance competition among financial institutions, the authorities in all GCC countries must ensure that transparent rules govern the entry and exit of new banks and other financial institutions, including the possibility of establishing new private banks and transforming other financial institutions, such as finance companies, into banks with a full array of financial services. Mergers and takeovers of banks and other financial institutions could be encouraged to strengthen the financial system without hindering competition; and, as needed, the closing of banks that become insolvent should be permitted. In the long run, this would allow the structure of domestic financial systems to be determined mainly by the markets and not by the regulators. At the same time, the authorities would need to strengthen and enforce antitrust regulations designed to maintain the contestability of the financial markets, and remove remaining regulations that require financial institutions to specialize in certain activities. Any degree of specialization by institutions should develop as a result of the choices made by the individual institutions.

In a market-determined financial system such as that emerging in the GCC countries, the panoply of financial instruments available to market participants can be expected to evolve in line with the needs of the customers for greater diversification of savings and borrowing instruments, and as a result of competition among financial institutions. However, the diversification of instruments can also be affected by the behavior of central banks and regulatory agencies. For instance, a tightening of central bank refinancing facilities and an expansion of market-based instruments to supply and withdraw reserves may be useful not only to control monetary expansion but also to

encourage banks to trade among themselves in the interbank market. The activation of the interbank and other money markets can be promoted by establishing prudential norms, improving the payment systems, and developing efficient mechanisms to distribute and trade government securities. In turn, the activation of interbank and other money markets can enhance the mechanisms for the efficient market determination of interest rates and the conduct of monetary policy through indirect instruments.

The GCC countries, particularly Oman and Qatar, need to complete the unfinished business of conducting monetary policy solely through the use of indirect instruments. The authorities can help this process by strengthening the efficient functioning of money and capital market mechanisms, including developing a primary dealers system for the trading of government paper in the secondary market, which can facilitate the use of open-market operations by the central bank as the principal instrument of monetary policy. This could also help improve public debt management.

B. Reducing Government Ownership and Increasing Foreign Participation

Integration of the GCC financial systems with the rest of the world has advanced rapidly in recent years as a result of the deregulation of domestic interest rates and the removal of remaining capital controls, which has facilitated free private capital movements. This has resulted in a progressive equalization of domestic interest rates with U.S. dollar interest rates. At the same time, it is often argued that rising profits do not reflect an absence of banking competition or the effects of the moratoria on new bank entry. Given the costs of setting up a bank, there is a natural tendency toward consolidation; consequently, according to this view, the GCC is not “under banked” and the markets do not require additional banks. However, more than the number of banks or concentration ratios, dynamic competition can be gauged by the effective possibility of entry and exit of financial institutions, without which bank profits and the cost of financial services would be determined under quasi-monopolistic conditions.

The process of integration of the GCC financial systems could be further promoted by allowing greater foreign participation in the ownership and management of financial institutions. For this to be achieved in an orderly manner, the authorities of the GCC countries could contemplate implementing this policy in two stages. The first stage would commence by publicly announcing the intention of the authorities to permit greater foreign competition starting at some future date several years into the future. During the intervening period, existing institutions would be encouraged to prepare themselves through restructuring, takeovers, and mergers to face the competition of foreign entities. As part of this preparation, the authorities would have to be ready to “commercialize” publicly owned banks and reduce government participation in others through a strong program of divestiture of their financial intermediaries. This policy would ensure a more level playing field among financial institutions; assist in encouraging new private entrants, both domestic and foreign; further enhance competition; and promote financial innovation and help mobilize domestic financial savings. During the second stage, the authorities would

allow freer entry of foreign banks either de novo or through purchasing stakes in domestic banks. Foreign investors should be allowed to participate in financial institutions on equal terms as domestic investors.

Allowing for greater participation by foreign institutions in the domestic financial system would encourage acquisition of technology and know-how and create competition through new entry and exit of financial institutions. Restrictions on some types of foreign participation in domestic financial institutions, as well as in portfolio investment through the stock exchange, have been somewhat reduced in some GCC countries in recent years, particularly for investments coming from other GCC countries. Also, restrictions on investment have been eased for expatriate residents in some GCC countries; for instance, in Kuwait, the United Arab Emirates, and other countries, expatriate workers can invest in equities through mutual funds. However, further progress is needed, especially in opening up the financial sector to competition outside the GCC area, and in developing the equity markets. The commitments made by a few GCC countries with respect to financial services under the WTO General Agreement in Trade and Services (Bahrain, Kuwait, the United Arab Emirates) need to be embraced by all other GCC countries and carried out to a higher level of open access. A first step toward an eventual universal opening of the GCC financial services sector could be a single GCC banking license. This would complement the recent agreement to allow GCC banks to open branches in all the member countries.

C. Strengthening Bank Soundness

In recent years, the GCC countries have strengthened the soundness of their financial systems through stepped-up enforcement of prudential regulations and accounting systems in line with international standards; provisioning for bad loans; and recapitalization of weak institutions. All the GCC countries now require banks to comply with the Basle Committee's minimum capital standards. Substantial progress has been made in overcoming the difficulties related to the nonperforming loans inherited from past shocks to the system, including the property market collapse of the 1980s, the 1990–91 regional crisis and, in the case of Kuwait, the failure in 1982 of the parallel Souk Al-Manakh stock exchange. Nonetheless, in some cases, the public sector has borne the cost of recapitalization, resulting in moral hazard concerns, given the laxity in the application of the ultimate market sanction, that is, the exit of insolvent financial institutions.

A number of important regulatory issues remain to be addressed fully in most GCC countries.

- Providing prompt and useful information to market participants has become an important matter in international discussions to ensure the efficient working of financial institutions, particularly in the emerging markets. Progress has been made in this area in the GCC countries; for instance, banks in Saudi Arabia and Kuwait already publish regularly audited accounts, although sometimes with a certain delay. All banks and other financial institutions in the GCC countries should be

required to release at least interim and audited annual statements within a prescribed reasonable time period and in accordance with international standards.

- The introduction of a simple, transparent, and limited deposit insurance system in those countries lacking such a system can help resolve the trade-off that normally exists between the need to protect small depositors and avoid bank runs, on the one hand, and the need to minimize the costs to the government of bank failures and avoid the moral hazard problem caused by unlimited bailout of depositors, on the other hand.
- Ensuring that the legal and judiciary systems can effectively help enforce contracts and allow banks to collect debts should be a major undertaking in the GCC countries. By and large, the judiciary system in most of these countries has hindered collection of bad debts and liquidation of collateral, because of delays, cumbersome procedures, and bias in favor of debtors. Moreover, in some countries, the courts have been ambiguous regarding the application of Sharia law to the payment of interest for bank claims. These problems need to be resolved promptly to ensure that the expected expansion of bank credit to the private sector does not lead to an increase in nonperforming loans, which would create inefficiencies in credit distribution and risk eventual bank failures. The law and the courts can help prevent a permissive credit culture.
- The harmonization of the financial sector regulatory system in the GCC countries, while maintaining consistency with internationally accepted standards, is a major objective of the authorities in the GCC countries. Much has been accomplished in terms of standardizing prudential regulation and supervision, where explicit international standards are available. Nevertheless, more attention needs to be paid to ensure that the regulatory and supervisory framework covers all financial institutions, including, in particular, Islamic banks, insurance companies, and securities markets. Wherever there is more than one regulatory authority, adequate coordination among agencies should be ensured.
- Although the supervisory systems in the GCC countries have improved notably in recent years, there is still need for further enhancements, particularly in the case of emerging institutions (for instance, capital markets) and special institutions (for instance, Islamic banks). With regard to Islamic institutions, the authorities must ensure that they maintain adequate liquidity matched to servicing obligations. This can be a particularly tricky issue in light of the often expressed view that the interbank market is to be avoided by Islamic banks; however, other countries' experience (e.g., Malaysia) demonstrates that innovative instruments could be designed to facilitate Islamic banks' access to interbank markets. The principles of consolidated supervision of financial institutions enunciated by the Basle Committee on Banking Supervision remain to be fully implemented in some of the GCC countries. Also, there is a need to improve financial surveillance and early warning systems and inspection procedures, as well as to establish a credit risk bureau or evaluation unit in GCC countries that have not already done so. Further

work will be needed in all countries to update the existing supervisory methods and procedures to conform with the Basle Committee's "Core Principles for Effective Banking Supervision," and with other suggestions for financial stability.⁵

D. Developing the Capital Markets

There is substantial scope in most GCC countries for further development of capital markets, including securities and money markets and stock exchanges. In this way, the range of instruments available to borrowers and savers could be expanded further as they switch from traditional banking instruments to equity and marketable securities.

The region would benefit from the introduction of more fixed-term securities of various maturities (for instance, government bonds and corporate paper). Such instruments would widen the choice of assets available to savers, help deepen secondary markets, facilitate the conduct of monetary policy, and more generally support the development of capital markets.

Country and, especially, regional stock markets could be expanded through standardization and improvement of stock market regulation and supervision, and reform of pension funds. On the supervisory side, the authorities in all countries should remain vigilant to ensure that the private sector borrowing from banks to invest in the stock exchange is in conformity with prudential norms and does not pose risks to the financial system. Capital markets could be further spurred by more ambitious programs of privatization, which are already at various stages of development in Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates, but need further impetus. The expansion of investment banks and investment advisory institutions could provide support to private corporations by offering a range of services that can help them become familiar with securities and exchange markets. In addition, further development of mutual funds in the GCC countries could help attract small savers to equity investment, as well as foreign direct and portfolio investment if the markets were opened to nationals of non-GCC countries.

To increase the supply of equity and improve liquidity, it would be helpful to provide appropriate incentives to share trading in stock markets. First, bringing prudential regulation and supervision in these markets fully up to international standards would be the most promising route to enhance confidence and accelerate growth of these markets. Second, the integration of the national markets into a larger regional market through opening them up to regional trading (as it is already the case in the Bahrain and Kuwait Stock Exchanges) would greatly enhance their growth; this may include cross-listing of shares, coordination of primary issues, common secondary trading arrangements, and coordination of regulatory and supervisory functions. Ultimately, the GCC countries should aim to open up their market to all foreign investors. In some countries, there is need for reform to make it easier for existing private companies to go public. Such measures could

⁵See International Monetary Fund (forthcoming), which also includes the Basle Committee's "Core Principles for Effective Banking Supervision" as Annex I.

help to reduce the existing reluctance of private owners to relinquish individual or family control by selling equity to the public, and also discourage share transactions outside the official stock market on a bilateral basis between investors.

V. Concluding Remarks

The GCC countries face important challenges of improving economic efficiency; diversifying their economic base, given their excessive reliance on depletable natural resources; and more important, providing increased employment opportunities to a growing indigenous labor force. To help achieve their objectives, the GCC countries have reduced financial imbalances and are gearing their medium-term economic policies toward achieving high economic growth through liberalization, deregulation, and promotion of private sector activity. These challenges and the required policy reforms to deal with them have important implications for the GCC financial systems, which will need to adapt to the changing demands of the private sector, support the structural changes in the period ahead, and position themselves to compete in the global economy.

The GCC bank intermediaries are at an advanced stage of development, having already undergone important changes in their size, structure, managerial capabilities, and adoption of modern technology. Nonetheless, domestic money markets remain underdeveloped, stock exchanges face various constraints, and corporate bonds and secondary markets for government paper have not emerged in any significant manner. Moreover, competition remains limited, government equity participation in and control of financial institutions is relatively significant, and there are moratoria on new domestic and foreign banks.

This paper has identified a number of steps toward completing the reform of the GCC financial systems, with a particular focus on the need to strengthen market forces; promote competition and efficiency; open up the financial sector to increased foreign participation; deepen and develop capital and equity markets; enhance prudential regulations and supervision; and upgrade the standards of transparency and the provision of financial information. These reforms will need to go hand in hand with structural reforms, including privatization and deregulation, as well as sustained efforts to maintain financial stability through prudent fiscal and monetary policies. The GCC policymakers are fully aware of these challenges and of the required structural changes, some of which are at various degrees of preparation or implementation. The reform measures outlined in this paper are signposts rather than a detailed road map; the latter will have to integrate other elements of the reform agenda and take into account the political and social dimensions of economic change.

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Labor Market Challenges and Policies in the Gulf Cooperation Council Countries

*Prepared by a staff team led by Cyrus Sassanpour, and
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Executive Summary

- The rapid growth of the GCC economies over the past three decades required large inflows of foreign labor. Expatriate workers currently comprise over one-half of the labor force in all GCC countries and as much as 90 percent in some countries.

- The labor markets in the GCC countries are segmented along several dimensions: between public and private sectors, between nationals and nonnationals, and between skilled and unskilled labor. Market segmentation reflects a number of factors, perhaps most importantly the more attractive wages and benefits as well as job security and social status offered by the public sector to nationals. It also arises from the mismatch between the qualifications of new entrants to the labor market and the requirements of the private sector. The segmentation of the labor market is such that in some GCC countries, as much as 90 percent of the national labor force is employed in the public sector with expatriate workers comprising a comparably high ratio in the private sector.

- In most GCC countries, unemployment among nationals is a relatively recent phenomenon and still of a largely frictional and voluntary nature. In the period ahead, however, the labor market conditions are expected to tighten in view of a rapidly growing number of nationals entering the labor force at the time when governments can no longer act as employers of first and last resorts because of budgetary considerations as well as for efficiency reasons.

- Policymakers in the GCC countries recognize these pressing challenges and have embarked on formulating labor market strategies to create employment opportunities for nationals within a broader framework of fiscal consolidation and structural reforms. The policy instruments to achieve the employment objectives have included an array of measures affecting the quantity (quotas and employment targets), price (wage subsidies to private sector, government wage restraint, and fees and charges on foreign labor), as well as the quality (education and training) of labor.

- Employment quotas and administrative measures may create jobs for nationals in the short run, but such measures offer no permanent solution and could even be counterproductive in the long run. An effective strategy to reduce labor-market segmentation and improve market efficiency would require a mix of measures aimed at increasing the market responsiveness of incomes and employment policies, minimizing distortions created by government benefit packages, and matching the skill profile of the national labor force with the present and future requirements of the private sector.

- The labor market policies in the GCC countries have broader regional implications. Workers' remittances originating from the GCC countries are a major source of foreign exchange earnings and an important source of financing private sector consumption and investment in a number of labor-surplus MENA countries.

I. Introduction

A distinguishing feature of the GCC countries is the significant proportion of expatriate workers in the labor force and the segmentation of their labor markets. Better educated nationals traditionally have been attracted to the government sector because of higher wages and generous benefits; early retirement with pension; and job security and social status associated with government employment. Private sector activity is heavily dependent on expatriate labor, which is readily available on the basis of fixed term, job-specific contracts under the sponsorship of nationals. Wages of expatriate workers are substantially lower than those for nationals at similar skill levels, and there are no significant nonwage benefits in the private sector. The segmentation of the labor market is such that in some GCC countries as much as 90 percent of the national labor force is employed in the public sector with expatriate workers comprising a comparably high ratio in the private sector.

The labor market conditions in the GCC countries are expected to tighten in the coming years, with a rapidly growing number of young, educated nationals entering the labor force at a time when the governments can no longer act as employers of first and last resort. There are budgetary considerations in some countries and all countries are stressing the need to foster private sector activity and employment for efficiency reasons. Indeed, labor market issues are clearly recognized as constituting pressing challenges for policymakers in the period ahead. Accordingly, the GCC governments have already embarked on formulating labor market strategies to create employment opportunities for nationals within a broader framework of fiscal consolidation and structural economic reforms.

Policy instruments available to the GCC policymakers cover a broad spectrum, ranging from market solutions at one extreme to mandatory and administrative policies at the other extreme. The key challenge is to develop an effective strategy to increase the efficiency of the labor market and reduce its segmentation by relying more on market forces and less on mandatory employment policies, which could prove counterproductive in the long run and would raise labor costs.

This paper is organized as follows. Section II establishes the conceptual setting and provides the background. Section III describes the present structure of the labor market in the GCC countries. The evolving labor market challenges and policies in the GCC countries are discussed in Section IV. Section V discusses the impact of labor market policies pursued by the GCC countries on the other countries in the MENA region. Concluding remarks are summarized in Section VI.

II. Economic Structure and Linkages in the GCC Countries

Employment is largely influenced by the pace of economic activity and the labor-intensity and efficiency of production processes. The endowment and the price of labor relative to other inputs (capital, natural resources, and land) determine the optimum mix

between labor and other inputs. Some inputs are internationally mobile (capital, natural resources, and labor); others are nontradable (land). As such, labor market issues in the GCC countries would need to be viewed in the context of factor endowments and relative prices, and in relation to evolving economic growth, structure and linkages. A number of features and developments stand out:

- The GCC countries have a long tradition of liberal and open economic policies and maintain no restrictions on movements of goods, capital, and labor across their national boundaries. Consistent with their resource constraints, the countries have become major exporters of natural resources and capital, and major importers of merchandise goods and labor.

- The oil and gas sectors dominate the GCC economies: oil GDP has a direct relation to oil production and prices, and non-oil GDP is greatly influenced by government expenditure, which itself is a function of oil revenue. Indeed, government expenditure policies have supported economic activity in the past, and the budget has been used as a vehicle to distribute the oil-export proceeds—either explicitly (e.g., employment, wages, and benefits) or implicitly (free or below-cost provision of utilities, health, and education services).

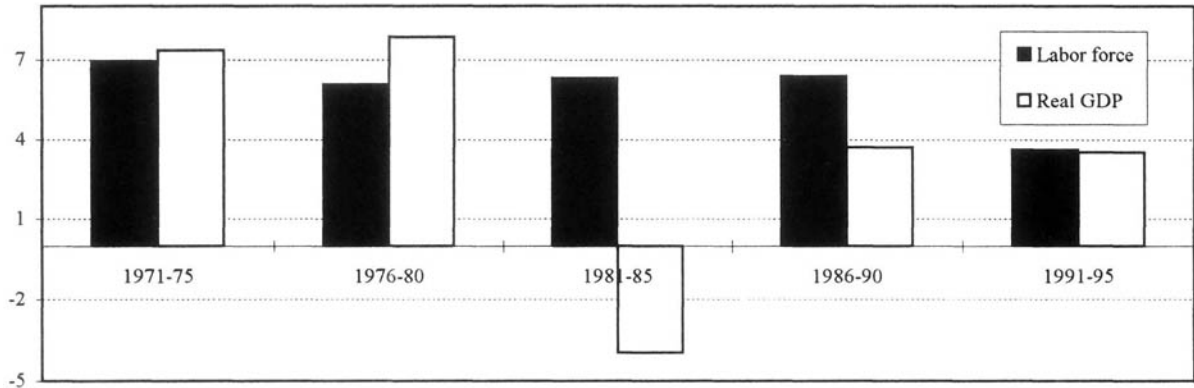
- High oil prices in the 1970s and the early 1980s were associated with periods of rapid economic growth combined with large fiscal and external current account surpluses.¹ This allowed the GCC countries to embark on ambitious investment programs to build up their physical and social infrastructure and diversify their production base. Initially, the emphasis was on construction and industrial development, but the rapid development of infrastructure and industries required the support of, and contributed to the development of, a host of service industries. Rapidly increasing population and per capita income levels also spurred the development of domestic household services. Additionally, economic diversification ushered the development of financial services and non-oil trade activity. Even the capital and resource intensive development of the oil and gas sectors required substantial support from service industries. For these reasons, the service sectors began to emerge as the main contributor to non-oil economic activity and as the principal source of new demand for labor (Chart 1). The shift in sectoral emphasis also implied a change in the composition of labor toward lower skill levels.

- With the continued erosion of oil prices through the second half of the 1980s, economic conditions weakened, and large internal and external financial imbalances emerged, prompting the authorities to implement adjustment policies primarily involving substantial cuts in expenditure. From the mid-1990s, the GCC countries intensified and broadened their efforts to reduce their fiscal imbalances and promote private sector growth and employment creation. The expenditure rationalization policies had to consider not only

¹Sassanpour (1996) reviews the different phases in economic development in the GCC countries since the early 1980s.

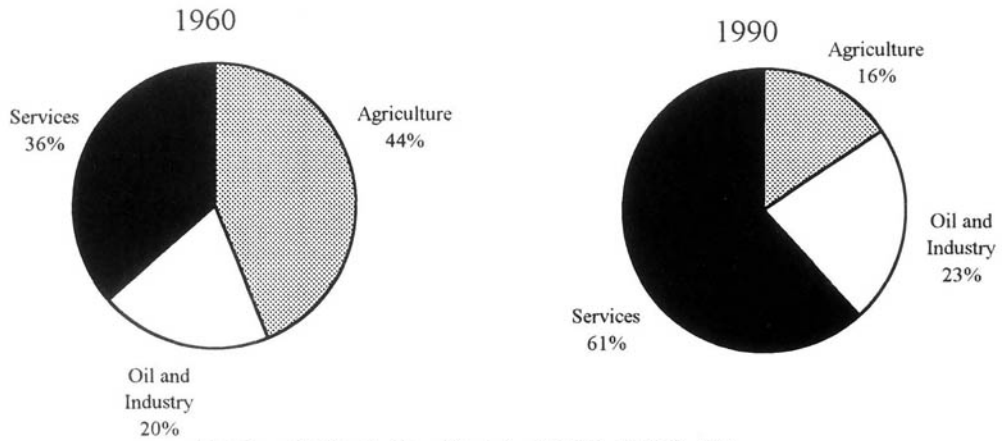
Chart 1. Employment and Economic Growth in GCC Countries, 1971-95

(Average annual changes in percent)



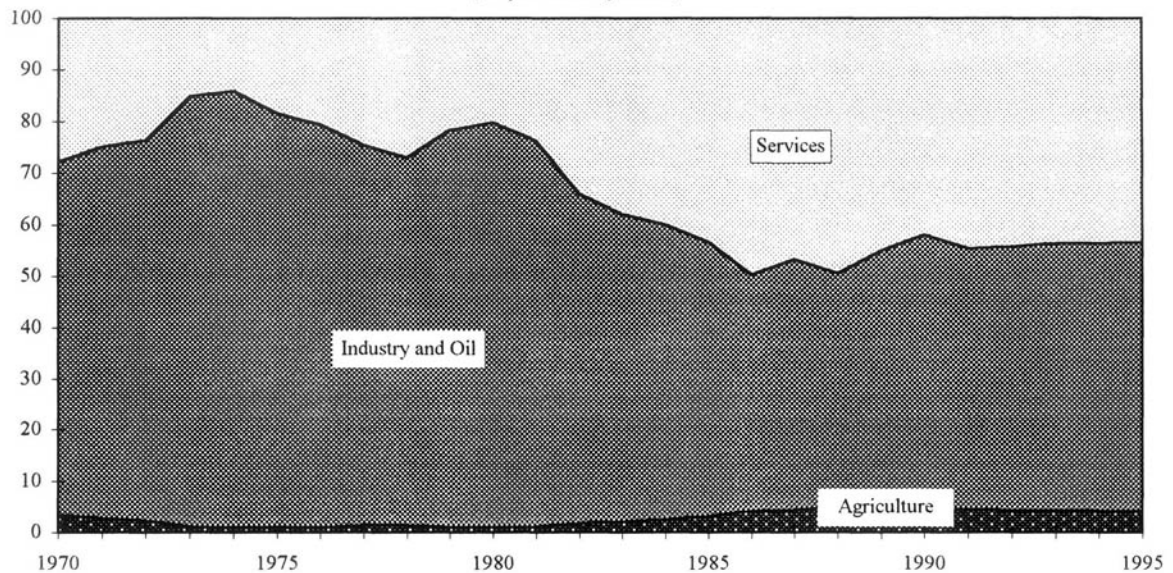
Distribution of Labor by Sector in 1960 and 1990

(In percent of total)



Sectoral Contribution to GDP, 1970-95

(In percent of total)



Sources: World Bank, World Development Indicators, 1997; UNDP, Human Development Report, 1997; and IMF staff calculations.

the relative efficiency of expenditures, but also the social dimension of expenditures, with specific reference to employment, wages, and benefits in the public sector.

- Given the limited resource base of the GCC countries, economic growth required large imports of materials and labor. In view of similar resource endowments and constraints, there was little scope for trade in goods and services between the GCC countries, but the established cultural and political relations with the other countries in the MENA region led to greater economic integration, essentially through labor market linkages.² Changes in the pace and composition of economic activity were reflected in the inflow of foreign labor. By some estimates, the foreign labor force grew, from a low base, by about 20 percent a year during the boom years, 1975–80, before moderating to 7 percent during 1980–85, and further to 3 percent annually in the next decade as economic growth consolidated (see Al-Qudsi, 1996). Expatriate workers currently comprise about 55 percent of the labor force in Bahrain, 65–70 percent in Oman and Saudi Arabia, and 85–90 percent in Kuwait, Qatar, and the United Arab Emirates (see Nur, 1995).³

Taken together, these factors have contributed to the current setting in the labor market and are defining the broad parameters for labor market issues and policies in the period ahead. In summary, an uncertain oil market outlook has underscored the importance of prudent macroeconomic policies and improved resource allocation to insulate the economies and support the growth of non-oil sector. Budgetary and efficiency considerations have also required a reassessment of government expenditure policies, including those on wages and employment. At the same time, the consolidation of economic growth and shifts in the structure of production in favor of services have moderated the demand for labor, possibly with a bias against higher skill levels. The link between economic growth and employment generation probably has also weakened over the years due to efficiency gains, industrial development based on capital-intensive technologies, and structural shifts in the nature of dependency on expatriate labor.⁴ As a result, the demand for foreign labor appears to have become less sensitive to fluctuations in overall economic activity.⁵ Given the GCC countries' open economic systems, the prices of foreign labor, capital, and natural resources are largely determined by international market conditions, but the price of domestic labor is, to a large extent, a policy variable and a social choice. This relative input price mix has created a bias against the use of national labor in the GCC countries.

²Issues and challenges in economic integration between the MENA countries are discussed in Section V. See also Shafik (1996).

³No firm data are available on the geographical origin of the foreign labor force. Workers from the labor-surplus countries in the MENA region (i.e., Egypt, Jordan, Lebanon, Morocco, the Syrian Arab Republic, Sudan, and the Republic of Yemen) and Palestinians initially dominated the GCC foreign labor force, but over the years, and particularly since the early 1990s, the number of Asian workers (mostly from the Indian subcontinent and the Philippines) has increased significantly.

⁴Al-Qudsi (1997) argues that in earlier periods, the demand for labor was related more closely to investment activities (e.g., building infrastructure), but recently, consumption activities (e.g., household services) appear to be contributing more to labor demand.

⁵Feiler (1991) and Al-Qudsi (1997) also stress the same point.

III. Labor Market Structure

A. Growth and Structure of Population and Labor Force

Over the past three decades, the GCC countries as a group have recorded one of the highest rates of population growth in the world⁶ (averaging 5 percent a year during 1970–95), reflecting the high rate of indigenous population growth as well as the large influx of expatriate workers. The rapid rate of growth of the national population (averaging 3 ½ percent a year in recent years) is attributable to the high fertility rates in the GCC countries (more than twice the world average) and significant advances in the areas of health and education, which have drastically reduced infant mortality rates (by a factor of 5 since 1970) and raised life expectancy (by some 20 years since 1970). The growth of indigenous labor force has been also influenced by the population's young age profile (40 percent below the age of 15) and the low participation rate of nationals in the labor market (Table 1).

The degree of labor market participation in the GCC countries (35 percent) is lower than that of other countries at the same stage of economic development and with similar per capita income levels. This reflects a combination of demographic, economic, social, and cultural factors. First, a relatively large proportion of the population is below working age. Second, there are incentives to delay entry into the labor force and continue education at least through university: education is free; a university degree significantly increases the chances of securing a government job or other highly paid jobs; and there is a social premium associated with university education. Third, a low retirement age in the public sector—typically about 45 years with 20 years of service—allows early exit from the labor force (although many retirees establish private businesses and remain active). Finally, the female participation rate in the GCC countries is low despite the growing number of educated and qualified women; at about 30 percent, Kuwait has the highest female participation rate among the GCC countries and even that is low by international standards.

Adult literacy rates in the GCC countries have improved significantly over the past three decades in response to large investments in education and the countries' compulsory education policies. Adult literacy rates in most GCC countries is about 80 percent because of high literacy rates among the younger adults, and the GCC average of 64 percent is higher than the MENA average of 55 percent. Moreover, the traditional gender imbalance in literacy rates in favor of men is narrowing because of similar enrollment ratios between males and females at primary and secondary education levels, and the larger share of women in local universities. In several GCC countries, women university students significantly outnumber men reflecting, among other things, the higher drop out rates among men, the greater opportunities for men in the local job markets and military, and the

⁶The GCC has a total population of some 27 million, ranging from 0.6 million in Qatar to about 19 million in Saudi Arabia. On average, nonnationals comprise about one-half of the population. With the exception of Oman, the GCC population is highly concentrated in urban centers.

Table 1. GCC Countries: Population, Labor Force, and Social Indicators

(1995 or most recent year)

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E.	GCC
GNP per capita (U.S. dollars)	7,840	17,390	4,820	11,600	7,040	17,400	8,592
Demographic indicators							
Population (millions)	0.58	1.66	2.20	0.64	18.98	2.46	26.52
Aged 0-14 (percent of total)	35	35	46	30	44	29	41
Aged 15 and over (percent of total)	65	65	54	70	56	71	59
Population growth (percent, 1993-95 average)	3.6	5.4	5.1	6.4	4.1	5.7	4.4
Population gender ratio (men:women)	57:43	56:44	53:47	63:37	55:45	63:37	56:44
Age dependency ratio 1/	0.6	0.6	1.0	0.5	0.9	0.5	0.8
Urban population (percent of total)	90	97	13	92	79	84	75
Labor force indicators							
Total labor force (millions)	0.25	0.82	0.55	0.33	6.26	1.14	9.35
Male (percent of total)	82	73	85	88	88	89	86
Female (percent of total)	18	27	15	12	12	11	14
Labor force growth (percent, 1993-95 average)	2.3	-1.6	5.2	3.9	3.3	3.9	3.0
Participation rate (percent)	44	49	25	52	33	46	35
Social indicators							
School enrollment (percent)							
Primary (1992)	111	...	85	90	75	110	79
Secondary (1992)	99	...	55	84	45	49	54
Tertiary (1992)	20	...	5	29	14	11	13
Adult literacy rate (percent, 1990)	85	79	35	79	63	79	64
Population per physician (1990)	760	667	749	1208	...
Access to safe water (percent of population, 1993)	100	100	93	98	...
Life expectancy at birth (years)	72	76	70	72	70	75	71
Infant mortality rate (per 1,000 live births)	19	11	18	18	21	16	19

Sources: World Bank, *Social Indicators of Development*, 1997; and UNDP, *Human Development Report*, 1997.

1/ Population under the age of 15 and over the age of 65 as a share of the total working-age population.

higher number of men studying abroad. Past investments in education have tended to favor primary, secondary, and tertiary education at the expense of technical and vocational training.⁷

The service sectors employ over one-half of the total labor force in almost all GCC countries for reasons discussed earlier (Chart 1). Employment in the industrial sector has reflected the GCC countries' different strategies toward diversifying their economic base. In some GCC countries (Saudi Arabia and Qatar), economic diversification has stressed the development of industries based on their hydrocarbon resources. Oman has also promoted the development of its non-oil industrial base. Policy emphasis in Kuwait has been on downstream diversification in the oil sector through assets acquisitions abroad. In the other GCC countries, the development of the industrial sector has been overshadowed by more dominant service sectors (transit trade in the United Arab Emirates and offshore banking in Bahrain). Reflecting these strategies, over the years industrial employment as a share of total labor force has increased in Oman, Qatar, and Saudi Arabia, but declined in the other three GCC countries. With the exception of Oman and to a lesser extent Saudi Arabia, the share of the agricultural sector in total employment is very small reflecting the GCC countries' limited potential in food production and the rapid urbanization of the population.

B. Institutional and Legal Framework of the Labor Market

The legal framework and institutional regulations governing the labor markets in the GCC countries have many common features. There is no minimum wage legislation and no tradition of collective bargaining in public or private sectors.⁸ Moreover, in some GCC countries, there are still no legal provisions in the existing labor laws to allow the establishment of social security or pension schemes in the private sector. Other legal provisions, however, protect the right of workers, and there are laws against child labor and against discrimination on the basis of race, religion, and gender.

In several GCC countries, the right of every citizen to work is formalized by legislation; in some countries, short of guaranteed employment, this had served as the basis for absorbing nationals in the government sector. Regulations and conditions governing down-sizing and staff retrenchment are practiced less widely, particularly in the government sector where job security for nationals is a key feature. In the private sector, the difficulty of dismissing a national increases the attractiveness of hiring an expatriate worker on a fixed-term contract.

The employment of expatriate workers in the GCC countries is based on renewable sponsorship visas and work permits. Visas and job-specific work permits are issued once the sponsor demonstrates the need and guarantees employment for the duration of the

⁷With the exception of Bahrain, enrollment in technical schools is insignificant (2–6 percent of total enrollment in secondary education), compared with 20 percent in some other MENA countries (e.g., Egypt and Jordan).

⁸In Oman, there are legal minimum monthly salaries for Omani workers at different skill levels.

contract. Sponsorships are either transferable only subject to restrictive terms and conditions, or not transferable at all. In many cases, the expatriate workers would have to leave the country and stay abroad for a minimum period of time before being considered for another position. Generally, there are no strict numerical quotas for hiring foreign workers—either by activity, nationality, or qualifications—but some GCC countries have limited the issue of visa to specific sectors or the number of workers sponsored by small businesses. The terms and conditions of employment, including compensation packages, are typically agreed bilaterally and specified in binding contracts. In some GCC countries, there are indicative sector-specific wage guidelines for hiring expatriates, but for all practical purposes, wages are based on market conditions and are broadly uniform across the GCC countries. Expatriate workers have recourse to local legal channels in the event of contract dispute on the same basis as nationals.

C. Labor Market Segmentation

The labor markets in the GCC countries are segmented along several dimensions: between public and private sectors, between nationals and nonnationals, and between skilled and unskilled labor. The extent of market segmentation is such that in some GCC countries (e.g., Kuwait and the United Arab Emirates), over 90 percent of nationals in the labor force are employed by the public sector. The segmentation of the labor market reflects a number of factors. Perhaps most importantly among them is the significant disparity in wage and nonwage benefits between the public and private sectors even for comparable skills, and between nationals and nonnationals employed in the same sector. Nationals and nonnationals of similar qualifications typically follow different career ladders, and certain positions are reserved for nationals even in the private sector. There are also marked dissimilarities in educational background, training, and qualifications between the national and nonnational labor.

Direct comparisons between private and public sector wages are difficult because of very dissimilar market structures between the two sectors and the lack of relevant data. It is hardly disputed, however, that wages in the government sector in most GCC countries are substantially higher than those in the private sector for comparable job content and skills. Moreover, in many cases, government workers receive guaranteed annual salary increments, and promotion through the public sector grade structure is virtually guaranteed for nationals in some countries. Even within the government sector, nationals command higher wages for similar grades, enter employment at higher levels, and move up the ladder faster. Wages for expatriate workers in the private and public sectors seem to be much more comparable across skill levels. The GCC countries' open border policies with regard to foreign labor have ensured the availability of a sufficient supply of labor at competitive wages at all skill levels.

In addition to high wages, the GCC nationals employed in the public sector benefit from generous family, housing, and transportation allowances, which together provide a significant income supplement. In some countries (e.g., Saudi Arabia), there are also incentives to continue training and education while on the job. Moreover, many

government institutions provide highly subsidized housing loans to national employees. Benefit packages in the private sector are generally less attractive, particularly at lower skill levels. Typical employment contracts in the private sector provide no family allowances and there are no provisions for formal training. Housing allowances or free accommodation are usually provided to unskilled expatriate labor, and in some cases, modest transportation allowances supplement the basic pay.

Pension benefits in the public sector—in some countries (e.g., Qatar and the United Arab Emirates) without contributions from employees during the years of service—and early retirement (sometimes after 20 years of service) are among the other chief attractions of government jobs. Bahrain, Oman, and Saudi Arabia have pension systems covering their nationals working in the private sector, but there is no social security coverage in the other GCC countries. For expatriate workers, end-of-service compensation is usually in the form of gratuity payments linked to years of service. Paid leaves are longer in the government sector, and shorter working hours allow many government employees to conduct private businesses after working hours. There are also important nonpecuniary benefits associated with government employment such as job security and social status.

The component of benefits provided to nationals in the government sector, which could be measured in monetary terms in many cases equals or even exceeds the basic salary, and all benefits put together significantly increase the reservation wages of nationals (i.e., the minimum wage for which they would be willing to work). The reservation wages of expatriate workers—reflecting their expected earnings in their home country, adjusted for the obligation to remit family support and save for investment on return home—are low and relatively even across labor-exporting countries, particularly those in Asia. Moreover, the shift in the geographical origin of expatriate labor over the past decade in favor of Asian workers appears to have effectively lowered the average cost of employing foreign workers. Additionally, free or highly subsidized availability of many services (e.g., utilities, education, and health services) in the host countries may have induced the expatriate workers to accept even lower wages in the GCC countries.

Market segmentation also arises from the mismatch between the qualifications of new entrants to the labor market and the requirements of the private sector even at the upper end of the market and at higher skill levels.⁹ Consequently, highly specialized technical positions as well as low-skilled menial jobs are filled by expatriate workers, whereas nationals tend to gravitate toward administrative positions.

⁹According to the Economic and Social Commission for Western Asia (1995), 38 percent of graduates from universities in the GCC countries completed studies related to social and Islamic studies, 34 percent in education (mostly women), but only 11 percent in business administration, and 18 percent in technical fields where private sector requirements are greatest.

D. Employment Conditions and Prospects

The lack of sufficient flexibility in the labor markets has been manifested in longer search periods and the growing evidence of tighter employment conditions for nationals. The scant information available on the unemployment situation in the GCC countries varies significantly across countries in terms of coverage, measurement, and currentness. At one extreme, open unemployment is believed to be almost nonexistent in Qatar. At the other extreme, the unemployment rate in Bahrain is reportedly in the range of 12–15 percent. The unemployment rates in the other GCC countries fall between these two extremes, with the rate in Oman being toward the upper end and the rates in the remaining GCC countries lying at the lower end of this spectrum. There is also strong evidence suggesting overstaffing in the public sector, contributing to underemployment of the national labor force.

Unemployment among nationals is still largely of a frictional and voluntary nature in most GCC countries. Those registered as unemployed include recent university graduates seeking government employment; job holders searching better paying jobs; and cultural factors and family ties limiting labor mobility, particularly among women. Nevertheless, in some GCC countries, unemployment is emerging as a more immediate economic and social concern, and virtually all GCC countries are facing the challenge of creating opportunities for productive employment for their nationals.

In those GCC countries where unemployment is a relatively recent phenomenon, the evolving supply-demand dynamics of the labor market suggest further tightening. (See Box 1, which provides an illustrative scenario of the evolving labor supply and demand conditions in the GCC countries.) More specifically, the rapidly growing supply of labor—reflecting both the high population growth and the rising participation rates—is outpacing the demand for labor, which is moderating due to slower economic activity and shifts in the structure of production. The situation is further complicated by the growing mismatch between the educational and technical qualifications of the new entrants and the skill requirements of the market. On the demand side, governments—the major employment outlets in the past—can no longer act as employers of first and last resort for efficiency reasons and because of the need to trim the high government wage bill (Chart 2). Also, given the traditionally strong link between public spending and domestic economic activity in the GCC countries, government expenditure restraint is affecting labor demand indirectly. At the same time, the private sector has not been able to pick up the slack because of labor market rigidities.

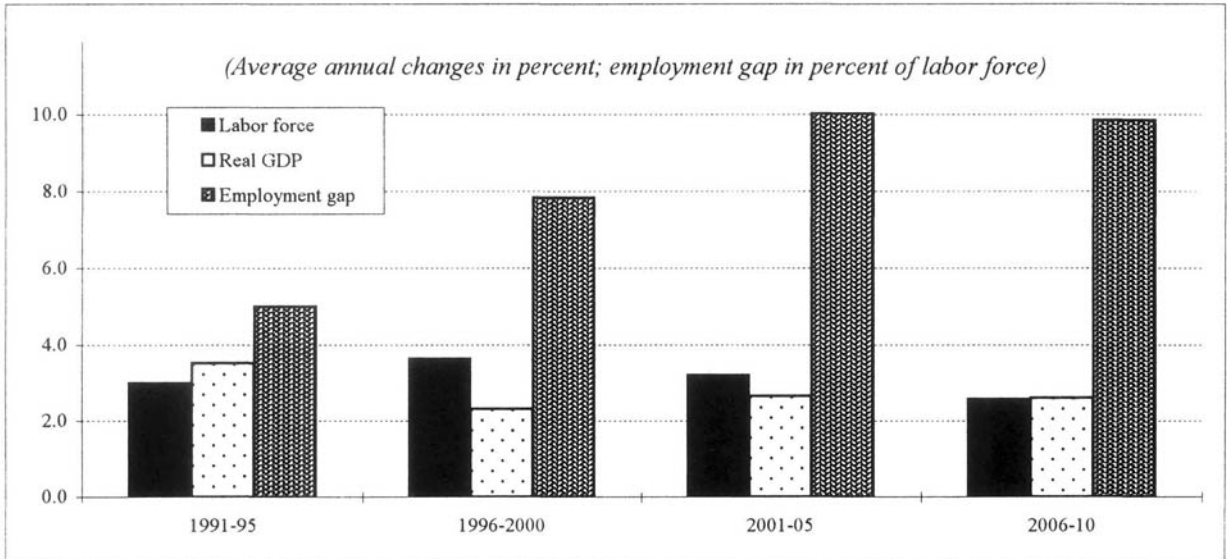
IV. Labor Market Challenges and Policies

A. Current Policy Approach

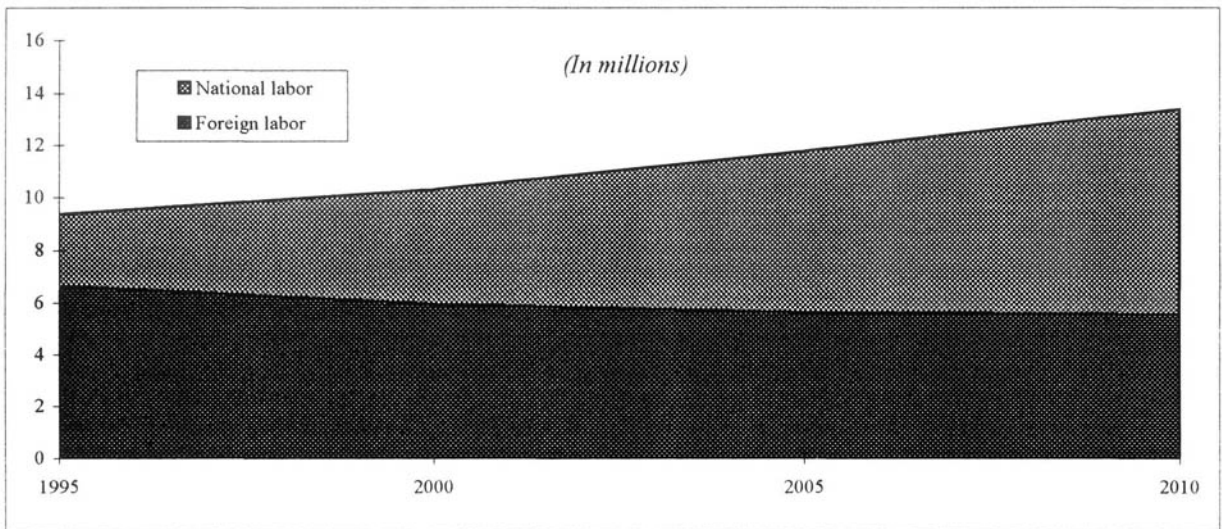
The prospects of tighter labor market conditions have already prompted a policy response in several GCC countries to facilitate the absorption of a large number of

Box 1. Illustrative Labor Market Scenarios in GCC Countries, 1995–2010 1/

Illustrative scenarios based on simple labor demand and supply functions suggest tighter market conditions in the coming decade. Demand for labor would be affected by slower real GDP growth (2–3 percent a year) and moderate productivity gains. Supply of labor is projected on the basis of population growth, population age and gender profile, and small increases in labor participation rates. Net migration is assumed to be small. On this basis, the overall employment gap – defined as the ratio of the difference between supply and demand for labor to total labor force – would double to 10 percent in the first decade of the next century.

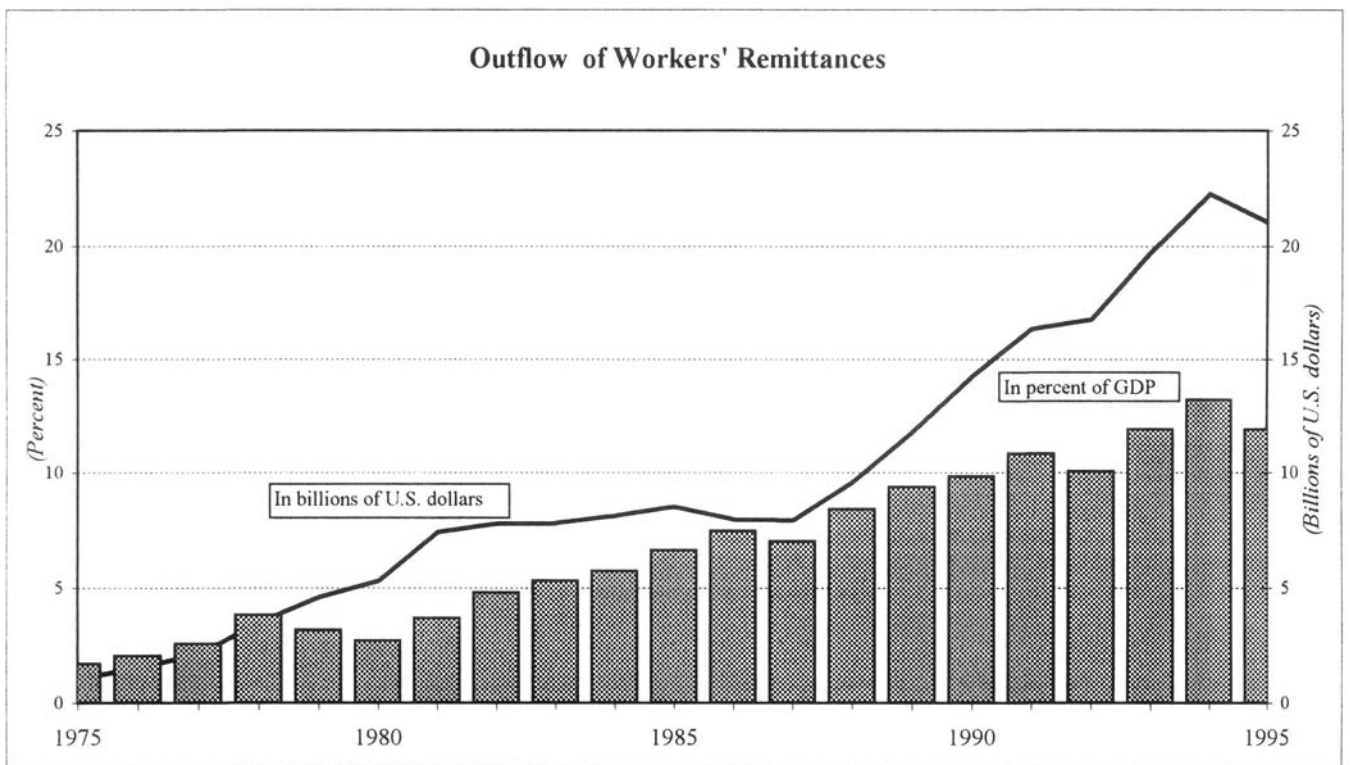
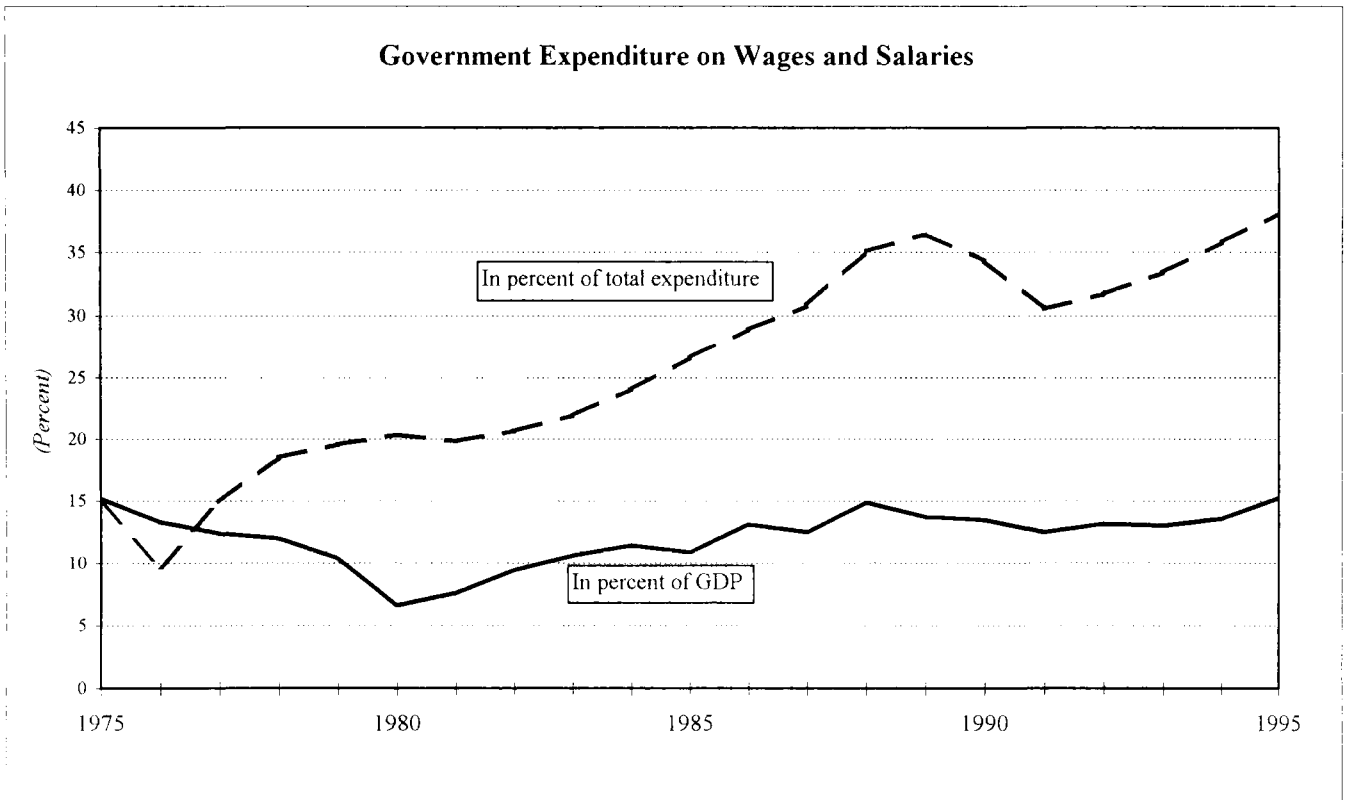


Employment opportunities for foreign labor could become more limited due to slower growth in overall employment and the labor substitution policies pursued by the GCC countries. Nevertheless, the GCC countries' reliance on foreign labor would still remain significant even if all new national entrants to the labor force find employment and foreign labor meets the residual demand.



1/ See appendix for details.

Chart 2. GCC Countries: Government Wages and Expatriate Remittances, 1975–95



Sources: IMF, *International Finance Statistics*; IMF, *World Economic Outlook*; and IMF staff calculations.

nationals expected to enter the labor force (see Box 2).¹⁰ These policies have many common features. Most importantly, labor market policies are formulated within a broader framework of government expenditure containment and structural reforms aimed at increasing the economies' resilience to adverse oil market developments and enhancing efficiency by creating a more conducive environment for private sector activity.¹¹ With the recognition that in the period ahead, the responsibility for economic growth and job creation primarily rests with the private sector, policies are being defined in the GCC countries to facilitate the employment of nationals and increase labor market flexibility.

The policy instruments to achieve the employment objective have included measures that affect the quantity, price, and quality of labor. Measures influencing the quantity of labor include quotas and targets on employment of nationals and the regulation of the foreign labor force through administrative means. The relative prices of national and foreign labor are being influenced by government wage policy, direct wage subsidies to private sector, and fees and charges on foreign labor. At the same time, the quality of national labor is being upgraded by proper education and training. Moreover, measures are being implemented to increase market efficiency by facilitating labor mobility in the private sector.

a. *Selective employment policy*

In almost all GCC countries, the traditional liberal employment policy in the government sector is gradually being replaced by a more selective recruitment policy to reduce overstaffing, which has emerged as a major problem in many government departments and organizations. Moreover, many vacancies in the government sector remain unfilled, qualifications for new recruits are being tightened, and early retirements and dismissals for inadequate performance are becoming more common. Labor shedding—always a socially sensitive issue—has also become a policy option in some countries. In Oman, as part of a broader policy, the government has launched an ambitious retrenchment program to retire some one-fourth of Omani civil servants over the 1996–98 period, and the number of expatriate civil servants was reduced by 7 percent in 1996 alone. Efforts are also being made to place expectations regarding future employment opportunities on a more realistic footing. Several GCC countries have formally announced that job openings in the public sector are likely to remain very limited and that job seekers should look toward the private sector. In Bahrain, the government has indicated that under

¹⁰In Kuwait, government estimates suggest a net flow of about 10,000 of job applicants a year during the next five years. The number of young Bahrainis entering the workforce in the coming years is officially estimated in the range of 4,500–6,500 a year. In Oman, the number of graduates seeking employment is officially projected at 17,400 a year during 1991–2000. Saudi Arabia's Sixth Development Plan estimates the total number of young Saudis entering the labor market at some 660,000 over 1995–2000.

¹¹El-Erian and Sassanpour (1997) discuss the evolving nature of macroeconomic challenges and strategies in the GCC countries.

Box 2. GCC Countries: Labor Market Reform Programs

Bahrain. *The Bahrainization program* established in 1988 was the earliest formal labor market strategy launched by the GCC area to create employment opportunities for nationals. The current program seeks to provide 6,000 additional jobs a year for Bahrainis by requesting firms to increase employment of nationals by 5 percent a year until one-half of their labor force are Bahrainis. At the same time, the Human Resource Development Support Program introduced in 1994 seeks to promote the employment of Bahrainis in the private sector by offering financial incentives to small- and mid-sized firms in the manufacturing sector that employs at least 30 percent Bahrainis and meet certain other criteria.

Kuwait. The *Five Year Plan (1996–2000)*, currently under consideration by the National Assembly, targets to creation of 10,000 jobs a year for Kuwaitis during the next five years raise the share of nationals in the labor force to 25 percent. Policies to achieve these objectives include raising the cost of expatriate labor, limiting employment of nonnationals in certain businesses and activities, and upgrading the skill levels of nationals.

Oman. The current *Five Year Plan (1996–2000)* sets labor market policies with the aim of providing 17,400 new jobs a year and increasing the proportion of national labor in the total labor force from 36 percent to 42 percent. Moreover, *National Vocational Qualification Program* launched by the government in 1995, and financed taxes on expatriate workers, aims to improve the skill levels of Omani nationals.

Qatar. Unemployment is virtually nonexistent in Qatar and there is no formal labor market strategy.

Saudi Arabia. The *Sixth Development Plan (1995–2000)* sets to create 319,500 jobs and reduce the number of non-Saudi workers by an average of 1.5 percent a year through a combination of incentives and target, including financial support to firms committed to training nationals; minimum targets for employment of Saudis; restrictions on employment of skilled and semiskilled workers; and a national information campaign. In April 1995, all private sector establishments with more than 20 employees were required to increase their Saudi workforce by no less than 5 percent annually and to ban hiring non-Saudis in certain job categories.

United Arab Emirates. There are no formal plans covering the federation, but the *Dubai Strategic Development Plan (1996–2000)* aims to increase the share of nationals in the Emirate's labor force from 7 percent to 10 percent by raising labor force participation and facilitating the employment of nationals in the private sector. The government supports vocational and technical training and chambers of commerce internship programs for nationals.

the current plan (1996-2000), the private sector would account for 80 percent of new job creations.

b. *Wage restraint*

Fiscal consolidation in several GCC countries has required exercising wage restraint in order to contain the large government wage bill. In Kuwait, wages have been frozen for some time, and wage increases awarded in 1996 to government employees in Qatar and the United Arab Emirates were the first such adjustments in many years. Although the government wage structure is being adjusted upward less frequently and more moderately, annual salary increments are being paid almost automatically and nonwage benefits and allowances have increased in some cases.

c. *Quotas on employment of nationals*

Quotas or targets on employment of nationals have been in existence in most GCC countries for many years, but rarely enforced until recently. In most cases, quotas specify a minimum number or ratio of nationals to be employed in private sector establishments, and in some cases eligibility for securing government contracts is linked to such a requirement. In Kuwait, private sector industrial establishments are required to have nationals representing at least 25 percent of their total employment (Industrial Law No. 6 of 1965). Consideration is also being given in Kuwait to award government contracts only to those domestic firms in which 40 percent of the labor force is composed of nationals, earning a combined salary of no less than 40 percent of the firm's total wage bill. In Saudi Arabia, the number of nationals employed in private establishments should not be less than 75 percent of the work force and their wages not less than 51 percent of the total wage bill (Article 45 of the Labor and Workman Law of 1969). In Bahrain, new establishments employing 10 or more workers are required to have 20 percent Bahrainis in their work force. In Oman, a ministerial decree in 1994 set sectoral targets on employment of nationals for firms with more than four workers. In the United Arab Emirates, there are indicative targets on the share of nationals employed in the banking sector.

d. *Regulation of foreign labor through work permits*

Some GCC countries have placed limits on issuing work permits to regulate employment in certain sectors and even in some occupations. Such measures are intended to regulate the market in certain low-skill activities (e.g., construction and farming) where surplus labor has emerged; and to encourage employment of nationals in areas of higher skill (e.g., banking, insurance, legal, and other services) by keeping wages high. In Kuwait, work permits issued to foreign workers are confined to selected activities in the private sector (1994 Amendment 107 to the Labor Law). Saudi Arabia has similar sector-specific restrictions on issuing work permits. In Oman, there are annual overall and regional ceilings on the number of new foreign workers. Compliance with the terms and conditions of work permits is also being enforced more tightly in most GCC countries. In the United

Arab Emirates, under a general government amnesty program, some 150,000 foreign workers without proper work authorization left the country by the end of 1996. In mid-1997, the government of Bahrain requested foreign workers without valid work permits to leave the country within a period of three months. A similar amnesty program was also announced by the Saudi Arabian government in July 1997.

e. *Direct subsidies*

In some GCC countries, cash benefits and wage subsidies are being offered to private sector establishments to encourage them to employ more nationals. In Bahrain, the government provides payments of up to BD 1,000 a year to midsize private manufacturing firms, which maintain 30 percent of the Bahraini workforce. In Kuwait, consideration is being given to provide social allowances from the government budget to all nationals working in the private sector in order to increase the attractiveness of private sector employment.

f. *Raising the cost of foreign labor*

Most GCC countries have imposed various fees and charges on expatriate workers and their families. Almost all countries have fees for issuing and renewing visas and work permits for foreign workers; in some recent cases (e.g., Saudi Arabia), these fees have been raised substantially. Kuwait has imposed a flat fee on hiring domestic servants. In Oman, the fee for issuing a work permit is set at 7 percent of the annual salary of the foreign worker and the proceeds are earmarked for training nationals. In addition to raising the cost of foreign labor, such fees and charges act to defray part of the administrative cost of processing and issuing entry visas and work permits, and have been viewed as a form of taxation of foreign labor for the use of free or highly subsidized public goods in the host countries. In some countries, the expatriate workers make nominal payments for using government health services and in the United Arab Emirates and Qatar, foreigners are subject to higher electricity and water tariff rates. Nevertheless, in all GCC countries, foreign workers continue to be exempt from income taxes and other direct taxes on the same terms as nationals.

g. *Education and vocational training*

All GCC countries recognize the central role of education and training in their labor replacement policies. Part of the skill deficiencies of nationals is being addressed by vocational training and by on-the-job and in-house training. In Oman, a national program on vocational training is being managed by the private sector and financed through taxes on the private sector, as mentioned earlier. Saudi Arabia's Five-Year Development Plan sets out specific targets for general and higher education, and for technical and vocational training as a part of its human capital development objectives. In the United Arab Emirates, school curricula have been revised to focus on vocational training, and local governments and chambers of commerce are providing training and internships financed from their own resources.

h. *Increasing labor mobility*

In parallel with measures aimed at facilitating the absorption of nationals in the labor market, some GCC countries have taken steps to increase market efficiency by increasing the mobility of expatriate workers between jobs in the private sector. Regulations in Saudi Arabia allow transfer of sponsorships subject to certain conditions. In 1995, Oman allowed expatriate workers to move between sponsors, subject to the approval of the original sponsor, without first leaving the country as had been the requirement earlier. Similarly, in early 1997, the United Arab Emirates permitted transfer of sponsorships between employers after one year of service subject to approval of the employee as well as the new and the original sponsors. Moreover, expatriate workers in selected trades and professions in the United Arab Emirates were allowed to hold a part-time job or a full-time job with another employer for a period of up to six months.

B. *Parameters of a Labor Market Strategy*

Policymakers in the GCC countries recognize the importance of sustained economic growth for generating employment opportunities. Growth and development strategies are being formulated consistent with the countries' comparative advantages and resource constraints, and policies correctly stress the role of the private sector as the principal source of employment creation in the future. Linkages between the labor market and private sector activity run in both directions: a more efficient labor market would contribute to economic growth, which would in turn support job creation. As such, broadening the role of the private sector would also need to consider policies that would involve transfer of responsibility between the private and public sectors, including those related to deregulation and privatization.

Labor market measures already adopted or being considered in the GCC countries range from market-based strategies (e.g., wage and employment restraint, increasing labor mobility) to mandatory and administrative policies (e.g., quotas on employment of nationals, market regulation through work permits). In between there is a mix of other measures (e.g., taxation of foreign labor, direct employment subsidies) intended to achieve the same objectives. An effective strategy to reduce labor market segmentation and improve market efficiency would need to consider: (1) determining wages and benefits on the basis of market conditions; (2) minimizing market distortions; (3) limiting mandatory employment policies; and (4) improving human capital. A menu of mutually consistent and reinforcing options to achieve these objectives would include the following.

- *Terminating the de facto or de jure policy of guaranteed government employment to nationals.* A commitment to provide gainful employment opportunities for nationals, as legislated in most GCC countries, should not be interpreted as a policy of guaranteed government employment. Reducing total government employment in a phased manner through attrition, elimination of vacancies, and trimming redundant workers would send a clear signal that the government can no longer be viewed as a source of permanent employment. Over time, this would reshape the expectations of nationals, alter their

educational objectives and priorities, and together with measures to reduce relative wage and benefit disparities, encourage them to seek employment in the private sector.

- *Reducing disparities in incentives between public and private sectors.* In principle, wages in all sectors and activities should reflect market conditions and the scarcity value of the labor, and the incentives associated with allowances and benefit packages should be neutral across sectors. As nominal wage cuts are likely to prove difficult, correcting the misaligned wage structure would mean, in practice, allowing public sector wages to erode gradually in real terms over time. Moreover, in some countries, the existence of minimum wages for nationals has increased the incentive for hiring nonnationals. This disincentive could be eliminated by removing the minimum wage requirement for nationals or, as the second best solution, by extending its coverage to nonnationals.

As regards nonwage benefits, it should be feasible socially—and justifiable economically—to reduce, restructure and better target various income supplements and allowances that are being provided to public sector employees. On a broader level, the real challenge is to separate social welfare policies manifested in benefit packages from strict wage policies. A bold and far-reaching approach—though administratively difficult—would involve replacing allowances currently provided only to nationals in government employment with a smaller social cash benefit package payable to all nationals employed in the public and private sectors. This would eliminate a major incentive associated with government employment and should not burden the budget excessively at this stage, given the relatively small share of nationals working in the private sector. Moreover, direct income transfers of this nature would allow a restructuring and eventual phase out of other subsidies and transfers provided to nationals.

A major disincentive for working in the private sector could be corrected by introducing an unemployment insurance scheme and a pension system funded by contributions from employers and employees.¹² Ideally, the coverage of pension benefits would need to be extended to expatriate workers in order to remove the disincentive of hiring higher-cost nationals. Other considerations would include narrowing the gap between the public and private sectors with regard to working hours, paid leave, and other related benefits.

- *Phasing out mandatory employment quotas for nationals.* Establishing employment targets for nationals in relation to the total labor force or for specific sectors and activities would provide useful indicative guides for governments' labor replacement policies, but mandatory quotas could be counterproductive in the long run in the absence of downward flexibility of wages. Under a quota system, employers are likely to hire nationals at lower skill and pay levels to meet the prescribed targets, thus defeating the initial purpose of providing opportunities for the national labor at higher skill levels. Quotas are also likely to be resisted by private sector employers who lose employment

¹²The pension system in Bahrain provides similar benefits to nationals working in the public and private sectors.

flexibility and may have to pay higher wages. This would contribute to underemployment of labor and by adversely impacting the firms' competitive position would tend to undermine the authorities' broader objective of promoting private sector activity. As a general rule, private sector employers should have sufficient flexibility to hire the most qualified labor—both national and expatriate—at market wages in order to maintain competitiveness.

- *Facilitating labor mobility across sectors and activities.* The existing system of hiring expatriate workers under the sponsorship of nationals, which is the practice in all GCC countries, has two major shortcomings: first, it creates rent-seeking opportunities, which could be easily exploited by potential sponsors; and second, it provides no or, in some cases, only limited scope for moving between sponsors and jobs. It is also not cost effective because in most cases, labor can only be hired from abroad at a higher initial installation cost when it would be more economical to tap the existing labor pool at home. Moreover, all other things equal, potential employers are likely to hire, train, and retain expatriate workers rather than nationals who could easily move to higher paying jobs after training. Allowing expatriate labor to move between sponsors and jobs—subject to compensation for initial installation costs and other arrangements agreed between sponsors—would increase the efficiency of the labor market by channeling labor to its most productive uses.

- *Requiring expatriate workers to pay for government services.* Imposing or raising fees and charges on expatriate labor would not, in itself, help the integration of the labor market. It also raises other issues and considerations: such fees may be absorbed by either the employer or the employee or both, and be reflected in higher final output prices and/or in reservation wages. Typically, the extent of disparity between the reservation wages of nationals and nonnationals in the GCC countries is such that higher fees and charges on expatriates could not close the gap to any significant extent without compromising the competitive position and the cost structure of the economy. Nevertheless, such fees and charges would act to internalize some of the costs associated with hiring expatriate labor. Reasonable fees and charges on expatriate labor could be justified—and indeed warranted—as partial compensation for free or heavily subsidized goods and services provided by the GCC governments to all residents, including expatriate workers. In the absence of other forms of direct taxation, the challenge is to strike the right balance between partial payments for government services and the impact of higher fees and charges on cost competitiveness of the economy.

- *Financial incentives to private sector employers for hiring nationals.* As an inducement for hiring nationals, consideration is being given in some GCC countries to providing wage subsidies to private sector employers, typically on a declining scale to be phased out over a relatively short period of time. Such direct incentives aim to close the gap between the public and private sector wages without significantly increasing the wage cost of the employer, and to finance on-the-job training. Over time, it is argued, labor productivity gains would be matched by higher contributions from the employer toward wage payments, thus allowing a phase-out of government financial support. Direct wage

subsidies may offer a strong and immediate incentive for hiring nationals—particularly if there are employment quotas in effect—but would be potentially costly and difficult to monitor. Moreover, it would not guarantee employment at the end of the subsidy period and is subject to misuse. From a practical point of view, it would probably be more efficient for the government to fund internships and on-the-job training organized and conducted by potential private sector employers without any direct linkages to salaries and employment.

- *Reorienting education and training programs.* Labor market policies would be reinforced by efforts enhancing human capital development through proper education and training programs geared to the future job requirements of the economy. Specifically, policies should stress vocational and technical training to respond to the skill demands of the private sector, and encourage creativity and productivity at all skill levels.¹³ The experience of a number of dynamic and competitive economies in Asia shows that investment in education and training result in high private and social returns; invariably, highly competitive economies are supported by a cadre of trained and highly skilled workers. To be effective, national training programs require close coordination between the governments and employers in the private sector with respect to the goals, management, and financing of training (see World Bank, 1995).

- *Creating an information bank on job seekers.* In most GCC countries, government agencies (usually ministries of labor and civil service commissions) maintain a registry of national job seekers and attempt to match them with vacancies in the government sector. The private sector typically relies on market information network to advertise its vacancies and meet its labor demand. Other government agencies (usually ministries of interior and immigration authorities) maintain information on expatriate workers on the basis of visas, work permits, and sponsors. One of the problems contributing to the segmentation of the labor market is the insufficient information flow between the different markets. As such, the availability of up-to-date and complete information on job seekers and potential employers in the public and private sectors would be an important element of an efficient labor market clearing system. A national data bank could be created with the purpose of matching national job seekers with the available positions in the private sector.

V. Labor Market Policies of the GCC Countries in a Regional Context

The labor market provides the strongest economic link between the GCC and the other countries in the MENA region; in contrast to sizable flow of workers' remittances

¹³Among the countries in the MENA region, Egypt and Morocco have had favorable experiences with vocational training programs that are providing a viable alternative to higher education and are meeting the economies' demand for technical workers. In Morocco, a payroll tax on employers is financing vocational training. See World Bank (1995).

(Chart 2), interregional trade and investment flows are less significant.¹⁴ The GCC countries have significant natural resources and surplus of capital but scarce labor resources. Most other MENA countries are labor rich but have limited natural resources and capital. In principle, such large disparities in resource base between the two groups of countries would offer significant potentials for economic integration and gains from trade. In practice, however, the degree of economic integration between the MENA countries has been modest because of differences in policies and the relative openness of the economies.¹⁵ More specifically, the inward-looking policies pursued in the past by many labor-abundant MENA countries inhibited the development of competitive export industries at the time when the GCC countries with their open trading systems were establishing trade links with countries outside the region. For these reasons, economic integration within the MENA region took hold not through the more traditional trade links, but rather through labor movements, which were actively encouraged by the labor surplus countries and made possible by the open employment policies of the GCC countries.

The outflow of workers' remittances originating from the GCC countries is a major source of foreign exchange earnings in a number of labor-surplus MENA countries and an important source of financing private sector investment and consumption spending in these countries.¹⁶ In addition to providing family support, workers' remittances have traditionally financed small-scale private investments (mostly in construction) in the recipient countries.

Employment opportunities in the GCC countries for labor from the other countries in the MENA region are becoming more limited. As indicated earlier, the pace of economic activity is leveling off in part due to the weakening growth impulse from the oil sector and initial impact of expenditure restraining policies being pursued by many GCC governments. More directly, as discussed earlier, labor substitution is taking place at two levels: (1) employment policies of the GCC countries are geared toward gradually replacing foreign labor with domestic labor; and (2) labor from Asia is increasingly replacing labor from the other countries in the MENA region. Workers from the MENA region are mostly employed in mid- to highly skilled technical and administrative positions—positions most likely to be replaced by nationals—but nationals are less likely to accept the less-skilled positions currently filled by Asian workers.

The prospects of reduced employment opportunities and a more moderate wage growth in the GCC countries suggest lower remittance flows that, in addition to a direct balance of payments impact, would affect investment and growth in the recipient countries.

¹⁴The other countries in the MENA region accounted on average for 2–3 percent of total GCC merchandise trade during the period 1991–94. Moreover, only a few countries in the MENA region accounted for a significant share of trade with the GCC. See Sassanpour (1996).

¹⁵This issue is articulated by Shafik (1996).

¹⁶During 1992–95, workers' remittance averaged 13 percent of GDP in Egypt, 18 percent in Jordan, and 23 percent in the Republic of Yemen. In relation to total external current receipts, the shares were 24 percent in Egypt, 26 percent in Jordan, and 40 percent in the Republic of Yemen.

The challenge in the period ahead is to seize on opportunities being created to strengthen economic linkages within the MENA region through expansion of trade and investment.¹⁷ Specifically, the ongoing economic and structural reforms in a number of MENA countries hold the promise of strengthening their trade links with the GCC countries. Moreover, in a number of countries in the MENA region, the simplification of investment laws and removal of barriers to the entry of private capital offers the GCC countries opportunities for increased investment.

VI. Concluding Remarks

Policymakers in the GCC countries have correctly identified labor market issues as one of the key policy challenges—not only in those countries where unemployment is more of an immediate economic and social concern, but also in countries where there is presently no apparent unemployment but where strains are emerging. Also important has been the recognition by GCC policymakers that labor market issues are closely linked to other structural policies related to economic efficiency and the division of responsibility between the public and private sectors. As such, policies to increase the flexibility of the labor market are being defined in the context of a broader framework also including fiscal consolidation and structural budget reforms, deregulation, and privatization. In the context of an uncertain oil market outlook, these policies are intended to increase the resilience of the GCC economies and help sustain non-oil sector growth based on private sector initiative. Indeed, the considerable downside risk in oil prices and the long gestation period for most structural reforms call for an early start at reforms.

Labor market issues in the GCC countries are largely of a long-term structural nature. Employment quotas on nationals, restrictions on foreign labor, and administrative directives may create jobs for nationals in the short run, but such measures offer no permanent solution and could even be counterproductive in the long run. Correcting the segmentation of the labor market and creating employment opportunities for nationals would require a mix of measures aimed at increasing the market responsiveness of incomes and employment policies and minimizing the distortions created by government benefit packages. None of these measures would—or indeed should—substitute for human resource development, which aims to match the skill profile of the national labor with the present and future requirements of the private sector.

¹⁷See IMF (1996) for a discussion of issues related to economic integration between the countries in the MENA region.

Appendix. Illustrative Labor Market Scenarios in GCC Countries, 1995–2010

Supply of Labor

The supply for labor is projected on the basis of the World Bank estimates of working age population (World Development Indicators CD-ROM, 1997) and staff estimates of labor participation rates by gender. Relative to the working age population, participation rates are assumed to remain constant for males, but increase slightly for females (see table below). Formally,

Labor supply = (working age population) x (participation rate of the working population)

	1996–2000	2001–2005	2006–2010
Participation rate (male)	92.0	92.1	92.1
Participation rate (female)	22.3	22.7	23.0

Labor Demand

The labor demand is projected separately for the oil and non-oil sectors based on sectoral real GDP growth (see table below) and output per worker. On the basis of 1995 data on employment in the oil and non-oil sectors, the base year output per worker is calculated. It is assumed that output per worker grows by 0.5 percent a year in the oil sector and by 0.7 percent a year in the non-oil sector during the projection period. The total demand for labor is the sum of labor demand in the oil and non-oil sectors. Formally,

Labor demand by sector = (real GDP) / (real output per worker)

	1996–2000	2001–2005	2006–2010
Real oil GDP growth	1.1	0.8	0.7
Real non-oil GDP growth	3.0	3.5	3.4

Employment Gap

The employment gap is defined as the difference between labor supply and labor demand divided by labor supply.

Demand for Foreign Labor

The demand for foreign labor is the residual between the total demand for labor (described above) and the supply of national labor, thus assuming that all new national entrants to the labor force find employment first. Using the 1995 data as a base, the projected increase in the national labor force reflects the increase in the total labor supply (described above) adjusted for net migration.

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